



nonprofit financial management

A Practical Guide

Charles K. Coe



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Nonprofit Financial Management

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CHARLES K. COE



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*This book is dedicated to the students in my Nonprofit
Financial Management classes, whose care for others gave
me the impetus to write this book.*

Who this Book Is For

The genesis for this book came from my students in a nonprofit financial-management course. Many of them work in or volunteer for nonprofit organizations. They have a deep passion for their cause and the people they serve. They hunger for knowledge that can enable them to use their scarce financial resources as efficiently as possible. Few, though, have a financial background, which is the case for most nonprofit managers. In 2009, there were 1,617,447 nonprofit organizations in the United States, 714,000 of which—about 44 percent—had gross receipts of less than \$25,000. Such an organization typically has an executive director who is knowledgeable about the mission and has experience in service delivery and, perhaps, fundraising, but with little financial expertise. Though appropriate for a nonprofit of any size, this book is especially useful for the nonprofit whose executive director and Board have relatively little experience in financial management.

If you are an instructor, go to www.wiley.com/college (search for the book title) for additional classroom tools including PowerPoint slides, cases, and testing materials, to use alongside the content presented in this book.

Acknowledgments

My most sincere appreciation goes to those who gave their time to review and comment on the book. Nancy Kwansnich, the assistant vice president, Branch Banking & Trust Company, who specializes in nonprofit banking services, reviewed the chapters on cash flow management, investments, and banking. Her long experience working with nonprofits of all sizes gave valuable insights into the particular cash management needs of nonprofits. Also shedding light on cash management was a team of professionals in the city government of Raleigh, North Carolina, namely, Perry James, the finance director; Jerrae Williams, the treasury manager, who has experience as a nonprofit banking specialist; and Jordan Topal, the investments and cash manager, who shared his wisdom about investments and referred me to *The Essentials of Treasury Management*, 2nd ed., the bible for financial professionals.

From the accounting and auditing world, two people were tremendously helpful. Kristen Hoyle, Audit Partner with the firm Thomas, Judy and Tucker, has audited nonprofits for many years and has graciously served on the boards of many nonprofits. Kristen reviewed the chapters relating to accounting, auditing, internal control, and evaluating financial condition. Also providing most valuable input in these areas was Mig Murphy Siström, CPA. Mig served as finance director for a nonprofit with an annual budget over \$10 million. She now provides accounting and tax services exclusively to nonprofits and teaches in the Nonprofit Management Program at Duke University.

Anita White, administrative officer, Haven House, helped me to understand the myriad funding sources that a nonprofit can receive. Exhibit 6.12 in Chapter 6, Prepare and

Manage the Budget, indicates the varying length, fiscal years, payment periods, and reimbursement time of Haven House's various funding sources. Cheryl Perry, procurement and risk service manager for the town of Cary, North Carolina, reviewed the chapters on purchasing and managing capital assets.

Students in my Nonprofit Financial Management class for the fall semester contributed significantly to the effort. Caroline Gibson contributed the notes to the financial statement problem; Kristen Feneley contributed material on contracting with hotels. My son, Lincoln, prepared many of the spreadsheets in the accounting and financial analysis chapters. Charlene Reiss contributed two very useful budgeting cases, as did Johanna Foster with the Wake County Community Service Department. Michael Riley, working as a graduate student, helped with the instructors' website materials. Mac McGee again exhibited his editing mastery to get the book in decent shape.

Chapter 1

Introduction

Background on Nonprofits

There are over 1.6 million nonprofits in the United States. They are diverse in size and mission, ranging from human service organizations to advocacy groups to religious organizations. They are growing rapidly in number. From 1995 to 2005, the nonprofits registered with the Internal Revenue Service (IRS) grew by 27 percent.¹ They are important economically, contributing 7.2 percent of the paid jobs and 6.6 percent of the total wages in the United States (see [Exhibit 1.1](#)).

Although nonprofits are extremely diverse in size in mission, each one must have a sound financial management system.

