Accounting Methods and Financial Viability for Not-for-profit Organizations

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Introduction

For more than a decade, the necessity and importance of not-for-profit organization (NPO) and non-governmental organization (NGO) activities have been advocated, and the number of such action groups appears to be rising. However in reality, more than a few of them have had their certification revoked or are on hiatus. This situation appears to be the result of the myriad constraints with which these organizations must contend. The most problematic of these limitations is arguably the difficulty of raising funds. NPOs raise funds through a variety of means, including donations, business income, grants, and subsidies. Unless they are temporary by nature, NPOs need to raise operating funds steadily, or they will be unable to continue providing their services.

If an NPO establishes a solid reputation in society or among resource providers, it is easier to receive grants and subsidies. As a result, the organization will be financially stable and able to continue management and operations. In straightforward terms, financial viability is the financial capability of an organization to continue in its stated purpose (details to follow). This paper examines what sort of accounting is helpful for an NPO that receives donations, grants, and subsidies (hereafter, we use "donations" to mean any and all of these categories), which will enable the organization to operate in a stable and continuous manner.

In this paper, we first touch on the concept of financial viability and how this is evaluated. Next, we look at accounting for NPOs in the United States, where research into accounting for NPOs has advanced. We check our thinking primarily against the Financial Accounting Concepts and Statements (FACS) of the Financial Accounting Standards Board (FASB), which is responsible for setting accounting standards in the United States. We then consider what the best point of view for assessing the financial viability of NPOs. In the final chapter, we consider how daily accounting should be done in NPOs to best record day-to-day transactions and also consider the importance of fundraising.

1. Financial viability of NPOs

(1) The concept of financial viability

The FASB was a leader in creating a financial accounting framework for NPOs.

In 1978, then Professor Robert N. Anthony of Harvard Business School was tasked with investigating the state of affairs in accounting at NPOs. Anthony published his findings in a research report (the "An thony Report" below). The Anthony Report made a major contribution toward establishing the conceptual framework for financial accounting at NPOs.

The Anthony Report was the first publication to use the term "financial viability."

As described in the Anthony Report and in the FASB's *Statement of Financial Accounting Concepts No.4, Objectives of Financial Reporting by Nonbusiness Organizations* ("SFAC-4" below), financial viability is the financial capability of an NPO to continue providing its services to society[1].

(2) Points to consider in evaluating financial viability

The key points[2] to consider with respect to financial viability are 1) the maintenance of net assets (including maintenance by category, with categories described later), 2) financial flexibility, and 3) ability to generate "hard money," which is non-donation funding.

1) The maintenance of net assets indicates whether net assets are maintained over every accounting period. If net assets are declining, it means that resources are being consumed faster than they are being replenished.

2) Financial flexibility evaluates the extent to which an entity can freely use resources. Resources that the organization is not able to use freely, such as those with restrictions placed on their use, must be used as stipulated. If such resources constitute a large share of the total, the organization is effectively constrained in its activities.

3) The ability to generate hard money evaluates to what extent the organization can generate resources which it is able to use in a manner it sees fit.

The concepts of "maintenance by category," "financial flexibility," and "hard money" mentioned here will be explained in the next pages and chapters, during the discussion of the relevant topics. We will explain hard money first, then financial flexibility, and finally maintenance of net assets by category.

(3) Hard money and soft money

The Anthony Report has this to say about the nature of resource inflows: "With regard to the nature of inflows, an important distinction in some organizations is between 'hard money' (e.g., revenues from services rendered) and 'soft money' (e.g., annual gifts.") (Anthony, 1978, pp.48-49). Hard money is the income received from providing services. Soft money refers to the usual donation income. Accordingly, "the higher the proportion of hard money, the firmer the financial foundation" (Anthony, 1978, p.49).

Also, the Anthony Report refers to the degree of resource transferability (financial flexibility). "Resource transferability refers

1 Financial viability is also considered in Wakabayashi (2002) on pp.26 and 29. It is also mentioned in paragraph 26 of SFAC-4 and p.49 of the Anthony Report.

2 Hino (2003) considers this in detail.

to the organization's freedom to use resources for various purposes." (Anthony, 1978, p.49). That is, the Anthony Report asserts that the more resources that are hard money, the greater the flexibility in using resources (financial flexibility) and thus the greater the financial viability.
From these three viewpoints then, what sort of financial reporting would be appropriate for assessing an NPO's financial viability? Next, we examine formats for financial reporting by NPOs.

