

IN THIS CHAPTER

- » Getting an overview of bookkeeping and accounting
- » Performing a balancing act with your books
- » Hitting up Uncle Sam for some free money
- » Paying payroll taxes to the IRS
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Chapter **1**

Introducing Nonprofit Bookkeeping and Accounting

Your accounting period indicates the beginning and end of your reporting period. This period can be usually 6, 12, or 18 months depending on your company's needs. Let's assume you chose the most common reporting period of 12 months; this period can be a calendar year ending from January to December or a fiscal year ending using another 12-month period. If you use the calendar year, the first transaction on January 1 starts your accounting cycle, and your last transaction on December 31 ends the cycle. You compile your financial statements after the cycle ends, perhaps get your financial statements audited, and start the cycle all over again.

Being a good steward for your nonprofit requires that your books are materially correct. To make this happen, you need sound financial management by qualified employees, independent accountants, and other consultants. This chapter serves

as a jumping-off point into the world of nonprofit bookkeeping and accounting and touches on the important concepts. Subsequent chapters dive deeper into these topics.

Getting Started with Your Nonprofit's Books

Before you start, keep in mind your goal, which most likely is the preparation of financial statements. The road to finalizing a set of financial statements begins with journalizing an event that happens in your nonprofit — for example, your nonprofit receives a donation or writes a check to pay the telephone bill. (See Chapter 8 for more information about journals and journal entries.)



TIP

Every financial transaction creates a record or document to support its occurrence/existence, accuracy, valuation, completeness, rights, and obligations (also known as *management assertions*). Adapting the habits of a pack rat isn't a bad idea when it comes to keeping up with your paperwork. For at least three years, hold on to every accounting document after you record it in the proper journal. Some nonprofits have a five-year record retention policy. For any asset you may purchase (such as a computer, a building, or a vehicle), you should keep all records related to the asset until you dispose of the asset and file the subsequent tax return reflecting the disposition.



REMEMBER

The central location of transactions can be your checking account, showing deposits from donors or checks written to pay the bills and can be an important key to tracking accounting transactions. (Check out Chapter 7 to find out how to manage and balance a checking account.)

Just as important is keeping in mind the users of your financial statements and their needs. Nonprofit users can fall into three categories:

- » Existing or potential donors
- » Individuals or businesses thinking about extending credit terms to your nonprofit
- » Governmental agencies, such as the Internal Revenue Service (IRS), which want to make sure your nonprofit is fairly presenting its financial position (See Chapter 13 for information about compliance and fair presentation.)

All users share a common need: They need assurance that the information on your nonprofit's statements (see Chapters 17 through 20) are both materially correct

and useful. In a nutshell, to be *materially correct*, the financial statements can't contain any serious or significant errors that could impact the decisions of its users. In order to be *useful*, the information has to be understandable to anyone not closely related to the nonprofit's day-to-day activities.

Identifying the difference between bookkeeping and accounting

Before you determine your role in the accounting cycle, you need to have a firm understanding of bookkeeping and accounting. In the following sections, I cover the main differences.

Bookkeeping

Bookkeepers are paraprofessionals who work in accounting. No specific education, experience, or licensing is required for this designation. Many bookkeepers learn accounting by starting off in the accounts payable or accounts receivable department, filling in accounting knowledge as they go along.

They record day-to-day activities in the accounting cycle and carry out routine tasks (such as paying bills, making deposits at the bank, or reconciling bank statements). Bookkeepers may record transactions when cash changes hands, called the cash basis of accounting or maintain the books on the *accrual basis*. (The next section of this chapter and Chapter 2 provide more insight on cash versus accrual.) Usually bookkeepers pass the books to the accountant at the end of the accounting period to generate financial statements.



TIP

Depending on their knowledge, some bookkeepers prepare financial statements, which are then reviewed and adjusted by an in-house accountant or by an independent certified public accountant (CPA) hired by the nonprofit.

Accounting

Accountants handle an array of tasks, including managing cash receipts and payments, tracking assets, preparing financial statements and budgets, or governmental reporting. Accountants generally have a four-year university degree in accounting with a certain number of accounting-based credit hours (which varies depending on what that particular university requires).

Accounting isn't complicated mathematics; it's adding, subtracting, dividing, and multiplying, or grasping the nuances of entering information into accounting software. The accounting professionalism comes into play when applying generally accepted accounting principles (see the "Adhering to GAAP and GAAS" section, later in this chapter) to decide how to handle accounting transactions.

