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Accounting principles and procedures of philanthropic institutions

Louis Englander

New York Community Trust

ACCOUNTING PRINCIPLES AND PROCEDURES OF PHILANTHROPIC INSTITUTIONS

(Report on a study sponsored by The New York Community Trust)

By Louis Englander, C.P.A.
Partner, Apfel and Englander, C.P.As., New York, N. Y.

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PREFACE

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The idea for this study was suggested and primarily financed by The New York Community Trust. However, neither the proposal nor the compilation of a survey of this size and scope can be wholly attributable to a single sponsor or author.

In the course of the inquiry, I met and consulted many individuals associated with various philanthropic institutions. I also called upon a number of independent public accountants for assistance. I have had the wholehearted cooperation of all with whom I have dealt. Not only individuals, but also institutions answered all requests for information. To all those who have helped, I acknowledge my appreciation for the many courtesies extended.

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Of course, the statements, opinions and conclusions contained in this report are the sole responsibility of the undersigned.

LOUIS ENGLANDER, C.P.A.

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1.1 Accounting Principles

Accountancy is a relatively young and expanding field of professional endeavor. The evolution of its governing principles usually involves two phases: (a) a tentative statement thereof, derived from a study of actual recording and reporting procedures, and (b) their reexamination as to general acceptability by the profession at large. Actually, these principles include three related groupings: (1) the accounting *conventions,* or generally accepted axioms of the profession; (2) the objectively determined accounting *standards,* against which the correctness and propriety of the practitioner's professional performance may be measured, as a safeguard against improper or irregular practices; and (3) the recognized *doctrines of* proper financial *reporting.* When approval is indicated by authoritative professional acceptance, they become "generally accepted accounting principles," and constitute the precepts by which members of the accounting profession guide themselves in the conduct of their professional practices.

Practitioners, teachers and professional organizations have prepared numerous compilations of the principles of accounting, mostly from the viewpoint of businesses organized for profit. The American Institute of Certified Public Accountants is one such professional organization whose pronouncements are highly regarded and carry great weight. The conclusions of its Committee on Accounting Procedures, as set forth in the published bulletins, reflect the generally accepted accounting principles applicable to present day practice.

1.2 Applicability of A.I.C.P.A. Bulletins

The opinions expressed by the committee in these bulletins, are limited in applicability. In its Bulletin #43, entitled "Restatement and Revision of Accounting Research Bulletins," the committee states

> "The principal objective of the committee has been to narrow areas of difference and inconsistency in accounting practices, and to further the development and recognition of generally accepted accounting principles, through the issuance of opinions and recommendations that would serve as criteria for determining the suitability of accounting practices reflected in financial statements and representations of commercial and industrial companies. In this endeavor, the committee has considered the interpretation and application of such principles as appeared to it to be pertinent to particular accounting problems. The committee has not directed its attention to accounting problems or procedures of religious, charitable, scientific, educational, and similar non-profit institutions, municipalities, professional firms, and the like. Accordingly, except where there is a specific statement of a different intent by the committee, its opinions and recommendations are directed primarily to business enterprises organized for profit."

The last sentence is important. The committee's opinions and recommendations are directed primarily to business enterprises organized for profit. Hence it is incumbent upon the profession to determine to what extent the opinions and recommendations apply to enterprises not organized for profit, and to fill in the gaps where they exist.

1.3 "Philanthropic Institutions" Defined

The word philanthropy is defined as "love of mankind, especially as manifested in deeds of practical beneficence." Hence philanthropic institutions are those whose aim is to perform deeds of practical beneficence—to render assistance to the needy; to initiate and further research beneficial to mankind, where the results of the research will not be used for private profits; to improve the mental, moral and physical well-being of humanity.

The specific areas in which these organizations function are numerous and varied, from individual care to international relations. Some are self-liquidating, others will go on forever. But their goal of service to humanity differs radically from the profit goal of business enterprises. A study and statement of their accounting principles and procedures is definitely warranted.

1.4 Reports on Prior Investigations

In several non-profit fields, reviews of procedure already have been undertaken, and resulting texts have been prepared. The American Council of Education has issued a two-volume text, *"College and University Business Administration,"* prepared by a committee of employees of member colleges and universities. Through a similar committee, the American Hospital Association has issued a text, *"Handbook on Accounting, Statistics and Business Office Procedures for Hospitals."* A committee of the California Society of Certified Public Accountants has prepared a *"Statement of Accounting Principles for Social Service Agencies."* A number of non-profit institutions have prepared accounting manuals for themselves as well as for their branches and chapters.

In all of these texts there are variances from the accepted accounting principles and procedures applicable to business enterprises organized for profit. The variances are sufficiently material to warrant their further study to determine their applicability to the broad field of philanthropic institutions.

1.5 Scope and Method of this Study

The study was undertaken to determine whether a uniform system of financial recording and reporting could be designed for all philanthropic institutions. Religious, social and governmental institutions were not considered as falling within its scope. Hospitals and educational institutions were also excluded because of prior studies and reports thereon.

The available published literature on the subject is quite sparse. Aside from the texts mentioned in preceding paragraphs, there were comparatively few articles appearing in technical journals—all of which were carefully examined.

Executives of many philanthropic organizations were interviewed. Through their courtesy, financial reports of various types of philanthropic institutions were made available for examination. Reports of internal and independent public accountants were studied; in this connection, reports for at least two successive years were sought, for purposes of comparison. In all, over one thousand reports of approximately four to five hundred individual agencies were reviewed. From these, one hundred or more, selected as representing typical institutions of differing types and varying size, were selected for detailed study.

A questionnaire regarding specific practices of recording and reporting was sent to twenty-five national philanthropic institutions; twenty-four replied. The answers in some cases were accompanied by charts of accounts, accounting manuals, and other helpful materials, all of which were carefully analyzed.