2. FASB's financial statements for NPOs

(1) Balance sheet

Figure 1 shows an NPO's balance sheet as given in the FASB's Statement of Financial Accounting Standards No. 117 ("SFAS-117" below). Assets and liabilities in this example are roughly the same as those of a for-profit enterprise. However, the net asset classifications are different between the organization types.
Under FASB standards for NPOs, net assets are divided into three categories: unrestricted, temporarily restricted, and permanently restricted. We explain these three

Figure 1. FASB's example NPO balance sheet

Not-for-Profit Organization
Statements of Financial Position
June 30, 19X1 and 19X0
(in thousands)

	19X1	19X0
Assets:		
Cash and cash equivalents	$ 75	$ 460
Accounts and interest receivable	2,130	1,670
Inventories and prepaid expenses	610	1,000
Contributions receivable	3,025	2,700
Short-term investments	1,400	1,000
Assets restricted to investment in land, buildings, and equipment	5,210	4,560
Land, buildings, and equipment	61,700	63,590
Long-term investments	218,070	203,500
Total assets	$292,220	$278,480
Liabilities and net assets:		
Accounts payable	$ 2,570	$ 1,050
Refundable advance		650
Grants payable	870	1,300
Notes payable		1,140
Annuity obligations	1,685	1,700
Long-term debt	5,500	6,500
Total liabilities	10,630	12,340
Net assets:		
Unrestricted	115,228	103,670
Temporarily restricted (Note B)	24,342	25,470
Permanently restricted (Note C)	142,020	137,000
Total net assets	281,590	266,140
Total liabilities and assets	$292,220	$278,480

Source: SFAS-117, paragraphs 153-156, appendix C categories in Section 3 after looking at the statement of activities.

(2) Statement of Activities

Figure 2 is an NPO's statement of activities, as shown in SFAS-117. This can be considered as the equivalent of a profit and loss statement in corporate accounting. The upper section shows funding such as revenue and interest income, and the bottom section shows expenses, losses, and so on. Subtracting the items corresponding to costs in the lower half from the income equivalents in the upper half, the difference, or item corresponding to net income for the period, is shown as "change in net assets."

Figure 2. FASB's example NPO statement of activities

Not-for-Profit Organization
Statement of Activities
Year Ended June 30, 19X1
(in thousands)

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Revenues, gains, and other support:				
Contributions	$ 8,640	$ 8,110	$ 280	$ 17,030
Fees	5,400			5,400
Income on long-term investments (Note E)	5,600	2,580	120	8,300
Other investment income (Note E)	850			850
Net unrealized and realized gains on long-term investments (Note E)	8,228	2,952	4,620	15,800
Other	150			150
Net assets released from restrictions (Note D):				
Satisfaction of Program restrictions	11,990	(11,990)		
Satisfaction of equipment acquisition restrictions	1,500	(1,500)		
Expiration of time restrictions	1,250	(1,250)		
Total revenues, gains, and other support	43,608	(1,098)	5,020	47,530
Expenses and losses:				
Program A	13,100			13,100
Program B	8,540			8,540
Program C	5,760			5,760
Management and general	2,420			2,420
Fund raising	2,150			2,150
Total expenses (Note F)	31,970			31,970
Fire loss	80			80
Actuarial loss on annuity obligations		30		30
Total expenses and losses	32,050	30		32,080
Change in net assets	11,558	(1,128)	5,020	15,450
Net assets at beginning of year	103,670	25,420	137,000	266,140
Net assets at end of year	$115,228	$ 24,342	$142,020	$281,590

Source: from SFAS-117, paragraphs 157-159, appendix C, format B

Of note here is that, in addition to the total column, there are three other columns, one for each asset classification (unrestricted, temporarily restricted, and permanently restricted). These are closely related to the net asset classifications on the balance sheet.

(3) Characteristics of financial statements for NPOs

An examination of NPOs' balance sheets and statements of activities is indispensable in explaining the maintenance of net assets by category, which is why we looked at these first. Now, we turn to the discussion of maintaining net assets by category; we refer to "categories" throughout this report when describing different classifications of net assets.