There are three types of nonprofits: *charity*, *foundation*, and *other*. In 2009, there were about 957,000 charities and 113,000 foundations registered with the IRS as 501(c)(3) organizations (“501(c)(3)s”). The “other” group includes 501(c)(4) registered mutual benefit organizations (e.g., medical plans, civic leagues, and advocacy organizations) and about 350,000 religious organizations not required to register with the IRS, although about half chose to do so.

All nonprofits are exempt from income taxes on their mission-related income, but only 501(c)(3)s can receive *tax-deductible* donations. A 501(c)(3) organization cannot support or oppose anyone running for public office but can engage in a political campaign consistent with its purpose. Most 501(c)(3)s can spend no more than 20 percent of their

resources on lobbying. [Exhibit 1.2](#) shows the types of public charities.

EXHIBIT 1.1 Charities' Employment

Source: Lester Saloman and S. Wojciech Sokolowski, Employment in America's Charities: A Profile (Baltimore: Johns Hopkins Center for Civil Society Studies, 2006).

Category	Number	Percent of U.S. Economy
Paid workers	9.4 million	7.2%
Volunteer workers (FTEs)	4.7 million	3.9%
Total workforce	14.1 million	11.1%
Wages	\$321.6 billion	6.6%

EXHIBIT 1.2 Number of Reporting Public Charities by Subsector

Source: Urban Institute, National Center for Charitable Statistics, Core Files (2007-2008).

Subsector	Number of Organizations	Percent of Total
Arts, culture, and humanities	125,170	7.7%
Education	216,021	13.3%
Environment and animals	58,209	3.6%
Health	101,458	6.3%
Human services	410,028	25.3%
International and foreign affairs	20,737	1.3%
Public and societal benefit	359,160	22.3%
Religion-related	231,858	14.3%
Other	94,806	5.9%
Total	1,617,447	100.0%

Board of Directors

Nonprofit governance and management rests on three legs: the Board of Directors (Board), the chief executive officer (CEO), and the staff. Board members nominate and elect fellow members. Board members have civil immunity for the official actions they take, as do volunteers, but the law does not protect Board members from criminal, intentionally

malicious, or reckless conduct. Board meetings are not subject to open-meeting laws, as government meetings are; however, Board members must exercise care, loyalty and obedience. Board members should:

- Determine the nonprofit's mission and issue the mission statement
- Select, support, and review the performance of the CEO
- Contribute time and resources to the nonprofit
- Raise funds
- Conduct business ethically and professionally
- Make well-informed, engaged decisions
- Adopt the budget
- Oversee the management of funds
- Adopt a human-resource policy
- Follow laws
- Serve on a committee
- Promote the organization's image

The mission statement should succinctly reflect the nonprofit's core values. The Board should adopt the mission statement with input from the CEO, the staff, and stakeholders such as clients, members of the organization and community members. Board members should contribute both time and resources to the nonprofit. Some Board members have needed skill sets. For instance, a Board member who is a certified public accountant (CPA) or has a strong business background can serve on the Finance Committee or even volunteer as the chief financial officer (CFO). Likewise, a Board member who is a lawyer can provide legal advice. Board members should visibly participate in fundraising activities, contributing their own funds, and ask community members to contribute.

Boards with many members typically break down into subcommittees and each Board member should have an

office or committee responsibility. As the policymaking body, the Board adopts policies, including the annual budget. This book discusses an array of financially related policies. For reference to these and other policies, the organization Boardsource offers downloadable policies in 48 topic areas, including 13 financial management policies (see <http://www.boardsource.org/?Bookstore/>).

Management

The second leg is the CEO, either volunteer or paid, who carries out the Board's policies. There is no single package of education and experience necessary to be a successful CEO. She (or he) may be an experienced professional with a graduate degree in public, nonprofit or business administration. Absent a management degree, she may have extensive nonprofit working experience as a program manager or CEO. She may even be a volunteer with limited nonprofit experience.

