Financial Management in Seventh-day Adventist Church Organizations: A Guide for Financial Professionals

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General Conference of Seventh-day Adventists
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Foreword

The General Conference and Division Treasurers have been working on developing and updating the denomination's accounting and financial reporting guidance for the world church. *Financial Management in Seventh-day Adventist Church Organizations* is the final product of that process. Volume 1 is *A Guide for Governing Boards and Executives*. Volume 2 is *A Guide for Financial Professionals.* Volume 3 is *A Resource Toolkit.* These volumes reflect and incorporate current international accounting and reporting guidance and denominational financial policies. The primary purposes of these volumes are to provide a standardized system of accounting and financial reporting in compliance with internationally accepted accounting principles for the global church and assist denominational accountants and treasurers to prepare financial statements that will provide meaningful information to church administrators, committees and constituencies.

Volume 2 is divided into four major segments. The first segment covers a general overview of financial accounting and reporting concepts. The second segment discusses the financial statement in detail by type of account. The third segment addresses accounting and reporting by type of entity: for example, accounting and financial reporting formats of conferences, schools, retirement plans, publishing houses, and food factories. Finally, the fourth segment deals with tools for using this volume.

Although the Seventh-day Adventist Financial Reporting Framework Committee is primarily responsible for these volumes, many individuals and committees have participated in the preparation, for which we are greatly indebted. As Chair of this Committee, we express our gratitude to Mack Tennyson, a member of this Committee who was the Principal Contributor of this volume. We express our appreciation to the other Committee members who were Brent Burdick, Paul Douglas, Annetta Gibson, Elaine Hagele, Daniel Herzel, Ian Heunis, Robyn Kajiura, Eugene Korff, Reto Mayer, Michael Park, Gerardo Tomasini, and Ray Wahlen for their time in reading and reviewing this volume. A special thanks to the Division Treasurers for their comments and suggestions.

This volume supersedes all previous denominational accounting manuals and has been approved by the General Conference and Division Treasurers. It shall be adhered to by all denominational entities.

It is my hope that the users of these volumes will find them user-friendly and an invaluable financial management tool for each part of the global church.

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July 2025

Chapter 1

Introduction to Financial Reporting

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Chapter 1
Introduction to Financial Reporting

This chapter explains the SDA financial reporting framework and its publications. It then looks at the value of unity and the need for flexibility in denominational financial reporting. It concludes with a look at the various components of the Church's financial management system.

Section 101 - Overview of the SDA Financial Reporting Framework

The SDA financial reporting framework has three volumes:

Volume	Contents	Audience
Volume 1	Introduction to various Financial Reporting topics	Church leaders and governing bodies
Volume 2	In-depth discussion of Financial Reporting	Financial leaders and managers
Volume 3	Resource: • Examples • Supplementary Documents • Checklists • Templates • Spreadsheets • Etc.	Accountants

Figure 1 – SDA Financial Reporting Framework

This manual is Volume 2. It replaces the former *Seventh-day Adventist Accounting Manual*.

101.01 Primary Objectives

This manual:

- Serves as a reference tool for financial leaders and managers of SDA organizations.
- Encourages uniformity and accuracy in financial reporting.
- Improves accountability and stewardship of denominational resources.
- Serves as a training tool for accounting and treasury functions.
- Raises professional standards among accounting staff.

Section 102 – Church Uniformity and Flexibility

The Seventh-day Adventist Church is one body with the united mission of spreading the Gospel to the world. The Church includes many types of entities and works with people who speak many languages. Its workers have a wide range of education and training backgrounds and hold very different world views because of their remarkably diverse cultures. This diversity means the Church operates within various legal structures and regulatory environments.

Given its complex structure and unifying mandate, the Church's financial approach must balance its united mission with valued flexibility. Every denominational entity must follow uniformly applied standards and procedures in many different situations. Church entities also require flexibility when supporting the demands of other regions and providing the information needs of various kinds of organizations in different business situations.

102.01 Uniformity

Uniform financial reporting standards and practices are essential for the world church (see section 105.04).

- Comparability - Administrators review financial reports from many Church entities within their region.

> *Example – Comparing Data*
>
> For instance, the Southern Asia-Pacific Treasurer reviews reports from the Pakistan Union and East Indonesia Union Conference. These unions are located six thousand kilometers apart and have vast cultural differences but are part of the same Division. Comparing data from both places is necessary for the Division. The use of similar principles means they can compare these reports.

Figure 2 - Comparing Data

The General Conference, divisions, and unions often make statistical and financial summaries of their units. Comparable information makes this process meaningful.

- Policies - Church policies give necessary limits and guidance. By nature, the policies imply uniformity.

> *Example – Policy Assuming Uniformity*
>
> Church policy recommends the need for a minimum working capital. Roughly put, "Be sure to have working capital minus restricted net assets that will support so many months of operating expenses."
>
> Having a policy like this infers a uniform calculation of current assets, current liabilities, operating expenses, and restricted net assets.

Figure 3 – Policy Assuming Uniformity

- Worker Transfers and Advancement – Career advancement in the Adventist Church often means moving between Adventist organizations.

> *One Example – Treasurer*
>
> Consider this Treasurer's denominational career so far:
>
> - She started in the Southern Asia-Pacific Division as an accounting faculty member at an Adventist university.
> - She then became a hospital controller.
> - She then became the hospital's Vice President for Finance.
> - She then moved to the East Central Africa Division, where she was a Vice President for Finance at an Adventist university.
> - She is now serving in the Northern-Asia Pacific Division as a Union treasurer.
>
> Who knows where God will lead her next?

Figure 4 - Worker Movement Calling for Uniformity.

While many workers stay closer to one geographical location, advancement often means moving between Adventist organizations. Such movement calls for uniformity in reporting requirements, systems, account structure, and policy.

- Training – Work transfers and advancement mean workers at every level need to understand the Church's financial approach from a broad point of view. Everyone must be able to implement their common financial understanding in different locations and job positions. Uniformity makes training for this easier and cheaper. This unified training occurs in many ways. Think of the efficiency and team building of Union and Division-wide training events: because of uniformity in reporting standards, these events can include accountants from schools, conferences, and healthcare clinics from many different countries.

- Audits – Notable savings occur when auditors work with familiar accounting processes, using standard vocabulary, and common reporting standards.

- Standard financial vocabulary.

Example – Standard Financial Vocabulary

If a worker uses “Allocated Net Assets” in Africa, it would be confusing to hear “Reserved Funds” in Asia, or to read training material that refers to “Balance Sheet Reserves”. Non-profit accounting uses all three terms. It is helpful if the Church can agree on one of the three for simplicity’s sake.

What about auditors serving unions, schools, and hospitals in several divisions? Will they have to jump between referring to “Plant Assets”, or “Fixed Assets”, or “Plant, Property, and Equipment”?

Figure 5 - Standard Financial Vocabulary

Standard financial vocabulary isn’t just about standardized words. It’s also about meaning. Does “Cash” include bank deposits or only currency? What do Current Assets and Liabilities include? What exactly is an Increase in Net Assets?

Volume three includes a Glossary of Adventist Administrative Terms and Acronyms.

Because the Church is so complex, complete uniformity isn’t possible, but consistent standards, procedures, processes, and vocabulary are a worthy goal.

102.02 Unity in Flexibility

This manual presents denominational accounting principles, reporting standards, and vocabulary. Agreement in these concepts is a big step towards denominational consistency, but they must also allow room for flexibility. Each organization has its own legal requirements, cultural environment, and style. Each has its own ministry and business priorities. This manual recognizes these differences and encourages the practical variety this diversity demands within the framework of consistent accounting principles and reporting standards.

Uniformity leads to meaningful, substantive, principle-driven ideas. This concept means that even the uniform requirements of this manual have materiality thresholds. These thresholds can be financial or conceptual. Focusing on trivial points of disagreement distracts from the meaningful pursuit of uniformity. Unthinkingly pushing one trivial view over another in the name of uniformity hurts uniformity.

Example of Trivial Differences

Consider the different spellings of "Organization" and "Organisation".

Or the difference between the British number format 1,234.00 and the French 1.234,00.

Or the American "For the Year Ending May 31, 2019" and the British "For the Year Ended 31 May 2019".

Figure 6 - Trivial Differences

Treasury leadership in various parts of the world hold vastly different views about the value of uniformity and diversity. These views are built on long-held cultural variations. Some push for uniformity down to standard fonts in the financial statements. Others think their job is all about staying out of trouble with their government, and they give little thought to uniformity. It is vital for those who push for one view or the other to see the value and contribution of the opposite view.

102.03 Materiality in Accounting

Materiality is an accounting concept that refers to the significance of information in financial statements. The concept considers the question: Could the missing or incorrect information impact the decisions of those using the financial statements? The concept of materiality acts like a filter to determine what information is relevant to the reader of the financial statements or the decision-maker who will rely on the financial statements for decision making purposes.

Here are some things to consider when determining materiality in accounting situations:

- *Relative size:* Larger sums of money are considered material while smaller sums are likely to be considered immaterial.
- *Impact on the organization:* The impact of the amount on the organization's total financial picture. What may be considered an insignificant cost to a large organization may be a material item for a small organization.
- *Impact on the user of the financial information:* Would the omission or misstatement mislead the user or change their actions?

In this *Manual*, materiality considerations are particularly important to subjects discussed in Chapter 2, Section 204.04, when deciding whether a Plant Fund is required; in Chapter 12, Section 1202, when deciding whether supplies should be immediately expensed upon purchase or placed in an asset account, to be expensed as used; in Chapter 13, Section 1304.02 when determining capitalization thresholds for assets; in Chapter 14, Section 1402.02 when accruing payroll; and Chapter 24, Section 2404 when determining profitability of a subsidiary that receives in-kind transactions from the parent organization. Consultation with the organization's auditor is recommended when deciding questions of materiality.

102.04 Regulatory Environments

Local or regional regulatory authorities often result in organizational differences. Almost all Adventist organizations relate to non-profit regulatory and tax authorities. All non-profit regulators need financial reports, and practically all Adventist organizations must make their filings to tax authorities. Each agency has rules about calculating such things as income and expense. However, rules from tax authorities and non-profit regulators do not supplant the church's reporting requirements and vice versa.

These local rules are important, but they hardly affect the use of the church's reporting principles in this manual. The government rules and Church rules are not one-or-the-other, competitive ideas. Instead, they are dual responsibilities. Both have reporting requirements, and the Church organization must prepare reports for both.

Fortunately, many differences between Church rules and those from local non-profit regulators are often immaterial. In this case, complying with both sets of rules is easily manageable. But often, this dual responsibility does mean some extra work.

Consider the information in the accounting software. The software has account balances, and the organization uses a working trial balance to adjust them to reflect government and Church rules. Both are using the same basic information. The organization must design and prepare the same basic information to meet the needs of both government and Church reporting. Often, organizations keep basic information to comply with one set of rules or the other. It then uses work papers to adjust from the basic information to the needs of the other set of rules.

Often, people think this dual responsibility is an unusual burden, but it is standard with most non-profit and for-profit organizations. Every large corporation must prepare financial information following both their financial reporting rules and their different government tax rules. Most companies and organizations have this dual reporting responsibility. Dual reporting means extra work, but this is not a reason for ignoring the requirements in this *Manual.*

Example - Regulatory Reports

Example - Meeting Government and Church Needs

Suppose a country wants rental income to be recorded on a cash basis for its tax and regulatory reports, but IFRS and the Church require the accrual basis.

The organization maintains the accounting system using one accounting basis or the other.

When reports are prepared, working papers can show the adjustment from the system records to the required report presentation. So, if the accounting software keeps the rental income on the accrual basis, it must adjust the amounts to the cash basis for the tax reports. Or if the information is on the cash basis, it must adjust the information to the accrual basis when it prepares the IFRS based denominational financial statements.

As a side note: this accounting manual is about reporting requirements and not about accounting processes. The focus is on the organization's financial statements reflecting the manual's requirements and not on how accounting systems accumulate data. In the current example, the organization can be said to comply with the accounting manual if its statements show rental income on the accrual basis. The manual is not stipulating that the accounting software must reflect the accruals. Rather the accruals may exist solely in workpapers. The workpapers are as much a part of the accounting system as the accounting software.

Scenario One

The Union A accounting records use the accrual basis, so the Rent Income account shows earned rent. The Unearned Rent Liability account shows the rent collected before it is earned. This means the Union:

1. Collects four months' rent of 400 and
2. Records the rent as a credit to Unearned Rent Liability
   Then:
3. Makes a monthly entry of 100 to move that month's rent to Rental Income

This approach follows the IFRS accrual rules this manual requires. For example, 300 has been moved over. 100 is left in Unearned Rent Liability. However, for their reports the government wants Rent Income on the cash basis.

Union accountants use working papers to prepare to meet the government report requirements. They:

- Make a 20xx working trial balance using the system's accrual account balances.
  - If this is the only Rent Income collected, there will be 300 in Rent Income

- Adjust Unearned Rent and Rent Income to reflect government rules
  - In this example, debit Unearned Rent Liability and credit Rent Income by the 100 balance in Unearned Rent.
  - This puts the part of cash receipts that has not been shown as Income into Income.
  - This is only done on the working trial balance. It shows cash basis Rent Income of 400. Unearned Rent Liability will be zero. This trial balance forms the basis for the government financial reports.
  - One may argue, "The system needs to show the government figures", or they could wonder how this is recorded in the system. Keep in mind that working trial workpapers are just as much a part of the accounting system as the general ledger.
- In the following year (20xy), the accountants need to do some work in the working papers.
  - The accounting system will show Rent Income 100 as the rent income for the first month of the year. This is the 100 recorded last year as 20xx income on government reports.
  - The accounting system will show 20xy Beginning Net Assets as 100 lower than the Net Assets listed in the government report. This is because last year's adjustment increased last year's income. Increased Net Income meant increased Net Assets.
  - In the 20xx working papers, the accountant debits Rent Income by 100. This removes the amount that was shown as income last year. They debit Net Assets to reduce the excess there.
  - This entry makes Beginning Net Assets on the working papers the same as Ending Net Assets on the 20xx's government reports.
- The reader might object, "My SunPlus accounting software will not allow entries in the Net Asset account" or "My auditor said to never make an entry into Net Assets." These objections miss the crucial point. The entries are only made in working papers.

Scenario Two

Union A keeps accounting records on the cash basis. This means all rent payments received are posted into Rent Income. At the end of the year, that income remains as Rent Income.

This is fine for the government reports. No working papers and adjustments are needed for those reports. The figure can be taken from the system.

But the Church requires IFRS Accrual statements. The accountants will work with working papers and adjustments to produce these statements. They will:

1. Create a working trial balance using the cash basis account balances from the system. Using the case from Scenario One, there is Rent Income of 400 and Unearned Rent Liability of zero.
2. Make an adjusting entry debiting Rent Income and crediting Unearned Rent by the 100. The balances from the working papers are then used to prepare Accrual statements.
3. In the next year's working papers, the accountant will reverse the last year's accruals. They debit 100 to Net Assets and credit it to Rent Income.

Figure 7 - Regulatory Reports

Section 103 - The Governing Committee

Church governing committees are either called the Controlling Board or the Executive Committee. This naming depends on the organization's location and organization type.

Whatever the organization calls it, its governing committee is responsible for its finances. It directs the organization's officers in this purpose. The Treasurer/CFO is responsible for giving financial information and leadership. The Board should listen to and consider the CFO's advice; however, the ultimate decision-making power and financial responsibility rests with the governing committee.

General Conference Working Policy (GCWP) specifically requires governing committee action and oversight of the following things:

- Appropriations to other organizations
- Response to auditor's reports
- Adoption of budgets
- Monitoring the results of the financial activity
- Authorization of new bank and investment accounts

Section 104 - The Chief Financial Officer

Church organizations use various job titles to refer to their chief financial employee. They are called Treasurers, Controllers, Bursars, Vice-Presidents for Finance, Vice-Rectors for Finance, or Business Managers. This manual calls them "Treasurer". This simplification is in the interest of streamlining the manual and should not influence the question of the proper title.

The Treasurer should understand the duties specifically assigned to that office. The entity's constitution or some other governing document usually describes these duties.

Example – Model Conference Bylaws

GC Working Policy (GCWP D 20 05) has the Model Conference Bylaws. The Model Bylaw’s Article VI, Section 1c, describes the Conference Treasurer:

> Section 1c Treasurer: The treasurer, associated with the president as an executive officer, shall serve under the direction of the executive committee. The treasurer shall report to the executive committee of the conference after consultation with the president. The treasurer shall be responsible for providing financial leadership to the organization which will include, but shall not be limited to, receiving, safeguarding, and disbursing all funds in harmony with the actions of the executive committee, for remitting all required funds to the union/division/General Conference in harmony with the division policy, and for providing financial information to the president and to the executive committee. The treasurer shall also be responsible for furnishing copies of the financial statements to the union officers.

Most denominational organizations have a variation of this job description.

Figure 8 - Model Conference Bylaws

Here are some essential points:

- The Executive Committee or Board is responsible for the organization, including the organization’s finances.
- The Treasurer is a top executive officer along with the President and Secretary. The church has sound reasons for not following a corporate model, using a single leader.
- The Treasurer serves under the direction of the Executive Committee.
- The Treasurer reports to the Executive Committee after consultation with the president.
- The Treasurer gives financial leadership. This principle differs from saying, “The Treasurer manages the money.” or “The CFO handles the finances.”
- The Treasurer carries out the financial transactions in harmony with Executive Committee actions.
- The Treasurer remits funds that belong to higher organizations.
- The Treasurer provides financial reports to the other officers and the Executive Committee.
- The Treasurer provides financial reports to the next higher organization’s officers, its President, Secretary, and Treasurer.

Section 105 - The Accounting and Financial Reporting System

The Accounting and Financial Reporting System:

- Includes all the organization's manual and automated accounting processes. The accounting system is much more than the accounting software.
- Includes such things as reconciliations, working papers, spreadsheets, and documentation. Accountants are an integral part of the system.
- It has the primary purpose of producing financial statements. In addition, it is about cost accounting, cost control, and budgeting. It includes stewardship and stewardship accountability.
- Assists the organization in following government regulations, Church policies, and committee actions.
- Produces statements and documents to show and support it has done the other things mentioned above. It must do those things and document it has done them well.

105.01 Stewardship and Custody of Assets

The accounting system records transactions and makes financial reports but does much more. It assists the church, as a good steward, in being accountable for its assets. This accountability is to fellow officers, constituents, donors, governing committees, the government, and others. This responsibility for accountability requires systems to include carefully designed and operating stewardship practices to properly manage the organization's assets. Properly managing assets means adherence to the law and to Church policies. Proper management means safeguarding the organization's own assets and assets held for others.

Example – Stewardship

Church members expect tithe and offerings to be properly handled. They expect the organization to use tithe as directed by Scripture, Spirit of Prophecy counsel, and policies. These donors may restrict offerings for specific purposes and they, rightfully, expect the organization to use the offerings as designated. Organizations make appropriations for specific purposes or general operations. Receiving organizations must use them as directed. This is all stewardship.

Figure 9 - Stewardship

Stewardship is using resources properly, but there is another responsibility. Stewardship also includes being able to show that it has done things properly. This dual role means stewardship has four elements:

1. It tracks the types of resources received by their purpose (e.g., Tithe, Restriction, etc.)

2. It accounts for resources by that purpose until it spends them.

3. It spends resources according to the stated purposes.

4. It shows that it has followed the other three steps correctly.

That is stewardship.

105.02 Financial Reports

The organization routinely issues financial statements that report the organization's financial health. It prepares them according to specific rules: International Financial Reporting Standards (IFRS) and Church Supplementary Requirements. These standardizing rules aim to achieve uniformity, which provides the benefits outlined in this chapter.

The Executive Committee or Board is ultimately responsible for the quality of the organization's financial statements; therefore, the Board needs to take the production of financial statements seriously.

For example, the Board must:

- Exert proper oversight by ensuring adequate staffing and proper supervision.
- Ensure the internal control system works correctly (GCWP S 04 30.3).
- Engage with the auditor and manage that relationship (GCWP S 34 05).
- Understand that the organization's financial health and reporting are their responsibility.

The Treasurer takes the lead in this responsibility. Overseeing the statement's preparation is a weighty concern of the Treasurer. In tandem with the Board, the Treasurer:

- Ensures the proper accounting system is in place. The accounting system includes the accounting software, people, documents, and workflow that produces the statements.
- Ensures compliance with the proper IFRS and denominational reporting standards.
- Builds the best staff by hiring the right people and providing training.
- Takes the lead in creating a sound internal control environment.
- Monitors the correct recording and review of transactions.
- Oversees the month-end and year-end processes.
- Manages the routine relations with the auditors.
- Presents the statements to the Board.
- Assists the Board in developing their financial skills.
- Ensures that the reports get to the proper recipients.

Some of these roles are obvious, and do not need further attention in this *Manual*. But that does not mean these actions are easy or unimportant. For example, it is generally understood what "Ensures that the reports get to the proper recipients" means, but the concept of "internal control" requires an explanatory chapter. Both are important.

105.03 Intended Users

Financial statements report to users. Users include the board, donors, constituents, higher organizations, creditors, regulators, and others. The idea is that these users are outside the central executive group. That group can get whatever reports they need to do their job. The statements should be understandable to the average, well-informed user. This principle balances several ideas:

- Users should get the information they need - not too much or too little.
    - Too much information can confuse true accountability.
- The statements should only give information relevant to the roles of general users.
    - The typical Executive Committee member does not need to see lists of bank accounts, receivables, or payables.
    - This extensive information may obscure more pressing threats.
- The amount of detail necessary for proper disclosure of information may vary.
    - The Treasurer must determine the amount of detail the statement users need. The Treasurer must guard against including so much detail that it is confusing and avoid the other extreme of giving too little detail. Inadequate detail will make the statements misleading or may omit required disclosures.
- The intended user of the statements is not the organization's day-to-day financial managers. They should not consider the financial statements a substitute for the detailed reports they need for this role.

Example – CEO and CFO Information Needs Comparison

Compare the information needs of the President and Treasurer (insiders) and the information needs of a board member. Treasurers must resist the urge to include in the statements what they want merely as a convenience.

For example, it is good for the CFO to know the balances at each bank. A board member does not require this detail.

Employee Accounts Receivable are another example. Let's say the Youth Director has a sizeable employee receivable balance. It might be important for the CFO to know this and understand why it has happened and be responsible for dealing with it. But having the financial statements include a detailed listing of Employee Receivables may distract the board member. They may ask, "Why does Tommy owe us so much money?" instead of the bigger questions, which is "How can we free up more cash for unentered areas?"

Figure 10 - CEO/CFO Information Needs Comparison

The decision about the information that should go in the financial statements is essential. It should focus on the virtues of clarity, brevity, and proper full disclosure.

- Similarly, financial statements are not the only source of financial information. More information might be readily required for groups of users.

> *Example – Information Detail*
>
> The Finance Committee at a school might ask for an Aging of Student Receivables.
>
> Boards in a country with high inflation can ask for a listing of the Cash account.
>
> Providing details to only those that require it reduces the need for including too much detail in the principal statements.

Figure 11 - Information Detail

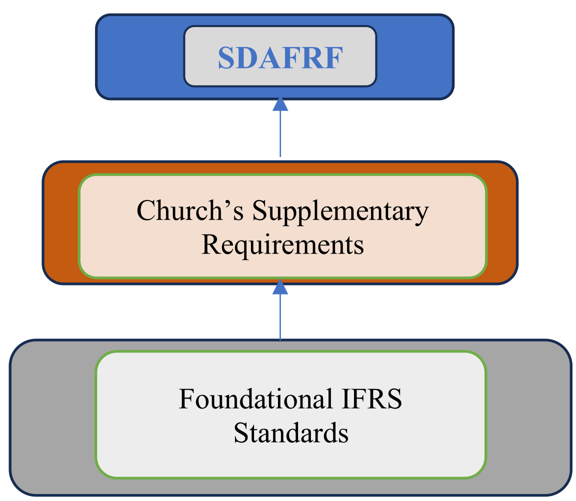
- The target is the well-informed user. The organization should not make the statements so complex that only experts can understand them. They should not so simplify them that essential information is lost.

This manual tries to help balance the proper level of disclosures. It seeks to balance the evils of too much and too little, but it is not a substitute for the treasurer's professional judgment.

105.04 International Financial Reporting Standards

The financial statements must follow International Financial Reporting Standards (IFRS).

The GC Treasurers and Division Treasurers Committee manages financial reporting issues for the church. They appoint worldwide representatives to the SDA Financial Reporting Framework Committee. The Framework Committee makes recommendations to them concerning IFRS and the way the church should use them. The result is the SDA Financial Reporting Framework (SDAFRF) embodied in these manuals. This picture best portrays the standards:



105.05 Foundational Standards

The International Accounting Standards Board (IASB) issues International Financial Reporting Standards (IFRS). One hundred forty-seven countries have agreed to follow the IASB.[1] The expectation is that Church organizations in those countries follow those standards.

Some countries have adopted IFRS but with some exceptions. In that case, the organization must comply with their country's exceptions. These are clearly defined exceptions to the IFRS.

The government agency that adopted IFRS in a country manages a country's exceptions. The IASB calls these Jurisdictional Authorities. For example, Cambodia's National Accounting Council is its "Jurisdictional Authority". The Jurisdictional Authority is the authority that oversees International Financial Reporting Standards in a country. To research a country's exceptions, go to:

https://www.ifrs.org/use-around-the-world/use-of-ifrs-standards-by-jurisdiction/

That website describes each country's Jurisdictional Authority. Only exceptions from that country's Jurisdictional Authority are a legitimate basis for varying from this manual's requirements.

Reporting rules coming from local tax authorities and regulators are not IFRS exceptions. If those agencies want financial reports done a certain way, organizations must make both localized reports and church-compliant statements, as this chapter described earlier. Those local tax and regulatory requirements do not supplant this manual's IFRS requirements.

The U.S. Financial Accounting Standards Board (FASB) and the Australian Accounting Standards Board have not adopted IFRS. Also, the Canadian Accounting Standards Board has specific requirements for not-for-profit organizations. Foundational Standards for those countries include the pronouncements from those organizations. Those three countries are working towards convergence of their rules with IFRS. IFRS will soon be the sole foundational standard for the denomination.

This principle does not mean that this IFRS-based manual is irrelevant to organizations in those countries. Those organizations must meet this manual's requirements to the extent they can within the constraints of their Foundational Standards. Additionally, they must apply the Church's Supplementary Requirements in this manual within that constraint. The following section explains this.

[1] https://www.ifrs.org/use-around-the-world/use-of-ifrs-standards-by-jurisdiction/

105.06 Church's Supplementary Requirements

These standards provide unified reporting rules within the boundaries of the Foundational Standards (e.g., IFRS and Australian/Canadian/US GAAP). These added requirements do not conflict with the foundational IFRS.

Here are the requirements:

- An organization follows one of the Foundational Standards. When the *Accounting Manual* is silent on a topic, the standards from that body apply. This manual does not replace the need for learning the rules within the organization's Foundational GAAP. Just knowing the *Accounting Manual* is not enough.

- Organizations may not mix rules from the various Standard Boards (e.g., FASB, IASB, AASB).

- If the Foundational Standards offer options, follow the choice specified by this manual.

> *Example – Depreciation*
>
> The U.S.'s FASB allows the Double Declining Balance Depreciation Method. The IASB and the AASB do not. However, all three allow Straight Line Depreciation. That is why this manual requires Straight Line Depreciation on its financial statements. So, a U.S. Church Organization must use Straight Line even though its Foundational Standard (the FASB) would allow Double Declining Balance.
>
> The IASB and AASB allow Fixed Assets to be revalued to reflect increasing market value. The FASB does not. However, all three boards permit Depreciated Historical Cost. That is why this manual unifies reporting by stipulating Depreciated Historical Cost for the denomination.

Figure 12 - Depreciation and Revaluation

- Within a Foundational Standard, this manual prescribes unifying details.

> *Example – Related Party Disclosures*
>
> All three boards require Related Party Disclosures. The manual specifies three related parties to be included when the standard is applied. Specifically, organizations above or below the disclosing organization must be considered related parties. For a union, related parties include the division and the union's conferences.
>
> Related parties include all Board members. This includes employees serving on the Board. This means related parties include the President, Secretary or VP, Treasurer, and other employee Board representatives. Most organizations have other related parties.

Figure 13 - Related Party Disclosures

Some of these supplementary standards are not additional but clarify things to help uniformly apply a rule.

- One or two Boards may require a particular standard, and the others are silent.

> *Example – Disclosure*
>
> Suppose the IASB and AASB require some disclosure, but the FASB is silent on it. The framework may require all organizations to make the disclosure.

Figure 14 - Disclosure

- The Church has reporting requirements of its own. These are in addition to the foundational standards.

> *Example – Church Reporting Requirements*
>
> The Church requires statements to have a prescribed Note about Working Capital. It requires Fund Accounting for most organizations, and it requires that Agency Cash be reported separately from regular Cash. It says Allocated Net Assets must be shown.
>
> These requirements do not conflict with any foundational standard, and the expectation is that they are in the report.

Figure 15 - Church Reporting Requirements

- Some reporting standards do not define how to prepare denominational financial statements; however, they are part of the SDA Reporting Framework. They are about the processes leading up to their preparation or about their distribution.

> *Example – Monthly Financial Reports*
>
> Consider this excerpt from GCWP S 19 05:
>
>> At least nine of the twelve-monthly financial reports must be provided to the organization's administrative officers.
>>
>> At least four of the twelve-monthly financial reports, reasonably spaced throughout the year, must be provided to the controlling board, executive committee, and officers of the next higher organization.

Figure 16 - Monthly Financial Reports

Here is another example:

Example – Internal Control
Church policy stipulates that the Board is responsible for Internal Control:
Controls – The controlling board or executive committee is responsible for ensuring internal controls which are adequate to the size and complexity of the organization. GCWP S 04 25.

Figure 17 - Internal Controls

So, supplemental requirements are not always about journal entries, account balances, or disclosure. Instead, they define other aspects of our financial reporting environment. The SDA Framework identifies requirements for all regions.

105.07 Sources of Information

This manual is a resource for denominational use, and it reflects current accounting standards, but it is not the only authority on questions of accounting standards. Access to additional reference resources is essential. The broader input includes resource material about international accounting standards, country-specific accounting standards, online resources, and accounting textbooks. Broader input also includes denominational policy books and actions taken at higher organizations.

105.08 Continuing Professional Education

Every church financial professional should have a personal program of Continuing Professional Education (CPE). This CPE is essential in financial reporting. The standards are changing in the direction of greater complexity (e.g., pension liability and lease accounting). Also, they are moving from a rules-based approach to a principles-based one. In the past, learning and applying the rules in a rules-based environment was easier. Following rules-based templates and models was easy. With that approach, manuals like this one were easier to prepare. They would just condense the rules.

Now, Standards bodies are moving towards a principles-based approach. This approach requires more professional judgments and, deceptively, sounds easier. However, the primary thing about professional judgments is that professionals are making them. This means professionals must thoroughly understand their problems and that they have - and can show they have - the professional background to make the right decisions. CPE is the key to operating in this professional environment.

Section 106 - Relationships Within an Organization

In the financial reporting context, the organization has several critical internal relationships.

106.01 CFO/Treasurer as an Administrative Officer

The treasurer is an administrative officer with notable influence and control of financial and other leadership matters. At the same time, the treasurer is responsible to the governing committee and constituents.

The governing committee, the president, and the treasurer balance this relationship between power and control. One extreme has the treasurer making unilateral decisions. The treasurer acts alone without consultation, guidance, or community input. At this extreme, treasurers ignore their committee and colleague officers.

The other extreme is too little treasurer independence. The governing committee and the president ignore the treasurer when they make key personnel, financial, and other decisions. They reduce the treasurer to a presidential assistant. Sometimes, they even blame the powerless treasurer unfairly when financial things go wrong.

The middle ground has the Board approving operating policy, general goals, and boundaries. This middle ground includes approving spending limits for the treasurer and subcommittees. With these plans and limitations, treasurers conduct the organization's business independently. They should be able to do a large portion of their day-to-day work without reference to either the Board or fellow officers.

When making far-reaching decisions, the CFO should get far-reaching support. This collaboration includes the treasurer seeking the cooperation of fellow officers and guidance from the Board. Gathering more widespread support on critical issues is protection against error and criticism. It is a matter of proper structure and processes.

106.02 Related or Affiliated Organizations

The denomination operates through a variety of organizations. Many of these entities are financial affiliates of each other. This affiliation is often through financial support. Or it could be because one organization selects committee members of another. For instance, the president of one organization may be the other organization's ex-officio committee chairperson.

"Related, affiliated, controlled, parent, or subsidiary" describes these relationships. These various kinds of relationships determine the proper reporting entity. For example, there are some organizations that most people consider separate; however, they are one reporting entity. There is one reporting entity because one exerts significant control over the other. See Chapter 18 - Reporting Entity, for a detailed discussion.

The treasurer's role in this regard is complex. As described earlier, they have direct responsibilities within their organization. That discussion was about the treasurer exerting too much or too little power and control within the organization. In addition to that concern, the treasurer must guide and mentor their constituent organizations.

The same balance of power and control exists when it comes to treasurers relating to the treasurers of organizations in their region. In this case, they are in the opposite role. Within their organization, the treasurer is at risk of the executive committee or president exercising too much involvement in the organizational finances. But they are in danger of committing the same error when they deal with their subordinate organizations.

Example – Union/Conference Treasurers

Consider a Union Treasurer exercising a mentoring role with Local Conference Treasurers. The Union Treasurer is a mentor, advisor, and guide, but does not have any direct authority over the Local Conference Treasurers. Instead, the Local Conference CFOs are responsible to their own conference committees. The Union Treasurer only has very limited direct authority.

Figure 18 - Union/Conference CFOs

It is essential to peace and proper financial reporting to understand and define the various roles clearly.

106.03 Audits and Auditors

GCWP SA 05 25.3 "Responsibility for Assurance and Related Services Provided to Denominational Organizations" requires almost all SDA organizations to have an audit.

Auditors examine the accounting records and underlying evidence so they can express an opinion about the reliability and validity of the financial statements.

The financial statements and their audit are the responsibility of the entire management/governance team (i.e., the President, Secretary, Treasurer, and the Executive Committee). This team is responsible for maintaining adequate accounting records and supporting documentation. They ensure that the statements follow the SDA Financial Reporting Framework. The Treasurer is the point person for doing this; however, the overall responsibility rests with the entire group.

The General Conference Auditing Service (GCAS) has the lead responsibility for the denomination's audit function. In most cases, GCAS does the audit. Policy assigns GCAS a role in selecting external auditors when they are needed.

Besides the tasks that policy assigns to them, GCAS helps in other ways. Here are some examples:

- They address accounting problems and give helpful information about applying standards.
- They can advise in such areas as evaluating and designing internal control processes.
- They can consult regarding designing and deploying changes in accounting methods.
- They can make suggestions regarding preparing financial statement note disclosures.
- They help those meeting with accounting challenges coming from organizational restructuring, by providing accounting guidance.
- They can research viable solutions to specific accounting problems.

106.04 Audit Committee

The Board must establish an Audit Committee, as required by GCWP S 34 05.

Here are their terms of reference:

- They make audit-related recommendations to the Controlling Board or Executive Committee.
- Select the auditor in those approved exceptional circumstances when the General Conference Auditing Service is not involved.
- Agree upon the fees and scope of the audit engagement.
- Maintain a direct and open line of communication with the auditor.
- Receive and discuss with the auditor the audited financial statement, audit communication letter, and response from management.
- Develop and review with management adequate internal controls.
- Develop and review procedures for receiving and resolving confidential complaints regarding unethical business practices.
- Discuss with management their assertions regarding compliance with core denominational working policies related to financial matters.
- Identify, evaluate, and respond to any potential business and fraud risks.
- Understand emerging trends in accounting standards and their impact on financial reporting for the organization.
- Review any serious difficulties encountered during the audit.
- Provide oversight for the conflict-of-interest policy and address risks associated with any conflicts identified.
- Hold an executive session where members of the management team, who may be attending as invitees, have been excused.
- At its next meeting, present a report to the Controlling Board or Executive Committee regarding the audit engagement results, internal control operational effectiveness,

compliance with core policies, and potential business risks. This report should include recommendations for the Controlling Board or Executive Committee to consider.

The policy prescribes the composition and operations of the committee in detail. The organization should carefully study the policy's details during implementation. In general, independent, competent, and confident members are needed.

- Independent. The members cannot be employees of the organization.

  Ideally, they should be laypersons.

- Competent. The member "Has proven knowledge in financial matters, including the ability to read and understand financial statements." The policy goes on to explain what this means.

- Confident. Quote from the policy: The member is "Not afraid to ask relevant and probing questions."

These requirements mean the organization must organize its Audit Committee long before it is needed. The organizational constituency should consider these requirements when selecting Executive Committee or Board members. They must ensure the newly elected board has several competent laypeople who can serve on the Audit Committee.

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Chapter 2
Overview of the Accounting System

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Chapter 2
Overview of the Accounting System

This chapter begins with an overview of the composition of the Financial Statements, including their purpose, users, and formatting. It then discusses financially related organizations and ends with a discussion of Fund Accounting.

Section 201 – Financial Statements

201.01 Financial Statements Users

Although the financial statements may be used by those within the organization and those outside of the organization, those within the organization have many other sources of financial data, but for external stakeholders, financial statements are the primary source of information about the organization's finances. These statements should give relevant and reliable information that is easy to understand.

201.02 Financial Statement Objectives

Non-profit organizations' objectives are quite different from those of for-profit businesses, as are their financial statements. Financial statements of for-profit organizations focus on the use of assets to produce profit. The spotlight is on the "bottom-line" net income and earnings per share. In contrast, non-profit financial statements answer different questions:

- Where did the non-profit get its resources?
- What resources does it have available to meet its objectives?
- How is the non-profit using its resources in carrying out its objectives?
- What are the main activities?
    - Non-profit parlance calls its main activities functions.
    - How are resources received and used by these functions?
- What restrictions have donors (and others) put on their donations and appropriations?
    - How well has the non-profit managed these restrictions?
- Financially, how well can it carry out its mission and objectives?

201.03 Financial Statement Format

The International Accounting Standards Board's accounting standards (IFRS) target all types of organizations. Much of their jargon and standards relate to for-profit business, but non-profits must adapt their standards and statement formats to the non-profit environment. Within that flexibility, the Church specifies its basic financial statement structure. It then modifies that basic structural framework for each type of Church organization (e.g., conferences, hospitals, schools, publishing houses, etc.). The first half of this manual addresses the basic structure generally applicable to all organizations, and the second half looks at the specific organizational types.

In addition to producing financial statements that conform to the format specified by this manual, most organizations must also make additional financial statements that conform to relevant government format requirements. These government requirements could come from the government's taxing authority or its non-profit regulatory agency. (See Chapter 1, Para 102.03 Regulatory Environments.)

