



# FISCAL MANAGEMENT

Dear Colleague,

On behalf of the National Minority AIDS Council (NMAC), thank you for picking up this manual and taking a step toward increasing your capacity in this struggle. As we enter the third decade of HIV/AIDS, it is more important than ever to develop our skills and knowledge to better serve our communities and our constituents.

NMAC, established in 1987 as the premier national organization dedicated to developing leadership within communities of color to address the challenge of HIV/AIDS, works to proactively produce and provide skills-building tools to our community. One such tool is the manual that you hold in your hands.

The Technical Assistance, Training and Treatment Division's mission to build the capacity and strength of community-based organizations, community planning groups for HIV prevention and health departments throughout the United States and its territories is supported through a multifaceted approach. This approach includes individualized capacity-building assistance, written information (manuals, publications and information provided through NMAC's website and broadcast e-mail messages) and interactive learning experiences (trainings). All components are integral to providing a comprehensive capacity-building assistance experience, as opposed to offering isolated instances or random episodes of assistance.

After undergoing a revision of existing curricula and publications and an expansion of our current catalog of subject areas to include more organization infrastructure topics, NMAC is proud to present you with this new manual, Fiscal Management. One of 15 topic areas in which we provide capacity-building assistance, this manual will provide you with detailed information, resources and the knowledge to enhance your capacity to provide much-needed services in your community.

Our hope is that this revised manual will give you the skills and knowledge to increase your capacity and serve your community at a greater level than ever before. Please feel free to contact us if you would like further information on other services we can provide to you and your community.

Yours in the struggle,

A handwritten signature in black ink, appearing to read 'Paul Akio Kawata'. The signature is stylized with bold, fluid strokes.

Paul Akio Kawata  
Executive Director

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# Preface

## Organizational Effectiveness

Successful community-based organizations (CBOs) can attribute their success to employing 15 key components that support organizational effectiveness. See the model below.

Ongoing learning and training in each of these areas will allow your organization to meet the needs of your constituents.

For information regarding training in any of these areas, contact the National Minority AIDS Council's Technical Assistance, Training and Treatment Division by telephone at (202) 234-5120 or by e-mail at [ta\\_info@nmac.org](mailto:ta_info@nmac.org).

## ORGANIZATIONAL EFFECTIVENESS MODEL

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# Introduction

## Purpose

Effective human services programs operate in the context of a well-managed and effectively administered organization and are supported by a solid fiscal management system. For nonprofit organizations (NPOs), fiscal management systems include financial planning, budgeting, cash management and accounting systems. Also, NPOs must operate systems for payroll, accounts payable, accounts receivable, grants management, cost allocation and fiscal reporting. Finally, NPOs are subject to audit. All these are integral parts of fiscal management.

The purpose of this training is to present the fundamentals and practical aspects of fiscal management. Participants who will benefit most include executive directors, chief financial officers, program directors and others responsible for major decisions of an organization. This is an elementary level course.

## Learning Objectives

Upon completion of this manual learners will be able to:

- ✓ Explain the major differences between for-profit organizations and NPOs;
- ✓ Identify the basic components of a fiscal management system;
- ✓ Describe the roles and responsibility of the board of directors, the executive director and program managers in fiscal management;
- ✓ Describe the linkage between financial and strategic planning;
- ✓ Identify the basic elements of financial planning and how to prepare a financial plan;
- ✓ Prepare and monitor a budget;
- ✓ Interpret financial statements, fiscal reports and audit reports, using basic techniques and simple calculations;
- ✓ Explain cash flow and the importance of cash management;
- ✓ Explain the basic concepts of managing accounts receivable;
- ✓ Explain the need for and importance of audits;
- ✓ State the major differences between an audit of the financial statements and the single audit (A-133);
- ✓ State the basic principles of internal control and be able to establish staff assignments that separate duties;
- ✓ Prepare a cost allocation plan;
- ✓ Explain how to utilize unit costs and cost allocation as a strategic tool; and
- ✓ Explain how to include financial information for practical decision making in nonprofit organizations.

## Pre-training Assessment

The Reality Check Assessment is an opportunity for you to check your knowledge against the information that will be addressed in this manual. You will have an opportunity to complete the assessment in the introduction unit. The correct responses to the assessment will be revealed in an activity in the last unit of the manual.

### Pre-training Assessment

Please circle the following statements True or False.

1. **True**    **False**    Only the chief financial officer of the NPO needs to be concerned about fiscal management.
2. **True**    **False**    The major difference between for-profit and nonprofit organizations is the use that is made of the profits that are earned.
3. **True**    **False**    Once a budget is approved by the board of directors, it should not be changed.
4. **True**    **False**    Every opportunity for obtaining new grant funds should be taken.
5. **True**    **False**    Financial planning is done before strategic planning.
6. **True**    **False**    Financial statements can be interpreted by use of ratios.
7. **True**    **False**    The treasurer is responsible for keeping an organization's books.
8. **True**    **False**    Internal control might include separation of duties among several employees.
9. **True**    **False**    NPOs should establish reserve funds to accommodate a cash shortage when routine expenses fall before the income to pay for the services is received.
10. **True**    **False**    Employees should complete time sheets showing the program areas in which they worked.
11. **True**    **False**    The auditor guarantees that financial statements are right and that no theft or mismanagement has occurred.
12. **True**    **False**    It is as important to know what the service will cost as it is to know how much the funder will pay for the service.

Check answers on page 64, after reading the manual thoroughly.

## Check the Pulse

This manual was developed based on feedback from other community-based organizations. The “Check the Pulse” exercise provides you with the opportunity to tailor this workshop to meet your learning needs by identifying and developing your most significant learning objectives. Consider what would be beneficial to you and to your organization.

### Exercise 1: Check the Pulse

This exercise is an opportunity for you to tailor this workshop to meet your needs. It is also an opportunity for you to think about what skills and information you bring to this workshop that can benefit others.

#### Directions:

- ✓ Review the learning objectives for each unit.
- ✓ Under Check the Pulse, list your learning objectives. Think about what knowledge and skills you would like to acquire in this unit.
- ✓ Then list what you have to offer to others on the unit topic. What experiences could you share with others?
- ✓ Repeat this process for each unit in this manual.
- ✓ Now, go back and review your learning objectives for each unit. Identify the most important learning objectives. Write the objectives below:

My most important learning objectives:

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# UNIT 1:

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## Overview of the Fiscal Management System

### Purpose:

To gain a better understanding of fiscal management. Effective human services programs operate in the context of a well-managed, effectively administered organization and are supported by a solid fiscal management system. Nonprofit organizations' (NPOs) fiscal management systems encompass financial planning, budgeting, cash management and accounting systems. NPOs must operate systems for payroll, accounts payable, accounts receivable, grants management, cost allocation and fiscal reporting. In addition, NPOs are subject to audit. All of these are part of fiscal management.

### Learning Objectives:

By the end of this unit, learners will be able to:

- ✓ List the basic components of a fiscal management system.
- ✓ Describe the roles and responsibilities of the board of directors, the executive director and program managers in fiscal management.

# I. Basic Components of a Fiscal Management System

The basic components of a fiscal management system include:

- ✓ **Financial planning:** the process of identifying the resources that are needed to implement the strategic plan. A financial plan is similar to the organization's budget because it identifies revenues and expenses. However, the financial plan usually covers a time period of two to five years while the budget is usually a one-year plan.
- ✓ **Budget management:** the system for developing, approving and managing the budget. Each organizational unit or program area is responsible for working with the chief executive officer (CEO) and/or the chief financial officer (CFO) to develop or request its budget for the coming year. The budget is approved by the board of directors (the board) or the governing body. The CFO is responsible for monitoring revenues and expenses and for identifying variances from the budget.
- ✓ **Cash management:** the system for ensuring that the organization has sufficient cash to meet its needs. Employees reconcile and review bank statements and account balances regularly to ensure accuracy.
- ✓ **The accounting system:** a system that conforms to fiscal policies and procedures approved by the board or the governing body. The accounting system operates with a chart of accounts that matches revenue and expenses to funding sources, organizational units and/or multiple sites.
- ✓ **Payroll:** the operation of compensation of employees. It includes controls on hiring, firing and salary adjustments. Payroll requires documentation of time and effort. Payroll accounts for time off, advances or loans to employees, employees' withholding taxes and employer taxes.
- ✓ **Accounts receivable:** the system used to manage the amounts owed to the organization by its customers. Most providers of human services meet with customers to determine customers' fees based on a sliding scale. The accounts receivable system usually includes billing to third party payers such as Medicaid or Medicare.
- ✓ **Accounts payable:** the system for managing the amounts paid out to the organization's vendors. Accounts payable usually requires approval of purchase orders for large items or employee travel reimbursement and the co-signing of checks.
- ✓ **Purchasing and fixed assets:** the systems that control the buying of and accounting for assets or equipment. A periodic inventory of assets is performed. Depreciation, which is the decline in the value of an asset over time, may be tracked in a system of accounting for fixed assets.
- ✓ **Grants management:** the system for ensuring compliance with requirements of grants or contracts. Usually, the grant or contract specifies expenditure or line item controls, performance measures, deliverables and reporting requirements.

## CHART OF ACCOUNTS

Numbered list of a company's accounts.

## COST ALLOCATION PLAN

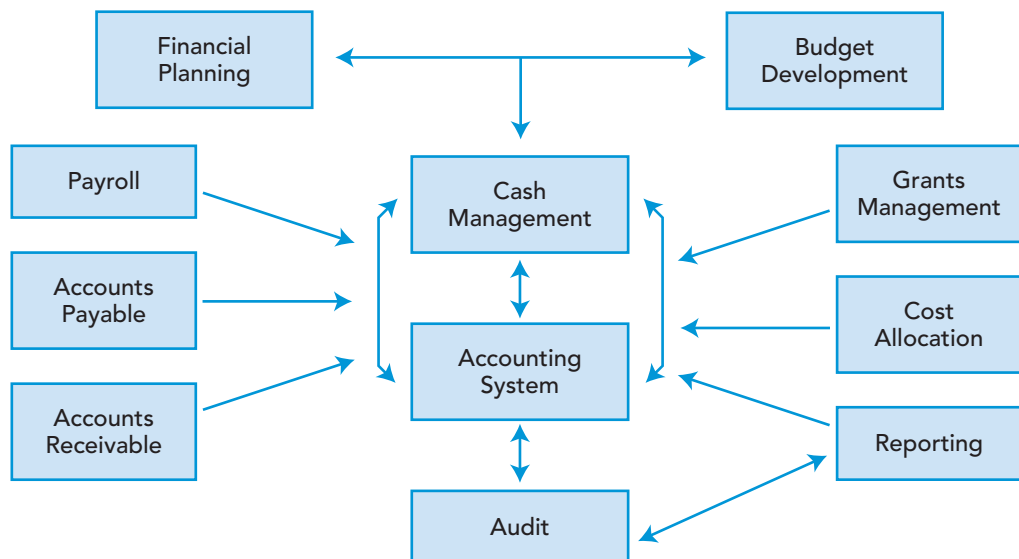
The assigning of indirect costs to the chosen cost center.