The CEO should facilitate the Board's interaction with herself and the staff. The CEO should seek broad Board involvement in setting policy. In serving the Board, the CEO should:

- Orient new members
- Help craft a mission statement
- Help adopt a strategic plan and envision change
- Prepare the budget for the Board's adoption
- Manage the budget during the fiscal year
- Provide financial and programmatic information
- Tout the organization's accomplishments to the community

In theory, the Board makes policy decisions that the CEO carries out. In practice, however, many Boards heavily depend on the CEO to engage more in policymaking. This is often because many Boards have an unwieldy size. For

instance, 47 percent of the Boards in Indiana have 10 or more members; 19 percent have between 15 and 29 members.² Another reason for strong CEO influence is Board member turnover. Often, Board members limit themselves to three-year terms.

In addition to Board-related responsibilities, many CEOs are extensive boundary-spanners, interacting with a host of stakeholders, including funders, community leaders, service recipients, volunteers, and staff members. A typical CEO must be entrepreneurial and should be thankful to deal with less red tape and enjoy more flexibility than do government managers.³

Staff

The third leg of the stool is the staff. Many nonprofits have an all- or mostly all-volunteer staff. Volunteers are motivated to serve because of a nonprofit's good works. The CEO and the Board should consistently laud the efforts of volunteers and staff members and compensate staff equitably. The CEO should:

- Follow best practices with regard to hiring and disciplinary action
- Orient new employees
- Build a high-performance management team
- Train employees to do their job
- Treat employees fairly
- Give performance feedback throughout the year, not just at annual performance review

Finances

Most reporting nonprofits have small budgets. Indeed, 44.6 percent had annual expenses less than \$100,000 (see [Exhibit 1.3](#)). Large nonprofits, with expenses of more than

\$10 million, account for only 3.7 percent of nonprofits, but a whopping 82.7 percent of total expenses.

EXHIBIT 1.3 Number and Expenses of Reporting Public Charities

Source: Urban Institute, National Center for Charitable Statistics, NCCS-GuideStar National Nonprofit Research Database: Special Research Version (2005).

Expenses	Percent of Total Charities	Percent of Total Expenses
\$10 million or more	3.7%	82.6%
\$5 million to \$9.99 million	2.6%	5.5%
\$1 million to \$4.99 million	11.4%	7.5%
\$500,000 to \$999,000	8.5%	1.8%
\$100,000 to \$499,000	29.2%	2.0%
Under \$100,000	44.6%	0.6%
Total	100.0%	100.0%

Nonprofits have three main revenue sources. The main revenue, fees for services and goods, includes items such as Medicare and Medicaid reimbursements, ticket sales and tuition payments (see [Exhibit 1.4](#)). The second principal revenue source, private contributions, includes grants and contributions from foundations, individuals and corporations. Other revenue sources are government grants, investment, and other income.

EXHIBIT 1.4 Sources of Revenue for Reporting Public Charities

Source: Urban Institute, National Center for Charitable Statistics, NCCS-GuideStar National Nonprofit Research Database: Special Research Version (2005).

Sources of Revenue	Percent of All Charities	Percent of Charities Excluding Hospitals and Higher Education
Fees for services and goods	70.4%	53.5%
Private contributions	12.3%	23.3%
Government grants	9.0%	17.0%
Investment income	5.4%	2.3%

Sources of Revenue	Percent of All Charities	Percent of Charities Excluding Hospitals and Higher Education
Other Income	2.9%	3.9%
Total	100.0%	100.0%

The revenue picture changes significantly when looking only at human service nonprofits, of which there are eight types: (1) crime and legal, (2) employment and job related, (3) food and nutrition, (4) housing and shelter, (5) public safety and disaster preparedness, (6) youth development, (7) community development, and (8) human service multipurpose organizations. These nonprofits depend far more heavily on government grants (see [Exhibit 1.5](#)).

EXHIBIT 1.5 Sources of Revenue Human Service Nonprofits

Source: The Urban Institute, National Survey of Nonprofit Government Contracting and Grants (2010).

Funding Source	Number of Nonprofits	Largest Funding Source
Government (federal, state, or local units)	19,657	60%
Donations (individual, corporate, foundations, federated giving)	6,124	19%
Fees (public and private) for services	5,179	16%
Other	1,663	5%
Total	32,623	100%

Financial Management Organization

The National Association of Schools of Public Affairs and Administration (NASPAA) has issued guidelines for graduate professional education in nonprofit organizations, management and leadership.⁴ One such guideline requires graduate education to cover in its curriculum budgeting and resource management, including general accounting practices and budget management, risk management, contract monitoring, supervision of grant projects, and

reporting to government agencies, philanthropic foundations, and other funding agencies. To perform these functions, nonprofits organize differently, depending on their size and resources.