201.04 Accrual Basis of Accounting

Volume 1 of this series covers several essential accounting principles. One of those principles, accrual accounting, drives much of this manual and bears repetition. All foundational standards (i.e. IFRS, US GAAP, etc.) require it, and so does this manual. (See section 1201 for a more in-depth discussion.) Accrual accounting is about deciding when statements show cash inflows as revenue and when they show cash outflows as expenses. The idea is to show revenue in the month and year it is earned, ignoring when the organization receives it. It then matches expenses to that revenue, ignoring when the organization pays for the expense. It shows expenses when it uses something, not when it pays for it. The main goal is matching expense to revenue.

Applying this definition of accrued revenue in the Church environment can be difficult. When are tithes and offerings earned? When is an incoming appropriation shown as revenue? After all, we don't usually think of conferences earning their tithe, donations, and appropriations. But in one sense, they do, and their expenses support these efforts. Chapter 16 - The Statement of Financial Activity discusses when to recognize cash collected as revenue.

Educational institutions have similar considerations when applying the principle of accrual accounting, as illustrated below.

Example - Tuition Revenue and Teacher Expense

Consider tuition revenue and teacher expense in a school environment.

When students are taught, tuition fees become tuition revenue. When student fees are collected is not part of the decision about when revenue becomes revenue. Think about November. Some students pay before November, some during November, and some after November, but November's tuition revenue remains the same. It consists of the fees for students being students in the classes in November.

Teachers' salaries are handled the same way. The cost of teachers teaching in November, producing revenue, becomes November's expense. If some teachers are paid before November, some during November and some after, November's salary expense stays the same. It is the teacher cost of teaching in November. The result is that November's tuition revenue is matched with November's expense.

Figure 1 - Tuition Revenue and Teacher Expense

Section 202 - Financial Statement Structure

202.01 Required Financial Statements

This manual requires the following general-use financial statements:

- Statement of Financial Position
- Statement of Financial Activity
- Statement of Changes in Net Assets
- Statement of Cash Flows
- Notes to the Financial Statements

202.02 Statement of Financial Position

The Financial Position includes assets, liabilities, and net assets. The Statement of Financial Position presents these as of a specific date. It gives a picture of fixed assets on December 31, 20xx. Historically, businesspeople called this the Balance Sheet. The foundational IFRS prefers "Statement of Financial Position" as more descriptive. This manual requires that IFRS wording.[1]

This manual adopts some of the IFRS options regarding this statement:

[1] Translators should search for the name a language's professional accountants use to comply with this IFRS requirement.

- The Church uses the classified format. This format shows subtotals for current and noncurrent assets.
    - Likewise, it shows subtotals for current and noncurrent liabilities.
- The equity section of the statement is Net Assets instead of Fund Balance, Capital, Owners Equity, or Stockholders Equity.
    - “Net Assets” is a confusing name since these are not assets at all, but rather the total assets minus total liabilities. This term is now the standard term for equity in non-profit accounting.

See Chapters 9-15 for a detailed discussion of the Statement of Financial Position.

202.02.01 Fund Balance versus Net Assets

The Church used to call the equity section “Fund Balance”. This term was unfortunate. “Fund” often refers to a pot of cash and investments. People frequently talk about a retirement fund, or they say, “I am short of funds.” The name “Fund Balance” falsely implies that cash and investments are on hand for a specific purpose, but they are not.

Non-profit accounting, and this manual has replaced the misleading term “Fund Balance” with “Net Assets”. Accountants should no longer use “Fund Balance” to refer to equity.

The Net Assets section of the financial statements is about the residual an organization has from its assets after it pays its liabilities. Think about using assets to settle liabilities. The remainder are net assets. The Board may allocate these remaining assets to a specific purpose.

These net assets are either allocated or unallocated. In addition, donors may have restricted them to a particular program. So, net assets are either restricted or unrestricted. Some of these remaining assets represent tithe assets that the organization must spend in a certain way. So net assets are either tithe or non-tithe net assets.

This partitioning is multi-dimensional. The system partitions the same net assets into multiple categories. For instance, the total net assets distinguish between tithe and non-tithe net assets and allocated and unallocated net assets. This results in many subcategories: Unallocated Tithe, Unallocated Non-tithe, Allocated Tithe, and Allocated Non-tithe.

The organization must design its accounting system to keep revenue, expenses, transfers, and net assets sorted by these dimensions: Allocated and Unallocated, Restricted and Unrestricted, and Tithe and Non-tithe.

202.03 Statement of Financial Activity

The Statement of Financial Activity shows financial activity over a period (usually specific months). It shows revenue, expense, gains, losses, and transfers between funds. It also separates these activities into operating and nonoperating activities. See Chapter 16, The Statement of Financial Activity, for detailed discussions.

202.03.01 Committee Designations and Donor Restrictions

Based on Bible study and the writings of Ellen White, Church working policy requires organizations to spend tithe in specific ways. Church accounting systems must provide for complying with these requirements. The organization's revenue and expenses must show the divide between tithe and non-tithe activity.

The system must also make distinctions for donor restrictions. Donors may restrict donations to a particular purpose, such as evangelism among the Igbo of Southeast Nigeria. Only the donor can set the restriction, and only the donor can change it. The revenue and expense must reflect a donation's restricted nature. The term "restricted" is limited to mean "donor-restricted". All revenue and expenses are either donor-restricted activities or not.

A similar process happens when the Board allocates resources to some specific purpose, such as Church Buildings in Catalonia or Tuition Assistance. Again, the statement's revenue and expense must keep this sorted. "Allocated" refers only to Board-designated resources. All revenue and expenses are either allocated or unallocated.

The accounting for revenue and expenses must keep all this sorted. Is the revenue Tithe or Non-tithe? All revenue is one or the other. Is it donor-restricted, or is it unrestricted? All revenue is one or the other. Is it Board allocated or unallocated? All revenue is either allocated or unallocated. The categories don't compete but overlap.

The same is true for expenses.

- Was the spending tithe or non-tithe?
    - Every expense is either one or the other.
- Is it restricted or unrestricted?
    - Every expense is either restricted or unrestricted.
- Is it allocated or unallocated?
    - Every expense is either Allocated or Unallocated.

The Church's accounting system and statements must reflect stewardship over this three-way, eight-category[2] partitioning. See Chapter 15 for a detailed discussion.

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[2] Conceptually, there are eight categories:
(1) Non-tithe, Unrestricted, Unallocated,
(2) Non-tithe, Unrestricted, Allocated,
(3) Tithe, Unrestricted, Unallocated
(4) Tithe, Unrestricted, Allocated
(5) Non-tithe, Restricted, Unallocated
(6) Non-tithe, Restricted, Allocated
(7) Tithe, Restricted, Unallocated and
(8) Tithe, Restricted, Allocated
Practically, there are fewer.

- By definition, tithe cannot be donor restricted. A donor is simply returning it to be used as God designated. A person cannot designate what is not theirs in the first place. This consideration eliminates the last two combinations, 7 and 8.
- Executive committees sometimes call for treating all restricted donations as allocated. This would eliminate combination 5. In financial statements all restricted net assets are reported as "restricted" rather than "allocated."

This leaves five practical combinations:
(1) Non-tithe, Unrestricted, Unallocated,
(2) Non-tithe, Unrestricted, Allocated,
(3) Tithe, Unrestricted, Unallocated
(4) Tithe, Unrestricted, Allocated
~~(5) Non-tithe, Restricted, Unallocated~~
(6) Non-tithe, Restricted, Allocated
~~(7) Tithe, Restricted, Unallocated and~~
~~(8) Tithe, Restricted, Allocated~~

202.04 Statement of Changes in Net Assets

Net Assets come from the accumulated financial activity over the organization's history. They are the sum of all surpluses and losses since the creation of the entity.

Example – Revenue and Expense

Consider this simple example.

A brand-new organization starts out with nothing.

In the first year, revenue came to 600:
- Tithe donations made up 300 of this revenue,
- restricted offerings made up 100, and
- unrestricted offerings made up 200.

Expenses that year came to 400:
- expenditures of Tithe made up 200,
- expenditures of restricted offerings made up 50, and
- expenditures of unrestricted offerings made up 150. At the end of the year 200 remained.

If revenue in the first year was 600 and expenses were 400 net assets at the end of the year would be 200.

The remaining 200 in net assets would consist of:
- 100 tithe (300-200),
- 50 restricted (100-50), and
- 50 unrestricted (200-150).

The following year starts with these separate amounts and adds its revenue and subtracts its expenses to arrive at its ending net assets for the second year. And so on.

The organization's accounting system must be able to sort revenue and expenses by type and be able to report the nature of the amounts currently on hand.

Figure 2 - Revenue and Expense

The Statement of Changes in Net Assets explains the changes in net assets. It does this for each type of net asset. The statement has a multiple-column format reflecting the multiple dimensions encountered in net assets (e.g., Fund, Allocation, Tithe, and Restriction).

For instance, Operating and Plant Funds may show the details of allocated and unallocated net assets. Those subsections may further show the details by restriction. This manual has several sample sets of financial statements that illustrate this presentation.

The Statement of Changes in Net Assets gives the details of each subgroup at the beginning of the year, what revenue it received, and its expenses during the year. Combining those three: the beginning amount, plus the revenue, minus the expense, results in the ending net assets. The Statement explains what happens to every type of net asset during the year. It also shows what is available for each type of net asset in the future.

202.05 Statement of Cash Flows

An organization has cash, gets more, pays some out, and so has some left. The Cash Flow Statement shows the details of this cash cycle. It breaks cash inflows and outflows into three major cash flow categories, answering three questions:

- What were the inflows and outflows coming from routine operations? In a kind of backward definition, operations in the Statement of Cash Flow are activities the following categories do not include. So, buying and selling investments, fixed assets, borrowing, and repaying debt are not routine operations.
- What were the cash flows, in and out, from investing? Investing activities refer to buying and selling investments and buying and selling fixed assets.
- What were the flows for financing activities? Financing activities refer to such things as cash inflows from borrowing and cash outflows to paying back debt.

The Statement of Cash Flows is emerging in importance in the non-profit financial community. See Chapter 6 for a detailed discussion of this Statement.

202.06 Notes to the Financial Statements

In the past, Church financial statements contained supporting schedules. These listed the details of the items on the principal statements. For example, the Cash Note listed the balances in each cash account. The Accounts Receivable Note listed the receivable accounts. These schedules are no longer part of this manual's standard IFRS statements. Such details may cause more harm than good. (See Chapter 1 for a detailed discussion about focusing on external users.)

Nothing prevents a treasurer from handing out old-style schedules at a Board meeting. The Board can usually ask for any information it wants[3]. In many circumstances, it is reasonable for the Board and other users to request such details, but those details are no longer part of the financial statements.

[3] This is not the same as an individual board member requesting information. Since treasurers are under the board's authority, they usually provide any supporting schedules the board wants. An individual board member does not have the same authority.

IFRS standards require certain specific disclosures about the organization, such as specific accounting policies used, related parties, and other relevant information that is not presented elsewhere in the financial statements. In contrast to these rudimentary schedules, these IFRS-compliant notes require a lot of preparation. See Section 605 for a detailed discussion of notes to the financial statement.

In addition to the foundational IFRS-required notes, the Church requires a few notes. The most notable is the Working Capital and Liquidity Note required by working policy.

Section 203 - Financially Related Organizations

203.01 Organizational Relationships

Note 1 - Organizational Structure - the first note in the financial statements describes the organization producing the statements.

The organization might be different than it appears to the casual observer. What seemed like one organization might be two or three different organizations, each producing a different set of Statements. For example, a union may have three sets:

- one set for its core activities
- one for its property holding corporation and
- one for its pension fund.

A user would study all three to get a broad picture of the union's finances.

Conversely, what seemed like separate organizations might report as a single entity. One organization may be so intertwined with the others that they must produce a single set of statements. An example of this might be a conference and its academy.

What determines this? The following section briefly discusses this complex topic. See also Chapter 18, Section 1803 for more detailed information.

203.02 Consolidation of Organizations

Showing a complete financial picture for the organization is very transparent and can be surprisingly helpful, while separate sub-unit financial statements miss this valuable high-level look at the entire organization. Consolidated financial statements are a perfect opportunity to show the organization's overall financial picture. They can highlight otherwise unseen trouble spots. Looking at risks as part of a bigger family picture can reduce and soften areas of concern.

When organizations share financial conditions and risks with other organizations, IFRS requires that these closely linked organizations consolidate financial statements.

Example – Conference

Consider a Conference that in addition to its primary conference activities, operates a bookstore and an academy.

The conference, the bookstore, and the academy share an intertwined legal structure. The Conference Committee focuses on conference operations. The Conference Bookstore and The Conference Academy each has an operating committee. The Conference Committee elects these two operating committees.

Each sub-unit produces its own financial statements. Looking at one sub-unit's reports would not give a fair picture of the conference. Rosy conference figures are misleading if the troubled bookstore and academy are left out.

The Conference's general purpose financial statements must show its entire financial picture, including the bookstore's and the academy's finances. Otherwise, readers are misled. This consolidated statement includes all the closely related sub-units in one report. This statement gives the most transparent picture of the entire conference.

Figure 3 - Consolidated Statements - 1

Because all Adventist organizations seem closely related to each other, how do organizations know when circumstances require them to consolidate their units? Here is how the IFRS answers that question:

- Can one organization significantly and directly affect the financial activity of another? If the answer is "yes," they must consolidate.
- Can one organization significantly influence the choice of another organization's management or governing committee? If the answer is "yes," they must consolidate.

Example – The Conference Bookstore Committee

Consider this. The Conference's Bookstore Committee votes to open a new downtown branch store.

- Can the Conference's Executive Committee make the bookstore change its plans?
- Can it block the bookstore from issuing new debt?
- Can it prevent the bookstore from hiring a new employee?

Notice: the question is not whether such intervention is prudent. The question is not whether it ever happens.

The question is***: Can they?*** If they have the ability, they must consolidate the organizations.

Figure 4 - Conference's Bookstore Committee

- Does one organization have significant noncontractual risk related to its involvement with another? If the answer is "yes," the organizations must consolidate.

To understand what the IFRS's term "noncontractual risk" means, consider what contractual risk means. Contractual risk means an organization has risk coming from a contract with or on behalf of another. An example would be one organization signing to guarantee a loan for another. Shared contractual risk does not require consolidation. One organization guaranteeing the debts of another does not mean they must consolidate.

"Noncontractual risk" means organizations share risks because of their legal situation with each other.

Example – Conference Noncontractual Risk

Shared management might mean the Conference is responsible for the bookstore's debts. The academy may operate in the same corporation as the bookstore. If so, the bookstore's assets are vulnerable to a student lawsuit.

The shared risks are noncontractual. The organization's local legal environment is an essential consideration in determining whether there is noncontractual shared risk. For instance, in one country, operating a conference and a school in separate corporations might shelter each organization from the other's risk. In other countries, separate corporations may not help at all.

Figure 5 - Consolidated Statements - 5

What does not matter, per the IFRS, are the following:

- The organizations' legal structure may not matter. Merely stating two organizations are legally separate is not sufficient.

- The financial statements that committees routinely look at do not matter. Committees often see monthly financial reports of only one organization.
- The delegation of authority to the sub-unit's leadership does not affect the decision.
- Common practice does not matter.

The IFRS rules focus on one organization's ability to influence the other's activities. That is the overriding question. It does not matter that the parent committee or management never uses or promises not to use that influence. It does not matter whether organizational leaders or board members know or recognize they have control. See Chapter 18, Reporting Entities, for a more extensive discussion of this subject.

203.02.01 Special Purpose Statements

In some situations, governing bodies and stakeholders may find an unconsolidated presentation of the parent organization more valuable than a consolidated financial statement. Auditors can provide a report on such a special-purpose presentation if it discloses the reason for the presentation and restricts use to those who understand the special purpose.

203.03 Related Party Transactions

A related organization or individual may not meet the consolidation requirements described in the previous sections and still be a "related party." IFRS requires the financial statements and notes to identify these related parties.

Related parties are of two types: persons and entities. Related party disclosures are essential to users.

> ***Example – Union A***
>
> A Union A's Executive Committee member should consider an accounts receivable from the Union President, who is a related party, differently from an accounts receivable from an unrelated firm.

Figure 6 – Union A

Financial statements must disclose all receivable and payable transactions with related parties.

A person is a related party if they:

- Have control over the organization,
- Have significant influence over the organization, or

- Are key management personnel.
  - The IFRS defines key management personnel as

    "those persons having authority and responsibility for planning, directing, and controlling the activities of the entity, directly or indirectly, including any directors (whether executive or otherwise) of the entity." [IAS 24.9].

All three of the above include close family members or entities controlled by the person. That means a president's wife is a related party. If the president owns an office supply company, it is a related party to the organization.

Definition of "Close"

What makes a family member "close"? Is a mother-in-law close? What about a cousin?

The IFRS deliberately avoids specifying which family members are "close". This manual does too. This is an example of principle-based standards.

Chapter 1 mentioned that accounting standards are moving away from rules-based standards to principle-based standards.

A rule-based standard would say something like, "A mother is close, but a mother-in-law is not close."

The IFRS's principle-based standard says, "A close family member is any family member able to influence the related party."

That means a defensible decision is based on study of the individual and societal context. The influence of mothers-in-law in Southern Asia is substantially different from their role in Australia.

Principle-based standards require use of professional judgment and the ability to support decisions.

Figure 7 – Meaning of "Close"

Other organizations can be related parties if they are:

- Members of the same consolidation group.
  - Each parent and subsidiary organization in a consolidation group is related to each of the others.

- Working in a joint venture with another organization.
  - Two unions jointly operating an academy are related parties.

- Joint ventures of the same third party.
  - A conference bookstore and conference academy are related parties.
  - The organization's pension plan is a related party.

    - If an organization receives key management services from someone or another organization, they are related parties.
        - If an unpaid treasurer is the union associate treasurer, the union would be a related party.

In the Adventist environment, related parties include, among others:

- Any Board member
    - Officers, departmental leaders, faculty representatives, students, etc., may serve on the Board. They are all related parties.
    - Related parties include the close family members of officers and any board members.
    - Non-employee Board members usually do not have financial dealings with the organization, but they are related parties.

- Any key management personnel are related parties.
    - This provision includes vice presidents and other key officers not on the Board.

- The organization's higher organization, if it has the power to participate in the organization's financial and operating policy decisions, is a related party.
    - Organizations that meet that definition have significant influence over an entity. (IAS 24, par 9)

- Church entities within the organization's field are related parties.
    - If an organization has the power to participate in lower entities' financial and operating policy decisions, it has significant influence over them.

- The organization's pension fund is a related party.

An organization should follow the valuable practice of maintaining a list of related parties. Simply listing related parties for the auditors at the end of the year makes accounting for them more difficult. If the organizations know their related parties throughout the year, it is easy to accumulate the information needed for the end-of-the-year disclosure.

The financial statements must disclose the following information for each related party:

- Management Compensation – The total salary and benefits for related party employees.
    - This disclosure reports the total amount; it is not a detailed list by name. It can be tricky.

Example – Management Compensation

Consider this: Joe Sample was President from January through October. His term ends. He serves as a pastor during November and December.

Tom Case did the opposite. He served as a pastor from January through October. He then took over as President during November and December.

Management compensation is the total compensation for these two presidents while they were presidents. In this case, it is the total of Sample's January through October compensation and Case's November to December compensation.

Figure 85 - Management Compensation

- Other Related Party Transactions –The disclosure includes transactions with management unrelated to compensation.

Example – Related Party Purchase

If a house is purchased from the President, report:

- The amount of the transaction
- The amount of outstanding balances, including terms, conditions, and guarantees.
- Provisions for doubtful debts related to outstanding balances.
- Expense during the period in respect of bad or doubtful debts due from related parties

Figure 9 - Related Party Purchase

For each type of related party (persons or entities), show the totals for the four things listed in the previous example.

Section 204 - Fund Accounting

204.01 Need for Fund Accounting

Fund Accounting is especially useful for the Church.

The foundational accounting standards boards (e.g., IASB, FASB) do not require fund accounting; however, none prohibit it. This is because fund accounting details administrative information and does not change the basic financial information presented to meet the requirements of the standards board. It provides the information they require and more.

For example, the total columns in the financial statements prepared using fund accounting match those prepared without fund accounting.

Fund accounting provides the same information and adds detail. Total cash, accounts receivable, investments, etc., are the same with or without fund accounting. This is true for every line on all four financial statements.

This idea is foundational to proper fund accounting-based journal entries. First, figure out how to make the entries without fund accounting. Then, without changing their net impact, add the details required by fund accounting.

Fund accounting is a great way to manage the Church's stewardship responsibilities. Stewardship means using resources correctly and showing that the organization did so. Fund accounting allows separate things to be kept separate.

Example – Savings and Investments

Consider savings and investments for new buildings and equipment.

Mingling these with regular operating resources confuses the operational financial position. Operational resources would be inflated. Segmenting savings and investments into the unexpended plant fund tidies things up, keeping apples with apples, and oranges with oranges.

Figure 10 - Savings and Investments

Example – Pension Funds

Consider a Union with Pension Funds.

The Union places pension assets, pension liabilities, and transactions with pensioners in a separate fund. This keeps these transactions out of its routine operations.

This practice accents problems that may exist in both the pension activities and the regular operations that otherwise may be hidden in reports that don't use fund accounting.

Figure 11 - Pension Funds

Separate Fund or Separate Department?

Consider this. Conference A operates a bookstore. Should the bookstore's accounting activities be kept in a separate fund, or is it enough to track those activities as a conference department?

It depends upon the circumstances.

- If most bookstore activities are revenue and expense, treating the bookstore as a department might be enough.
    - If the bookstore operates as a department, the Statement of Financial Activity can use columns to separate bookstore activity from other activity.
    - Drawback: treating the bookstore as a department means the Statement of Financial Position (SFP) and Statement of Cash Flow (SCF) cannot show bookstore information separately.
- If the bookstore activity has notable cash, inventories, and payables, it is better to treat it as a fund.
    - With fund accounting the Statement of Financial Position (SFP) can have a bookstore column
    - The Statement of Financial Activity (SFA) would show the bookstore's assets, liabilities, and net assets in one column and the other operations in another.
    - The total column would be the same as if fund accounting were not used.
    - The Statement of Cash Flows (SCF) would have a column for bookstore cash flows. This clarifies the bookstore's cash picture and gives a better idea of what is going on in the other operation's cash flow.
    - Advantage: This gives a clear picture of what belongs to the bookstore, while it keeps bookstore clutter out of the information for other operations.

Figure 12 - Separate Fund or Separate Department?

An organization may set up any funds it needs to give users a clearer picture of its operations.

204.02 Definition of Fund Accounting

In one sense, all for-profit organizational assets have the same status. They all have the same purpose: they advance the business's profit goals. Non-profits are different.

A non-profit's donors, grantors, Board, and others often limit certain resources to specific purposes. The limits can focus on different objectives. For example, a wealthy donor may set up a nursing education endowment. The Board may designate certain assets as belonging to a desired new building. A grantor may give money to the Igbo Global Mission project or for pension funding.

Segmentation may focus on sources.

Example – Substantial Donation

A non-profit receives a substantial donation. They may want to segment it.

Why? Segmentation allows them to account for how the donation is used without disrupting their normal ongoing operations. They can easily explain how the donation was spent. They hope to prevent themselves from unintentionally spending it incorrectly.

Or the non-profit may want to segment a specific activity. A conference, for example, may want to segment off its bookstore accounting.

Figure 13 - Substantial Donation

Non-profits use fund accounting to segment receiving, spending, and holding resources. It does this to account for resources with different objectives, sources, or activities.

204.03 Definition of a Fund

A Fund is like a separate accounting entity. It has its own self-balancing accounts for recording assets, liabilities, net assets, revenue, and expenses. This segmented system can produce its trial balance and financial statements (e.g., Statement of Financial Position, Statement of Financial Activity, and Statement of Cash Flows) for each segmented Fund.

204.04 Plant Funds

Around the world, terms related to land, buildings, and equipment have different meanings. To some, the term "property" means only land. To others, it means land and buildings, but not equipment and furnishings. To some, the term "plant" means factory or industrial buildings and equipment.

This manual adopts these unifying standard terms:

- "Plant Fund" designates the two Funds that hold the assets specifically earmarked to purchase plant assets, and the assets themselves, such as land, land improvements, buildings, equipment, vehicles, furniture, electronic equipment, and intangibles. These two Funds are the Unexpended Plant Fund and the Invested in Plant Fund. (See Chapter 7, Sections 702.02.01 and 702.02.02 for further discussion of the Plant Funds.)
    - The Unexpended Plant Fund controls resources, such as property-related cash and investments.
        - These include restricted donations or allocated resources set aside for a new building or assets allocated to equipment replacement.

    - The Invested in Plant Fund includes the plant assets, and the liabilities originally attached to plant assets such as financing contracts, mortgages or loans, etc.
- "Land, Building, and Equipment" designates land, land improvements, buildings, equipment, vehicles, etc., on the Statement of Financial Position.

Conferences or tertiary institutions must use a Plant Fund if the entity has a material amount of land, land improvements, or buildings to report. This manual uses the term "conferences" to include the General Conference, divisions, unions, conferences, and missions.

Do not overlook the keyword "material". Suppose an entity has an insignificant amount of equipment and no other assets (i.e., cash and investments) allocated to plant purposes. In that case, it does not need a Plant Fund, but using other non-plant funds might be helpful. (See Chapter 1, Section 102.03 for a discussion of "materiality.")

Example – Organizations and Buildings and Land

Consider a Union which may have two organizations, each with a set of financial statements.

One organization holds the Union's buildings and land. The other, holding the entity's operating organization, holds only a few fixed assets. It has a few fully depreciated desks and a photocopier. They manage each of the two organizations in such a way the accounting rules do not require them to consolidate. The operating organization might not need a Plant Fund, but it may operate a bookstore for which it wants to maintain a fund – just to keep things tidy.

Figure 14 - Organizations and Buildings and Land

This manual requires tertiary institutions (e.g., post-secondary colleges and universities) to use Fund Accounting. The manual recommends using Plant Funds for secondary schools. However, this is not required. Plant Fund Accounting is especially useful if the school has sizable plant-related assets or endowments. This may seem confusing because Fund Accounting is as helpful for secondary schools as elsewhere. Many divisions require all their secondary schools to use it. To them, requiring it for everyone simplifies training and makes moving accounting staff between their organizations more effortless. However, this manual does not require secondary schools to use Plant Fund Accounting because of the schools' local accounting challenges.

The Church does not require Fund Accounting for entities such as publishing houses, book centers, literature evangelism organizations, healthcare entities, and industry operations. These are like for-profit organizations and have less need to partition off various kinds of resources. In some instances, Fund Accounting would significantly improve financial management, and in some cases, it would only be a painful distraction. This challenge again illustrates the need for professional judgment.

This manual includes an entire chapter (Chapter 13) on land, buildings, and equipment. It explains what is and is not land, buildings, and equipment and thoroughly discusses Plant Fund accounting.

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Chapter 3

Internal Control Foundations

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Chapter 3
Internal Control Foundations

This chapter lays the foundations for the Church's Internal Control systems and cycles. Later chapters will discuss specifics, connecting Internal Controls and how they interact with the various financial topics. This chapter discusses the principles on which the future chapters build their discussion on internal control.

Section 301 - Accounting Systems and Accounting Cycles

An accounting system covers the entire process of managing financial activities. These financial activities include:

- Financial Management
- Budget Control
- Cost Control
- Financial Reporting
- Payroll

The system is the process of people, paper, spreadsheets, emails, software, printers, etc., working towards managing financial activities. Often, accountants misuse the name "Accounting System" to refer solely to the accounting software. In actuality, the accounting system includes all aspects of processing accounting information.

The best way to look at the accounting system is to consider it a set of subsystems. Accountants refer to these subsystems as cycles.

301.01 Typical Church Non-profit Cycles

The typical Church Non-profit cycles are:

- Revenue Cycle
- Cash Receipts Cycle
- Payable Cycle
- Cash Payments Cycle
- Petty Cash Cycle
- Purchasing Cycle

- Travel Authorization and Reimbursement Cycle
- Interorganizational Cycle
- Payroll Cycle

This chapter looks at the big picture of internal control and its role in the accounting cycles. The in-depth look at internal control for a specific cycle takes place in the chapter that focuses on that specific topic. For example, Chapter 9 – Cash and Cash Equivalents has a section discussing the internal control of cash (see Chapter 9, Section 907).

To make sure the idea of cycles is clear, here are some examples:

Example – Revenue Cycles

The Treasurer receives the Conference's Tithe and Offering Report as an attachment to an email. He transfers the information to an import spreadsheet. Then he sends it as a printed hard copy to Accountant A for review. She reviews the information and signs the hard copy to show she has done so. Accountant A returns it to the Treasurer, who imports the spreadsheet and sends the import journal voucher (JV) and the signed hard copy to Accountant B for a quick review. Accountant B signs the hard copy and the JV and puts them in the stack for the accounting clerk to file.

Figure 1 - Revenue Cycles - 1

Example - Revenue Cycles

The university registrar downloads student enrollment information from the student records system and passes the report, in both spreadsheet and signed hard copy format, to Accountant A. Accountant A prepares the import spreadsheet that will charge the students for their courses and gives the signed import spreadsheet and the hard copy to Accountant B for review. Accountant B makes sure everything agrees and approves it with a signature. Accountant B then gives the document to the accounting clerk to import. The accounting clerk imports the documents and sends the import JV and the printed hard copies to Accountant C for review. Accountant C shows she reviewed the import by signing the hard copies.

Figure 2 - Revenue Cycles - 2

Example – Cash Receipts Cycles

The Treasurer logs into the online donation system and prepares an export spreadsheet that lists the donors, the donation purposes, and the donation amounts. The Treasurer adds the necessary accounting information and sends it, along with a signed PDF of the spreadsheet, to Accountant A for review. Accountant A logs into the donor system to ensure that the Treasurer has included every donation. Accountant A signs his approval on the PDF and gives everything to Accountant B for import.

Figure 3 - Cash Receipts Cycles - 3

Example - Cash Receipts Cycles

Two mail room clerks together open the mail and prepare a summary in duplicate of all monies received. This is an import spreadsheet. They print and sign the spreadsheet and give it to Accountant A for review, including comparing the document with the incoming checks. She sends everything to Accountant B for import. Meanwhile, the clerk prepares the deposit slip and makes the deposit. She gives a copy of her deposit slip and the bank receipt to Accountant C for input into the accounting software.

Figure 4 - Cash Receipts Cycles - 4

Example - Cash Receipts Cycles

The Cashier receives cash at the cashier window, enters the information in the software, and prints the receipt. Daily she "closes out" her cash drawer and prepares the deposit. Her printed daily summary includes a reconciliation between her entries and the deposit. Her summary goes to Accountant A, who reviews the recap and the bank deposit information. Accountant A signs the document to show that he has examined it.

Figure 5 - Cash Receipts Cycles - 5

These examples describe accounting cycles and clarify the role of internal control. Sometimes internal controls are clearer when drawing flow charts. Sometimes, however, writing a simple description works best.

The above descriptions involve two intertwined systems. One is the accounting system and the other is the internal control system.

Section 302 - Internal Control Systems

Internal control is a parallel system that interacts with accounting cycles. Internal control is how financial managers ensure the cycles produce relevant, timely, and reliable results (e.g., transactions, information, accountability, etc.)

Often, the two systems intertwine so that they appear as one system. In the past, accountants considered internal control part of the accounting system. Thoughts on this have changed. Later, the manual will show that internal control is about much more than the accounting system. The following examples will clarify accounting and internal control systems.

Example – Revenue

The Treasurer receives the Conference's Tithe and Offering Report as an attachment to an email. He transfers the information to an import spreadsheet. Then he sends it as a printed hard copy to Accountant A for review. She reviews the information and signs the hard copy to show she has done so. Accountant A returns it to the Treasurer, who imports the spreadsheet and sends the import journal voucher (JV) and the signed hard copy to Accountant B for a quick review. Accountant B signs the hard copy and the JV and puts them in the stack for the accounting clerk to file.

The Treasurer's task of preparing the spreadsheet and import are straight accounting system activities. The reviews by Accountant A and Accountant B are internal control activities. Assigning a different person to import the data is a control activity. It is separation of duties type control activity.

Figure 6 - Revenue - 6

Example – Revenue

The university registrar downloads student enrollment information from the student records system and passes the report, in both spreadsheet and signed hard copy format, to Accountant A. Accountant A prepares the import spreadsheet that will charge the students for their courses and gives the signed import spreadsheet and the hard copy to Accountant B for review. Accountant B makes sure everything agrees and approves it with a signature. Accountant B then gives the document to the accounting clerk to import. The accounting clerk imports the documents and sends the import JV and the printed hard copies to Accountant C for review. Accountant C shows she reviewed the import by signing the hard copies.

The Registrar's signature is internal control. Specifically, it is an authorization type control activity. The manual will discuss authorization type controls later. The reviews by Accountant A and Accountant B are internal controls; they are review type control activities. Assigning a different person to import the information is a separation of duties type control activity.

Figure 7 - Revenue - 7

Example - Cash Receipts

The Treasurer logs into the online donation system and prepares an export spreadsheet that lists the donors, the donation purposes, and the donation amounts. The Treasurer adds the necessary accounting information and send it, along with a signed printout of spreadsheet to Accountant A for review. Accountant A logs into the donor system to ensure that the Treasurer has included all the donations. Accountant A signs his approval and gives all documents to Accountant B for import.

Both logons are security type control activities. Accountant A's review is a review type control activity. Assigning a different person to import the information is a control activity.

Figure 8 - Cash Receipts - 8

Example – Cash Receipts

Two mailroom clerks together open the mail and prepare a summary in duplicate of all monies received. This is an import spreadsheet. They print and sign it and give it for review to Accountant A , who compares the report to the incoming checks. She sends everything to Accountant B for import. Meanwhile, the clerk prepares the deposit slip and makes the deposit. She gives a copy of the deposit slip and the bank receipt to Accountant C for input into the accounting software.

Two people preparing the listing with their signatures is a security-type control activity. Accountant A's review is a review-type control activity. Assigning someone else to import the sheet is a separation of duties-type control activity.

Figure 9 - Cash Receipts - 9

The examples clearly show that internal control intertwines with the accounting system. While the two weave in and out of each other, there is more to an internal control system than the control activities that touch the accounting system.

Consider the internal control activities in the examples. They were the authorizations, security, confirmations, reviews, and spot checks. They are critical to internal control but only part of a broader system.

This chapter looks at the parts of an internal control system. First, a few related topics need attention.

Section 303 - People, Job Positions, and Internal Control

Internal control rises above individuals. It is positional, not personal. Internal control is not about who is holding the position. It is not a matter of trusting someone or not. An organization can completely trust a worker and still hold them to the control procedures demanded by their position.

Also, the example situations could make it seem like internal control requires many people to make it work. It does not. In one cycle, a person may review and check another person's work; in another, the system can reverse the roles.

Example – Sharing Internal Controls

For instance, in a cash payment cycle, Accountant A makes the cash payments and Accountant B does the bank reconciliation. Then, in the receivable cycle, they reverse their roles. Accountant B does the inter-organization accounting, and Accountant A does the reconciliation.

Figure 10 - Sharing Internal Controls

Including employees from outside the Accounting Department is another approach to internal control, especially when there is a small staff.

Example – Inter-Department Controls

For instance, the president’s secretary can handle the Petty Cash box. The Union Secretary can sign checks.

They do this with an understanding of reciprocity. In a small office, the president’s office and secretariat have similar needs to share work outside their offices.

Figure 11 - Inter-Department Controls

Section 304 - Internal Control and Financial Reporting

Internal control is critical for the financial arena as it does more than only apply to the financial and management systems. Internal control makes sure management has good financial information. Good decisions rely on sound financial information and internal control focuses on the reliability of financial information as a top priority.

Section 305 - Legal Compliance and Internal Control

All countries prohibit bribery. Church leaders understand bribing someone is both morally and legally bad. Of course, the Church condemns all immoral acts. It especially condemns illegal, immoral acts. It realizes illegal actions bring disgrace to the Church's reputation.

The Bible has a lot to say about bribery. Check out these passages:

- Exodus 23:8
- Deuteronomy 10:17; 16:19; 27:25
- 1 Samuel 12:3
- 2 Chronicles 19:7
- Job 6:22
- Psalms 15:5
- Proverb 17:8; 23; 21:14
- Ecclesiastes 7:7
- Isaiah 1:23; 5:23; 33:15
- Ezekiel 16:33
- Micah 3:11; 7:3

Figure 12 - Bible Stance on Bribery

Many leaders do not understand that most bribery laws are international. Paying bribes in one country can affect the organization in a different country. A bad decision in one country can affect the Church's tax-exempt status or lead to fines or even arrest in another country. Some Church leaders think the Church's organizational and legal structures provide protection. Specific provisions in the anti-bribery laws say that they do not.

Many leaders claim ignorance of the violation to be a defense. "We did not know he was making the payments." This is not a defense. Take, for instance, the U.S. Foreign Corrupt Practices Act, the U.K.'s Bribery Act of 2010, or the Kingdom of Thailand's sprightly named Act Supplementing the Constitution Relating to the Prevention and Suppression of Corruption B.E. 2561[1]. All three make it illegal for an organization to pay a bribe. When a violation happens, the laws penalize the employees who paid the bribe and their organization.

Including the organization as well as the individual should not be a surprise. Like those in almost every country, all three Acts are even more damning. It is not a defense for the organization to claim that it did not know the individual was paying bribes. Also, it is not much of an argument to show that the organizations had policies prohibiting bribes.

[1] Thailand dates its documents by the years since Buddha.

These observations offer insight into the legal community's thinking about internal control because organizations should have internal control systems that prevent bribery. There should be enough internal control measures to stop all stoppable bribery. The organization is responsible for the crimes it could prevent, whether it knew about them or not. This broad definition means the organization is not at fault for the bribery itself. Instead, it is at fault for not having systems to prevent bribes.

How can an internal control system prevent a worker from giving a bribe? Think through the regular, non-bribe cash transactions. A system is in place to ensure everything about those transactions is proper. An approval process ensures all payments are for legitimate purposes. Receipts are required, etc. Internal control prevents bribery merely by doing those things well. With or without anti-bribery acts, the organization wants control systems to be in place so it can know where its money is, where it is going, and where it went. These Acts merely require the same thing.

These observations offer insight into the legal community's thinking about internal control. The worker who does the illegal act is responsible; however, the Acts also require the organization to have systems to stop whatever illegalities it can stop.

God requires the same thing. The Church cannot keep out every corrupt businessperson, child molester, or crook. But it can have systems in place to prevent them from acting. Society is right to expect this. This diligence is the role of internal control.

Section 306 - Internal Control Objectives and Morality

The typical textbook focuses on four goals of internal control:

1. It helps the organization be effective and efficient in meeting its objectives.
2. Helping the organization supply reliable financial information.
3. Helping the organization follow laws and regulations.
4. Building and enhancing the organization's credibility with stakeholders.

These four goals are so standard that this discussion does not need to dwell on them. However, moral organizations want to provide a safe work environment. A safe work environment calls for three more internal control goals:

5. Protecting employees from unjust accusations.

A proper internal control system takes the focus off the worker's morality. It focuses on the system, not the person. A particular cycle's lack of internal control creates a challenging interpersonal situation. Without internal control, the organization must have extreme confidence in the employee.

