# IV. ACCOUNTING

**Effective Date: April 21, 2008**

## A. FEDERAL AND STATE TAX FILING REQUIREMENTS

An annual return on FORM 990-Return of Organization Exempt from Income Tax is required from most organizations which have been granted exempt status under Section 501(c) of the Internal Revenue Code. The FORM 990 is due by the 15th day of the 5th month after the close of the organization's tax year.

In the case of small organizations with gross receipts under $100,000 and total assets of less than $250,000 at year-end, an abbreviated annual return on FORM 990-EZ can be filed rather than the more complex FORM 990. However, the due date remains the 15th day of the 5th month.

Small tax-exempt non-profit organizations (Gross receipts of $25,000 or less) must now fill a short electronic form, called Form 990-N, with the IRS. Form 990-N, also called the E-postcard, is a short electronic notice that most small, tax-exempt organizations (such as 501(c)3s) have to file with the IRS, as of 2008, for activities from January 1, 2007 onward. Form 990-N is filed if your non-profit organization:

- Is Tax-exempt
- Has gross receipts of $25,000 or less
- Is not required to file another IRS form such as Form 990, Form 990-EZ, or Form 990-PF
- Is not part of a group return

Then the organization must file the e-postcard with the IRS. Your organization may choose to submit a completed IRS Form 990 or Form 990-EZ instead. However, the Form 990-N is much simpler and quicker to fill out. The IRS's e-postcard is short and simple. Here is what you must provide: Organization's name, Any other names your organization uses, Organization's mailing address, Organization's website address (if applicable), Organization's employer identification number (EIN), Name and address of a principal officer of your organization, Organization's annual tax period, A statement that your organization's annual gross receipts are still normally $25,000 or less, If applicable, indicate if your organization is going out of business. Before, most small non-profits (grossing less than $25,000 a year) did not have to file anything with the IRS. The Pension Protection Act of 2006 (PPA) requires that you file annually ensuring that the IRS and potential donors can access up-to-date information on your organization.

The IRS requires that the e-postcard be filed electronically. There is no paper form. You must be able to access the internet, but no software or download is required. If your non-profit does not have a computer, you will be able to fill out Form 990-N using a computer at a public library. Form 990-N must be filed every year; however there is no one due date for filing the e-postcard. Instead, you must file "by the 15th day of the 5th month after" your non-profits' fiscal year ends.

For instance, if your fiscal year is the same as the calendar year (ie, ending on December 31st), your organization does not need to file the e-postcard until May 15. If your non-profit fails to file the e-postcard for three consecutive years, the IRS will revoke the organization's tax-exempt status.

When it becomes evident that an exempt organization will be unable to complete and file its FORM 990 (or FORM 990-EZ) by the due date, FORM 2758 should be filed to request an extension of time to file the required annual return. Generally the Internal Revenue Service will not grant an extension of time for more than 90 days unless sufficient need for an extended period can be clearly justified by the organization. In no event will an extension of more than six months be granted.

The importance of timely filing the required annual return is demonstrated by the fact that a penalty of $20 per day, not to exceed the smaller of $10,000 or 5% of the organization's gross receipts for the year, can be assessed against the exempt organization unless a timely extension was filed or the organization can show that the late filing was due to reasonable cause. In addition, the penalty can also be charged if an organization files either an incomplete return or furnishes incorrect information on the return.

If an exempt organization has gross income from an unrelated trade or business of $1,000 or more, the organization must file FORM 990-T (Exempt Organization Business Income Tax Return) and pay the tax due. The return is due by the 15th day of the 5th month following the close of the organization's tax year.

Unrelated income is the gross income derived from any trade or business that is regularly carried on and is not substantially related to the organization's exempt purpose or function aside from the organization's need for funds or income or the use which the organization makes of the profits. Not substantially related means that the activity which produces the income does not contribute importantly to the exempt purpose of the organization, other than the need for funds to support the organization's activities. It should be noted that whether or not an activity contributes importantly depends on the facts and circumstances of each case.

An exempt organization will be subject to a penalty for failure to file a required FORM 990-T, penalty for late filing, and interest and penalty for late payment of tax due.

With regards to State of North Carolina filing requirements, exempt organizations must file either federal FORM 990 or FORM 990-EZ. marked “State Copy”. Tax-exempt organizations with unrelated business income must complete the income tax schedules of the North Carolina Corporate Franchise and Income Tax Return (Form CD-405) and file the return by the fifteenth day of the fifth month after its year end and pay tax at the statutory corporate rate.