Organizational Options

Very small nonprofits rely on a volunteer to do the accounting. Somewhat larger ones have a full- or part-time bookkeeper with some accounting experience and usually structure themselves as shown in [Exhibit 1.6](#). A still larger nonprofit can hire a CFO with an accounting degree and perhaps is a CPA as shown in [Exhibit 1.7](#).

EXHIBIT 1.6 Organization with a Bookkeeper

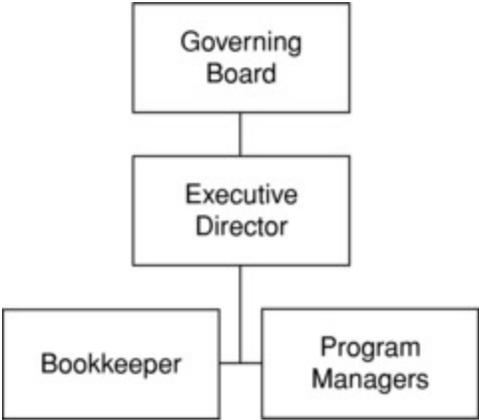
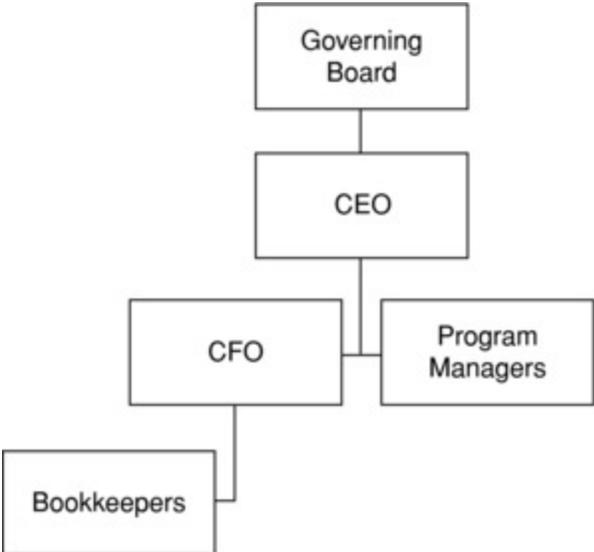


EXHIBIT 1.7 Organization with a CFO



Conclusion

Nonprofits are extremely diverse with regard to their size, mission, funding sources, and organizational structure; however, one constant remains. Each nonprofit should have a *sound* financial management system with which it can be accountable to its funders and perform capably. This book is designed to assist all nonprofits, from the smallest to the largest and most financially sophisticated, to manage their finances responsibly and professionally.

Chapter 2

Account for Transactions

Staffing Structure

Depending on their size and complexity, nonprofits can staff the accounting and financial management function in several ways. Large, relatively complex nonprofits are more likely to have an in-house certified public accountant (CPA). Small, less complex nonprofits can have a non-accountant administrative staff member handle the day-to-day bookkeeping operations and have the books periodically reviewed and adjusted by a CPA adviser. Alternatively, the entire accounting function might be outsourced to a CPA adviser. For organizations that do not need an in-house CPA, outsourcing the accounting work often ensures competency at a lower cost than paying a full-time employee. Regardless of the staffing approach, it is helpful for any nonprofit to have a finance professional, preferably a CPA, on its Board.

Even with a strong staffing structure, it is imperative that the Board and chief executive understand (1) basic accounting terms and (2) the accounting process.