Managers should be able to defend their employees because they trust them, but also because there is an adequate system of checks and balances. Compare "Fred is a trustworthy guy. I believe he is not stealing" to "Fred is a trustworthy guy. I know he is not stealing. It is unlikely he could steal anything without our system catching him." Which is better?

The Treasurer's affirmations in this example focused on honesty. They could just as quickly focus on information accuracy. Compare, "Jim is a careful accountant. I am confident the information is good because of our system of checks and balances," with "I know the report is accurate because I believe Jim is a careful accountant." The same internal control system that prevents information carelessness, prevents stealing, and vice versa.

A sound internal control system takes the spotlight off employees. Thoughts about their integrity, motivation, and carefulness are secondary. Instead, internal control focuses attention on the system itself.

This concept applies to financial and other organizational goals. For instance, membership data needs to be correct. It must protect financial information. Employees must be safe from false accusations in all areas. A sound internal control system addresses all these management challenges.

Morality supplies two more reasons for good internal control:

6. Internal control protects workers from unnecessary temptation.

Example – Theft

Consider this true story.

John had worked a few years in a finance office with very slack internal control when his daughter got extremely ill. The family finances collapsed. John never stole. He never gave in to the daily temptation to ease his finances by “borrowing” the organization’s money. It sounds like a success story. It was a success story – for John. But it was not a success story for the organization.

John says work became hell for him. He knew the money that could solve his daughter’s problems was at his fingertips. Each day he fought an eternal battle. “There were long fights against the constant temptation to ‘borrow’ what I needed. Stealing crossed my mind every time I took a cash receipt.” A good system of internal control would have made it almost impossible to borrow that money. John did not need internal controls to keep him from stealing. But it was unfair that he had to work in the tension of such a morally unsafe environment. A good internal control system would have protected John. It would have made his job safer and more pleasant.

Figure 13 - Theft

7. It protects people from moral failures.

Moral failures are when individuals fail to uphold moral or ethical standards. This includes stealing. Moral failures include other crooked things, such as accepting or giving kickbacks and bribes. They include intentional misstatements in financial reports. The wrongdoer is responsible. The moral responsibility, however, goes beyond the actual wrongdoer.

Consider the sobering way Ellen White put it:

> "For evils that we might have checked, we are just as responsible as if we were guilty of the acts ourselves." {DA 441.3}

This is sobering indeed.

The damage of a wrongdoer's direct moral failure, though that is serious, is not the only concern. There is also organizational guilt. The organization is immoral if it does not prevent the sins it can prevent. This immorality discourages donors, other employees, and other organizations. It places a cloud of guilt over the entire organization. To avoid this, the organization must create a sound internal control system.

Section 307 - The Internal Control System as a System

The internal control system runs through all management systems – including the accounting system. Internal control has five vital components. There is no internal control system if one piece is missing. Excelling in one does not compensate for the absence of another.

The five vital components are:

1. Control environment
2. Risk assessment
3. Control activities
4. Information and communication
5. Monitoring

Many accountants focus on control activities (Component 3) without thinking about the control environment (Component 1). A dozen control activities are useless if the control environment is terrible.

Each of the five components has governing principles. These principles make each of the five components successful. If the principles are working, the component is working. There are 17 principles spread over the five components.

Section 308 - Component One: The Control Environment

Top leadership needs to get the first component right. It is the control environment.
Five principles form the foundation of the control environment. The organization:

1. Demonstrates commitment to integrity and ethical values.
2. Demonstrates independence between the Governing Board and management.
    - The Board actively oversees the development and performance of internal control.

3. Management sets up structures, reporting lines, and assigns authority and responsibility.
    - This occurs in pursuit of their management goals and building an internal control system.
    - The Board gives oversight.

These principles are fundamental in the Adventist Church. Respect for authority is a Christian principle.

Respect for Authority

Consider this: the university president is in a panic. She needs cash for a trip. She rushes into the Finance Office to get some petty cash. Christian principles say the cashier owes the president proper respect. The school's internal control requires approval before the cashier makes payments. This leads to some important questions:

- Does the university president have the right to override the system?
- If so, then does the academic vice president?
- What about the dean of the Business School?
- Does the head of the Marketing Department?
- Does the Marketing Department secretary?
- Who decides what is okay and what is not okay?

The poor cashier is at the bottom of the authority structure. Once any raw authority can override the system, all raw authority overrides the system. There is no system.

When the president sets a model of throwing her weight around to get things done, so will everyone else. On the other hand, if the control system frustrates the president, she can work to streamline it. There is room for respect for authority, without undermining the system.

Figure 14 - Respect for Authority

4. Demonstrates commitment to worker competency.

    - The organization commits to attracting, developing, and keeping competent individuals. These individuals are committed to organizational and internal control goals.
    - This principle helps ensure all employees are properly qualified for skilled accounting and other financial tasks.

5. Holds employees accountable for their internal control responsibilities.

308.01 Proper Employment Practices

This last principle illustrates the importance of proper employment practices. In the context of internal control, consider these principles:

1. Conflicts of interest. Employees should sign Conflict-of-Interest Statements.
    - Committee members, officers, other employees, and volunteers must be free from conflicting interests. (GCWP E 85 gives the rule's specifics):
        - Every employee must sign a Conflict-of-Interest Statement upon the start of employment.
        - Every year, the organization must give employees a copy of the Statement of Ethical Foundations and a copy of the Conflict-of-Interest and Commitment Policy.
        - The organization must remind employees to disclose potential conflicts every year.
        - Every year, the chief administrative officer must collect a Conflict-of-Interest Statement of Acceptance from every:
            - administrator,
            - department director,
            - member of the Board/Executive Committee, and
            - any other person authorized to handle organization resources.
    - The board must review the Statements of Acceptance and Compliance. The organization must report this to the entire board.

2. Job Descriptions - Effective internal control depends on clear job descriptions.
    - Job descriptions should specify the duties and responsibilities of the position, the extent of authority on responsibilities, and to whom the employee is responsible. The organization should give each employee a copy of their job description.
    - Management should review copies of the employee’s job description when they are reviewing the organization’s system of internal control. It is particularly important that new employees understand the importance of internal control as it relates to their particular assignment.

3. Evaluation of personnel – Supervisors should do annual evaluations of all employees.
    - They must base this evaluation on job descriptions and standards of performance. The review will cover internal control matters. Everyone should view this as a constructive exchange of views and a time to be helpful.

The Church's Working Policy on internal control spotlights these control environment principles:

> S 04 25 Responsibility for internal controls—The controlling board or executive committee is responsible for ensuring internal controls that are

> adequate to the size and complexity of the organization. ... The effectiveness of internal controls will be determined mainly by the tone set by those entrusted with leadership and governance of the organization.

The following GCWP quote reinforces that top management handles internal control. It is about the Governing Committee's audit sub-committee:

> The following represents the expected responsibilities of the Audit Committee to be fulfilled each year. This charter should represent a working document that guides in managing the agenda of the committee....
> e. Develop and review with management adequate internal controls. (GCWP S 34 05, paragraph 2e)

Church policy puts the responsibility for this on the top leaders. Regulatory authorities do the same. So does Ellen White's warning about preventing sins. All three place this responsibility and morality on the board and the organization's officers.

Section 309 - Component Two: Risk Assessment

An internal control system's second component requires top management to assess risk. This risk assessment is similar but different from what the Church usually calls risk management. Risk assessment helps management to identify and evaluate risks to the organization, including the likelihood and potential impact of those risks. Risk assessment can help organizations determine which processes are most susceptible to errors and what the potential impacts of those errors could be.

309.01 Risk Assessment Principles

Four principles govern risk assessment:

1. Name clear organizational goals.
    - Align management system goals with the overall goals, including the accounting system goals.
2. Find specific threats to the achievement of these goals.

   - This principle includes an analysis of risks associated with threats. This analysis means looking at the likelihood and cost of risks. These form the basis for deciding how to manage risks.
   - Remember: potential costs are not only financial; they include ethical, societal, and worker-related costs.

3. Consider the potential for fraud.
   - Fraud threatens the achievement of organizational goals.

4. Assess the current risk situation for emerging threats that might change internal control activities.

Risk assessment is a massive task for leadership. It is likely and proper that the treasurer oversees the risk assessment administration in the financial arena. The treasurer taking leadership does not mean the treasurer does everything. Including the whole treasury team in risk assessment sets the right tone.

309.02 Assessing Threats

Risk assessment requires consideration of a threat. Threats are bad things that might happen. A more complete definition includes the threat that a good thing that should happen doesn't occur.

There is a straightforward process for doing this in the accounting system:

- Figure out what could go wrong for each step in the cycle.
- Find the breakdown that may cause the issue.
- Try to get a sense of the likelihood of this breakdown and an idea of the damage it would cause.

The first step is to write down the threats or problems that could happen in each accounting cycle. Do not think so much about someone cheating or stealing. Instead, consider the risks in the context of control goals as listed in Section 306:

1. Organizational goals

2. Proper financial reporting

3. Legal compliance

4. Organization's credibility with stakeholders

5. Employee protection
   - Protecting employees from false accusations,
   - Protecting employees from unnecessary temptations and
   - Protecting employees from moral failures.

Remember: Employee protection is about more than stealing. Stealing is not the only cause of false accusations, unfair temptation, and moral failure. For example, false accusations can be about laziness or incompetence.

Example – Assessing Threats

A university has 1,000 students. Each student takes an average of four courses. Management wants to do an internal control risk assessment of the revenue cycle that records the student's tuition charge.

Organizational Goals – Determine the organization's goals. Find risks or threats to each goal. Some goals may sound silly when the assessment team writes them down. Write them down anyway:

- Charge every student for the courses they are taking.
- Charge every student the right amount.
- Don't charge any student for courses they are not taking.

Some goals are not obvious. Those doing the risk assessment know about these goals. This illustrates why higher management must be involved in risk assessment:

- Track revenue by course number.
- Track revenue by academic department.

This information helps set up course and departmental priorities.

Financial Information – Record revenue correctly. This is tricky. The billing is not revenue until the school earns it. Recording revenue correctly involves getting the total billing right and then showing it as revenue in the period in which the school earns it. Write the goals down even if they are obvious and if they are repetitive.

- Record Revenue in the correct period.
- Do not understate revenue.
- Do not overstate revenue.
- Do not understate accounts receivables.
- Do not overstate accounts receivable.

Legal Requirements - The government gives student grants.

- The school only bills the government for courses in which the grant students have enrolled.
- It only bills for students that the government has approved for student grants.
- It only bills the government for the correct amount.

False Accusations - Be as specific as possible.

- No one can falsely claim the accountant has carelessly or intentionally left a student's course off the billing.
- No one can falsely claim the accountant has carelessly or intentionally added a student or double-billed a student.

Undue Temptation - Be as specific as possible.

- Protect employees from the temptation to undercharge a relative or friend.
- Protect employees from the temptation to undercharge someone in exchange for money or favor.

Cont'd on next page …

Moral failure

- An employee does not undercharge someone in exchange for money, favors, or friends.

The listed risks are redundant, but it is easier to just write them all down without worrying about redundancy. The next step takes care of it.

Find the threats in the whole accounting cycle. This will be a consolidation of the threat list.

- The process must charge students for every course in which they are enrolled.
- It charges the right amount.
- It should not charge students for courses in which they are not enrolled.
- The accounts receivable entry to each student's account must be correct.
- It should correctly accrue revenue.
- It should correctly charge the government for student loans.

The process without internal control would look something like this:

- Someone downloads the student registration from the student system, adds the per course charges, and imports them into the accounting software. They also use this spreadsheet to bill the government for student loans.

Find the danger points. Then answer them considering the threat list.

- Are all applicable students included in the download?
- Can the process prevent the download from including wrong or extra students?
- Are course tuition rates correct?
- Is there a way to tell whether the registrar or accountant has not intentionally or accidentally dropped or added a name to the spreadsheet?
- Is there a way to make sure the upload did not accidentally leave off a student, because of a glitch?
- Is there a way to determine that the upload did not accidentally double up on a student because of a glitch?
- Is there a way to determine whether the charges went to the right account receivable?
- Is there a way to determine whether the charges went to the right unearned tuition accounts?
- Is there a way to determine whether the government billing includes all the correct students?
- Is there a way to determine whether the government billing uses the correct grant rate?

Figure 15 - Threat Assessment

This review of threats is not generalized pessimism or paranoia. Instead, it is an intentional and systematic review of the cycle and the risks.

309.03 Risk Likelihood and Potential Damage

Risk assessment means considering two aspects of the identified threats:

- The chance of the thing happening.
- The amount of damage that will result from the thing happening.

Of course, the biggest concern is something that has a high chance of happening and being expensive when it does. And vice versa: a low-cost thing with a low probability of happening is a minor concern. The challenge is figuring out the middle ground. For instance, there may be a slim chance that a horrible thing will happen. Even though there is a slight chance, set up steps to prevent it. The organization must prevent high volume, low-cost events and remote but horrible events from happening.

This is not overly scientific, mathematical, or analytical. The organization must give deliberate thought to risk assessment. For example, rate each threat with two number scores ranging from 1-10, with 10 being the worst. The first number scores the likelihood that a threat might happen. The second number scores the potential for damage if it does.

Example – Tuition Threats

To reinforce how this works, check out a few threats from the Tuition example.

Does the download include all applicable students?
This receives a low probability score (3) and a high damage score (9). Not including all students, for example, all students with family names beginning with a letter after ‘S’, could be especially serious. What if the download leaves out all students enrolled in Theology Department courses?

Does the download exclude all wrong or extra students?
The probability score of including wrong students may be medium (6), and the damage, if it happens, may not be too bad. It is about a 4. Students who the school incorrectly bills will complain, and the office can adjust the billing. Of course, this is not a good scenario, since it will upset the mistreated students.

Another result of including students that should not be included is misleading Financial Statements that overstate the university’s financial well-being. This damage could be more far reaching that it first appears.

An organization cannot always estimate damages in terms of direct financial costs. If students complain about their bill, the student finance office can fix things. But the incorrect billing has already done its damage. This includes the student’s ill will and possible decisions made in anger, such as dropping out of school or complaining to others, thus influencing how those people think about the school.

Are the course tuition rates correct?
Sending out incorrect course rates can be easy, with a high probability score of 10, and devastating, with a high damage score of 10, when it happens. It is difficult to reverse and correct every student’s incorrect billing. If the billing accidently uses last year’s tuition rates, it is hard to bill students and government again.

Figure 16 - Tuition Threats

Risk assessment goes through each accounting cycle and finds the risks. In each step of the cycle:

- Consider each control objective.
- Brainstorm to find possible threats.
- Condense threats to a single list to account for overlap.
- Rate each threat's probability and potential damage on the condensed list. Use math-like intentionality.
- Think of a control activity to mitigate the risk of each danger.
- Balance the cost and difficulty of the control activity against the probability and potential loss of the threat.

The last two steps of the risk assessment approach get into the next component.

Section 310 - Component Three: Control Activities

Control activities are the third component of an internal control system. Control activities are actual internal control actions that head off threats. They prevent harm from failures in management systems, including accounting systems. Risk assessment includes finding control activities that could counter a given threat. Although the presentation split risk assessment and control activities, they are a concurrent and interactive process. At times, risk assessment results in ongoing changes to control activities.

In general, there are two types of control activities:

1. Those that occur during a process.
2. Those that involve a review of the transaction's processing after it has been done.

310.01 Control Activity Examples

310.01.01 Ongoing Control Activities

The following are examples of ongoing control activities:

Authorization

One person, usually a superior, approves an activity before it goes forward.

For example, the cashier gets the treasurer's written approval before an invoice is paid.

Figure 17 - Authorization

Security

Security involves making sure there is proper accountability and control over (1) information and (2) the asset. It specifies the custodian and who may make transactions with either the information or assets. It answers the questions:

- Who produced what?
- Who has access to what? Why?
- Who did what with the information or assets?
- When was something done with the information or assets?

Securing information is as important as securing stacks of cash. Security over transactions is as essential as security over information or assets themselves.

Figure 18 - Security

Separation of Duties

One person controls the assets or activity. Another person tracks the asset or activity with the record keeping. Comparing the two puts the spotlight on something wrong happening with the asset or activity and comparing the two shows up the errors in the record keeping. Each serve as a check on the other. The purpose of separation of duties is protecting the reliability of the record keeping. It is also about protecting the asset.

Figure 19 - Separation of Duties

310.01.02 After-the-Fact Control Activities

The following are examples of after-the-fact internal control activities:

Review

Someone reviews the work of someone else. It is as simple as that.

- Although the expected paradigm is a supervisor reviewing a subordinate's work, this is not always the case. Peers or even subordinates reviewing each other's work can solve many problems. For instance, the accounts payable accountant can review the payroll accountant's worksheets.
- Many accounting firms require someone to review everything leaving the firm. This means junior accountants look over their supervising partners' work.

Figure 20 - Review

Confirmations

Confirmations are reports, receipts, and other documents sent out to allow for feedback about the accuracy of the information.

An example would be sending a listing of a worker's travel expenses to the worker for validation.

Figure 21 – Confirmations

Reconciliations
Reconciliations compare internal record keeping to the record keeping done elsewhere.

Reconciliations Example 1

Union A and its Conference AB have mirrored accounts: Union A's account shows how much the Conference owes the Union. Conference AB's account shows how much it owes the Union.

Some transactions, like tithe and insurance charges, increase how much Conference AB owes Union A. Other transactions, like appropriations, decrease how much Conference AB owes Union A. The accounts at both places record the same thing. Notionally, they have the same mirrored transactions and balances.
At some point they get out of sync, and someone must figure out why. One entity may record something that the other misses or an entity makes a recording error.

A reconciliation sorts out the differences. For instance, the Conference compares their account with the Union's account. This requires the union to give a copy of their account to the Conference.

Then there is the mechanical process of looking for differences by comparing the printed copy of the Union's account with the Conference's account in their system. Then they work with the Union staff to resolve discrepancies. They make journal entries to correct the Conference's errors. The organization that made the error makes the correction.

The organizations work together throughout this entire process. It finds bookkeeping mistakes and misunderstandings. Reconciliations are a valuable way to ensure information is correct.

Example - Bank Reconciliations

Bank reconciliations do the same thing. They compare the bank's accounting with the mirrored account in the organizations' accounting system. An accountant sorts out any differences. They record any bank transactions that the accounting system has not recorded and correct any errors in the recorded transactions.

Figure 14 – Reconciliations

Most transactions go through either the bank or the inter-organizational accounts. Correcting missing or incorrect transactions goes a long way toward getting revenue and expense records correct.

No one should trust the financial information until the accounting office has processed reconciliations. Reconciliations find missing items and highlight incorrectly recorded items. A key step in the reconciliation process goes beyond simply spotting errors; it includes preparing the entry to correct them. During the reconciliation process, the accountant records missing items and corrects errors.

310.01.03 More on Reconciliations

Incomplete reconciliations are as bad as reconciliations that the organization never does.

Reconciliations – Example 2

A new accountant finds all the discrepancies and declares the accounts reconciled, but that is only half the chore. Someone must resolve differences with the corresponding organization and record unrecorded transactions and correct errors discovered during the reconciliation. The process of finding differences is useless unless someone corrects the discrepancies.

Figure 153 – Reconciliations – Example 2

Don't let this discussion of reconciliations give a narrow view about that they mean. There are many more reconciliations than those discussed so far. Any time there are two systems, there is a reconciliation opportunity.

Reconciliations – Example 3

The student billing example presented earlier is a good illustration of a reconciliation opportunity.

The registrar system keeps record of student enrollments, and the accounting system keeps records of revenue and receivable accounts.

A reconciliation of all three to each other ensures the billing has not left any student out of the billing and that the billing did not include billing students who were not enrolled.

Reconciliations – Example 4

Online donation systems are another good example.

The donation system records online donations. The reconciliation accountant can reconcile that donation system to the accounting system's records of online donations.

Further, reconciliations (e.g., inter-organizational, bank, and inter-system reconciliations), do not necessarily need to be bound to a monthly process. They can be ongoing, daily, weekly, or monthly. Modern bank websites and accounting software allow weekly – even daily – reconciliation.

Figure 24 – Reconciliations Examples 3 & 4

310.02 Control Activity Principles

Here are the general principles that make the control activities component successful.

1. Select or develop control activities in response to identified risks.
    - Control activities help manage the chance or the damage posed by the threat.
    - Organizations implement control activities to reduce the threat to acceptable levels.
    - It is crucial to consider the likelihood of a threat, figure out its potential damage, and estimate the control cost.

2. Applying control activities in technology is essential.
    - Technology in this context includes networks, passwords, web pages, and databases.
    - Internal control over technology is a vast discussion beyond the scope of this chapter. It is as vital as internal control over the entity's finances.

3. The control activities must be required by policies.
    - Control activities must be included in organizational policies.
        - The Executive Committee may not need to approve them all. Instead, the control activity can be a departmental work plan, a process flow chart, or an accounting manual.
        - Everyone concerned must clearly understand who handles each task.
    - Control activities have more weight and gravity than simple supervisor instructions or routine practice. These activities must survive personnel changes at the accountant and supervisor levels.
        - This last principle is essential. It leads to the fourth internal control component.

Section 311 - Component Four: Information & Communication

Someone must document the work done in the other components. Someone must ensure everyone who needs to know the information knows it. This information and communication component includes communication with people both inside and outside the organization.

Three principles fall under this significant component:

1. Produce and use information supporting the internal control system. This information must be relevant and reliable.

2. Share the information internally. Also, share assigned responsibilities within the system.

3. Communicate, as necessary, with parties outside the organization.

Church leaders who are natural communicators find the documentation step to be easy. This might mean they overlook the value of documentation. The Church practices dramatic employee movement. When employees move to other positions, their control activities can quickly fall apart. It is helpful to document an employee's responsibilities. Supervisors can verify that they communicated the job description and control tasks with the new employee. It is even comforting for employees to prepare documentation showing they have done their best. Document all efforts to ensure a sound control environment, along with assessment and documentation of all perceivable threats. Documentation should show the control activities set up in response to these threats.

Example – Cash Advance

Suppose the control environment and the risk assessment led to setting up a control activity that says a cash advance for travel needs a supervisor’s approval. The internal control system needs other information:

- Is this set by policy?
- Is it clearly documented?
- Does everyone who needs cash advances know?

This decision is not effective until management clearly documents it and communicates it with employees giving and receiving the advances.

Figure 25 - Cash Advances

Section 312 - Component Five: Monitoring

The fifth internal control system component is monitoring. It is crucial to have an ongoing process to ensure the internal control system continues to work. Someone could consider this as internal control over the internal control system. Monitoring includes:

1. Select, develop, and perform ongoing evaluations to see if all the internal control components are present and functioning.

2. Check for and communicate internal control deficiencies to the concerned parties promptly. This notification includes informing those responsible for taking corrective

action. Responsible parties include senior management and the Executive Committee/Board.

Example – Tuition Revenue
Consider the internal control activities in the tuition revenue example.
Several employees are involved in checking the work, signing the support documentation, and processing the JV. At some point, someone needs to verify that this review is carefully happening. It is important to document that.

Figure 26 - Tuition Revenue

This monitoring is easier if the organization has documented the revenue recording process (See Section 311). Someone in the organization but outside the process walks through the steps. They check to make sure everything is happening as it should.

Monitoring also means reviewing whether all the other components are working. It is a critical look at the control environment.

- Do the Board and organization leadership respect internal control?
- Do they give it the attention required by good management and policy?
- Is risk assessment accurately finding the threats and evaluating the likelihood of potential damage?
- Has the design team overlooked any threats?
- Are there new threats that the organization did not foresee?
- Is the process working?

The control activities improve with regular investigation and review of their effectiveness.

- Do internal control activities do what the system set them up to do?
- Should the system reconsider the risk associated with an activity?
- Are there too many control activities?
- Are the right people doing control activities?
- Are decision-makers documenting and communicating information about the system?

Monitoring is a process of continuous improvement. Changing opinions and circumstances requires the organization to change the first four components continually. Monitoring evaluates this dynamic environment.

312.01 Internal Control and Auditors

Auditors are not a replacement for any of the steps in the internal control process.

Outside auditors focus on a very narrow aspect of internal control. Recall that the role and purpose of outside auditors is concerned with the reliability of external financial information. They assess internal control to decide if control activities help them in this role and purpose. Reliability of external financial information makes up about 1/6th of the reasons for internal control. Even if there were no auditors, sound internal control would be valuable. Outside auditors don't worry about whether the organization's system delivers on its other goals. The auditors are not responsible for whether the organization follows laws, whether it subjects employees to unfair accusations, or whether the work environment is unhealthy. They have a Christian interest in such things, but it is outside their professional mandate.

Auditors are a tremendous help when it comes to financial processes. However, thinking an unmodified audit report means the financial operations are tidy and under proper control is a grave mistake. The audit does not replace a sound internal control system.

Section 313 - Conclusion

Management systems are essential for meeting an organization's goals. The quality of information is vital. The organization's compliance with legal requirements matters. Christian organizations do their best to protect employees from false accusations, unnecessary temptation, and moral failure. A healthy internal control system is the only way to do this.

This chapter presented internal control as a series of steps, but internal control is not a step-by-step process. All components take place at almost the same time. For instance, in a healthy control environment, at the same time, during their risk assessment, the design team makes decisions about control activities; they document and communicate activities as they are implementing them. There is a conceptual progression, but the actual process is more simultaneous.

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Chapter 4
The Account Structure

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Chapter 4
The Account Structure

This chapter begins with an overview of the goal of every financial system – the required reports that the organization must prepare to conduct its business effectively. It then moves into a discussion of concepts fundamental to the account structure and how they interact. Appendix 4A provides a detailed template of necessary account numbering.

Section 401 - The Goal: Required Financial Reports

401.01 General-use Financial Reports

The account structure lies at the heart of the accounting system. Appropriate account structures help ensure the organization gathers the information it needs to prepare the Church's financial statements. Its tools and techniques also provide for a variety of other helpful reports (e.g. income and expense by cost centers, expenses by both natural and functional categories, etc.).

The account structure balances between requiring enough details for reports and avoiding overburdensome data entry. However, detailed reports rely upon detailed data—the more detailed the data entry, the more detailed the report. At a minimum, the account structure must enable the production of the financial statements. This chapter focuses on the minimum account structure. It is not the end of this discussion. (See Chapter 6, Financial Statements, for a detailed discussion of Church financial statements.)

This chapter gives a brief introduction to the four required IFRS statements and summarize the account structure needed to produce each statement:

- Statement of Financial Position (SFP)
- Statement of Financial Activity (SFA)
- Statement of Net Assets (SNA)
- Statement of Cash Flows (SCF)

401.01.01 Statement of Financial Position (SFP)

- Shows assets, liabilities, and net assets.
- These are "as of" or "as at" a specific moment.
  - For instance, annual calendar year-end statements show them "as of" midnight on the last day of the year.

The account structure must support tracking of assets, liabilities, and net assets by their "nature". Cash, account receivables, investments, buildings, accounts payable, and notes payable are examples of the nature of accounts. Later, this chapter will discuss the nature of accounts in greater detail. The account structure must sort (or separate) transactions by their nature.

In most Church cases, the SFP uses separate columns to keep the assets, liabilities, and net assets by fund. For instance, it distinguishes cash in the Operating Fund from cash in the Plant Fund. The account structure must find a way to designate the fund to which a cash transaction belongs. (See Chapter 7, Fund Accounting, for detailed discussion.)

The Net Assets section is a challenging part of the SFP. This section shows the availability of the various kinds of net assets. For example, it shows the amount of allocated net assets available for their specific purposes. It also shows which net assets are donor-restricted and the tithe or non-tithe resources on hand. The account structure must support all this categorization by allocation, restriction, and tithe.

401.01.02 Statement of Financial Activity (SFA)

- Shows the financial activity for a period.
  - For example, it may show income and expenses for the year's first six months.
- Shows financial activity by function.

Example – Financial Activity by Function

For example,
- Tithe Income
- Interest Income
- Sabbath School Expense
- Evangelism Expense

Figure 1 - Financial Activity Nature

- Shows activity for each Fund.

Example – Financial Activity Fund

For example,
- Operating Fund
- Plant Fund

Figure 2 - Financial Activity Fund

- Supporting note shows activity by nature.

Example – Financial Activity Function

For example,
- Electricity Expense
- Salary Expense
- Depreciation Expense

Figure 3 - Financial Activity Function

401.01.03 Statement of Net Assets (SNA)

The SNA and SFA show similar information.

- The SFA looks at the function that changes net assets.
- The SNA focuses on the source and use of types of net assets.

Example – Source and Use Net Assets

For example,
- It shows Fund, Resource, Restriction.
- It shows Income by Fund.
- It distinguishes between Tithe and Non-tithe donations.
- It shows whether the organization has allocated receipts to a specific purpose.
- It specifies whether changes are donor restricted.

Figure 4 - Source and Use Net Assets

- The SNA shows expenses in the same way.

> *Example – Expenses*
>
> For example,
> - It shows if expenses reduced the balance of a particular Fund.
> - It shows whether expenses were paid using Tithe or Non-tithe donations.
> - It specifies if expenses reduced Allocated or Unallocated Resources.
> - It shows if it spent expenses from Restricted or Unrestricted donations.

Figure 5 - Expenses

The account structure must support this careful stewardship over the resource's inflows and outflows.

401.01.04 Statement of Cash Flow (SCF)

- Focuses on the sources and uses of cash.
  - In accounting, cash means more than currency on hand.
  - It includes money in bank accounts.
- The SCF shows these in-flows and outflows by the type of activities that produce or use the cash.

> *Example – Sources and Uses of Cash*
>
> For instance,
> - Selling an asset is a source of Cash.
> - Buying an asset is a use of Cash.

Figure 6 - Sources and Uses of Cash

- It details these inflows and outflows by Fund as well.
- It does not track cashflows by Function, Restriction, or Allocation.

The following section takes another approach by examining the account structure's dimensions. It discusses dimensions relative to the financial statements they support.

Section 402 - Account Structure

This manual does not dictate the specifics of an organization's account structure but describes certain required characteristics. Recorded transactions should reflect their:

- Nature
- Fund

- Function
- Resource
- Restriction

402.01 Nature of Transactions

If an asset is cash, its nature is Cash. If a liability is Notes Payable, its nature is Notes Payable. If an expense was for electricity, its nature is Electricity. Nature may seem like an "account"– it is close but not the same:

Example – Electricity Expense

Consider Electricity Expense.

The nature dimension views three electricity expense accounts as "Electricity Expense." This is their nature. The system may use the first few digits of account codes to group similar accounts by their nature. For instance, all electricity expense codes may start with 907 and then use more digits to capture specific details. Take, for example, these accounts:

- 907124 Electricity Expense – Office Building
- 907125 Electricity Expense – Book Center

The organization may benefit from monitoring those two costs separately, but the financial statements do not need those details. The statement uses the first three digits of the account codes, 907, to get the nature of the expense. The financial statements need the information only at the nature level.

Figure 7 - Electricity Expense

402.02 Functions

Functions are the organization's financial activities. Functions come in two varieties:

1. The first variety is the organization's cost and revenue centers.
2. The second variety is committee-allocated resources.

402.02.01 Cost and Revenue Center Functions

Cost Centers are the most prevalent. Cost Centers are groups of activities that help with financial management or organization.

It is handy to think of Departments and Cost Centers as the same thing. Departments are the starting place for thinking about Cost Centers but be careful. Not all Cost Centers are

Departments, and all Departments are not Cost Centers. One Cost Center can have several Departments. It also works the other way around: one Department can have several Cost Centers. Cost Centers are groups for which the organization would like to track costs, while Departments are an administrative grouping.

Example – Adventist College in Thailand

Consider an Adventist College in Thailand.

The Maintenance Department and the Housekeeping Department often work together. Maintenance workers help with housekeeping and Housekeeping workers help out with maintenance.

The Maintenance Department has twenty workers. The Housekeeping Department has three workers. The cost of the Housekeeping Department workers is small.

Administration considers Housekeeping a full-fledged department. It has an office and a department head. Financial leadership prefers to consider both departments as one Cost Center. Financial reports show Housekeeping as the Maintenance Department cost center. Budget and Financial reports both reflect that combined status.

Then there is the Library Department. This department may give regular library services while also handling the campus' audio-visual services. The audio-visual team may take care of the campus' graphics work, and their student workers manage classroom projectors.

The Treasurer may want separate Library and Audio-Visual Departments since Audio-Visual is an expensive Cost Center. The Financial leadership has a budget for each even though they are both in the same department.

Figure 8 - Adventist College in Thailand

Example 2 – Conference Youth Department

Consider a Conference Youth Department administers Pathfinders along with other Youth activities.

Administration may want to separate the cost of Pathfinders from the cost of other Youth activities. Splitting the expenses means there would be two Cost Center Functions: Pathfinders and Youth.

Figure 9 – Conference Youth Department

Finally, there can be Cost Center Functions for which no Department exists.

Example 3 – Conference-owned Staff Housing

Consider Conference-owned Staff Housing.

Leadership may want to look at the costs of housing; for example, maintenance, utilities, insurance, etc., separate from other Conference expenses.

The Housing Function, which is not a Department, would capture that activity.

Figure 10 - Conference-owned Staff Housing

402.02.02 Revenue Centers

Revenue centers are like Cost Centers. The difference is they focus on revenue instead of costs.

Example 1 – College Development Office

The College Development Office focuses on general donations and also on bequests. It may want to separate the donation income (nature) into two revenue center functions: General Donations and Legacies. From an account structure perspective, its revenue centers are like Cost Centers.

Figure 11 - Revenue Centers

402.02.03 Cost Center Functions Compared to Nature

Nature and Function dimensions are two distinct ways of looking at the same financial activity.

Salaries, Electricity, Office Supplies: these are examples of considering cost by Nature. Presidential Function, Evangelism Function, Pathfinders: these are examples of Function.

Reports can show a two-dimensional look at the same outlays—for instance, a single Cost Report. Rows show expenses by their Nature: Salaries, Electricity, Office Supplies, etc. Columns show expenses by Cost Centers: Family Ministries, Staff Housing, etc.

Organizations create Cost Center Functions to answer questions like:

- How much is it spending on Pathfinders?
- How much is it spending on Evangelism?
- How much is it spending on Staff Housing?

The Statement of Financial Activity must show expenses by function. The financial statement footnotes must include a table of expenses by both function and nature. This manual's sample financial statements illustrate this table.[1] (See Volume Three)

402.02.04 Resource Functions

Resource Functions track the ins and outs of Allocated Resources. Allocated Net Assets are Resources the committee has set aside for specific activities. (See Chapter 2, The Accounting System, for a detailed discussion.)

> *Example 1 – Biga Tribal Group*
>
> Consider this: An Executive Committee designates 100,000 of its resources for work with the Biga Tribal Group in Papua New Guinea.
>
> The Biga Evangelism Resource Function holds the 100,000. It records Resources flowing into and out of that activity. The goal of the Biga Evangelism Resource Function is to show resources set aside for that activity as well as Resources spent for that activity. The remainder of the inflows minus the outflows is the unspent Resources still on hand for that purpose.

Figure 12 - Resource Functions

Up to this point, this chapter has discussed three dimensions used to track revenue and expenses: Nature, Cost Center Functions, and Resource Functions. These dimensions empower reporting capabilities. They give answers to tough questions such as:

- How much did the conference spend on Sabbath School Department Salaries for reaching the Biga Tribe?
- How much did it spend, in total, for printing?
- How much did its Sabbath School Department spend on printing?
- How much did it spend on materials for Chambri Evangelism?

402.03 Restrictions

The Restriction Dimension tracks stewardship of Tithe Income and Donor-Restricted Donations.

Consider the stewardship role over any accounting period. The system must show the Donor Restricted Net Assets it had at the beginning of the period and what it received and spent during

[1] This requirement is different from the 2011 Accounting manual.

the period. The ending result of this beginning amount and the period's ins and outs is the amount of Tithe and Donor Restricted Net Assets still on hand at the end of the period.

402.03.01 Tithe Restricted Income

Church policy built upon Biblical principles specifies how Church organizations can spend Tithe. The account structure provides for accountability for the use of Tithe. Church policy (GCWP V 20) applies to conferences, unions, divisions, and the General Conference. Policy delineates a particular report and reporting process. The account structure must support the production of this report. For a more complete discussion of tithe in these organizations, including the requirements of the Use of Tithe Report, see Chapter 20, Section 2002.01.

402.03.02 Donor Restricted Donations

An organization's stewardship includes properly handling donations and showing it did. The account structure must support both priorities. This dual responsibility is particularly true with restricted donations. Restricted donations are donations (including grants) earmarked by the donor (or grantor) for a specific purpose.

Consider unspent Restricted Donations. The structure should help isolate and identify these Net Assets and guide leadership as they make spending decisions. The structure must support adding more restricted receipts to and spending from this restricted purpose. The account structure then must show that the organization followed donor wishes.

Conversely, financial administrators need to know the available unrestricted resources. They need this total for budgeting and to react to emergencies. When the organization carefully tracks restricted donations, leadership can quickly know what unrestricted funds it has available.

402.04 Interaction Between Structural Dimensions

Earlier, this chapter discussed a two-dimensional report. Rows showed the Nature of the accounts, like Salary Expense, Electricity Expense, Office Expense, etc. Columns held Cost Center Functions like Youth Ministries, Pathfinders, Staff Housing, etc. A separate page in this report could be for each Resource like Tithe, Non-tithe, General Evangelism, Youth Outreach, Camp Columbia Building, etc. Each resource would have a page showing its activity by Nature and Cost Center Function. This stack of pages became a book of sorts. Continue this imagery to think about a different book for each Restriction. This description is solely to give a picture of the dimensions; it is hard to imagine needing such details.

Dimensions are a data element added to general ledger transactions that supplements natural accounts and provides the ability to track financial information by using subcategories to extend the chart of accounts. Dimensions are not subsets of any other Dimension. Go back to consider the book imagery. The rows, columns, pages, or books could represent any dimension paired with the other dimensions filling the other roles. Each dimension is a free-standing look at the same activity.

Example – Dimension Report

Picture this report:

- A single page shows how much of an Allocated Net Asset a Cost Center has spent.
    - Rows show Cost Centers like:
        - Youth Ministries
        - Pathfinders
        - Staff Housing
        - Etc.
    - Columns show Resources like:
        - Tithe
        - Non-tithe
        - General Evangelism
        - Youth Outreach
        - Camp Columbia Building
        - Etc.
- Each page could represent a Nature like:
    - Salary Expense
    - Electricity Expense
    - Office Expense
    - Etc.
        - The particular page would show how much of an expense a Cost Center used and the Resource from which the funds came.

Figure 13 - Dimension Report

Any Dimension could take on any role in this book imagery. This breakdown presents valuable information. A well-thought-out structure enables such rich reporting.

Section 403 - Careful Maintenance

In addition to proper initial design, financial leadership keeps the structure tidy. Structural errors often show up in the creation of new accounts.