The files of a committee of the California Society of Certified Public Accountants, which prepared the statement of accounting principles previously mentioned, were made available and were carefully studied.

As each step of the study progressed, the findings were discussed with individuals directly involved in the financial division of some philanthropic institution. The tentative conclusions were discussed at several meetings with groups of financial personnel representing national and local philanthropic agencies. Of course the responsibility for the statements and opinions contained in this report is entirely that of the author.

2 BASIC OPERATIONAL CONCEPTS

2.1 *Concepts Affect Accounting Systems*

There are some basic concepts peculiar to philanthropic organizations, which differ from those found in commercial enterprises. These concepts may be considered as a basic philosophy which must be recognized when an accounting system is designed. They affect operational, financial and accounting procedures as well as methods of recording and reporting financial transactions. They become the chief causes of the differences in the principles and procedures between profit and non-profit enterprises.

2.2 *Social Service Motive*

Business enterprises are organized primarily for the purpose of making profits. Philanthropic institutions by their very nature cannot achieve profits; they are organized primarily for the purpose of rendering some form of social service to the community.

The determination of the net profits of business enterprises ordinarily involves the process of matching all applicable costs against the corresponding revenues of a fiscal period. As a result, principles and procedures have been evolved for the allocation of costs which should be applied currently and costs which should be deferred until the related revenue is attained. In this way, all applicable costs are matched against the related revenues of a fiscal period, for the purpose of determining the net income.

Philanthropic institutions do not make profits. The principles and procedures set up for the determination of business net income, therefore, do not necessarily apply. There is no compulsion to charge revenue with corresponding applicable costs. Thus, expenditures for capital assets need not be apportioned between current and deferred costs, and other expenditures which normally would be allocated in profit-making enterprises, need not be allocated. There may be reasons why such allocations may be permissible or even desirable, but the principles involved are different. They will be discussed later in this report.

2.3 *Budgetary Control*

In order to enlist public support, a philanthropic institution must inform the public of its program,—the estimated social service program costs, and the necessary expenses to implement the program. Therefore budgets must be prepared, outlining the specific projects to be undertaken. The budgets include estimates of income as well as costs, and are sufficiently detailed to make possible a comparison with achieved results. Besides acting as a guide to estimated expenses, the budget may become an authorization for expenditures. A carefully planned budget becomes a valuable adjunct to proper recording and reporting.

While budgets do not establish a contractual relationship with the contributor, they are at least a part of an implied promise that expenditures will be made in accordance with their provisions. In reporting the results of operations, the actual results should be compared with the budget.

2.4 *Income Derived from Contributions*

The chief source of revenue of many philanthropic institutions is the contributed income. This is classified into two major groups or categories—the portion received without restrictions imposed by the donors, and the portion received from donors, restricted to some specific use or purpose. The unrestricted contributions are available for the general purposes of the institution, and may be used as the directors see fit. The restricted contributions may be used only in the manner or for the purpose designated by the donors.

It becomes an obligation of the institutions to account separately for each group. Separate records of income and expenditures must be maintained. The assets, liabilities and net worth of each group are recorded and reported separately. These groups or funds, are given appropriate account titles such as Unrestricted Funds, and Restricted Funds. The groups or funds may be subdivided, so that each fund clearly denotes the nature of the transactions included therein. For example, Unrestricted Funds may be subdivided into those used for current operations (the Operating or General Fund) and those used for the creation of future income (the General Endowment Fund). Restricted Funds may be subdivided into groups showing the nature of the restrictions (Building Fund, Research Fund).

Contributions are further classified as to their source. They may have been received from individuals as a result of an appeal or campaign. Some may have come through sources where no direct campaign has been undertaken—from affiliated organizations, from other fund-raising agencies, from foundations, from governmental agencies. Some may have been received through legacies and memorial gifts. Each source is regarded as a separate type of income, and is recorded separately in the accounts.

2.5 *Need for Annual Appeals*

Because of the nature of contributed income, there is no assurance of its continuity. Despite the fact that the purposes of the institutions may require long-term planning, the emphasis must be on year-to-year projects. Basic records must be set up and reports must be made in the light of this fact. Annual statements of operations become more important than annual statements of condition.

2.6 *Nature of Costs and Expenses*

Expenditures fall into two classes—those necessary to carry out the specific activities of the social service program, and those necessary to service or implement the program. Each of the two classes is further subdivided to indicate the category of expenditure. The social service program costs may be subdivided into separate projects, such as research, patient care, rehabilitation, etc. The second cost classification may be subdivided into groups for general direction of the enterprise, raising the required income, public relations, etc. It is not sufficient to record and report expenditures by nominal accounts (such as salaries, rent, supplies, etc.). These must be further allocated among the various categories to show the functional nature of the expenditure.

Expenditures made for the purpose of carrying out the provisions of a restricted fund must be applied against the income of the fund. They must not be recorded with the general costs of the institution.

2.7 *The Goal of Accounting*

If we say that the goal of accounting for profit-making enterprises is the proper determination and reporting of enterprise profits, or net income, we may say that the goal of accounting for philanthropic institutions is the proper determination and reporting of their stewardship of contributed and other income. It is their accountability for contributed and other income, and for the expenditure of this income in the manner outlined in the appeal and in the budget.

3 RECORDING AND REPORTING—GENERAL

3.1 Varying Types of Philanthropic Institutions

In the broad field of philanthropy, there are many different fields or areas. These may be placed in four major categories—(a) fund-raising agencies, (b) participating members of fund-raising groups, with their individual social service programs, (c) agencies which have their own fund-raising and social service programs, and (d) organizations of groups of agencies with similar aims, for the purpose of gathering statistics and setting financial standards within the groups.

Within these categories, there are numerous areas or fields of social service, —such as health, welfare, research, recreation, individual care, cultural activities, international relations, character building, and many others.

