Second and Concluding Part

Accounting Principles and Procedures of Philanthropic Institutions

By LOUIS ENGLANDER, C.P.A.

Functional Classification of Expenses—Content of Categories

The social service objectives of an institution are translated into a program of activities or projects beneficial to the public. Each year the budget contains a list of such projects. All costs in connection with these projects, for which funds have been requested, should be included in the category, Social Service Program. Both direct and allocated costs should be included. By examination of the individual expenditures, the project which should be charged for a direct cost should be determinable. The indirect costs, such as rents, materials, etc. should be determined by the purpose for which the expenditures are made. The types of services vary with the objectives of the individual institutions. A few illustrative types taken at random, are: research, professional education, grants to other agencies; vacations for children; vocational training; individual case work; rehabilitation. Allocable costs include apportionable salaries, social security taxes, fringe benefits, travel and other expenses attributable to the individuals who work partly on some phase of social service, rent, utilities, etc.

Fund-Raising Costs

Fund-raising costs should include all expenses whose primary purpose is the solicitation of contributions. They should include publicity and promotion expenses incurred in connection with starting a campaign, all campaign costs, and all the necessary clerical and office expenses necessary to implement the campaign. Both direct and allocated expenses should be included. If several types of fund-raising effort (such as mail appeals, membership drives, special

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affairs and functions) are used, the expenses of each should be recorded separately. In connection with the special affairs and functions, only the expenses should be included. The direct costs should be deducted from the gross income.

A majority of the institutions do not consider that public education materials and services which are used in connection with a fund-raising effort, should be included in Fund-raising Costs. They allocate such costs to Public Information and Education. In a number of accounting manuals of various institutions, specific reference is made to this method of allocation. Two such manuals give the following definitions of Fund-raising Costs.

1. "Fund raising includes the expenses of the annual campaign and other fund-raising activities and the costs of publicity and promotion for the campaign. Materials and activities which are primarily educational in content and effect should be allocated to public education."

2. "Fund raising includes the expenses of the annual campaign, fees to fund-raising organizations and consultants, and all the costs of publicity and promotion for the campaign. While all the activities of the society in research, education and service may influence the willingness of the public to contribute to the support of the society, only those expenses directly incurred in fund raising should be allocated to this category. For example, publicity which is primarily educational in intent and in effect should be allocated to public education."

While not attempting to give a complete listing of all types of fund-raising costs, the following groupings indicate the major subdivisions of costs and expenses. These groupings will include all apportionments of expense account totals properly allocable to each sub-category.

1. *Publicity*—including the cost of media used in preparation for and conducting the campaign; television and radio time; newspaper, magazine and periodical space.

2. *Dinners and meetings* — for the purpose of fund raising.

3. *Campaign materials* — including costs of writing, producing or purchasing of campaign publications, products, exhibits or films; printing of pledge cards, receipt forms and other forms necessary for statistical data and record-keeping.

4. *Mailings* — including addressing, stuffing and postage.

5. *Salaries and fees*—including salaries of the fund-raising staff, and apportionment of time of others assigned to work on fund raising; fees to fund-raising organizations or consultants; social security taxes, fringe benefits and incidental expenses of fund-raising personnel.

6. *Other costs*—including clerical and bookkeeping time for receiving and acknowledging contributions, follow-up of pledges, keeping statistical records and preparing statistical reports; maintenance of contributors' mailing lists; rent and utilities.

Public Information and Education Costs

These costs should include all expenses for keeping the public informed of the services being offered; how and where these services can be obtained. In health organizations, it should include the cost of mass education of the general public with respect to a particular disease. In many institutions Public Education is one of the projects of the social service program, and as such, normally would be included in the Social Service category. However, nontechnical information, whose appeal is directed to the general lay public, usually is included in the category of Public Information and Education.

The major costs and expenses of Public Information and Education are:

1. *Publications*—writing, publishing and distributing educational materials, including television and radio scripts and announcements, pamphlets, articles, books.

2. *Instruction*—planning and presenting programs, lectures, classes, courses to the general public; training of personnel to participate in instruction.

3. *Information*—preparation, printing and distribution of materials concerning the nature and objectives of the institution; how and where the general public may avail itself of the services offered. Cost of a central information bureau open to the general public.