Example 1 – Online Donation

An innovative conference sets up a way for members to donate online.

Reasonably, leadership wants to track how much their members donate using this forum. There is strong temptation to create new income accounts to reflect this:

- Tithe – Online
- SS Offering – Online
- Conference Evangelism Offering – Online
- Etc.

The problem is, creating these new accounts would double the number of Tithe and Offering accounts, and it would double the number of Related Agency Liabilities accounts.

A better alternative would be to view the two sources as separate Functions. One Function would track regular donations. The second would track online donations. One tithe account would record all tithe income and Functions would track the various revenue sources.

Figure 14 – Online Donation

Example – Inner-city Evangelism

A Conference decides to focus on Inner-city Evangelism.

Leadership asks for reports on inner-city spending.

The quick and thoughtless solution is to create an Inner-City Expense account. Considering the structure laid out in this chapter, this is not the best approach. For one thing, it is counter to the idea that accounts capture the transaction's nature, like Salaries, Supplies, etc.

If the treasurer creates the Inner-city Expense account, the treasurer can answer the question of how much the conference spent on Inner-city Evangelism. However, the treasurer cannot explain what it spent on things like salaries and printing. Also, it would baffle further analysis for the entire organization.

The expense accounts should describe the Nature of the payment and not the program, allocated resource, or restriction to which it is related.

Think about this: if the accountants posted printing costs for Inner-city Evangelism to Inner-City Expense and posts other printing costs to printing expense, it would be hard to answer a question about how much the Conference has spent on printing. Likewise, if they posted postage for Inner-City Evangelism to Inner-City Expense and posted other postage to Postage Expense, it would be hard to answer questions about how much the Conference spends on postage.

So instead of using an account, a Cost Center function allows for tracking both the nature and the function of the spending.

Figure 15 - Inner-city Evangelism

Section 404 - Account Numbering

In the past, complex account numbers captured this dimensionality. The first two numbers might capture the Fund; the following three numbers might capture the account's Nature; the next four might show the Function, and so on. This system has its limits. This manual does not mandate a specific account number structure.

There are, however, several Church activities that ask organizations to summarize balances of various dimensional combinations. For instance, GCAS auditors need to receive information in such a format. The organization's accounting system should be able to supply such summary listings.

Appendix 4A - Framework for Required Account Structure

For Organizations Using Fund Accounting:

Fund Segment (XX)

Definition: A Fund is a self-balancing set of accounts separated for management purposes.

1x	Operating Fund(s)
2x	Plant Funds
3x	(Reserved for future use)
4x	Endowment Funds
5x	(Reserved for future use)
6x	Demand Funds
7x	Charitable Gift Annuities
8x	Charitable Remainder Trusts
9x	Retirement Funds

Function Segment (Minimum XX – Expandable)

Definition: A Function identifies areas of activity or specific purpose.

0x **Undesignated** (Unallocated - not yet designated for a Specific Purpose)

01	Unallocated Tithe
02	Unallocated Non-Tithe

1x-9x **Designated** (Allocated - Specific Purposes - Areas of Activity)

1x	Program Services (Operating)
11	Church and Evangelistic Programs
12	Education Programs
13	Publishing Programs
14	Medical and Health Programs
15	Humanitarian Programs
18	Other Programs

3x **General Supporting Services (Operating)**

32	Conventions and Meetings
34	Employee Hospital and Health Benefit Programs
35	Employee Defined Benefit Retirement Plan Contributions
36	Fund-Raising

39 General Administration

4x Auxiliary Operations

41 Conference Auxiliary Operations
42 Educational Auxiliary Operations

7x Contingencies (Operating)

73 Investments Value Fluctuation Allocated Fund
75 Currency Exchange Fluctuation Allocated Fund

8x Independent Operations

9x Non-Operating Functions

90 Investment in Plant Function
91 Unexpended Plant Capital Functions
92 Pooled Investment Functions
93 Gift Annuities Functions
94 Endowment Functions
95 Agency Functions
96 Revolving Loan Fund Functions
97 Irrevocable Trusts
98 Revocable Trusts

Restriction Segment (X)

Definition: Identifies Restriction on financial activity and net asset accounts.

0 Assets and Liabilities (Asset and liability accounts use zero as a default)
1 Tithe (Quasi-restricted)
2 Non-tithe (Unrestricted)
7 Temporarily Restricted (Donor Restricted for Programs or Departments)
9 Permanently Restricted (Donor Restricted Endowments or Similar)

Nature Segment (Minimum XXX – Expandable)

Definition: Description of the actual account.

ASSETS

1xx Current Assets

10x **Cash and Cash Equivalents**

11x **Investments**

119 Unrealized Appreciation (Decline) in Fair Value
120 Remittances Receivable (Tithe and Offerings)

13x **Accounts Receivable (current)**

14x **Accrued Receivables**

15x **Notes and Loans Receivable (current)**

16x **Inventories**

17x **Prepaid Expenses**

18x **Other Assets (current)**

19x **Inter-Fund Receivables (current)**

2xx **Long-term Assets**

20x **Plant Assets** (cost and accumulated depreciation accounts)

240 Accounts Receivable (long-term)
250 Notes and Loans Receivable (long-term)
259 Allowance for Uncollectible Notes and Loans 280 Other Long-term Assets
290 Inter-Fund Receivables (long-term)

LIABILITIES

3xx **Current Liabilities**

320 Remittances Payable (Tithe and Offerings)

33x **Accounts Payable**

34x **Accrued Payables**

35x **Notes and Loans Payable (current)**

36x **Offering Funds and Agency Accounts**

37x	Deferred Revenue
38x	Other Current Liabilities
39x	Inter-Fund Payables (current)
4xx	Long-term Liabilities
44x	Leases Payable
45x	Notes and Loans Payable (long-term)
48x	Other Long-term Liabilities
49x	Inter-Fund Payables (long-term)

NET ASSETS

5xx	Net Assets
51x	Prior Year Adjustment
55x	Principal Corpus
59x	Suspense (Used only for importing data)

REVENUE

6xx-7xx	Revenue and Increases
60x	Net Sales (including gross sales and cost of goods sold)
61x	Tithe (including gross tithe and percentages passed on)
620	Academic Tuition
63x	Non-tithe Offerings and Donations
65x	Appropriations and Subsidies Received from SDA Organizations
66x	Subsidies and Grants Received from Non-SDA Organizations

67x Direct Operating Income

71x Investment Income

711 Investment Earnings **[expandable]**
712 Realized Gain on Sale of Investments
715 Unrealized Gain in Fair Value of Investments

73x Irrevocable Split-Interest Agreements Additions

74x Endowment Additions

75x Currency Fluctuation Gains

76x Additions to Unexpended Plant Assets

77x Additions to Investment in Plant Assets

78x Other Income

781 Retirement Plan Contribution Income

790 Restricted Income Released

EXPENDITURES

8xx-9xx Expenses and Deductions

80x Advertising and Selling Expenses

81x Employee-Related Expenses

811 Salary and Allowances
812 Contributions Made To Retirement Plans

82x Travel Expenses

83x Appropriations Made to SDA Organizations

84x Student Grants and Scholarships

850 Other Appropriations Made

86x Program Specific Expenses

87x Administrative Expense

88x Office Expenses

89x General Expenses

90x Plant Operation and Maintenance

91x Investment Deductions

912 Realized Loss on Sale of Investments
915 Unrealized Loss in Fair Value of Investments

93x Irrevocable Split-Interest Agreements Deductions

94x Endowment Deductions

95x Currency Fluctuation Losses

96x Deductions from Unexpended Plant Assets

97x Deductions from Investment in Plant Assets

98x Other Expenses

981 Retirement Plan Benefit Payments

TRANSFERS

99x Transfers

992 Internal Tithe Exchange
995 Transfers Sent to Other Functions
996 Transfers Received from Other Functions
997 Transfers Sent to Other Funds
998 Transfers Received from Other Funds

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Chapter 5
The Accounting Cycle

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Chapter 5
The Accounting Cycle

This chapter begins with an overview of how the accounting cycle drives day-to-day and period-end accounting activities. It then moves to a discussion of the nature of accounting records and more detailed information about various components of the accounting cycle. It ends with a discussion of reconciliations.

Section 501 - The Activity Cycle

Every organization has an accounting cycle that repeats each accounting period[1]. That cycle involves many routine day-to-day transactions and some non-routine period-end transactions. It is essential to capture both the routine and the non-routine transactions in the accounts.

501.01 Schedule of Operations

The accounting office staff performs daily activities, such as processing cash receipts and payments. Other tasks take place “As of” the close of the accounting period. Accountants do these tasks early in the next calendar period. On April 5, they may post March’s depreciation entries in a March accounting period with an “As of” date of March 31.

Specific planning ensures they do everything in a timely fashion. All accounting offices have detailed task assignments. These specify what, who, and when of each job. For example, “Run monthly depreciation, Joyce, 30th”. Besides focusing on internal accounting office tasks, this planning includes gathering information from others. For example, they collect cafeteria charges from the cafeteria and accumulate tithe reports from churches.

[1] Throughout this chapter (and the entire manual) “accounting period” can mean either month or year. The accounting work at year-end is like month-end work. The year-end work receives more care but is not that different from month-end work.

Section 502 - The Nature of Accounting Records

502.01 Origin of Information

An accounting entry is the record of an event. The basis for the record is the fact that something has happened or has the right to happen. The events are often specific transactions between an organization and another economic entity. These entities can be suppliers, employees, or other organizations. Some events, such as depreciation and accruals, are neither external nor specific. The accounting process must capture them all — specific and not so specific.

502.02 Source Documents

Every accounting entry is the result of a supporting document. That document is either received from outside the organization or prepared within the organization. It may be an invoice, a debit or credit voucher, a letter of authorization, a journal voucher, or a download from a bank website. Source documents can be spreadsheet summary data or even handwritten estimates on note paper. Very often, the source document also provides authorization for the entry. For example, the CFO may approve payment by signing the source document.

502.03 Committee-Authorized Transactions

Often, committee actions authorize transactions. In this case, the source document would be the committee's minutes. For example, a committee authorizes an appropriation. The accountant attaches that action identified in the committee minutes to support the journal voucher making the appropriation.

502.04 Journals

Journal vouchers record accounting events. In the past, these journal vouchers were manual listings in chronological order, written in books. The world has changed. Now, accounting software lists transactions in unseen database tables, still in chronological entry order.

Special journals serve two purposes:

1. They group similar transactions to assist analysis, and

2. They streamline data entry.

Example – Cash Receipts Journal

Consider a Cash Receipts Journal.

This journal's debit is always to a particular bank account. Automation specific to the cash receipt journal automatically enters the needed debit account. The bookkeeper no longer must enter that account on each entry.

Special journals provide another advantage by tagging each transaction with the journal type. This tagging makes it easier to produce reports and analyze specific transaction types.

Figure 1 - Cash Receipts Journal

502.05 Preparing Journal Vouchers (JVs) and Internal Control

The accountants build journal vouchers in the context of an entire range of internal control activities. Careful thought goes into setting up how to process journal voucher authorization, preparation, and review. Every internal control system must specify:

- Who can authorize a particular kind of JV?
- Who can make the transaction entry?
- Who reviews the entry?
- What supporting documents must accompany the transaction?

The CFO should never leave these decisions to expediency or chance.

As discussed in Chapter 3, one significant internal control activity is the segregation of duties. Segregation of duties focuses on identifying who will perform each role. See also Chapter 3, Sections 307-312 for a complete discussion of the importance of internal control in the accounting cycle.

502.06 General Ledger

The general ledger is a report depicting transactions grouped by account. As with journals in manual systems, in the past, the ledger was a physical record; in computerized systems, it is not. The general ledger lists chronological transactions made by the journal voucher process, organized by account. Each item is part of a balanced transaction. When the general ledger report depicts them by account, it, too, will be balanced.

Section 503 - Completing the Accounting Cycle

503.01 Preparation for Financial Statements

The production of sound financial information is the whole purpose of the accounting process. With it, leaders can evaluate the past, understand the present, and navigate the future. Complete and accurate data support the entire process. Completing the accounting cycle means carefully reviewing all day-to-day transactions and adjusting items that require a more precise or correct definition.

503.02 Adjusting Entries

To a large degree, understanding adjusting entries[2] separates accountants from clerks. A data clerk may think the correct entry of transactions is the essence of accounting. "If I put them in right, then the account is right." An experienced accountant knows that correct transaction entry is a good beginning — but it is not the end.

Accountants need to adjust many account balances before making financial statements. This is the process: The accountant prepares a Trial Balance listing the accounts and their balances. Then, they systematically review each account and affirm that the balance correctly represents the truth. If they determine the balance is incorrect, they investigate until they understand why. When this review indicates the need to adjust an account, they make an adjusting entry by preparing a journal voucher. Adjustments can be complicated, so the treasurer must review them closely. If a treasurer made the adjustments, a knowledgeable accountant should review them.

Example – Cash in Bank Account

Consider a cash in bank account.

The accountant reviews the account with the following questions in mind:
- Have the accountants recorded all the cash transactions?
- Does the cash account balance match the reconciliation?
- Has someone made all the needed adjustments coming from the reconciliation?

Figure 2 - Cash in Bank Account

[2] In previous accounting manuals the term "Closing Entries" were used. In nonchurch environments, closing entries refer to entries made to bring revenue and expense accounts to zero at year end. This manual adopts the current term, "Adjusting Entries".

With receivables, does the accounts receivable balance match supporting schedules? Is the allowance still reasonable? Have the accountants recorded all the receivable transactions?

While focusing on existing accounts, the accountant must also consider what accounts may be missing. For example, is the organization receiving services without recording related expenses and liabilities? Contrarywise, is the organization giving services and not recording the receivables and revenue they produce?

This review process focuses mainly on the asset and liability accounts, but a clear-eyed look at the revenue and expense account will also reveal necessary adjustments.

In addition to error correction, adjusting entries catch certain accounts up with the organization's realities.

Example – Petty Cash Vouchers

Consider Unrecorded Petty Cash Vouchers and Inventory.

Many organizations use an Imprest Petty Cash box. (See Chapter 9 - Cash for a detailed discussion of how they work.) Briefly, Petty Cash custodians put a Petty Cash Voucher in the box whenever they pay petty cash. When the cash amount gets low, the Cash Payment Cashier pays the box for the vouchers. This reimbursement brings the balance of cash back up to its standard level.

At the end of a period, the petty cash account may show an asset of 1,000. However, the box may not have that amount of cash. The difference would be the petty cash voucher slips. The 1,000 petty cash box may have 300 cash and 700 petty cash vouchers. The adjusting entry debits the voucher's expense accounts and credits the petty cash account. The cashier can readily reverse this entry so the bookkeeper can record the actual petty cash reimbursement in the customary way. (See Section 503.12 for a discussion of reversing entries.)

Figure 3 – Petty Cash Vouchers

Example – Inventory

Consider small inventories like Office and Pathfinder Supplies.

Accounts payable and cash payment entries record purchases to their inventory account or to their expense account. Often, the clerk does not record the daily usage of these supplies. At the end of the period, the accountant will adjust the inventory account to reflect the items still on hand and adjust the expense account to reflect the items that the department used.

For example, the supplies inventory account has a 1,000 balance. This balance reflects the amount of inventory on hand at the last adjustment. During the period, the conference buys another 5,000 worth of supplies. It records the cost as supplies expense.

At first glance, this looks like an error. The entry overstates the expense because the departments may not have used all the supply items. It understates inventory since some items are still on hand. However, recording the transaction as inventory brings the same objections, but in reverse.

Recording the entry as an expense or as an inventory likely produces accounts that misrepresent actuality. It makes no difference. Regardless of how the organization first records the entry, it will adjust the accounts before they appear on the statements. This adjusting entry adjusts the Inventory to reflect what is on hand and the inventory expense to reflect items the organization has used.

Continue the example started above. At the end of the month, there are 3,000 on hand, but the inventory account shows 1,000. A look at items still on the shelves shows that 2,000 of the month's purchases are still on hand. The adjusting entry is:

Dr	Inventory		2,000	
	Cr	Supplies Expense		2,000

The debit to inventory combines with the 1,000 that was in the account from the start of the month. The beginning 1,000 plus the debit of 2,000 results in a 3,000 balance.

The credit to supplies expense reduces its balance to fairly show the supplies the organization has already used. How much have they used? The purchase was 5,000; supplies worth 2,000 are still on hand. So, they must have used 3,000. This should be the balance in the expense account: The original purchase entry puts the 5,000 payment into the expense account and the adjustment took out 2,000. This leaves a correct balance of 3,000 – which is the amount used. (See Chapter 12 for a detailed discussion of the challenges of inventory accounting.)

Figure 4 - Inventory

503.03 Accruals

Reviewing accounts before making the financial statements will reveal that some accounts need adjustment to reflect time passing. In Chapter 2, this manual discusses the accounting principle of accrual accounting (See Section 201.04). Accountants use accrual adjusting entries to facilitate accrual accounting.

Accrual accounting is an effort to put income in the period that the organization has a claim to the income, and expenses in the period the organization incurs the expense. Accrual accounting corrects the wrong idea that revenue is money coming in and expenses are money going out. All financial reporting standards bodies and this manual require accrual accounting.

503.04 Cash Flow Before the Period

The first grouping of accrual entries relates to when the cash flow happens before it is time to show the revenue or expense. Two examples: A tenant may pay the organization the rent before using the building, or the organization may pay the rent it owes before using someone else's building.

503.05 Prepaid and Unearned Rent

Many organizations rent properties to employees or others – the accrual goal here is to show revenue in the period they earn it - not when they receive the cash. Many entities rent properties from others. The opposite accrual happens when the organization is the tenant. Those accrual entries show rental expense in the period the organization uses the building, not when they pay the rent. Prepaid items are also discussed in Chapter 12, Sections 1201 and 1202.

Example – Auditorium Rental

A conference rents its auditorium to a Methodist church for a period of three months. In June, it collects the entire 3,000 rental for July, August, and September. In June, when it collected the money, the bookkeeper made this entry:

Dr	Cash in Bank		3,000	
	Cr	Unearned Rent		3,000

This unearned rent is a liability; it is a proper liability even if it is non-refundable – the financial statements show it as a liability even though there is no requirement to give the tenant back their money if they cancel the lease. Thinking of it as a liability, even if there is no need to ever pay money, broadens the understanding of a liability. The definition of liability includes the concept of owing services and rights.

The debit to cash in bank and credit to unearned rent requires a second thought. That entry is straightforward but unrealistic. Knowing nothing about accrual accounting, the bookkeeper alternatively simply records all incoming rent to rent income:

On June 15, the cashier deposits the check and records:

Dr	Cash in Bank		3,000	
	Cr	Rent Income		3,000

Accrual Accounting says this entry overstates revenue, since it shows revenue too soon. The month-end adjustment to correct this overstatement is:

Dr	Rent Income		3,000	
	Cr	Unearned Rent		3,000

At the end of June, rent received for July, August, and September are unearned and "owed" to the Methodist. The adjusted accounts reflect this.

At the end of July, the 3,000 is still in Unearned Rent. But the Conference has earned 1,000 of the 3,000. So, it can move the July rent out of unearned and show it as earned:

Dr	Unearned Rent		1,000	
	Cr	Rental Income		1,000

At the end of August and September it makes the same adjustment. The July, August, and September adjustments leave nothing in the unearned rent liability at the end of September.

Figure 5 – Accrual Accounting

Example – Renting Others' Property

When the conference is the tenant, the sequence will be similar, but opposite. When the conference paid the rent at the beginning of the 3-month period (July, August, and September), the bookkeeper records the payment on June 15:

Dr	Rent Expense		3,000	
	Cr	Cash		3,000

At month's end, June 30, the accountant makes this accrual adjustment:

Dr	Prepaid Rent		3,000	
	Cr	Rent Expense		3,000

The prepaid rent is an asset, even if the rental contract says there will be no refund if the conference cancels the lease. Thinking of this as an asset, even though it has no potential monetary value, expands the idea of what constitutes an asset. An asset not only involves the prospect of collecting cash, but it also includes the right to a future service.

On July 31, August 31, and September 30, the accountant makes this entry to show each month's rent expense:

Dr	Rent Expense		1,000	
	Cr	Prepaid Rent		1,000

Most accounting systems allow posting entries in future periods. In the June period the bookkeeper can record prepaid rent, and, in the same accounting session, make the entries for July, August, and September in the proper periods.

Figure 6 - Accrual Accounting Example

Look broadly at the example entries and develop a mental template for similar circumstances:

- Look at the above case where the money comes in before the proper time to recognize the revenue. The entries use a liability account to report the value until it is time to show it as revenue. Then, the accountant reduces the liability and recognize the revenue when it is time.

- The opposite occurs when the cash outflow happens before the proper time to show it as an expense. The entries report the flow as an asset until it is time to move the cost to an expense.

Accrual accounting uses the same process in many other circumstances. Accrual accounting requires using an asset to hold the cost until it is time to show the expense. The entries are similar. They focus on getting the cost into expenses at the right time, even if it creates an asset with no monetary value. The conference can hardly sell the prepaid maintenance or the prepaid insurance, but it still shows an asset for these items. Additional examples of adjusting entries are shown in Volume 3.

503.06 Depreciation

Fixed asset depreciation is an example of accrual accounting (see Chapter 13 for a detailed discussion of depreciation.) Above, the entry records prepaid rent as an asset. As the rental progresses, the bookkeeper makes entries reducing the asset and showing an expense for each period.

Conceptually, entries recording the rental over a brief time are the same as what depreciation does over a long time. When the organization purchases equipment or a building, it treats that purchase as an asset. The asset stores cost that waits for its time to be an expense. Over its life, the depreciation entries reduce the asset's cost and show that period's expense.

Depreciation is not about showing the asset going down in value or the organization using it up. Instead, it is primarily an effort to register its cost during the period the organization uses the asset.

Example – Depreciation

Compare the following with the prepaid rent example.

Consider this. A conference buys a copier for 3,000. It estimates the copier has a three-year useful life. To record the purchase, the bookkeeper enters:

Dr	~~Prepaid Rent~~ Equipment	3,000	
	Cr Cash in Bank		3,000

Every year the entries are:

Dr	~~Rent Expense~~ Depreciation Expense	1,000	
	Cr ~~Prepaid Rent~~ Accumulated Depreciation		1,000

The entry uses Depreciation Expense instead of Rent Expense. Instead of reducing prepaid rent, the depreciation entry reduces total equipment by crediting Accumulated Depreciation.

Figure 7 - Depreciation

Fixed asset accounting has complicating nuances, but it is fundamentally just accrual accounting. It would be unfair to ask this year's income to absorb the entire equipment purchase. Instead, accountants hold its cost as an asset until the proper time to show the cost as an expense in the periods it benefits.

This depreciation example, like the prepaid rent example, illustrate the process of accruing when cash flows happen before it is proper to show them as revenue or as an expense. In these cases, the entries park the cash flow in a liability or asset. Later, they move them to revenue or expense when it is time to show them there. Many situations require such a process. Here are a few:

- Graphic design work
- Magazine subscriptions
- Student tuitions
- Photocopier rentals
- Outsourced IT services
- Software licenses
- Consultants

503.07 Cash Flow After Showing the Revenue or Expense

The last section discusses situations where the cash flow comes in or goes out before the statements can correctly show the item as revenue or expense. In these cases, the cash flow prompts the proper accounting for a known amount. This section covers a more complex variety of adjusting entries; they require the anticipation and often estimation of future cash flows. The following discussion illustrates two common examples: interest income on loans receivable and interest expense on loans payable.

503.08 Accrued Interest on Loans Receivable and Payable

Interest on loans receivable and loans payable grows unseen as time passes. When the organization ignores this ever-increasing interest, the accounting numbers fail to faithfully represent the true receivable or payable they say they represent. To adjust the out-of-date balances, accrual entries are needed record more interest.

For a receivable, that means debiting interest receivable. For example, a debtor owing an organization 100 at the beginning of a period may owe that organization 110 at the end. There is no visible transaction to prompt an entry to show this increase. It is therefore necessary for the accountant to increase the asset, Interest Receivable, for 10 to show the amount the debtor owes. The credit is to Interest Income. This credit shows interest in the month the organization earned it. Accrual accounting is all about showing what the organization earns when they earn it.

The accrual for payables is similar but the opposite. The organization is still recording interest, but now, it is an interest expense. The organization may owe 100 at the beginning of a period and 110 at the end of the period. The debit of 10 is to Interest Expense. This entry puts the interest in the period when the organization benefited from borrowing the money. This, again, is what accrual accounting is about. The credit is to Interest Payable. It increases the liability. The organization owes that extra amount even if it is not yet due and is only an estimate.

When the organization receives (or makes) the payment for the interest, be careful. Remember, it has already recorded that income or expense. The payment does not affect income or expense. Instead, the incoming payment decreases interest receivable. It does not increase interest income. The outgoing payment reduces interest payable. It does not increase interest expense.

Use this as a standard model for other transactions where the cash flow occurs after the proper time to show them as revenue or expense. For delayed cash inflows, the entry requires the debit of an asset account and a credit to a revenue account. When it is an outflow, it is the same idea but with expenses and liabilities. With both types of cash flow, the accountant often must make an entry based on an estimate of what belongs in the current period.

Example – Accrued Payroll Expense

There is a comparable situation with payroll. The correct payroll expense for a period is not the payroll paid in the period — it is the amount owed for the work done in the period. Monthly payrolls make this easy. Payroll that is paid on the 30th of the month has the same period for both earnings and payment. But if payroll on May 4 is for the work done in April, the payroll belongs to April, not May. It is the function of accrual accounting to get expenses in the period the organization used a good or service.

To get the payroll in the correct period requires an accrual entry as of the end of the month the employees earned the salary or wages. The entry is a debit for payroll expense for the unpaid expense for that month. The credit is salary payable.

This entry is tricky for weekly or biweekly payroll. As of month-end, record the days since the last payroll as a liability. Suppose the weekly payroll amount for the week ending May 3 was 500. Two days of that week belong in April. The entry accrues 200. As of April 30, make the entry:

Dr	Salary Expense		200	
	Cr	Salary Payable		200

The tricky part comes from recording the entry at payment time. Some of the payment reduces the liability set up as of the end of the previous month.

Dr	Salary Payable		200	
Dr	Salary Expense		300	
	Cr	Cash		500

Recording a reversing entry (discussed in Section 503.12) on the first day of the following month takes care of the awkward entry illustrated above. The reversing entry makes the opposite entry to the accrual entry (i.e., debit Salary Payable and credit Salary Expense). This allows the accountant to make the typical entry to the salary expense account for the next pay period (i.e., debit Salary Expense for 500 and credit cash for 500.)

Figure 8 - Accrued Payroll Expense

503.09 Accrued Vacation and Sick Time

Usually, employees earn their vacations and sick days for their work in the present period. For example, a person may build up one vacation day and one sick day each month they work. Accrual accounting records these future absences as expenses as the employee earns them.

Example – Vacation and Sick Leave

Joe earns a day of vacation leave and a day of sick leave for every month he works. The cost of those days is an expense in the month he worked and not in the month in which he takes the vacation. It is rightfully a liability at the end of the month he worked. The organization owes him a vacation or sick day, even if it is not payable in cash if he were to leave.

Suppose June payroll for ten employees is 30,000. On average, each employee earns two days of vacation and sick leave a month. An estimate of the cost of this vacation and sick leave is about 2,000 (100 per day for each employee). This is the 30,000 monthly cost, divided by 30 or 1,000 per day. Because the employee earned two days of paid leave, the estimated cost of the accrual is 2,000. The June 30 adjusting entry is:

Dr	Sick and Vacation Days Expense		2,000	
	Cr	Sick and Vacation Days Liability		2,000

Entries in the following months record vacation and sick days the employees use. The following entry assumes the accountant has recorded that month's payroll into Salary Expense. If employees took five days off, the entry is:

Dr	Sick and Vacation Days Liability		500	
	Cr	Salary Expense		500

Check often to be sure the balance in the liability account makes sense with the balance of days still owed in personnel records.

Figure 9 - Vacation and Sick Leave

503.10 Fair Value of Investments

Unrealized investment income is income that the organization cannot access yet. It is like the accrued interest income topic discussed earlier.

Example – Stock Investment

Consider a stock investment costs 1,000, increasing in value to 1,100.

The 100 increase is an unrealized gain. The debit is to an asset account Unrealized Increase (Decrease) in Investment Market Value. It brings the total investments up to current fair market value. The credit is to an income account: Unrealized Gain(Loss) in Investments.

Dr	Unrealized Increase (Decrease) in Market Value	100	
	Cr Unrealized Gain (Loss) in Investments		100

If there is a loss, the entry is opposite. (For more detailed discussion on Investments, see Chapter 10 – Investments.)

Figure 10 - Stock Investment Example

While a thorough, detailed discussion of investments will be the focus of Chapter 10, this example illustrates that while many accounting topics and rules may appear unrelated and disjointed, accrual accounting is the unifying logic behind most accounting requirements. Recording the fair values of investments is just one more case of unrecorded future cash flows.

503.11 Pensions

The largest accrual of unrecorded future cash flows is a period's pension expense. The workers earn their pension in the current work period, not when they collect it. The period in which they earn the pension is the period that deserves the expense; however, the organization does not pay the pension for years. It is unfair to force the future year's revenue to bear the expense of the retirees. In response to this lack of fairness, pension accounting estimates the future pension cost belonging to the current period, then records it as a Pension Expense and a Pension Liability in the period the employees worked for the organization. The estimate is complex, the numbers are enormous, and the periods are long. Still, at its essence, it is the same as the other accruals shown above: the organization debits an expense and credits a liability for an estimate of the expense belonging to that period. Chapter 19 - Pension Liability and Expense thoroughly explains this.

This example is the last where the cash flow is paid or received after the proper period to show the revenue or expense. As a summary principle, the entry records a receivable and revenue when the cash flow is an anticipated inflow. Then, when the inflow occurs, the entry reduces the receivable. When there is an expected outflow, the entry records an expense and a payable. Then, when the outflow occurs, the entries reduce the payable.

Understanding this principle will guide you in situations this manual does not illustrate. Other examples are uncompleted contracts for services, bookseller commissions, and taxes.

Many people think of accounting as mathematical, precise, and scientific. Often, it is not. Many new accountants balk at adjusting entries since adjustments are less precise than the accountant's idea of accounting.

Consider the accruals for vacation days illustrated in Figure 12, Section 503.09. The office records vacation days based on an estimate of the future cost of those days when the employees take them. Such an estimate is imprecise. Employees will leave without taking sick days, and their salaries will go up, weakening the estimate made at their old salary.

The example of accrued pension expense (see Section 503.11) is more complex. It depends on estimating salary growth over decades, estimated retirement age, the life expectancy of retirees, and investment returns far into the future. Still, accounting rules require the accountant to estimate and record the pension cost their organization will not pay for decades. The estimates are not very precise, but they are more precise than not making any estimates.

The life of buildings is another significant estimate in accrual accounting (see Section 503.06).

Suppose an organization pays 100,000 for a building. It estimates the building will be useful for 12 years. The depreciation is 8,333.33 a year, which is 694.44 per month. This precise-looking number is the result of a very rough estimate, 12 years.

Another good example is when a building declines in value, with its real value becoming lower than the amount in the books. Consider the building in the last paragraph. After two years, it would have a book value of 83,333.33. Then, market forces push the fair value of the building down to around 40,000.

The hitch is everyone can agree that the building is not worth 83,333, but figuring out what it should be worth is much harder. Some say 30,000, some say 45,000. Keeping the value as 83,333 would be very misleading – it is precise, but also it is very wrong. However, a rough estimate of 40,000 is more truthful (and useful) but very imprecise.

With many adjustments, accountants must make entries based on rough estimates and prepare documentation to support them. Even so, such accounting is more truthful than a precisely wrong answer.

503.12 Reversing Entries

Reversing entries help keep accrued amounts in the correct period. To see the problem, reversing entries solve, refer to the following examples.

Example – Reversing Entries

Accruals Without Reversing Entries

Payroll for May 5 is 7,000. Of that amount, 2,000 is an April expense. As of April 30, make the following entry:

Dr	Salary Expense		2,000	
	Cr	Salary Payable		2,000

The actual payment occurs on May 5. The simplified payroll entry is:

Dr	Salary Expense		5,000	
Dr	Salary Payable		2,000	
	Cr	Cash in Bank		7,000

The 5,000 Salary Expense is for five days in May.

The 2,000 debit to Salary Payable reduces the Salary Payable left over from the end of last month. The payment entry would make sense to the accountant who made the accrual entry in the first place.

However, if the Payroll Accountant is a different person, they may not know about the accrual. They will want to make their routine entry debiting Salary Expense and crediting Cash for the full amount of the payroll. A reversing entry supports that action.

Figure 11 - Reversing Entries

Example - Accruals With Reversing Entries

The accrual is the same:

Dr	Salary Expense		2,000	
	Cr	Salary Payable		2,000

On the first day of the next period, reverse it by making the opposite entry:

Dr	Salary Payable			2,000
	Cr	Salary Expense		2,000

After this entry, the expense for this month oddly begins with a credit of 2,000. Expense accounts do not usually have credit balances.

The Payroll Accountant now records the payroll without consideration of the accrual entry or reversing entry. He might not even know about them. He records this:

Dr	Salary Expense		7,000		
	Cr	Cash in Bank			7,000

The debit of 7,000 goes into an account that has a starting credit for the month of 2,000. Both entries collide and leave the proper 5,000 in the account for May.

The idea is that the bookkeepers make daily entries, entering transactions that look like revenue to revenue. They enter transactions that look like expenses to an expense. They do this without worrying about or perhaps even knowing about the period-end accrual entries. To allow this to happen, the accrual accountant makes the period-end accrual entry and then reverses it as of the first day of the next period. It is important to note that the accrual entry and the reversal entry can be recorded within minutes of each other.

Figure 12 - Accruals with Reversing Entries

Example – Recording Reversing Entries

There is one more critical point: the accrual and the reversal can be recorded within minutes of each other.

Imagine working on the morning of May 10. Enter the entry illustrated above for the May 7 payroll and make the accrual entry as of April 30. Immediately after that, make the May 1st reversal. The reversal uses a May 1 transaction date and a May period.

Figure 13 - Recording Reversing Entries

Section 504 - Reconciliations

504.01 Need for Reconciliation

Reconciliations are essential to ensuring the faithfulness of the financial statements. Reconciliations validate the ledger accounts against other confirming and validating information. Ideally, this is information from outside the organization.

Bank reconciliations are the best-known reconciliations. With them, the accountant reconciles the general ledger's bank account to the bank's account. Both are tracking the same information. Church accounting requires reconciling one organization's inter-organizational accounts to the corresponding organization's accounts. An example is a conference reconciling its Union Payable general ledger account to the corresponding account in the union's accounting system. The conferences' and unions' accounts are tracking the same information.

504.02 Reconciliations and Error Correction

Bank accounts and inter-organizational accounts touch many of an organization's transactions. This relationship can be immediate, such as debiting cash and crediting rental income. Other times, the relationship can be secondary, such as a transaction that might first debit an expense, credit the payable's vendor account, and later debit the vendor's account and credit cash. The bank reconciliation might catch an error in this last credit, which means that its debit is also wrong, indicating that the first entry was also incorrect. The reconciliation helped spot a mistake in what looks like an unrelated account.

Since bank and inter-organizational accounts directly or indirectly touch many transactions, reconciling them finds many bookkeeping errors. Often, bookkeeping errors come in pairs: a reconciliation revealing an overstated debit to cash also uncovers another error, perhaps overstating revenue.

504.03 Near Real-Time Reconciliations

Because reconciliations can validate much of the accounting, they should be done on a timely basis. Timely monthly reconciliations are the standard; however, nowadays, many external sources of information are available in near real-time. Many accountants do reconciliations weekly or even daily. This near-perpetual reconciliation is comforting to cash receipts and cash payment accountants. The frequent reconciliations to the online bank accounts increase their confidence and make monthly reconciliations a quick exercise.

504.04 Bank Reconciliations

The bank records track the same information as the general ledger bank account. If they have different balances, the reconciliation figures out why:

- The difference could partially result from ledger transactions not yet in the bank's records.
- Errors could cause the difference. Banks may make errors, and this process finds them. But usually, the errors occur in the organization's entries and require correcting entries.
- Finally, the difference could occur when the bank may have transactions not yet on the ledger, such as service charges. The reconciliation process must include recording such unrecorded transactions.

504.05 Bank Reconciliations as an Internal Control Activity

Reconciliations have an essential internal control role. Correctly done, they will disclose unauthorized bank transactions and record errors. This role in validating the rest of the accounting and its role in internal control is why it is critical to do reconciliations soon after the month ends. Waiting to perform all of the monthly reconciliations until the end of the year destroys this value. Also, for those same reasons, someone other than the cash receipts and cash payment cashiers should do reconciliations.

Often, the accountant doing reconciliations focuses on the transaction amounts. They tick off the amounts on the bank statement that match the amounts in the ledger, and, after all, the goal is to get the reconciliation to balance. Yet, they should also ensure that the payees in the bank statements match those in the ledger. The reason for the quick comparison is obvious. A dishonest person may substitute a legitimate payment to a supplier with a payment to themselves in the same amount. Comparing the payees is as much a part of a reconciliation process as reconciling the amounts.

504.06 Inter-organizational Accounts

The Church's debit/credit memo system and worldwide network of inter-organizational receivable/payable accounts are priceless. This system is valuable in passing donations, appropriations, and enabling worldwide services. A donation in the United States can quickly reach a need in Nairobi. A school in Thailand can confidently register an employee's child from Tanzania because the memo is on its way. Accountants must keep the system working smoothly by reconciling all those inter-organizational accounts.

The concept is like bank reconciliations. The conference accountant compares their ledger transactions to their statement from the union, and the union does the same with the division, and the division does the same with the GC. This comparison identifies reconciling items. These are items that still need to be recorded, or they could be items that the higher organization has not yet recorded, or they could be errors that need correcting.

504.07 Reconciliation Review, Unresolved, Unrecorded Reconciling and Items

It is common to assign reconciliations to the most junior accountant. Doing this is appropriate if that accountant understands their internal control role, but, like everything done in the accounting office, the reconciliations need review. Likely, the reviewer will also need to use the reconciliation to review (or even initiate) the necessary entries to the appropriate account. These were the entries recording the corrections and missing transactions that were reconciling items on the reconciliation.

Resolving differences between the ledger and another organization's accounts is a denomination-wide challenge and often requires senior accountant engagement. The accounting office must clear reconciling items such as error corrections and contested entries. Clearing them is as vital a part of the reconciliation process as getting the reconciliation to balance. Unrecorded and unresolved reconciling items are significant weaknesses in many accounting offices.

504.08 Other Reconciliations

Besides bank reconciliations and inter-organizational reconciliations, an organization may have other reconciliations. Here is a sample list:

- Major supplier's payable or customer's receivable accounts.
- Inter-fund receivable/payable accounts.
- Subsidiary ledgers and general ledger control accounts. Some organizations use a subsidiary ledger and control account structure.