Many nonprofit accounting transactions are simple exchanges of cash or credit for a good or service, but there can be situations in which accountants have to dig a bit deeper into the right way to handle a particular transaction. Examples of this may be elimination of funds for reporting purposes, whether donor stipulations make the gift conditional, or how to handle customer revenue contracts. (Don't worry, I discuss all this and more in Chapters 6 and 8.) A bookkeeper may not be able to analyze accounts, but they can record the transaction after receiving guidance from the accountant.

Another important consideration is that accountants get paid more than bookkeepers. Your nonprofit may be better served by having a bookkeeper on your payroll to perform day-to-day functions and an accountant on retainer to put together reports on a quarterly or annual basis.

Some accountants opt to take the Uniform CPA Examination. This standardized examination is developed, maintained, and scored by the American Institute of Certified Public Accountants (AICPA). It contains four parts:

- » Auditing and Attestation
- » Business Environment and Concepts (business law)
- » Financial Accounting and Reporting (the main topic of this book)
- » Regulation (taxation)

Accountants who pass the test are called CPAs. CPAs are the only individuals who can audit your financial statements. To maintain this licensure, the CPA must take 80 hours of continuing education, including an ethics course, every two years.



REMEMBER

Don't be intimidated by CPAs because they have passed this tough exam. Use their knowledge and ask questions about your nonprofit issues. That's what you're paying them for!

Picking your accounting method

It's important to distinguish between the key accounting methods. Your *accounting method* determines when you record activities. For a nonprofit the key methods are either cash or accrual:

- » **Cash basis:** Records transactions only when cash is received or paid
- » **Accrual basis:** Records revenues when they're earned, expenses when they're used, and purchases when they take place

Using the cash method is quite easy. However, the ease of using the cash method is offset by two important facts:

- » If your nonprofit is required to have audited financial statements, cash-based books must be converted to accrual.
- » Because the cash method doesn't match donations or any other program income to expenses that the nonprofit incurs to earn that income, cash basis financial statements usually do not present as accurate a picture of how the nonprofit is carrying out its mission as accrual method statements do.

Let's say in March, your nonprofit has pledged donations of \$50,000 and expenses totaling \$35,000 associating with those donations. Donations for \$40,000 were received in cash, and the entire \$35,000 in expenses was paid. Using the cash method, your nonprofit shows \$5,000 of net income.

Under the accrual method, you record income under the revenue recognition guidelines set forth in the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 958. (You find out more about FASB and ASC in Chapter 14.)

Unconditional contributions (donations for which the donor has placed no restrictions on their use), including the promise to give, are recorded as income as soon as you receive the cash or pledge. It gets slightly more complicated when the donor imposes conditions on the use of the donation (for example, if the donor states that a future and uncertain event has to occur in order for the nonprofit to be able to retain the donation). Conditional donations are usually only recognized as income when the conditions set by the donor are materially met.

The accrual method takes cash out of the equation, because money changing hands doesn't determine if you recognize a transaction. As a result, a nonprofit keeping accrual-based books will have an accounts receivable, which shows that donations and other program income are owed to the nonprofit, and an accounts payable, which shows all the money the nonprofit owes to its vendors.

Using the same example as shown earlier for the cash method, under the accrual method, your nonprofit shows \$15,000 of income ($\$50,000 - \$35,000$). For this example, the difference is relatively small — \$10,000 ($\$15,000 - \$5,000$) — but proportionately the difference is 67 percent, which is material.

Check out Chapter 2 for more in-depth discussion about these two methods and which one may be best for your nonprofit.



WARNING

KEEPING WATCH OVER YOUR NONPROFIT'S FINANCES

Sometimes nonprofit directors and managers feel they don't have the knowledge to do their own books, so they turn everything over to a CPA. This book gives you the help you need to do some of your nonprofit's basic bookkeeping and accounting. However, you may rightfully need a licensed professional to help with the more technical aspects of keeping your nonprofits books. Certainly, you will need an independent CPA if you need a set of audited financial statements. (See Chapter 14 for more information about financial statement audits.)

Understanding the basic terms

Before jumping into doing the bookkeeping and accounting, let's walk through some basic terminology, accounting procedures, and processes. This section introduces you to important concepts, all of which I discuss at length in subsequent chapters in this book.