4. *Materials*—cost of all materials and supplies applicable to any information or education project.

5. *Salaries of participating employees*—either entire or apportioned, social security taxes, fringe benefits, and incidental expenses of these employees.

6. *Other costs*—including a portion of rent and utilities and other sundry expenses, whose purpose wholly or partially is informational and educational.

Administration Costs

Administration costs are those which deal with planning and directing institutional policies and finances. They should include the expenses of boards of directors who set policies, prepare and approve budgets; the expenses of the executive directors who carry out and interpret the policies to the staff, to other institutions, and to the public. They should also include the costs of financial management and control. Some examples are:

1. *Board of directors*—costs of meetings, travel.

2. *Overall direction*—executive director's salary, fringe benefits, travel and sundry expenses.

3. *Expense of assistants*—including secretary.

4. *Financial*—bookkeeping and accounting; legal fees; personnel management; purchasing; any other related costs.

It must be remembered that part of these costs may be incurred directly for one of the other categories, and will be so allocated. The costs remaining in the category of administration will be those not directly applicable to any other function.

Payments to Affiliated Organizations

This category applies to fund-raising agencies, and to the chapters, divisions, or branches of national institutions. The payments made by fund-raising agencies to the participating members of the agency should be included in this category. These payments represent the net cash available after all expenses of the fund-raising agency have been deducted.

Chapters of national institutions remit a portion of their contributed income to the national body. The amounts remitted are either on a percentage basis or on a budget basis, as agreed upon between the two. Certain types of income may be excluded from the divisible amount. Contributions received by the national body for the account of a chapter are credited to the branch; such amounts are included in the contributed income of the chapter. Where the chapter remits a percentage, the total contributed income is considered as the base for the apportionment. On the books of the chapter, this category should include all payments (either in cash or through credits) to the national institution.

Chapter Expansion Costs

National institutions, in attempting to increase the scope of their activities and to render service to more communities, either expand existing chapters or create new chapters. On the books of the national body, all costs expended for these purposes should be charged to this category.

It is recognized that the chapters furnish opportunities to extend the social service program to new communities, or to a larger public in communities already being serviced. There are corollary advantages in the process. New sources of contributions are opened. It is possible that some of the costs of chapter expansion might be chargeable to fund raising, but no workable formula has been suggested for such an apportionment. If the purpose of the expenditures truly is for greater opportunities for social service, it would not appear necessary to make such an allocation. Some institutions do not take the required cash from current contributions, but use earmarked funds to meet this objective.

Central Services Costs

This category is used primarily by fund-raising agencies and by national institutions. To it are charged all costs of services performed for the benefit of participating institutions and chapters. In fund-raising agencies, all costs are apportioned between those applicable to the agency itself and those applicable to its participating members. In national institutions, special services such as central purchasing, recordkeeping, preparation of fund-raising and public information materials may be performed.

Capital Expenditures

This category is used by institutions which do not capitalize their expenditures for fixed assets. It should include all expenditures for furniture, fixtures and equipment.

Methods of Allocating Expenses

Because expense accounts indicate merely the nature of the expense, it is necessary to analyze them further to indicate their purpose. Each nominal account may contain expenditures for various categories of expense. The account "Salaries" indicates the payment for services performed by employees, but not the purposes of the services. It is necessary and in accord with sound accounting principles to allocate the salaries into categories, showing the purpose of the expense. Although each institution can determine which method of allocation best suits each type of expense, a few general suggestions may be made which should be applicable to all institutions. For this purpose, expenses may be divided into three groups—(a) those in which employees' time spent is the determining factor (such as salaries); (b) those which may be allocated on a predetermined percentage basis (such as rent); and (c) those whose purpose must be examined when the expenditure is made to determine its allocation (such as materials and supplies). In groups (a) and (c), allocations should be made concurrently with the expenditures. Actual time and expense records of employees should be maintained. Allocations should not be made at the end of a period, on an estimated basis. In group (b), the basis of the determination of the percentage should be noted. The allocation may be made periodically.

Expense allocations may be made on the basis of:

1. Time spent by employees, as determined by time sheets.
2. Space used.
3. Activity or category benefited.
4. Nature and content of materials.
5. Immediate purpose of the expenditure.