Since federal and state tax filings for exempt organizations can be quite complex and result in severe penalty charges if not handled properly, it is important for not-for-profit organizations to retain the services of a qualified CPA to serve as tax advisor to the entity.

The following types of organizations exempt from tax under section 501(a) do not have to file Form 990 (or Form 990-EZ) with the IRS:

> **1.** A church, an interchurch organization of local units of a church, a convention or association of churches, an integrated auxiliary of a church (such as a men's or women's organization, religious school, mission society, or youth group), or an internally supported church-controlled organization described in Revenue Procedure (Rev. Proc.) 86-23 1986 - 1 C.B. 564.

**2.** Church-affiliated organizations that are exclusively engaged in managing funds or maintaining retirement programs and are described in Rev. Proc. 96-10, 1996-1 C.B. 577.

**3.** A school below college level affiliated with a church or operated by a religious order.

**4.** A mission society sponsored by, or affiliated with, one or more churches or church denominations. If more than half of the society's activities are conducted in, or directed at persons in foreign countries.

**5.** An exclusively religious activity of any religious order.

**6.** A state institution whose income is excluded from gross income under section 115.

**7.** An organization described in section 501 (c)(1). Section 501 (c)(1) organizations are corporations organized under an Act of Congress that are:

- Instrumentalities of the United States, and

- Exempt from Federal Income Taxes.

**8.** A private foundation exempt under section 501 (c)(3) and described in section 509 (a). (Required to file Form 990-PF, Return of Private Foundation.)

**9.** A black lung benefit trust described in section 501(c)(21). (Required to file Form 990 - BL, Information and Initial Excise Tax Return for Black Lung Benefit Trusts and Certain Related Persons.)

**10**. A stock bonus, pension, or profit-sharing trust that qualifies under section 401. (See IRS Form 5500, Annual Return/Report of Employee Benefit Plan.)

**11.** A religious or apostolic organization described in section 501(d). (Required to file IRS Form 1065, U. S. Partnership Return of Income.)

**12.** A foreign organization whose annual gross receipts from sources within the U. S. are normally $25,000 or less (Rev. Proc. 94-17, 1994-1 C.B. 579). See the discussion on the $25,000 gross receipts test in General Instruction C. See also General Instruction A if the organization received a Form 990 Package.

**13.** A governmental unit or affiliate of a governmental unit described in Rev. Proc. 95-48, 1995-2 C.B. 418.

**14.** A political organization that is:

- A state or local committee of a political party;

- A political committee of a state or local candidate;

- A caucus or association of state or local officials;

- An authorized committee (as defined in section 301(6) of the Federal Election Campaign Act of 1971) of a candidate for federal office;

• A national committee (as defined in section 301(6) of the Federal Election Campaign Act of 1971) of a political party;

• A United States House of Representative or United States Senate campaign committee of a political party committee;

• Required to report under the Federal Election Campaign Act of 1971 as a political committee (as defined in section 301(4) of such Act); or

• An organization described under section 6033(g)(3)(G).

**15.** An organization whose annual gross receipts are normally $25,000 or less (but see General Instruction A, if the organization received a Form 990 Package). (Required to file Form 990-N, E-postcard)

a) Calculating gross receipts. The organization's gross receipts are the total amount it received from all sources during its annual accounting period, without subtracting any costs or expenses.

i. Form 990. Gross receipts are the sum of lines 1d, 2, 3, 4, 5, 6a, 7, 8a (both columns), 9a, 10a, and 11 of Part 1. Gross receipts can also be calculated by adding back the amounts on lines 6b, 8b (both columns), 9b, and 10b to the total revenue reported on line 12.

ii. Form 990-EZ. Gross receipts are the sum of lines 1, 2, 3, 4, 5a, 6a, 7a, and 8 of Part 1. Gross receipts can also be calculated by adding back the amounts on lines 5b, 6b, and 7b to the total revenue reported on line 9.

b) Gross receipts when acting as agent. If a local chapter of a section 501(c)(8) fraternal organization collects insurance premiums for its parent lodge and merely sends those premiums to the parent without asserting any right to use the funds or otherwise deriving any benefit from collecting them, the local chapter should not include the premiums in its gross receipts. The parent lodge should report them instead. The same treatment applies in other situations in which one organization collects funds merely as an agent for another.

c) $25,000 gross receipts test. An organization's gross receipts are considered normally to be $25,000 or less if the organization is:

i. Up to a year old and has received, or donors have pledged to give, $37,500 or less during its first tax year;

ii. Between 1 and 3 years old and averaged $30,000 or less in gross receipts during each of its first 2 tax years; or

iii. Three (3) years old or more and averaged $25,000 or less in gross receipts for the immediately preceding 3 tax years (including the year for which the return would be filed).