- ✓ **Cost allocation plan:** the method for allocating revenue and expenses to the organizational divisions or functional areas. The cost allocation plan ensures that each organizational program area bears a proportionate share of administrative costs of the organization. The cost allocation plan tracks employee time and effort to ensure that labor costs are charged to the appropriate organizational unit.
- ✓ **Reporting:** the system that presents all fiscal information in formats that are useful for decision making. Reporting includes internal reports, reports to the board or governing body and reports to grantors or other funding sources.

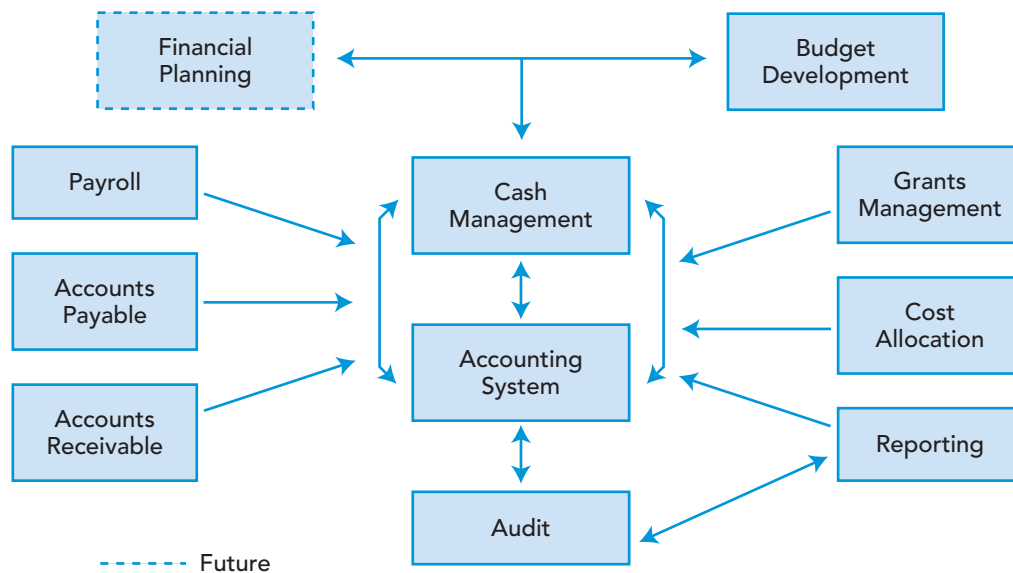
## Participant Exercise

The following flowchart, "Basic Fiscal System," depicts the relationship of the components within the fiscal management system. The next flowchart, "NPO Fiscal System with Future Needs," provides an example of an NPO flowchart that is missing some components. Using colored pens, complete the assessment flowchart to identify the gaps in your NPO's fiscal management system.

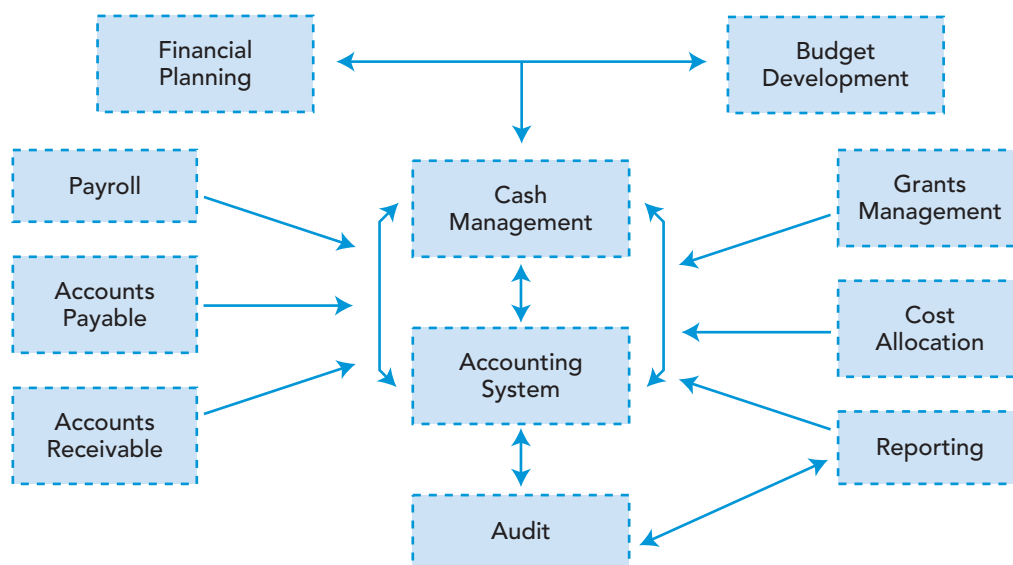
## BASIC FISCAL SYSTEM



## SAMPLE: NPO FISCAL SYSTEM WITH FUTURE NEEDS



## ASSESS THE NEEDS OF YOUR ORGANIZATION



## II. The Differences Between For-Profit and Nonprofit Organizations

The major differences and similarities between nonprofit organizations (NPOs) and for-profit organizations (FPOs) are shown in the table below.

	For-Profit (private inurement doctrine)	Nonprofit (not permitted to use the private inurement doctrine)
<b>Tax Exempted Status</b>	No	Tax-exempted
<b>Sources of Income</b>	Shareholders Operation of the organization	Donors Operation of the organization
<b>Usual Purpose</b>	Increase shareholder value	Charitable service to the community
<b>When the Operation Generates Earnings</b>	Shareholders may receive dividends	No dividends paid; earnings directed to charitable purposes
<b>Usual Term for Earnings</b>	Profit	Increase in fund balance or net assets; profit
<b>Usual Term for Loss</b>	Loss	Decrease in fund balance or net assets; loss

### NONPROFIT ORGANIZATION

Corporation that has been granted tax-exempt status by the Internal Revenue Service.

### FUND BALANCE (ALSO CALLED NET ASSETS, NET WORTH OR EQUITY)

Total assets minus total liabilities.

### EQUITY

Ownership interest in a business.

One of the differences between FPOs and NPOs is that shareholders provide equity for profit while donors provide equity through donations. However, both can, and in most cases should, gain equity through operations. The major functional difference between FPOs and NPOs is what can be done with the profit gained through operations. FPOs can pay dividends with the profits generated through their operations. NPOs cannot distribute dividends to their members. Rather, the equity NPOs generate must be put back into their programs. In other words, NPOs can generate profits or surplus, and those that do so are in a position to provide their communities with more stable services.

Because the customers of NPOs often cannot afford to pay for services, organizations frequently lose money on every "sale." As a result, an increase in the number of clients or customers may increase the likelihood of a fiscal crisis. However, turning a profit may mean that an NPO has turned away consumers, including, perhaps, the neediest. To determine an NPO's success, it is necessary to look at its goals. The board can measure success by comparing the results achieved with the results sought. This points to the importance of a clear mission statement as well as regularly updated short- and long-term goals that reflect an NPO's purpose. It also underscores the need to look at service data in conjunction with financial statements. In this way, the board can begin to measure whether the agency is meeting its goals.

### III. Roles in Fiscal Management

The board of directors and its subcommittees has a responsibility for the public trust because the NPO is tax-exempt. The board has responsibility for fiscal oversight. Examples of tasks performed by the board are:

- ✓ Establishing policies that govern the resources of the NPO.
- ✓ Approving and monitoring the budget.
- ✓ Selecting and engaging the auditor and receiving the report of the auditor.

#### **PROFIT (ALSO CALLED INCOME)**

Increase in net assets over a specified period of time.

The executive director (ED) reports to and advises the board. The ED oversees the operations of the NPO and is responsible for ensuring that the NPO operates in accordance with board policy. Examples of tasks performed by the ED are:

- ✓ Supervising all programs operated by the organization (may be done in concert with intermediate supervisors or program managers).
- ✓ Managing, directing and assigning the NPO's human, financial and physical resources.
- ✓ Supervising the preparation of the budget.

#### **FINANCIAL STATEMENTS**

Standard set of reports that document a company's financial status. Produced at least annually, they include a statement of activities, a statement of financial position, a cash flow statement and explanatory notes.

The chief financial officer (CFO) is responsible for the operation of all fiscal systems. Examples of tasks performed by CFO are:

- ✓ Preparing the budget, with input from program managers and other staff.
- ✓ Supervising the operation of the accounting system.
- ✓ Preparing special analyses or fiscal reports.

Program managers are responsible for planning and implementing a program or functional unit. Examples of tasks performed by the program managers are:

- ✓ Operating the program and managing resources in accordance with a budget.
- ✓ Resolving or explaining budget variances.

# UNIT 2:

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## Financial Planning and Budgeting

### **Purpose:**

To examine the basic elements of a financial plan and of the budget management system. We will complete an exercise in budget preparation.

### **Learning Objectives:**

By the end of this unit, learners will be able to:

- ✓ Describe the linkage between financial planning and strategic planning.
- ✓ State the basic elements of financial planning.

**S**trategic planning is a disciplined effort to produce fundamental decisions and actions that shape and guide what an organization is, what it does and why it does it. Strategic planning usually engages all the key decision makers in the organization. Strategic planning often entails an analysis of the organization's strengths, weaknesses, opportunities and the threats it could face.

Strategic planning deals with what the NPO plans to do. Financial planning is one of several tools for deciding how to accomplish the objectives of the strategic plan. Strategic planning is the framework that guides the choices that determine an organization's nature and direction. A strategic plan usually includes a mission statement and sets forth goals, objectives and strategies for the organization, covers a time period of three to five years and is followed by a financial plan.

Financial planning is the development and implementation of coordinated plans for the achievement of the enterprise's overall financial objectives. Just as the strategic plan identifies goals, the financial plan identifies objectives. Financial objectives usually relate to improvements in the organization's financial position or increased profitability. Examples of financial objectives include:

- ✓ Maintaining a specified cash reserve.
- ✓ Maintaining a specified current ratio.
- ✓ Maintaining a set percentage of program services, management, general or fundraising costs.
- ✓ Specifying a desired amount of income or rate of return to be derived from investment assets.
- ✓ Maintaining a level of pay that is above the general labor market in order to attract and retain the number and level of staff members needed.
- ✓ Specifying the amount of risk that the agency is able to assume on potential liabilities.
- ✓ Owning a for-profit venture that returns a 5 percent after-tax profit.
- ✓ Entering into a joint venture with another organization to expand the number of clients served.
- ✓ Limiting the amount of Medicaid revenue to a specified percentage.

#### **CURRENT RATIO**

Measure of liquidity or the company's ability to meet currently maturing or short-term obligations.

#### **INCOME (ALSO CALLED PROFIT)**

Increase in net assets over a specified period of time.

#### **LABOR**

Salaries, wages and fringe benefits paid to employees (may also include payments to contractors).

