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Restricted Funds—Accounting and Auditing Problems

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*Presented before The New York State Society of Certified
Public Accountants, New York City — November 1962*

THE TERM restricted funds, as applicable to non-profit organizations, comprises all funds not available for current general operating purposes of the institution. It is my intention not to attempt a discussion of all such funds, which could include endowment funds, plant funds, agency funds, to mention but a few. Instead, I shall discuss current restricted funds, that is, operating funds restricted by an outside agency or person as to use. This class of fund frequently is created by gift, grant, or bequest. In addition, income from restricted endowments and income from current restricted funds' investments also gives rise to such funds.

Because restrictions have been placed on the use of these funds, careful consideration must be given to the accounting records necessary to assure the use of the funds for the intended purposes. As contrasted with the receipt of unrestricted funds, which constitute income when received, the receipt of current restricted funds does not become income to the institution until such time as the funds are expended. Receipt of current restricted funds has no effect on net income, since income can be recognized only to the extent of expenses. When an institution accepts current restricted funds it must acknowledge its accountability through the creation of a separate liability or fund account for each such fund. It is desirable to include in the names of the individual accounts some description of the nature of the restricted purpose. Correspondence of the donors, copies of grants, etc., which give the particulars of the restrictions, should be maintained and kept current in the accounting department.

METHODS OF RECORDING CHARGES

Institutions generally have followed two methods of recording charges to current restricted funds. Under one method, transfers are made from the current restricted fund to a general fund income account. The amount transferred would be equal to amounts charged to operating expenses that could have been charged to the fund. Under this method, the responsibility of establishing the extent to which a

restricted purpose fund has been used is assigned to the accounting department. This method can be applied without difficulty under circumstances where the restrictions are rather general and where such activities are readily disclosed by the operating accounts. As an example, assume that a teaching institution has current restricted funds for teaching salaries. The accounting department can readily ascertain the teaching salary expense and transfer from the funds to a general fund income account the lesser of either the fund balance or the amount of expense. Institutions have attempted to apply this method to current restricted funds embodying complex restrictions. They found it necessary to analyze current operating expense and in effect to estimate those expenses that could have been charged directly to the funds. Operating statements showing the activity and unexpended balances of current restricted funds would therefore appear to be unnecessary to those officials in the operating departments. The philosophy underlying this accounting method appears to be that all operations will be conducted in disregard of the source of funds.

Under the second and certainly preferred method, charges are made directly to the current restricted funds. Here we find the responsibility for the use of the funds being directed not to the accounting department, but to those operating officials who are also responsible for accomplishing the restricted purposes. It appears that only the operating officials of institutions can intelligently judge when and to what extent funds are being expended in the accomplishment of the restricted purposes. The responsible operating officials accordingly must inform the accounting department of this activity. It follows then that the distribution of charges to be made against current restricted funds represented by payrolls, invoices, stores requisitions, etc., should begin with the operating officials. Under these circumstances, the accounting department assumes its proper role. It now must inform operating sections of the existence of funds, and the restrictions on their uses, as well as provide periodic operating statements containing charges to the funds and balances unexpended. The philosophy underlying this method appears to be that the activity sought by the funds will continue only to the extent of the availability of current restricted funds.

STATEMENTS OF INDIVIDUAL FUNDS

Frequently, institutions seek current restricted funds to carry out certain operations that ordinary operating income is insufficient to

finance. For these institutions especially, it is essential to their financial well-being that timely and reliable periodic operating statements of the individual funds be prepared for the use of operating officials. From experience, certain institutions learned that timely statements prepared from the general ledger were often misinterpreted by operating officials using them. Because such items as outstanding purchase orders, unprocessed stores requisitions, or other encumbrances might not be included, the balances shown by the statements were in reality not the amounts available for expenditure. As a result, funds were often overdrawn. Controllers of certain institutions have developed operating statements for internal reporting that include actual expenditures as well as encumbrances not yet entered in the general ledger. This requires the maintenance of an encumbrance ledger. Generally, purchase orders and stores requisitions before becoming effective are entered in the encumbrance ledger and approved for availability of funds. When these items are subsequently recorded in the general ledger, they would be removed from the encumbrance ledger. The use of an encumbrance ledger has proven an effective aid in carrying out budgets for current restricted funds.

BASIC FINANCIAL STATEMENTS

Let us consider for a moment the manner of presentation in the basic financial statements of the balances and activities of current restricted funds. The basic financial statements for a non-profit organization should comprise at least a balance sheet, statement of current operations, and statement of changes in fund balances. The statement of changes in funds should contain the opening balance, receipts (preferably by source, such as gifts) restricted endowment income, expenditures, and closing balance. The expenditures so reported should also be reflected in the operating statement as both income and expense. There are instances where institutions fail to include in operating statements the income and related expenses resulting from activity of their current restricted funds. This treatment is appropriate for agency funds, which are funds held by the institution as custodian. Current restricted funds on the other hand become income to the institution when they have been expended for the intended purposes. Failure to include such activity in the operating statement can result in substantial understatement of activity. Certain institutions follow the preferred practice of reporting in the balance sheet as a separate

balancing fund group, the assets, liabilities, and fund balances of the current restricted funds. Since the identification of specific assets and liabilities with current general and current restricted funds may not always be practicable, it is sufficient to identify only the balances of the current restricted funds on the liability side of the balance sheet.