Example – Accounts Receivable

For example, detailed accounts receivable accounts may be in another part of the accounting system. The Accounts Receivable Accountant makes detailed entries in the subsidiary ledger, and the General Ledger Accountant makes the equivalent summary entry in the general ledger control account. Someone then must reconcile the detailed subsidiary ledger and the general ledger. This task involves checking that the control account entries and totals match the subsidiary ledger entries and totals.

Figure 14 - Accounts Receivable

- Property records. The organization must reconcile its property ledger with the general ledger. Specifically, it must reconcile its detailed historical costs and accumulated depreciation records to the corresponding general ledger accounts.

504.09 Review and Compilation

Experienced controllers often develop a way to manage their routine adjustments. This checklist can be as simple as a to-do list or as complex pre-staged entries that only need the amounts changed. This checklist should be specific to the unique transactions in the organization. The controller should still do a complete trial balance review with professional scepticism:

- How do the balances compare to the same period in the previous year?
- Do the cash and investment balances make sense?
- Do the receivable and payable account balances make sense?
- How do revenue and expense balances compare to the budget?
- Do tithe and non-tithe net assets make sense?
- Do the balances of the allocated net assets look reasonable?
- Is there a plausible explanation for non-normal[3] accounts?

The review can extend to a trial look at the financial statements. Here is a short list of financial statement review items:

- Does the Statement of Financial Position (SFP) Balance for each Fund and for the prior year columns?
- Consider the Statement of Activity (SFA) and the Statement of Net Asset (SNA). Do their beginning net assets match the ending Net Assets from last year’s statements?
- Do the ending balances match the total on the SFP?
- Does the ending cash on the Statement of Cash Flows match the cash showing in the SFP?
- Do the notes balance their items in the SFP and SFA?

This quick review can find many bookkeeping errors.

[3] These are asset and expense accounts with credit balances and liability, equity, and revenue accounts with debit balances.

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Chapter 6
General-Use Financial Statements

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Chapter 6
General-use Financial Statements

This chapter begins with an overview of the required general-use Financial Statements and then moves into a detailed discussion of each primary statement. It ends with discussions of Notes and Schedules to the Financial Statements.

Section 601 – Required Financial Statements

General-use Financial Statements must have the following:

Primary statements

- Statement of Financial Position (SFP)
- Statement of Financial Activity (SFA)
- Statement of Changes in Net Assets (SNA)
- Statement of Cash Flows (SCF)

Notes to the Financial Statements (Notes)

- Organizational description and accounting policies
- Additional Notes
- Working Capital and Liquidity Note

These names often include the term “Consolidated” (e.g., Consolidated Statement of Cash Flows). This term means the statements include all the reporting organization’s-controlled entities. (See Chapter 18 - The Reporting Entities – for guidance on consolidated entities.)

601.01 Retirement Funds

General-use financial statements include all funds and all controlled entities except retirement funds. Combined statements do not include retirement assets and liabilities and their related revenue and expense. Those assets and liabilities imply a fiduciary relationship with a specific group of employees, so IFRS requires them to have separate financial statements. The entity’s financial statements do show the retirement contribution for the hosting entity's employees. (See Chapter 19 - Retirement Funds - for guidance on this matter.)

601.02 Comparative Statements

IFRS requires general-use financial statements include comparative information. Each of the statements must show comparable information for the previous year.

Here are the details:

- The Statement of Financial Position (SFP) shows the ending balances for the interim period and the comparable figures as of the end of the previous accounting year[1].

> For instance, the date heading for a 31 May 20XX monthly Statement of Financial Position would be "31 May 20XX and 31 December 20XW".
>
> Its comparable balances would be those on the 31 December 20XW.

- The Statement of Financial Activity (SFA), Statement of Net Assets (SNA), and Cash Flow Statements (CFS) show the year-to-date activity for the interim period and the comparable year-to-date activity for the previous period.

> Continuing the example used for the SFP above, the date heading for May interim statements would be "For the five months ending 31 May 20XX and 20 May 20XW".

The Notes have corresponding comparative structures. Notes relating to the other statements (i.e., SFA, SNA, SCF) show the interim period's activity and compare it to the activity in the same months of the previous year.

> For instance, Notes relating to cash explain the cash as of the end of the interim period and the end of the previous accounting year.

Usually, statements display comparable information by adding a column for the prior year. Accounting rules do not require that format. For instance, this *Manual's* sample Statement of Net Assets (SNA) shows comparable years on separate pages.

[1] IAS 34.20

601.03 Internal Consistency

The financial statements combine to form a unit—each present one aspect of a complete story of operations and financial position. The statements must logically and mathematically tie together. Checking for this unity is particularly important.

Here are some examples:

- The Statement of Financial Position (SFP), the Statement of Financial Activity (SFA), and the Statement of Changes in Net Assets (SNA) show a total for net assets.
    - These totals should be identical on all three statements.
- The Statement of Cash Flows (SCF) should show the same ending cash as the SFP.
- The totals in the Notes must agree with the corresponding figures in the primary statements.
- On the SFA and the SNA, the previous year's ending net assets should match this year's beginning net assets.
- On the SCF, last year's ending cash should match this year's beginning cash.

601.04 Illustrative Sample Statements

The remainder of this chapter will explain general-use financial statements in greater detail. Instead of adding illustrations here, this manual encourages the reader to follow along by looking at the illustrative financial statements in Volume 3.

Section 602 - Statement of Financial Position

602.01 The Heading

The Statement of Financial Position (SFP) is a snapshot of assets, liabilities, and net assets on a specific date: the last day of the reporting period. The heading includes:

- the name of the organization,
- the title of the statement, and
- the dates.

For the Statement of Financial Position, the dates look like "31 December 20X1 and 20X0". There are two years because these are comparative statements. It is wrong for the SFP to show a date heading for a period such as “Year ended 31 December 20X1 and 20X0” or “Three months Ending 31 March 20X1”. Those refer to a period rather than a specific date. The SFP is as of a certain date, not a period.

602.02 The Body of the Statement

The SFP shows assets, liabilities, and net assets. The statement classifies assets and liabilities as current or other; “other” means non-current. Current assets are assets that are expected to be converted to cash within one year. Current liabilities are liabilities that are due to be paid to creditors within one year. Non-current assets and liabilities are expected to be converted to cash (or paid to creditors) at some point more than one year from the date of the SFP. The statement classifies net assets as unallocated, allocated, tithe, and restricted. There are subtotals for each of these subcategories.

602.03 Totals Columns

The SFP has columns for each fund and a totals column that combines all the presented funds. This totals column represents the whole organization’s financial position. The total column is what the SFP would look like if the organization were not using fund accounting or what the SFP would look like if it were not keeping its various consolidated entities in separate systems.

The division of the organization’s activities into various columns (or systems) introduces the concept of inter-fund and inter-entity borrowing.

Example – Inter-fund and Inter-entity Borrowing

Consider this: A Union accounts for its bookstore in a separate accounting system from its regular Union operations. Accounting rules for its situation require the Union to combine these units in one SFP.

Because the A Union Committee usually sees these organizations separately, the union accountant decides the SFP should present each unit as a distinct column. The SFP has one column for the regular Union operations and one column for the Bookstore. A totals column shows the combined totals for the A Union. So far this is good.

Now consider this: the Union operations owe the Bookstore 20,000. The Bookstore has a receivable, and the Operating Fund has a payable of 20,000. It is reasonable for the Bookstore to feel it has an asset of 20,000; however, the Union, as a unified reporting entity, does not. No one owes the 20,000 to the Union. The same logic applies to the liability. The Union operations owe 20,000, but the entire organization does not. It is incorrect for the totals column to show this 20,000 asset and liability.

The same situation occurs when one fund owes money to another fund.

The solution is to leave the inter-fund receivable and payables out of the total's column. Because this omission looks a little odd, a Note at the bottom of the SFP should explain: "Inter-fund borrowing is eliminated in the totals columns". (Check out the sample SFP in Volume 3 to see this presentation and the Note explaining the absence of the totals for inter-fund borrowing.)

Figure 1 - Inter-fund and Inter-entity Borrowing.

Section 603 - Statement of Financial Activity / Statement of Net Assets

603.01 General Observations

Two statements report the same financial activity in complementary ways:

- The Statement of Financial Activity (SFA)
- The Statement of Changes in Net Assets (SNA)

The Statement of Financial Activity (SFA) looks at financial activity by function and type. For instance, it shows the Sabbath School Expenses (function) for regular Operations (type). It further breaks down the information about activities by fund. This statement presents separate columns for each fund: a totals column for the Current Year's activity and a totals column for the Previous Year's activity. There are lines for each type of activity (Revenue, Expense, Transfers, etc.).

The Statement of Changes in Net Assets (SNA) summarizes the same activity by Resource and Restriction. It has columns for Revenue, Expenses, and Transfers (nature) and separate lines for each Unallocated and Allocated Net Asset (resources). The user can see the Revenue, Expenses, Transfers, and Balance for each Allocated Net Asset, so the SNA shows the changes and the available balance for each Allocated purpose. It further subdivides the activity by Restriction (Tithe, Non-tithe, etc.)

Date headings for both the SFA and the SNA are different from the SFP. While the SFP presents balances at the end of the reporting period, the SFA and SNA report activity for the reporting period. SFA and SNA date headings describe the reporting period like this:

Year Ended 31 December 20X1 and 20X0,

Or this:

For the Four Months Ending 30 September 20X1 and X0.

It is incorrect for SFA and SNA date headings to be like this:

30 September 20X1 and X2

The terms "Year Ended" or "Six Months Ended" are only proper after the period has ended. "Year Ending" or "Six Months Ending" are appropriate both before and after the period ends. Since the organization issues statements after the described period, either is suitable. Some countries' English leans toward one wording, so this manual does not specify a preference.

603.02 Statement of Financial Activity (SFA)

Accounting standards designed this statement to meet the unique needs of not-for-profit organizations. The focus is on the organization's resources: where they came from and how the organization used them. This perspective contrasts with the for-profit income statement's focus on the "bottom line" profit. The users of for-profit financial statements are eager to learn about profits. The not-for-profit users want to know where the organization got its resources and how it used them to further its mission; they may even object if there is too much profit.

The SFA includes two significant subsections:

1. Operating and Nonoperating Revenues and
2. Operating Expenses by function[2].

It includes a small subsection showing:

1. Transfers Between Funds and
2. Transfers Between Functions.

The subsections' combined activity is the SFA's "Increase (Decrease) in Net Assets." It is reminiscent of a for-profit's "Net Income"[3].

The SFA ends by combining this year's increase or decrease in net assets with the previous year-end balance. The combination results in the final net assets at the end of the reporting period. It does this for each fund, the total of all the Funds, and the previous year's comparable amounts. These amounts should be identical to those on the SFP.

The Statement of Financial Activity (SFA) explains how the financial operations changed the aggregate balance of all net assets. It does not track the kind of net asset the organization received or spent. For example, it reports the details of the types of revenue (e.g., tithe income, donation income, rental income, etc.) without explaining which kind of net asset (e.g., unallocated tithe, unallocated non-tithe, allocated, etc.) is affected.

See also Chapter 16 for a more comprehensive discussion of the Statement of Financial Activity.

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[2] This requirement is a change from the 2011 accounting manual.

[3] Not-for Profit's Accounting Standards do not use the for-profit label "Net Income" for its "Increase in Net Assets" since it implies earned income. In a conventional business sense, a not-for-profit may not have earned any of its net asset increase.

603.03 Reference to Notes

The Financial Statement Notes further explain the summary information on the SFA and SNA. In those cases, they have a cross-reference notation directing the reader to a particular Note. The statements include the footer notation, “Notes to the Financial Statements are an integral part of this statement.”

603.04 Internal Consistency with Funds

The amounts reported for individual funds must be consistent with those on the combined statements. If each fund has a separate statement, the amounts from the fund’s statements are the same as their columns of combined SFA. This requires that accounting policies be the same for individual funds and combined statements.

603.05 Statement of Changes in Net Assets (SNA)

This statement presents the summarized activity for each Unallocated and Allocated Net Asset function. It reports the details of the changes in each type of net asset without giving detailed information on the revenue and expense. For example, it will report revenue for a specific allocated net asset (e.g., evangelism) without showing the types of revenue (e.g., tithe income, donations, etc.). The statement includes a line for each Allocated Net Asset. For instance, there is a line for Evangelism, Scholarships, Contingency, and Exchange Fluctuations. It includes lines for Unallocated Tithe and Unallocated Non-tithe to explain all the net assets. Each line has columns for the Allocated Net Asset’s Total Revenue, Expense, Transfers, and Balance.

The Financial Statements must have both the Statement of Financial Activity (SFA) and the Statement of Changes in New Assets (SCNA) for each year that is shown on its Statement of Financial Position (SFP). Therefore, if the SFP shows 20X1 and 20X2, it needs a SFA and a SCNA for both years.

Section 604 - Statement of Cash Flows (SCF)

604.01 Introduction

The Statement of Cash Flows (SCF) focuses on the inflows and outflows of cash and cash equivalents.[4] It classifies these inflows and outflows as Operating, Investing, or Financing activities. It concludes by adding the net cash flow for the period with the beginning cash, resulting in a total ending cash.

604.02 Operating Activity

Operating activity consists of cash receipts and payments relating to regular, ongoing operations. It includes any activity that does not meet the definition of an Investing or Financing activity. The SCF's definition of an operating activity differs from the Statement of Financial Activity's (SFA) definition of Operating Income and Expense. Operating activities on the SCF show the amount of cash generated by the organization's regular business activities, whereas Operating Income and Expense on the SFA shows numbers derived from activities accounted for by accrual accounting rules, not from cash activities.

The following examples illustrate what is included in cash flows from operating *activities*:

- Receipts for sales of goods or services
- Interest and dividends received which donors, contracts, or the board have not earmarked for long-term purposes.
    - Those for long-term purposes are financing activities.
- Cash contributions received which donors have not restricted to long-term purposes.
    - Those for long-term purposes are financing activities.
- Receipts for settlement of lawsuits
- Proceeds of insurance settlements such as theft or liability claims (other than those related to investing or financing activity).
    - Such as claims for building damage.
- Refunds from regular suppliers
- Payments to suppliers and vendors
- Payments for taxes, duties, fines, fees, penalties, refunds
- Contributions to other not-for-profit organizations
- Payments to employees
- Interest paid on all indebtedness.

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[4] See Chapter 9 – Cash and Cash Equivalents – for cash specifics.

- Student financial aid payments
- Payments to settle lawsuits.

604.02.01 Direct Method

The International Accounting Standards Board prefers the direct method of presenting cash flow from operations. The direct method directly reports cash flow from each type of activity that produces and uses cash.

For example, it might begin with listing the cash received from Tithe, Other Donations, Rental Income, Investments, etc. Then, it shows what the organization paid for Personnel Costs, Office Costs, Evangelism, Rent, etc. The rows on the SCF look like the Statement of Financial Activity (SFA), but instead of reporting revenue and expense, it reports cash inflows and outflows.

604.02.02 Indirect Method

The indirect method adjusts the SFA's "Increase (Decrease) In Net Assets" to remove non-cash effects on that amount to calculate the cash flow from operations. Both the direct method and the indirect method provide the same numerical answer. While the direct method is theoretically preferred because it presents cash inflows and outflows directly and is easier for the reader to understand, the indirect method is more commonly used by most for-profit and non-profit organizations and is supported by SDA denominational software. Accordingly, this *Manual* recommends the use of the indirect method for preparing the SCF.

604.03 Investing Activity

The SCF's idea of investing differs from the Statement of Financial Position's (SFP) idea of Investments, as the SCF emphasizes the *activity* of investing, not the asset. The SCF's investing activity cash flows are receipts and payments that relate to these three categories of transactions:

- Investments in debt or equity securities
- Loans Receivable (Loans Payable are financing activities)
- Buying or selling land, buildings, and equipment.

Here are examples of cash flows from investing *activities*:

- Receipts from the sale of marketable debt or equity securities

- Receipts from liquidating dividends or other returns of investment on marketable securities.
- Receipts from the sale of land, buildings, and equipment
- Receipts from insurance on losses to land, buildings, and equipment
- Collections on loans receivable, including employee loans.
- Receipts from the sale of works of art or historical treasures.
- Payments to buy marketable debt or equity securities.
- Payments to purchase land, buildings, and equipment.
- Payments causing loans to other organizations or individuals, including employee loans.
- Purchases of works of art or historical treasures.
- Payments loaning cash, including employee loans.

604.04 Financing Activity

Financing activity cash flows relate to borrowing and repaying loan principal. They include contributions that donors restrict to long-term purposes, such as donations for buying fixed assets.

The following are examples of cash flows from financing *activities*:

- Contributions received which donors have restricted for long-term purposes.
    - These would include donations for such things as
        (a) permanent or term endowments,
        (b) purchases of land, buildings, and equipment,
        (c) or revolving student loan funds.
- Interest, dividends, and other investment income that donors say the organization must reinvest in endowments.
- Investment income that, by agreement, it must hold to make payments to beneficiaries of life income funds.
- Interest income it must reinvest in revolving loan funds.
- Proceeds from issuing notes, mortgages, or other short- or long-term debt the organization owes.
    - When the organization loans the money, it is an investing activity.
- Repayments of principal on the organization’s debt
- Payments to beneficiaries under life income agreements
- Refunds to donors of gifts that they had earmarked for long-term purposes.

604.05 Non-cash Activities

Accounting standards require that statements disclose certain kinds of activity on the face of the financial statements or in the Notes, even though they are not cash inflows or outflows:

- Gifts of securities held as long-term investments.
- Donated services that create long-term assets.
    - For instance, disclose someone's donated construction labor.
- Gifts of long-lived assets, whether for use or ultimate sale
- Acquisition of assets by assuming liabilities, such as through leases
- Refinancing or renegotiation of long-term debt

Typically, a schedule at the bottom of the SCF reports these items. It is also possible to report these items in a different schedule or in the Notes to the Financial Statements.

604.06 Preparation of Statement of Cash Flows (SCF)

See Volume 3 of the *Accounting Manual* for instructions and examples for preparing the Statement of Cash Flows (SCF).

Section 605 - Notes to Financial Statements

605.01 The Purpose of Notes

The primary financial statements - SFP, SFA, SNA, and SCF - paint an incomplete picture of the organization's financial position and activity. As users read those statements, some questions naturally arise:

- What basic accounting and reporting procedures did the statements use?
- What non-monetary factors help explain the reported amounts?
- What are the various kinds of risks associated with the investments?

The organization prepares the statements for a broad spectrum of readers. This wide readership means the statements must include everything necessary to make the information valuable and understandable to its non-management readers.

Example – Long-time Liabilities Consider long-term liabilities. The Statement of Financial Position (SFP) shows the amount owed, 350,000. This amount is meaningless without more information. Knowing the terms of repayment, interest rate, security of the liability, and schedule of maturities are crucial to understanding what the amount means.

Figure 2 - Long-time Liabilities Explanation

Notes present more information so that the primary statements are more informative.

To emphasize the relationship between the primary statements and the Notes, include this announcement at the bottom of the pages containing the primary statements: "The accompanying Notes are an integral part of the financial statements."

605.02 Required Notes

The first one (or two) Notes describe the reporting entity and summarize its accounting policies. Having a Note to clarify the reporting entity might seem unnecessary. After all, the organization's name, XYZD Union, is on the Statement's front cover; but usually, the name fails to describe precisely what financial reporting entity the statements are about.

"XYZD Union Statement of Financial Position" does not tell the reader if it includes the Union Bookstore, Union Academy, its Asset Holding Corporation, or its Retirement Plan.

What the statements include and do not include may be evident to insiders, but the statements are for outside stakeholders, not management. That is why this first Note describes the entity and its activities.

In addition to this description, the first Note(s)[5] include a description of significant accounting policies. The organization's accounting policies can make an enormous difference in understanding the statements. For example:

- What is the reporting currency?
- How does it value its investments? (e.g., fair value, historical cost)
- What depreciation method does it use? (e.g., straight line, sum of the year's digits)
- How is its inventory valued? (e.g., FIFO or weighted average)
- How does it recognize revenue related to donated assets?

[5] Some organizations prefer to make two separate Notes to disclose the Organizational Description and the Accounting Policies.

It is appropriate to place the description of the accounting policies in the Note that addresses that asset or activity. For instance, including pension information in this first Note summary and duplicating it in the Pension Note is unnecessary.

The Notes following the Organizational Description and Accounting Policy Note come in the same order as the accounts are listed in the Statements of Financial Position. They give specific disclosures that the IFRS requires and provide further insight into the items, including their risk and liquidity. IFRS further requires that the organization identify its related parties. See Chapter 2, Section 203.3 for a discussion of related party disclosures.

The notes for the other statements follow their sequence in the statements.

605.03 Adequate Disclosure

To provide all the information stakeholders need, the IFRS requires certain minimum disclosures. It leaves it to management's judgment to decide what information to include and where to show it. This flexibility means the organization can put the disclosures in the primary statements as additional lines or parenthetical information or show them as Notes. The Statements and Notes, taken as a whole, should answer all the stakeholder's material questions.

IFRS and this manual require all organizations to disclose the following information:

- Organization Description - This identifies the reporting entity, describes its principal programs and significant sources of revenue, and briefly describes the types of related parties the entity is associated with.
    - It is usually the first part of Note 1.
- Accounting Policies - This describes the statement's important principles and their application.
    - It is usually the last part of Note 1 or Note 2
- Financial Statement Issue Date – This note discloses the individual or group authorizing the issuance of the statements, the issuance date, and whether that body has the authority to amend the financial statements at any later date.
    - Often, the organization includes this information as part of the Accounting Policies Note.
- Compensation of Administrative Employees - This discloses the total for all compensation paid to executive officers, vice presidents, and governing committee members who are employees as a group[6], separate from compensation paid to all other employees.

[6] This note does not identify individual employees.

- **Retirement Plan** - This is a brief description of the retirement plan(s) the reporting entity contributes to, the total contributions made to the plan(s) during the reporting period, and disclosure about minimum funding required for future obligations.

Organizations that have balances in the following types of accounts disclose this information:

- **Investments** - other than cash and cash equivalents - This discloses the cost, fair value, and unrealized appreciation or decline by type of instrument.
- **Accounts and Loans Receivable and Payable with Related Parties** - This includes the balances at the reporting date for each type of related party, whether the related parties secure (e.g., guarantee) the balances, the terms of repayment, and the amounts of significant transactions with those parties.
- **Land, Buildings, and Equipment** - This includes cost, accumulated depreciation, current period changes, and depreciation expense by type of asset.
- **Notes and Loans Payable** - This discloses current and long-term portions, total balance, payment terms for each account, and the principal amount due in the next five years.
- **Contingent Liabilities -** This is a brief description of the organization's exposure to certain types of potential liability.

Section 606 - Schedule of Working Capital and Liquidity

606.01 Nature of the Schedule

IFRS does not require a Schedule of Working Capital and Liquidity; however, the denomination's Working Policy does. GCWP S 24 25 requires the organization to produce this schedule as frequently as the financial statements are produced. GCWP S 19 describes this frequency:

1. The treasurer must provide at least nine (of the twelve) monthly financial reports to the organization's administrative officers.

2. The organization must provide at least four monthly financial reports, spaced throughout the year, to the controlling Board, Executive Committee, and officers of the next higher organization.

This manual includes this schedule as a Note to the Financial Statements for convenience. See GCWP S 24 25 for detailed information and a sample of this report.

Section 607 - Other Schedules

This *Manual* focuses on the Notes required to meet the IFRS disclosure requirement. These are an integral part of the general-use financial statements. The Notes are not a listing of the accounts that make up the account balance; such listings or schedules may overwhelm the user with information that is outside their responsibility. For example, a detailed list of each student receivable may distract the user. The accounting office may provide such a detailed listing for management use but does not consider them part of the financial statements. Neither IFRS nor this manual requires them.

607.01 Sample Notes to Financial Statements

Volume 3 has examples of the Notes for accounting policies and other matters for each type of organization. Except as noted earlier, the sample notes are not obligatory or intended to be complete. Each organization should use the illustrated notes as a guide and tailor them to fit the needs of their governing committee.

607.02 Supporting Schedules

Financial managers often want Financial Statement Supporting Schedules. These schedules are one way for management to understand what accounts make up the statement amounts; however, they may confuse outside users. More information is not always better.

Schedules often have details that are not the concern of non-management users. For instance, it might not be proper for general users to see detailed employee or student receivables lists.

This *Manual* does not mandate Supporting Schedules for financial reports. It also does not preclude them. Accounting packages helpfully produce supporting schedules with their statements. That does not mean the organization should distribute them without a good reason.

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Chapter 7

Fund Accounting

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Chapter 7

Fund Accounting

This chapter covers the basics of Fund Accounting. It starts by laying out why the Church uses Fund Accounting and then discusses the various types of Funds. Fund-based Financial Statements and accounting are both touched upon. The chapter ends with a focus on Inter-Fund Transactions.

Section 701 – Fund Accounting

This manual requires tithe-based organizations[1] and tertiary institutions[2] to use Fund Accounting. This manual strongly encourages Fund Accounting for academies with significant physical plant assets or endowments. It explains the purpose of Fund Accounting and how it works.

Fund Accounting is a long-standing accounting tool. Orphanage financial statements from 17th Century England typically show Operating Funds and Plant Funds. These separate funds kept donors from mistaking the orphanage's building funds for Operating funds or vice versa. The same sort of confusion happens in the 21st Century. Fund Accounting is here to help.

701.01 The Purpose of Fund Accounting

Fund Accounting follows some basic rules or principles. The first principle is foundational to why the Church uses Fund Accounting:

The funds are subsets of the general-use financial statements.

This simple sentence is an important concept. It is common for for-profit organizations to use various operating divisions.

[1] These are the organizations listed as Local Fields, Unions, Divisions, and the GC in the SDA Yearbook.

[2] These are the Colleges, Universities and other institutions listed in the SDA Yearbook as Tertiary Institutions.

Example – Hardware Store, Inc.

For instance, Hardware Store, Inc., might have Downtown Store and Suburban Store divisions. They would have one set of accounts for the Downtown Store and another for each of the Suburban stores. Each store has its own assets, liabilities, equity, revenue, and expenses. The store's accounts are subsets of the overall company accounts. Hardware Store Inc might show the two divisions in its overall financial statements to show the contribution from each. Fund Accounting works the same way. The separate funds are subsets of the whole organization's financial statements.

Figure 1 - Hardware Store, Inc.

Departmental Accounting is different. In Departmental Accounting, each department has its own revenue and expense accounts, but they share asset and liability accounts. Suppose the organization is only interested in keeping track of separate income and expenses for each segment. In that case, Departmental Accounting works fine. But Fund Accounting also keeps one fund's assets, liabilities, and net assets separate from another's.

Fund Accounting is the same as for-profit organizations reporting segments or divisions by region or product line. In the same way, Fund Accounting sorts the distinct kinds of financial activities into various funds.

The first principle of Fund Accounting is that funds are subsets of the overall organizational accounts. For example, the total organization receivables are the sum of the receivables in each fund. The total for payroll expense would be the same with or without Fund Accounting.

This first principle guides Fund Accounting entries.

Example – Complicated Entry

Consider a complicated entry in Fund Accounting:

A conference uses cash from the Operating Fund to buy equipment in the Plant Fund.

If it had not used fund accounting, it would have made a debit to Equipment and a credit to Cash. Nothing happens to the net income.

The conference's Fund Accounting entries must have the same combined result.

Figure 2 - Complicated Entry

701.02 Why Create a Fund?

For-profit reporting divides its reporting by such things as regions or product lines. Fund Accounting divides various kinds of financial activities into different funds. Here are some examples:

- **Operating Fund** - This type of fund accounts for resources earmarked for routine day-to-day activities.

- Unexpended Plant Fund - This fund handles assets to be used for acquiring plant items, such as cash earmarked for use on plant assets.
- Invested in Plant Fund - This fund manages the ownership and debt of plant assets.
- Agency Funds - Organizations use this type of fund when they serve as agents over large or sensitive agency activities—for instance, a conference operating as a bank for its local churches.
    - The resources in the Agency Fund belong to someone else.
- Endowment Funds - Schools use these when they have significant contributions earmarked for specific activities, such as student scholarships.
    - Endowment Fund Accounting is most valuable because the school must invest the gifts and only use the income from those investments.

Later, this chapter looks at each of these funds individually. For now, think of them as a whole. Imagine not using Fund Accounting and intermingling these different financial activities in the same Statement of Financial Position. The cash and investment accounts would have investments belonging to all of them. The liabilities would confound those due to operating suppliers and those owed to those churches putting money in the conference bank. The statements would present a single amount for payables, combining those connected to building a new building, endowment funds, and day-to-day operating payables. Think about the various activities mingled in one Statement of Financial Activity. What happens if an organization uses one statement for building and operating donations? A significant contribution to the new building does not mean there is more for evangelism. The need to avoid comingling of these activities is clear.

701.03 Fund Accounting and Reporting

The second principle of Fund Accounting is about presentation.

Some accountants use a multitude of accounts to keep activities identified. They have a set of accounts belonging to each purpose. Some may keep things separate by detailed calculations. Others think tagging revenue and expenses is enough to keep things sorted. These approaches are passable but still miss a valuable aspect of Fund Accounting. The user should readily see what asset, liability, net assets, revenue, and expense belong to each activity. The reports should reveal when the organization spends money earmarked for one purpose on another purpose.

Fund Accounting is about presentation as well as accounting. It is not enough to do things correctly. The statements should clearly show that all assets are not equally available. The well-known fruit analogy might help. The reports must clearly show the organization's apples and what is going on with them. They must separate the apples from the oranges and account for what is happening with them.

The comprehensive financial reports are the same whether the organization uses Fund Accounting or not. Fund Accounting gives segment information that helps users understand which assets are available for what purpose and which liabilities are the responsibility of which sector.

701.04 Self-Balancing Set of Accounts and Fund Statements

The third principle is that a Fund is a self-balancing set of entries and accounts. Funds are a complete set of accounts with debits equaling credits. All debits and credits in one transaction belong to just one fund. In one entry, Fund Accounting would not debit in one fund and credit in another. Balanced debiting and crediting within one fund mean the accounts in the individual funds are self-balancing subsets of the whole Chart of Accounts.

Because each fund is a self-balancing set of accounts, each can have its own balanced set of statements. These Fund Statements mirror the statements presented in the previous chapter. For example, one way to make the statements is first to show the four combined primary statements[3]. This first set is for all the organization's information. Next comes a complete set of all four statements for the Operating Fund. Then comes a complete set for each of the remaining funds. This presentation is useful when an organization has a lot of funds.

Another way to make Fund financial statements is to make only one of each of the primary statements. For instance, the single Statement of Financial Position (SFP) would have columns showing the SFP information for each fund. The Statement of Financial activity (SFA) would show each Fund's SFA activity in columns. And so on. This method is what this manual uses in its illustrative statements.

This manual does not specify which of these two formats an organization must use. However, whichever format is selected, the organization must show the information for each fund's four primary statements. For instance, the organization may not show only a Statement of Financial Activity for a Fund without showing the other statements.

701.05 Accounting vs. Financial Presentation

These standards have to do with presentation. The organization may set up separate funds in its accounting for management control and present them as one fund in the financial statements.

[3] Primary means the Statement of Financial Position (SFP), Statement of Financial Activity (SFA), Statement of Net Assets (SNA), and Statement of Cash Flows (SCF).

Example – Church Travel Agency

For instance, one Church Division runs a travel agency. This super-department manages the Division's airline and hotel bookings. The Division operates this activity in a separate fund, which helps its management manage the travel agency. However, the Division's Financial Statements present this fund as part of the Operating Fund.

Figure 3 - Church Travel Agency

Alternatively, some accountants make entire Fund Accounting reports without funds at the initial entry level. They do this by sorting the fund information when they construct the statements.

701.06 Combining Funds

Some funds have closely related information. The statements can incorporate these into one fund if they have related content. The accounting system or worksheets can do this before producing the statements or on the face of the statements.

Example – Combining Funds

The Division with the travel agency which combined its regular Operating Fund with its Travel Agency Operating Fund is an example.

The statements would have columns for the Main Operating Fund and the Travel Operating Fund. A Total Operating Funds column would combine the two.

Figure 4 - Combining Funds

Another combination is the Unexpended Plant Fund and the Invested in Plant Fund. Both funds relate to Plant Assets. The Unexpended Plant Fund holds investments earmarked for Land, Buildings, and Equipment, and the Invested in Plant Fund holds fixed assets and their related debt. (See Chapter 13 – Land, Building, and Equipment – for a detailed discussion.) It is common to show these as one set of Plant Fund Statements because they are both related to Plant Funds; they do not have overlapping accounts. The Unexpended Plant Fund's assets are only long-term investments[4] , and the Investment in Plant Fund never has investments. It only has plant assets. Combining the two in one Plant Fund on the face of the Statements is a convenient presentation. This combination uses a limited number of columns, and the financial statement can print on one page.

[4] In the Unexpended Plant Fund, cash and short-term investments are actually long-term assets. The Plant Fund discussion in Chapter 13 explains why.

701.07 Budget Comparisons

Statements of Financial Activities (SFA) for Operating Funds must include budget comparisons. This manual recommends these comparisons for all funds. A SFA for a single fund must have a budget comparison, and an SFA for a group of funds must have a budget comparison for the funds in the group. (See Chapter 8 – Analysis, Budgeting, and Control – for a detailed discussion.) It explains budget preparation, approval, and monitoring at the Fund level.

Section 702 - Individual Funds

The rest of this chapter looks at four kinds of funds:

1. Operating Funds
2. Plant Funds
   a. Unexpended Plant Funds
   b. Invested in Plant Funds
3. Agency Funds
4. Endowment Funds

While it is easy to think of these as four separate funds, they are types of funds. An organization can easily have several Agency and Endowment Funds. Having more than one Operating Fund or Plant Fund is conceivable but less likely.

702.01 Operating Fund

The Operating Fund receives and administers all operating income. Operating income is income that directly relates to the organization's primary mission. Examples of operating income are:

- Tithe Income
- Tuition Income
- Rental Income

The criteria focus on the *income's intended use*. Rent or Investment Income may not sound like they relate to the primary mission, but if the income's intended purpose is to carry out the primary mission, they are Operating. If their intended use is for some nonoperating activity, such as buying Plant assets, they belong to a different fund.

Everything the organization does is related to its mission. So, the keyword in the definition is "*directly*". The other funds also affect the mission, but indirectly. For example, the income for Scholarship Endowment Funds first goes to the Endowment Fund. Then, it directly affects the mission as it pays scholarships.

702.01.01 Operating Fund Financial Statements

Chapter 6 described the items included in general-use Financial Statements:

- The Statement of Financial Position shows:
    - Current Assets
    - Current Liabilities
    - Net Assets by Allocation and Restriction
- The Statement of Financial Activity (SFA) shows:
    - Operating Revenue
    - Operating Expense
    - Appropriations
    - Nonoperating Income
    - Nonoperating Expense.
- The Statement of Cash Flows (SCF) shows:
    - Operating Cash Flows
    - Investing Cash Flows
    - Financing Cash Flows

Principle 1[5] requires that the individual fund's statements meet all the provisions described in the Financial Statements (see Chapter 6). So, each fund's statements must include those subheadings if they apply to the fund.

702.01.02 Differentiating Between Operations, the Operating Fund, and the Plant Fund

Some activities are clearly Operating Fund activities. Some activities are clearly Plant Fund activities. The problem comes with those that seem to be in a grey area between the two.

Example – Operating or Plant?

For instance, some may feel that building churches and schools are direct Operating activities. But to provide for uniformity across the denomination, this manual assigns all land, building, and equipment to the Plant Fund.

Figure 5 - Operating or Plant?

[5] Fund Financial Statements are a subset of the General-Purpose Financial Statements.

Chapter 6 noted that the Statement of Financial Activity (SFA) shows activity divided into Operating and Nonoperating subsections. The Statement of Cash Flows (SCF) shows Cash Flows from Operations distinct from Investment and Financing Cash Flows.

It may seem that the Operating Fund would only have Operating Income and Expenses, but it includes non-operating funds as well. It may seem that the SCF should have only cash flows from Operations. Unfortunately, things are not that tidy.

Both the *Manual* and accounting literature use the term "Operating" loosely. Their definitions define Operations from a residual perspective. Operating Revenue and Expenses are generally everything that is not Appropriations and not Capital activities. Cash flow from Operations is everything that is not cash flow from Investments and Financing. The Operating Fund is for things not in the Plant Funds, Endowment Funds, Agency Funds, etc.

702.02 Plant Funds

Some accountants think of the Plant Fund as a fund split into two sub-funds; others think of the Plant Fund as two separate funds displayed together. These two perspectives are demonstrated in the denomination through its two primary accounting software programs. The Sun Plus software, used in a majority of the denomination's Divisions, supports a single Plant Fund. ASSI, used in two of the denomination's Division's organizations, recommends that entities use two funds—Unexpended Plant Fund and Invested in Plant Fund--for accounting purposes, while combining these funds for financial statement purposes.

As mentioned above, the Plant Fund is composed of:

- Unexpended Plant Fund which accounts for resources (e.g., Cash, Investments) earmarked for buying, replacing, and repairing land, buildings, and equipment.
- Invested in Plant Fund which accounts for the amounts already invested in land, buildings, and equipment and any related liabilities.

Each of the above meets the definition of a fund, each having a self-balancing set of accounts. Accounting staff can make Journal Vouchers (JVs) entirely in one or the other fund. (See Chapter 13, Section 1305 for additional discussion.)

> *Example – Plant Funds*
>
> For instance, two separate JV's record the purchase of an asset.
>
> In the Unexpended Plant Fund JV, one set of debits and credits records use of the earmarked resources.
>
> In the Invested In Plant Fund, another JV records the acquisition of the assets.
>
> A JV never crosses its debits and credits between the two funds (or subfunds if you prefer).

Figure 6 - Plant Funds

702.02.01 Unexpended Plant Fund

The Unexpended Plant Fund's assets are noncurrent investments.[6] This fund may also have accounts receivable and amounts due from other funds. It is less likely for this fund to have liabilities. If they have liabilities, they are liabilities connected to investments and amounts due to other funds. The Unexpended Plant Fund also includes payables related to the purchase of an asset (e.g., legal fees). These payables would only be payables for which the Unexpended Plant Fund is responsible. It would not have the liabilities, such as mortgages, connected to financing the acquisition of the plant assets. It would have unallocated net assets allocated to specific future land, building, and equipment purchases and mortgage repayment. This calls for some clarity: the Operating Fund's Unallocated Net Assets are available for any purpose. The Unexpended Plant Fund's Unallocated Net Assets are available only for fixed asset purposes.

702.02.02 Invested In Plant Fund

The Invested in Plant Fund holds fixed assets and the fixed asset's associated debt. The fixed asset accounts are the Land, Building, and Equipment accounts and their accumulated depreciation accounts. The liabilities are only debt related to financing the asset (e.g., mortgages). The fixed assets minus their associated liabilities equal its net asset: Net Invested in Plant.

Most organizations do not have debt on their fixed assets. Not having debt means their net fixed assets equal their Net Invested in Plant.