To begin, it's important to understand that accounting is based on a double-entry system. That means that for every action, there must be an equal reaction. In other words, if you add \$4,000 in assets by buying a new computer using store credit, there must be a corresponding \$4,000 entry showing the nonprofit has an obligation to pay this debt. (Check out Chapter 2 for more info on double-entry accounting.)

In accounting lingo, these actions and reactions are called *debits* and *credits*. You find out more about them in the "Logging debits and credits" section, later in this chapter, as well as in Chapter 6.

Classifying your transactions

When classifying your transactions, all of them will generally fit into five different types of accounts:

- » Assets
- » Liabilities
- » Net assets
- » Revenue
- » Expenses

First, I walk you through assets, liabilities, and net assets, which show up on the statement of financial position. Then I walk you through revenue and expenses, which show up on the statement of activities.

ASSETS, LIABILITIES, AND NET ASSETS

Assets are accounts for items your nonprofit owns or that adds value. An asset adds value, whether it's monetary or not. Common examples of nonprofit assets are

- » Accounts receivable
- » Buildings
- » Cash
- » Equipment
- » Furniture
- » Inventory
- » Pledges receivable
- » Prepaid expenses
- » Property (land)
- » Vehicles

Liabilities are debt your nonprofit owes or other items that in some way reduce equity. A liability is something the nonprofit owes or has an obligation in terms of time, money, or resources. Anything that must be paid is considered a liability. Some common nonprofit liabilities are

- » Accounts payables
- » Accrued expenses
- » Car notes
- » Mortgages
- » Notes payable
- » Short-term payables

Net assets are the difference between assets and liabilities. In the for-profit world, net assets are called *retained earnings* or *owners' equity*, which is net earnings or loss over the years less dividends paid to shareholders. Nonprofits do not have owners, so the term *owner's equity* is replaced with *net assets*.

A nonprofit must also break net assets between those with donor restrictions and without donor restrictions.

Assets, liabilities, and net assets are listed on the *statement of financial position*, which is the equivalent of a for-profit business balance sheet. Going back to the double-entry accounting system discussion earlier in this chapter, total assets must equal total liabilities plus net assets. (See Chapter 18 for more information about assets, liabilities, net assets, and how to prepare the statement of financial position.)



TIP

Your statement of financial position summarizes how financially stable your organization is and how solvent it is. A quick eye can look at this statement and gain great insight into your future to determine whether your organization can sustain the forces of the market.



REMEMBER

If you've taken financial accounting classes or worked at a for-profit business, you're probably familiar with the fundamental accounting equation, which states "Assets = Liabilities + Owners' Equity." Truncating the equation results in "Assets - Liabilities = Net Assets." In general (like everything in accounting, there can be exceptions, which are outside the scope of this chapter), a nonprofit doesn't have any owners, so this truncated version is what nonprofits report via the statement of financial position.

REVENUE AND EXPENSES

In addition to assets, liabilities, and equity, two other important account categories are revenue and expenses. Nonprofit *revenue* is generally program income, such as grants, community support, and donor contributions. Nonprofits can also have income from investments and fees. *Expenses* are current-period costs needed to run the nonprofit, such as payroll, rent, and utilities. Operating income/loss, which is the difference between revenue and expenses, affect equity. If revenue is more than expenses, the operating income increases net assets (equity).

Find revenue and expense accounts on your statement of activities, which is the nonprofit term for what the for-profit world calls the *income statement*. On the statement of activities, operating income is the difference between income and expenses. Next comes any non-operating revenue and expenses, such as interest income or loss on sale of assets. The bottom-line figure shows up as either an increase or decrease to net assets.



TIP

Gains and losses also reflect on the statement of activities. Gains and losses show accounting events not reflected to program revenue expenses such as gain on the sale of a fixed asset or casualty loss from a fire or weather. (Keep this information in the back of your mind for now — I cover them completely in Chapter 17.)

Your goal at the end of the year is to have an increase in net assets and not a decrease in net assets. (See Chapter 17 for more information about operating and non-operating revenue and expense and how to prepare the statement of financial position.)

