

Accounting for Not-for-Profit Organizations

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Not for Profit Organizations

- Chapter Outline
 - Fund Accounting
 - External Financial Reporting
 - Budgetary Control and Encumbrances
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Fund Accounting

- Fund accounting may be defined as accounting procedures in which a self-balancing group of accounts is provided for each accounting entity established by legal, contractual or voluntary action, especially in governmental units and not for profit organizations
 - Not for profit organizations often receive amounts designated by the contributor as being for a specific purpose. With specific restrictions placed on these amounts, the organization requires a mechanism whereby the amounts allocated to a particular purpose may be identified and tracked. Fund accounting provides such a mechanism.

Fund Accounting

- In many not for profit organizations, a basic objective of financial reporting often becomes the tracking of changes in each fund balance over the year and associated stewardship
- Fund accounting provides a segregation of assets for a given purpose, a recognition of the set of separate operations which pertain to those assets, recognition of the equities which pertain to that fund, and complete classification by fund of revenue, expense and income accounts

Fund Accounting

- In short, the complete self balancing set of accounts for each "fund" removes the emphasis from the bottom line and places it more closely on the individual activity of interest, the fund
- The total of assets less liabilities of the not for profit organization will equal the total of the fund balances, the same way that in a business organization, assets less liabilities equals owners' equity

Fund Accounting

- Fund accounting may be said to have the following conceptual differences from conventional accounting:
 - The fund is viewed as an entity
 - Valuation is a minor issue
 - Equities (fund balances) are viewed as restrictions upon assets, not liabilities
 - Current and long term items are segregated
 - Differing concepts of revenue and expense may be employed
 - There is an absence of emphasis upon net income

Fund Accounting

- It would be difficult to make an exhaustive list of possible funds
 - In a university, for example, there are research funds, scholarship funds, residence funds, athletic funds, and the like
 - In a church, there may be mission funds, memorial funds, building funds, operating funds, and so on
 - *An organization that uses fund accounting in its financial statements should provide a brief description of the purpose of each fund reported*
- Funds required are specific to the objectives and activities of the particular organization

Not for Profit Organizations

- The accounting and financial reporting needs of not for profit organizations, although perhaps not as complex as those of public corporations, are nonetheless complex
- Stakeholders of not for profit organizations are diverse, and are faced with many of the same resource allocation decisions that the stakeholders of business organizations face, often with significant resource constraints
- The CICA Handbook provides extensive guidance for not for profit organizations

External Financial Reporting

- Most (but not all) not for profit organizations publish financial statements which are seen by both direct stakeholders (in many cases members) and by members of the general public
- These financial statements must be prepared in accordance with the relevant provisions of the CICA Handbook, including the conceptual framework

External Financial Reporting

- Most of the *Handbook*, however, is oriented toward the needs of users in the private sector and therefore toward business organizations
- A new series of sections in the *Handbook* is oriented exclusively toward not for profit organizations, and addresses their special needs
- Significant progress is being made toward improvements in financial reporting practices of not for profit organizations

External Financial Reporting

- Financial statements for a not-for-profit organization now normally include:
 - a statement of financial position;
 - a statement of operations;
 - a statement of changes in net assets; and
 - a statement of cash flows
- Supplementary disclosure provided with a full set of financial statements is now extensive, and many specific rules have been published
- The detailed provisions of section 4400 to 4460 should be reviewed carefully

Encumbrances and Commitments

- Budgetary Control with Encumbrance and Commitment Accounting
 - It is a common practice in not for profit organizations to set up the approved budget in the accounts
 - This practice permits actual expenditures to be tracked against budget, so that the difference may be tracked for management purposes.
 - Additional control is maintained by recording various expenditures when first approved, rather than when completed
 - These approved expenditures, when recorded, are referred to as "encumbrances"; the related expected obligation, an "estimated commitment".

Encumbrances and Commitments

- The formal incorporation of approved future expenditures in the accounts enables the computation of a "free" balance at any time
 - This free balance is the amount which may be expended on other contracts or purchases, as of that point in time
 - This system also provides budgetary control with commercial enterprises, especially on large, fixed price projects (such as shipbuilding or large commercial construction projects)
 - The encumbrances entered into are generally shown as if expenditures (with the commitments shown as if liabilities)

Encumbrances and Commitments

- The important point is that the free balance must be readily available in the accounts so that the managers may promptly access this information when required for expenditure management decisions
- Knowledge of the free balance (especially when it is limited) and associated planned expenditures for the remainder of the fiscal year helps not for profit organizations to meet budgetary objectives

Encumbrances and Commitments

- **Setting up the Budget**
 - When the budget is formally approved, budgeted amounts are set up in a separate set of "budgetary accounts"
 - normal debit and credit rules are reversed, and the budgeted surplus or deficit is also entered
 - As expenditures are made, these are entered in the normal manner
 - Comparison of the approved budget with actual expenditures will indicate a free balance
 - This system is supplemented by the recording of encumbrances

Encumbrances and Commitments

- **Encumbrances and Commitments**
 - An additional layer of control is provided by generating an entry to a third set of accounts (using normal debit and credit rules) at the time a purchase order is issued or a contract is entered.
 - The estimated expenditure or **encumbrance** is debited to these accounts; the expected future obligation or **commitment** is credited.
 - The free balance in such a system is computed by comparing the budgeted expenditure limit to the total of actual expenditures plus encumbrances.