While certain basic principles and procedures will be applicable to all groups, it is evident that there will be variations in detailed practices and procedures. It may be that these variations will be material enough to prevent the preparation of a single accounting manual for all. However, within each field, such manuals are entirely feasible. Common basic principles and procedures will form the foundation upon which to build the superstructure of procedures peculiar to the particular field.

3.2 Need for Uniform Terminology

Except for commonly encountered income and expense accounts, there appear to be wide variations in the matter of terminology. This subject requires intensive study on its own account. It is suggested that after general agreement on principles and procedures has been attained, committees of accountants, both private and public, turn their attention to creating a more uniform terminology. Unless dictionary definitions apply, titles and terms used in this report will be explained.

3.3 Bases of Recording and Reporting

The accounting records are kept and financial reports are made on one of three bases,—cash, accrual, and modified accrual. The first two are commonly used in business enterprises. The modified accrual basis is a variation of the accrual method, which departs from one or more of the latter's usual procedures.

These variations include the following:

(a) Income is reported on a cash basis. Pledges are not included, hence pledges receivable are not set up in the balance sheet. Interest on investments is reported as received, hence accrued interest receivable is not set up in the balance sheet.

(b) Minor prepayments are ignored. Unless they represent a significant outlay, long-term insurance premiums are charged directly to expense in the year of payment.

(c) Fixed assets are not usually capitalized, but are treated as expense at the time of acquisition. In the event that buildings are capitalized, however, then depreciation is not taken as an operating expense.

(d) Minor accruals are ignored.

If any one or more of these variations occur, or if the amount involved is material, the recording is classified as modified accrual.

The goal of accounting for philanthropic institutions has been stated to be the stewardship or accountability for contributed and other income and for the expenditures of this income in the manner promised (either explicitly or impliedly) in the appeal and the budget. Any system of recordkeeping which results in a simple, accurate record of the financial history of the enterprise, and which achieves the intended goal may be considered a proper system. The current trend, except in comparatively small institutions, is toward the use of the modified accrual method.

The use of any one of the bases does not preclude the necessity for subsidiary records. Whether or not fixed assets are capitalized, plant ledgers should be maintained. Whether or not pledges receivable are set up, individual receivable records should be kept. Insurance registers are necessary, regardless of the method of recording premiums.

3.4 Recording—Funds, in General

The two groups of contributions, donor-unrestricted and donor-restricted, are separately recorded and accounted for. Separate ledger accounts are maintained, in which to record the assets, liabilities, income and expenses of each group. The first group may be designated as General Fund or Operating Fund, the second as Restricted Funds. Each of these groups may be subdivided further. Whatever the subdivisions, each constitutes a separate entity, and its records are kept as a separate unit, complete within itself.

General Funds consist of unrestricted contributed income and also include all non-contributed income. They are used for the general purposes of the institution, as authorized by the directors. Frequently some of the assets of the General Fund are set aside by the governing board for some special purpose. Separate earmarked funds are thereby created. In some instances, special types of income, such as unrestricted legacies, are not even included in the General Fund, but are immediately segregated and recorded in an earmarked fund (either in the Legacy Fund or in the General Endowment Fund).

3.5 Recording—Restricted Funds

Restricted funds arise from monies contributed for special purposes only or whose manner of use is restricted by the donor. At times these funds may require augmentation to enable the institution to carry out their purposes. The directors may authorize the transfer from some earmarked funds to meet the requirements. Restricted funds should be carefully analyzed as to the nature and purpose of the restrictions. After the restrictions have been interpreted by counsel, they should be noted in the records. Both moral and legal obligations compel the institution to account separately for all transactions involving restricted funds.

A number of the restricted funds are self-liquidating. In some instances, the balances remaining after their purposes have been accomplished inure to the benefit of the institution; in others, they revert to the original donor.

3.6 Recording—Earmarked Funds

It must be borne in mind that although earmarked funds represent unrestricted contributions by donors, they have nevertheless been restricted and set apart by management for some special reason. Normally they will not be used for the current operation of the institution. They are set up for three major purposes—(a) the creation of an investment or endowment fund, whose income will become a secondary source of income for current operations; (b) the creation of temporary funds for some special self-liquidating objective, which cannot be financed entirely out of current contributions, and (c) the creation of a revolving fund which may be utilized as the need occurs and as the directors decide.

4 VARIATIONS IN ACCOUNTING FOR INCOME

4.1 Income, in General

Ordinarily, in a profit-making enterprise, income arises upon the completion of a sale or a service, regardless of when that income is converted into cash. In a philanthropic institution, the principal source of income is contributions. These contributions come either through a special appeal or campaign, or from various other individual or corporate sources. The appeal contributions are received in cash, or individuals may pledge themselves to make future payments. Most philanthropic institutions (except possibly fund-raising agencies) do not consider pledges as income until the pledges are paid. Most institutions do not consider interest as income until that interest has been received. They record income on a cash basis.

There are several material exceptions to this procedure. Institutions which receive allotments from fund-raising agencies may set up the anticipated income as soon as it is due them. Some national organizations accrue income due from chapters or branches.

At least two governmental bodies which require philanthropic institutions to submit reports, have decreed that income must be reported on a cash basis. These are the State of New York, and the City of Los Angeles.

Where unpaid pledges are included in income, the pledges receivable are set up with corresponding provision for uncollectible pledges, so that only the amount expected to be collected actually finds its way into income.

Because of the stewardship concept of recording and reporting, there is not too material a difference between the two methods. This is so because recording and reporting must answer the questions, "What has been received? Have the receipts been expended according to plan?" If the cash basis of recording income is used, a separate category of income will show contributions from prior years' campaigns, and will be accounted for in the year received. Costs of collections of that income will be recorded in the same year, so that they may be applied as an expense in the year the income materialized.

