LEARNING MADE EASY

2nd Edition

Nonprofit Bookkeeping & Accounting

for dummies®

A Wiley Brand

Learn the basics of financial accounting

Prepare for an audit and avoid common mistakes

Balance your nonprofit accounts with ease

Maire Loughran, CPA

Nonprofit Bookkeeping & Accounting

2nd Edition

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Sharon Farris, author of the first edition

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Contents at a Glance

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Introduction

Counting the money in your wallet or purse is an act of accounting. And if you ever make a note of how much you have, you're performing a bookkeeping function. You count things all the time in everyday life without thinking twice about accounting. For example, you count the plates before setting the table at home. You count the number of emails you receive while you're out of the office. Even a gesture such as looking at your watch and thinking about how much time you have before your next appointment is a form of accounting.

Bookkeeping and accounting involve general accounting, cost accounting, budgeting, and internal auditing. Even though your organization is a nonprofit, these services are essential parts of your daily activities. Adjacent to bookkeeping and accounting tasks and important for most nonprofits are external auditing, tax return preparation, and management advisory services.

In the wake of increasing nonprofit accountability, understanding how to track and account for the everyday activities of your nonprofit is important. Keeping the books for a nonprofit is exciting. Getting federal grant money to fund your programs relieves financial stress. Getting a clean bill of health from your financial audit adds credibility.

About This Book

Bookkeeping and accounting for nonprofits involves several fundamental steps. Beginning with a simple transaction such as a donation and ending with financial statements, you go through a yearly accounting cycle of 12 months. The cycle repeats as long as your nonprofit continues to operate.

This book explains normal day-to-day transactions, preparing financial statements, and getting ready for audits. It also discusses keeping your books using a manual or automated system. Thus, this book is helpful for nonprofit directors, managers, bookkeepers, and accountants.

This book is designed to help you with everything you need to know to operate your nonprofit according to generally accepted accounting principles (GAAP). It covers information about the steps to file your own payroll taxes and federal tax Form 990. It also explains how to account for many different nonprofit situations.

This book is a reference tool you can pick up from time to time during your accounting cycle to brush up on the following nonprofit events:

- Entering into a transaction with a second party
- Preparing a business document, such as a sales invoice, that leaves a paper trail
- Recording a transaction in a journal, which is the book of original entry
- Posting journals to the general ledger
- Reporting on financial statements
- Paying taxes and getting ready for audits

This book serves as a reference tool, no matter where you are in the accounting process, by helping you reach your ultimate goal of accurate financial statements.

Within this book, you may note that some web addresses break across two lines of text. If you're reading this book in print and want to visit one of these web pages, simply key in the web address exactly as it's noted in the text, pretending as though the line break doesn't exist. If you're reading this as an e-book, you've got it easy — just click the web address to be taken directly to the web page.

Foolish Assumptions

I assume you don't have more than a rudimentary knowledge of nonprofit accounting, and I'm guessing you're one of the following people:

- The executive director of a newly formed, small nonprofit, wanting to know how to manage your own books
- The director or manager of a midsize nonprofit wanting to understand a little more about how to manage day-to-day accounting operations
- Someone interested in seeking employment keeping the books of a nonprofit organization

» Someone interested in bookkeeping and accounting as a profession
» Someone who has already been performing the functions in this book who's not sure if they've been doing them correctly
» Someone who's thinking about starting their own nonprofit and wanting to know how an effective nonprofit keeps track of its bookkeeping and accounting needs

Icons Used in This Book

Throughout the book, you see the following icons in the margins:

TIP

Text accompanied by the Tip icon contains useful hints you can apply to make handling your nonprofit a bit easier and more successful.

REMEMBER

When you see the Remember icon, warm up your brain cells, because this icon sits next to information you want to commit to memory.

WARNING

Looking for what not to do in the world of nonprofit accounting? Check out paragraphs next to the Warning icon, because they alert you to what can trip you up while working in the field.

TECHNICAL STUFF

The Technical Stuff icon includes information that enhances the topic under discussion but isn't necessary to understand the topic. If you're short on time, you can skip anything marked with this icon.

Beyond the Book

In addition to the material in the print or e-book you're reading right now, this product also comes with a free Cheat Sheet that covers the three key nonprofit financial statements, as well as important terms and definitions. To get this Cheat Sheet, simply go to `www.dummies.com` and type **Nonprofit Bookkeeping & Accounting For Dummies Cheat Sheet** in the Search box.

Where to Go from Here

If you're a nonprofit director wanting to find out how to start keeping your books, turn to Chapter 2 on basic bookkeeping, Chapter 7 on balancing your checkbook, or Chapter 5 on setting up your chart of accounts. If securing a federal grant is on your mind, head to Chapter 11. Check out the table of contents or index for a topic that interests you, or jump in anywhere to find the nonprofit accounting or bookkeeping information you're wondering about.

1 Accounting and Bookkeeping Nonprofit-Style

IN THIS PART . . .

Brush up on basic accounting terminology and financial statements.

Account for your nonprofit's activities using either a manual recordkeeping system or a sophisticated computerized system.

Understand the difference between a debit and a credit.

Find out how to expense assets and which steps you should follow to keep your accounting books in order.

Get a basic understanding of the bookkeeping and accounting processing you need to master to get an approved audit.

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
- Closing the year with financial statements

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.