There are many employees who perform more than one function, whose time must be allocated among the categories. While the best method of determining the allocation is through daily time sheets, many institutions believe this is too arduous and expensive a method. They keep these records for a portion of the year (such as a month or a quarter), and determine therefrom a percentage to be used for the year as a whole. Of course, where an employee works wholly within one function or category (fund raising, social service program) no allocation is required.

Occupancy expenses should be allocated on the basis of space used. The floor space allotted to and used for each category should be determined, and a percentage of the total space should be calculated. This percentage should be applied to all occupancy costs to determine the final apportionment. There are some expenditures (such as stationery and office supplies) made for the joint advantage of all the categories. These should be allocated on the basis of the activity of the category benefited. Since at the time of purchase it would be difficult to determine the amounts to be allocated, a percentage basis may be used. The percentage should be determined by an analysis of the actual distribution over a period of time (as a minimum, a two- or three-month period). Printed materials, publications, etc., are prepared or purchased for various purposes. The nature or content of such materials should determine their allocation. Where none of the methods clearly indicate the categories to be charged, the immediate purpose of the expenditure should determine its allocation.

Financial Reports

In the preparation of financial reports, the goal of accounting for philanthropic institutions must be borne in mind—that the reports are the financial presentation of management's stewardship of unrestricted funds and of its fiduciary obligations with respect to restricted funds. Reports should be prepared on the basis of this dual relationship, as if the institution had two individual entities. There should be two sets of financial reports, one for unrestricted funds, the other for restricted funds. Each of the two groups may be subdivided. The unrestricted funds may be segregated into current operating funds and earmarked funds reserved for special current or deferred purposes. Restricted funds may be segregated in accordance with restrictions. Each of the subdivisions may be reported as if it were a separate entity. The reports are prepared and issued for the benefit of management itself, for the contributors, for governmental agencies, and for other regulatory bodies. They should be prepared in as simple a manner as is consistent with the full disclosure of all material facts, since they will be examined not only by individuals trained to read and interpret the statements, but by the general public which is not so trained.

The Balance Sheet

The balance sheet should be presented not as a single unit of assets and liabilities, but as a group of individual statements—one for each fund. In effect, there should be as many balance sheets as there are funds, each independent of the others. There are a number of methods of presentation—(a) an individual balance sheet for each fund, presented in separate exhibits; (b) one exhibit, showing first the combined balance sheet of all unrestricted funds, followed by the combined balance sheet of restricted funds, the details of the individual funds of each group to be presented in separate supporting schedules; (c) one exhibit for all funds, showing the balance sheet of each individual fund, one following another; (d) one exhibit showing the balance sheet of each unrestricted fund, one following another, and a second exhibit showing the statement of changes in net assets of restricted funds.

If income is reported on a cash basis, the amount of pledges receivable should be disclosed. This may be done as a footnote on the balance sheet, disclosing the gross amount, and the anticipated collections thereon, or in the balance sheet itself, showing the gross amount less a 100 per cent reserve.

If buildings are set up at a nominal cost, the purchase price of the buildings and the fair market value of donated buildings should be shown. In lieu of this, or in addition, it may be desirable to show the estimated current market value.

The Operating Statement

The operating statement may be either a statement of cash receipts and disbursements, or a statement of income and expenses. In either case both income and expenses should be reported by funds and by categories.

Income other than contributed income and endowment income should be related to the costs necessary to obtain it. Membership dues should be related to membership costs and expenses; the costs and expenses of sales or services rendered should be segregated and applied against earned income from sales and services.

Unlike the balance sheet treatment, where each subdivision of unrestricted and earmarked funds may be considered as a separate unit, income and expenses should be reported in only two groups—unrestricted funds and restricted funds. The income and expenses applicable to each subdivision of the groups should be reported, either in columnar form in the proper exhibit or as separate schedules of the exhibits.

Reporting expenses by expense classifications, through nominal accounts only, does not present full disclosure of the facts. The functions or purpose of the expenditure should be reported by means of functional classifications or categories. Since this type of classification requires allocation and apportionment of expenses, the auditor should include a statement in his report to the effect that the bases of allocation have been examined and approved by him.