Whichever method is used, a full disclosure of the facts should be made in reports. The gross amount of pledges receivable should be stated either as a footnote or as a comment. Where it can be determined, an estimate of the anticipated collections might be included. If prior experience does not indicate a pattern which may be used as a basis for estimating collectibility, it might be advisable to set up all pledges receivable, with a one hundred percent allowance for uncollected pledges.

4.2 Income from Membership Fees or Dues

An important source of income in many institutions is membership fees or dues. In some instances, these are included with contributions, in others, they are reported as a separate category of income. Membership fees are obtained from the body of the contributing public who are interested in the aims and social service program of the institution. In many cases, membership entails no more than that. There are no obligations except that of paying annual dues. Even if dues are unpaid, there is no penalty beyond being dropped from the membership roster. The right to vote at annual meetings may be included in the membership status; the right to receive some literature may also be included. Some institutions believe that the right to vote is a material privilege.

In the instances where no material privileges are obtained, the fees are, in reality, contributions. Membership entails no more than being one of a group who will most likely repeat its contributions annually. The fees should be included as contributions. Even if the membership receives literature for which non-members must pay, that in itself is insufficient to classify the fees in a separate category. The fees should be applied first to the subscription price, and the balance should be included with contributions.

Where membership includes material rights and privileges not available to the non-member, membership fees become a separate category of income. The costs of maintaining the rights and privileges so given should be segregated, so that the costs can be matched against the expenses.

4.3 *Income from Supplemental Fund-raising Activities*

In some institutions, events which are partly social, are planned to raise additional funds. These events include theatre parties, bazaars, dinners, etc. They are undertaken by the institution itself, but more frequently by a committee of interested members who are outside the jurisdiction of the institution. In most instances, the committee in charge of the function turns over the net proceeds without details of gross receipts, costs and expenses. The net amount received is recorded as income by the institution.

In principle, this method of recording is inaccurate. It is accepted merely because of expediency. Where the institution has any control of the function, it should insist on obtaining the figures of gross income and costs and expenses. In a number of institutions, where these figures are obtainable, the net figures are still included as income, but the others are disclosed in the report. While this method is an improvement, it still is not entirely accurate.

The following example illustrates the suggested method of recording: A participant receives something of value, as for example, a theatre ticket costing $7.50, for which he pays $15.00. The committee incurs expenses of $1.00 per ticket sold, and turns over the net proceeds of $6.50 per ticket to the institution. The institution should record $7.50 as income and should charge $1.00 to fund-raising costs.

4.4 *Income from Legacies*

Restricted legacies are recorded in restricted fund accounts; the terms of each legacy determine whether it shall be recorded separately, or whether it may be included in a group having the same or similar restrictions.

Unrestricted legacies are recorded either in an operating fund or in an earmarked fund. In the smaller philanthropic institutions, where the receipts of legacies are rare and the amount not too significant, the amounts are included in the General Fund. It has not been found necessary to set up a special Legacy Fund.

In larger institutions, where legacies of material size are frequently received, they are immediately recorded in a special Legacy Fund or in an Endowment Fund, even though the legacies are unrestricted. This has the effect of eliminating these receipts from the operating income of the institutions.

This method of recording has been justified on three counts—(a) the income received is not the result of a fund-raising campaign, (b) if included in the unrestricted operating income, it would cause fund-raising percentages to fluctuate so greatly that they would become valueless, and (c) since it is incumbent upon the directors to set aside a portion of unrestricted income for future emergencies, this is exactly the type of income to be used for that purpose.

In so far as recording is concerned, this method does not appear to violate any accounting principle of recording. However, in reporting to the general public, it must be remembered that such legacies constitute unrestricted income, and must be reported as such.

In calculating fund-raising percentages, it is true that the inclusion of legacies would tend to make comparisons almost worthless. It is also true that fund-raising costs usually do not include expenditures directly attributable to legacy income. But there can be no question that prior appeals at least partially have been responsible for current legacies. Hence in this calculation, some recognition should be given to the receipt of unrestricted income from this source.

Perhaps it might be advisable to calculate and publish two sets of percentages—one where the base includes all unrestricted legacy income, and one where the base excludes all such income.

5 VARIATIONS IN ACCOUNTING FOR EXPENDITURES

5.1 *Buildings*

(a) *Methods of Recording Used by Philanthropic Institutions*

A minority of philanthropic institutions own buildings. Where they are owned, they have been acquired with funds provided by a special building fund drive, by direct donation, or by appropriations from unrestricted or earmarked funds.

There are several ways in which the acquisition is now recorded.

(1) It is set up, at cost or some designated value, as an asset of a Building Fund. The annual depreciation is charged as an expense of operation.

(2) The asset is recorded as in (1), but no depreciation charge is made.

(3) It is recorded as an expense of the Building Fund at the time of acquisition. A nominal asset value may or may not be set up. In one instance a value of one dollar per building is set up. Subsidiary records are maintained, which contain all necessary information about each building.

(b) *Methods of Recording Used by Business Enterprises*

In accounting for business enterprises, the determination of net income requires the matching of all applicable costs with the current revenue of each fiscal period. Hence, when a building is acquired for business purposes, it must be recorded in such a manner that each fiscal period during which the building is in use, will bear its proportionate share of the total cost of the building.

The original cost is recorded as an asset value; the current element of expired cost is recorded by an annual depreciation charge and the corresponding decrease in the asset value eliminated is recorded by means of a valuation account. The original cost, decreased by the amount of the valuation account, furnishes the current book value of the building. This figure gives the basis for the determination of gain or loss, should the building be sold.

(c) *Methods Used by Business Enterprises are Not Applicable*

Do these procedures and their implied principles apply to philanthropic institutions?

The purpose of matching all applicable costs with current revenues is to determine net income. In philanthropic organizations, profits do not exist. There is no necessity for differentiating between the expired and deferred portion of any expenditure. The fact that depreciation is an element of cost which affects net income in business enterprises does not apply to philanthropic institutions.