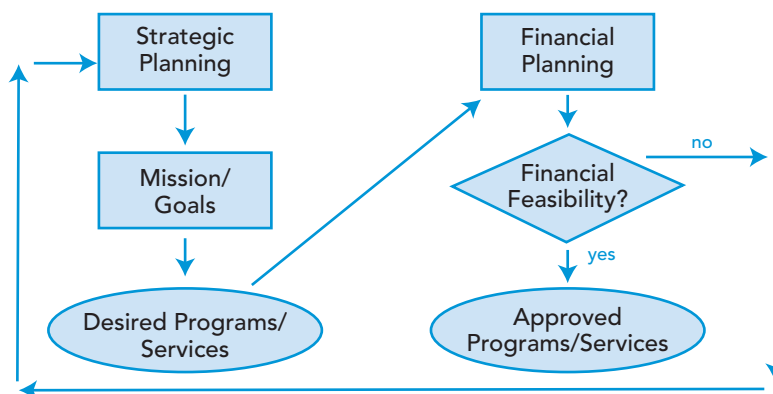
## **I. Financial Planning**

Most observers agree that financial policy and financial planning should be closely integrated with the strategic-planning process. Briefly, strategic planning is predicated on the values of the organization and is concerned with two basic decision outcomes. First, a statement of mission and/or goals is required to provide guidance to the organization. Second, a set of



programs or activities to which the organization will commit resources during the planning period is defined.

The chart below shows the integration of the financial-planning process with the strategic-planning process.



#### FINANCIAL PLAN

Quantitative expression of a plan of action, usually with a time horizon of two to five years and usually entailing feasibility studies or comparative analyses of options.

Financial planning assesses the financial feasibility of the programs and services provided or to be provided by the NPO. In many cases, a desired set of programs and services may not be financially feasible. This may necessitate extended planning and negotiations with the funding sources to find a way to work together to implement programs.

Strategic planning should come **before** financial planning. The financial plan identifies the resources that are needed to implement the strategic plan. It projects revenues or profits that may be redirected to the implementation of the strategic objectives. Also, it identifies financial shortfalls and any seasonal or cyclical cash flows that may affect implementation of the strategic objectives.

Successful financial planning requires an accounting system that is capable of providing costs, revenue and volumes (numbers of services provided or numbers of people served) and data for organizational units or program areas.

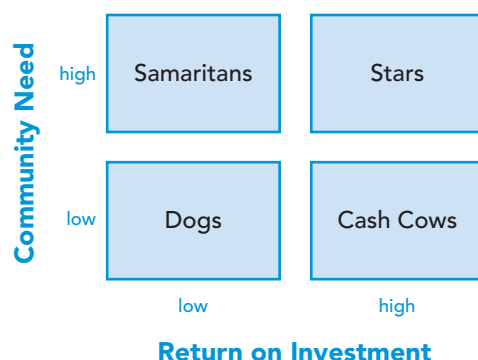
We recommend that NPOs considering the addition or expansion of programs consider value of the program in the community and the profitability or return on investment.

#### RETURN ON INVESTMENT

Amount earned by an investment minus the cost of the investment.

The figure (below) categorizes programs as "dogs," "cash cows," "stars" and "Samaritans." With the exception of Samaritans, these terms are identical to those used in the financial literature. An example of a Samaritan is a program with a small or negative return on investment but a high community need. Thus, an NPO may offer a specialized program that loses money but meets a community need not addressed by any other organization. The program can continue if the NPO has some stars or cash cows to subsidize the program's poor profitability or if the funding authorities will subsidize the program. Dogs (i.e., programs with low community need and low profit), should be considered in light of the resources they draw away from potential Samaritans. Cash cows (i.e., programs with high profit and low community need) are, unfortunately, rare

among NPOs. When they exist, they are often small programs that exist only to provide income to the organization (e.g., a thrift shop).



Financial planning may also include an analysis of the NPO's financial statements and fiscal reports. This analysis will demonstrate how well the organization has performed. It will identify the programs that have contributed to the NPO's success and those that have not. The analysis will identify changes that are needed to improve future performance and create resources for the desired strategic objectives.

## II. Budgeting

A budget is a statement of the financial costs of an organization for a definite period of time based on estimates of expenses during the period and proposals for funding them.

The rules of budgeting are as follows:

- ✓ Any budget or plan is only as good as the time, effort and information people put into it. Good budget practices should foster collaboration and exchange of information among the budget team participants.
- ✓ No budget or plan is perfect because none of us can predict the future.
- ✓ In order to reach the goals, all budgets and plans must be monitored and changed as time goes on.

Each functional area of the organization is responsible for developing its budget and is accountable for managing revenue and expenses within the budget. All the budgets of the various programs are consolidated into the organizational operating budget. Budgets should identify income and expenses for the organization for a year.

### BUDGET

Quantitative expression of a plan of action and an aid to the coordination and implementation of the plan.

### EXPENSE

Cost of goods or services that are used by a company in an effort to generate revenue.

#### REVENUE

Amount received by a company, including earned revenue, such as sales of products or services, and revenue from investments.

All labor costs, supplies, travel, equipment, contractual services and other considerations should be included and all units, programs and activities should be delineated.

Different sources of funding or types of income may affect budgeting. For example, unrestricted funds are budgeted largely at the discretion of the nonprofit organization and may be assigned to any budget category or line item. Also, unrestricted funds may be reassigned with budget modifications made in accordance with organizational policy. However, contract or grant funds may be restricted for specific purposes and, as such, may specify eligibility requirements for consumers of the services. They may also specify budget category or line items. Therefore, it may be necessary to have the pre-approval of the funding source to modify or change the budget. In addition, compliance with the grant or contract budget may be subject to audit.

### III. Monitoring the Budget

Budgets are used to monitor performance. Financial reports are used to identify variances from the budget and possible problems. Top and middle NPO management may compare approved budgets to actual financial reports to assess progress and monitor expenses. Regular comparisons will also help managers identify income shortfalls in revenue, excessive expenses or operational problems early enough to take appropriate action.

Program and unit managers should receive monthly reports on actual versus budgeted expenses and income for their areas of responsibility. These reports should identify variances from the budget. The program or unit manager should be asked to explain any differences beyond a specified percentage or amount.

The chief financial officer (CFO) and program managers should work closely together to identify potential or emerging problems and develop plans for correcting them. If budget variances are identified early enough, simple corrective actions may be adequate (e.g., postponing filling new or vacant positions, deferring nonessential purchases, looking for alternative sources of revenue or restricting travel or training). If the budget variances are large or discovered late in the fiscal year, more severe action may be required (e.g., freeze on hiring or purchasing or staff layoffs). It is important to act immediately when budget variances are found. Most problems worsen over time and delays in resolving them can lead to serious deficits, operational problems and potential difficulties with funding sources.

## IV. Budget Variance Analysis

Budgets may be categorized in one of two conditions. A budget is **static** if it operates in a stable environment, at predictable levels of revenue, expense, volume of services, etc. A budget is **flexible** if it operates in an uncertain environment; however, revenue and expense may vary according to volume of services.

A budget management system identifies budget variances. Variances are differences between actual and budgeted amounts, and they can be favorable or unfavorable (positive or negative). For example, if an organization collects more revenue than is budgeted, that is a favorable variance. Then, the organization may modify the budget to increase spending by hiring more staff, buying new equipment, approving raises for staff or by taking other actions. An unfavorable variance occurs if revenue earned is less than the budget or if expenses are greater. Then, management may need to cut spending in order to avoid a deficit.

Ideally, the budget management system will focus primarily on variance analysis of items that are significant or items that can be controlled. Variance analysis displays the budget amount, the actual amount and the amount of the difference. Sometimes, the variance is also expressed as a percentage of the budget. This format allows management to identify problems early and take corrective action if necessary. The following is an example of budget variance analysis.

Item	Budget	Actual	Favorable Variance (Unfavorable Variance)
Revenue	210,000	190,000	(20,000)
Salaries	140,000	100,000	40,000
Non-Labor Expenses	60,000	63,000	(3,000)
Surplus (Deficit)	10,000	27,000	17,000

### Learner Exercise

Review the above example of the budget variance analysis. What are some factors that could cause these variances? What are some possible corrective actions?

# UNIT 3:

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## Financial Statements and Reports

### **Purpose:**

In this unit, we will identify the major types of financial statements and use basic techniques and simple calculations to interpret them.

### **Learning Objectives:**

By the end of this unit, learners will be able to:

- ✓ Identify the basic types of financial statements and understand their purpose.
- ✓ Perform simple calculations to interpret financial reports.

# I. Financial Reports

**F**inancial reports, usually produced on a monthly basis, give managers the opportunity to review their organization's financial position. At the time of the report, the overall performance of the organization is shown in terms of gain or loss during the period of time covered, the performance of the organization relative to budgeted goals, and how well each area of the organization is doing relative to budgeted goals. Managers may also find it useful to review aspects of billing and payment activity pertaining to the length of time between service provision and receipt of payment. In addition, managers may wish to develop other reports that give staff members feedback on how their performance contributes to the organization's financial health. Important elements are:

- ✓ The **statement of financial position** (formerly called the balance sheet) presents the organization's financial position (i.e., the value or worth of the organization at a given time).
- ✓ The **consolidated activity statement** presents the overall organization's performance for the report period.
- ✓ The **activity statement by cost center** (service center or revenue center) presents the performance of a cost center (e.g., program or area) for the report period.
- ✓ The **statement of cash flows** shows an organization's cash receipts and payments.

## Statement of Financial Position

The statement of financial position presents an overall picture of the organization's financial position at the end of the report period. In very broad terms, fund balance is the difference between the organization's assets and liabilities, with assets being the economic resources of the organization and liabilities being obligations to pay.

The statement of financial position reports:

- ✓ What is owned by the organization (assets) at a specific point in time;
- ✓ What is owed by the organization (liabilities) at a specific point in time; and
- ✓ The value or worth of the organization (assets minus liabilities) at a specific point in time.

Elements of the statement of financial position include:

- ✓ **Assets:** Resources that could potentially provide the organization with future economic services or benefits (what the organization owns). Examples of assets are cash, investments, pledges to make donations, accounts receivable, equipment and furniture.

### STATEMENT OF FINANCIAL POSITION (ALSO CALLED BALANCE SHEET)

A statement that shows a company's financial position at a particular point in time.

### COST CENTER

Responsibility center for which a manager is accountable.

### ASSET

A company's resource that has future value. Includes tangible assets (e.g., buildings, cash, inventories, land, supplies, vehicles) and intangible assets (e.g., copyrights, patents, drilling rights).

### ACCOUNTS RECEIVABLE

Amount owed to a company by customers who purchase goods and services on account.

### ACCOUNTS PAYABLE

Amount owed to vendors for goods and services received but not yet paid for.

- ✓ **Liabilities:** Obligations of the organization to make payments of a determined amount at a future time for benefits or services received currently or in the past (what the organization owes). Examples of liabilities are accounts payable, wages owed to employees, mortgages and lines of credit outstanding (net assets = assets – liabilities).
- ✓ **Net Assets:** Represent the difference between assets and liabilities (the net worth of the organization).

## II. Statement of Activities

The **consolidated activity statement** presents activity over a period of time—annually, monthly, quarterly—consolidated for the organization. It includes the organization’s bottom line, that is, the net assets for the report period.

### STATEMENT OF ACTIVITIES (ALSO CALLED PROFIT AND LOSS STATEMENT)

Summary of a company’s revenues and expenses for an accounting period.