Using the Invested in Plant Fund keeps the Operating Fund focused on operations by removing the fixed assets from the Operating Fund. Their removal leaves the Operating Fund holding only

[6] Investments include cash and bank savings if the organization holds them for nonoperating purposes. Since the investments are not available for operations, they are not current. This is true no matter how liquid the investments are.

assets more easily deployed for Operations. (See Chapter 13, Section 1305 for further discussion.)

702.03 Agency Funds

An agent is someone who acts in the place of another. The agent holds the agency cash and does things with discretion about spending the funds in accordance with the owner's instructions.

Example – Agency Funds

If I sent you to the store with cash and a shopping list, you would be acting as my agent. To be careful, you put the money I gave you in a special place in your wallet. You know that money belongs to me.

The money I gave you is agency cash. You would have an equal agency liability. When you spend the money following my instructions, you have less agency cash and a lower agency liability.

Figure 7 - Agency Funds

The Agency Fund holds the agency assets (e.g., cash and investments) separate from the other funds held by the organization. It also carries the balancing agency liability. This separation partitions assets from the agent's own assets and liabilities. Besides properly handling things, it adds transparency and accountability by clearly reporting the agency relationship.

The fact that the assets and liabilities of the agency have their own fund means they are not in the Operating Fund. This segmentation helps prevent confusion about what is available for the organization's operations.

Example – Agency Funds

Consider a conference whose Operating Fund has about four million in current assets. Mostly this is in Cash in the Bank. The conference has little debt. The four million is primarily available to carry out its mission. In addition, their local churches have about twelve million "banked" with them. In this country the local churches cannot open bank accounts. This conference helps their churches by holding and processing their cash, thus serving like a bank for the local church's cash.

Imagine if they had their operating assets and the assets held for the local churches in the same Fund. Their cash would be 16 million, but only 4 million was theirs. This colossal figure would easily mislead conference decision-makers to think they are wealthier than they are. It would be easy for the conference to overspend by unwittingly using some of the local churches' funds.

Figure 8 - Agency Funds

Agency Funds consist solely of assets and balancing liabilities. There is no net assets equity. Revenue and expense might exist, but they do not accumulate in net assets.

Example – Agency Funds

Consider once again the case where individual churches may not be able to open their own bank accounts. The conference, as the only legal entity, can open bank accounts. The following details describe how they solved this problem:

1. The conference sets up one bank account.
    a. The bank tags an individual church's deposits and checks.
    b. By looking at the bank statement, the conference can tell which local church originated the deposits and checks.
2. The conference sets up an investment account.
    a. As agent, the conference moves idle money into the investment account from the checking account to earn a little interest.
3. The conference's Operating Fund also uses this bank and investment account for its cash and investments.
    a. From the Agency Fund's perspective, the Operating Fund is just one more customer.
4. The conference charges the churches a small fee for this service.

The conference wants to be accountable and transparent in this service, so it uses an Agency Fund. Its assets are the checking and investment accounts. Its liabilities are the payable accounts to each church and the due to operating fund account. This due to operating fund account is the conference's share of the cash and investments. The agency fund's assets equal the liabilities, so there are no net assets. It distributes all the income and costs to each of the church liabilities, so there are no revenue or expense accounts. When a church issues a check, it credits the checking account and debits the payable to the church. It allocates service charges and interest income to the church's conference account.

The conference charges a small percentage of the balance as a service charge. It debits all the churches' accounts to reduce the agency liability to the churches, and it credits the due to operating fund payable. This entry increases the conference's share of the assets. The conference Operating Fund records its increase as Income. The bookkeeping section below explains this more fully.

Figure 9 - Agency Funds

Example - Agency Funds

Reconsider the above example of a Conference Agency Fund charging a service fee on behalf of the Operating Fund. The conference does not show the service fee as income in the agency fund. Instead, the Agency Fund decreased the amounts owed to the churches and increased its payable to the Operating Fund.

In the Operating Fund a reciprocal entry is made, debiting its receivable from the Agency Fund. It credits a revenue account to record the income.

This two-entry process honors both principles explained in the section above:

- The aggregate conference has been careful not to record the same revenue twice; and
- Each fund had its own sets of debits and credits.

Figure 10- Agency Funds

Agency Funds are valuable in these types of situations:

- The government matches the percentage of donations a conference receives. The conference holds the match on behalf of its churches.
- A university has deposit accounts holding cash for its students and the student clubs.
- A conference holds a central investment pool for its churches.
- A union sets up a cost-sharing plan to manage specific activities, such as IT or software.

702.04 Endowments

Endowments arise when a significant contributor earmarks donations for a particular purpose, and the organization needs to segment these funds from its operating funds. University scholarships are an excellent example of endowments. Endowments often have a permanent part, sometimes called “principal” or “corpus”. The organization invests this permanent principal, and only the investment returns are spendable for the particular purpose.

Endowment funds have a different purpose than other funds; intermingling the operating assets and activities with endowments would be confusing, and in some countries, illegal.

Endowment Fund accounting is described below:

- Each endowment may have a permanent and a spendable part.
- The accounting must track each.
    - Some organizations do this by having one fund for the endowment corpus and one for the spendable part.
    - Another way to do this is by using one fund.
        - Tag revenue and expense transactions as either permanent or spendable.
        - The resulting spendable net assets would be available for the endowment’s purpose, as outlined in the endowment documents.

The value of keeping endowments in funds separate from operating funds is obvious.

Section 703 - Fund Accounting

Fund Accounting follows two basic principles:

- When the organization’s financial statements combine all funds, the totals will match the reports prepared from a system not using Fund Accounting.
    - Total assets, liabilities, net assets, and increases in net assets for the entire organization are the same with or without Fund Accounting.
    - This alignment means Fund Accounting does not do things differently. Instead, it separates things.

    - Should the results of recording the transactions violate this core principle, reassess.
- Each fund is a separate entity with its own balancing Trial Balance.
    - A single Fund holds the entry's debits and credits.
    - Think of each Fund as a different business with its own set of records; an organization can make financial statements for each fund from those records.

Section 704 - Inter-fund Transactions

It is easy to understand the idea of keeping the Operating and Plant Funds separate - treat them like different businesses; however, be on full alert when the Funds interact.

704.01 Due To/ Due From

Consider the Operating Fund loaning money to the Unexpended Plant Fund. The entry would look like this:

The Operating Fund decreases its cash and records a Receivable:

Due from Plant Fund	10,000	
Cash		10,000

The Unexpended Plant Fund increases its cash and records a Payable:

Cash	10,000	
Due to Operating Fund 1		10,000

This entry is like a business loaning money to another company. Even though separating transactions into funds may seem complex, the entries offset each other on the combined statements. They do not affect the total assets or liabilities. This satisfies the first principle. The entries balance by each fund's debits and credits, obeying the second principle.

Opposite entries will be made when the Plant Fund repays the loan.

704.02 Transfer Out/In

Suppose that the Operating Fund gives the money to the Plant Fund instead of loaning the money.

The Operating Fund's net assets decrease in the same way they would reduce with an expense item. Here is the entry:

Transfers Out	10,000	
Cash		10,000

The Plant Fund would increase its cash and record an increase in its Net Assets:

Cash	10,000	
Transfers in		10,000

Transfers Out acts like an expense: debits increase, and credits decrease the account. Both Transfers Out and expenses reduce asset equity. Transfers are expense-like, but they are not an expense to the organization. They are a transfer of net assets.

Likewise, Transfers In acts like revenue: the account increases with credits and decreases with debits. Both Transfers In and revenue increase equity. Transfer In is revenue-like, but it is not revenue.

During preparation of the Combined Statement of Financial Activity (SFA), the Transfers Out in some Funds will match the Transfers In from other Funds. This offsetting means the SFA Total column shows no Transfers. The total column is as if the Statements had not used Fund Accounting. Accounting jargon does not call Transfers In "revenue," or Transfers Out "expense" to prevent violating the above-mentioned principle.

Notice that the first loan example is like one organization loaning another organization money. This loan produces a receivable in one and a payable in the other. The second example is like one organization charging another for a service; the second example's entries produce a revenue-like Transfer In in one fund and an expense-like Transfer Out in the other. However, the revenue-like Transfer In may not increase the combined company-wide revenue or net income. And the expense-like Transfer Out may not increase the combined expenses or decrease net income.

704.03 Due To/From Transfer In/Out

In the same way, it is possible to combine the loan and the transfer examples. This combined example is like one organization providing a service, on account, for another.

Example – Transfers

The Board tells the Operating Fund to transfer 10,000 to the Plant Fund. The Operating Fund doesn't have the cash in the bank to make the transfer. It will have the cash next month when a bond matures.

Operating Fund acknowledges the burden on its Net Assets and that it owes the money:

Transfers Out	10,000	
Due to Plant Fund		10,000

This Operating Fund entry is like an entry recording an unpaid expense.

The Plant Fund increases its Net Assets and records the asset:

Due from Operating Fund	10,000	
Transfers In		10,000

This Plant Fund entry is like recording a Revenue for which the customer has not yet paid.

When the Operating Fund pays the Liability, the entry in the Operating Fund is:

Due to Plant Fund	10,000	
Cash		10,000

This entry is like an entry recording the payment of an Accounts Payable.

The Plant Fund entry is:

Cash	10,000	
Due from Operating Fund		10,000

This is like collecting a receivable.

Figure 11 - Transfers

Section 705 - Summary of Major Points

The 8 Principles of Fund Accounting, as explained in this chapter, are:

- **Principle 1** – Financial Statement totals of all Funds must be the same as organization-wide figures would be in a non-Fund Accounting system.
- **Principle 2** – Fund accounting is about presentation and the proper recording of economic activity.

- **Principle 3** – Funds are self-balancing sets of accounts.
    - A Journal entry makes debits and credits entirely in one fund.
    - One economic event may generate multiple entries in different Funds, but the individual entry is in only one fund.
- **Principle 4** – Each fund must have an SFP, SFA, SNA, and SCF in some fashion.
    - These follow the presentation rules of the overall Financial Statements.
- **Principle 5** – Due From XXX Fund is a receivable.
- **Principle 6** – Due To XXX Fund is a payable.
- **Principle 7** – Transfers In are like a revenue account.
- **Principle 8** – Transfers Out are like an expense account.

Table of Figures

Chapter 8
Analysis, Budgeting, and Control

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Chapter 8
Analysis, Budgeting, and Control

So far, this manual has focused on preparing Financial Statements. Now, it looks at how to use them. This chapter begins by exploring Financial Statement Analysis and planning based on financial reporting. It covers different types of analysis, ratios, and budgets. It includes Statistical Form F49 and ends with a discussion of the Compensation Review Committee and direct and indirect expenses.

Section 801 – Planning and Decision-Making

Church leaders often struggle to find the money for critical programs and services. The following counsel should be encouraging:

> *In our work for God, there is danger of relying too largely upon what man with his talents and ability can do. Thus, we lose sight of the one Master Worker. . . The means in our possession may not seem to be sufficient for the work; but if we all move forward in faith, believing in the all-sufficient power of God, abundant resources will open before us. If the work be of God, He Himself will provide the means for its accomplishment. He will reward honest, simple reliance upon Him. The little that is wisely and economically used in the service of the Lord of heaven will increase in the very act of imparting. In the hand of Christ, the small supply of food remained undiminished until the famished multitude were satisfied. If we go to the Source of all strength, with our hands of faith outstretched to receive, we shall be sustained in our work, even under the most forbidding circumstances, and shall be enabled to give to others the bread of life. Desire of Ages, pp. 370-371*

Church leaders need current, relevant, and reliable financial information. With it, they can plan better and make wise decisions about using scarce resources. Planning based solely on hope is not sober stewardship of Church resources. Properly using financial reports is more than a quick review of bare facts. It involves thoughtful analysis and prayerful financial planning.

Section 802 - Financial Statement Analysis

Financial Statement Analysis is a crucial financial management tool. When done well, it gives valuable insight into the organization's finances. Correctly done, it will clarify many difficult decisions. Many books focus on financial analysis. This manual could not hope to cover it in-depth, but this chapter peeks at it, hoping to spark an interest.

802.01 The Need for Analysis

Analysis varies with management concerns and tastes: Some organizations worry about cash flows, others about resource allocation, and others about cost control. No one analysis solution suits everyone. Only use calculations that apply to your situation and only those you understand and can interpret for others. More numbers are not always better analysis, so an avalanche of ratios will not serve you well. A few carefully chosen and followed indicators are better.

802.02 Which Data to Measure

It may be necessary to analyze a vast array of data. An abundance of ratios and trend analysis is available. It can be challenging to decide which data to focus on. Here are a few criteria to help identify and prioritize analysis.

Measure only those accounts, balances, or activities for which:

- The analysis results would trigger management decisions.
- The decision is not apparent but would be of consequence for the entity.
- The results impact constituents, other entities, or financial performance.
- Other officers or committee members wish to know more about the amounts.
- There is concern regarding specific items.

802.03 Comparative Information

By nature, financial analysis is comparative. Financial reports for the current month are helpful; comparative information is vital for making sense of them. Knowing June Tithe Income was 679,000 is a little helpful, but it is not that valuable until a comparison is made to the May Tithe of 429,000 or to the 720,000 Tithe for last June. IFRS requires Financial Statements to include comparative data unless unusual circumstances make it impractical or misleading.

Financial leaders often make a monthly summary of key amounts from their statements. This summary may be a monthly Tithe and Offerings report spanning several years, or they might get insight into their January gas cost by comparing January gas expense to the past three Januarys. The history of the gas expense is the starting place for predicting next January's expense. The past few years' actual spending is the starting point for projecting and budgeting for what happens next year.

802.04 Peer and Aspirational Comparisons

Treasurers often wonder how their organization is doing compared to other organizations. They ask such things as:

- Is the amount I am spending on salaries reasonable?
- Does conference office cost make sense compared to total pastor pay?
- Considering my tithe income, what should I budget for evangelism?

Some wish there were Church-wide statistics:

- What does the average conference spend on church schools?

Instead of looking for industry averages, it is helpful to study the statements of a few regional peer organizations about the same size and situation.

Another approach is to search for admirable and successful organizations to use as a model for aspirational comparisons. These peer and aspirational comparisons might be more valuable than comparisons to division-wide averages.

802.05 Vertical and Horizontal Analysis

Standardized denominational Financial Statements make comparisons easier; however, directly comparing raw accounting numbers is useless. Comparing your personnel cost, 232,999,167, to someone else's 312,156,122 is not helpful. Likewise, comparing this year's expense to the same expense from four years ago might not be much better. It is better to compare ratios and percentages. The most basic examples of this type of comparison are:

- Vertical Analysis and
- Horizontal Analysis.

802.05.01 Vertical Analysis

Vertical Analysis focuses on common-size Financial Statements. A common-size Statement of Financial Position (SFP) shows its amounts as a percentage of total assets. So, instead of showing cash of 121,987, it would show 14%. This ratio is the percentage of Operating Assets that are cash. The column and row headings stay the same, but instead of accounting numbers, they show percentages.

Likewise, a common-size Statement of Financial Activity (SFA) recasts its amounts as a percentage of total revenue and net appropriation income. Instead of tithe of 343,129, it would show 73%. This percentage means that 73% of income was tithe. Instead of showing a personnel cost of 232,999,167, it would show 65%. This percentage says the organization spent 65% of its income on personnel expenses. Again, the column and row headings stay the same, but instead of accounting numbers, they show percentages.

Tracking these percentages over months or years and comparing them to peer organizations will give valuable financial insights. Observing that the organization is now spending 10% of its income on utilities and, just a few years ago, it spent only 3% – and that its peers are now only paying 5% – may guide strategic thinking about utility spending.

802.05.02 Horizontal Analysis

Horizontal Analysis restates Financial Statements as a growth percentage. Instead of showing personnel costs of 232,999,167, for instance, it would show 10%. This percentage means personnel costs increased 10% from last year or last month. Often, comparisons match one year or month to the next, but you could compare this year’s figures to five years ago.

Frequently, horizontal analysis adds a column showing the percentage change to the existing statements. Comparing the tithe increase to the previous years and this year’s increase to the increase experienced by the organization’s peers is an excellent strategy.

802.06 Financial Position Ratios

Listed below is a sampling of financial ratios. They draw on the amounts from the Statement of Financial Position. These indicators help make sense of the organization’s financial position. They might show the monthly (or even daily) ratios for at least three or four years. Such a long-term view shows trends that, unless unchecked, will continue during the coming years.

Ratio	Remarks
Percentage of Liquid Assets to Commitments = Liquid Assets[1] divided by Current Liabilities x 100	This percentage gives insight into your ability to pay your commitments.
Months of Working Capital = Available Working Capital divided by 12 Month Operating Expense divided by 12	The answer is the number of months the Working Capital can support Operating expenses.
Percentage of Receivables to Operating Fund Net Assets = Net Current Accounts and Loans Receivable divided by Operating Net Assets	This ratio gives insight into the reasonableness of receivables.[2]
Current Ratio = Total Current Assets divided by Total Current Liabilities	This ratio gives insight into the ability to pay current liabilities.
Debt Percentage = Total Operating Liabilities divided by Total Operating Net Assets x 100 Or Equity (Net Asset) Percentage = Total Net Assets divided by Total Assets x 100	These two are similar. The first looks at the reasonableness of Operating debt considering total Operating assets. The ratio leaves out non-operating (e.g., Plant Assets) and non-operating liabilities (e.g., mortgages). The second ratio includes everything.

Figure 1 - Chart of Financial Indicators

The above ratios look at the financial position at a point in time. The following section looks at financial activity for time periods.

802.07 Operating Activity Ratios

The entire leadership team wants to know about the organization's financial activity. They want to know if spending makes sense considering income.[3] For example, does payroll cost make sense considering Tithe Income? Is the organization moving towards self-support? What is the amount of tithe per member? The following types of ratios provide operating activity analysis:

Ratio	Remarks
Percentage of Self-Support = Earned Income (without subsidies) divided by Total Income (including subsidies) x 100	This ratio gives the percentage that an organization is self-supporting.
Percentage of Personnel Expense to Tithe = Total Personnel Expenses divided by Tithe Income x 100	This ratio is the percentage of tithe going to Personnel expenses. The analysis can make the same calculation for all major expense categories.

Figure 2 - Operating Activity Ratios

[1] From the Working Capital and Liquidity Statement.

[2] Usually these are due from employee, students, and other organizations. These amounts are somewhat in your control.

[3] Your fellow officers, committees, and yourself

802.08 Bookstores and Publishing Ratios

For-profit entities have many valuable ratios. Here are a few that work well in similar church for-profit-like organizations such as bookstores:

Ratio	Remarks
Percentage of Net Income to Net Sales (or Total Earned Income) = Net Income divided by Net Sales (or Total Earned Income) x 100	This ratio gives the percentage of income to sales. It is the percentage of sales not spent on expenses (i.e., income) that the organization keeps.
Gross Profit Percentage = (Sales - Cost of Goods Sold) divided by Net Sales x 100	This percentage is the Sales Income kept after paying for sold items. It relates mathematically to the markup. A 100% markup produces a 50% gross profit percentage; a 50% markup is a 33% gross profit percentage.[4]
Percentage of Operating Expense to Net Sales = Total Operating Expense divided by Net Sales x 100	This is the percentage of the Sales Income paid as Operating expenses.
Inventory Turnover = Cost of Goods Sold divided by Average Inventory (i.e., Inventory Beginning + Ending divided 2)	This ratio shows if the organization is holding more Inventory than it needs. So, a turnover of three means that the organization is, in a sense, selling everything it has three times a year. Said differently, the average item stays on the shelf for four months[5].

Figure 3 - Business Ratios

802.09 Schools Ratios

There are many creative ratios for schools. Here are two examples looking at student receivables.

Ratio	Remarks
Collection Percentage = Net Collections (i.e., A/R Beginning + Student Charges - Write-offs - A/R Ending) divided by Student Charges x 100	This percentage compares your collection percentage to student charges.
Accounts Receivable Turnover = Total Credit Sales or Total Student Charges divided by Average Accounts Receivable (A/R Beginning + A/R Ending divided by 2)	This ratio shows if the accounts receivable balance is too high because the collection rate is too slow. A turnover rate of 4 means collections occur every 3 months (12 months divided by 4). A desirable collection rate is collecting receivables every 30 days (i.e., a turnover close to 12).

Figure 4 - School Ratios

[4] This assumes no shrinkage. A GP% askew from what is expected from the markup raises shrinkage concerns.
[5] This is twelve months divided by 3.

802.10 Analysis of Departments, Programs, or Functions

There are many other ratios and tools than those identified in the preceding paragraphs. You can even create your own. Search out some that are unique to your type of entity.

- Do specific departments, programs, or functions reveal more fluctuation than others?
- Are some of them using an increasing percentage of available income?
- What is the trend for administration or other supporting services?

Additional Accounting Analysis

Cost Accounting provides valuable data for analysis, cost control, and budgeting. This manual focuses on external reporting and not on Cost Accounting, which is an internal management tool. That does not mean that Cost Accounting is unimportant. The Church's accounting systems make Cost Accounting easy.

Consider the cost of an airplane ticket. Standard accounting expects you to expense it to the proper account. It is an expense in the period in which you incurred it. But:

- Who traveled?
- What department was the trip for?
- What organization did the trip serve?
- Was the trip part of a unique initiative? (e.g., Urban Evangelism)

Consider maintenance expenses. The Statement of Financial Activity (SFA) only concerns the aggregate expense. But consider the wealth of information behind that total:

- What building was maintained?
- What kind of work did the maintenance department and contractors do (e.g., electrical, painting, etc.)?

Consider knowing all the vehicle costs of a particular vehicle:

- Insurance expense
- Fuel
- Maintenance

External financial reports do not require this cost information, but cost data is critical for proper financial control. This level of detail only comes with careful accounting system design and well-thought-out journal entries. Well-thought cost information gives vital insight into the organization.

Figure 5 - Cost Accounting

This discussion hopes to prompt you to deeper analysis. The goal is for insight to guide planning and prevent financial embarrassment.

802.11 Committee Presentations

Financial leaders work hard assembling and analyzing their data. This work often leads to committee presentations or reports. Preparing such presentations, which should be more than simply presenting the financial statements, can be a daunting task. Volume 3 has some sample treasurer presentations and Volume 1 has a more detailed discussion on presentations to committees. These presentations must include analysis and trends, but these can be difficult to understand if there is too much numerical data. Use graphs and charts to simplify things. Carefully done visual aids can significantly improve clarity by including only vital information.

Section 803 - Budgets

Financial leaders need budgets to guide their day-to-day activities. They base their budgets on analyzing their financial condition, operating results, economic conditions, and plans.

Denominational policy requires budgeting:

> *Each organization shall have a mission driven, broadly based consultative financial planning and budgeting process with a committee structure that can give detailed review to the ongoing financial planning and budgeting for the organization. GCWP09.05*
>
> *All denominational organizations shall use an annual budget which is approved by the controlling board or executive committee. It shall be the responsibility of the officers of each level of organization to require organizations located within their territory to use a budget. Guidelines for preparing budgets are included in the Seventh-day Adventist Accounting Manual. GCWP.09.10*

The following policy applies specifically to General Conference operations; however, the principle it advances is universal.

> *The budget is to serve as the primary instrument of financial authorization and control for every organization. The Treasurer/Chief Financial Officer is to provide timely financial information to his/her fellow officers …, comparing actual operating results with budgeted projections. The administration is accountable to the constituency for budget implementation, taking appropriate actions to best ensure the financial stability of the organization, using the budget as a guide. GCWP S 38.20*

803.01 Types of Budgets

Operating Budgets are fundamental to financial operations. An Operating Budget has two parts:

1. It predicts income by source for the coming year[6].
2. It outlines how the organization will use the expected income in its operations.

Besides the Operating Budget, two other budgets are vital:

1. Capital Budget – This budget specifies plans for purchasing land, buildings, and equipment over the coming year or more.
2. Cash Flow Budget – This budget adjusts the Operating Budget to predict monthly cash flow. It will show the months that end with excess cash and other months when there is a cash shortfall.

Often, Organizations have project budgets that help them manage projects. Project Budgets focus on the income and expense of a single project over the project's life.

All four are essential parts of financial planning.

803.02 Operating Budget Nature

The first step in making these budgets is preparing the Operating Budget. The starting point for the Operating Budget is estimating income for the coming year. Next, this budget divides the income by planning the spending for the various programs and supporting services. The estimated revenue and excess Working Capital must fund those planned expenses. This idea is different from saying the budget must balance. Often, the organization will budget fewer expenses than their income; this planned surplus is the primary way to build Working Capital. Also, there may be excess Working Capital; this extra working capital permits budgeting more expenses than income.

803.02.01 Operating Budget - Timing

The organization needs to prepare the budget before the year in which it applies, which means the officers need it before the onset of the year. This timing means the organization must make significant effort preparing next year's budget in the last half of the previous year. This preparation includes time to analyze current finances and time to project the results for the rest

[6] This discussion focuses on annual budgets. However, it is often wise to prepare budgets for multiple years. This is especially true in organizations with working capital troubles or big projects.

of the year. It also takes time to obtain input from the other officers and directors, and it takes time to resolve the resulting trade-offs and negotiations. Finally, it takes time to get committee approval. It seems one hardly finishes with one budget before it is time to start the next. So, allow for plenty of time to prepare the budget.

803.02.02 Estimating Donor-Based Income

Budget preparation begins months before the year ends and requires the estimation of tithes and offerings for the rest of the current year. This estimate can be difficult.

It may seem simple to take this year's average monthly tithe (so far) and multiply it by twelve. This extrapolation would miss the December bump in tithe. In the USA, for instance, nearly one-third of charitable donations are made in December. A better estimate is to use the preceding twelve months as a pattern.

Example – Budget

Suppose you are working in October 20xx, preparing a budget for 20xy: make an estimate of next year's income by looking at Tithe offerings at the twelve months from October 20xw (the October of the preceding year) to September 20xx (the latest month for which you have actual numbers).

Figure 6 - Budget Example

Prudence suggests that budgeted income should not exceed the actual income for the past twelve months. If the organization's numbers are better than the estimate, budget the abundance on special initiatives or retain it to build Working Capital.

803.02.03 Estimating Student-Based Income

Schools often unrealistically expect an increase in Tuition Revenue over the previous year. They base this on expanding programs, optimistic recruiting, and inflation. Questions to ask when making the Tuition Revenue estimate include:

- How many students is it reasonable to expect to enroll?
- What will the conference and constituent churches pay for operating subsidies?
- Using these estimates, what will the tuition charge have to be?
- Will the parents and sponsors accept this charge?

This estimate calls for particular care and objectivity. Defensible assumptions must support every factor of the income estimate. If income estimates fall short, resist increasing the estimated student count. Many seasoned organizations estimate income at, say, 90% of the previous year to play it safe. This underestimate guides their employment decisions, which are at the heart of successful school budgets. Hopefully, this care will result in an Operating surplus available for Working Capital or spending on capital needs or new initiatives.

803.02.04 Estimating Sales Income

Bookstores and publishing houses have their own challenges in estimating sales income. The starting point is analyzing the trend of prior years' sales. Then, adjust the projection for economic ill-winds, customer, and product mix and other factors that might affect the sales forecast. Do this objectively; avoid understating or overstating expected sales. It is wise to use more conservative assumptions and ideally receive more income than what was budgeted. A budgeted revenue shortfall may result in budgeted expenses for which the organization cannot pay.

803.02.05 Estimating Operating Expense

The easiest way to budget expenses is by starting with the current year's expenses. Then, adjust those expenses for expected changes in circumstances.

Example – Employee-Related Expenses

For example, the organization may have hired an employee midway in the previous year. This means it might have to increase last year's total Salaries to allow for this new employee.

Consider increases required to historical salaries totals to reflect annual salary increases.

An educational subsidy may be starting or ending for an employee's child.

Figure 7 - Employee-Related Expenses

After these changes occur, make the necessary adjustments to reflect new initiatives, balancing these new initiatives against available funds. Within the limitations of available income, build the budget focusing on these defined goals and plans.

803.02.06 Wage Factor Adjustment

Setting wage factors well before the end of the year is crucial. Promptness is vital because wage factors impact many organizations. Those organizations need time to integrate changes into their budget.

803.02.07 Budgeting for Departments or Functions

The budget represents the general authority to spend. It is the expense plan for the entire organization, so it must include:

- Spending from allocated Functions.
- Donations earmarked for specific purposes
- Spending from unrestricted income
- Transfers between unallocated Functions to allocated Functions.
- Transfers between allocated Functions
- Depreciation
    - Budgeting for depreciation is essential.
    - It provides resources the organization can allocate for future asset replacement.
    - There is more about this later in this chapter (see 803.03.01)

803.02.08 – Budgeting Direct and Indirect Expenses

Budgeting and accounting for direct expenses is relatively easy. Charging basic salaries and supplies to specific departments is usually straightforward. Indirect costs apply to the whole organization. They are not controllable at the department or function level. There may not be a need to allocate these to the department or function. Allocating indirect costs may help find the actual cost of a department or function.

Example - Direct and Indirect Expenses

Consider health care expenses. Direct costing these expenses means debiting the employees' medical costs to their departments. These direct debits create issues on several fronts.

Suppose a department has an ill employee. The organization could directly charge medical costs to the department. That leaves less for the department to spend on accomplishing its mission. One seriously ill employee might wipe out the entire Operating Budget of their department. Alternatively, all the departments should share in the cost. Next year, the sick employee might belong to a different department. Besides the internal disruption, direct charges disclose private medical information to the department head. By law in some places and good sense everywhere else, the organization must minimize the number of people who know an employee's private medical information. It is hard to keep medical information confidential if the doctor and hospital bills are the source documents in direct departmental charges.

The alternative is to charge all medical costs to their own function, say, Health Care. Then, distribute all the organization's medical expenses in that function to departments as an indirect charge. For example, distribute it based on total salary costs. Alternatively, use a longer-term allocated resource, let's say, the Health Care Pool.

The organization would debit payment for the expense based on medical bills as a Medical Expense and to the Health Care Pool function (or resource). A monthly transfer debits the Department Functions and credits the Pool. Both sides of the entry would be to the Medical Expense account. Base this monthly departmental debit on a standard per-employee charge estimated by looking at the total expenses in the pool. Routinely, let's say annually, evaluate the per-employee transfer for its adequacy. This allocated pool smooths out the department's year-to-year Medical Expenses. The smoothing makes it easier for them to plan, and this process improves the confidentiality of the health care costs.

This medical cost scenario is just one example. The same principle could apply to all sorts of indirect costs (e.g., receptionist costs, depreciation, utilities, etc.)

Figure 8 - Direct and Indirect Expenses

803.02.09 Interaction and Negotiation

It is a mistake to make a budget without input from department heads. Discuss and negotiate with them throughout the budgeting process. Preparing a budget without their help increases the chance of missing something; neglecting them will undermine their planning and perpetuate the status quo. Imposing it from above hurts any chance of getting them to accept it. They will not try if they do not believe they can work within a mandated budget. Broad agreement by the management team and all others involved will minimize unpleasant crises.

803.02.10 Monthly Budgets

Income inflows and expense outflows rarely happen uniformly throughout the year.

Example – Inflows and Outflows

- U.S. charities get one-third of their donations in December.
- In Finland, almost all their utility expense occurs in the Winter.
- Youth programs spend the lion’s share of their budget in the Summer.

Figure 9 - Inflows and Outflows

Simply using 1/12 of the annual budget as the monthly budget is misleading.

Accounting systems easily give the historical amounts for each month. It is easy to convert these amounts to monthly percentages: 33% in December, 25% in June, etc. Apply these percentages to the budget to get accurate monthly distributions. Using these figures makes the budget-to-actual comparisons very meaningful. With careful distributions, when the organization exceeds the utility budget in May, it is easy to see there is a real problem. This clarity is lacking when the annual budget is calculated by dividing the annual amounts by twelve.

803.02.11 Budget Approval

The management team and the Governing Committee must approve the budget. Without this approval, the budget preparation alone does not authorize the financial activity.

803.03 The Capital Budget

The Capital Budget is the plan for purchasing land, buildings, and equipment. Usually, the organization gets approval for this and the Operating Budget simultaneously. This simple listing of planned purchases is straightforward; however, funded depreciation can be a confusing part of the decision.

803.03.01 Funding Depreciation

The Operating Budget is a plan for using the estimated income. Usually, income increases Working Capital (e.g., increases in cash inflows and receivables). Primarily, expenses decrease Working Capital (e.g., increases in cash outflows and payables). Depreciation is the exception to this.

Depreciation does not use Working Capital, so following an Operating Budget increases Working Capital by the depreciation amount. Funding depreciation is moving this retained Working Capital to a bank or investment account. There is a corresponding entry to allocate the net assets to this purpose.

> *Example – Budget*
>
> Consider a budget of 1,000,000 in planned Income and 1,000,000 in planned expenses. This expense budget includes 50,000 in planned depreciation. Surprisingly, by following this budget, the Working Capital will increase by 50,000.
>
> This increase is the 50,000 depreciation expense. Depreciation does not use Working Capital like the other expenses do.

Figure 10 - Budget Example

Depreciation appears to produce Working Capital. The organization partitions off this retained Working Capital by putting it into a separate bank or investment account and allocating the net asset amount. Accounting jargon calls this process of budgeting for Depreciation and setting it aside for the future, “Funding Depreciation”.

It is tempting to think it is okay not to budget for Depreciation since it does not use Working Capital. A better alternative is to treat depreciation as a cash expense and “pay” for the expense by sequestering the cash of the amount of depreciation its own account. This budgeting and accounting device is a way to save for upcoming Capital needs.

The Capital Budget includes the plans for spending from these savings. Thus, the Operating Budget provides for funding depreciation, and the Capital Budget provides for spending it. Do not get the idea that the two amounts are equal. This described plan hopes the funded amount grows as more is set aside than spent. That way the organization has the funds available to replace major assets as needed.

803.04 The Cash Flow Budget

A Cash Flow Budget is a monthly plan of cash receipts and payments. Its primary purpose is to see if the organization has enough cash to pay its expenses and liabilities.

803.04.01 Cash Flow Budget

The Cash Flow Budget begins by showing the organization's cash at the first of the month and then adds that month's estimated receipts. The total is what is available to spend that month. If it is enough to cover payments, all is good. If not, one must change spending plans or raise the alarm. Early predictions that the organization will run out of cash provide time to adjust. There is then time to cut or shift expenses, delay capital purchases, or borrow money. Having that kind of foresight is the mark of a competent financial leader.

The first step in making a Cash Flow Budget is the most challenging. It starts with the monthly Operating Budget. It shows the budgeted income and expenses for each month. The budget then divides the income and expenses of the annual budget into months. Earlier, this chapter discussed the need for the realistic spreading of the budget over the months. This realistic spreading is vital for preparing the Cash Flow Budget. Simply dividing the budget by twelve will make for an inadequate Cash Flow Budget.

The Operating Budget focuses on accounting for income and expenses. Because of accrual accounting (discussed in Chapter 2, section 201.04), accounting income is not the same as cash receipts.

Example - Income

For instance, it is correct to record tuition as income over the semester, but the cash receipt from tuition might come early in the semester.

Cash from tithe may come a month after the Treasury records the tithe as income.

Figure 11 - Income Examples

Something similar occurs with expenses.

Example – Expenses

For instance, the recording of rent expenses occurs when the building is used, not when the payment is made.

Figure 52 - Expenses

The Cash Flow Budget comes together a month at a time.

1. First, adjust the monthly Income Budget to reflect plans to collect the cash.

2. Next, remove from the month's income amounts which will be collected in subsequent months.

3. Then, add income cash items carried forward from previous months.

4. Next, go through the same process with expenses.
   a. Remove the expense items the organization will not be paid that month and add them to the month when they will be paid.

These steps estimate cash Inflow from the income on the Operational Budget and estimate cash outflows from its planned spending. Offsetting the two is the monthly net cash flows from the Operations Budget.

5. Subtract planned Capital purchases for the month.

6. Subtract increases in employee receivables.

7. Deduct any debt repayments that are required.

The result is the net cash inflows or outflows for the month.

8. Adding the beginning cash gives the estimate of the ending cash.[7]

At first, this process seems challenging. Over time, there is clarity about the needed adjustments. Early Cash Budgets may be off. The creation process is, itself, valuable. It gives a more precise idea of how to think about the relationship between accounting numbers and cash flows. Over time, accuracy will improve. As accuracy improves, the organization's preparedness for difficult times improves.

A template for preparing a cash budget is provided in Volume 3 of this *Manual*.

[7]This calculation is like what is happening in the Cash Flow Statement. One way to look at it is the cash flow budget is budgeting the Cash Flow Statement in the same way the operations budget budgeted the Statement of Financial Activity.

Section 804 - Monitoring Budget and Actual Results

It is not enough to develop a Budget; the organization must continue to analyze the budget data. Leadership should closely review these budget comparisons. They are vital checkpoints for managing operations.

804.01 Monthly Budget Comparison Statements

Policy (GCWP S 19 10) requires Treasury to give the Governing Committee monthly Statements of Financial Activity (SFA), stipulating that these must have budget comparisons. The Committee should carefully study these reports, and its Minutes should record the receipt of the Statements and Budget comparisons. These comparisons are optional for the annual audited statements. This *Manual's* sample Financial Statements illustrate these comparisons (see Volume 3).

804.02 Corrections and Adjustments

When a close review reveals unfavorable budget variations, the organizational leadership should take prompt corrective action. It is incorrect to think that budget variations are inevitable and unmanageable. Be prepared to make any needed mid-course changes to continue to work within the plan.

804.03 Budget Revisions

Changing circumstances may require revisions to the budget. All revisions must go through a similar process as the original budget preparation. The Governing Committee must approve the changes.

804.04 Internal Budget Compliance

While staying within the budget for overall expenses is essential, but the individual budget items matter.

Example – Unfilled Employment Positions

Suppose there are several unfilled employment positions. Thus, salary expense is lower than budgeted salaries. This surplus does not automatically mean more is available to spend on travel.

The Committee's authorization includes the details as well. The Committee should approve any significant realignment.

Figure 13 - Unfilled Employment Positions

Section 805 - Statistical Form F49

The Church uses Form F49 to gather financial data. The General Conference gathers and analyses the data for similar organizations. It compiles data from it for its statistical reports.

One copy of the audited financial statement of each denominational organization shall be sent by General Conference Auditing Service (or the chief operating officer, in cases of organizations audited by other than the General Conference Auditing Service) to the General Conference Office of Archives, Statistics, and Research as outlined below. This statement shall include all supporting schedules and signed auditor's opinions and shall be accompanied by a summary on Form F-49 no later than one month after the audit report has been released GCWP S 19 25

The organization can get a copy of the statistical summaries. They may be a source of valuable comparisons. The same policy requires the organization to submit a copy of its audited financial statements with it.

Section 806 - Compensation Review Committee

GCWP S 34 10 requires a Compensation Review Committee to be a sub-committee of the organization's Governing Committee. The policy describes its purpose, composition, and terms of reference. This *Manual* does not replicate the policy here but summarizes the required reports.

Notably, the policy calls for:

- A list of compensation and allowances/benefits paid to all officers and board-appointed personnel.