Basic Accounting Terms

The accounting profession, like all others, has its jargon, understandable to accountants but “Greek” to others. Common terms include:

- Fiscal year
- Generally accepted accounting principles
- Basis of accounting

- Chart of accounts
- Functional expense cost allocation
- Single- and double-entry accounting
- Capitalization and depreciation
- Federal grant indirect cost allocation
- Accounting and fundraising software

The Fiscal Year

The fiscal year, sometimes erroneously called the “physical year,” refers to the 12-month period that the nonprofit selects as its accounting year. A nonprofit may choose any 12-month period for its fiscal year. This decision is usually made when the nonprofit initially applies for its tax exemption, using IRS Form 1023 or 1024. Some nonprofits, at the time they are formed, establish their fiscal year to coincide with the grant year or fiscal year of their first funder. For instance, the federal government's fiscal year runs from October 1 to September 30. The fiscal year of states and most local government units is July 1 to June 30. Other funders typically have a fiscal year ending either June 30 or December 31, but some have a different fiscal year.

If the organization has a major program or event that ends at a certain time each year, the fiscal year-end might ideally be shortly after it is completed. For instance, an organization whose primary activity is to work with schools during the academic year might choose to end its fiscal year on July 31, when staff will have more time to close the books in preparation for the year-end audit.

Generally Accepted Accounting Principles (GAAP)

GAAP refers to the set of rules used to record transactions and prepare financial statements. The Financial Accounting

Standards Board (FASB), a private organization supported by the Financial Accounting Foundation, sets the standards for nonprofits and private sector firms. Since July 1, 2009, these rules are collectively organized into a system called the *Accounting Standards Codification* (ASC). ASC did not change the rules; it merely reorganized them. GAAP is organized into about 90 topics, each of which includes subtopics, sections, and subsections. [Exhibit 2.1](#) indicates three principal Statements of Financial Accounting Standards (SFAS) and the ASC reference.

EXHIBIT 2.1 Accounting Standards

Topic	SFAS Standard	ASC Reference
Accounting for contributions	SFAS 116	ASC Section 958-605-25
Required financial statements	SFAS 117	ASC Subtopic 958-205
Investments in debt and equity Securities	SFAS 124	ASC Subtopic 958-320

Generally, non-CPAs need not be familiar with specific passages of ASC, but it is incumbent upon every organization's management and Board of Directors to maintain a level of familiarity with the basic accounting principles sufficient to exercise their fiduciary duties.

Nonprofit leaders who have worked in the sector since before the mid-1990s may be familiar with the term *fund accounting*, which once was the method nonprofits used to account for contributions. Using fund accounting, nonprofits would account for contributions without regard to donor intent and would record money only when received. In contrast, GAAP now require contributions be grouped into three categories of net assets, depending on a donor's intent.

- 1. Permanently restricted.** Assets, such as endowments, land, and artwork, that the donor permanently restricts. In an endowment, the nonprofit must keep intact the corpus of the gift in perpetuity and can spend only investment income.

2. Temporarily restricted. Funds temporarily restricted to a particular use, (e.g., a contribution to be used only by a donor-specified program or campaign or only at or after a certain time.

3. Unrestricted. Funds free of donor-imposed restriction, such as unrestricted contributions grants.

[Exhibit 2.2](#) shows where to record different types of transactions in a net asset account.

EXHIBIT 2.2 Net Asset Accounts

Transaction	Unrestricted Asset	Temporarily Restricted Asset	Permanently Restricted Asset
An individual sends a check for \$2,000 to support the nonprofit's general operations.	X		
An individual donates \$1,000 to pay four students to participate in a camp run by the nonprofit.		X	
A local government grants \$50,000 for a building campaign.		X	
An individual gives \$150,000 to provide scholarships in perpetuity to two students from the interest on the principal.			X
A special events auction raises \$30,000 for the nonprofit.	X		
A foundation awards a \$10,000 grant for a three-year period.		X	

Basis of Accounting

The basis of accounting specifies how to record and report income and expenses. There are three bases of accounting:

- 1.** Cash accounting
- 2.** Accrual accounting
- 3.** Modified cash accounting

The *cash basis* of accounting, similar to making a checkbook entry, records income when cash is received and records expenses when they are paid. The *accrual basis* of

accounting, in contrast, records income when *earned* and expenses when *incurred*. For example, using the accrual basis, a foundation award of \$25,000 is recorded at the time the grant is announced though the funds are not received until later. Similarly, an expense is recorded when it is obligated in the form of a purchase order or contract, though the bill is not paid until later.