The **consolidated activity statement** usually presents supports and revenue such as grants, donations, patient fees, investment income and fundraising income.

The **consolidated activity statement** also includes expenses, usually accrued and categorized by line items. Expenses include salaries, consultant fees, employees’ fringe benefits, rent, utilities, supplies, travel costs and other such items. In addition, the organization might acquire money in the form of donations.

Finally, all of the figures are combined, leading to the profit or loss, or in nonprofit language, the change in fund balance or change in net assets.

Elements of the statement of activities include:

- ✓ Revenues from providing services, fundraising, investments or other activities of the organization.
- ✓ Expenses incurred in the operation of the organization.
- ✓ Gains or increases in net assets.
- ✓ Losses or decreases in net assets.

### STATEMENT OF CASH FLOWS

Statement that shows cash coming in and going out over an accounting period.

### Statement of Cash Flows

The statement of cash flows shows an organization’s cash receipts and payments over a period of time, set up by principal categories and uses. Cash receipts and payments are categorized as operating, investing and financing activities. Operating cash receipts and payments arise from the organization’s primary business. For example, fees collected for providing counseling services are considered operating cash receipts. Investing and financing activities may also generate cash receipts and

payments. For example, interest earned on a cash reserve account is a cash receipt from an investing activity. The statement of cash flows provides information regarding the sources and uses of cash.

## Elements of the Statement of Cash Flows

Cash flows from operating activities include:

- ✓ Cash received from clients, contributors, grants, contracts, payors, etc.
- ✓ Cash used to provide services, solicit funds and generate goods for sale such as salaries, rent, inventory, administrative and other operating costs.
- ✓ Cash receipts from both short- and long-term notes receivable from service recipients or customers.
- ✓ Payments on customer accounts.
- ✓ Short- and long-term notes payable to suppliers for materials or goods.
- ✓ Interest and dividend income.
- ✓ Interest expense.

Cash flows from investing activities include cash received and disbursed as a result of the following activities:

- ✓ Lending money and collecting on loans.
- ✓ Acquiring and selling or disposing of securities that are not cash equivalents.

Cash flows from financing activities include cash received and disbursed as a result of the following activities:

- ✓ Borrowing resources from founders or officers of the organization.
- ✓ Receiving restricted resources that by donor stipulation must be used for long-term purposes.
- ✓ Borrowing money and repaying amounts borrowed or otherwise settling the obligation.
- ✓ Obtaining and paying for other resources from creditors on long-term credit.

Cash flows from the following non-cash investing and financing activities that are excluded from the statement of cash flows include:

- ✓ Acquiring assets by assuming liabilities.
- ✓ Obtaining assets by entering into a capital lease.
- ✓ Exchanging non-cash assets or liabilities for other non-cash assets or liabilities.
- ✓ Net change in cash during the period — difference between beginning and ending cash balances.



## III. Statement of Functional Expenses

The statement of functional expenses provides information about an organization's service efforts by presenting expenses by its service category and natural classifications in a matrix format. The statement reports expenses by the various functions and services of the organization such as major classes of program activities and supporting services. The functional classifications are determined by the organization. For example, an organization providing HIV counseling and testing, substance abuse and mental health services might consider these as separate functions.

### STATEMENT OF FUNCTIONAL EXPENSES

Summary of expenses by responsibility center.

The statement of functional expenses also displays management and general expenses. This display allows the reader of the statement to compare the cost of operating the programs to the cost of administering the organization. Administrative management and general expenses relate to the overall direction of the organization and are not identifiable with a particular program or with fundraising or membership development activities. Examples of management and general expenses include the salary of the executive director and other management staff, legal expenses, insurance and general office supplies.

The statement of functional expenses also displays the cost of fundraising activities. These are costs related to activities that involve encouraging potential donors to contribute assets, services or time. Fundraising expenses include the costs of publicizing and conducting fundraising campaigns, maintaining donor mailing lists, conducting special fundraising events, preparing and distributing fundraising manuals, instructions and other materials.

### DIRECT COST

Costs that are related to particular product or service and that can be traced to it in an economically feasible way.

### Elements of the Statement of Functional Expenses

The statement of functional expenses contains two main parts, program services and supporting services.

### INDIRECT COST

Costs that are related to cost center but cannot be traced to it in an economically feasible way.

- ✓ Program services:
  - Are activities carried out in fulfilling an organization's mission or purpose;
  - Constitute the major purpose for, and output of, the organization; and
  - Are composed of direct and indirect costs related to providing program services.
- ✓ Supporting services—activities other than program services—are:
  - Management and general.
  - Fund-raising.
  - Membership development.

## Responsibility Reports as Additional Management Tools

In most nonprofit organizations, financial reports are held closely within the organization and distributed only to senior administrative staff and the board. However, wider distribution of some report information may help managers encourage other staff members to contribute to the financial health of the organization.

Some organizations develop responsibility statements that measure the financial performance of those aspects of the organization under their control. For example, if a manager has responsibility for a cost center, it may be appropriate to hold the manager accountable for the profit and loss of that cost center. Doing so would help encourage the manager to join with the financial objectives of the organization. In any case, the manager should receive regular reports that summarize performance. For example, some organizations have established each outpatient therapist as a cost center with all expenses, other than therapist compensation, divided among therapists and compensation added back individually for each therapist. Therapists then receive a monthly or quarterly report that compares their costs against what money they brought into the organization.

### **PROFIT AND LOSS STATEMENT (ALSO CALLED STATEMENT OF ACTIVITIES)**

Summary of a company's revenues and expenses for an accounting period.

## Internal Financial Reports

Internal financial reports are prepared primarily for the organization board and management. The information contained in these reports may serve several purposes. Internal reports can be used to monitor revenue and expenses and compare them to prior periods and budgeted amounts. Internal reports may be used to plan or evaluate services.

Internal reports are often prepared in standard financial statement formats, but other report formats may be used. They may be prepared monthly, quarterly, semiannually or for another stated period of time. The most common form of internal financial reports used by nonprofit management is a comparison of current-month actual totals with year-to-date actual amount totals.

## IV. Interpreting Financial Statements

Ultimately, the most important measure of an NPO is not found in the financial statements. To determine success, an NPO measures progress against its goals. For example, an NPO has set a goal of providing counseling services to 100 persons living with AIDS during a given year. Determining how many consumers were served and the cost is not difficult. But these calculations show how efficient the NPO has been, not the quality of the services received.

Financial indicators are tools for the NPO managers when used in pursuit of meaningful goals and when used in conjunction with measures of quality. Readers of financial statements can learn about the financial health of an NPO by careful reading of the quantitative information presented. Financial information helps readers do the following:

- ✓ Measure the organization's efficiency, by examining such factors as:
  - Units of service produced, compared to costs;
  - Fundraising income compared to amount spent on fundraising; and
  - Net income in a fee-producing program compared to fees received.
- ✓ Evaluate the adequacy of financial resources through:
  - Ratios that measure the ability to cover debts, such as the current ratio;
  - Comparisons of total liabilities or total assets with net assets (fund balance); and
  - Cash flow projections.
- ✓ Identify financial trends by:
  - Evaluating a line item as a percentage of total revenue or total expense; and
  - Comparing prior periods with the current period.

For different NPOs, the figures on the financial statements will have different meanings. For example, an NPO shows a \$20,000 operating deficit for the year. Is that a problem? In a small organization with small reserve, such a deficit may indicate serious overspending or failure to generate revenue. In a large organization, \$20,000 may represent a small percentage of revenue and may be considered a timing problem or a normal fluctuation in business and may be easily covered by reserves. Another NPO might be starting up a new program and using reserves to finance the costs in the first year.

Also, ratios can have different meanings in different situations. For example, an organization may spend 70 percent of total expenses on fundraising. For an established organization, this might be excessive, but for a newer NPO that is relying on volunteers to provide services and is paying staff for fundraising, this ratio might be acceptable.

## Key Financial Indicators from the Statement of Activities

### Surplus or Deficit

If the NPO's income exceeds the expenses for the year, the NPO has generated a surplus (has additional money). If expenses exceed income, the NPO has experienced a deficit (does not have enough money). Sometimes, an organization may spend reserves to start a new program, resulting in a deficit that is planned. However, an unplanned deficit would be analyzed to determine the causes and to plan for the implications.

### Budget to Actual for Revenue and Expenses

The most commonly used financial indicator for NPOs, this comparison is made both on a monthly and a year-to-date basis. Significant variances from the budget should be examined to determine whether corrective action is necessary.

### Vertical Analysis and Horizontal Analysis

Vertical analysis refers to evaluating a line item as a percentage of total revenue or total expense. For example, the cost of supplies represents 11 percent of the total expenses.

Horizontal analysis refers to comparing a line item or a total with prior periods. For example, travel expense is 6 percent greater than it was last year.

### Functional Expenses

#### Ratio of Administrative Expenses

NPOs must report expenses associated with each program area of the organization and administrative expenses. Donors and funding agencies usually want to see that most of the funds are used for programs and services rather than administration. The ratio of administrative expenses to the total expense is often considered by grantors and may be limited. For example, certain federal agencies allow only 10 percent of the total budget for administrative expense.

#### Current Ratio

The current ratio shows the organization's ability to cover its debts. Many federal agencies expect grantees to have a current ratio at an acceptable level and may impose sanctions on organizations that do not maintain adequate cash to cover debts. If the ratio is high, there may be too much cash, which could be moved to investments to earn more. If the ratio is low, there may be a danger of a cash flow crisis. (To get this ratio, divide current assets by current liabilities.)

Other important ratios that can be used to analyze financial statements are listed in the following table.

<b>Profitability Ratios</b>	<b>Formula</b>
Gross profit margin	Gross profit/Net revenue
Profit margin	Net income/Net revenue
Deductible ratio (Uncompensated care ratio)	Deductions from gross client revenue/ Gross client revenue
Markup ratio	(Gross client revenue + Other operating revenue)/ Operating expenses
Cost to charge ratio	Average cost of services/Average price of services
Operating margin ratio	Net operating income/Total operating revenue
Liquidity Ratios	Formula
Net working capital	Current assets – Current liabilities
Current ratio	Current assets/Current liabilities
Day's cash on hand ratio	(Cash + Marketable securities)/[(Total operating expenses – Depreciation)/365]

<b>Leverage Ratios</b>	<b>Formula</b>
Debt ratio	Total liabilities/Total assets
Debt equity ratio	Total liabilities/Retained earnings
Equity financing ratio	Fund balance/Total assets
Fixed asset financing ratio	Long-term debt/Net fixed assets

<b>Activity Ratio</b>	<b>Formula</b>
Total asset turnover ratio	Total operating revenue/Total assets
Fixed asset turnover ratio	Total operating revenue/Net fixed assets
Current asset turnover ratio	Total operating revenue/Current assets

# UNIT 4:

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## Cash Management and Accounts Receivable

### **Purpose:**

To understand the importance of a cash management system. This unit provides examples of cash flow forecasting and cash management techniques. Also, accounts receivable and some typical reports and analyses that assist in managing accounts receivable will be discussed.