At least two categories of expenditures should be included in the report—expenditures for the social service program, and expenditures required to implement the program. Each group may be subdivided as required by the reporting institution.

The operating statement for restricted funds may be omitted if it is replaced by a statement of changes in the net assets of these funds.

Transfers between unrestricted and restricted funds result in income for one and expense for the other. Transfers between any two unrestricted funds do not. If a restricted fund whose income is available for general purposes transfers cash to an operating fund, the amount transferred is an expense of the restricted fund and is income for the operating fund. If the operating fund transfers cash to an earmarked endowment fund or to a temporary special purpose fund, (all of which are unrestricted funds) neither the income nor the expenses of unrestricted funds as a group is involved.

Illustrative Financial Reports

In the following statements, only the generic titles will be used. "Cash" will represent all the individual items usually appearing on balance sheets, such as cash on hand, cash in individual banks, cash in savings accounts, etc. The accounts will not be listed by groups, such as current, fixed, etc.

The following statements are presented:

(a) Balance Sheet.

(b) Statement of Changes in Balances of Unrestricted Funds.

(c) Statement of Changes in Balances of Restricted Funds.

(d) Statement of Income and Expenses.

(e) Statement of Expenses Allocated into Categories.

Figure II

BALANCE SHEET—DECEMBER 31, 19—

Assets			Liabilities and Fund Balances		
Unrestricted Funds					
Operating Fund:					
Cash	$x		Accounts payable	$x	
Investments	x		Accrued expenses	x	
Receivables	x		Operating Fund balance (Note)	x	
		$x			$x
Endowment Fund:					
Cash	$x		Endowment Fund balance	$x	
Investments	x				
		$x			$x
Restricted Funds					
Research Fund:					
Cash	$x		Unpaid appropriations	$x	
Investments	x		Research Fund balance	x	
		$x			$x
Building Fund:					
Land and building, at nominal value (cost $)	$x		Building Fund balance	$x	
		$x			$x

Note: Pledges receivable in the amount of $.......... are not included.

Figure III

STATEMENT OF CHANGES IN BALANCES OF UNRESTRICTED FUNDS

Year Ended December 31, 19—

OPERATING FUND		
Balance of Fund—January 1, 19—		$x
Additions		
(Specify)	$x	
Income for year (Page)...	x	
		x
		$x
Deductions		
(Specify)	$x	
Expenses for year (Page)...	x	
		x
Balance—December 31, 19— (Page)		$x

Note: Continue with similar statement for each unrestricted fund.

Figure IV

STATEMENT OF CHANGES IN BALANCES OF RESTRICTED FUNDS

Year Ended December 31, 19—

RESEARCH FUND:			
Balance of Fund—January 1, 19			$x
Consisting of			
Cash	$x		
Investments	x		
	$x		
Income			
Contributions		$x	
Gain on sales of securities		x	
			x
			$x
Expenses			
Awards for research		$x	
Custodial fees		x	
			x
Balance of Research Fund—December 31, 19—			$x
Consisting of			
Cash	$x		
Investments	x		
	$x		
Less unpaid appropriations	x		
	$x		

Figure V

STATEMENT OF INCOME AND EXPENSES

Year Ended December 31, 19—

	Total	Operating Fund	Endowment Fund
INCOME:			
Contributed income ...	$x	$x	$x
Membership dues	x	x	
Endowment income ...	x	x	x
Earned income	x	x	
	$x	$x	$x
Interfund transfers		x	(x)
TOTAL INCOME	$x	$x	$x
EXPENSES:			
Fund raising	$x	$x	
Public information and education	x	x	
Administration	x	x	x
Chapter expansion	x	x	
Capital expenditures ..	x	x	
Social service program	x	x	
TOTAL EXPENSES ..	$x	$x	$x
EXCESS OF INCOME	$x	$x	$x

NOTES:

1. If earned income is material, separate schedules should be prepared showing gross income, costs and expenses.
2. Contributed income should be classified in accordance with form presented on page 284 (April 1958 issue).
3. Supporting schedules of expenses are shown on page 340.

Suggested Accounting Principles for Philanthropic Institutions

This article has attempted to point out differences in accounting procedures of business enterprises and philanthropic institutions. From a review of the subject and an analysis of the differences, it is possible to formulate a statement of accounting principles applicable to philanthropic institutions. These suggested principles will be presented in three groups—conventions, standards of recording, and doctrines of reporting.