As mentioned previously, the FASB classifies net assets as permanently restricted, temporarily restricted, or unrestricted. Under U.S. Generally Accepted Accounting Principles, as explained by Larkin and DiTommaso (2004), "permanently restricted net assets are net assets required by donor restriction or by law to be maintained by the organization in perpetuity" (p.79). In contrast, "temporarily restricted net assets represent those whose use has been limited (restricted) by restrictions placed either on the time period during when the assets may be used or the purposes for which the assets may be used." (p.79). Finally, "unrestricted net assets are all other net assets." (p.79).

This classification of net assets distinguishes them according to the restrictions placed on their use by the donors and other resource providers who have supplied them to the NPO. Restriction means there are stipulations about the use of the provided assets. If the donation received is specified as permanently restricted, it will increase the balance of permanently restricted net assets; if the donation is specified as temporarily restricted, it will increase the balance of temporarily restricted net assets. If the donation has no restrictions, it will increase the balance of unrestricted net assets. An unrestricted donation will increase financial flexibility and boost the financial viability of the receiving organization.

(4) Restrictions on donated resources

As seen above, the FASB's accounting for NPOs looks at restrictions placed on the resources received by NPOs, such as donations, and this is reflected in their accounting treatment and financial reports. This appears to be a useful method for assessing financial viability. The maintenance of net assets suggests that an organization is financially viable, but information on only maintenance is insufficient to ascertain that assets overall are being maintained; declines in one category of net assets may be offset by increases in other categories. If losses in unrestricted assets are offset by an increase in temporarily restricted assets, it suggests that resources are being consumed on a single-year basis.[3] Considering one financial reporting period,

3 According to Concept Statement No.6 from the FASB, "whether an organization has maintained certain classes of net assets may be more significant than whether it has maintained net assets in the aggregate." (FASB, 1985, paragraph 106)

the cost of providing a service by using unrestricted resources must be financed somehow. On a single-year basis, the consumption of unrestricted net assets is tantamount to a loss. This means that maintaining net assets by category is important. Additionally, because each category of net assets has donor stipulations, it is useful from the perspective of fiduciary duty to ascertain that assets are being maintained on a per-category basis.

For the purpose of assessing financial viability, it is useful to focus on the restrictions placed on donations, as donations without restrictions increase financial flexibility.

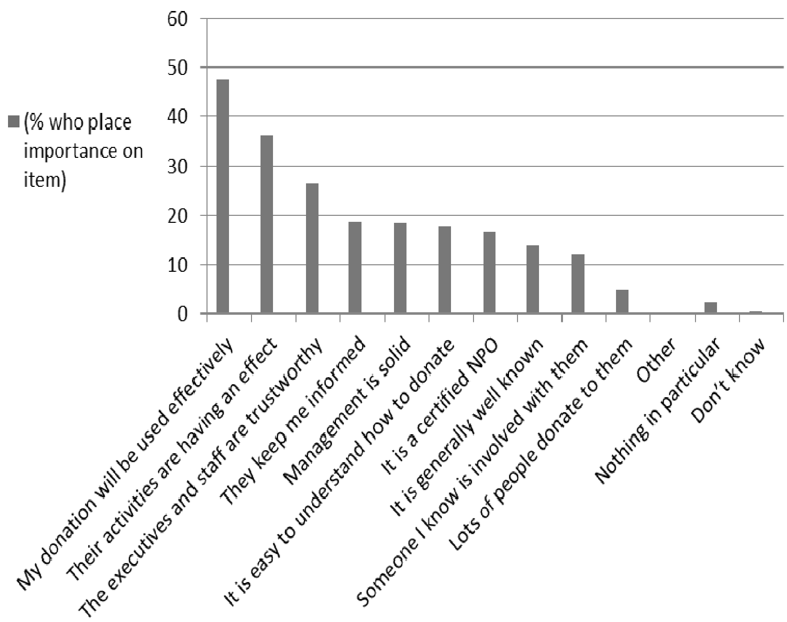
Identifying donations that increase the balance of permanently restricted assets is also useful for evaluating financial viability. These have the effect of generating income on deposits, and thus are equivalent to obtaining unrestricted resources.

3. Diary of daily transactions and fundraising

(1) Donors' decision-making process

We now consider donors' attitudes. The data shown in Figure 3 are based on the opinion survey on NPO organizations conducted by the Cabinet Office and published in June 2013[4].

Figure 3. What do you place importance on when donating?