## B. SALES AND USE TAXES

A not-for-profit organization is required to pay sales/use tax when taxable personal property is purchased for use or consumption. Also, sales of building materials, supplies, fixtures, and equipment to contractors who are performing contract work for nonprofit organizations are subject to the sales/use tax.

When taxable purchases are made from out-of-state suppliers who do not collect he applicable state and local sales/use tax, the not-for-profit organization is required to register with the North Carolina Department of Revenue and file returns monthly with remittance of the tax due on such purchases. In the case of a month during which no purchases have been made from out-of-state suppliers, the monthly report should be filed to indicate no tax due.

General Statute 105-164-14 states that nonprofit hospitals and educational institutions, churches, orphanages and 501 (c)(3) charitable or religious not-for-profit organizations are entitled to semi-annual refunds of sales/use taxes paid in North Carolina on the direct purchase of taxable personal property. This refund provision also applies to purchases by contractors who build, alter, or repair buildings or structures used by the above referenced organizations.

The refund provision does not apply to taxes incurred in the following situations:

1. Purchases of fuel, lodging, and other travel expenses by employees of eligible organizations even though the employees receive reimbursement from the employer for such travel expenses.

2. Charges by a utility for electricity, piped natural gas, and telecommunication services.

3. Occupancy tax levied and administered by certain counties and cities here in North Carolina.

4. Highway use tax paid on the purchase, lease, or rental of motor vehicles.

5. Scrap tire disposal fee levied on new motor vehicle tires.

6. Sales / use taxes paid to states other than North Carolina.

The organization's financial records must clearly document the amount of sales/use tax which is eligible for refund. Therefore, it is suggested that the chart of accounts include balance sheet accounts entitled "Sales/Use Tax Receivable - State" and "Sales/Use Tax Receivable - Local".

When an invoice is processed and a check is issued for payment of an obligation which includes a refundable sales/use tax amount, the payment would be coded as follows.

| | **Debit** | **Credit** |
|---|---|---|
| Cash in Bank – checking | | 106.00 |

| | |
|---|---|
| Sales/Use Tax Receivable – State | 5.00 |
| Sales/Use Tax Receivable – Local | 1.00 |
| Supplies and Materials | 100.00 |

The process of identifying refundable sales/use tax amounts at the time of payment should facilitate preparation of the **CLAIM FOR REFUND OF STATE AND COUNTY SALES AND USE TAXES - NC FORM E-585** http://www.dor.state.nc.us/downloads/fillin/E585_2003.pdf

In order for an organization to be entitled to 100% of the refundable taxes, the refund claim for the first six months of the calendar year (January 1 through June 30) must be submitted to the Department of Revenue on or before the 15th of October while the claim for the second six months (July 1 through December 31) is due by April 15th of the following year. Effective July 2006, there are no late filing penalties on claims for refund which are filed within three years after the due date. Claims for refund filed more than three years after the due date are barred by statute.

All refund claims must be supported by proper documentation and should reflect a separate breakdown as to state and local taxes. In the case of purchases made by an organization for its own use or consumption, the date of purchase and the amount of state and local sales/use taxes paid will normally constitute sufficient documentation.

If an organization is entitled to file a claim with the Department of Revenue for refundable sales/use tax, the Department of Health and Human Services funding agency will reduce total program or project costs by the amount, eligible for refund when calculating costs for state participation purposes.

CLAIM FOR REFUND OF STATE AND COUNTY SALES AND USE TAXES

**FORMS MAY BE OBTAINED FROM:**

**North Carolina Department of Revenue**

**Central Examination Section**

**Sales and Use Tax Unit**

**PO Box 871**

**Raleigh, NC 27602**
**1- 877- 252-3052**

**Taxpayer Assistance and Collection Center** http://www.dor.state.nc.us/downloads/fillin/e585s_webfill.pdf

## C. ALLOWABLE COSTS

Expenditures of State funds by any grantee shall be in accordance with the Cost Principles outlined in the Office of Management and Budget (OMB) Circular A-87. If the grant funding includes federal sources, the grantee shall ensure adherence to the cost principles established by the Federal Office of Management and Budget. (09 NCAC 03M .0201 Allowable Uses of State Funds Effective July 1, 2005) Nonprofit organizations are to use OMB Circular A-122, Cost Principles for Non-Profit Organizations, if the grant includes federal funds.