Considering the transaction methodology

Before you enter an event into your accounting system, you have to consider the *transaction methodology*, which is a five-step process to confirm the correctness of whatever entry you're preparing. Here are your five considerations:

- » **What's going on?** This question addresses the precipitating event causing the entry. For example, did your nonprofit receive a contribution or buy a new piece of office equipment?
- » **Which accounts does this event affect?** In the case of a cash contribution, it would affect both cash and an income account.
- » **How are the accounts affected?** You increase or decrease an account based on how the account is affected. Assets and expenses increase using a debit, and decrease using a credit. On the flip side, liabilities and revenue increase with a credit, and decrease with a debit. For example, to record paying \$250 to buy merchandise at an office supply store using cash, you debit supplies expense (increase) for \$250 and credit cash (decrease) for \$250. Find out more about debiting and crediting by jumping ahead to the "Logging debits and credits" section of this chapter.
- » **Do all debits for an entry equal all credits for the same entry?** I talk about this more in Chapter 6. For now, just remember that for every debit there must be a credit.
- » **Does the entry make sense?** Does what you enter in the books match the facts and circumstances of the accounting event? For example, although the net effect on the books is the same, you can't credit an expense to book income such as a cash contribution.

Keeping a journal

Accounting journals are the day-to-day recording of events affecting your nonprofit. Accountants call journals the *books of original entry* because no transaction gets into the accounting records without being entered into a journal first. Your nonprofit can have many different types of journals. (See Chapter 8 for more information about cash, income, purchases, and the general journal.)

Logging debits and credits

Accounting reflects what happens financially by increasing and decreasing accounts in the form of debits and credits. You also need to know the normal balance of each account. The *normal balance* of asset, net asset, and expense accounts is a debit. The normal balance of liability and revenue accounts is a credit.

Accountants use the following methodology to report debits and credits in the journals:

- » The date of the entry is offset in the left-hand column.
- » The account debited or credited is in the middle column.
- » The left side is the *debit* side of an account.
- » The right side is the *credit* side of an account.
- » The amounts are shown in the right-hand column.
- » Proper journal entries always list debits first and credits afterward.

Figure 1-1 shows the general format of a journal entry.

FIGURE 1-1:
The standard journal entry format.

Date	Debited account	XX,XXX
	Credited account	XX,XXX

For every debit, there must be a credit, but you can have more than one debit or credit in a single journal entry. For example, Figure 1-2 shows cash received on March 10 from two sources.

FIGURE 1-2:
Recording cash received via donors and grants.

10-Mar	Cash	55,000
	Campaign contribution	5,000
	Government grant	50,000

Throughout your accounting period, you make debits and credits not only to your statement of financial position accounts, but also to your statement of activities accounts. Understanding how to increase and decrease these accounts is also important.

Adhering to GAAP and GAAS

Before you can play a game, you read the instructions, right? Well, before you can fully understand bookkeeping and accounting for your nonprofit, you have to familiarize yourself with the accounting ground rules. The ground rules of the accounting profession — the standards that accountants follow when making decisions about how to handle accounting issues — are generally accepted accounting principles (GAAP).

GAAP defines for financial accountants the acceptable practices in the preparation of financial statements in the United States. Specifically, GAAP tells accountants exactly how financial data has to show up on the nonprofit's statement of activities, statement of financial position, and statement of cash flow (see Chapters 17, 18, and 19 for more information about each of these statements). GAAP was put in place to help accountants put their clients' needs first, behave ethically, and make sure that all accountants are playing by the same rules. (See Chapter 13 for more on GAAP.)

Many nonprofits need a set of audited financial statements, which means your nonprofit has to secure a qualified independent CPA to conduct a financial statement audit and prepare an audit report giving an opinion on your financial statements. Auditing is gathering and reviewing evidence about your organization to report on the degree between the way your nonprofit's financial information is presented and the standards set by rule makers.

Generally accepted auditing standards (GAAS) are rules or standards your independent CPA uses in this process to perform and report audit findings. Statements on auditing standards for CPAs working with nonprofits are issued by the Auditing Standards Board (ASB), which is part of the AICPA.



TECHNICAL
STUFF

AICPA is the U.S. national professional organization for all CPAs. The ASB is a senior technical committee of the AICPA. The ASB issues standards and procedures that financial accountants must follow when conducting audits. It also sets quality-control standards to use for peer reviews, which is when one CPA firm evaluates the operations of another CPA firm.