Source: Public opinion survey on NPO organizations by the Cabinet Office, June 2013

4 This nationwide survey was conducted on the population of Japanese citizens aged 20 years old or older by a two-stage stratified random sampling method on a sample size of 3000. Survey items were (1) awareness and expectations of NPOS; (2) attitude toward participating in NPO activities; (3) awareness of amount of NPOs' information; (4) attitude toward donating to NPOs; and (5) requests about NPOs' agenda and administration.

There are five items surveyed. From among these, we focus on reasons for donating to NPOs. The most common response is “I can sympathize with the objective or the activities,” with 69.0%. Second most common is “my donation will be used effectively,” at 47.7%. This is followed by “their activities are having an effect,” at 36.3% and “the executives and staff are trustworthy,” at 26.4%.

With regard to the top response “I can sympathize with the objective or the activities,” it is only natural for a person to donate if they sympathize with the organization’s mission. In this paper, we think it is appropriate to focus on the second-most popular response, “my donation will be used effectively.” Moreover, we think it is important to focus on the fact that around half of the respondents answered this way. When donors provide resources to an organization, they want those resources to be used effectively towards the purpose for which they were given. This is because they are concerned with how the donation gets used.

With regard to attitudes when making a donation, the Donation White Paper published by the Japan Fund Raising Association comes to similar conclusions[5].

(2) Making use of a donation journal

In light of the results described above, financial reporting using the financial reporting templates shown in Figure 3 and Figure 4 is an effective method to raise funds. However, financial reports are not sufficient by themselves; the day-to-day use of resources must also be in accordance with stipulations. That is, there must be a record book tracking the balance sheet and statement of activities backed by double-entry bookkeeping. A simple closing statement cannot be deemed sufficient from a fiduciary perspective. During the course of research, the author could find no NPO that was currently employing such accounting methods.

We created a donation journal as an exercise, focusing on the daily accounting treatment of donor-stipulated restrictions on resources. We propose that NPOs should use a donation journal similar to the one shown in Figure 4.

Figure 4 assumes an accounting period of 1 month. The credit side of the ledger show donations received, and the debit side shows expenditures of the donations received. We explain the hypothetical transactions and record keeping in order of date.

April 1: Received cash donation of 200,000 yen as an endowment.

This is permanently restricted, so an entry is made in the “permanently restricted”

5 In the 2010 Donation White Paper, when asked “what do you emphasize when choosing where to donate?” the most common response with 56.7% was “I support/empathize with/have expectations for the activities’ intentions/purposes.” Next was “the use of donations is clear, and they will be used effectively” (55%). The next answer was well behind with only 29.7% identifying it as important. (Donation White Paper 2010) (2011). In the 2011 Donation White Paper, “the use of donations is clear, and they will be used effectively” was the top answer (51.5%). (2011 Donation White Paper (2012) p.63). Next was “I support/empathize with/have expectations for the activities’ intentions/purposes.” (47.8%). (2011 Donation White Paper (2012) p.63). The top and second responses traded places from 2010 to 2011.

Figure 4. Donation Journal

Date		Donations spent	Notes	Page	Permanently restricted	Temporarily restricted	nrestricted	Date		Donations received	Notes	Page	Permanently restricted	Temporarily restricted	nrestricted
4	3	Cash	Activity costs				7,000	4	1	Cash	Endowment		200,000		
	17	Cash	Supply purchase			5,000			〃	Cash	Activity funds				10,000
	30	Restriction lifted	Reclassified due to depreciation			1,000			5	Cash	Building purchase			100,000	
	〃	Accumulated depreciation	Depreciation				1,000		10	Supplies	Supplies in kind			20,000	
									15	Cash	For supply purchase			5,000	
									17	Supplies	Supply purchase			5,000	
									30	Restriction released	Reclassified due to depreciation				1,000
					0	6,000	8,000						200,000	130,000	11,000
	30		Release (temporary)				6,000		30		Temporary restriction				130,000
	〃		Release (permanent)				0		〃		Permanent restriction				200,000
	〃		Donation spent				14,000		〃		Donation received				341,000
			Carry forward to next period				326,000				Carried forward from previous				0
							341,000								341,000

column. On the same day a 10,000 yen donation is received, and this has no restrictions placed on it, so it is entered in the "unrestricted" column.

April 3: 7,000 yen cash is spent as part of activities.

This is in line with the organization's mission, so it is entered in the "unrestricted" column.

April 5: 100,000 yen cash is received for the purpose of purchasing a building.

This 100,000 yen is considered to be restricted until a building is purchased, so it is entered in the "temporarily restricted" column.