Conventions

1. *Non-profit Viewpoint.* Philanthropic institutions are organized for social service, not for profit. Therefore, the accounting principles and procedures applicable to the determination of business net income do not necessarily apply.

2. *Dual Entity Concept.* As in business enterprises organized for profit, each individual agency is deemed to be a separate and distinct entity. However, in philanthropic institutions, each agency may have a dual entity—one which receives and accounts for the unrestricted

Figure VI

STATEMENT OF EXPENSES ALLOCATED INTO CATEGORIES

Year Ended December 31, 195——

Account	Total	Fund Raising	Public Information and Education	Administration	Chapter Expansion	Capital Expenditures	Social Service Program
1. Salaries							
2. F.I.C.A. and fringe benefits							
3. Rent and utilities							
4. Building repairs and maintenance							
5. Travel, auto expense, carfare							
6. Telephone and telegraph							
7. Meetings, conferences, dinners							
8. Professional fees							
9. Office supplies and expenses							
10. Rental and service of equipment							
11. Insurance							
12. Printing and lettershop, including distribution expenses							
13. Publications purchased							
14. Development of materials for publications							
15. Publicity and promotion							
16. Furniture and fixtures							
17. Chapter assistance and expansion							
18. Special fund-raising events							
TOTALS							

contributions and sundry other income; the other, which acts as custodian for restricted contributions, to be used and accounted for as the donors have prescribed.

3. *Annual Accounting Period.* The life of any enterprise ordinarily is planned to extend over a period of years. In order to facilitate recording and reporting, the financial data are recapitulated in terms of annual fiscal periods. In philanthropic institutions, a further reason exists for this procedure. Their major source of income is contributions, received in the main as a result of annual fund-raising efforts. There is no assurance that there will be a repetition or continuity of contributions, without additional fund-raising efforts. The annual accounting period is not only convenient, but also logical.

4. *Responsibility for Adherence to Budget.* To justify requests for contributions, the public must be informed of the aims of an institution, the specific projects contemplated to fulfill the aims, and the anticipated costs. For this reason, budgets should be prepared and presented to the public as part of the appeal. The budgets constitute an implied promise as to the manner in which contributions will be utilized.

5. *Special Nature of Accounting Goal.* The goal of accounting should be the recording and reporting of financial transactions in a manner which will best account for the stewardship of unrestricted funds and the trusteeship of restricted funds.

Standards of Recording

1. *Recordkeeping on Fund Accounting Basis.* The books should be set up and reports made on the basis of funds, each fund to be treated as if it were a separate entity. If unrestricted funds are thereafter earmarked by the directors for special purposes, each such fund should be treated as a separate entity.

Accounts should be set up not only by natural classification, in nominal accounts, but also should be subdivided by functional classifications, into categories.

2. *Matching of Revenues and Expenditures.* In business enterprises operating on the accrual basis, revenues must be related to applicable costs in the determination of net income. All costs, whether or not paid for, must be matched against all revenue, received or receivable. Costs are ordinarily incurred with the primary expectation that they will produce revenue. In philanthropic institutions this principle is applicable only to earned income, where corresponding costs and expenses should be related.

In philanthropic institutions, contributed and other income must first be released or raised in order to provide the means of meeting all expenditures, whether for current operational costs or for capital expenditures. Hence the matching process consists of relating the contributed and other income to all expenditures made in the same fiscal period, whether or not the expenditures have been wholly consumed therein.

Income and expenses may be recorded either on a cash, accrual, or a modified accrual basis, as long as there is full disclosure of material facts. It should be noted that a majority of institutions use the modified accrual basis of recording.

3. *Expense Proration Principle.* Normally, expenditures should not be prorated by accounting periods, but should be recorded as expense in the year they are incurred. This includes payments for capital expenditures — buildings, furniture and fixtures and automotive

equipment. It includes expenditures for items whose useful life extends beyond the current accounting period—insurance premiums, publications distributed without charge, etc.