The total cost of a grant or award is the sum of the allowable direct costs as well as allowable indirect costs less any applicable credits. In order to be an allowable cost, certain criteria must be satisfied:

**1. Be reasonable and necessary for the performance and administration of the award/grant and be allocable to the activity.**

**2. Be authorized or not prohibited under State, Federal, or local laws/regulations and approved by the funding agency.**

**3. Conform to any limitations or exclusions set forth either in applicable cost principles or the grant award as to type or amount of cost items.**

**4. Be consistent with policies and procedures that apply uniformly to both State financed programs and other activities of the grantee organization.**

**5. Be accorded consistent treatment and be determined in accordance with either generally accepted accounting principles or another comprehensive basis of accounting.**

**6. Not be included as a cost or used to meet cost-sharing or matching requirements of another State financed program in either the current or prior period.**

**7. Be adequately documented with time and attendance payroll records, personnel activity reports, or other time and effort records for employees charged to State awards or to more than one activity. Other types of documentation may include approved purchase orders, receiving reports, vendor invoices, canceled checks, etc. In addition, the costs must be correctly charged on the financial records as to account, amount, and period.**

A cost is considered to be reasonable if, in its nature or amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time a decision is made to incur the cost. Consideration must be given to whether the cost is of a type generally recognized as ordinary and necessary for the operation of the organization, the performance of the award, or the provision of services.

A cost is allocable to a particular cost objective, such as a grant, project, service, or other activity, in accordance with the relative benefit received by the cost objective. In order for a cost to be allocable to a State grant or award, the cost must be treated consistently with other costs incurred for the same purpose under like circumstances. The cost must benefit both the award and other activities of the organization and be distributed to the cost objective in a reasonable proportion to the benefits received although a direct relationship to a particular cost objective cannot be shown.

It should be noted that any cost allocable to a particular award or cost objective cannot be shifted to other State awards either to overcome funding deficiencies or to avoid restrictions imposed by law or by the terms of the award.

Direct costs are those that can be identified specifically with a particular final cost objective, such as a particular award, project, service, or other direct activity of the organization. However, a cost may not be assigned to an award as a direct cost if any other cost incurred for the same purpose, in like circumstances, has been allocated to an award as an indirect cost. Costs identified specifically with awards are direct costs of the awards and are to be assigned directly thereto. Costs identified specifically with other final cost objectives of the organization are direct costs of those cost objectives and are not to be assigned to other awards directly or indirectly. However, any direct cost of a minor amount may be treated as an indirect cost for reasons of practicality where the accounting treatment for such cost is consistently applied to all final cost objectives.

The costs of certain activities are not allowable charges to State awards. However, even though these costs are unallowable for purposes of computing charges to State awards, they must be treated as direct cost by the grantee organization for purposes of determining indirect cost rates. Such costs must be allocated their share of the organization's indirect costs when the costs represent activities which benefit from the organization's indirect costs.

Indirect costs represent costs that have been incurred for common or joint objectives and cannot be readily identified with a particular final cost objective. Direct cost of minor amounts may be treated as indirect costs for reasons of practicality where the accounting treatment for such costs is consistently applied to all cost objectives. After direct costs have been determined and assigned directly to awards or other activities as appropriate, indirect costs are those remaining to be allocated to benefiting cost objectives. A cost may not be allocated to an award as an indirect cost if any other cost incurred for the same purpose, in like circumstances, have been assigned to an award as a direct cost.

Because of the diverse characteristics and accounting practices of nonprofit organizations, it is not possible to specify the types of costs which may be classified as indirect cost in all situations. However, typical examples of indirect costs for many nonprofit organizations may include depreciation or use allowances on buildings and equipment, cost of operating and maintaining facilities, general and administrative expenses, such as officers, personnel administration, and accounting.

Where a not-for-profit organization has only one major function or all major functions benefit from indirect costs in approximately the same degree, the allocation of indirect costs and the computation of an indirect cost rate may be accomplished through simplified allocation procedures. However, where an organization has several major functions which benefit from indirect costs in varying degrees, the allocation of indirect costs may require an accumulation of such costs into separate cost groupings which then are allocated individually to benefiting functions by means of an allocation base which best measures the relative degree of benefit. Indirect costs which have been allocated to each function are then distributed to individual awards and other activities within that particular function by means of an indirect cost rate. The determination of what constitutes major functions will depend on the organization's purpose, types of services rendered to the public, clients, and members as well as the amount of effort devoted to activities such as fund raising, public information, and membership activities.