### **Learning Objectives:**

By the end of this unit, learners will be able to:

- ✓ Describe cash flow and the importance of cash management.
- ✓ State how to use and interpret information related to accounts receivable.

## What Is Cash?

Cash is ready money in the bank or in the NPO. It is not amounts owed by consumers or funding sources. These will be converted to cash at some point in time, but it takes cash on hand or in the bank to pay suppliers and the rent and to meet payroll costs. Earning a profit or increasing net assets does not necessarily mean that more cash is available.

## What Is Cash Flow?

Cash flow is an NPO's in- and outflow of cash during a given period of time. Watching cash in- and outflows is one of the major management tasks of the CFO, the executive director and/or the board of directors. Cash outflow is measured by checks written to pay salaries, suppliers and creditors. Cash inflow is cash received from customers, funding sources and donors.

If the cash inflow is greater than the cash outflow, the NPO has a positive cash flow. If the cash outflow is greater than the cash inflow, the NPO has a negative cash flow.

# I. Components of Cash Flow

The cash flow statement is typically divided into three components to show the sources and uses of cash. These components include the following internal and external sources:

1. Operating cash flow, often referred to as working capital, is the cash flow generated from operations. It is generated from an NPO's grants, the payments under contract for services provided and collections from customers and from third party payers. It is the lifeblood of the NPO, and because it is generated internally, it is under the NPO's control.
2. Investing cash flow is generated internally from non-operating activities. This component includes purchase or sale of investments, interest or dividends on investments, acquisitions or disposals of equipment, payment or refund of security deposits or other sources and uses of cash outside of normal operations.
3. Financing cash flow is the cash coming from external sources such as lenders or investors. A new loan, the repayment of a loan, the issuance of stock and the payment of dividends are some of the activities that would be included in this section of the cash flow statement.

## Cash Reserves

Although the financial position of an organization is determined by using the accrual method, organizations pay bills using the cash method. Many community-based substance-abuse treatment programs are cash poor in relation to their needs. This unfortunate situation may be due to the policies of public purchasers, the practices of the NPO, slow payment or a combination of all three. But cash reserves are needed in order to help organizations meet operating expenses, fund the start-up costs of new services, respond to the uneven payment practices of many purchasers and withstand business fluctuations.

Cash reserves are measured according to the time the reserves could meet operating expenses. The amount of reserves in terms of time can be determined by dividing the amount of cash in reserve by the total operating budget and then multiplying the result by the number of days, weeks or months of the year.

### Example:

The ABC Hospital has an annual operating budget of \$1,200,000 and cash reserves of \$100,000. Its annual operating budget breaks down to a monthly budget of \$99,231.

$\$100,000 \text{ divided by } \$1,200,000 \text{ equals } .0833.$

$.0833 \times 52 \text{ weeks} = 4.3$  or about four weeks of cash reserves, which is inadequate by almost any standard.

To meet the standard of most hospitals, the organization would need three months of cash reserves or about \$300,000 ( $\$99,231 \times 3$ ).

## Appropriate Reserves

The appropriate level of cash reserves depends on the circumstances and the funding stream of the organization. Several years ago, The United Way routinely asked CBOs to justify cash reserves of greater than two months of operating expenses. Most hospitals consider cash reserves of less than three months to be inappropriately low. Organizations that receive payments according to fee-for-service contracts tend to need cash reserves comparable to hospital standards for periods of lower service or delayed payments. An organization that receives most of its funding through predictable grant payments would have less need for cash reserves, although grant-funded organizations would be prudent to develop cash reserves for the time that their funding sources might change to less predictable methods of funding.

## Cash Flow Projections

Many organizations develop cash flow projections. These projections help them anticipate cash needs and monitor activities, and this in turn leads them to make needed expenditures.



## Appropriate Cash Management Practices

New managers sometimes attempt to manage cash in ways that are time consuming and counterproductive. They devote a great deal of time to watching for the receipt of payments, reviewing cash balances, projecting short-term expenses and, at times, delaying expenditure requests, even for critical items such as supplies, repairs and equipment. A better approach is to establish cash flow projections, borrow as needed through a long-term loan or a short-term line of credit, and devote management time to more productive activities such as marketing or improving the billing system. Chronic cash flow problems, however, should indicate a need to modify or eliminate programs that drain cash.

## Timing of Payments

Some organizations experience cash flow problems because of the discrepancy between their prompt payment of bills and the payment practices of their purchasers. For example, some organizations pay their vendors within 30 days while some of their purchasers might wait months to pay claims. Managers could improve their cash flow by delaying payments of some or all bills, except in cases of significant discounts for early payment or other contractual features.

## Line of Credit

A line of credit is a short-term loan that is paid in full within 12 months. The line of credit establishes a certain credit amount, and the organization borrows funds as needed up to that amount. As an example, some substance-abuse providers experience seasonal fluctuations in revenues because of fewer admissions and units of reimbursed services during the summer and holiday periods and more admissions and service units during the fall, late winter and spring. A line of credit can resolve the cash flow problems during these times.

## Cash Management through Short- and Long-Term Investments

The organization should generate as much interest as possible in cash reserves through short-term investments and interest-bearing accounts. A cash flow analysis might identify the amount that the organization could invest in various kinds of funds. Community stakeholders expect the investments to be conservative and not risk loss through speculation.

## Decisions about the Cash and Capital Assets

Organizations that own buildings have a number of interesting options. They might consider prepaying the mortgage when they are enjoying a period of increased cash. It is unlikely that the interest they received on the cash would exceed the cost of borrowing money, so the prepayment could reduce their costs. They might consider a line of credit, secured by the building, to help in times of tight cash flow.

Conversely, an organization that owns a building might consider using it to secure a long-term loan in the event of cash flow problems. However, the organization would need to make sure that its ability to secure a loan does not mask its need to address a more fundamental operational problem that may be causing the cash flow problem.

## Special Considerations for Recipients of Federal Grants

Most federal programs allow grantees to draw down the funds through electronic transfer. Depending on the specific requirements of the federal program and the grantee's track record with the federal agency, grantees may need to meet certain requirements about frequency of drawdowns or submission of reports of expenditures since the last drawdown. Generally, grantees may not draw down more than three days in advance of the actual disbursement of cash (e.g., three days before payday).

The calendar (below) illustrates the planning for cash needs. In this example, the NPO may draw down cash from the federal grant not more than three days in advance of the expenditures. The NPO may not draw down cash more than three times per month. Most of the NPO's cash needs occur on a regular schedule (e.g., the NPO has a biweekly payroll or it pays its rent on the first of every month).

Sunday	Monday	Tuesday	Wednesday	Thursday	Friday	Saturday
30	31	1 Rent & Other Bills	2	3	4 Payroll	5
6	7	8	9	10	11	12
13	14	15	16	17	18 Payroll	19
20	21	22	23	24	25	26
27	28	29	30	31	1	2
				Payroll, Rent & Other Bills		

## Learner Exercise

Review the calendar in the above example.

### Discussion Questions:

1. What level of cash reserve is appropriate for your organization? Why?
2. Given many CBOs' cash flow problems, how can managers move from a short-term focus on cash management to a long-term focus on efforts to generate cash such as marketing and an improved billing system?
3. Are any of the cash management strategies listed here appropriate for your organization? Does your organization use other cash management strategies that might be helpful to other organizations?

## II. Accounts Receivable

Accounts receivable refers to payments due to the organization. Sometimes the term accounts receivable is used almost as a synonym for the term billing. Accounts receivable information is vital because it underlies the accuracy of the financial reports and, therefore, can be used to improve billing processes. Financial reports can be misleading unless an organization has effective practices in place for estimating the amount of payment it will eventually receive for billed services or pledged donations. Billing activities are vital to organizational success.

### Bad Debt and Contractual Allowances

Health services providers frequently charge fees to third-party payers such as Medicaid, Medicare and other insurers. The contracts between third-party payers and the provider establish rates of reimbursement. The provider agrees to accept these rates as full payment or as a payment plus a fixed co-payment from the client (e.g., \$10 per visit). If the reimbursement rates are less than the provider's customary fees, the provider accounts for the difference as a contractual allowance.

Some consumers can be unreliable in meeting their financial obligations. Similarly, insurers can be extremely efficient at finding reasons not to pay claims. As a result, bad debt can be very high. Therefore, organizations must devise effective methods for estimating contractual allowances and bad debt in order for their financial statements

#### **BAD DEBT EXPENSES**

Amount included as an expense on the company's income statement that is based on an estimate of accounts receivable that will not be collected.

to have meaning. Otherwise, accounts receivable statements will become inflated. Providers can recognize contractual allowances and bad debt on a case-by-case basis or at the time the financial statements are prepared.

## Days in Receivable

One important accounts receivable measure is the number of days in receivable. This number represents the average length of time it takes to collect a payment. A rapid turnaround from rendering care to receiving payment is important to help cash flow and to increase the probability of collections, because the chances of collecting diminish over time. Days in receivable can be calculated by totaling the average cash per day received for a period (a quarter is sufficient, a year is fine). This average amount can be determined by dividing the revenues collected during the period by the number of days in the period and then dividing the current receivable by the average revenues collected per day.

### DAYS IN RECEIVABLE

Represents the average length of time it takes to collect payment.

**Note:** Organizations that receive a significant amount of grant money might calculate their days in receivable for first- and third-party payers separately.

### Example: Days in Receivable

ABC NPO collected total revenues of \$1,200,000 during the past year. This included \$800,000 in grants, donations and miscellaneous income and another \$400,000 in first- and third-party payment. ABC NPO's current accounts receivable total is \$200,000, with \$75,000 due from grants and pledges and another \$125,000 due from first- and third-party payers.

Total days in receivable:

\$1,200,000 total revenues divided by 365 days equals an average collection rate of \$3,288/day.

\$200,000 receivable divided by \$3,288/day = 61 average days in receivable.

**Note:** At first glance, 61 days in receivable appears to be good performance. However, most of this represents grant funding paid on a monthly basis. The accounts receivable data for first- and third-party payment present another picture.

\$400,000 in first- and third-party revenues divided by 365 days equals an average rate of \$1,096/day.

\$125,000 divided by \$1,096/day equals 114 average days in receivable.

This number of days in receivable suggests problems with the billing systems, the payment policies of payers or both.

For most hospitals and healthcare organizations, 70 days in receivable is within the normal range, 85 days is high and somewhat problematic, and anything more than 100 indicates serious trouble. Community-based organizations often struggle with billing, and receivables beyond 90 days for first- and third-party payment are not unusual.

## Aging Reports

Aging reports present the amounts of the receivable according to age categories. This is an important measure because the older the account, the less likely it is that the program will be able to collect payment on it. The usual categories for an aging report are current and over 30, 60 and 90 days. More categories can be added.

### AGING SCHEDULE (ALSO CALLED AGING REPORT)

A summary of accounts receivable in categories according to the time elapsed since a bill was issued, usually less than 30 days, 30–60 days, 60–90 days and over 90 days.

