

Good Financial Records: A Must for Every Nonprofit

07.23.15 | Linda J. Rosenthal, JD



Welcome a favorite local politician at your offices with a banner emblazoned: “Good luck on your reelection, Congressman. We love you!” That’s a sure-fire way to jeopardize your tax exemption. What’s another way? Have a shoddy accounting system and forget to file federal and state information returns for a few years. That will do it, too.

“Why Keep Records?”

The Internal Revenue Service has a helpful publication about record-keeping duties: the “[Compliance Guide for 501\(c\)\(3\) Public Charities](#).” Eventually – on page 16 – the IRS gets around to posing (and answering) the key question: “Why Keep Records?”

In a nutshell, here’s why: A 501(c)(3) organization must faithfully comply with all of the rules and restrictions that come with that favored tax status *and* that organization must be able to *prove* its compliance with these laws.

“What Records Should Be Kept?”

Section 501(c)(3) charities must “maintain books and records” to “ensure that they continue to be recognized as tax-exempt ...” At a minimum, these books and records must show “sources of receipts and expenditures” and whether a group is a public charity or a private foundation. They must be adequate enough so the organization can “complete its returns accurately.”

“Except in a few cases,” explains the IRS in its [Compliance Guide](#), “the law does not require a special kind of record,” so long as the system “clearly show[s]” income and expenses, and the organization has documents to

support the accounting data.

A 501(c)(3) may operate either on a cash or accrual basis, and the annual accounting period may be either the calendar year or a fiscal year.

Although this Compliance Guide is specifically for public charities, its key message about adequate books and records (and timely filing required returns) applies to private foundations as well, and more generally to all other nonprofits.

The California Attorney General's Office offers similar advice: "A charity's accounting system "should reflect accurate, understandable data that is useful in making management decisions and preparing reports."

Is It One-Size-Fits-All?

What's appropriate and useful for a small organization with a single program will be quite different from the sophisticated accounting system used by a larger or more complex nonprofit. "The types of activities a ... charity conducts [also] determines the type of records that should be kept for federal tax purposes." A health clinic will have different accounting needs than a museum or a grant-making organization. It's definitely *not* one-size-fits-all. For most charities, accounting records should follow generally accepted accounting principles and the standards of Accounting and Financial Reporting for Nonprofit Health and Welfare Voluntary Organizations. There are exceptions for certain organization categories which have specialized rules and standards.

How a Nonprofit's Financial Records Are Used

"When good recordkeeping systems are in place," advises the IRS, a 501(c)(3) organization can not only prepare financial statements and returns, but can also "...evaluate the success of its programs" and "monitor its budget."

Preparing Returns and Reports

Of course, from the perspective of government regulators, the most compelling reason for an organization to have a solid accounting system in place is to provide the core information necessary to complete and file required returns and reports. This is not a simple task – even with adequate books and records. For example, the current IRS [Form 990](#) has a core 12 pages and additional required schedules. At just 4 pages long, the Form 990-EZ is *easier* but is not – as its name suggests – easy. The [Form 990-PF](#) for private foundations is a formidable challenge. An organization with unrelated business income must file the complex Form 990-T. Various state agencies require additional annual information returns and reports, and disclosures for activities like charitable fundraising and special events like [raffles](#).

Evaluating Mission Success

An organization's financial books and records are useful as a guide to evaluating the success of the charitable program and determining whether budgetary guidelines are being met. "Nonprofits should use their financial resources to accomplish their missions in an effective and efficient manner, and should establish clear policies and practices to regularly monitor how funds are used."

Reporting to Funding Sources

A good accounting system, and useful books and records, are crucial in writing accurate grant applications. And most foundation and government grants require detailed performance reports and records to show that funds have been properly spent.

Managing Risk

The Form 990 was substantially overhauled in 2008. There are now "questions about risk and compliance," including whether the organization has sufficient internal controls to prevent private benefit or inurement, or diversion of funds away from the stated charitable purposes. Nonprofits may not realize their special vulnerability to bad actors committing theft and embezzlement:

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The do-good personalities of the people drawn to work for ...[nonprofits] ... may make that sector more susceptible to fraud People drawn to the noble purposes of nonprofits are less likely to recognize 'bad stuff' that may happen because they do tend to be good-hearted and think the best of everyone....

Conclusion

The importance of good financial records can't be overstated. They are key to complying with government reporting requirements, measuring program success, and avoiding problems that can have devastating consequences.

"No matter how small your organization, following good financial management procedures makes good sense. Doing so helps ensure the staff and board of the organization are fulfilling their stewardship responsibilities and makes it more likely the organization will be sustainable for the long term and continue to fulfill its mission."