The base period for the allocation of indirect costs is the period in which such costs are incurred and accumulated for allocation. The base period normally should coincide with the organization's fiscal year, but in any event should be a period which avoids inequities in the allocation of indirect costs.

Many non-governmental entities receive federal funds/grants directly from a federal agency. The Federal cognizant agency approves (or disapproves) such an entity's indirect cost rate(s) on behalf of all federal agencies that provide funds to that organization. Once the Federal cognizant agency approves the rate, it is expected to be accepted by other agencies when determining the amount of indirect costs applicable to their contracts and programs. As a general rule, the cognizant agency is the federal agency that provides the largest amount of funds to a non-governmental entity over a certain period of time. Therefore, if a non-governmental entity receives funding directly from a federal agency (or agencies), the Federal cognizant agency shall be established. The Federal cognizant agency may provide technical assistance and guidance to entities on how to prepare a proposal requesting establishment and approval of an indirect cost rate.

In situations where a non-governmental entity does not receive funds directly from a federal agency and where no Federal cognizant agency is designated, an indirect cost rate may be established using criteria and cost principles outlined in the applicable federal circular. Under these conditions, a person or firm, preferably one knowledgeable of this subject should establish the rate. **This person or firm should not be associated with the audit firm that conducts an audit of the entity's records.** Once a rate has been established, this person or firm should certify in writing to the non-governmental entity that the rate has been established in accordance with the applicable federal circular and that the documentation should be maintained and made available to any auditor requesting such information. The entity should also provide a copy of the letter to any and all agencies with whom they contract and from whom they wish to claim reimbursement of indirect costs.

When making application to a State agency for possible funding of a particular program or activity, the grantee organization should make specific inquiry relative to allowable direct and indirect costs and applicable cost principles.

## D. COST-SHARING AND MATCHING REQUIREMENTS

Under certain circumstances, the funding agency may require a not-for-profit grantee organization to provide partial support for the proposed budget which supports a particular program or service. Such participation on the part of the grantee is referred to as a cost-sharing or matching requirement.

The requirement may be satisfied by either cash or "in-kind" contributions (costs/expenditures); however, the "in-kind" amounts must satisfy certain criteria.

1. **Must be verifiable on the grantee's financial records.**

2. **Cannot be costs or expenditures which have been funded by another State grant or award. However, if the grant was State appropriations, it can be used for matching purposes against federal funds.**

3. **Must represent costs or expenditures which are necessary and reasonable for proper and efficient operation of the program or service.**

4. **Are allowable costs under the provisions of the grant or award.**

**5. Are not "in-kind" amounts which have been used to satisfy cost-sharing or matching requirements of other State or federal awards.**

**6. Are identified in the grant award and approved budget as acceptable "in-kind" contributions.**

**7. Must not be costs borne by the federal government.**

A cost-sharing or matching requirement may be satisfied by attaching a reasonable value to volunteer services provided by professional and technical personnel, consultants, and other skilled and unskilled labor if such services represent an integral and necessary part of the approved project or program. Rates for such volunteer services must be consistent with amounts paid for similar work within the grantee organization. In the event the required skills are not found in the grantee organization, rates shall be consistent with those paid for similar work in the local labor market. In either case, paid fringe benefits that are reasonable, allowable, and allocable may be included in the valuation. However, it is imperative that volunteer services be documented and, to the extent feasible, supported by the same method used to document time and effort of grantee employees.

Donated supplies, such as expendable equipment, office supplies, etc.; may be used to satisfy a cost-sharing or matching requirement. However, the value assigned to such supplies must be reasonable and should not exceed the fair market value of the property at the time of donation. The value of the donation applicable to a particular grant period is limited to the amount that is utilized during the period.

While cash represents the preferred source of support for a cost-sharing or matching requirement, many not-for-profit organizations do not have surplus cash readily available for this purpose. Therefore, the governing board and finance committee are often required to explore various alternatives in an effort to satisfy such a requirement if imposed by a funding agency.

## E. INTERNAL CONTROL SYSTEM

Management of a not-for-profit organization is responsible for establishing and maintaining a system of controls, consisting of policies, procedures, and methods, which provide reasonable assurance that the following specific objectives will be achieved: reliable operational and financial data; safeguarding of assets and records; operational efficiency; and compliance with managerial policies and applicable laws and regulations.

Set forth below are a number of control objectives which should be incorporated into the system of internal control.