April 10: Supplies worth 20,000 yen are received.

This 20,000 yen worth of supplies must be used over their service life, so they are entered in the "temporarily restricted" column.

April 15: 5,000 yen in cash received for the purpose of supply purchase.

Because this 5,000 yen will be restricted until the money is spent on supplies, it is entered under the "temporarily restricted" column.

April 17: Supplies purchased with the 5,000 yen listed above.

These funds are the 5,000 yen earmarked for supply purchases received on April 15. At this point, the funds were used as intended, so the restriction is temporarily lifted; however, because the supplies purchased are meant to be used over their useful life, they are considered to have a temporary restriction placed upon them. Accordingly, on the credit side of the ledger, 5,000 yen worth of supplies purchased are entered into the "temporarily restricted" column.

April 30: Supplies are depreciated.

This is the most particular accounting treatment. Restrictions are lifted, but only for the amount of the depreciation. This is so that spending due to depreciation does not affect changes in net assets. The reason is that the decline in resources that the depreciation represents is funded by donations[6]. Accordingly, first an amount of 1,000 yen is deducted and entered on the debit side of the donation diary and, on the credit side in the “unrestricted” column, 1,000 yen in resources are released from restriction and recorded as an inflow. The payment of depreciation costs from the unrestricted resources is then recorded on the debit side.

(3) Monthly profit and loss accounts and profit and loss account spreadsheet

Figure 5 shows profit and loss accounts. In company accounting, there is one normal profit and loss account. However, as we have seen, in an NPO, there are three forms of resource inflow (unrestricted, temporarily restricted, and permanently restricted). This requires a three-pronged accounting treatment. The profit and loss accounts are divided into three different accounts: unrestricted, temporarily restricted, and permanently restricted profit and loss accounts.

The profit and loss accounts displayed here are constructed from the entries in the donation journal and classified by category. The reasons for increases and decreases are recorded in the notes section of the donation journal. The columns for donation inflows and outflows are account title columns, which are transferred to the usual general ledger.

Assuming that an accounting period is one year and that the donation journal and profit and loss accounts are ruled off each month, the statement of activities will represent 12 months of entries. We consider the construction of the profit and loss spreadsheet covering 12 months in the next article.

As we have shown, using the donation journal in this way enables management of

Figure 5. Statement of activities by category

Unrestricted statement of activities

4/3	Activity costs	7,000	4/1	Activity funds received	10,000
30	Depreciation	1,000	30	Depreciation reclassified	1,000
〃	Unrestricted net assets	3,000			
		11,000			11,000

Temporarily restricted statement of activities

4/17	Supply purchase	5,000	4/5	For building purchase	100,000
30	Depreciation reclassified	1,000	10	Receipt of supplies in kind	20,000
〃	Temporarily restricted net assets	124,000	15	For supply purchase	5,000
			17	Supply purchase	5,000
		130,000			130,000

Permanently restricted statement of activities

4/30	Permanently restricted net assets	200,000	4/1	Endowment funds received	200,000

6 Anthony advises that for depreciation to function properly these must be “fixed assets purchased with operational resources.” He also says that donations equivalent to the amount of depreciation should be drawn down (Anthony, 1989, p.63).

the donated resources in the manner stipulated by the donors.

Conclusion

This paper addresses some points to consider when assessing financial viability: 1) net asset maintenance, particularly by category; 2) financial flexibility; and 3) capacity to generate hard money, with a particular focus on donor-imposed restrictions on the use of donations. The reason we considered maintaining net assets by category was that for an organization to maintain its finances, it is, of course, necessary to preserve net assets overall, but it is also necessary to have an accounting treatment that enables the maintenance and management of each category (unrestricted, temporarily restricted, and permanently restricted). We examined financial flexibility because donor-imposed stipulations on resources can affect financial flexibility. That is, the more the assets are unrestricted, the greater the financial flexibility of the organization, which means that the organization will be more able to carry out activities to fulfill its mission without limitations imposed from outside. Additionally, to generate hard money, the existence of permanently restricted assets is important. That is, it is possible to obtain income (which is unrestricted) from the long-term investment of permanently restricted assets.

This paper proposes the use of a donation journal. This journal enables appropriate classification and accounting of donations to assure they are used in accordance with donor stipulations.

However, as there is still not yet a complete double-entry bookkeeping system, further investigation is necessary.

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