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Managing Restricted Funds

A resource article by Nonprofits Assistance Fund

Unique accounting standards require that nonprofit organizations report contributed income in one of three categories – unrestricted, temporarily restricted, or permanently restricted. These different income classifications are determined by either the absence or the existence of donor-imposed restrictions on the use of funds. It's helpful to start with the premise that, although restricted contributions and grants pose financial management challenges, these sources of funds for program and organizational support are important and desirable.

This resource article aims to define unrestricted, temporarily restricted, and permanently restricted income and give nonprofit leaders the tools to record, report, and effectively manage contributed income and net assets.

Definitions

Restrictions can only legally be placed on funds by their donors. The shape and form of the restrictions are defined in the "gift instrument." The gift instrument is the document that establishes the use of the donated funds. Examples of gift instruments include award letters from foundations and letters from individual donors.

- **Unrestricted**: These funds are free from any external restrictions and available for general use. Many individual contributions are unrestricted, as are general operating and unrestricted grants.

- **Temporarily Restricted**: These funds have donor-imposed restrictions that can be fulfilled in one of two ways – passage of a <u>defined period of time</u> (time restriction) or <u>by performing defined activities</u> (purpose restriction). These funds most often come from a grant received to operate a specific program or project or individual contributions given with the intent of supporting a particular program or campaign.

- **Permanently Restricted**: These funds are restricted by the donor for a designated purpose or time restriction that will never expire. The intent is that the principle balance of the contribution will remain as an investment forever, and the nonprofit will utilize the interest and investment returns, such as with an endowment.

Exhibit A

The following examples illustrate how to classify funds:

	U	TR	PR
An individual sends a check for $3,000 to support the nonprofit's work.	X		
A nonprofit sends an appeal to its donors seeking funds to support the expansion of its legal services program.		X	
A foundation awards a grant for $150,000 for a capital campaign.		X	
A foundation awards $50,000 for use over two years for general Operating support.	X	X	
An individual gives $2,500 to pay for 5 students to participate in a camp run by the organization.		X	
An individual gives $100,000 to provide scholarships for campers in perpetuity from the interest and investment returns.			X

Accounting Requirements

Once a contribution or grant is identified as restricted, the accounting and recordkeeping requirements are of paramount importance. Two principles are at the core of the accounting requirements. First, restrictions are imposed by the donor when they make the gift or grant. Second, income must be recognized, or recorded in the accounting records, in the year that an unconditional commitment for the funds is received regardless of when the related expenses will occur. These principles add a complexity to nonprofit financial reports due to the timing of funding, which makes accurate and reliable accounting especially important. The following examples – an Income Statement and Balance Sheet for the fictional nonprofit Family Advocacy Network (FAN) – illustrate how these rules work.

Exhibit B: Income Statement

Family Advocacy Network (FAN)
Income Statement
For the Twelve Months Ending 12/31/2007

INCOME	Unrestricted	Temporarily Restricted	Total
Individual Contributions	8,285		8,285
Grants	0	60,000	60,000
→ Net Assets Released from Restrictions	20,000	(20,000)	0
User Fees	5,250		5,250
Contract Income	3,900		3,900
Total Support & Revenue	37,435	40,000	77,435
EXPENSE			
Personnel	24,000		24,000
Program Related	6,985		6,985
Rent & Utilities	4,750		4,750
Marketing	1,375		1,375
Total Expenses	37,110	0	37,110
Change in Net Assets (Surplus/deficit)	325	40,000	40,325

The accounting requirements for restricted funds can be managed in a few different ways, depending on the accounting software being used and the sophistication level of the chart of accounts. The most effective practice is to create accounts in the chart of accounts for restricted grants and contributions. These accounts affect both the Income Statement and the Balance Sheet. As shown on Exhibit B, new income from a restricted grant is recorded in the restricted income account. When the time or purpose restriction has been met, a journal entry is made to transfer funds from the temporarily restricted account to the unrestricted account, called "release from restrictions." When reporting restricted funds, a simple approach is to add an additional column as shown on both the income statement and balance sheet called "Temporarily Restricted." This format is commonly used in audited financial reports. Nonprofits that adopt this format for internal financial reports find the information to be easier to understand and manage.

Accurate accounting is especially important for restricted contributions and grants that are intended for use over a multi-year period. In the example shown in Exhibit B, FAN receives a three-year, $60,000 grant to support a new program for the years 2007, 2008, and 2009. When the award letter is received, FAN records the full $60,000 as temporarily restricted grant income on the income statement. A portion of the grant will be released from restriction in each year of the three-year grant period. The income statement for 2007 in the example shows $20,000 being released from restrictions, while the remaining $40,000 remains in the temporarily restricted column. The same release of $20,000 will occur in future years two and three of the grant award.