**1. Transactions, as recorded, are reasonable. Any transaction that appears to be unreasonable or out of the ordinary should be investigated.**

**2. Recorded transactions are valid. The system of control should not permit invalid transactions to be posted to the accounting records.**

**3. All transactions are properly authorized. The control system should identify unauthorized transactions which then should be investigated.**

**4. Existing transactions are recorded. The control system should identify all legitimate, actual transactions and ensure that they are recorded in the financial records.**

**5. Transactions are properly valued. Procedures must be in place to detect errors in recording and summarizing the value assigned to a transaction, including mathematical and clerical errors.**

**6. Transactions are properly classified. Internal control procedures must ensure that each recorded transaction is properly classified so the financial statements will be properly stated.**

**7. Transactions are recorded at the proper time. Procedures must be in place to ensure that transactions are recorded in a timely manner and in the proper reporting period in order to provide accurate financial information for the unit.**

**8. Transactions are properly included in subsidiary records and correctly summarized. The internal control system must provide for accurate summations of transactions and ensure that subsidiary records are correctly updated.**

In order for the above referenced control objectives to be accomplished there are certain features vital to an effective control system.

**1. Competent, trustworthy personnel with clear lines of authority and responsibility**

a) The human factor is the most important element of any system of internal control. Dishonest or incompetent employees can render almost any system of internal control useless. Backgrounds of applicants should be checked thoroughly.

b) Well defined job descriptions and a detailed organizational chart are other means of improving personnel adherence to the internal control system. Employees perform better when they know what is expected of them.

**2. Adequate segregation of duties**

There are four elements of proper segregation of duties:

a) Segregation of the control or custody of assets, including cash, from the accounting function.

b) Segregation of authorization of transactions from custody of related assets. This element of segregation helps to prevent fraud. For example, not allowing staff members who authorize the hiring of new personnel to distribute paychecks.

c) Segregation of duties within the accounting function. One person should never be responsible for recording a transaction from its origin to its posting to the general ledger. Posting to the journals should be separate from posting to the related subsidiary ledgers.

d) Segregation of operational responsibility from recordkeeping responsibility.

### 3. Rotation of duties

Job duties should be rotated within an organization on occasion, preferably on a surprise basis. This will reduce the likelihood of fraud since employees are aware that, at any time, another employee could be given their work assignments or tasks, and therefore may detect fraud being committed. Job duties should also be rotated when employees are on vacation. In this regard, all employees should be required to take vacations, with persons in finance or cash-handling positions required to take several consecutive days off at some point during the year.

This practice helps to detect lapping, which is the postponement of entries for the collection of receivables in order to conceal an existing cash shortage.

### 4. Bonding

Bonding protects an organization from loss should fraud or a misappropriation of funds be committed by a bonded employee. The finance officer should be bonded for at least $10,000 and not more than $250,000. Any employee who has custody of more than $100 or has access to inventories also must be bonded for an amount to be determined by the governing board.

### 5. Supervisory review of records

A supervisory review of records serves as an internal check of records and transactions. A thorough review of records serves to detect fraudulent activity and unintentional errors. The timeliness of the review is extremely important to its effectiveness. Supervisors must be thorough and knowledgeable in the area they are reviewing.

### 6. Proper procedures for authorization

Clear and concise lines of authority for each transaction are essential. This authorization may be general or specific. For example, a purchasing clerk may have general authorization to purchase office supplies up to a certain dollar limit. However, where the purchase of fixed assets is concerned, a specific and individual authorization should be required.

### 7. Adequate documentation

Adequate documentation is essential to a good system of internal control. Fraudulent activity is deterred if substantial documentation is required to initiate and complete a transaction. Errors in recording transactions can more easily be detected if adequate documentation exists. Good documentation also helps ensure that all transactions have been properly authorized.

a) Well designed and properly used documents increase the effectiveness of internal control. Whenever possible, documents should be prenumbered consecutively to help account for missing documents. Transactions should be documented in a timely manner, preferably at the point of transaction.

b) Another element of documentation is the chart of accounts used to classify transactions into balance sheet and income statement accounts. The chart of accounts is important because it provides the framework for determining the information that is presented to financial statement users.

c) The use of a procedures manual is another element of good internal control. A detailed procedures manual encourages consistent application of a unit's policies, including those concerning internal controls.

**8. Physical control of assets**

It is essential that assets be physically protected. Cash on hand should be maintained under the sole control of the person directly responsible for it.

## F. BANK ACCOUNTS

All checking and investment accounts of the grantee organization should be authorized by the governing board and such approval recorded in the official minutes. The board action should include the name of individuals who are authorized to sign checks and perform other duties associated with the bank accounts.