SCOPE OF THE AUDIT

At this time I wish to make certain comments concerning the responsibilities of the public accountant whose examination is to enable him to express his opinion on the basic financial statements of a non-profit organization. These comments are intended for current restricted funds but may be applicable to other fund groups as well.

As for any audit, whether or not a non-profit organization, the auditor must study and evaluate existing internal control in order to determine the extent of his tests. We shall therefore not discuss the extent of testing but consider the general scope of the audit of current restricted funds.

Contributions generally compose a substantial part of the receipts of non-profit organizations. It is advisable for the public accountant to prepare an audit program for the examination of all contributions whether or not restricted. Generally, such a program should provide for the examination of receipts on a test basis for the purpose of establishing the validity of the amounts recorded as well as the propriety of the distribution to the various accounts. In order that this phase of the examination be properly performed the accountant doing the work must have a working knowledge of the various types of funds of non-profit organizations. The audit program should provide for the reading of correspondence accompanying the contributions for the purpose of determining the type of fund created, considering the restrictions, if any, placed on the use of the funds. For restricted purpose funds, copies or excerpts of the correspondence should be kept in the working papers for use in determining whether expenditures are in conformity with the donors' intentions. Copies or excerpts of grants, contracts, and the like establishing restricted purpose funds should also be made part of the working papers.

As part of his examination of endowment funds, the auditor should obtain for his permanent records, the restrictions on the use of endowment income. Further, he should provide sufficient audit steps for the verification of income from endowments as well as

income from restricted funds' investments. As stated previously, such income is credited to a current restricted fund.

Having satisfied himself with receipts, he must now establish that the current restricted funds were expended for the intended purpose. In those instances where charges are made directly to the funds the auditor should satisfy himself that those persons responsible for the use of the funds are initiating and/or approving payrolls, accounts payable, stores, and other distributions to the restricted purpose fund. Frequently the terms of grants outline in detail certain expenditures that are not to be charged to the grant. It is necessary therefore that the limitations on the use of the funds be kept in mind as this phase of the examination is undertaken.

The auditor should satisfy himself that the expenditures made out of current restricted funds, when they are charged directly to the fund, are thereafter included in the operating statement as income and expense. One type of exception may be pointed out at this time. Certain current restricted funds contain provisions for equipment purchases. When a portion of a fund is used for capital expenditures, such amount is not includable in the statement of operations. Instead, it should be shown in the statement of fund changes as a transfer to plant funds or other appropriate fund group.

As stated previously, for those charges to current restricted funds recorded as transfers to current income made by the accounting department the auditor must also satisfy himself concerning the use for the intended purpose. Copies of clients' working papers and other available evidence supporting the use of the funds for the intended purpose should be examined and evaluated by the auditor.

Current restricted funds, especially those created through grants and contracts, frequently give recognition to administrative and other indirect expenses as chargeable to the funds. When such charges are permitted they are generally expressed in terms of a percentage of certain direct expenses. Under the circumstances, the institution is entitled to and should charge the fund for such indirect or overhead expenses. Not infrequently, however, the terms of current restricted funds make no mention of administrative or other overhead expenses. When this is true, it appears that no such charge should be made to the fund. It would appear reasonable however, that certain indirect expenses such as payroll taxes should be chargeable to the funds. Charges for general institutional administrative overhead expense should not be made to such funds without the advice of counsel.

The public accountant may find instances where certain current restricted funds remain inactive for years. This can occur where the purpose for which the fund was intended is so rare in occurrence that the likelihood of the use of the fund is remote; or, operating officials of the institution may not be aware of the fund's existence. The public accountant's services are not in conflict with such conditions. As a constructive service to his client, he should inform him that inactive funds exist. The client thereafter may seek from the grantors, modifications in the restrictions of such funds. The auditor should also suggest that periodic review be made of all funds and restrictions on their uses for the purpose of establishing a policy for their utilization.

Deficit balances or overdrafts of funds should normally be recognized as expenditures of current general funds. Unless restricted funds are irrevocably committed, which commitment constitutes an account receivable to the institution, mere expectation of additional funds does not justify carrying forward to another period, expenses chargeable to current operations. When such overdrafts exist, the auditor is faced with the reality of having to insist that they be charged off as current expenses.

CONCLUSION

Administrative officials of non-profit organizations most often prefer unrestricted contributions. In recent years, however, especially with the current prominence of United States government grants, current restricted funds have become a substantial source of revenue to non-profit organizations. It appears reasonable that greater emphasis be placed on accounting and reporting for current restricted funds, for consumption both internally and in published form, so that these funds may be used for their intended purpose to the best advantage of non-profit organizations.