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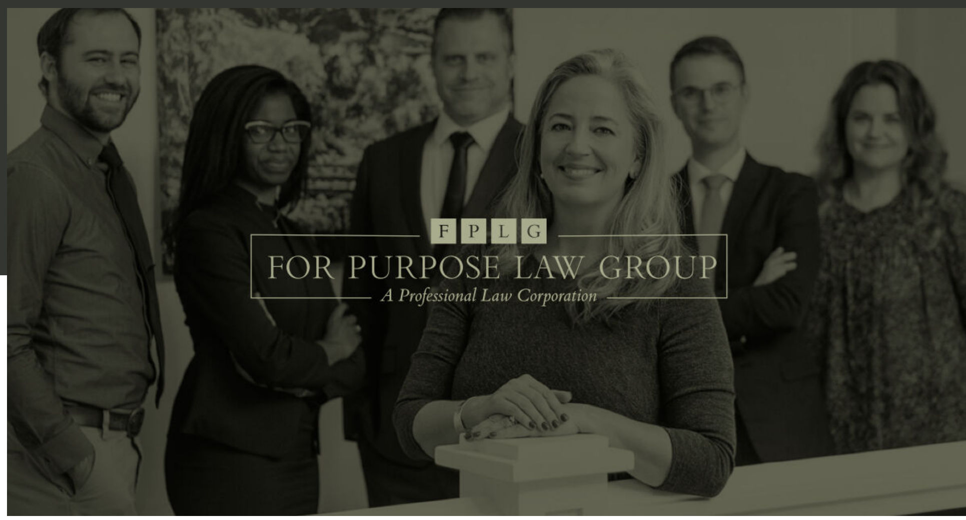
NONPROFITS: BOARD GOVERNANCE

Charity Boards and Accounting Literacy

08.18.16 | Linda J. Rosenthal, JD



Any expert in the philanthropy sector will tell you that it's crucial for any and every charity board member to be actively involved in the affairs and activities of the organization. Regular attendance at board meetings is key, of course, as well as participation in decisions on mission and program activities, but it's important, too, for every director to be aware of, and understand, the charity's finances.

Under the law of California and all other states, a charity director has fiduciary duties of care and loyalty. California Corporations Code section 5231:

> *(a) A director shall perform the duties of a director,*
> *including duties as a member of any committee of the board upon which*
> *the director may serve, in good faith, in a manner that director believes to be in the best interests of the corporation and with such*
> *care, including reasonable inquiry, as an ordinarily prudent person*
> *in a like position would use under similar circumstances.*

In particular, each director should be given a copy of each year's information return, Form 990 series, before it is filed with the Internal Revenue Service.

Accounting Knowledge of Board Members

Tax-exempt, 501(c)(3) organizations come in all shapes and sizes. Similarly, board members range from novices with no prior experience in the nonprofit world or in business, to community leaders with many rounds of charity-board service under their belts.

But even successful entrepreneurs or business executives who sit on nonprofit boards may have little or no knowledge at all about the fundamentals of *nonprofit* accounting – which are different than regular business accounting.

And, just to let you in on a little secret, relatively few lawyers have a firm grasp of *for-profit* accounting principles much less *nonprofit* accounting concepts.

Many board members, then, regularly fail in their fiduciary duties because (a) they don't know what they don't know; accounting is just a big blur to them; or (b) they draw a blank when faced with nonprofit financial documents, but are reluctant to admit that they don't understand the essentials of this branch of accounting.

How is Nonprofit Accounting Different?

Unlike in a business where the goal is to make money for shareholders, the purpose of a nonprofit is to carry out a charitable mission, and to raise funds to do that work.

Because of that distinction, the accounting system that will work well for one will not necessarily be adequate for the other. Here are some illustrations and examples.

Presentation of Financial Statements

There are differences in the financial-statement components:

For-profits

- Balance Sheet
- Profit/Loss Statement
- Statement of Cash Flows
- Statement of Owner's Equity

Nonprofits

- Statement of Financial Position
- Statement of Activities
- Statement of Cash Flows
- Statement of Functional Expenses
- Change in Net Assets

Compare, for instance, the second item in each list. A business' profit and loss statement shows income and expenses with either a profit or a loss as a result. The statement of activities for nonprofit organizations also shows income and expenses, but for nonprofits, income is not derived primarily from sales of goods or services, but rather it can be from sources of funds such as "fee for service", gifts, grants, donations, and (hopefully) fundraising revenue. While nonprofit and for-profit businesses may have similar expenses — such as utilities, rent, payroll, and office supplies — nonprofit organizations also have something called "functional expenses," where uses of funds are related to specific programs, with the net of sources of funds and expenses listed as either a surplus or a deficit.

Compare, also, the final item in each list. For-profits have a section for owner's equity, but nonprofits (which do not have owners) have a net assets category instead. This net assets item "lists sources of funds and is broken down into three areas: *unrestricted net assets, temporarily restricted net assets,* and *permanently restricted net assets."*

The "Functional Expenses" Requirement

Because of the nonprofit organization's special purpose of using resources for its mission, it must "itemize expenses across management (general and administrative), fundraising, and program areas. These are called "functional expenses" and the IRS requires that they be reported."

Having a cost-allocation plan is advisable; that is, "establishing a system that defines how [to] allocate expenses across the various functional areas and to specific programs." If, for example, personnel carrying out administrative functions take up to 30% of office space, then an allocation of 30% of an expense like paper to the administrative function may be appropriate. "A cost allocation plan can be extremely useful in determining how much a program or activity actually costs and, done accurately, it gives a clearer picture of the organization's finances."

Financial Accounting Standards No. 116

The Statement of Financial Accounting Standards No. 116 is issued by the Financial Accounting Standards Board (FASB). It discusses some additional points of interest unique to nonprofit accounting, including –

- Contributions revenue: "how and when to recognize that revenue has been earned," e.g., "unrestricted and restricted funds, donated goods, in-kind contributions, [and] pledges."
- Value of donated services: "services to be recognized include those that "(a) create or enhance nonfinancial assets or (b) require specialized skills, are provided by individuals possessing those skills, and would typically need to be purchased if not provided by donation."

Conclusion

A board member who finds any of this unfamiliar or confusing will want to get up to speed. Resources like those below can help are a good starting point:

- "Nonprofit Accounting" – a useful, easy-to-read introduction to the fundamentals

- FASB Statement of Financial Accounting Standards No. 116, "*Accounting for Contributions Received and Contributions Made,"*and No. 117, "*Financial Statements of Not-for-Profit Organizations*"

And if you'd like more information on nonprofit accounting, you can reach out to the experts at For Purpose Accounting.