The board should implement a procedure which ensures that the list of check signers is periodically reviewed for the purpose of determining if duties and responsibilities of the respective signers have changed to such a degree that the signing of checks now represents an improper function or an inadequate segregation of duties. Also, the board should ensure that the list of authorized persons is changed immediately in the event of a death, retirement, or resignation. All changes should be recorded in the official board minutes.

The board may decide to have two checking accounts, an operating account and a payroll account. The payroll account would be limited to the issuance of payroll checks to employees and the payment of payroll taxes to federal and state authorities. Funds would be transferred periodically from the operating account to the payroll account to cover payroll related costs since all grantee income and receipts should be deposited into the operating account. The separate payroll account provides a process whereby funds designated for personnel costs and payroll taxes are segregated from general operating activities.

**Controls and Operating Procedures**

**1. On a monthly basis, bank balances per the accounting records should be reconciled to the bank statements. The person performing the reconciliations should not have duties and responsibilities in the cash receipts and disbursement functions.**

**2. In the case of small organizations with limited staff, it is often impossible to have the desired degree of duties segregation. Therefore, the board should request that the bank mail monthly statements directly to a board member so that the reconciliations can be performed in an independent manner.**

**3. On at least an annual basis, the board should review and authorize all bank accounts and check signers. Also, the board should adopt policies and procedures governing the use of signature stamps, daily deposits, investment activities, endorsements and the receipts process.**

**4. Employees and board members who handle cash or have check signing responsibilities should be bonded either individually or under a blanket bond.**

**5. Current signature cards and other documents required by the financial institutions should be maintained on file at all times. The documents should be in accordance with the actions approved by the governing board and recorded in the official minutes.**

**6. Financial institutions should be instructed in writing that the governing board is to be notified immediately of any unusual transactions or items such as insufficient fund notices or checks made payable to cash.**

## G. PETTY CASH FUND

It is quite common for an organization to have occasion to expend small amounts for items such as postage/freight charges, office supplies, etc. Since it is not cost-effective to issue checks in payment of these expenses, a petty cash fund is often used to accommodate these situations.

The governing board should authorize the fund and establish certain policies and procedures which govern the manner in which the fund is utilized by management and staff.

1. A dollar limit, usually in the range of $25 - 100, should be set for the fund.

2. One individual should be designated as fund custodian and should have responsibility for maintaining control over the cash and accounting for the expenditures. Because of the small amount involved, the segregation of duties requirement is not considered necessary under the circumstances.

3. Expenditures in excess of a specified amount should not be reimbursed from the fund.

4. Prior to making payment, the custodian should complete a petty cash voucher and have it signed by the person receiving reimbursement. Documentation in the form of a cash register tape, delivery ticket, invoice, etc., should be attached to voucher.

5. Employees should not be allowed to have personal checks cashed by the fund.

6. A person other than the custodian should periodically review fund activities to determine that the total of vouchers and cash on hand equal the authorized fund amount.

7. The fund should be replenished as needed during the year; however, it must be replenished at year-end to ensure that all expenditures are included in the financial statements. When the fund is replenished, disbursements from the petty cash fund are charged in the accounting records to accounts which reflect the nature/purpose of the expenditures.

In order to establish a petty cash fund, once it has been approved by the board, a check is written, on the regular checking account, payable to either the fund custodian or to "cash". The check is cashed at the bank and the currency becomes the organization's petty cash fund.

Accounting entries to establish and replenish the fund would be as follows:

| | | | Debit | Credit |
|---|---|---|---|---|
| July 1 | Petty Cash Fund | | 50 | |
| | Cash in bank-checking | | | 50 |
| | To establish petty cash fund | | | |
| Sept 15 | Office Supplies | | 26 | |
| | Postage/Freight | | 19 | |
| | Cash in bank - checking | | | 45 |

**To record petty cash expenditures from July 1 - September 15.**

## H. PROGRAM INCOME

Grantee organizations are encouraged to earn income to help cover the cost of state-funded projects or activities. Program income includes, but is not limited to, income from services rendered, the use or rental of real or personal property acquired with state funds, sale of commodities, etc. Interest earned on state funded deposits is considered to be program income.

When program income has been earned during the project period by a component funded with state monies, the grantee should request written authorization from the Department of Health and Human Services funding agency to utilize the income in one or more of the following ways.

