

Sage Nonprofit Solutions

Increase Your Accountability and Transparency:

Ten Reasons Why Nonprofits Need True Fund Accounting
Instead of a Commercial Accounting System



Introduction

In today's world, financial management and accountability are critical for all types of businesses and organizations. For nonprofits, the pressures are mounting. Restrictions around the use of government grants continue to rise. Private foundations and corporations are asking organizations for specific measurable outcomes resulting from grant awards. Tightening federal regulations further increase the demands.

Compounded with stories of funding misuse grabbing headlines, the temperament of the donor community, although positive, is more cautious than in previous years. Accountability for your organization's financial and program management is an absolute necessity—one more imperative than ever.

In this paper, we will look at the differences between commercial and fund accounting and outline ten key reasons why your organization may need a true fund accounting system.

What is fund accounting?

There are two basic types of accounting packages on the market: fund and commercial accounting. Commercial organizations, such as enterprises and businesses, have accounting systems that measure product, division, and company performance by gain and loss of profits. Some small businesses have nothing more than a checkbook. Revenue is generated and expenditures are paid. The same can be said for a nonprofit, but nonprofits have social and legal responsibilities that extend beyond the balance sheet.

In the simplest form, the key difference is in understanding the word "fund." A fund, as described by Merriam-Webster's dictionary, is the "sum of money or other resources whose principal or interest is set apart for a specific objective." For example, when you purchase groceries for the week, say \$100 worth, you do not tell the grocery store what to do with the \$100. However, if you were to donate \$100 to a nonprofit organization, you may designate \$50 to the children's program, \$25 toward the operating budget, and \$25 to purchase new books for the learning center. These three divisions of the donation represent the programs you wish to support with your donated money. A fund accounting program automatically keeps these monies separate and ensures they are used for their intended purposes.

The key difference between needing a commercial accounting and fund accounting system is understanding the definition of the word "fund."

Most nonprofits find that commercial accounting systems do not meet their special tracking and reporting requirements.

How do I know if I need a fund accounting solution?

Many nonprofits use commercial accounting products initially, but once most organizations have multiple funding sources, they find that off-the-shelf accounting software will not meet their special tracking and reporting requirements. The process can grow impractical and difficult to maintain. At worst, it can open the door to costly errors and complex or erroneous audits.

To determine whether your organization requires a nonprofit or commercial accounting system, ask yourself the following ten questions:

1. Do you have certain funds that you must spend in accordance with specific restrictions—in particular ways or for certain purposes?

Nonprofits must carefully track and report on separate restrictions on money as used to support their programs. Major donations and grants are commonly given with a set of specific and unique requirements, restrictions, and responsibilities. The associated funds are either “restricted” or “unrestricted.” Failure to demonstrate that “restricted” funds have been used correctly can have some serious organizational consequences, including termination of executives, loss of funding, and worst case, the loss of tax-exempt status. Solutions that deliver a financial solution which is built specifically for fund accounting (such as Sage MIP Fund Accounting) are specially designed to help nonprofits meet those tracking responsibilities and handle the special requirements that may come with each new source of funding.

2. Do you need to measure the performance of a specific program, activity, or performance by location?

Nonprofit organizations typically have the need to track more than financial information. They need to report on program results and report on outcome measures. Most commercial accounting software is not designed to track or report on programs. For those that do, it is usually managed with a Job Cost system, primarily used by the construction industry, which tracks financial information. Nonprofits should ensure their accounting toolset is robust enough to track and report performance or outcome measures on financial statements, as well as budgeting outcome measures for accurate forecasting. This is where nonprofit-specific fund accounting systems excel.

3. Are you required to create reports for fiscal years that are scheduled differently than your own?

Fund accounting is also different from traditional business accounting in its time period flexibility. Each grant and donation may be applied for and granted annually, but each funding agency or organization may function on unique timetables that probably do not correspond with your organization’s fiscal year. So, while commercial accounting often assumes that fiscal years end in the same months each year, nonprofits often have to report to several different audiences, with different information requirements and reporting timelines. One foundation may want annual reports that span the period from January 1 to December 31, while another requests them to reflect from October 1 to September 30. Your fiscal year, however, may run from July 1 to June 30. Many times funding sources may request biannual or multi-year reports. Thus, the ability to track and report across different time periods is critical for nonprofits and is a key attribute of solid fund accounting.