The need for a cost base in determining gains or losses on the sales of buildings arises from governmental income tax regulations. Since philanthropic institutions are not subject to taxation, this need is not applicable.

One of the doctrines of reporting for business enterprises is that "financial statements should be free from the practice of such conservatism as will result in the distortion of the net income determination and the misstatement of the net worth." For many years, however, a previously allowable practice permitted the writeoff of fixed assets at the date of acquisition, on the theory that the resulting balance sheet was more liquid and therefore more conservative. The fact that this would result in distortion of net income does not affect institutions which are not concerned with profits. However, the fact that it would result in a misstatement of net worth may give rise to some limited justification for recognition of that fact.

(d) *Recommended Methods to be Used by Philanthropic Institutions*

Buildings are acquired mainly through cash provided by special appeals or campaigns. It is anticipated that their eventual replacement will be accomplished in a similar manner. When received, the cash is recorded in a restricted Building Fund. When acquired, the building replaces the cash as the asset of the Building Fund. The asset thus acquired should be recorded at cost. To establish current book value of the asset, depreciation may be charged annually, as an expense of the Building Fund, thus producing no effect on the operating statement. Depreciation should not be charged against current operations in the Operating Fund. Contributors have already paid for the cost of the building, and should not be charged twice for the same expenditure.

Some institutions believe it is more conservative to create their own fund for replacement of buildings rather than to rely upon future campaigns; hence they do charge depreciation to current operations. This procedure can be justified only if (1) the amount of depreciation is set aside and retained in a special replacement fund account, (2) there is a provision in the budget for such a funding and (3) the amount of the depreciation is such that it will provide the funds required.

Some institutions charge off the cost of the building upon acquisition, setting up a nominal value as the asset. It is true that this procedure understates the net worth of the Building Fund. Since the net worth of each fund is reported separately, and there is no total net worth shown for all funds, the understatement is localized. If found to be desirable, footnotes or comments, can present the facts. It is suggested that the procedure of writing down buildings to a nominal value be also acceptable.

5.2 *Furniture and Equipment*

(a) *Methods of Recording Used by Philanthropic Institutions*

Expenditures for furniture and equipment are recorded in two ways. They are charged immediately as an operating expense, or they are capitalized, and the annual depreciation is charged as an operating expense. The majority of philanthropic institutions use the first method.

Ordinarily, the expenditures for the replacement of furniture and equipment do not vary radically from year to year. The amount anticipated is included in the operating budget. The only objection to an immediate charge-off to expense is that the net worth would be understated.

(b) *Justification for Immediate Charge to Expense*

The doctrine of conservatism has been mentioned previously in connection with the treatment of buildings. A further examination seems necessary.

Why are contributions given to an institution? It is because contributors approve of its objectives, and are satisfied with the immediate program as outlined in the budget. They recognize the fact that money must be spent not only for the immediate social service needs, but also for expenses in connection with the implementation of the program. Reasonable amounts budgeted for furniture and equipment are recognized as necessary for the furtherance of the program. From the point of view of the contributor these items may be accounted for as an expenditure in the year in which they are acquired. Any residual value inherent in any still usable fixed assets is merely a potential benefit of future years, and it seems logical to assign only a nominal value to this benefit. The fact that the net worth is thereby understated becomes unimportant—or even commendable.

It is important to remember that in business enterprises, net income is affected if the deferred portion (asset value) of the cost is charged to the current operations. This is not true in philanthropic enterprises; hence, this portion of the doctrine is not pertinent.

It must be concluded that the advantage of the immediate charge-off of furniture and equipment outweigh the disadvantage of understating the asset.

(c) Justification for Capitalization

Why then, do some institutions capitalize these items and charge depreciation to expense? The justification is that expenditures are not regular, but periodic. If charged when purchased, there would be wide variations in the annual charge, and the comparability of accounting periods would be affected. If comparability is important enough, this method of recording should be accepted.

5.3 Prepaid Expenses

Items such as insurance premiums which in business enterprises are apportioned between the current charges (expense) and deferred charges for future periods (asset) are recorded in two ways. The first method is to charge the entire expenditure to expense when it is incurred. The second method apportions the expenditure as in business enterprises. A majority uses the first method. The adherents of the second method use it because it equalizes expenditures year by year, and makes comparisons between years more equitable. Unless the amount of the prepayment is material, the total amount should be charged to expense. However, for the reasons stated in the discussion of the treatment of furniture, fixtures and equipment, either method should be acceptable.

6 CLASSIFICATION OF INCOME

6.1 *Unrestricted vs. Restricted Contributions*

It has been stated previously that in most institutions, the chief source of income is contributions; that these are classified, as the donor directs, into restricted and unrestricted contributions; that management may segregate or earmark some of the unrestricted contributions for purposes other than current operations. Contributions are recorded in the income accounts of the group or fund to which they have been allocated.

This differentiation between donor-restricted and donor-unrestricted contributions is important because it creates two separate entities, each independent of the other. Not only are separate records kept for each group, but separate financial reports also must be prepared.

6.2 *Primary Classifications of Income*

Within each group, income may be classified into five major categories—contributed income; income from affiliated organizations; endowment income; earned income; other income. A sixth category, membership dues, may be used when required.

(a) *Contributed Income*

All contributions received as a result of appeals to the public, are included in this category. If appeals are made periodically, the results of each appeal are recorded separately. If contributions are received which cannot be identified with a particular appeal, they are recorded separately. Prior-year pledges may be collected. Committees in charge of supplementary fund-raising activities may turn in the proceeds of each function. Legacies and memorial gifts, grants from foundations and governmental agencies may be received. Each of these is recorded separately, in individual accounts.