**1. Add the program income amount to the project award which would allow the grantee to use the additional funds to further project or program objectives.**

**2. If the project has a cost-sharing or matching requirement, allow the grantee to use the program income to satisfy the non-state share of project costs. This option is not available if funds received from the State represent federal funds and/or if prohibited by legislation.**

**3. Use the program income to reduce total allowable costs of the project when determining net costs upon which the state share is based for participation purposes.**

If program income at the end of the project period exceeds an amount previously approved by the Department of Health Human Services funding agency in accordance with either option one or two above, the excess shall be administered in accordance with Option 3 as a reduction to allowable costs.

When allowable costs have been incurred by the grantee incidental to the generation of program income and such costs have not been charged to a state-funded program, the costs may be deducted from the total program income to determine net program income.

A grantee should also have program income policies and procedures in place which would be applicable to subrecipient organizations.

# I. PROPERTY MANAGEMENT

Not-for-profit organizations should have policies and procedures which provide proper control and accountability for fixed assets acquired with state funds. Fixed assets include real property (buildings), moveable equipment, and vehicles. The governing board has responsibility for adopting a formal property management policy and approving the internal controls and operating procedures developed by management.

The formal policy adopted by the board should include features such as the following:

**1. Board approval is required for either all fixed asset acquisitions or for purchases in excess of a specified dollar amount, such as $5,000.**

**2. Management has to secure board approval before selling or disposing of fixed assets.**

**3. Equipment is defined, for example, as having a useful life of more than a year and an acquisition cost of $5000 or more per unit, so that immaterial amounts will be expensed and not accounted for through the fixed asset system.**

**4. Board approval is required for property management controls and procedures.**

A properly designed fixed asset system is important because it provides for effective property management and control as well as the safeguarding of investments. The system can also be useful in the management decision making process and the presentation of accurate financial statements.

**Real Property**

Upon acquisition, title to real properly should normally vest in the organization subject to a condition that the entity shall use the property for the authorized purpose of the state funded project. When an entity determines that the property is no longer needed for the original state project, it should secure written approval from the state agency to use the property in conjunction with another state funded project.

If an organization determines that real property is no longer needed in either the original or another state funded project, the entity should request disposition instructions from the state agency which funded the original acquisition. The state agency may allow the organization to proceed with one of the following alternatives:

**1. Retain title to the real property after compensating the state agency in an amount computed by applying the state's percentage of participation in the original cost to the fair market value of the property.**

**2. Sell the property and compensate the state agency in an amount to be calculated by applying the agency's percentage of participation in the cost of the original purchase to the proceeds of the sale after deduction of any actual and reasonable selling and fixing-up expenses. When a grantee or subgrantee is directed to sell property, procedures shall be followed that provide for competition to the extent practicable and result in the highest possible return.**

**3. Transfer title to the state agency or to a designated third party. The entity would be paid an amount calculated by applying its percentage of participation in the purchase of the real property to the current fair market value of the property.**

**Equipment**

Title to equipment acquired with state funds shall vest in the grantee organization. The equipment shall be used in the project for which it was originally acquired as long as needed regardless of whether the project continues to receive state funds. When it is determined that the equipment is no longer needed to support the project, written instructions should be obtained from the state agency as to disposition.

When acquiring replacement equipment, the grantee or subgrantee may use the equipment which is being replaced as a trade-in or sell the property and use the proceeds to off-set the cost of the replacement property, subject to the approval of the awarding state agency.

**Controls and Operating Procedures**

Specific property management controls and procedures will vary from grantee to grantee; however, the following features should be applicable to most organizations.

**1. Detail property and equipment records should be maintained which accurately include:**

a) description and location of the equipment, serial number, acquisition date/cost, useful life and depreciation expense;

b) source/percentage of funding for the purchase and any restrictions as to use on disposition;

c) disposition data, including date of disposal and either sales price or the method used to determine fair market value (FMV).

**2. All fixed assets should be assigned a control number in the accounting records and each piece of moveable equipment should be tagged with a permanent identification number.**

**3. At least once every two years, a physical inventory of property and equipment should be taken and the results compared to accounting and fixed asset records. A process should be in place which ensures that discrepancies are immediately brought to the attention of management and the governing board.**

**4. A control system should be in place to ensure adequate safeguards to prevent loss, damage, or theft of equipment. Also, the process must provide for full documentation and investigation of any losses or thefts.**

**5. Adequate maintenance procedures should be implemented to ensure that equipment is maintained in good condition.**

Procedures should be implemented which ensure that adequate insurance coverage is maintained on all real and personal property. A review of coverage amounts should be conducted on a periodic basis, preferably at least annually.