

Financial Statements in NPOs

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Abstract

The World Bank defines NPOs (Not-for-profit organizations) as “private organizations that pursue activities to relieve suffering, promote the interests of the poor, protect the environment, provide basic social services, or undertake community development”. The term NPO is very broad term and includes community groups, non-governmental organizations, charitable organizations, faith-based organizations, self-help groups and other foundations.

Like any other organization, the financial statements of the NPO are used by different users for different purposes. The chief users of financial statements in an NPO are the members, beneficiaries, resource persons, creditors, employees and government or other authorities. In preparation of financial statements in an NPO key characteristic of understandability, relevance, reliability and comparability should always be considered.

In this paper the author has given a brief discussion on what comprises as the financial statements of NPOs and what are the key components of these financial statements of the NPOs

Keywords: NPOs, statement of affairs, restricted funds, unrestricted funds, endowment funds, deferred income, statement of financial activities, restricted revenue, unrestricted revenue, accumulated fund

1. Introduction

At the end of each year (the year adopted by the organization, may be a financial year, calendar year or any other period involving 12 months) final accounts are drawn up. These final accounts show the financial position of the organization in a brief and ready to understand way. These are used by management, funding agencies, and members etc. to analyze and understand the financial position of the organization [1, 2].

In the succeeding paragraphs we shall discuss the key components and elements of financial statements in greater detail.

The Financial Statements in NPOs include [3] –

- Balance Sheet/ Statement of affairs

- Income and Expenditure account/ statement of financial activities
- Statement of changes in funds
- Cash flow statement
- Accounting policies and notes on accounts

2. Balance Sheet/Statement of affairs

Balance Sheet provides a bird's eye view on the assets and liabilities of any concern at the end of the accounting year. It also shows an entity's state of affairs at a particular date. In case of NPOs the main purpose of the Balance Sheet is to depict the availability of resources to the NPO and whether these resources are freely available or whether they have to be used for specific purposes as per the restrictions imposed by the donor agencies or any other legal restrictions. The main items of assets of an NPO Balance Sheet includes plant, property and equipment, investments, financial assets, intangible assets, inventories, biological assets, receivable and cash and its equivalents. Similarly, the major items of liabilities in an NPO Balance Sheet shall include payables, provisions, financial liabilities and the balances of accumulated fund both restricted as well as unrestricted. The nature, disclosure and presentation of some of the key components of the of the Balance Sheet are discussed below-

2.1. Unrestricted Funds

Unrestricted fund is like the capital of an NPO. It includes funds which neither have any restriction on their use nor have been designated for any specific purpose by the management. This is disclosed separately in the financial statements. The increase in this fund may be caused by way of free contribution from donors or transfer of any surplus remaining in restricted funds provided that such is permitted by the relevant contract or agreement. This fund may also be presented as General Fund.

2.2. Restricted Funds

Restricted funds are funds subject to certain conditions set out by the contributors and agreed to by the NPO when accepting the contribution. These are also called 'Unspent Grants'. These represent a part of Restricted Net Assets in NPOs. Such funds are recognized in the Balance sheet only at the time of actual receipt of such funds or when there is reasonable assurance that the money will be received.

2.3. Designated Funds

Designated funds are part of unrestricted funds which are designated by the management of an NPO for specific purposes or to meet future commitments. These are shown separately in the Balance Sheet.

2.4. Endowments funds

Endowments funds are those funds which are received with the stipulation that only the income earned can be used, either for the general purposes of NPO or for specific purposes. Such funds should also be shown separately in the Balance Sheet.

2.5. Capital Reserve

Donations and Grants which do not require fulfillment of any obligation and are related to non-depreciable assets are included in Capital Reserve.

2.6. Deferred Income

Deferred Income is that income which has been received but for which obligations has not yet been fulfilled. Grants and donations which are related to non-depreciable assets which require fulfillment of certain obligations and grants and donations related to specific depreciable assets are shown as deferred income.

An NPO shall present current and non-current assets and current and non-current liabilities as separate classifications on the face of its Balance Sheet except when a presentation based on liquidity provides information that is more reliable and relevant. When presentation is based on liquidity all assets and liabilities should be presented in order of liquidity. An asset or liability should be classified as current only if it is expected to be realized or settled in the organizations normal activity cycle or it is expected to be realized or settled within twelve months after the balance sheet date.

3. Statement of financial activities/ Income and Expenditure Account

Statement of financial activities is a single accounting statement with the objective of presenting all incoming sources and resources expended by the organization during the year in respect of all of its funds. This statement shows whether there has been a net inflow or outflow of resources. It shall also provide a reconciliation of all movements in organization's fund. As a basic requirement this statement should distinguish between restricted and unrestricted income and between general administrative expenses, direct project expenses and expenses incurred on the generation of funds. On the face of the statement of financial activities amount related to incoming resources, project expenditure, revenue, general costs, finance costs, tax expense may be disclosed separately [4]. The following paragraphs deals with the recognition criteria of major components of revenue and expenditure in an NPO.

3.1. Recombination of Revenue

1) *Restricted Revenue*¹: Since there are conditions imposed on the restricted contributions from donors etc. and such contributions are not gratuitous, revenue should not be recognized until there is reasonable assurance that the contribution will be received and the conditions stipulated for its receipt have been complied with. The principle of 'matching' revenue against cost should also be followed in recognizing revenue. Such contributions should be recognized only to the extent that the organization has provided the relevant services or performance [5].