Auditors give opinions by writing a report about your operating procedures, compliance with specific laws, and whether your financial statements are stated according to GAAP. As a nonprofit director or manager, you need to be concerned with three types of audits (see Chapter 14 for more information about the auditing process):

- » **Audit of financial statements:** An audit of financial statements, sometimes called an accounting audit, verifies whether statements have been prepared according to GAAP.

- » **Compliance audit:** A compliance audit, sometimes referred to as a grant audit, reviews your financial records to determine whether your nonprofit is following specific procedures, rules, or regulations set down by some higher authority.
- » **Operational audit:** An operational audit, also called the *management audit* or *performance audit*, measures and evaluates how efficiently you're operating and how effectively you're managing your nonprofit's resources. Boards of directors often request this audit to evaluate organizational systems, computer operations, and marketing. The aim of an operational audit is ultimately to optimize efficiency.

Keeping a paper trail

Leaving tracks in the sand is essential to proper management of your nonprofit's books. You need documentation to support why you did what you did, which adds credibility to your management of funds. Good housekeeping starts by keeping your checkbook register balanced (see Chapter 7) and continues with maintaining organized records (see Chapter 4) using either a manual bookkeeping system (see Chapter 8) or an accounting software program (see Chapter 9).



TIP

Keep original source documents of where every donation comes from and how each dollar is spent. Part of being a good steward is leaving a clear audit trail to account for your nonprofit activities and support how you treat transactions.

Additionally, your auditor will want to backtrack in your steps to find the initial record that began a single transaction. Auditing can be like looking for a needle in a haystack. Sometimes only your auditor knows what they're looking for and why, but you'll have to provide the records in order to complete the financial statement audit. Depending on your nonprofit circumstances, getting an audit of your financial statements may be a necessary part of keeping your nonprofit status. (Chapter 14 tells you what to expect during an audit.)

Making Sure Your Books Are Balanced

Staying on top of your nonprofit's financial activities is important because, as the director or accountant, you can be held accountable. The way to start is making sure you have balanced books. Balanced books are up-to-date, current information about your accounts, in which debits equal credits. Every transaction that takes place affects two or more items in accounting, and you have to make sure everything stays in balance. Whether you create your own manual system or take advantage of the software on the market, you need to keep your books in order.

This section walks you through some basics to help you ensure your books are balanced. Follow the chapters in Part 2 for tools to assist you in maintaining balanced books.

Establishing a chart of accounts

Your chart of accounts is your blueprint for assigning numbers to specify accounts and having a method to track all accounts. Using a chart of accounts, you can recognize what type of account it is based on the beginning number. For example, accounts beginning with 1 are usually assets accounts. After you get used to using the chart of accounts, you'll enjoy the benefits of coding transactions according to their classification. (Chapter 5 has more on setting up your chart of accounts.)

Tracking transactions

To have a firm grasp on your nonprofit's financial status, your records have to be accurate. The best way to have accurate records is to record transactions when they take place, when the event is still fresh in your mind.

Tracking your income and costs and keeping your checking account balance up to date lets you know when you're short on cash and when you've got plenty of money to pay the bills. Without a good tracking device or accounting system, you can easily lose track of your true checking account balance.



TIP

So, how can you keep track of transactions? Don't feel overwhelmed. You don't need a PhD in aeronautical engineering. The following are a couple of easy ways to track them. Check out Chapters 6 and 7 for more on recording transactions and using a checkbook.

- » **Use online banking.** Online banking gives up-to-date, current balances any time, day or night.
- » **Itemize your transactions when they happen.** When you swipe your credit card or bank debit card, write it down right away in your checkbook register.



REMEMBER

One of the most important things you need to keep track of is your donors list. A donors list includes contributors' names, addresses, and phone numbers, as well as the donation dates. Your auditor will use this list to verify where the money came from and when.

Developing a budget

Your budget is your financial plan. It shows your expected sources of income and how much you expect to spend. When you create a budget, you develop a formal plan for paying for your organization's future activities.

You need not only an operating budget for your organization, but also a separate budget for each and every program. (Chapter 10 explains how to create a budget.)



REMEMBER

Always know how much money is needed to operate your nonprofit. If a private donor asks, you should know the exact amount needed to break even (the amount of money it takes to cover all expenses).