#### Example 1: Accounts Receivable Aging Report, Fees

Total Receivable	Current	1–30 days past due	31–60 days past due	61–90 days past due	91–120 days past due	Over 120 days past due
\$432,512	\$108,235	\$95,535	\$84,239	\$65,788	\$22,543	\$56,172

#### Example 2: Accounts Receivable Aging Report, Fees

Total Receivable	Current	1–30 days past due	31–60 days past due	61–90 days past due	91–120 days past due	Over 120 days past due
\$728,734	\$98,235	\$75,535	\$64,239	\$45,788	\$28,304	\$416,633

**Discussion Question:** In Example 1, 25% of the accounts receivable are current and 13% are over 120 days past due. This is more favorable than Example 2 where 57% of the receivables are over 120 days past due. Why?

Some organizations carry accounts with little if any potential for collection. As a result, the organization's financial position is much harder to understand, and its billing system may be dominated by useless letters and other transactions. Effective programs regularly write-off accounts that have little potential for collection. These programs establish write off procedures that often include turning the accounts over to a collection agency as a preliminary step. Some well-meaning programs clutter and distort their accounts receivable systems by carrying accounts in which clients may pay small amounts (e.g., \$5 per month). If NPOs encourage low-income clients to make small payments, it is best to collect these in cash at the time of service, rather than incur the cost of sending a bill.

### WRITE-OFF

Transfer of remaining balance of an asset account to an expense account, such as when an account receivable is determined to be not collectible.

Programs may wish to run aging reports for particular purchasers. For example, a program might find that one HMO is paying claims within 30 days while another takes more than 120 days. These data can be significant when new rates are negotiated or when the slow-paying purchaser claims that the delays are all the fault of the provider's inability to submit clean claims.

## Accounts Receivable Ratios

### Turnover of Accounts Receivable

The turnover of accounts receivable ratios measures the velocity of collection and tests the efficiency of collection. The formula is:

$$T_{a/r} = S / [(A/R_1 + A/R_2)/2]$$

Where

$T_{a/r}$  = Accounts Receivable Turnover

S = Sales on account

$A/R_1$  = Accounts Receivable at the beginning of the period (also know as Prior Year A/R)

$A/R_2$  = Accounts Receivable at the end of the period (also know as Current Year A/R)

#### Example:

From the following data abstracted from financial statements, compute the accounts receivable turnover for the current year.

	Current Year	Prior Year
Cash	\$20,000	\$10,000
Accounts Receivable	50,000	30,000
Inventory	45,000	35,000
Sales on Account	400,000	300,000

**Solution:**

$$T_{a/r} = S / [(A/R_1 + A/R_2) / 2]$$

$$T_{a/r} = 400,000 / [(30,000 + 50,000) / 2]$$

$$T_{a/r} = 10$$

Average Collection Period (Days in A/R) = 10

The days in receivables ratio measures the average number of days to collect amounts that are due. The formula is:

$$\text{Days in A/R} = 360 / T_{a/r}$$

Where

Days in A/R = the collection period

$T_{a/r}$  = Accounts Receivable Turnover

360 = Number of days in a year

**Example:**

See example above for accounts receivable turnover.

**Solution:**

$$\text{Days in A/R} = 360 / T_{a/r}$$

$$\text{Days in A/R} = 360 / 10$$

$$\text{Days in A/R} = 36 \text{ days}$$

# UNIT 5:

## Audits and Internal Control

### **Purpose:**

To understand financial statements, requirements for the single audit (A-133) and the principles of internal control.

### **Learning Objectives:**

By the end of this unit, learners will be able to:

- ✓ State the need for and importance of audits.
- ✓ Describe the major differences between a financial audit and the single audit (A-133).
- ✓ State the basic principles of internal control and how to establish staff assignments that separate duties.



# I. Audits

An audit is an examination of a company's books or operations. NPOs are primarily concerned with the financial audit. In performing a financial audit, the accountant must conduct his/her work in accordance with generally accepted auditing standards (GAAS). These standards are promulgated by the Auditing Standards Board, an arm of the American Institute of Certified Public Accountants (AICPA). Also, organizations receiving substantial amounts of government funds may be audited in accordance with Government Auditing Standards, issued by the Comptroller General of the United States.

## AUDIT

An examination of a company's books or operations.

The audit is not a guarantee that there are no inaccuracies on the financial statements. The auditing standards require that the audit is planned and performed to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by the management of the organization as well as evaluating the overall financial statement presentation.

## GENERALLY ACCEPTED AUDITING STANDARDS (GAAS)

Guidelines for auditing financial statements.

The auditor's report or opinion will appear in the company's annual report. The major types of auditor's reports are:

- ✓ **Unqualified opinion.** The auditor finds that the financial statements fairly present the company's position and results of operations, as specified by the generally accepted accounting principles (GAAP). Because companies tend to work with their auditors to make sure that their procedures are sound, this is by far the most common type of audit report. It is sometimes referred to as a clean opinion.
- ✓ **Qualified opinion.** The auditor includes a particular limitation in his opinion supported by objective or independent evidence of a particular transaction or policy. The issue giving rise to the qualification must be set forth clearly in the auditor's opinion.
- ✓ **Adverse opinion.** The auditor issues an unfavorable report because the company has not presented its financial statements according to GAAP provisions. Adverse opinions are rare, and the auditor must disclose the conditions that led to his/her conclusions.
- ✓ **Disclaimer of opinion.** The auditor is unable to render an opinion, usually because the auditor cannot complete the audit. This might happen if the records are unavailable and cannot be reconstructed.

## GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)

Official criteria underlying financial reporting by U.S. companies.

In 1990, the Office of Management and Budget (OMB) issued Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations*, which defines audit requirements for NPOs receiving more than \$25,000 in federal funds. NPOs are subject to these requirements even if the federal funds are passed through another agency. For example, a state

health department may make a grant to an NPO, which includes funds from the Center for Substance Abuse Treatment (CSAT). The NPO is subject to A-133 requirements even though the funds were not received directly from CSAT.

## II. Summary of Audit Requirements for NPOS Receiving Federal Grants

### Federal Requirements (Single Audit)

Federal guidelines permit the NPO to combine a financial audit of the whole organization with a program-specific A-133 audit of the program receiving the federal funding. The total amount of federal funds received by the NPO determines the type of audit required. The following table shows when an A-133 audit is not required, when a program-specific A-133 audit may be elected and when an agency-wide A-133 audit is required.

Total Amount of Federal Funds	One Program	More Than One Program
0–\$24,999	No audit	No audit
\$25,000–\$299,999	Elect Program-specific or A-133 Single Audit	Elect Program-specific or A-133 Single Audit
\$300,000 or more*	Elect Program-specific or A-133 Single Audit	A-133 Single Audit

\* The Office of Management and Budget (OMB) is considering a change in the threshold from \$300,000 to \$500,000. NPOs should check with their auditors for the most current information.

A-133 audits, like financial audits, test financial statement information. However, the A-133 audit looks more closely at tracking and classifying revenue from federal sources. In addition, the auditor looks for compliance with general and specific government audit requirements, which cover both financial and nonfinancial factors such as program effectiveness, client eligibility and efficiency with which resources are used. The auditor must test internal control procedures more rigorously than in a standard audit, making sure that adequate systems are in place for complying with the requirements.

Because of the expanded procedures involved and increased reporting requirements, the A-133 audit may cost substantially more than a financial audit and involve more staff members' time.

## III. State Requirements

In addition, some states require NPOs to have audits conducted under certain conditions. NPOs are encouraged to check the requirements in the states in which they operate. For example:

Section 57–49 of the Code of Virginia requires every charitable organization that intends to solicit contributions from the public to file an initial registration form with the Commission of Agriculture and Consumer Services. Also, the charitable organizations must re-file annually after the initial filing. When re-filing, the charitable organization must submit audited financial statements if gross revenue is \$25,000 or greater. If the gross revenue is less than \$25,000, the charitable organization may submit a balance sheet and income statement that are verified by the treasurer of the organization.

Certain charitable organizations are exempt from the requirement to submit the annual re-filing, including:

- ✓ Charitable organizations that do not intend to solicit and receive during a calendar year and have not actually received in any of the three preceding calendar years contributions from the public in excess of \$5,000.
- ✓ Charitable organizations that solicit only within the membership of the organization.
- ✓ Healthcare organizations that have been granted tax-exempt status under Section 501(c)(3) of the Internal Revenue Code and are:
  - Licensed by the Virginia Department of Health or the Virginia Department of Mental Health, Mental Retardation and Substances Abuse; or
  - Designated by the Center for Medicaid and Medicare Services as federally qualified health centers; or
  - Designated by the Center for Medicaid and Medicare Services as rural health clinics; or
  - Wholly organized for delivery of healthcare services provided without charge.

### INTERNAL CONTROL

A process designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations.
- Reliability of financial reporting.
- Compliance with applicable laws and regulations.

### BALANCE SHEET

A statement that shows a company's financial position at a particular point in time; also called a statement of financial position.

### Choosing the Auditor

An NPO's audit report is addressed to the board of directors, which has responsibility and accountability for the organization. The board's finance committee should recommend an auditor for approval by the full board. Criteria to consider when selecting an auditor include experience in the nonprofit sector, experience with other NPOs in the same area of work and references for the audit firm and the auditor.

## IV. Internal Control

Federal regulations require grantees to have appropriate fiscal management systems that provide for internal control. Internal control comprises those measures and methods adopted within the organization to safeguard the cash and other assets of the organization, check the accuracy and reliability of the accounting data, promote operational efficiency and encourage adherence to management policies. A system of internal control includes:

- ✓ Processes designed to provide reasonable assurance regarding achievement of management objectives.
- ✓ A plan of organization that provides appropriate segregation of functional responsibilities. That is, no single individual is responsible for an entire transaction. An example is the person who writes checks but does not reconcile the bank statement.
- ✓ A system of authorization and procedures adequate to provide reasonable control over assets, liabilities, revenues and expenses.
- ✓ A degree of quality of personnel commensurate with responsibilities.

Procedures for internal control may vary, depending on the size of the NPO and other factors. Usually, an NPO that can answer “Yes” to most of the following questions has adequate internal control.

- ✓ Does the board of directors authorize bank accounts and signers on the bank accounts?
- ✓ Does the board of directors approve and monitor the budget?
- ✓ Are employees who handle cash bonded?
- ✓ Is incoming mail opened and are cash receipts listed in duplicate by two or more people having no access to cash receipts or accounts receivable records?
- ✓ Are receipts deposited on a daily basis?
- ✓ Are checks required to be countersigned?
- ✓ Is signing blank checks prohibited?
- ✓ Are bank accounts reconciled by someone other than the persons participating in the receipt or disbursement of cash?
- ✓ Does a responsible individual receive the bank statements unopened from the bank?
- ✓ Are fees charged for services approved by the board of directors and publicly announced in fee schedules, bulletins and other announcements?
- ✓ Does an accounting manual detail account coding of expenditures in compliance with funding and organization accounting requirements (e.g., program and other functional bases)?
- ✓ Do procurement policies govern purchases of equipment, supplies and other items?
- ✓ Are authorizations for new hires, terminations and changes to salaries authorized by someone other than the person responsible for processing the payroll?
- ✓ Are timesheets or timecards prepared by employees who identify the amount of time spent in each program area or functional unit?
- ✓ Does a responsible person periodically review classes of position and pay rates for compliance with the provisions of the personnel practices or other documents designating rates of pay for employees?