Cash accounting, though simpler and less expensive than accrual, inaccurately reflects the financial position. Revenues are *understated* by the amount of awarded grants not yet received and by program-service revenues receivable. On the other hand, the available balance in accounts is *overstated* by the amount of purchase orders and contracts for which the nonprofit is obligated. [Exhibit 2.3](#) shows how the available balance changes with cash and accrual accounting. Assume a nonprofit has \$100,000 in unrestricted net assets but has billed for grant reimbursements for \$50,000 and has \$30,000 in outstanding purchase orders and contracts, what is the amount of unrestricted net assets in an accrual versus cash basis accounting system?

EXHIBIT 2.3 Cash vs. Accrual Accounting

	Accrual Basis	Cash Basis
Unrestricted net assets	\$100,000	\$100,000
Outstanding grant reimbursements	+60,000	
Outstanding purchase orders and contracts	-40,000	
Unrestricted net assets	\$120,000	\$100,000

Moreover, cash accounting does not comply with GAAP, which means that the auditor cannot give an unqualified opinion that the financial statements comply with GAAP. To comply with GAAP, all but the smallest nonprofits must use accrual accounting.¹ There are two ways to perform accrual accounting:

- 1.** Accrual accounting throughout the fiscal year

2. Cash accounting during the fiscal year but convert to the accrual basis at the end of the fiscal year for financial reporting

Year-round accrual accounting requires more expertise than cash accounting. The other option, to convert from cash to accrual at fiscal year-end, is less expensive but does not afford an accurate financial picture during the fiscal year. A nonprofit with an experienced accounting professional can make the year-end conversion from cash to accrual; however, nonprofits without such expertise must pay a CPA advisor, not their auditor, to make the conversion. Making the conversion from cash to accrual would compromise the independence that an auditor must have to audit the financial statements.

Some nonprofits use a third basis of accounting, the *modified cash basis*, which records some transactions on a cash basis and others on an accrual basis. For example, unpaid bills are recorded on an accrual basis but uncollected income on a cash basis.

The Chart of Accounts

A *chart of accounts* (COA) is a list of uniquely numbered accounts, typically arranged in order of their appearance in the financial statements. Nonprofits are not required to follow a standard chart of accounts. While suitable for large nonprofits, the Unified Chart of Accounts, with over 1,200 accounts, is too complex for medium- and small-sized ones. In designing the accounting system, each nonprofit, regardless of size, should ensure that its COA meets its *particular* reporting needs. Adopting a rigid COA that cannot be easily changed can lead to future reporting problems if the account structure cannot produce reports in a needed format. The COA should be flexible enough to permit changes. For instance, the account codes may need

modification to add cost and revenue centers. Most nonprofits need assistance from a CPA to design their COA.

What follows is an explanation of the accounts in a COA. All nonprofits must file annually one of three Form 990s with the IRS.² Thus, explained below are the accounts in IRS Form 990, which fall into five classifications:³

Type of Accounts	Location in IRS Form 990
Asset accounts	Part X
Liability accounts	Part X
Net-Asset accounts	Part X
Revenue accounts	Part VIII
Expense accounts	Part IX

Assets Accounts (Found in Part X of IRS Form 990)

An asset is something owned or pledged, including the accounts described in [Exhibit 2.4](#).

EXHIBIT 2.4 Assets Accounts

Assets Account	Line on 990	Explanation (Line)
Cash	1	Cash held including “petty cash” and cash in non-interest-bearing bank accounts but not cash held in investment accounts
Savings and temporary cash investments	2	Short-term investments readily convertible into cash (e.g., U.S. Treasury Bills, saving accounts, money market funds) ⁴
Receivables	3-7	Money owed from pledges and grants (line 3), accounts receivable (line 4), officers and key employees (line 4), other qualified persons (line 6), and notes and loans (line 7)
Inventories for sale or use	8	Materials, goods and supplies held for future use or sale
Prepaid expenses and deferred charges	9	Short- and long-term prepayments of expenses
Land, buildings, and equipment	10a	Cost of land, buildings, and equipment held at the end of the year
Accumulated depreciation	10b	Accumulated depreciation of the assets reported on line 10a