Being compliant

After all your hard work setting up your nonprofit, you don't want to inadvertently have your nonprofit status revoked. Make sure you file your paperwork with the IRS, abide by any state and local regulatory guidelines, and keep your non-program income in line (see Chapter 16 for more on unrelated business income). Additionally, operate according to your bylaws, be mindful of your mission statement and steer clear of any perceived conflict of interest.

In addition, you have to mind some accounting standards: GAAP, rules set by FASB, and laws established by the Sarbanes–Oxley Act (SOX). (I explain the ins and outs of these guidelines in Chapter 13.)

Finding Out about Federal Grants

Finding donations and revenue for your nonprofit may be frustrating at times. The good news: The federal government provides free money in the form of grants that you can apply for and not have to pay back. Grants come in all sizes, from tiny ones of \$10,000 to supersizes of \$1 million and more.

Positioning your organization to receive grants requires four important things:

- » **Organization:** You need to keep up with the paperwork involved to make the application and management process easier.
- » **Reading:** In order to understand the dos and don'ts of how to put together your grant application, you need to carefully read all the grant application guidelines.
- » **Writing:** You need to put your plan on paper. Federal proposal writing is different from other writing you may do on a regular basis.

- » **Accountability:** To fulfill reporting requirements, you need to be accountable. You successfully receive the grant; now you have to tell the government how you're spending the grant money and how folks are benefiting from the funds.

This section gives you a snapshot of the federal grant process. (Chapters 11 and 12 provide more information about federal grants and accounting for them.)

Gleaning some grant basics

Federal grants are award instruments given by the federal government to implement programs that benefit people. You don't have to pay grants back — they're not loans. It's free money! With some work, figuring out the grant application process is easy, and the benefits of receiving a grant are phenomenal.

Although many sources other than the federal government offer grants, Chapter 11 of this book focuses on federal grant. Hundreds of federal agencies provide grants to:

- » Help nonprofits implement programs to benefit communities
- » Do work that government can't do
- » Carry out a public purpose



TIP

Go to www.federalgrants.com/agency to browse through grants by federal agency.

Following the rules

When your nonprofit gets federal grant money, you're not free to spend it however you want. Like any grant you may be awarded, federal grant money has red tape and paperwork. For the grant novice, managing a grant can be a bit tricky, but after you get your first one behind you, managing subsequent ones should be easier. (Chapter 12 provides more insight to managing grant money.)



REMEMBER

The main challenge of managing a federal grant is submitting two reports in a timely manner. These reports tell the federal agency from whom you secured the grant:

- » What progress you've made toward your program goals to date
- » How you've spent the federal money and how much is left

After you master the rules, you can play the grant game like a pro and become a grant guru.

Going through a grant audit

For many people, the word audit brings to mind the freezing of assets and the endless search for paper trails that may lead to the discovery of something that wasn't handled properly. For the record, an audit verifies and confirms the accuracy of your financial records and your compliance with the grant requirements.

The grant audit is usually conducted by someone from the granting agency and is done to ensure grant funds have been used as per your agreement with the funding agency. Your grant auditor checks out the federal government's investment by seeing if you're a good steward of grant dollars. The auditor will view your accounting system to see how you separate your grant money from the rest of your funds. Your auditor also looks at other areas, such as your organization's travel, personnel, and purchasing policies and procedures. (Chapter 14 discusses what to expect during a grant audit.)

Paying Federal Taxes

Although your organization is a nonprofit and is exempt from paying federal taxes, you're still responsible for collecting and remitting federal payroll taxes for all of your employees, which includes FICA and federal withholding tax. The Federal Insurance Contributions Act (FICA) is a federal payroll tax that both employees and employers have to pay. The funds collected from FICA are used to fund Social Security and Medicare retirement benefits and to provide for disabled workers and children of deceased workers.

As of the publication date of this book, the FICA rate is 15.3 percent. Of the 15.3 percent, you withhold 7.65 percent of each employee's gross wage (subject to threshold limits) for FICA. As the employer, you must match this amount by paying 7.65 percent of the employee's gross wage. Federal withholding amounts are a function of how the employee filled out Form W-4.

Chapter 15 has more information about calculating payroll and payroll taxes, as well as figuring any thresholds. It also provides a guide on when and how to remit payroll taxes to the IRS.



WARNING

Nonprofits generally pay no federal income tax, but your nonprofit may be subject to federal income taxes if you engage in for-profit business enterprises in which you gain unrelated business income. Unrelated business income is any income generated by a business that is regularly carried on and unrelated to the exempt function of your nonprofit.