At times, contributions of food, clothing, etc., may be received. These contributions in kind should be recorded at a fair market value of the items received. They should be classified as contributed income. Because of their special nature, they are sometimes regarded as a special category of income.

(b) *Income from Affiliated Organizations*

Two types of income are included in this category—the income received by a national institution from its branches, and the income received by a participating institution which is a member of a fund-raising agency.

National institutions may have various agreements with their branches whereby a portion of the contributed income received by the branches is remitted to the national body. The amounts to be remitted are arrived at by agreement, or by specific formulae. The amounts received by the national institution should be recorded herein.

Community chests are fund-raising agencies for a group of participating philanthropic institutions. Contributions received by the chests are allocated to the participants. The amounts received by the participating institutions should be recorded herein.

(c) Endowment Income

This category includes the income from investments, interest earned on savings bank deposits, and earnings of restricted funds whose income is designated to be used for operations.

Whether the investments of an institution are held as part of the assets of the Operating Fund, or of an Endowment Fund, all income derived from monies not presently required for current operating purposes should be reported in this category.

In some restricted funds, the income may be designated for general purposes or for some activity of the social service program. Where this is so, the income is transferred to the operating fund and is reported in this category.

Obviously income derived from Endowment Fund assets should be classified as endowment income. In addition, income from institutional investments held temporarily as part of the Operating or General Fund assets, is likewise classifiable in this category.

(d) Earned Income

Earned income includes any income derived from the sales of products or services. It includes, among others,—proceeds of sales of articles made by beneficiaries of the institution's services; sales of supplies; sales of and royalties on publications; fees for special case work; fees for educational seminars; camp fees.

(e) Other Income

This category will include any other type of income not included in the other categories. Each type should be given an appropriate title descriptive of its nature. It includes, among others—gain on sales of equipment; purchase discounts, where they are not deducted from the invoice cost.

6.3 Reporting the Income

The following schedule presents one way in which income may be reported:

INCOME:			
CONTRIBUTED INCOME:			
Annual appeal		—	
Special mail appeal		—	
Prior years' pledges		—	
Functions:			
Gross	—		
Less: Direct costs	—	—	
Membership dues		—	
Legacies		—	
Memorial gifts		—	
Foundations		—	
Governmental agencies		—	
Contributions in kind		—	
			—
INCOME FROM AFFILIATED ORGANIZATIONS:			
Branches		—	
The X Community Chest		—	
			—
ENDOWMENT INCOME:			
Interest and dividends on securities		—	
Interest on bank deposits		—	
Transferred from the Y Fund		—	
			—
EARNED INCOME:			
Sales of literature		—	
Service fees		—	
Film sales and rentals		—	
			—
OTHER INCOME:			
(Specify)			—
TOTAL INCOME			—

7 CLASSIFICATION OF EXPENSES—
BY TYPE AND FUNCTIONAL CATEGORY

7.1 Primary Classification

Expenses are classified in accounting records primarily according to their nature, in accounts whose titles are descriptive thereof. They are divided into two groups—those required to carry out the various projects of the social service program, and those required to implement the program.

There are a number of institutions which make no further classifications. They record and report expenses only as described above. They list these expenses—Salaries, Rent, etc.—in any order they wish. There is no set arrangement or order in which the expenses are stated. While there may be some instances in which such reports may be acceptable, in most cases further subdivisions and sub-classifications are required, if full disclosure is to be achieved.

7.2 Classification by Functions, into Categories

In addition to identifying the nature of an expense, it is desirable also to show its purpose or function. For this reason, expenses are often regrouped into various functional categories.

Many such categories appear in the reports of philanthropic institutions, with different titles. However, even where the titles are similar, there is no assurance that the contents of each category are similar among different institutions.

All expenses may be regrouped functionally in eight categories—(1) Social Service Program; (2) Fund-raising Costs; (3) Public Information and Education; (4) Administration; (5) Payments to Affiliated Organizations; (6) Chapter Expansion; (7) Central Services; (8) Capital Expenditures. The first four categories are generally applicable; the others are used as required.

The titles suggested for the eight categories are not necessarily those used by institutions at present. They are suggested because they are descriptive of the functional purposes of the expenses included in each.

All of these categories are not applicable to every institution. Institutions which capitalize their fixed assets will not require the category Capital Expenditures. Those which have no branches or chapters will have no expenses for Central Services or Chapter Expansion. Even where there are chapters, these two categories may be included in some of the others.

Some institutions consider the category of Public Information and Education too broad, and subdivide it, showing some or all of the following as separate categories—Professional Education; Nurse Education; Lay Education; Professional Information; Public Information.

Some institutions consider the categories Fund-raising Costs, and Public Information and Education, to be too closely allied to permit a meaningful separation. One institution combines the two into a category called "Cost of Public Support." In one group of institutions, all costs incurred to implement their social service program are grouped together. For statistical purposes, they are then equally divided into two categories—Fund-raising Costs and Administration.

7.3 Selecting the Category—the Problem

It is obvious that while some expenditures will be readily identified with a particular category, others will present more difficulty. Fees paid to a consultant on fund raising, purchases of equipment, research grants, will be included in the categories Fund-raising, Capital Expenditures, and Social Service Program, respectively. The salary of the director, who may spend part of his time in attempting to secure contributions, will be allocated between Administration and Fund-raising.

A health agency may prepare and issue a pamphlet, describing its program and the current projects included therein. The cost of the pamphlet would be charged to Public Information. If the pamphlet included a paragraph requesting contributions for the program, should the cost still be charged to Public Information or to Fund-raising, or should the cost be allocated between the two categories?

The problem becomes one of analyzing each expenditure, of classifying it into the category which will best disclose its purpose. Are there any general principles which will aid the analysis?