Exhibit B demonstrates the impact on the Income Statement of a multi-year grant. Accounting rules require a nonprofit to record all the income of a multi-year grant in the year it is received. If an organization's income statement shows just total income and expenses without separating the restricted dollars, inflated surpluses can appear in year one of the grant period and possible artificial deficits in the remaining years of the grant period. In this FAN example, the Total column for 2007 total income shows the full $60,000 multi-year grant and reports a surplus of $40,325. For practical purposes, only $20,000 could be used to support the program during this year. The Unrestricted column is the most valuable tool for monitoring the current year financial activities.

Exhibit C: Balance Sheet

Family Advocacy Network (FAN)
Balance Sheet
12/31/2007

ASSETS	**Unrestricted**	**Temporarily Restricted**	**Total**
Cash & Investments	26,558	40,000	66,558
Accounts Receivable	3,000		3,000
Leasehold Improvements	8,000		8,000
Equipment and Furnniture	14,000		14,000
Total Assets	51,558	40,000	91,558
LIABILITIES AND NET ASSETS			
Accounts Payable	4,375		4,375
Accrued Expenses	1,100		1,100
Equipment Loan	9,000		9,000
Total Liabilities	16,275	0	16,275
Net Assets			
Beginning of Year	34,958	0	34,958
Change in Net Assets	325	40,000	40,325
Total Net Assets	35,283	40,000	75,283
Total Liabilities and Net Assets	51,558	40,000	91,558

Exhibit C shows the Balance Sheet for Family Advocacy Network (FAN). This format also delineates temporarily restricted funds from unrestricted funds. By focusing on unrestricted net assets, organizations are given the most accurate and relevant picture of the net assets available. For the purpose of analysis, planning, and decision-making, it is most relevant for an organization to understand their unrestricted net asset position.

In this example, FAN has recorded the three-year, $60,000 grant in the first year as required. After releasing the first $20,000, as shown on the Income Statement earlier, the remaining balance of the grant award for years two and three are shown on the balance sheet as temporarily restricted assets. These funds are included in the Total Net Assets on the Balance Sheet, but they are not actually available to the organization to use in any way except according to restriction. For this reason, it is strongly recommended to report restricted dollars separately, as in the example above, and to pay particular attention to the unrestricted amounts when planning and making operational decisions. In addition, directors and managers need adequate training to understand the nuances of restricted funds that present financial management challenges unique to nonprofit organizations.

Legal

Not only do nonprofits have an obligation to their donors to spend contributed dollars as designated, they are also bound by law. If a condition on restricted funding has not been fulfilled and the money has been spent, the donor can demand that the funds be returned, pursue legal action, or contact the Office of the Attorney General.

Management Practices

In addition to these tracking and recording requirements, nonprofits that receive restricted funds face increased management challenges. When making financial decisions with restricted funds, consider these guidelines:

- Do not budget to spend money unavailable to you. When planning and budgeting, be mindful of any and all of the time and activity restrictions present on your funds.
- Educate staff and board members who are accountable for the organization's financial decisions so that they fully understand funding restrictions.
- When analyzing financial reports, pay close attention to unrestricted funds and, unless you are making decisions regarding programming for which the funds have been restricted, avoid basing decisions on restricted funds. Try to focus your attention on the "Unrestricted" amounts. Formatting financial report with columns that delineate unrestricted and restricted funds can be very helpful.
- Understand how restrictions will impact cash flow and availability of funds.
- Understand the restrictions. Know when the restrictions are satisfied and how to release the funds from restriction.
- Develop a simple and reliable way to track restrictions on funds.

Concerns with Restricted Funds

If you often find yourself with your hands tied due to restrictions on funds, there are a few tactics you might consider:

- Most restrictions on funds directly relate to the grant or fundraising request. When researching and applying for grants, be aware of any challenges that potential restrictions could present to your organization.
- Fundraising letters and appeals can inadvertently place restrictions on donations. Be certain that managers and donors understand the purpose of contributed dollars and understand if restrictions are present. Also, be certain that staff charged with fundraising understand that appeals can lead to restricted gifts.
- Work with staff to understand the true cost of programming. Allocate all direct costs associated with a program. These allocations help to prepare more accurate budgets for grants and fundraising appeals, and better utilize contributions restricted to specific programs to ease the pressure on limited general operating dollars.

While managing restricted funds may present extra challenges to your nonprofit, diligent tracking is essential to demonstrate accountability and ensure legal compliance. Beyond legal compliance, proper use of restricted funds will provide additional benefits to your organization, including attracting support for quality programs, meeting the expectations of your funders, and having the most accurate financial picture possible when planning for the future.

For more detailed information on accounting standards, visit the Financial Accounting Standards Board's website at http://fasb.org. FASB 116 and 117 treat the topic of Financial Statements of Not-for-Profit Organizations.

This is an article authored by Nonprofits Assistance Fund. Nonprofits Assistance Fund helps nonprofits realize their visions. Other resources and articles on nonprofit financial management topics can be found at www.nonprofitsassistancefund.org. You can contact Nonprofits Assistance Fund at 612.278.7180.