4. Do you have funds that need to be recorded as encumbered?

Nonprofits may require an accounting system where expenditures are encumbered prior to receipt of goods and services. In encumbrance accounting, nonprofits can track and report on spending commitments to significantly reduce the risk of fund over-commitment. The ability to report on encumbered funds provides nonprofits tighter controls on spending while fully utilizing a grant budget. Commercial accounting systems are not designed to properly address these reporting and tracking requirements. Fund accounting systems, on the other hand, are specifically designed to address this unique need.

5. Do you need to perform allocations of indirect costs by grantors?

Allocations of interest and program expenses can become very complex depending on the requirements of the funding sources. Because of the unique nature of nonprofits, these allocations typically are not handled well by a commercial accounting system. In fund accounting systems, allocations can be performed on virtually any account balance at the program level, department level or grant level, and across multiple segments at one time with advanced calculation options, including fixed or dynamic percentages, unit measures, and more. Accuracy of allocations is critical in providing auditors and grantors a complete audit trail which demonstrates that expenses allocated have a consistent and reasonable basis.

6. Do you have multiple audiences that require you to provide various report types showing how money is being spent?

As with any organization, reports and financial statements must be readily available for internal and external audiences. Because of the nature of funds, nonprofit and government organizations have distinctly different reporting requirements from commercial companies. Their accounting methods must reflect those differences. Reporting is a critical issue and function for nonprofits as continued funding can depend on reporting accuracy. An organization that is able to provide detailed levels of reporting has a much better chance of seeing its funding and the scope of its mission increase. Each of the audiences and the reports that are specific to the organization will have unique requirements. They need access to sophisticated, audit-level reports for good accounting, as well as simple, high-level reports that can be understood by less accounting-savvy audiences. The flexibility of detail and presentation in reporting is crucial, and graphing and charting capabilities to improve presentation of complex financials are must-haves in any fund accounting system. Being able to easily generate necessary reports without custom report writing is vital with the ever-changing reports required by funding sources.

7. Can you easily adhere to nonprofit-specific accounting rules?

Nonprofits need to comply with stringent reporting standards. Audited financial statements must present information in accordance with the Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 116 and 117 or Governmental Accounting Standards Board (GASB) guidelines. Fund accounting software typically includes reports that make compliance easy, whereas commercial accounting software does not usually provide these reports without costly customization.

Fund accounting systems can track and report on multiple fiscal years, funds that need to be encumbered as well as allocated for specific purposes.

Reporting and compliance is critical for nonprofit organizations, and fund accounting software makes this easy.

Providing auditors, stakeholders, and key decision-makers a clear look at the life cycle of every dollar from receipt to expenditure is the strength of a true fund accounting system.

8. Do you need to manage and report on multiple budgets?

In commercial accounting, budgets are primarily used for planning. Although this is also true for nonprofits, the budget is a much more critical component. Nonprofits rely on the budget as a compliance and monitoring tool, and it is a formal part of the organization's financial records. The ability to produce unlimited budget versions, create "What if" scenarios, report on multiple budgets simultaneously, have capabilities to prevent overspending, and fully utilize budget functionalities are characteristics of a true fund accounting solution.

9. Do you have the need for a self-balancing chart of accounts?

Because of the nature of funds, a separate chart of accounts must be maintained for each fund. In commercial accounting systems, separate revenue and expense accounts are maintained, but are intertwined on balance sheet accounts. For fund accounting, funds must be treated as separate entities with their own general ledger and individual revenue, expense, income, and balance sheet reports. And the need to produce multiple balance sheets within the same organization is common. True fund accounting software will automatically handle the offset postings to cash or payable accounts by fund, as well as the encumbrance processing, grant tracking, and budget controls.

10. Do you need to integrate with other mission-critical or back-office software?

Providing auditors, stakeholders, and key decision-makers a clear look at the lifecycle of every dollar from receipt to expenditure will continue to be the focus for the future. This is where integration to mission-critical software such as program management software and back-office software—including fundraising and human resources—is essential. Commercial accounting systems also offer integration to other systems, just not those that are aligned specifically to the nonprofit sector. Because fund accounting software is created with a nonprofit's needs in mind, it has integration capabilities to allow non-financial, yet mission critical data to be recorded, tracked, and reported on within the fund accounting financial software.

If you answered "yes" to any of these questions, you should use accounting software designed to handle the specialized accounting requirements specific to the nonprofit sector. Customizing or overlaying features onto commercial software to achieve nonprofit accounting functionality has the potential to be inefficient, incomplete, and expensive to buy and maintain. Good fund accounting meets the complex fund tracking and flexible reporting requirements that are vital to a nonprofit's continued ability to serve its community.



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09-51099/0209

