1 Literature Review

1.1 Introduction

Nonprofit organizations (NPOs) are private entities that operate for collective social benefit, typically directed at a particular group of clients or beneficiaries [Hall and O'Dwyer, 2017]. Unlike commercial organizations, which aim to maximize their monetary profit, NPOs prioritize social impact over financial gain [Chenhall et al., 2016]. Because of this financial structure, NPOs typically do not have primary stakeholders. Any revenue generated must be reinvested for organizational purposes rather than distributed to shareholders or owners. Like any organization, NPOs secure sufficient resources to sustain operations [McCarthy et al., 2012]. For this, NPOs are dependent on external funding such as donations, grants, and fundraising events.

1.2 The Accounting Challenges & Needs of NPOs

Nonprofit organizations aim to achieve social objectives rather than generate profit; there is no standardized financial metric to assess their performance [Hall and O'Dwyer, 2017]. Due to limitations in measurement standards, NPOs face challenges in accounting for funds, allocating resources, and tracking donations and grants. Since they rely heavily on external funding, NPOs must maintain accountability to donors and the public, often adhering to specific donor-imposed restrictions on fund usage. In addition, NPOs are the primary recipients of collections – valuable cultural, historical, or scientific assets maintained for public benefit. To effectively manage these, NPOs must establish a clear and consistent capitalization policy [McCarthy et al., 2012]. Such disclosure provides transparency to stakeholders, complies with accounting standards, reflects ethical collection management, and fosters public trust [Mook, 2018]. As public confidence in an NPO grows, it enhances the organization's credibility and ability to secure competitive funding.

In the United States, NPOs are granted tax-exempt status. To qualify for tax-exemption, an organization must be structured and function solely for exempt purposes, with no portion of its earnings benefiting private shareholders or individuals [Internal Revenue Service, nd]. The IRS has established a process through which an organization can obtain tax-exempt recognition by receiving a ruling or determination letter [Hopkins, 2013]. Therefore, NPOs seeking tax-exemption should prepare financial reports that demonstrate compliance with these regulations.

In the absence of a single primary stakeholder, NPOs often face challenges in balancing the multiple accountability expectations of their diverse constituents [Hall and O'Dwyer, 2017]. Moreover, because NPOs generally have more limited resources, they must carefully monitor and maintain control over their financial environment. Donors and stakeholders need assurance that their contributions will be safeguarded and allocated according to their intended purpose [McCarthy et al., 2012]. Therefore, NPOs must produce detailed financial statements to demonstrate their mission progress and the needs of their members, stakeholders, and beneficiaries [Lang, 2017]. For example, nonprofits are required to produce a functional report of their expenses [Galasso, 2020], which outlines how funds are allocated across key activities. This ensures that stakeholders are aware of how much funding is directed at the organization's mission versus how much is spent on operations. [McCarthy et al., 2012].

1.3 Cash vs. Accrual Basis Accounting

An organization that uses cash-basis accounting exclusively records transactions involving cash. In contrast, accrual accounting records revenue when earned and expenses incurred, regardless of when cash is involved. The primary advantage of cash-basis accounting is its simplicity, making it easy for non-accountants to understand and keep records [Larkin and DiTommaso, 2020]. However, accrual-based accounting offers a more comprehensive view of the financial position of an organization.

Larger-scale NPOs typically follow accrual accounting. However, cash accounting may be more practical in small organizations with minimal financial complexity. Some NPOs use a modified version of cash accounting in which certain items are recorded on an accrual basis and others on a cash basis [McCarthy et al., 2012]. Additionally, it is common for an organization that use the cash method to have their auditing CPA convert it to the accrual method [McMillan, 2010].

1.4 Fund Accounting

Most NPOs use fund accounting, a system in which financial amounts are divided into categories according to their restrictions and designations, known as funds. Each fund acts as an independent accounting entity with its own financial records, allowing NPOs to track the sources and use of funds.

In fund accounting, activities in each fund are reported separately. This ensures that the organization is complying with legal restrictions, using funds for their intended purpose, and maintaining accountability [McCarthy et al., 2012]. However, managing multiple funds can be complicated, requiring additional resources for accounting, auditing, and compliance. Moreover, with separate financial reports for each fund, it can be challenging to assess the overall financial status of the organization. NPOs must be able to present their financial statements clearly and effectively [Greiling and Stötzer, 2016]. Without effective management, fund accounting can hinder organizational efficiency.

1.5 Conclusion

Due to the fundamental differences between for-profit and nonprofit organizations, NPOs must adopt a distinct approach to accounting. NPOs use fund accounting to ensure that funds are allocated for their designated purposes. By effectively tracking and reporting contributions, they maintain transparency and accountability to stakeholders. This approach helps them secure funding, manage compliance, and maintain stability. Using the appropriate accounting software reduces the cost of financial accounting and provides built-in tools for fund tracking, budget management, and compliance that align with their accounting needs.

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