- ✓ Are payrolls prepared by an outside service center?
- ✓ Do accounting procedures, charts of accounts and other tracking devices provide for identifying receipts and expenditures of program funds separately for each award or grant?
- ✓ Does the organization account for unused vacation and sick leave time?

## Separation of Duties

As the series of internal control questions illustrates, separation of duties is a key mechanism to have in place. For example, one person prepares the checks, one or more persons sign the check and another person reconciles the bank statements. If a single individual were responsible for all these tasks, the internal control would not be adequate.

NPOs, particularly small NPOs, have some difficulty assigning tasks to employees in a manner that provides sufficient internal control, which also accommodates the size of the organization.

## Assignment of Tasks

In some small nonprofit organizations, the executive director or another key staff member is responsible for all fiscal management, with no oversight or review by any other party. This person prepares the budget, authorizes purchases, hires employees, approves timesheets, calculates the payroll, writes and signs checks, receives payments for services, makes bank deposits, reconciles bank statements, prepares fiscal reports for the board of directors and handles other tasks. This practice is not acceptable for grantees receiving federal funds.

It is expected that the program will have adequate stewardship of federal grant funds through sound fiscal management systems. In practical terms, this means that the executive director concentrates on achieving the program objectives: he/she has overall responsibility for the organization and its fiscal management; and oversees the work of staff members responsible for maintaining accounts, writing checks, preparing reports and other tasks. The executive director may handle some tasks personally, but they are usually related to the leadership role, such as ensuring that the budget provides resources consistent with the needs of the program or reviewing others' work (e.g., reconciling the bank statement).

Equally important, grantees must assign responsibilities for sets of transactions to more than one person. No individual should be allowed to execute all transactions within the set. For example, the same person should not authorize a payment and write the check. Separation of duties is a critical element of internal control. Small organizations may need to rely on one person to do the tasks and have the work reviewed by another person. In other instances, board members may take some responsibility (e.g., in some small nonprofit organizations, the board treasurer reviews the monthly bank reconciliation).

Each grantee must decide how to assign duties and how to establish internal control. The federal agencies will not prescribe that duties must be assigned in a particular way.

# UNIT 6:

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## Cost Allocation and Decision Making

### **Purpose:**

This unit will help understand cost accounting and how to use it in practical settings.

### **Learning Objectives:**

By the end of this unit, learners will be able to:

- ✓ Define cost accounting, including profitability, contribution margin and other concepts.
- ✓ Define and explain a breakeven analysis.

# I. Accounting for Costs (Unit Cost)

The purpose of accounting for the cost of health services is to help managers make better decisions. Purchasers of these services, especially government agencies and managed care organizations, are increasingly concerned about the cost of the services and the value of the benefits derived from them. Accordingly, providers must be knowledgeable about costs and must be able to manage costs.

## Profitability

Terms such as "profit," "net income" and "profitability" do not have the customary meanings for NPOs. For NPOs, these terms refer to the excess of income over expenses. The principal sources of financial support for the NPOs are grants, contracts or fee-for-service reimbursement and fundraising. Costs include labor, consultants, space and other expenses. The financial goal of an organizational unit or service area within the NPO is to cover its operating costs and to help the overall operating cost of the organization. For the purpose of this manual, profitability may be defined as the degree to which this goal is achieved.

In any profitability analysis, it is necessary to examine the interrelationships among gross revenue, costs and net revenue, usually called the cost-volume-profit analysis. In addition, it is advisable to think of revenue and cost in terms most meaningful to the individuals responsible for generating the revenue or incurring the cost. For health services, the best descriptive unit is the measure of volume that represents utilization (e.g., visits, sessions, consumers, families, days, weeks and months).

### FUNCTIONAL AREA

Part, segment or subunit of an organization whose manager is accountable for a specified set of activities. See responsibility center.

## Organizations and Functional Areas

NPOs typically have more than one functional area to which costs are identified. For example, a large behavioral health organization may have an inpatient unit, community-based residential services and outpatient services. A small organization may offer several types of services (e.g., substance abuse counseling, community education and school-based services) and may consider each type of service a functional area. Also, most organizations consider administration or management a separate functional area, including the ED, accounting and the human resources and secretarial staffs.

Often, functional areas are defined by funding authorities. That is, a grantor may require that the program or service funded by the grant be accounted for separately and operate as a distinct unit of the organization.

The organization must define its functional areas and determine which functional areas require cost analysis. As noted above, the organization must identify the unit of measure for each functional area (e.g., visits, number of consumers, days and weeks). Also, the organization must determine its method for the allocation of overhead.

### OVERHEAD

Indirect costs of running a company (e.g., space cost, utilities) that cannot be traced specifically to a product or service.

Costs that can be readily identified with a functional area are considered direct costs. Costs that are related to the functional but cannot be traced to it in an economically feasible way are considered indirect costs. Usually, the administrative or management functional area is treated as an indirect cost that supports other functional areas. Indirect costs are allocated to the functional areas on the basis of the cost driver (i.e., the factor(s) that is/are the primary factor(s) that will cause a change). For example, building costs are allocated on the basis of the number of square feet occupied by a functional area, and the cost of a human resources office is allocated on the basis of number of employees in a functional area. Administrative or management services can usually be allocated on the basis of direct labor cost for a functional area.

#### **FIXED COST**

Cost that does not change in total despite changes in a cost driver.

#### **Relevant Range**

A fundamental assumption in most cost analyses is that it is unnecessary to increase fixed costs when a new program is added. For example, adding a new program will not require the acquisition of a new building or the addition of more administrative staff.

### **Labor Cost**

Labor cost includes salaries, wages, fees and fringe benefits paid to employees or consultants. It is the most significant element of cost of human services. A labor-intensive service is one in which labor accounts for more than half of the total cost.

Labor costs can be considered direct or indirect. Direct labor costs are those incurred by staff providing services to the client (e.g., counselors, clinicians, health educators). Indirect or administrative costs include supervision and management, secretarial support, accounting and human resources personnel.

### **Volunteers and In-kind Costs**

In some circumstances, GAAP or certain grantors require that the value of volunteer services and in-kind services be recorded on the organization's books. For the purpose of internal cost management, the organization can disregard costs that are not borne by the organization.

However, it is important to be cognizant of the value of volunteer and in-kind services. First, if the support provided by the volunteers or in-kind services were to be reduced or eliminated, the organization would have to incur the cost to continue the services at the same level. Second, volunteer and in-kind services are often desirable for purchasers, and it may be advisable to present relevant cost information to the grantor or other purchasers.



## Overhead

Overhead or indirect cost includes all costs other than direct costs (e.g., the ED's salary, legal and auditing costs, space costs for common areas of the building).

Some organizations "charge" functional areas for overhead by assigning a percentage of all overhead costs to the functional area by adding a surcharge to total direct cost incurred by each functional area.

## Contribution Margin

Management of labor cost is critical to profitability. Analysis of contribution margin is an effective tool. Contribution margin is the excess of revenue over direct costs. For labor-intensive services, contribution margin is essentially revenue minus direct labor costs.

The most important aspect of intelligent cost planning and control is an understanding of cost behavior patterns and influences. The behavior pattern of costs may be described as either variable or fixed. Mixed costs contain both variable and fixed elements.

Variable costs are those that are expected to fluctuate, in total, in proportion to sales, production or other measures of activity. Included in this category are direct labor, direct material and variable overhead.

Fixed costs are those that are not expected to change in total within the current budget year, regardless of fluctuations in the volume of activity. Their incurrence provides the capacity to produce and sell. Committed costs largely consist of those fixed costs arising from the possession of plant, equipment and basic organization. Discretionary costs are the fixed costs arising from periodic appropriation decisions that directly reflect top management policies. The amount of fixed costs is affected by long-term marketing factors, technology and methods and philosophies of top management.

### CONTRIBUTION MARGIN

Sales of a product or service minus the variable cost.

### VARIABLE COST

A cost that changes in total in proportion to changes in a cost driver.

## II. Breakeven Analysis

The breakeven point is the volume of services that will result in no gain or loss, but below which will result in loss and above which will result in a gain. The breakeven point is that point of volume where total revenues and total expenses are equal; it is the point of zero profits. It also shows how much an agency needs to yield in services to break even.

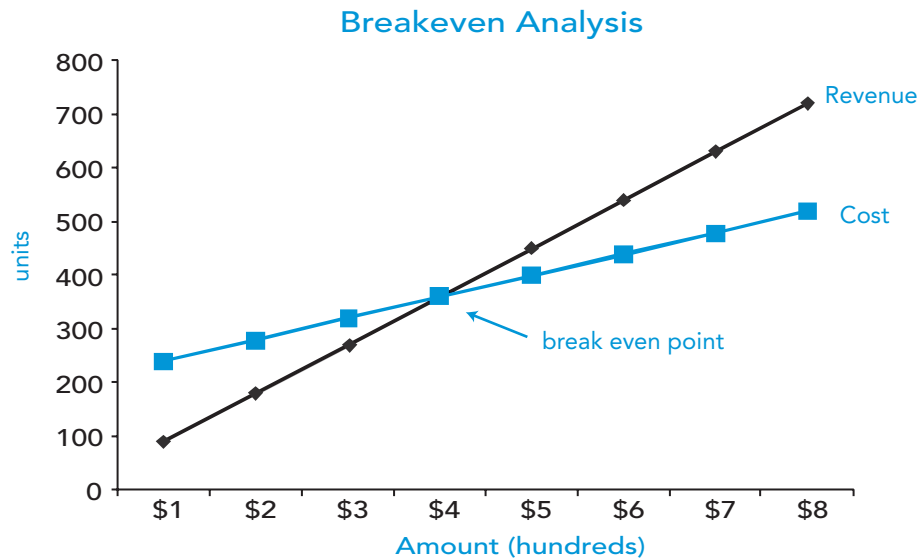
### BREAKEVEN POINT

Quantity of output where total revenue and total costs are equal; it is the point of zero profits.

## LOSS

Decrease in fund balance over a specified period of time.

Breakeven analysis has wide applicability for managerial decision making. It has been used in the industry for decades with a high degree of satisfaction. The analysis of costs, revenue and units of services provides helpful information for decisions as to addition or deletion of services, contract pricing in a workshop, cost alternatives, revenue mix and entering new geographic markets. Breakeven analysis may be presented in chart form as follows:



The derivation of cost-volume-profit, whether in connection with breakeven charts or budgets, permits a quick preview of potential profitability over a wide range of volume. Many organizations use preliminary budget figures as a basis for the calculations relevant to a planned conversion to supported employment. If the forecast does not satisfy management, changes can be made before a final decision is reached.

When deciding to acquire or renovate buildings within a span of one to five years, breakeven charts may be helpful in showing future operating conditions if certain expenditures are to be made. A breakeven chart is also helpful in showing the relative costs of borrowing and additional ownership capital.