Getting a Grasp on Financial Statements

Financial statements are records of where your income comes from, where it goes, and in some instances, accumulated balances. (Check out the chapters in Part 4 for more in-depth explanations on these statements and how to create and use them to keep track of your organization's finances.)

Your financial statements include the following:

- » **Statement of activities:** The equivalent of a for-profit income statement, the statement of activities lists all program revenues earned and all expenses paid for a specific time period. It also reports other income and expenses, such as interest income or loss on the sale of an asset. The difference between revenue, expenses, other income, and other expenses increases or decreases net assets. (Refer to Chapter 17 for more info.)
- » **Statement of financial position:** Similar to the for-profit business balance sheet, this statement reveals your organization's solvency and stability by summarizing its assets (things it owns) and liabilities (things it owes) and calculates its net assets (the difference between what the organization owns and what it owes). Your statement of financial position reports your organization's assets, liabilities, and net assets as of a certain date. The difference between assets and liabilities equals your net assets. (Check out Chapter 18 for more.)
- » **Cash flow statement:** This statement evaluates all inflows and outflows of cash for the accounting period according to the activity. The cash flow statement breaks activities into three categories: operating, financing, and investing. (See Chapter 19 for more on the cash flow statement.)
- » **Statement of functional expense:** Your statement of functional expense reveals by line item and category how much you've spent for the different categories of expenses reported on the statement of activities — program costs, management and general expenses, and fundraising expenses. As such, this statement is an itemized list providing detailed information about the expenses reported on the statement of activities. After you've completed the statement of activities, the statement of functional expense allocates your total expenses among activities. (See Chapter 18 for functional expense classifications.)

» **Notes to the financial statements:** The notes section tells the story behind the numbers. The notes describe your organization, explain your accounting methods, and explain any changes in those methods, potential lawsuits, or contingencies that threaten the livelihood of your existence. Plus, they provide detailed information for some of the amounts in the financial statements.

In addition, the notes clarify all restricted assets. In the notes you find pertinent information about bonds and notes payable. Anything that can have a material impact on your organization should be disclosed in the notes to the financial statements. (See Chapter 21 to understand the importance of completing the notes to your financial statements.)

ANSWERING FIVE IMPORTANT QUESTIONS

Don't be a nonprofit director or manager staying up nights worrying that you've missed an important deadline or done something to jeopardize your nonprofit status. Manage that worry by staying organized. Here are five questions and answers to make your life a little easier:

- **Why do I need a system to track and record revenues and expenses?** You need to do so because you're a good steward of the funds you manage, and you want to keep your supporters happy. A good steward is wise and prudent in the way they handle money. You want to establish and then maintain a good reputation as being a good charitable investment. You need a bookkeeping system that tracks and accounts for the funds you manage and the expenditure made. This makes you accountable and gives your nonprofit credibility.
- **How do I go about finding more stable sources of income to fund my programs?** Explore all relevant grants (see Chapters 11 and 12 for more information). One of the most stable sources of income are government grants. First, do a little research on applicable grants. Carefully read the criteria and go over the grant application. Gather necessary paperwork and prepare your application. One last thing: Be mindful of the grant application submission deadline.
- **What do I need to do with my records so I'm ready if I'm ever audited by the IRS?** Record and store for safekeeping all backup documents for any transactions you make. In other words, keep copies of everything pertaining to income received, expenses paid, and assets purchased. Leave a paper trail that leads to every purchase. In real estate, it's all about location, location, location. With the IRS, its document, document, document. (Chapter 4 can help you set up a recordkeeping system.)

- **Donations are so unpredictable — why do I still need an operating budget?**

Whether your organization is flat broke and you don't know where the next dime is coming from or it has millions in the bank, you always need to have an operating budget. You need to know how much is needed to operate your organization on a weekly, monthly, quarterly, and annual basis. Your operating budget is your financial plan. (Check out Chapter 10 for more advice.)

- **What do I need to know about complying with IRS guidelines to keep my non-profit status?** One thing that applies to all nonprofits, no matter how big or small, is timely filing information with the IRS annually through Form 990. Which version of Form 990 you file depends on your annual gross receipts. (Turn to Chapters 13 and 16 to find out more.)