- A list of all employee accounts/notes receivable balances that exceed one month of their salary.
- A list of all travel advances outstanding for more than three months.
- A list of travel expenses compared to the approved budget for each traveling staff.
- A list of these items for officers of subsidiary mission organizations.

Financial leaders must understand the policy well. This *Manual* lists these requirements to spotlight the need to prepare these reports.

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Chapter 9
Cash and Cash Equivalents

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Chapter 9
Cash and Cash Equivalents

This chapter begins by defining cash and cash equivalents. It discusses cash that falls into categories other than operating. It reviews cash accounts and denominational policy and discusses cash management.

Section 901 - Cash and Cash Equivalents

901.01 Definition of Cash and Cash Equivalents (CCE)

People often think of “Cash” as meaning currency. Accounting jargon includes much more in the term. Surprisingly to some people, “Cash” also includes checking and saving accounts. It also includes anything someone can deposit into a bank account, such as someone else’s check made payable to us that we have not yet deposited.

901.02 Cash Equivalents

CCE includes certain short-term, highly liquid investments. Accounting standards refer to these near-cash investments as Cash Equivalents. The organization can easily convert them to cash, so the accounting rules treat them as cash. The standards specify which investments are cash equivalents and which are not. Here are the rules:

To be a cash equivalent, the investment must meet three conditions:

- At purchase time, the investment’s maximum remaining lifespan must be less than three months.
  - The investment determines this – not the purchasing individual’s intention or policy.
  - Suppose you buy a ten-year bond that matures in two months. This bond would be a cash equivalent.
  - In contrast, consider a two-year Treasury Note bought two years ago. It is never a cash equivalent, even within one day of maturing because its life is longer than three months and it was not purchased three months or less before maturity.
- Further, the rules require the investment to be readily saleable.

  - There cannot be uncertainty about getting your money when the investment matures.
- The investment must have a known maturity value. The purchaser must know the value at maturity.
  - Minor possible price fluctuations are okay.

901.02.01 Cash and Cash Equivalents Accounting Options

Consider accounts that you could treat as CCE. The rules do not require the organization to treat them as CCE. Instead, it can treat them as Investments. An excellent example of when this is important is money market accounts. Often, investment brokerage statements have money market accounts temporarily holding dividends and other amounts waiting for investment decisions. Even though an organization usually shows a money market account as CCE, it can also show it as an investment. This decision includes these requirements:

- The Committee should set a policy deciding how to show these Investments.
- The financial statements must show this investment policy as an Accounting Policy Footnote.
- The organization must follow the same policy consistently from year to year.
- The organization may make a formal change in policy. If so, they must restate their financial statement's comparable years to reflect the newly adopted policy.

901.03 Cash as a Current Asset

Chapter 6 (Section 602.02) defined current assets. A current asset is an asset that is available to fund current operations. There are two conditions in the definition:

1. First, for an asset to be available for current operations, the asset must be convertible to cash within the operating cycle, usually defined as twelve months.
   a. Since it is already cash, it easily satisfies this constraint.

2. For an asset to be a current asset, it must be usable for current operations.
   a. Accountants often overlook this condition.
   b. This manual defines "operations" as the organization's routine business cycle. For denominational organizations, the routine business cycle is twelve months.
   c. It expressly excludes sales and purchases of Land, Buildings, and Equipment from the definition.

Example – Building Fund

For instance, a bank account holds donations to a building fund.

That money is not available for operations, so that cash is not a current asset.

Figure 1 - Building Fund

Example – Triennial Pastor's Conference Fund

A bank account holds money for a triennial pastor's conference.

The pastor's conference is part of operations. Thus, it meets that hurdle. But if the conference is years away, the money is not for current operations. It is not a current asset.

Figure 2 - Triennial Pastor's Conference Fund

The organization must show these non-current cash accounts as non-current investments.

901.04 Agency Cash

Agency Cash is cash held on behalf of others. Conference-held tithes and offerings belonging to the union are familiar examples. Global Mission funding passing through a union headed to a mission is another. These pass-throughs to someone else are debts in the agency liability accounts. Agency Cash is the cash to service these liabilities.

Specifically, this happens when making the Statement of Financial Position (SFP).

Example – Agency Liability

Suppose the general ledger bank account shows a balance of 100,000 and that agency liabilities are 40,000.

The SFP shows the 100,000 cash in two places:

- Cash and Cash Equivalents is 60,000
- Agency Cash is 40,000

Figure 3 - Agency Liability

What if the agency liabilities are greater than cash? This shortfall means the organization has used money it was holding for others. (Cash held for others would include tithe and offerings due to a higher organization or Global Mission Funds due to a field.)

Example – Agency Liability 2

Reconsider the above example, where the bank balance is 100,000. This time suppose agency liabilities are 120,000.

Since there is only 100,000, the organization has spent 20,000 of cash "belonging" to others.

In this case, the organization would show all its cash, 100,000 as agency cash. There would be zero (0) Cash and Cash Equivalents – since all the cash they are holding belongs to another.

The organization would not show 120,000 agency cash and a negative CCE of 20,000.

Figure 4 - Agency Liability 2

Section 902 - Cash for Other Than Operating

So far, this chapter has focused on the Cash and Cash Equivalents (CCE) line in the Statement of Financial Position (SFP). That is the current asset in the Operating Fund. There are many other cash accounts that are not CCEs. The rest of this chapter deals with all cash, whether the statements show the cash as a CCE or not.

Each fund that holds cash will have ledger accounts within that fund for those accounts, even though the organization may use a single bank account with two or more funds.

It is important to note that the cash internal control activities (see Section 907) apply to all cash. Internal control requires the same authorization and documentation for all bank accounts, whether CCEs or not.

Consider cash held in non-operating funds.

Example – Cash and Plant Fund

Consider the cash that donors or the Board designate for Plant purposes.

The Plant Fund should show this cash as an investment. However, this does not mean that the cash is in a separate bank account. The Funds can share the same bank account with the accounting partitioning each Fund's transactions and balances. This would track the portion of the bank account that belongs as an operating fund cash account and the portion that belongs as a plant fund investment account.

Figure 5 - Cash and Plant Fund

902.01 Crypto Currency

Crypto currencies are digital “crypto assets” based on blockchain encryption technology. Their designers intend them to be a broad medium of exchange. Cryptocurrencies must realize this aspiration before they can be a cash and cash equivalent.

Some countries recognize crypto currency as lawful currency, and if they became a widespread payment method, they would be legitimate CCE. At the time of this writing, however, this manual does not recognize any crypto currency as meeting that threshold. So, for now, account for crypto currency as an Intangible Asset at the lower of its purchase price or its fair market value.

902.02 Nonconventional Banking

Nonconventional accounts may meet the definition of cash and cash equivalents. An example would be a PayPal® account. The unique nature of nonconventional banking accounts does not mean accounting standards disqualify the SFP from showing them as cash and cash equivalents. It is necessary to evaluate nonconventional accounts as to:

- Whether they are available to operations (see Section 901.03.[1])
- Their usefulness as a medium of exchange.
    - Are these accounts widely helpful in collecting and making payments?
- Whether they are liquid
    - Can you readily convert their balances to other types of cash?
- Can you reliably find their value compared to other forms of cash?

Section 907 discusses internal control in the context of cash. Vigorously apply the same internal control practices and policies used with conventional bank accounts to these nonconventional accounts. Their unconventional nature demands more internal control, not less.

902.03 Bank Fees and Income

Banks and nonconventional accounts often record transactions net of a service fee. (Also see a discussion of this topic in Chapter 16, Section 1601.07.)

[1] Even cash sitting in a safe is not a CCE if it is not available for operations. It does no good to reason an unusual account or even a cryptocurrency is as good as cash. It must also be available for operations to be a CCE. Its availability to operations should be the first consideration.

Example – Bank Fees

For example, banks often take a small percentage for processing credit and debit card deposits.

Suppose a donor uses a debit card to pay 1,000 tithe to the church bank account. The bank credits the bank account for 997. It is holding back 3 as its service charge.

The accounting for this transaction must credit tithe for 1,000 and debit 3 to bank service charge expense.

It is incorrect to simply record the 997 as tithe income.

Figure 6 - Bank Service Fees

902.04 Online Tithe and Offerings Collection

Many countries have moved to almost cashless economies, so the Church is adapting by constructing cashless methods of collecting tithes and offerings. (See also Chapter 16, Section 1601.07 for a discussion of this topic.) These systems must have a way for members to specify if the donation is tithe or offering. The Church's policies regarding tithe and its use are outlined in GCWP V 20, and discussed in Chapter 20. Accordingly, an organization must consider any contribution as tithe unless the donor has said it was an offering.

Section 903 - Cash Accounts, Authorization, and Denominational Policy

Model constitutions and bylaws, denominational policy, and this manual stipulate that the Governing Committee must:

- Authorize the opening or closing of all bank and savings accounts. This requirement applies to both permanent and temporary accounts.
- Approve those authorized at the bank to sign checks or transact business with the bank. Keeping the authorized signatories current is crucial. These must reflect changes in work assignments and employee departures.

Committee Minutes should specify the following:

- Effective date
- Bank
- Account name
- The committee action taken.

Section 904 - Cash Overdrafts as a Liability

Organizations sometimes write checks and/or prepare online authorizations for more than they have as a balance in the bank. This overdraft condition may or may not be egregious. That depends on bank policy and the balances in the organization's other accounts.

When a bank account has a credit balance, the Statement of Financial Activity shows it as a current liability, Bank Overdrafts.

There is an important and common exception to this general rule. If the account with the credit balance has the right to offset its shortfall from another cash account,[2] the SFA treats all the accounts the bank can offset as one account.

[2] This is the typical arrangement when an organization has multiple accounts at the same bank.

Example 1

Suppose Conference A had these accounts and balances.:

First National Bank Operating	100,000
First National Bank Reserves	-30,000
Second National Bank	70,000

The First National Bank has the right to offset balances from one account to another. The SFP's Cash and Cash Equivalents would be 140,000.

Example 2

Suppose Conference A had these accounts and balances.:

First National Bank Operating	100,000
First National Bank Reserves	30,000
Second National Bank	-30,000

The First National Bank has the right to offset balances from one of its accounts to another, but the Second National Bank had no access to the First National Bank accounts. The SFP's Cash and Cash Equivalents would be 130,000, and there would be a Bank Overdraft Liability of 30,000.

Example 3

Suppose Conference A had these accounts and balances.:

First National Bank Operating	100,000
First National Bank Reserves	-130,000
Second National Bank	70,000

The First National Bank has the right to offset balances from one of its accounts to another, but the Second National Bank had no access to the First National Bank accounts, and vice versa. The SFP's Cash and Cash Equivalents would be 70,000, and there would be a Bank Overdraft Liability of 30,000.

Figure 7 – Overdrawn Bank Accounts

Section 905 - Cash Receipt and Payment Cutoff

It is essential to show a factual Cash and Cash Equivalents (CCE) amount on the Statement of Financial Position (SFP). This balance is the total of the receipts minus the payments up to the

SFP date. Continuing to record receipts from the following month overstates the CCE amount. Contrarywise, recording payments after the month's end understates the correct CCE amount.

Sometimes, this is a careless mistake.

Example – Accounting Software Default Period

Take, for example, the accounting software's default period.

Perhaps in early July, the system is still set to June to accommodate an accountant finishing recording legitimate June transactions.

Meanwhile, another accountant may not change the period to July to record a July receipt, or they may make an early July payment run using the June default.

A novice accountant may wrongly consider paying June's bills in July as a part of June's transactions.

Figure 7 - Accounting Software Default Period

On the other hand, there is deception when leaving the cash receipt process open after the month-end on purpose. This is intentionally overstating cash. This dishonesty also overstates income or understates receivables.

One improper practice is preparing and recording checks but holding them until the cash is sufficient to cover them. This causes the statements to misrepresent cash and accounts payable. The organization should record the unpaid bills as payables and not record them as paid until they have mailed the payments.

The Chief Accountant must ensure a clean month-end cash receipts and payments cutoff. This calls for staff training and considering this concept when reviewing transactions early in the month.

Section 906 - Cash Management

906.01 Cash Status Report

The CFO and other officers must carefully watch their cash balance. Looking at the bank balance on the bank's website can be misleading. That balance does not capture transactions in transit, such as outstanding checks and unprocessed standing payments. Instead, the accounting system should be able to quickly and accurately produce a Cash Status Report that reflects these outstanding transactions.

This Cash Status Report requires the organization to keep the accounting records as current as possible. That way, the Cash Report and bank balances are meaningful. The treasurer should not have to guess what accountants have or have not recorded. At a minimum, the CFO should get an accurate weekly Cash Report.

This Cash Report should show:

- the beginning balance of cash from the previous report
- a summary of cash received and deposited,
- a summary of disbursements (including an itemization of significant items),
- resulting in a new bank balance.

The report should present this information for each bank account – including inactive accounts, savings accounts, and other cash items.

906.02 Cash Cycles

CFOs are well acquainted with the cyclical nature of their cash flow. Organizations have a sequence of high and low cash balances that repeat year after year. Besides this annual cycle, there are also cycles within a month. CFOs can understand these patterns if they chart their weekly Cash Status Reports. Understanding these cycles will help the CFO avoid embarrassing mistakes.

906.03 Utilization of Funds

Analysis of the cash-flow cycle can help the CFO make the best use of their available cash. Cash itself is an unproductive asset. Large cash balances show poor planning and stewardship and are a lost opportunity for advancing the Church’s mission or maximizing income.

Section 907 - Cash and Internal Control

An internal control system ensures correct financial information and protects the organization’s assets. Both goals are vitally important in the cash context. Recall from the internal control chapter (Chapter 3, Section 307) that the internal control system consists of five vital components.

Here they are as a reminder:

1. Control Environment
2. Risk Assessment
3. Control Activities
4. Information and Communication

5. Monitoring

The Governing Committee must ensure these five elements are active in the organization's receipting, payments, and other cash processes. The accompanying internal checklist gives detailed information on the five components for the three processes. The following section illustrates the five components in the cash payments process.

907.01 Control Environment and Cash Payments

This control environment component focuses on the bigger picture of cash payments. For example, it focuses on ensuring top leaders always respect the payment authorization process.

> ***Example – Breakdown in Control Environment***
>
> An example of a breakdown in the control environment would be a president that can bypass the system's checks and balances in his eagerness to get a payment made.
>
> Another example would be hiring unqualified accountants to manage cash payments or assigning accountants who make cash payments to also do bank reconciliations.

Figure 8 - Breakdown in Control Environment

907.02 Risk Assessment and Cash Payments

A cash payment risk assessment is an intentional and documented review of the cash payment process. This review looks at such things as threats to the proper authorization and accuracy of the payments. Chapter 3 - Internal Control Foundations thoroughly discussed the concept that accounting accuracy and protecting employees from false accusations and undue temptation may be more critical than preventing theft. The risk assessment of cash payments should also focus on these broader threats (See Chapter 3, Section 309).

The threat assessment must focus broadly on the payment's control environment and minutely on the details of the payment process. Study each step in the cash payment process and find its related threats to the accuracy of the record-keeping, the accountant's integrity, or the cash itself.

For example, consider the simple step of entering an invoice into the system. It sparks these sorts of risks:

- How easy is it for someone to access payment-related passwords or documents?
- How easy is it for the accountant to record the payment to the wrong account?
- How easy is it for the accountant to enter a payment twice?

- How easy is it to make an unauthorized payment?
- How easy is it to make a payment to a fake supplier?

Notice that only the last one was about preventing someone from intentionally stealing from the organization. Focusing on protecting record accuracy and the accountant's integrity is a positive approach to risk assessment. That focus will, by default, also protect against intentional theft.

907.03 Control Activities and Cash Payments

After finding the control threats, the next step is to address them by implementing control activities. There are many cash control activities available. Some are necessary for everyone's cash payment processes, and others are necessary only in particular circumstances.

Here are some examples:

- **Mathematical Accuracy** – Who checks invoices for mathematical accuracy?
- **Separation of Duties** – Is the person authorizing the payment different from the person making the payment?
- **Authorization** –All payments should be properly authorized.
  - Who does the system allow to authorize payments?
  - Does the organization prohibit pre-signing checks?
  - Does someone specifically review the account classification?
  - Does the organization properly authorize standing payment drafts?
- **Documentation**
  - Does someone mark the supporting documents as paid to prevent reuse and confusion?
  - Does the documentation clearly show the authorization for the transaction?
  - Does the office preserve voided checks to show that no one used them for nefarious purposes?
- **Review** – are payments reviewed to ensure proper authorization, the accuracy of the payee, and the account classification?

These are just examples. The accompanying checklist is more thorough.

907.04 Information/Communication of Cash Payments Internal Control Process

It is essential to document and broadly communicate the organization's risk assessment process and the resulting control activities it has put into place. This may be done by preparing detailed Minutes of risk assessment activities.

Another good method of information and communication is preparing and distributing a detailed office procedure manual. These specify who does what and when they do it. The format is flexible but can include flowcharts, process narratives, and task descriptions. Leadership should keep this document up-to-date and ensure accounting staff and auditors study it.

907.05 Monitoring the Cash Payments Process

After the organization puts the internal control system into operation, it must monitor to ensure the staff follows the outlined system. Monitoring includes an intentional assessment of whether the control activities do what the design meant for them to achieve regarding the threats found in the risk assessment. As with everything in the accounting office, it is essential to document the monitoring process.

This section has been an overview of the internal control system in the cash payments context. The internal control checklists in Volume 3 give examples of the five internal control components in Cash Payments, Cash Receipts, and Cash Holding activities.

Section 908 – Bank Reconciliations

Bank reconciliations are important control activities. (See Chapter 3, Section 301.01.03).

Carefully select the person who will prepare the bank reconciliations. To preserve their usefulness as a control activity, the preparer should not be someone who records receipts, makes bank deposits, or makes payments. Someone outside the cash payments and receipts functions, such as a payroll accountant, often does reconciliations. Sometimes, the treasurer assigns them to an entry-level accountant or outsources them to a qualified retiree. No matter who does it, a qualified accountant must review them.

Whoever does the reconciliation must be aware of its control function. Reconciliations include comparing the payees in the bank to those in the accounting records.

Example – Bank Reconciliations

For instance, there is a payment on the bank statement and in the accounting records for 183.76.

Just checking that the two numbers match and “reconcile” might miss the fact that the transaction in the accounting records shows a payment to the contract cleaner (the correct payee), whereas the actual payee on the check is the accountant’ wife.

Figure 9 - Bank Reconciliations

Internal control is about ensuring the accuracy of the accounting records. Most accounting activities ultimately touch the cash account, so carefully reconciling a bank account may also reveal errors in non-cash parts of the accounting system. Finally, make sure to record the entries needed to correct the errors discovered by the reconciliation. Failure to do this is the number one mistake made with bank reconciliations. It does no good to do a reconciliation without working on the problems they reveal.

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Investments

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Chapter 10
Investments

This chapter discusses the resources that produce investment income for the organization. It covers the GC Working Policy discussion of investment strategies, reviews investment valuation, impairment, and income.

Section 1001 – Resources Producing Investment Income

Most organizations have resources they do not need immediately but want to have available when needed. They may also want to hold certain resources for producing Investment Income. Common examples of these Investments include financial instruments and real estate. Financial instruments include such things as:

- medium and long-term time deposits at banks,
- debt securities issued by financial institutions, corporations, and government entities,
- equity securities issued by corporations,
- mutual funds that invest in debt and equity securities, including index funds
- shares in exchange-traded funds (ETFs)

Chapter 9 - Cash and Cash Equivalents thoroughly discusses cash equivalents. Cash equivalents are often so cash-like that the Statement of Financial Position (SFP) shows them as cash rather than investments. This chapter does not cover them again.

1001.01 Investment Strategy and Accounting

GC Working Policy (GCWP S 85) gives a detailed discussion of the investment strategies available to Adventist organizations. Church financial leaders should thoroughly understand those policies. To avoid confusion, this chapter will not rehash and interpret those policies; instead, it focuses on investment accounting. However, your investment strategy strongly influences your accounting. For instance, the Policy says, “Assets for investment at all organizational levels must be divided into three classes.” It then describes the nature of each “class” and stipulates the type of investments proper for that class. The first of these classes is:

> *“1. Short-Term Funds—Those funds not needed to cover immediate expenses but that may be needed during the next twelve months to support operating activities or projects that are anticipated to commence during that period.*

> *Short-term funds are to be invested to maximize current income with an emphasis on security of principal and liquidity." (GCWP S 85 30)*

Notice the similarities between the Policy and the accounting classification for short-term assets (See Chapter 6, Section 602.02). Both include twelve months and the availability of the resources for operations.

The other two classes mentioned in the Policy are intermediate- and long-term funds. These classes hold resources needed beyond twelve months and include funds held for buildings. The financial statements report both classes as noncurrent assets. It would be inconsistent for the Investment Committee to consider certain Investments as intermediate-term or long-term and the statements to treat them as short-term.

1001.01.01 Current and Noncurrent Classifications

Correctly classifying investments as current or noncurrent can challenge the best accountant. Management intent and donor restrictions are significant considerations in this decision.

To be current, an investment must be:

- Available to current operations.
  - This constraint means that Investments earmarked[1] for property plant and equipment are always noncurrent.
  - Investments to be used for repaying noncurrent debt are always noncurrent.
  - Investments earmarked for pensions are noncurrent since they are not available to operations.[2]
- Available for operations within the next twelve months[3].
  - This constraint means Investments set aside for allocated resources are noncurrent if the organization will not use them for their assigned purpose in the next twelve months.
    - A typical example is allocations for constituency sessions occurring beyond the twelve-month horizon.
    - Or allocated resources for plant purposes (a non-operating purpose) even if the organization will spend them within twelve months.

[1] This earmarking can happen by executive committee allocations or donor restrictions to a non-operating purpose.
[2] That is, except for the small amount needed for current pension expenses.
[3] Specifically, the period can be longer if the operating cycle is longer than twelve months. The operating cycle is the time it takes to receive inventory, sell it, and collect the cash from the receivable. An operating cycle of greater than twelve months is unlikely in denominational entities, but conceivable.

Keep in mind that using the investment's maturity date to decide if the investment is current can be confusing:

- If there is a market for a financial instrument, it can be classified as current, even if its maturity date is years in the future if the intent is to use the investment within the next twelve months for current operations.

Example – Five-Year Bond Maturity Date For example, the organization can invest in a five-year bond with plans to sell it whenever operations need the cash. The five-year maturity date is irrelevant to the classification decision. The Investment line on the Financial Statement will show the bond's fair value, and it can sell the investment whenever it wishes. If proceeds from the sale of the bond will be available for operations, the investment can be current.

Figure 1 - Five-Year Bond Maturity Date

Section 1002 - Investment Valuation

The asset section of the Statement of Financial Position (SFP) shows the total value of the Investments, and the Statement's Notes show the details. As far as valuation is concerned, there are basically two valuation investment classifications. At the SFP date[4], decide the classification to which investments belong, based on the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial asset, then use the guidance for that valuation type to determine the valuation method to use in the related accounting entries. The two valuation classifications, as well as a description of how to value the investments in that classification, are:

- Amortised Cost
- Fair Value

1002.01 Amortised Cost

The amortised cost classification is prevalent in denominational organizations. This category is financial assets held within a business model with the objective to collect contractual cash flows that are solely payments of principal and interest. These financial assets are typically loans

[4] Often, this is the end of the accounting year.

receivable. If the loans receivable are also available for sale, the amortised cost classification is not appropriate for them.

1002.02 Loans Receivable

Loans Receivable are loans made without plans to sell them. Church organizations often make these types of loans to other organizations.

The model financial statements in this manual show these amounts separate from the organization's other investments. Show these amounts at amortized cost. Chapter 11 – Accounts and Loans Receivable - explains how to account for these loans.

1002.03 Fair Value

The fair value classification consists of investments that do not fit into the amortised cost classification. This classification is for most investments in debt or equity securities. IFRS 9 further divides this classification between adjustments to fair value that go through profit and loss, and those that go through other comprehensive income. Since the denomination does not believe the "other comprehensive income" section outlined in IFRS standards is applicable to not-for profit entities, it does not utilize that option.

The SFP shows these investments at fair value if a market price is available or if it can be estimated. The original cost of the security is not changed, but instead a valuation account is used to adjust the value of the security by adding to or subtracting from the original cost to yield a net value which equals the fair value of the security.

Section 1002.04 - Allocated Net Assets

The organization must keep a net asset allocation equal to any net debit balance in the investment valuation account(s). This reserve for unrealized investment gains sets aside a reserve for future declines in value. It might be necessary to have several of these allocated reserves to help with a fair distribution of the earnings when the investments are sold.

Section 1003 - Investment Income

Investment income includes realized income, such as interest and dividend income, and unrealized income from investment gains and losses. The Statement of Financial Activity (SFA) shows this income on a revenue line: Investment Income (Losses).

Occasionally, the losses overwhelm the gains and realized income, and there is a net investment loss. The SFA shows this net loss as a negative figure on the identical revenue line. Placing net investment income and losses on the same line each year allows easy year-to-year comparisons of investment results.

The SFA showing investment income and losses on one line is sufficient, but the financial statements can use its Notes to show investment income detail. Section 1005 looks at the Statement Notes.

1004 Investment Real Estate

At the basic level, investments in real estate are recorded like other investments.

First, decide if the real estate asset is a genuine investment or if the asset belongs to Plant, Property, and Equipment (PPE). Real estate assets held to conduct the organization's mission belong in PPE. To be PPE, an organization does not need to be using it for its mission. On the other hand, investment property is only held to earn rental revenue or capital appreciation or both.

Example– Investment in Real Estate

Suppose a Union owns an apartment building. They are holding the building so they can use it for staff housing if they need it. It can be PPE even if no staff are currently using the apartments or if the Union is unlikely to rent all the apartments to only staff.

Another example would be a university that receives a house in a legacy from a graduate. It is quite a distance from the university, and it is unlikely to use the house for staff housing, student housing, or other operating purposes. The university rents out the house at the market rental rate. It is investment property.

Figure 2 – Investment in Real Estate

After deciding that the asset is properly classified as an investment, use the cost model to measure the property following initial recognition. Although IAS 40 provides two options for accounting for investment property after initial recognition – the fair value model and the cost model, the denomination has chosen the cost model as the only acceptable method for measuring the property after initial recognition.

Do not show real estate investments as PPE. Instead, show the real estate investments separately from PPE.

Show investment property at depreciated cost – the same as the valuation of assets in PPE, even though the real estate is an investment, not PPE. The expense side of the depreciation entry is part of the investment property gain or loss, not a PPE expense. Do not revalue the real estate to the fair value at the end of each year.

For an asset to be current, it must have a ready market and planned to be sold within the next twelve months. Accordingly, investment property are not typically current assets.

Section 1004.01 - Investment Impairment

For all investments, accounting standards require recording and reporting any impairment to the investment's value.

Example – Leased Building

For example, suppose the organization owns a share of a building leased to another organization as an investment. For contractual reasons, it will hold this building into the future without considering other economic influences. It is proper to consider this asset investment property.

Usually, these investments are reported at depreciated cost, while ignoring the building's fair value. There are, however, factors that hurt the investment's value (say, an earthquake or any other significant decline in value) that it cannot ignore.

Figure 3 - Leased Building

This requirement applies even when using amortised cost for financial assets or the cost model for investment property which do not require fair value revaluations. For example, organizations which do not carry investments at their market value, must still reflect any significant impairments to these investments' value in their Statement of Financial Position. This may call for a write-down of their values to reflect the impairments.[5]

[5] This is a credit to the investment asset and a debit to Investment Loss.

1005 Financial Statement Notes

After determining the fair value, regroup the investments into various portfolios. The financial statement notes will summarize the investments by type of investment instrument. The portfolio grouping helps financial statement readers understand the types of investments and how much the organization has invested in each category.

Here are some examples of investment types:

- Mutual Funds
- Exchange-traded Funds
- Large-cap Corporate Stock
- Small-cap Corporate Stock
- Emerging Markets Corporate Stock
- Government Bonds
- Corporate Bonds
- Real Estate

Further, the notes can subdivide the groups to show instruments from within and outside the organization's country.

Portfolio grouping depends on the organization. If there are only one or two disclosure groups (e.g., corporate stock), search for ways to show the information for reasonable subgroups (e.g., small-cap, large-cap, emerging markets, etc.). The opposite is also true. If there are too many groups, search for ways to combine them. Too few groups may not clarify the investment risks, and too many groups may confuse statement readers.

For each disclosure portfolio, Financial Statement Notes should show:

- Descriptive name (i.e., emerging markets)
- Valuation method (e.g., fair value, amortized cost, etc.)
- Group's total cost
- Unrealized gains and losses on those investments
- Carrying value (For those held at FV, this is the combination of the cost account and the valuation account.)
- Realized investment income (i.e., interest income and dividends)
- Unrealized investment gains and losses for this period
- Total investment income (this is the total of the previous two items)

Report only the totals for each portfolio grouping; do not report the individual Investments in the group.

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Chapter 11

Accounts and Loans Receivable

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Chapter 11
Accounts and Loans Receivable

This chapter describes how to account for the distinct types of receivables that Church organizations hold. This discussion includes the rules about the amounts the Statement of Financial Position shows as receivables and their disclosures.

Section 1101 - Receivables

Church organizations handle many receivables. Some large Adventist schools have over 10,000 student receivables accounts and thousands of employee accounts. Receivables dominate inter-organizational transactions, tracking local church remittances, and employee accounting. They are also in unexpected places, such as donor accounting and rental deposits.

1101.01 Current or Noncurrent

Generally, the classification of receivables as to current or noncurrent depends on whether they will be collected in the next twelve months. If collectable in this period, they are current assets. However, beware! The focus on the collectability of the receivable overlooks whether the receivable relates to current period operations or not. If not, it is noncurrent – no matter how collectible.

> ***Example – Conference's Appropriation Receivable***
>
> For example, a conference's receivable recording of an appropriation receivable from the union would be current if the appropriation were for operations, but it is noncurrent if it is a receivable for a capital appropriation, such as earmarked for a new conference office.

Figure 1 - Conference's Appropriation Receivable

The decision of whether a receivable is current can hinge on the organizational leadership's intentions and abilities. A receivable is noncurrent if, in a financial pinch, an organization's administration would not or could not press for its collection.

Example – Union Bridge Loan

Suppose a union advances a bridge loan to a conference to allow the conference to buy a new building prior to selling the one it is currently using. The creditor Union's management does not plan to try to collect the loan until after the conference sells the old building, and it is unknown when that will occur.

The receivable is noncurrent.

Figure 2 - Union Bridge Loan

The debtor's intentions and ability to repay the receivable are also relevant.

Example – Union Bridge Loan Continued

Consider the bridge loan in the earlier example. The debtor conference may not be capable of repaying the loan until their older building sells. Even if the debtor will likely repay the loan, the funds from the receivable are not available to current operations.

For that reason alone, it is a noncurrent asset.

Figure 3 - Union Bridge Loan Continued

Later, this chapter (see Section 1102.03 and Section 1106) will discuss loans receivable. Reporting the current part of loans receivable is slightly more challenging because one part of the loan may be current while another part is noncurrent.

Section 1102 - Specific Types of Receivables and Their Accounting

Several types of Church receivables need consideration:

- Tithe and offerings remittance accounts
- Inter-organizational receivables
- Inter-organizational loans vs. appropriations
- Employee receivables
- Student and customer receivables

1102.01 Tithe and Offerings Remittance Accounts

Collecting tithe and offerings in a local church and sharing the tithe among the conferences, unions, divisions, and General Conference produces numerous receivable and corresponding payable accounts. Chapter 14 - Liabilities thoroughly explores the ideas of the agency relationship and agency liabilities. It specifically calls for agency accounts to record agency payables. This accounting keeps those payables separate from regular organizational payables.

> *Example – Agency Liability*
>
> For example, a conference may have an agency liability of 30,000 for tithe sharing and owe 10,000 because of an advance from the union. These are both debts to the union, but as the liability chapter explains, they have different natures, so the accounting should keep them in separate accounts.

Figure 4 - Agency Liability

There is an agency receivable for every inter-organizational agency payable. Likewise, a receivable owed to your organization because of the agency relationship differs from a loan receivable owed to you by the same organization.

> *Example – Agency Liability Continued*
>
> Consider the example in the earlier paragraph from the union's perspective. The union holds an agency receivable (30,000) and a receivable for the advance (10,000) from the conference.

Figure 5 - Agency Liability Continued

Chapter 14 - Liabilities requires organizations to keep agency liabilities in separate accounts from regular payables. Likewise, the creditor organizations should show corresponding receivables separately to make reconciliations easier and to emphasize the agency relationship represented by those different accounts.[1]

1102.02 Inter-Organizational Receivables

The Church's vast network of interlinked receivables and payables is essential to God's world Church. This network of moving funds and mutual financial support is vital to its global mission. One of the keys to the network's success is account reconciliation – one organization's receivables match the other's payables. This task allows for the early detection and resolution of disagreements about charges. Organizations must do their monthly reconciliations and raise objections to transactions within a month or two of when the underlying transactions first appear. There should not be more than four months between the origination of a charge and its receipt by the final recipient. Quickly passing debit and credit memos allows the recipient to show realistic financial information and make prompt objections to questioned charges.

[1] It is proper to first book the Receivable to the agency Receivable account and then to move it to a combined Receivable if the paying organization pays its balance each month. The resulting accounting should clearly reflect whether you are collecting agency Receivables each month and from whom the balance is outstanding.

1102.03 Inter-Organizational Loans vs. Appropriations

Maybe a debtor organization cannot repay an inter-organizational loan receivable, or the organization's leadership does not intend to try to collect the loan. It is more forthright to record this as an appropriation at the onset. Perhaps the transaction was initially recorded as a receivable, but it later appears more likely to be an appropriation. With committee approval, the creditor organization should reclassify the remaining balance as an appropriation. Suppose the only way to "collect" a receivable is through applying future appropriations to the receivable account. In that case, the receivable is, in fact, uncollectible, and the creditor should recognize it as such as soon as possible.

1102.04 Employee Receivables

Some Church organizations limit employee receivables to their payroll settlement and monthly expense reports. Others allow for cash advances, purchases of goods at the church bookstore, and food at the employer's cafeteria. The organization must immediately record transactions in its employee receivable accounts. They should promptly record when employees get cash advances, make purchases, and have other charges. Holding cash advances and other charges outside the accounting records is improper.

1102.05 Student and Customer Receivables

These receivables are the heart of managing school, bookstore, and publishing house finances. Controlling the amount of the credit extended and its collection is vital to their survival. Well-organized accounting reports are essential in this process. The accounting system should easily handle the number of students and customers and separate the various charges (e.g., tuition, cafeteria, dorm, sales invoices, etc.). It should also routinely produce an accounts receivable aging schedule. This aging schedule shows the age of the unpaid charges in each account.[2]

Section 1103 - Invoices and Monthly Statements

2 It may show the unpaid charges made in the current month, for the prior month, and the one prior to that. Its preparation may require an assumption about payments. It is convenient to identify payments as going toward the oldest charges.

The organization should send a monthly account statement to every person and organization with a balance in accounts receivable. If there are many transactions, it should send invoices as the charges occur. The monthly statement must itemize the charges with sufficient detail so that the debtor (and its auditor) can clearly understand what the charge relates to, or the charge should refer to invoices that have the necessary information.

The CFO ought to routinely[3] ask debtors to confirm the correctness of the balance of unpaid balances.

Section 1104 - Subsidiary Ledgers

Occasionally, organizations keep the details of their receivable transactions in a subsidiary ledger, apart from the general ledger. At least monthly, these organizations must ensure their general ledger's receivable control account accurately reflects the total in the receivable subsidiary ledger.

1104.01 Allowance for Doubtful Accounts

Example – Student Receivable Accounts

Consider a school with one hundred student receivable accounts. These one hundred accounts total 100,000. At the Financial Statement date, all the students are up to date with their payments; however, it is unrealistic to think that the asset is worth 100,000 – at least based on experience.

Based on experience, the school estimates that 3% of its receivables will be unpaid. This means, the value of the receivables is closer to 97,000.

The challenge is that at the Financial Statement date, no one knows who will not be able to pay. Instead of reducing a specific account, the school credits a valuation account. This allowance for doubtful accounts account reduces the overall value of the receivables shown on the Statements.

Figure 6 - Student Receivable Accounts

The specifics of handling this situation are outlined in volume 3 of this *Manual*, but the general procedure is to first, estimate the collectability of the receivables and then make a journal entry to adjust the allowance account to equal this estimate.

[3] At least once a year.

1104.02 Estimating Bad Debts

There are two methods of estimating bad debts:

- Percentage of Sales Method and
- Accounts Receivable Aging Method.

1104.02.01 Percentage of Sales Method

The Percentage of Sales Method compares the bad debts over the past periods to the total charges (debits) to accounts receivable over the same period. Do not be confused by the method's name. "Sales" merely refers to the debits (increases) to the accounts receivable accounts.

Example – Bad Debts – Student Receivables

For example, over the past four years, the organization had 100,000 in charges (debits) to its student receivable accounts. Of these, it has had to write off 4,000 as bad. So, 4% of the value of its charges (debits) go bad.

If there were 30,000 in charges (debits to AR) this month, the estimate of the bad debts for this month would be 1,200 (i.e., 4% of 30,000).

Figure 7 - Bad Debts - Student Receivables

Here is an important distinction: when using this method, the adjusting entry ignores the balance in the allowance for doubtful accounts from the earlier periods and simply records this period's estimated bad debts as an expense. This method leaves the estimating errors from past periods in the allowance account with the idea that the estimating errors will offset each other. This method focuses on the accuracy of the Statement of Financial Activity's expense account.

1104.02.02 Accounts Receivable Aging Method

The accounts receivable aging method focuses on the accuracy of the SFP receivable balance. As of the SFP date, the organization looks at the ages of its receivables for various age categories. For example, it might categorize them as:

- Current (i.e., less than a month old),
- Two Months Old,
- Three to Six Months Old,
- Six to Twelve Months Old, and

- Over a Year Old.

It then calculates an estimate of the collection likelihood for each age group. It bases this estimate on historical trends. Alternatively, it can use the historical collection success at the organization or at similar institutions. This is its key distinction: the adjusting entry adjusts the allowance account to equal the estimated uncollectable amount.

Section 1105 - Forward-Looking Information

IFRS rules require the estimates to look beyond an organization’s historical trends. Both estimating methods must change their results to reflect current economic conditions. For example, if the organization’s country is in recession and unemployment rates are rising, the organization must adjust historical estimates upward to reflect these newer, unfortunate conditions.

1105.01 Bad Debts Write-Offs

With allowance for doubtful accounts entries, the estimate entry records an uncollectible accounts expense and a decrease in net assets. So, when a specific debtor’s account is written off, there is no expense nor is there a reduction of assets. Instead, the write-off entry reduces the gross receivable and the allowance by equal amounts: total assets stay the same, and there is no new expense.

Because there is little real impact, there is no pressure to immediately write off bad debts. You must seek Board or Executive Committee approval to write off an account.