7.4 Selecting the Category—the Principles

(a) Purpose Determines Category

The primary purpose of the expenditure should determine the category to which it belongs. Indeterminable collateral benefits may accrue to other categories. A sound social service program undoubtedly creates a greater desire on the part of the public to contribute to the institution. Training volunteer workers for a fund-raising campaign involves some element of public education. Educational releases may influence some of the readers to send in contributions. Collateral benefits of an indeterminable amount should not influence the classification. The answer to the question, "Why is this cost being incurred; why is this expenditure being made?" will determine the category to which it belongs.

(b) Analysis of Expense Accounts is Required

Many expenditures of the same nature are recorded in a single expense account. Each such nominal account should be analyzed to determine the purposes of the expenditure, and should be reclassified according to functional categories.

All payments for salaries may be recorded in one salary account. The salaries may be for the clerical staff, the technical staff, the fund-raising staff, etc. An analysis should be made to determine how much should be allocated to each category of expense.

The determination of its purpose and the allocation to its proper functional category should be made at the time the expense is incurred.

It is inadvisable to wait until the end of a fiscal period before analyzing and allocating expenditures. If salaries are paid weekly, they should be classified when paid, and the amounts allocable to each category should be recorded, either in columnar form in the Salaries account, or in separate salary accounts maintained for each category.

Classifications which are based solely upon the estimates of an individual employee at the end of a fiscal period, should not be considered adequate.

(c) Formulate Proper Bases for Allocations

A proper basis for allocating each type of expense should be formulated and utilized. It is evident that all expenses cannot be allocated on the same basis. The time spent by an employee for any activity might be the proper method of allocation. The space used might be the proper basis for the allocation of rents. (See the table on Page 31.)

8 CLASSIFICATION OF EXPENSES—ALTERNATE VIEWPOINT

8.1 Changing Concepts and Conditions

There is evidence that some institutions and individuals working in the field of philanthropy believe that the currently used categories of expenses are no longer adequate—that a reclassification would present more useful information to management and to the public. Especially is this true in the categories of Fund Raising, and Public Information and Education. Changing concepts and conditions in these areas give some validity to their belief. Two of these will be discussed—the change in the concept of fund raising, and the difficulty of differentiating between Fund-raising and Public Information and Education Costs.

8.2 The Changing Concept of Fund Raising

Fund-raising activities are no longer purely eleemosynary in character. Originally, there was a need. The need was made known to potential contributors. The contributors responded, merely as an act of charity. The need was met. The whole process was entirely personal. Then, a second element was injected into the activities—the element of civic pride and civic responsibility. The contributors had a second reason for giving. They responded, not merely as an act of charity, but to fulfill a responsibility to the community.

The number and types of fund-raising agencies increased materially. With their growth, the competition for the contributors' dollars increased. A third element was introduced, and became part of the activities. There was a definite attempt made to bring the contributors into closer personal and emotional affiliation with the agency; to make the contributors potential or actual beneficiaries of the agency's social service program. In this way the agency secured a more stable clientele of contributors and volunteer workers.

These changes necessitate greater expenditures—all for the purpose of securing contributions. Perhaps other collateral benefits are obtained. Perhaps the title Fund-raising Costs should be changed to one which will give recognition to the additional factors involved. But the primary purpose of these expenditures still is the securing of contributions.

8.3 Problems in Differentiating Fund-raising and Public Information and Education Costs

Fund raising and public education overlap, in many cases, to such a degree, that total allocation to one or the other category may be impractical and undesirable. Both purposes may be so intermingled as to make them joint in nature.

Some agencies include mass education as one of the projects of their social service programs. They prepare educational materials which are distributed to the public throughout the year. During the campaign this same material is mailed with campaign material to lists of potential contributors. The purpose of the mailing is to secure contributions. How should the cost of the educational material be classified?

Some agencies will classify the total cost as Fund Raising; most will include the handling and mailing costs in Fund Raising, but will include the cost of the materials in Public Education Costs.

8.4 Criticism of Administration Category

There is some criticism of the title of this category. It is believed that there is too much association in the minds of the public with the administrative and general expense category of business enterprises. A further definition of the character of administration is sought, which will exclude general services applicable to all categories. It is believed that this category should be supervisory in character—should deal with carrying out policy, and with the direction of operational and financial management procedures.

8.5 Changes Suggested by Those Expounding Alternate Viewpoint

(a) Because of the changed nature and purpose of fund raising, it is suggested that the title Fund Raising be eliminated, and a more descriptive title be substituted. One such title already being used is Cost of Public Support. Other suggestions include—Work with Contributors; Work Related Primarily to Contributors (Present and Potential); Cost of Public Support (Including Fund Raising).

(b) In connection with the changes in categories, it is suggested that a detailed list be prepared of the different types of expenses which are to be included in each category. If allocations are to be included, the bases of the allocations should be designated. If estimated prorations of expenses are used, the bases which underlie the estimates and the identity of the officer who fixed the bases should be disclosed in the financial statements.

(c) Education materials included with mass mailing appeals, as part of the solicitation, should be classified in the category substituted for Fund-raising Costs. However, when so included, the cost should be identified separately from the other costs in an appropriately titled sub-heading, such as "Public education materials accompanying direct solicitation of contributions."

(d) The category, Administration, should be limited in scope and the name should be changed to one more descriptive of its purposes. Several suggested changes have been made—Program Planning and Direction; Management and Leadership. The titles are indicative of the type of expenses to be included in this new category.

8.6 The Study Report Recommendations

It is apparent that the criticisms of the existing categories are due to three factors—(a) the terminology is faulty; (b) the content is not clearly defined; (c) the classification of an expenditure where a primary and an important secondary purpose exist may prove to be unduly difficult.

If more descriptive titles can be found, which will be understandable to the general public as well as to management, they should be substituted for those in use at present. Certainly it would be beneficial if a substitute title could be found for Fund-raising Costs, which appear to have attained an undue significance in the public mind. It is a task which well may be left to a committee on terminology.