On receipt of restricted contribution it should first be credited to a separate account under the liabilities side of the balance sheet from which amount may be recognized as revenue on a systematic basis equivalent to the amount spend on 'restricted' activities. Thus there will be no surplus or loss arising from restricted activities. The net result of restricted activities will always be 'Zero'. The net surplus or deficit in any financial year will only be due to 'unrestricted' revenue or cost.

2) *Unrestricted Revenue*: Revenue derived from unrestricted resources should be recognized when the amount of revenue can be measured reliably, or when it is probable that the economics

benefits from the transaction will flow to the NPO. The broad criteria related to revenue recognition as in case of business entities should be followed in recognizing revenue from unrestricted resources i.e. when no significant uncertainty exists regarding the amount of the consideration that will be derived from and it is not unreasonable to expect ultimate collection of the consideration. Example of unrestricted revenue includes membership fees, sundry donation, and sale of goods or other sources of unrestricted income.

3.2. Recognition of costs/Expenditure

An expense is a cost relating to the operation of an accounting period or to the revenue earned during the period or the benefits of which do not extend beyond that period. 'Cost' means the amount of expenditure incurred on or attributable to a specified article, product or activity. Cost and expenditure should be recognized as an expense at historical cost. Recognition must be in the period in which the cost and expenditure is incurred.

In an NPO when expenditure is linked to performances, it should be recognized to the extent that the NPO or any other nominated recipient of the contribution has provided the specified services or work or incurred the specified expenditure.

Further the expenses should be distinguished between general administrative expenses which are not related to any project and direct project cost/expenses. Expenses incurred on generation of funds may also be disclosed separately.

On the face of the statement of financial activities amount related to incoming resources, project expenditure, revenue, general costs, finance costs, tax expense may be disclosed separately.

4. Statement of changes in Accumulated Fund

Statement of changes in Accumulated Fund shall be presented by an NPO comprising of restricted, unrestricted and other funds. The statement shall show for each fund the following-

- the opening balance at the beginning of the year,
- additional funds received during the year and the total amount received,
- the amounts transferred from the respective funds and charged to the statement of financial activities to meet expenses incurred during the period,
- deductions during the year, and
- any surplus or deficit transferred from the statement of financial activities at the end of the period.

The change in the accumulated fund represents the total amount of income and expenses and gains and losses generated by the entities overall activities during the reporting period. It is not material whether the items of income and expenses are recognized in Income and Expenditure or directly in the accumulated fund. Any change in the unrestricted funds in the accumulated fund between balance sheet dates shows the increase or decrease in its net assets for the period.

5. Cash Flow Statement

The cash flow statement as a part of financial statements helps users of financial statements in making socio economic decisions. Cash flow statement should report the cash flows during the period

classified by operating, investing and financing activities. It can be prepared by using either direct or indirect method.

Under the direct method, cash receipts and cash payments are worked out by analyzing accounts relating to cash, bank and short term liquid investments qualifying as cash equivalents. Adjustments are made in Income and Expenditure account for non-cash items and other items for which the cash effects are investing or financing cash flows in the Income and Expenditure account.

The Indirect method commences with the “Net incoming/ outgoing resources’ as per the statement of financial activities. This comprises net incoming/ outgoing resources before the disposal of investment and assets. Adjustments would be made for non-cash charges and credits in order to arrive at cash generated from operations. Adjustment is also made for credits and expenditure related to restricted funds as no cash is involved at this point. Restricted income to the extent of direct project expenses is shown in the ‘financial’ section of the cash flow statement.

The cash flow statement help users of financial statements in assessing the ability of the entity to access cash and cash equivalents and the needs of the entity, which utilizes those cash flows.

6. Accounting Policies and Notes on Accounts

An NPO should disclose significant accounting policies followed in preparation of accounts. All accounting policies should be disclosed at one place. The summary of significant accounting policies should include the measurement bases like historical cost, current cost, net realizable value, fair value or recoverable amount used in preparing the financial statement and other accounting policies used that are relevant to an understanding of the financial statements. This helps users in analysing the financial statements in a more proper way.

The notes shall include any information that is required by any law and is not presented on the face of the balance sheet, statement of financial activities, statement of changes in accumulated fund or cash flow statement and should provide additional information that is not presented on the face of the balance sheet, income and expenditure account, statement of changes in accumulated fund or cash flow statement but is relevant to an understanding of any these statements.

Any item in the balance sheet, income and expenditure account, statement of changes in accumulated fund, cash flow statement should be cross-referred to the information in notes.

Other disclosures regarding the legal form of the NPO, its country of incorporation, details of principal place of activities, nature of principal activities of the organization and any other relevant information that helps the user of the financial statements in decision making may also be disclosed.

However, in preparation of the above financial statements it should always be seen that the basic requirements of most of the users is met. It should also be seen that in preparation of these financial statements the benefits derived from the information exceeds the cost of providing it. Whatever statements are prepared the ultimate aim of the financial statements is to present a true and fair view of the results for the period and the state of affairs at the end of the period.

REFERENCES

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