Encumbrances and Commitments

- When goods are received or services are delivered, the accompanying invoice will be recorded in the accounts.
- Completion of the contract should also give rise to the reversal of the related encumbrance and commitment
- Discrepancies are investigated
- Expenditures should not be approved which exceed the free balance available for expenditure

Encumbrances and Commitments

- **Closing entries in Fund Accounting Systems**
 - In a not for profit, as with a business, all temporary accounts are closed at the end of the fiscal period:
 - **Close the budgetary accounts**, to provide for the "set up" of next year's budget.
 - **Close outstanding encumbrances to expenditures** for the period, so that encumbrances are charged against the budget in the year approved (entry is **reversed** at the beginning of the next period).
 - **Close actual** revenue and expenditure accounts, updating the fund balances and clearing the accounts for the following years expenditures.

Encumbrances and Commitments

- Note that commitments *remain on the balance sheet*, and represent the amount of approved expenditures undelivered at the end of a fiscal year.
- As the entry to close encumbrances was reversed, when invoices are actually received and expenditures entered, encumbrances are cancelled against commitments in the normal manner.

Public Sector Accounting

- The Public Sector Accounting Board (PSAB) of the CICA issues Recommendations and guidance on accounting in the public sector
 - The "public sector" includes
 - Federal, provincial, territorial and local governments, government organizations, government partnerships, and school boards.
 - Government organizations that are accountable for the administration of their financial affairs and resources either to a minister of the government or directly to the legislature or local government council, and are owned or controlled by the government.

External Financial Reporting



World Vision Canada
Annual Report 2001

- *For many not for profit organizations, publication of basic financial statements provides an essential element of credibility to their fund raising activities*

Condensed Statement of Financial Position

As at September 30, 2001,
with comparative figures for 2000

| | 2001 | 2000 |
|--|---------------------------|---------------|
| | (in thousands of dollars) | |
| Assets | | |
| Current Assets | | |
| Cash and short-term investments | | |
| Unrestricted | 1,667 | 2,608 |
| Restricted | 14,742 | 12,617 |
| Prepaid expenses and other current assets | 2,674 | 2,293 |
| | 19,083 | 17,518 |
| Due from Affiliates | 462 | 788 |
| Capital Assets | 22,489 | 5,597 |
| Total Assets | 42,034 | 23,903 |
| Liabilities and Net Assets | | |
| Current Liabilities | | |
| Bank indebtedness | 8,700 | — |
| Accounts payable and other current liabilities | 7,534 | 4,496 |
| Deferred contributions | 12,541 | 10,035 |
| | 28,775 | 14,531 |
| Capital Lease Obligation | 1,240 | 56 |
| Deferred capital contributions | 220 | — |
| Net Assets | | |
| Net investment in capital assets | 11,730 | 5,397 |
| Funds for program | 69 | 3,919 |
| Total Liabilities and Net Assets | 42,034 | 23,903 |

External Financial Reporting



World Vision Canada
Annual Report 2001

Condensed Statement of Revenue and Expenditures

Year ended September 30, 2001,
with comparative figures for 2000

| | 2001 | 2000 |
|--|---------------------------|----------------|
| | (in thousands of dollars) | |
| Revenue | | |
| Donations from the public | | |
| Cash | 131,082 | 120,179 |
| Donated goods | 39,228 | 23,624 |
| Government grants | | |
| Cash | 21,292 | 22,497 |
| Donated goods | 3,846 | 3,112 |
| Investment and other | 274 | 1,042 |
| Total Revenue | 195,722 | 170,454 |
| Expenditures | | |
| Program services | | |
| International programs | 150,594 | 131,834 |
| Canadian programs | 1,455 | 1,238 |
| Public awareness and education | 5,053 | 5,085 |
| Fundraising | 27,675 | 26,478 |
| Administration | 8,463 | 7,738 |
| Total Expenditures | 193,240 | 172,373 |
| Excess of Revenue over Expenditures (Expenditures over Revenue) | 2,482 | (1,919) |

- *The statements published in this context are often “condensed” or “summarized”, yet the underlying concepts of external financial reporting must be rigorously applied*
- *Section 1000 of the CICA Handbook applies **equally** to not for profit organizations*

International View

- At present, governments and other public sector entities follow widely diverse financial reporting practices and, in many countries, there are no authoritative standards for the public sector. In some countries where standards do exist, the body of standards may be either at an early stage of development or limited in application to specific types of entities in the public sector (IPAC, Preface to International Public Sector Accounting Standards)
- The comprehensive standards of Canada for the public sector are among the world's best

International View

- Radical changes in accounting standards for not for profit and public sector organizations have made the news in many countries:
 - New York City will have to dust off decades old files to determine the value of the 116 year old Brooklyn Bridge. California will have to value hundreds of miles of eight lane freeways. And, hundreds of cities will struggle to tally up the cost of schools, jails and sewers built many years ago ... governments will for the first time have to calculate the value of nearly every major asset they own, from roads to bridges to prisons to hospitals, even if those assets were acquired or built decades ago *(New York Times, June 6, 1999)*

International View

- There is no true counterpart to the International Accounting Standards Committee with the comparable stature of “general acceptance” that IASs seem to be achieving
- However, the Public Sector Committee of the International Federation of Accountants (IFAC) has recently published a series of International Public Sector Accounting Standards (at least 8 standards and several exposure drafts) which seek to improve the quality of financial reporting in the public sector around the world

International View

- Adoption of these standards will be slow, especially as there is not the stimulating effect of international capital markets that has provided considerable impetus to financial reporting in the private sector
- However, with the hoped for support from multilateral financial institutions (such as the International Monetary Fund and the World Bank) there is some hope that standards for public sector and not for profit organizations will improve, at least gradually, everywhere

Reference

Secord, Peter. 2003. *Modern Advanced Accounting*.
Canada: McGraw-Hill.