If at present the content of the categories is not clearly defined, the remedy should come from the philanthropic institutions and from their accountants and auditors. Certainly the principles involved are simple enough. When an expense is incurred, it is recorded in an appropriately titled nominal account which indicates the nature of the expense—Salaries, Rent, Travel Expense. When it is necessary to record the purpose of the expense, the expense account is analyzed, and is either subdivided into functional categories therein, or separate accounts are created which indicate both nature and purpose of the expense—Salaries, Administration; Salaries, Research; Rent, Administration; Rent, Fund-raising.

The difficulty in classifying certain expenses as Fund-raising or Public Education, or both, can be resolved by referring once more to the principle—classify according to the primary purpose of the expense. Education materials are used in connection with mass appeals for contributions. What is the purpose of the inclusion of these materials in the appeal? If the main purpose is to secure contributions it is a fund-raising expense. It does not matter that a certain amount of collateral benefit will result—that the project of public education may be assisted. If the main purpose is public education, the same principle holds. It is an educational expense even though a more favorable attitude toward contributing may be created.

However, in this particular illustration, there may be some doubt whether a real or a collateral benefit is created. Therefore, to assure full disclosure, the classification selected should be identified in such a manner that all who read a report will be apprised of the facts. By classifying the expense as Fund Raising, and by indicating the amount thereof as a separately subdivided portion of the category, full disclosure is made.

Limiting the category Administration to the functions indicated ignores the fact that management and planning require certain tools. Recordkeeping, clerical services, may be performed in part for some specific categories, but at least part are for the institution as a whole. These central services, which are not definitely performed for one particular category, should be considered as an administration expense. However, there is sufficient force to the reasoning of those expounding the alternate viewpoint to justify a further study of the problem.

9 FUNCTIONAL CLASSIFICATION OF EXPENSES— CONTENT OF CATEGORIES

9.1 Social Service Program

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.

9.2 Fund-raising Costs

(a) General

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 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."

(b) Examples of Costs

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.

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

Dinners and meetings—for the purpose of fund raising.

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 recordkeeping.

Mailings—including addressing, stuffing and postage.

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.

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.

9.3 *Public Information and Education Costs*

(a) General

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, non-technical information, whose appeal is directed to the general lay public, usually is included in the category of Public Information and Education.

(b) Examples of Costs

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

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

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

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.

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

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

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

9.4 *Administration Costs*

(a) General

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.

(b) Examples of Costs

Board of directors—costs of meetings, travel.

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

Expense of Assistants—including secretary.

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.

9.5 *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.

9.6 *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.

9.7 *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.

9.8 *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.

10 METHODS OF ALLOCATING EXPENSES TO FUNCTIONAL CATEGORIES

10.1 Need for Further Analysis of 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.

10.2 Bases of Expense Allocations

(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.

10.3 Resumé of Suggested Allocation Bases

It would serve no purpose to enumerate all nominal accounts which are in current use. There are many basic accounts common to most philanthropic institutions. Some of these will be listed together with a suggested method of allocation, on the following page.

ACCOUNT	ALLOCATION
1. Salaries	1. Time spent by employees
2. Social security taxes Group insurance costs Hospitalization costs Pension plan payment	2. Time spent by employees. Alternate, approximate time, on percentage basis of payrolls.
3. Rent Light, heat, power and water	3. Space used
4. Building repairs and maintenance	4. Space used
5. Travel Auto expenses Carfares	5. Purpose of travel. Alternate, on the basis of the salary allocation of employee traveling.
6. Telephone and telegraph	6. Direct charge for toll calls and telegrams to category affected; balance distributed on basis of extensions, then to salary allocation of employees affected.
7. Meetings—directors Meetings—other Conferences—dinners	7. Immediate purpose of meetings, conferences or dinners. When dinners are part of special fund-raising functions, deduct direct costs from income; include expenses in this account, and allocate to fund-raising costs.
8. Professional fees — legal and auditing Consultants Custodial fees Fund-raising fees	8. Activity or category benefited. If legacies are set up in a special earmarked fund, legal fees in connection therewith should be charged to that fund.
9. Stationery and office supplies General office expenses Dues and subscriptions	9. Category benefited; percentage allocation approved
10. Rental and service of equipment	10. Category benefited
11. Insurance	11. Category benefited; compensation insurance on same basis as salaries
12. Printing and lettershop Distribution expenses (cost of packing, mailing, carting and shipping materials)	12. Nature and content of materials
13. Publications purchased Development of materials for publication Publications, bulletins, newsletters	13. Content of materials
14. Publicity and promotion (media and mechanics)	14. Immediate purpose of expenditure, or content of materials

11 FINANCIAL REPORTS

11.1 Function of 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.

11.2 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% 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.

11.3 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.

11.4 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

(a)

THE PHILANTHROPIC INSTITUTION

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.

(b)

THE PHILANTHROPIC INSTITUTION

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.

(c)

THE PHILANTHROPIC INSTITUTION

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		

(d)

THE PHILANTHROPIC INSTITUTION

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 in paragraph 6.3, Page 18.

3. Supporting schedules of expenses are shown on Page 38.

(e)

THE PHILANTHROPIC INSTITUTION

STATEMENT OF EXPENSES ALLOCATED INTO CATEGORIES

Year Ended December 31, 19...

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							

12 SUGGESTED ACCOUNTING PRINCIPLES FOR PHILANTHROPIC INSTITUTIONS

12.1 *Proposed Statement of Accounting Principles*

The preceding chapters have 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.

(a) *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 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.

(b) *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.

(c) 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.

13 A FORWARD LOOK

13.1 *The Ambit of this Report*

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.

13.2 *The Next Steps*

(a) *Testing the Principles*

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 accounting 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.

(b) *Standardizing the Terminology*

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.

(c) *Revising the Expense Category Classifications*

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.

13.3 *Concluding Remarks*

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.