The following are fundamental assumptions of breakeven analysis:

- ✓ Data fairly represents balanced operations.
- ✓ Site operates at approximately normal capacity.
- ✓ There are no extraordinary gains or losses.

The principal weaknesses of breakeven analysis are:

- ✓ If more than one service is provided, changes in revenue mix will change the breakeven point.

- ✓ Breakeven analysis is subject to inaccuracies in classifying costs as fixed or variable.
- ✓ Errors may exist in estimates of market conditions as they relate to demand.

Notwithstanding its underlying assumptions and inherent weaknesses, a breakeven analysis may be a useful tool to begin planning for the conversion to supported employment because it offers a straightforward analysis that can establish basic targets.

Whenever the underlying assumptions of cost-volume-profit analysis do not correspond to a given situation, the limitations of the analysis must be clearly recognized. A single breakeven analysis is static because it is a picture of relationships that prevail under only one set of assumptions. If conditions change, a different set of cost-volume-profit relationships is likely to appear. The fluid nature of these relationships must be kept uppermost in the minds of the executive and the accountant if the breakeven tool is to be useful and educational.

Properly used, cost-volume-profit analysis offers essential background for important management decisions. It offers an overall view of costs and revenue in relation to profit planning and provides for possible changes in management strategy. It is also the springboard for a different type of income statement that emphasizes cost behavior patterns. This is called the contribution approach.

Here is an example of the formula:

A boy plans to sell toy rockets at the state fair. He may purchase these toys at \$.50 each with the privilege of returning all unsold rockets. The booth rental is \$200, payable in advance. The rockets will be sold at \$.90 each. How many rockets must be sold to break even?

The equation that underlies income statements is:

$$\text{Sales} = \text{Variable Expenses} + \text{Fixed Expenses} + \text{Net Income}$$

This equation may be adapted to any breakeven or profit estimate situation. For this example:

Let X = Number of units to be sold to break even

$$.90X = .50X + \$200 + 0$$

$$.40X = \$200$$

$$X = \$200/.40$$

$$X = 500 \text{ units}$$

## Post-training Assessment

The following answers to the Pre-training Assessment that was given at the beginning of the manual are designed to provide a brief recapitulation of the material that has been presented in this manual.

### Post-training Assessment

Please circle the following statements True or False.

1. **True** ☒ **False** Only the chief financial officer of the NPO needs to be concerned about fiscal management.
2. ☒ **True** **False** The major difference between for-profit and nonprofit organizations is the use that is made of the profits that are earned.
3. **True** ☒ **False** Once a budget is approved by the board of directors, it should not be changed.
4. **True** ☒ **False** Every opportunity for obtaining new grant funds should be taken.
5. **True** ☒ **False** Financial planning is done before strategic planning.
6. ☒ **True** **False** Financial statements can be interpreted by use of ratios.
7. **True** ☒ **False** The treasurer is responsible for keeping an organization's books.
8. ☒ **True** **False** Internal control might include separation of duties among several employees.
9. ☒ **True** **False** NPOs should establish reserve funds to accommodate a cash shortage when routine expenses fall before the income to pay for the services is received.
10. ☒ **True** **False** Employees should complete time sheets showing the program areas in which they worked.
11. **True** ☒ **False** The auditor guarantees that financial statements are right and that no theft or mismanagement has occurred.
12. ☒ **True** **False** It is as important to know what the service will cost as it is to know how much the funder will pay for the service.

# APPENDIX A

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## Glossary

**Accounts payable:** amount owed to vendors for goods and services received but not yet paid for.

**Accounts receivable:** amount owed to a company by customers who purchase goods and services on account.

**Accrual basis:** method of accounting in which revenues are recorded as they are earned, regardless of when the money is actually received.

**Aging schedule (also called aging report):** a summary of accounts receivable in categories according to the time elapsed since a bill was issued, usually less than 30 days, 30–60 days, 60–90 days and over 90 days.

**Asset:** a company's resource that has future value. Includes tangible assets (e.g., buildings, cash, inventories, land, supplies, vehicles) and intangible assets (e.g., copyrights, patents, drilling rights).

**Audit:** an examination of a company's books or operations.

**Bad debt expenses:** amount included as an expense on the company's income statement that is based on an estimate of accounts receivable that will not be collected.

**Balance sheet:** a statement that shows a company's financial position at a particular point in time; also called a statement of financial position.

**Breakeven point:** quantity of output where total revenue and total costs are equal; it is the point of zero profits.

**Budget:** quantitative expression of a plan of action and an aid to the coordination and implementation of the plan.

**Cash basis:** method of accounting in which revenues are recorded when the money is received and expenses are recorded when the money is paid.

**Chart of accounts:** numbered list of a company's accounts.

**Contribution margin:** sales of a product or service minus the variable cost.

**Cost allocation plan:** the assigning of indirect costs to the chosen cost center.

**Cost center:** responsibility center for which a manager is accountable.

**Cost driver:** any factor that affects total costs (i.e., a change in the driver will cause a change in the level of the total costs).

**Countersignature:** a signature on a check from a second party, which constitutes a second review of the expenditure.

**Current ratio:** measure of liquidity or the company's ability to meet currently maturing or short-term obligations.

**Days in receivable:** represents the average length of time it takes to collect payment.

**Direct cost:** costs that are related to a particular product or service and that can be traced to it in an economically feasible way.

**Equity:** ownership interest in a business.

**Expense:** cost of goods or services that are used by a company in an effort to generate revenue.

**Financial plan:** quantitative expression of a plan of action, usually with a time horizon of two to five years and usually entailing feasibility studies or comparative analysis or options.

**Financial statements:** standard set of reports that document a company's financial status. Produced at least annually, they include a statement of activities, a statement of financial position, a cash flow statement and explanatory notes.

**Fixed cost:** cost that does not change in total despite changes in a cost driver.

**Functional area:** part, segment or subunit of an organization whose manager is accountable for a specified set of activities. See responsibility center.

**Fund balance (also called net assets, net worth or equity):** total assets minus total liabilities.

**Generally accepted accounting principles (GAAP):** official criteria underlying financial reporting by U.S. companies.

**Generally accepted auditing standards (GAAS):** guidelines for auditing financial statements.

**Income (also called profit):** increase in net assets over a specified period of time.

**Indirect cost:** costs that are related to cost center but cannot be traced to it in an economically feasible way.

**Internal control:** a process designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- ✓ Effectiveness and efficiency of operations.
- ✓ Reliability of financial reporting.
- ✓ Compliance with applicable laws and regulations.

**Labor:** salaries, wages and fringe benefits paid to employees (may also include payments to contractors).

**Liability:** amount owed to an individual or entity.

**Loss:** decrease in fund balance over a specified period of time.

**Nonprofit organization:** corporation that has been granted tax-exempt status by the Internal Revenue Service.

**Overhead:** indirect costs of running a company (e.g., space cost, utilities) that cannot be traced specifically to a product or service.

**Profit (also called income):** increase in net assets over a specified period of time.

**Profit and loss statement (also called statement of activities):** summary of a company's revenues and expenses for an accounting period.

**Program budget:** budget of a responsibility center or subunit of a responsibility center.

**Portfolio analysis:** analysis of investments based on risk and return.

**Responsibility accounting:** system that measures plans (by budgets) and actions (by actual results) of each responsibility center.

**Responsibility center:** part, segment or subunit of an organization whose manager is accountable for a specified set of activities. See functional area.

**Return on investment:** amount earned by an investment minus the cost of the investment.

**Revenue:** amount received by a company, including earned revenue, such as sales of products or services, and revenue from investments.

**ROI:** a company's earnings, expressed as a percentage of its capital.

**Single audit (also called A-133 audit):** an audit that includes both the entity's financial statements and its federal awards.

**Statement of activities (also called profit and loss statement):** summary of a company's revenues and expenses for an accounting period.

**Statement of cash flows:** statement that shows cash coming in and going out over an accounting period.

**Statement of financial position (also called balance sheet):** a statement that shows a company's financial position at a particular point in time.

**Statement of functional expenses:** summary of expenses by responsibility center.

**Turnover of receivables:** measure of the length of time it takes to collect on accounts receivable.

**Variable cost:** a cost that changes in total in proportion to changes in a cost driver.

**Write-off:** transfer of remaining balance of an asset account to an expense account, such as when an account receivable is determined to be not collectible.



# APPENDIX B

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## Frequently Asked Questions

### 1. How does a budget differ from a financial plan?

A budget covers a one-year period and is a plan of revenue and expenses for the organization as a whole and for each functional unit of the organization. A budget focuses on the operation of programs. A financial plan covers a two- to five-year period and is a plan to obtain resources needed to carry out the organization's goals. A financial plan focuses on the implementation of the strategic plan.

### 2. When should a budget be modified?

A budget should be modified when management determines that a significant variance in revenue or expenses will occur. Usually, the organization's fiscal policies specify the level of approval that is necessary for a budget modification (e.g., the board, ED, program director). Budget modifications are often controlled by the funding source.

### 3. What factors can cause a budget variance?

Factors such as increases or decreases in volume of services can cause budget variances. Also, unanticipated expenses or windfalls in revenue can cause budget variances.

### 4. What are time and effort reports and why are they important?

Organizations with more than one functional area usually require employees to report hours worked by functional area on a timesheet or a time-and-effort report. This information is critical for cost allocation and is usually required by grantors or other funding authorities. Also, time-and-effort reports provide information that is useful for planning and program evaluation, compensation studies and other matters.

### 5. What are the board's fiscal management responsibilities?

The board and its subcommittees have a responsibility to the public trust, because the NPO is exempt from taxes. The board is responsible for fiscal oversight, establishes policies that govern the resources of the NPO, approves and monitors the budget, selects and engages the auditor and receives the auditor's report.

### 6. How can a program's fiscal performance be evaluated by the organization?

The organization can evaluate fiscal performance by determining the conformance to the budget and the surplus or deficit generated by the program. Also, the organization can compare the amount of surplus or deficit to the value the program provides to the community. In addition, the organization can determine the contribution margin (i.e., the amount of overhead that is offset by the program's income).

**7. Can a nonprofit organization “earn a profit”?**

Yes, the major difference between for-profit organizations and nonprofit organizations is the use made of the surplus of revenue over expenses. A nonprofit may “earn a profit” by producing more revenue than expenses. This surplus is called net increase in assets.

**8. In a small organization with only a few employees, how can an appropriate level of internal control be maintained?**

Separation of duties is a critical element of internal control. Small organizations may need to rely on one person to do the tasks and have the work reviewed by another person. Or, board members may take some responsibility (e.g., in some small non-profit organizations, the board treasurer reviews the monthly bank reconciliation).

**9. What level of cash reserves is appropriate for my organization?**

The appropriate level of cash reserves depends on the circumstances and funding stream of the organization. An organization that receives most of its funding through predictable grant payments would have less need for cash reserves, although grant-funded organizations would be prudent to develop cash reserves for the time their funding sources might change to less predictable methods of funding.

**10. Does an audit guarantee that the financial statements are accurate?**

The audit is not a guarantee that there are no inaccuracies in the financial statements. The auditing standards require that the audit is planned and performed to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by the management of the organization as well as evaluating the overall financial statement presentation.



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