There may be two exceptions to this procedure

a. In the case of expenditures related to earned income from sales or services, as noted above, prorations should be made unless they are immaterial in amount.

b. In some instances, this procedure may have the effect of invalidating comparisons of operations between years. Although variations of expenditures for a particular item of expense may readily be explained, if proration is used as a better method of comparison, it should be considered acceptable.

The cost of buildings should not be amortized by periodic depreciation charges in the operating statement of the General Fund. It should be set up, in a special fund, either at cost or at a nominal value. If the building is set up at cost, depreciation may be charged against the special fund, so that a record of the current amortized value of the historic cost is available. It must again be emphasized that depreciation should not be charged as an operating expense.

4. *Expense Allocation Principle.* Expenses should be allocated among functional classifications or categories, to show their purpose as well as their nature. Those methods of allocation should be applied which best fit the various types of expenditure. The purpose for which the expenditure was made should serve as a guide for its classification.

Doctrines of Reporting

1. *Full Disclosure.* Reports should reveal all material financial data in as simple a manner as possible. In furtherance of this requirement, the reports of unrestricted and restricted funds should be presented separately. Income and expenses of each fund should be segregated into functional categories.

2. *Budget and Operating Statement Comparison.* Actual results of operations should be compared with budgeted figures. In this way the public is afforded the opportunity of judging how well the implied promises of the budget had been fulfilled.

3. *Bases of Expense Allocations.* A statement concerning the methods of allocation should be included as part of the financial report. Although a detailed report of the bases used need not be included, those who read the report should be assured by the auditor that the methods employed were investigated and found to be satisfactory.

4. *Consistency.* Reports should be prepared from accounting records maintained on a basis consistent with that of prior years. Any material variation in principles applied should be noted in the report.

5. *Conservatism.* Fixed assets may be reported at a nominal value, which is less than the cost. In business enterprises, this procedure is unacceptable because

a. It reduces profits improperly, while

b. It creates a hidden reserve, thereby understating the net worth.

There is justification for the doctrine as applied to philanthropic institutions. No profits are involved; hence, there is no improper reduction thereof. The hidden reserve created applies only to the plant or building fund, which was created through contributed income. The expenditure of that income will have been reported in the year it was received, thereby fulfilling the obligation of the institution to account for income received. The building may be regarded as a necessary tool for the implementation of program over subsequent years. While it is true that there is an intrinsic value not recorded among the assets, thereby creating a hidden reserve, that reserve normally cannot be used for the current purposes of the institution. If desired for the purpose of full disclosure, the original cost of the assets recorded at a nominal value may be noted in the report.

A Forward Look

The present report does not pretend to be a complete study of the accounting principles and procedures employed by all philanthropic institutions. On the other hand, it is based upon a thorough investigation of a sufficiently representative cross-section of this field. There is sufficient agreement in the major areas of recording and reporting to conclude that a statement of generally accepted accounting principles for philanthropic institutions can be formulated. Certainly there was an intense desire among the participating individuals and institutions to cooperate fully. The necessity for continued study is recognized.

The combined knowledge and experience of all public and private accountants involved in this field should be utilized in the reexamination and appraisal of the statement of acounting principles proposed herein. Those which withstand such a test of general acceptability should be incorporated into a statement of generally accepted accounting principles for philanthropic institutions. This may best be done under the sponsorship of some recognized professional accounting group working in conjunction with research agencies in the various fields of philanthropy.

There is a definite need for the creation of a uniform terminology in this field, and a refinement of the concepts applicable to the terminology established. This is of sufficient importance to warrant further study by a special committee of the group suggested previously.

Two factors give rise to the opinion that the categories of expenses in use at present may be inadequate or impractical — the changing concept of fund raising and the mass education program of many institutions. The title of the category, Fund Raising, is believed to be inadequate and misleading to describe the types of costs presently included therein. Mass education is the purpose and the program of a number of institutions, which would classify the costs as part of their social service program, not as public information and education. The problem of reclassifying and renaming of categories should be investigated.

The accounting problems of philanthropic institutions differ from those of business enterprises organized for profit. These institutions form a sufficiently large segment of enterprise activity to have warranted this study. It has been undertaken with a view to assisting in the establishment of uniform accounting principles and procedures which will make financial reporting more useful to the institutions themselves and to the general public. It is hoped that this report on the study has fulfilled these objectives.