Section 1106 - Loans Receivable

Loans receivables are longer-term than accounts receivables. The Board or Executive Committee usually approves the loans, and the debtors sign a promissory note or a loan agreement confirming the terms.

Their accounting has two considerations:

- Classification as current versus noncurrent and
- Their required disclosures.

1106.01 Classification as Current or Noncurrent

For a receivable to be a current asset, an organization must be able to collect it in the current period and intend (and be able to) spend the funds collected on operations after the receivable is collected.

1106.02 Current Period

The current period is usually twelve months from the Statement of Financial Position (SFP) date. The part of the loan receivable's principal[4] the organization will collect in the next twelve months is current; the rest is noncurrent.

One challenge comes from having one account to reflect the total Loan Receivable. This single account simplifies managing the loan receivable and giving statements to the debtor, but it does not show the current and noncurrent portions.

A standard solution is to keep the individual loan receivable accounts in the noncurrent section of the ledger. These accounts reflect the total the debtors owe the organization. At the end of the period, the accountant prepares a schedule that calculates the current part of each loan. The worksheet has a grand total of all the loans' current amounts. A period-end adjusting entry debits a current asset account, Loans Receivable – Current, and credits a noncurrent asset account, Loan Receivable – Allowance for Current Portion for this single grand total amount. (This noncurrent asset account is a contra account since it is an asset account with a credit balance.)

The Statement of Financial Position shows the current asset account as Loans Receivable Current. The SFP's noncurrent section shows the total of its noncurrent loan receivable accounts reduced by the contra-asset account.

It also shows an allowance for bad debts for both the current and noncurrent portions. Calculate and account for this allowance using the principles this chapter discussed for accounts receivable.

[4] Mortgage-type loans require the preparation of loan amortization tables that delineate the part of the payment that is interest and the part that is principal. The SFP shows the current part of the principal it will collect as a current asset. The rest of the principal is noncurrent. The expected interest collections are not receivables.

1106.03 Available for Operations

To be current, the proceeds from the loan's collection must be available for operations.

> *Example – Building Loan Pool*
>
> Consider a conference that has a building loan pool. It loans the money in that pool to help churches in buying or remodeling their buildings. As the churches repay the loan, the conference returns the money to the pool, earmarked for future building loans to other churches.
>
> As earlier chapters in this manual explain, to be a current asset, the value represented by the asset must be available for operations. It is also the position of this manual that buildings are not the Church's primary purpose.
>
> Any assets earmarked by donors or the Board for building purposes are noncurrent, even if the assets are readily available. For that reason, the loans from this building pool are all noncurrent since the Board or donors have earmarked their underlying funds for buildings or equipment purchases.

Figure 8 - Building Loan Pool

Section 1107 - Financial Statement Disclosures

Notes to the Financial Statements report information about the loans receivable in groupings, but they do not show individual loans within a grouping. The groupings help the user in assessing the risk connected to each group of loans. Here are some examples of groupings:

- Type of debtor (i.e., employee, churches, organizational.)
- Nature of the loan's security (Car titles, mortgages, unsecured, etc.)
- Purpose of the loan (i.e., furniture loans, mortgages, building loans, etc.)
- Aggregate loans to organizational administrators, higher organizations, and organizations within the administrative scope of the organization.[5]

For each grouping, the organization must report whether collateral secures the loans, and the interest rate range charged to loans. Do not list specific debtors and their balances in the Notes.[6]

[5] For example, a union would have loans to its conferences and its school in this group.
[6] Boards and executive committees may ask for these details as a separate treasurer report.

The sample Financial Statement Notes show an example of these groupings and the information the Notes must show for each group. Here is an excerpt from those sample statements:

Notes 6 - Loans Receivable

	20X1	20X0
Affiliated SDA Entities, Secured, 5 to 6% interest, payments due monthly	2,328,233	3,268,313
Administrative Employees (as defined in Note 19)	1,439,263	1,644,868
Other Employees	1,177,579	1,345,802
Employees Car Loans, Unsecured, 8 to 10% interest, payments due monthly		
Administrative Employees (as defined in Note 19)	140,100	191,244
Other Employees	72,400	96,600
Other Loans, Secured, 8 to 10% interest, due on demand	15,000	32,000
Total Loans Receivable	5,172,575	6,578,827
Allowance for Uncollectible Loans	(10,000)	(25,000)
Net Loans Receivable	5,162,575	6,553,827
Current Portion - Due Within One Year	(886,033)	(750,000)
Long-term Portion	4,276,542	5,803,827

Section 1108 - Below-market Interest Rate Loans

Below-market interest rates (including interest-free loans) are common between affiliate Adventist organizations. Likewise, sometimes employee loans have a below-market interest rate. When below-market interest rates are offered in the loan documentation, the organization providing the loan has effectively granted the recipient of the loan a hidden appropriation. When the loan receivable is listed on the Statement of Financial Position (SPF) at fair value (i.e., the present value of future cash receipts), the loan will be discounted using the current market interest for similar loans and credit ratings.[7] The difference will be an appropriation to the recipient organization. See Volume 3 of this *Manual* for an example of entries for a loan receivable at below market interest rate.

[7] If such terms as present value, present value of an annuity, future value, face value, and discounted cash flows are unfamiliar, study the topic of the time value of money prior to reading this section. Wikipedia has an excellent article on the topic. [Time value of money - Wikipedia]

Section 1109 - Employee Educational Loans

It is a widespread practice within Adventism for employers to pay for employee's training and academic advancement and for the employing organization to refer to this payment for education as a "loan." The employer may further stipulate that the employee will work a certain number of years to repay the amount expended. For financial reporting purposes, the original payment of educational costs is an expense of the period in which the organization makes the payment. The Financial Statements do not show this payment as an educational loan receivable.[8]

Despite the immediate expensing of these educational expenses, employers often consider the agreement that the employee will work for a certain number of years as a "loan" and use the accounting term "amortize" in this context. Often, when another Adventist employer hires that employee, the old employer passes the unamortized amount of the "loan" to the new employer. Nothing in the *Accounting Manual* precludes this agreement between employers and employees. Employers can define the agreement as a "loan," and the "loan" can "amortize" by the employee's years of service, but not for Financial Statement purposes. Nor does this manual dampen the idea of one employer expecting another to reimburse them for the unamortized balance.

Because, as noted, the Statements have already shown the entire outlay as an expense, they do not duplicate the expense by any efforts at "amortization" by the employer over the employee's employment term.

What if an employee reimburses the original employer for an "unamortized" balance? For clarity, since the employer treated the outlay for the training as an expense, there would not be a receivable balance on its SFP. (This "unamortized balance" is a contractual concept but not a financial reporting concept.) The employer shows the proceeds from the employee's reimbursement as miscellaneous income. What if the employee changes jobs and the new employer reimburses the old for the "unamortized" balance? The old employer reports the money received as miscellaneous income, and the new employer shows the payment as employee educational expense.

[8] Some accountants record the educational loans receivable and contra-asset accounts so that it brings educational loans under accounting control without showing them as assets in the financial statements. Nothing in this accounting manual would prevent this practice.

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Chapter 12

Prepaid Expenses, Supplies, and Inventory

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Chapter 12
Prepaid Expenses, Supplies, and Inventory

This chapter explores putting expenses in their proper accounting period. It then moves into a detailed discussion of accounting for inventory.

Section 1201 - Prepaid Expenses: Expenses Waiting to Happen

Accrual accounting is one of accounting's most essential principles. (See also Chapter 2, Section 201.04, for a discussion of accrual accounting.) It is all about showing revenue and expenses in their proper accounting period. Accrual accounting puts revenue in the period it earns the revenue and shows expenses in the period the expense occurs. That is, the expense belongs to the period in which the organization uses up an asset or takes on debt. Electricity becomes an expense when you use electricity. It is not an expense when you get a bill or when you pay it. So, an electricity bill for June, received in July and paid in August, is a June expense. When you receive the bill in July, you record it as a June expense and a payable at the end of June. Nothing happens to electricity expense when you pay the bill. (The payment only reduces cash in the bank and the payable.)

This electricity example illustrates accrual accounting when you record an expense in one period and pay for it later. This chapter is about the opposite accrual problem: Paying for an expense in one period and showing it as an expense in a later period.

Example – Office Rental

Consider a conference that rents its office.

In December 2XXX, it renews its rental agreement for the next year, 2XXY. It pays 12,000 for the annual, 2XXY, rent at the lease signing. The journal entry for the payment decreases Cash-in-Bank (Cr) and increases another asset, prepaid rent expense. Prepaid expenses are assets waiting for the correct period to become expenses. The cost paid does not become an expense until the conference uses the office.

Figure 1 - Office Rental

In addition to prepaid building and equipment rentals, organizations frequently encounter a similar situation with prepaid insurance. Usually, you pay for insurance in advance. That payment's journal entry records an asset, prepaid insurance. Over the insured periods, adjusting entries decrease the asset with a credit and record an insurance expense.[1]

Besides prepaid rent and insurance, organizations may occasionally encounter prepaid expenses with taxes (payment of tax estimates), salaries (with the payment of sign-on bonuses), and interest.[2] There is another prepaid expense to consider: supplies.

Section 1202 - Office, Pathfinder, & Sabbath School Supplies

The financial statements correctly show supply costs as an expense only when the organization uses the supplies.[3] When the organization pays for the supplies does not affect when it shows the cost of the supplies as supplies expense. It is incorrect for the statements to show supplies as an expense if you have not used them, even if you have paid for them.

Example – Pathfinder Supplies

For example, the conference pays 1,000 for Pathfinder supplies, but they are still in the storage cabinet. The statements must show those supplies as an asset rather than as an expense. In the next month, suppose they use some of the supplies. The conference needs need an entry reducing the supplies asset account and increasing supplies expense for the cost of what was used.

Figure 2 - Pathfinder Supplies

Conferences and unions often have office, Pathfinder, and Sabbath School supplies. They can record them in separate supplies asset accounts. While the upcoming Inventory section gives more information about accounting for inventories that may be sold rather than used (such as supplies), the principles discussed in the following sections apply to office, Pathfinder, and Sabbath School supplies.

[1] Most accounting systems allow the original entry made at the payment date and the twelve entries into the twelve periods to be made during one accounting session. This means it is not necessary to remember to record the expense each month.
[2] Prepaid interest happens with mortgages when the lender subtracts the interest amount from a loan closing amount for the period between the closing date and when the first monthly payment is due.
[3] The reader should always consider materiality when applying any principle in this manual. It is especially true when looking at the proper accounting for supplies. If the amounts that should be assets are not large relative to the overall cost of the department, show them as expense when you pay them.

Section 1203 - Inventory

Inventory is an excellent example of the requirement of showing expenses in the period you use something.

Example – Publishing House Inventory

Consider a Publishing House, which buys 300 books for 3,000 in Period One.

In Period Two, it sells 100 books for 2,000.

What is the correct profit for this book in periods one and two?

If you did not follow accrual accounting, you would have a 3,000 Loss in Period One and a 2,000 Income in Period Two. But Accrual Accounting forces us to show both the income and expense in Period Two. There is no income or expense in Period One, and there is 1,000 in profit in Period Two.

This profit is the 2,000 in revenue minus the 1,000 of cost of sales.

Figure 3 - Publishing House Inventory

1203.01 Inventory Costs

The first challenge of Inventory accounting is straightforward: it is how to capture the total cost of the inventory when you buy something. At a minimum, the incremental payments related to the Inventory purchase are its direct cost. For a published book, it might be the costs paid to the printing house, payments for import duties, VAT, and shipping.

This manual does not require allocating indirect costs to the inventory. (Indirect costs include editorial work, graphic design, overhead, etc.)

The inventory system needs to track the number of inventory items and their cost. It must do this for the items the organization has and for what it uses.

1203.02 Inventory Cutoffs

Another critical inventory costing consideration is the need to execute correct end-of-period cutoffs. The goal is to ensure that you have recorded things that should be part of the inventory and have not recorded things that should not be part of the inventory. This careful cutoff includes ensuring you have recorded all invoices for items received by the period-end and that you have not recorded invoices for items not received.

It is slightly more difficult for outgoing inventory. Many accounting systems simultaneously record an inventory sale, the reduction of inventory, and the increase in cost of goods sold. The entries must record these in the same period. At the end of the period, you might need to write adjusting entries to get the sale, and its cost of goods sold in the period you earn the sale. Usually, this is the period in which you ship the inventory. You do not let the period in which you take the order or when the customer pays you for the order affect your decision about the period in which you show the sale and the inventory reduction.

What about goods on their way coming to and leaving the organization? Who includes items on trains and trucks as part of their inventory – the buyer or the seller?

A straightforward approach to this problem is to consider who would make a claim against the shipping company if they damaged the cargo. That buying or selling organization should show those goods in transit as part of their inventory.

1203.03 Inventory Sales and Usage

The above sections were about the number of items the organization bought, sold, and still has at the end of the period. This section looks at the second challenge of inventory accounting. It is about finding the cost of those items to remove from inventory and put into expenses as you sell or use them. To correctly record selling or using items, the organization (1) must decide which cost flow assumption it follows and (2) account for it using its selected inventory accounting method. The following two sections cover these concepts.

1203.03.01 Cost Flow Assumption

Consider three "assumptions" about how costs flow from inventory to cost of goods sold. There are three possibilities:

- Specific Identification
  - Use for low-volume, high-cost items. For example, hospitals will use this cost flow assumption when dealing with high-cost pharmacy items.
  - Use item serial numbers (or something similar) to help keep track of what specific items the organization bought and then sold.
  - When the organization sells a specific item, it moves the cost of those items out of the inventory and into the cost of goods sold accounts.
  - It is not technically an assumption.

- Average Cost
    - Assumes that the cost of the items sold was the weighted average item cost of the purchased inventory.
    - This method assumes that the items sold cost what the average item cost.
- First-In-First-Out (FIFO)
    - Assumes the organization moves the costs for the first items bought out of inventory into the cost of goods sold account.
    - This assumption is about cost flow and does not require items to physically move in this way.

1203.03.02 Inventory Method

In addition to making a cost flow assumption, an organization must have an inventory accounting method. The two basic types are:

- Perpetual and
- Periodic

Perpetual method - moves the cost from the inventory account to the cost of goods sold account each time the organization sells an item. This method results in somewhat accurate ongoing inventory and cost of goods sold accounts. The perpetual method would be important for organizations such as hospitals, bookstores, and publishing houses.

Periodic method - does not record the cost of sales when you sell an item. Instead, the organization moves the costs from inventory to cost of goods sold at the end of each period. This method requires a physical count, or an inventory estimate to find the amount of cost to move. This is when you make a single period-end entry that sorts out which portion of your inventory purchases are in inventory and which portion is in cost of goods sold.[4] This method only reflects accurate inventory and cost of goods balances at the end of the period. Organizations, (e.g., conferences and schools) where inventory is less critical in their finances might use the periodic method.

1203.04 Inventory Counts

[4] There are several inventory estimation methods. Their explanation is outside the scope of this manual. But two common methods include the Retail Method and the Gross Profit Method. Explanations on how to do these estimating methods abound on the internet.

Organizations must make routine inventory counts. The need for physical inventories is obvious for organizations using the periodic method. Still, both methods must have a physical count at least once a year to provide for unrecorded inventory errors and shrinkage.[5] This chapter's inventory Internal Control tables include controls relating to proper internal control over physical inventory counts.

[5] One advantage of the perpetual method is that it is easy to make ongoing physical counts and correcting adjustments throughout the year.

1203.05 Summary

Integrate the ideas of cost flow assumption and inventory method. The cost flow assumption determines how costs will flow from inventory to cost of goods sold, and the accounting method determines the bookkeeping timings of making the entries.

Example – Perpetual Method or Periodic Method

Here is a simplified example: Suppose an organization buys 100 items at 10 and 50 items at 12. Later they sell 120 items, leaving 30 items in inventory.

- If they use the Perpetual Method, each time they sell one of the first 100 items, they will debit the Cost of Goods Sold and credit Inventory for 10. After they sell the first 100, they record the next 20 at 12.
- If they use the Periodic Method, at the end of the month they will do a physical count or an inventory balance estimate.
    - Suppose a physical count concludes they have 30 items on hand. Since they purchased 100 at 10 and 50 at 12, they must have sold 120 items. But what did those 120 items cost? Using the FIFO assumption, the Inventory value on hand would be 30 items costing 12, or 360. Before the period-end adjustments, the Inventory balance is 1,600. An adjustment is needed to move the difference, 1,240, from inventory to cost of goods sold. This will leave the 360 in the Inventory account.

Figure 4 - Perpetual Method or Periodic Method

1203.06 Inventory Impairment

With all assets, it is routinely necessary to assess whether their balance reflects economic reality. Making correct transactional entries without doing this reality check on the total is foolhardy. This reality check is especially true for inventory balances. You must remove items that are unusable or have no value. For example, you should write off items purchased for sale in a particular program if the program has stopped, and you must remove damaged or unsaleable items.

1203.06.01 Net Realizable Value

Besides damaged and unsaleable items that have gone to zero value, you should evaluate all Inventory items for a decline in value. Specifically, things that have declined in value should be written down to their net realizable value. Net realizable value is what you can sell the inventory for.[6] Suppose a publishing house has 100 books in its inventory costing 7 per book. But it can only sell them for 5. It must write the inventory down to its net realizable value, 5. The total write-down is 200. This entry is a debit to a Decline in Inventory Value expense and a credit to inventory. If, for some reason, the value recovers, make an entry recording them back to their original cost. The SFP should show inventory as an asset at the lower of its cost or its net realizable value.

[6] Specifically, this is an estimate of what you could sell it for minus an estimate of reasonable selling costs.

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Chapter 13
Property, Plant, and Equipment

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Chapter 13
Property, Plant, and Equipment

This chapter is about financial reporting of property, plant, and equipment. It describes how an accountant records these in the Plant Fund. In the process, it defines and describes Plant Fund Accounting.

The chapter organizes itself around the life cycle of these fixed assets:

- Accumulation of resources needed to buy the asset
- Asset purchase
- Asset depreciation over its life
- Debt repayment
- Asset sale and disposal

Section 1301 - Plant Fund Accounting

This manual requires the use of Plant Fund Accounting.[1] The Plant Fund separates Operating activities and Plant Fund activities. Managing these two distinct functions requires different mindsets and considerations.

Example – Cash and Investments for Building

Consider the cash and investments held for a new building. Decision-makers are confused when the Statements show these mingled with regular operating cash and investments. Many financial leaders have experienced the horror of discovering they have unintentionally spent resources earmarked for a new building, which results in the difficult task of explaining to a committee why building funds are unavailable for their big plans.

Figure 1 - Cash and Investments for Building

[1] As with everything in this manual, the reader must consider materiality. For instance, a small school, with very few fixed assets, could ignore Plant Fund Accounting without materially misrepresenting their financial situation. See Chapter 1, Section 102.03 for a discussion or materiality.

Plant Fund Accounting moves the distracting elements of the plant fund (e.g., land, buildings, and equipment) out of the operating fund. Likewise, it is helpful to see all the elements of plant acquisition, capital debt, and disposal (and replacement) in one place.

Section 1302 - Fixed Asset Leasing

International Reporting Standards (IFRS 16) require financial statements to show leased assets similarly to how they show regularly purchased assets. These rules refer to any asset leased for more than twelve months as a “Right of Use” fixed asset. The statements show these “Right of Use” assets along with their fixed assets and depreciate them using the same principles as regular fixed assets. Recording them produces a liability like the long-term notes or mortgages associated with regular fixed asset purchases. This manual will discuss these lease considerations as it goes through the fixed asset life cycle topics (see Section 1305.02).

Section 1303 - Accumulation of Plant Resources

The first step in the fixed asset life cycle is accumulating cash and investments to fund the asset’s purchase. Usually, an organization does this by getting restricted donations and appropriations or by making allocations from the organization’s operating resources. They may transfer funds from a general building pot of resources to an allocated resource specifically for the new project. Financial statements must show all resources earmarked for new land, buildings, and equipment in the plant fund.

This requirement does not mean the organization has to have the Plant Fund in separate accounts in the bank or investment broker accounts. The accounting system can earmark a part of a bank account or an investment account as belonging to the Plant Fund.

Section 1304 - Asset Acquisition

There are several considerations when recording the asset purchase. This section will cover them topically. The first few topics relate to whether an organization should record the acquisition as an asset. For illustrated journal entries, refer to Volume 3 of the *Accounting Manual*.

1304.01 Ownership and Use

International Reporting Standards (IFRS 16) have the following helpful definition:

> *Property, plant, and equipment are tangible items that:*
> - *are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and*
> - *are expected to be used during more than one period.*[2]

Notice that IFRS does not mention ownership of the asset. An organization's Statements can show an item as a fixed asset without it having legal ownership.[3] The decisive factor in whether an organization includes it as a fixed asset is whether it controls the asset and how it uses it.[4]

1304.01.01 Property Held for Churches and Schools

GCWP S 5510 requires that the local conference record local churches on the conference's records. The traditional method has been to record the local church land and building at cost and show an accompanying Accumulated Depreciation amount so that the net amount for each church is shown at some minimal amount (e.g., US$1). This brings the ownership of these properties under the accounting control of the Conference and provides a cost figure which is helpful for other financial decisions, such as determining appropriate insurance levels for the property. While differences in this practice may occur due to local legal requirements, this *Manual* recommends that the GCWP and the traditional practice be followed in all denominational organizations that hold legal title to these properties, even if that organization is not responsible for the care or use of the property.

The nominal net amount of these holdings may be shown on the face of the financial statements, with disclosure of the total cost and accumulated depreciation shown in the Notes to the Financial Statements.

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[2] Period here means one accounting year.
[3] This is at odds with U.S. GAAP, which focuses more on ownership.

1304.02 Capitalization Thresholds

Each Executive Committee or Board must stipulate its organization's capitalization thresholds. This amount determines whether the organization treats a purchase as an asset or expenses it as a period cost. Financial statements show purchases below the threshold as an expense and those above the threshold as an asset. If the capitalization threshold is too low, trivial amounts are in the asset register. If the organization sets the threshold too high, it overburdens one year's operating results with the asset's total cost, even though the asset is used over several years.

Organizations should also consider if its tax authorities specify the cut-off point and/or whether there is a community-wide convention as to the proper threshold level.

1304.03 Asset Cost

Once the organization decides to show the purchase as an asset, it must capture the total cost. This is the total cost of bringing the asset into its useful role. For example, this would include shipping, taxes, and legal costs connected to its acquisition. Sometimes, the purchase is instantaneous, as in the case of buying a computer at a local shop. Then the asset is recorded at the cost (including VAT) paid to the store. Sometimes, finding the cost takes some time and effort.

Example – Land Purchase and Building Construction

For instance, a conference may buy land and construct the building over a few years. It will use a Work-in-Process account to accumulate the cost of building an asset before it starts using the facility.

These costs include legal fees, surveying fees, amounts paid for materials, landscaping, contractors, etc.

Figure 2 - Land Purchase and Building Construction

1304.03.01 Financing Cost vs. Asset Cost

The Financial Statements must show financing costs separately from the assets' cost.

Example – Building Purchase

Consider a conference buying an office from a member.

The conference buys the building for 500,000.

The agreement specifies the conference will pay for the building with five annual payments of 100,000. The conference gets a 5-year mortgage at a 6% interest rate. The conference records a fixed asset and a mortgage liability of 386,086.75. [A] When they make the 100,000 payments, they will show a part as a payment of the mortgage principal and a part as interest payments.

A This is the present value of the 100,000 per year annuity for five years, at 6% interest. If such terms as present value, present value of an annuity, future value, face value, and discounted cash flows are unfamiliar to the reader, they should study the topic of the time value of money. Wikipedia has an excellent article on the topic [Time Value of Money – Wikipedia](#).

Figure 3 - Building Purchase Example

1304.03.02 Fixed Asset Components

Once the organization decides to record a purchase as a fixed asset and establishes the total cost, it must consider the asset's components. Usually, this is just a consideration for real estate purchases. The entry recording the asset purchase must separate land (which will not depreciate) from the building's cost. The organization can determine the land cost by looking at the comparable cost of vacant land.

Section 1305 - Invested in Plant Assets

Recall that Non-profit Accounting refers to the equity part of the Statement of Financial Position as Net Assets.

Equity consists of the organization's assets minus its liabilities and measures its financial wealth. It is the financial wealth that the organization owns to conduct its mission. But not all this wealth is spendable. A sizable part of the Equity is in Plant Assets. This part of the net assets is less immediately spendable for mission since the fixed assets may be difficult to sell or be so fundamental to the organization's operation that it would never sell them.

The Invested in Plant Assets account sets aside this portion of the net assets. It is the total of the Property, Plant, and Equipment minus any debt on those assets. See Chapter 7, Section 702.02.02 for further discussion.

1305.02 Building Leases

As discussed in Section 1302, current IFRS rules require accounting for leases to mirror fixed asset accounting. Accordingly, an illustration of such accounting is shown below to demonstrate the similarity of accounting for a lease acquisition and a normal purchase acquisition of PPE assets.

Example – Conference B – Leased Office

In this example, Conference B leases an office space instead of buying it. The lease requires the Conference to pay 1,000 a month for five years. The Conference can borrow money at 5% interest per year, so the present value of the sixty payments is 53,211.[A] The rest is interest expense. The Conference will show this as Interest Expense over the life of the lease.

To record the signing of the lease:
In the Plant Fund:

Right-of-use Asset	53,211	
Lease Payable		53,211

____

A. This is the present value of an annuity of 1,000 over 60 months at 5% a year interest or .4167% per month. The assumption is that they made the first payment at the beginning of the lease.

Figure 4 - Conference B - Leased Office

Section 1306 - Depreciation

Depreciation is accrual accounting distributing the building or equipment's cost from assets to expenses. It does this systematically over the asset's productive life. It is not an effort to simulate the asset going down in value. We will record depreciation even if the asset's value is increasing.

The earlier section (see Section 1304.03) helped determine the total cost of the asset. Besides knowing that amount, to record depreciation, three decisions are necessary:

- Depreciation Method
- Asset's Estimated Life
- Residual Value.

1306.01 Depreciation Method

International reporting standards allow four methods of depreciation:

- Straight-line
- Declining Balance
- Sum-of-the-Years'-Digits
- Units of Production.

The Church's standard is the Straight-line Method, which will be the focus of this explanation.[5] Straight-line Depreciation distributes the asset's depreciable cost equally over its productive life.

1306.02 Estimated Life

Estimated life is an estimate of the productive life of the asset. It may be quite different from its physical life. The concrete and steel of most modern buildings may physically last for many years. The economic life of the building will be much shorter. The end of its economic life is the point where the building will need substantial rehabilitation to keep it useful.

Each year, the organization must re-estimate the remaining lives of its assets and revise them in its depreciation calculation if necessary.

1306.03 Residual Value

The estimated useful life approximates the asset's productive life to the organization. Residual value is an estimate of what value may remain at the end of that estimated life. The depreciation calculation needs an estimate of this residual value.

[5] This manual recognizes that some governments mandate a different depreciation method. It also acknowledges that the Units of Production method is more logical for such organizations as printing presses. Using such alternatives for good reasons would not mean the organization must do dual depreciation calculations and issue different financial statements. Such organizations follow the Accounting Manual standard in these and similar cases.

Example – School Van

For instance, a school may want a reliable van to carry its students. It may estimate its new van's useful life as only five years. After five years, the school figures the van may be too unreliable for the school's purposes and will sell the then five-year-old van to someone who does not need such reliability. The estimated selling price at the end of the five years is its residual value.

Figure 5 - School Van

Each year, the organization must re-estimate the estimated residual value of its assets and revise them in its depreciation calculation if necessary.

1306.04 Asset Impairment

As with all assets, the organization must evaluate its fixed assets annually to ensure that the asset's value has not diminished. This impairment can be from internal causes, such as when someone wrecks a vehicle. Impairment can also originate from external causes.[6]

Example – Impaired Laptop

Consider a two-year-old laptop with a net recorded value (cost minus accumulated depreciation) of 1,500; a comparable new laptop costs 1,000.

Figure 6 - Impaired Laptop

If an asset is impaired, the organization must decrease its recorded value to its fair market value.[7]

Section 1307 - Depreciation Expense and the Proper Use of Tithe

In Chapter 20 the *Manual* discusses the need to track revenue and expenses by tithe (vs. non-tithe), restriction, and allocation. Those principles equally apply to the Plant Fund. Plant Fund revenue and expense can follow the flow of restricted and allocated net assets as the Operating Fund did. However, tracking tithe vs. non-tithe is another matter. The Plant Fund usually holds

[6] Anything can cause impairment: faulty foundation, earthquake, toxic wastewater dump discovered next door, overall dramatic decline in building's market value, etc.

[7] If the impairment is later removed, an entry can write it back up to its depreciated cost.

non-tithe resources. There is no practical reason for tithe revenue and expense to be in a Plant Fund.

Organizations cannot use tithe to build buildings or buy equipment; however, the tithe policy does affect fixed asset accounting at two points. Consider this policy:

> "The operating expenses of the conferences or missions/fields/sections, unions, divisions, and General Conference headquarters office are considered an appropriate use for Tithe." *GC Working Policy V14 05.3.b*

Depreciation is an Operating expense, so for these organizations, it is a proper use of tithe. For clarity, notice that the policy does not refer to using tithes for purchases but for expenses.

Tithe policy also interacts with Fixed Asset Accounting in GCWP V14.06:

> *Evangelistic equipment comes in many forms. Whether the preacher's voice is projected by microphone across a rented hall, carried into homes by DVD players, or beamed around the world by radio transmitters, satellite uplink systems, or the internet, the principle is the same. The purchase of evangelistic equipment and support of these evangelistic means may be an appropriate use for tithe if their purpose is to support soul winning endeavors and other funds are not available. GCWP V14.06*

In this case, the policy refers to purchases, not expenses.

The accountant must use care to follow the tithe policy in both cases.

Section 1308 - Loan Repayment

An organization must account for all debt collateralized by fixed assets in the Plant Fund. It will also use the Plant Fund to account for any resources the Board or donors earmarked for future principal and interest payments. The interest expense for this debt is a Plant Fund expense. Journal entries illustrating this concept are included in Volume 3 of this *Manual*.

Section 1309 - Fixed Asset Disposition

Eventually, there will be a point when the organization sells, scraps[8], or trades a fixed asset. Before the accountant addresses dispositions, they should record depreciation up to the month of the disposal.

1309.01 Selling or Scrapping

Accounting for both selling and scrapping assets is similar. There are two entries. The first entry is the same whether the organization sells or scraps an asset.

- This first entry is in the plant fund. It removes the asset's cost, accumulated depreciation, and any net assets from the plant fund records.
    - It credits the asset cost account for the asset's cost. This credit removes the asset's cost from the accounts.
    - Debits the accumulated depreciation for its total depreciation. This removes the asset's accumulated depreciation from the accounts.
    - If the item is not fully depreciated, the entry:
    - Debits the book value to the 977xxx **Net Value of Plant Assets Sold** account. This debit indirectly reduces the investment in Plant Asset's net asset balance.
    - It has no gains or losses (as in for-profit accounting).

The organization makes this adjustment to the accounting records no matter the method used to dispose of the asset (e.g., sold for a gain, sold for a loss, scrapped, given away, or trashed)

When it sells an asset, the accountant makes a second entry. Deciding which fund makes this second entry depends on what it will do with the sale proceeds.

- Suppose the organization will hold the proceeds for future fixed asset purposes. Then, it will record this second entry in the Plant Fund.
- On the other hand, it might plan to use the proceeds for routine operational purposes. In that case, the accountant makes this entry in the Operating Fund.[9]

In either case, the entry is the same:

[8] i.e., Disposal of the asset with nothing in return.
[9] This does not require a separate plant fund cash account if the accounting system can designate certain amounts in a single bank account that belong to each fund.

- It makes this second entry in the proper fund, depending on what it does with the proceeds from the sale.
    - Debits Cash-In-Bank and
    - Credits 762xxx Proceeds from the Sale of Fixed Assets.
    - The entry can put proceeds in an allocated net asset account at the direction of the executive committee.

Illustrative entries for these activities are included in volume 3 of this Manual.

Section 1310 - Trade-Ins

Trade-ins add some complications. The transaction usually involves the organization giving a trade-in asset with added money and getting a new asset in return. However, the organization can give a trade-in asset and receive a new asset and some money in return.

If the organization pays cash:

- The fund paying the money:
    - Credits Cash for the amount it paid.
    - Debits the Transfers Out account. The ANA: Will be the net asset resource used to pay for the asset. The restriction is usually non-tithe or temporarily restricted.
- The plant fund:
    - Removes the old asset.
        - The entry credits the fixed asset account for the cost of the old asset.
        - It debits the accumulated depreciation account for the old asset's accumulated depreciation.
    - Record the new asset.
        - The entry has a debit that records the new asset at its fair market value. This value may differ from the new asset's advertised or catalog price.
    - Records the transfer in. This amount is the same as the transfer out recorded in the other fund. The net asset type is Investment in Net Assets.
    - Recording the new asset at its fair market value might mean that the plant fund must record a gain or loss. This gain or loss arises when the fair market value of the new asset is different from the trade-in's book value plus the cash paid. This gain or loss means that the trade-in's book value was greater or less than its economic value in the trade. The gain or loss changes the Investment in Plant net asset type.

If the organization receives cash:

- The fund receiving the cash.
    - Debits cash for the amount received.

        - Credits Proceeds from Sale of Plant Assets
- The plant fund:
    - Removes the old asset.
        - The entry credits the fixed asset account for the cost of the old asset.
        - It debits the accumulated depreciation account for the old asset's accumulated depreciation.
    - Records the new asset.
        - The entry has a debit that records the new asset at its fair market value. This value may differ from the new asset's advertised or catalog price.
    - Recording the new asset at its fair market value might mean that the plant fund must record a gain or loss. This gain or loss arises when the new asset's fair market value differs from the trade-in's book value minus the cash received. A gain or loss means the trade-in's book value was greater or less than its economic value in the trade. (Notice that receiving or paying cash in a trade does not in itself mean there is a gain or loss). The gain or loss changes the Investment in Plant Asset net asset type.

Illustrative entries for these activities are included in volume 3 of this *Manual*.

Section 1311 - Other Fixed Asset Topics

1311.01 Accounting for Major Repairs

Entries should treat a significant repair as a new asset if the repair creates an asset that replaces a separate part of an older asset—rewiring a building or replacing a staircase.

One entry disposes of the old asset (or part thereof). Depreciation uses this new asset's estimated life.

Suppose the repair did not replace an existing asset but extended its life. Also, suppose its cost is less than the existing asset's accumulated depreciation. In this case, the entry reduces the accumulated depreciation of the repaired asset. This reduction also results in a new estimated life.

What if the significant repair did not replace an existing asset but extended its life? Unlike the last example, suppose the repair cost is more than what the accumulated depreciation can absorb. Treat the entire repair as a new and separate asset in that case.

1311.02 Land, Building, and Equipment Disclosures

The Financial Statements must disclose the following for each fixed asset category (e.g., land, land improvements, buildings, equipment, vehicles, etc.). The sample Financial Statements in volume 3 illustrate these disclosures.

- The basis for measuring the carrying amount - usually, depreciated historical cost
- The Depreciation Method(s) used
- The useful lives or depreciation rates
- The gross carrying amount and accumulated depreciation and impairment losses
- A reconciliation of the carrying amount at the beginning and the end of the period, showing:
    - additions
    - disposals
    - acquisitions through combinations with other organizations (this includes entity reorganizations)
    - revaluation increases or decreases
    - impairment losses
    - reversals of impairment losses
    - Depreciation
    - net foreign exchange differences on translation
    - other movements
- Any restrictions on title and items pledged as security for liabilities
- Any expenditures to construct property, plant, and equipment during the period
- Any contractual commitments to buy property, plant, and equipment
- Any compensation from third parties (e.g., ARM) for items of property, plant, and equipment that were impaired, lost, or given up

1311.02.01 Sample Land, Buildings, and Equipment Financial Statement Note

Note xx - Land, Buildings, and Equipment

Balances on 31 December 20X1	Total Cost	Accumulated Depreciation	Net Value	Depreciation Expense
Land	900,000	0	900,000	0
Land Improvements	35,980	8,639	27,341	1,033
Buildings	3,045,000	707,460	2,337,540	45,900
Furnishings & Equipment	2,138,225	427,250	1,710,975	133,076
Leased Right-of-Use Assets	304,500	70,746	233,754	4,590

Land, Buildings, & Equipment, 20X1	6,423,705	1,214,095	5,209,610	184,599
Balances on 31 December 20X0				
Land	200,000	0	200,000	0
Land Improvements	35,980	7,606	28,374	1,033
Buildings	1,545,000	661,560	883,440	39,200
Furnishings & Equipment	1,738,470	344,848	1,393,622	132,731
Leased Right-of-Use Assets	154,500	66,156	88,344	3,920
Land, Buildings, & Equipment, 20X0	3,673,950	1,080,170	2,593,780	176,884

Summary of Changes	Balance			Balance
Total Cost	**31-12-20X0**	**Additions**	**Deletions**	**31-12-20X1**
Land	200,000	700,000	0	900,000
Land Improvements	35,980	0	0	35,980
Buildings	1,545,000	1,500,000	0	3,045,000
Furnishings & Equipment	1,738,470	500,429	100,674	2,138,225
Leased Right-of-Use Assets	154,500	150,000	0	304,500
Total Cost	3,673,950	2,850,429	100,674	6,423,705
Accumulated Depreciation				
Land Improvements	7,606	1,033	0	8,639
Buildings	661,560	39,200	0	707,460
Furnishings & Equipment	344,848	133,076	50,674	427,250
Leased Right-of-Use Assets	66,156	3,920	0	70,746
Accumulated Depreciation	1,080,170	177,229	50,674	1,214,095
Net Value	2,593,780	2,673,200	50,000	5,209,610

Valuation Basis – Conference A carries its assets at Depreciated cost.

Depreciation –Conference A uses Straight-line Depreciation. The annual depreciation uses the following estimated lives:

- Land Improvements, 5-7 years
- Buildings, 30-50 years
- Furnishings & equipment, 3-10 years.

Restrictions on Title –Conference A fully uses its Shandon Road property. It has built a small warehouse there to store conference materials. The Union B of SDA holds the title of that property as a courtesy to the conference.

Conference A holds the title deeds of its churches. However, it has decided that since it does not have direct management and control of the assets, it does not show them as conference assets.

Property pledged as security for liabilities – The conference owns 234 Joyce Street Apartment Building. It has a mortgage balance of 450,000 as of 31 December 2021 and 500,000 as of 31 December 2020

Expenditures to Construct Property, Plant, and Equipment – The conference has made the following construction expenditures on its Camp Junaluska project: 2021 – 300,000 and 2020 – 200,000.

Compensation from Third Parties – In June 2021, a fire destroyed three servers with a combined book value of 7,000. Adventist Risk Management has given the conference 8,000.

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Chapter 14
Liabilities

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Chapter 14
Liabilities

This chapter begins by defining liabilities. It then moves into a listing and discussion of the various types of liabilities. After discussing accrued expenses, the chapter ends by covering loan guarantees.

Section 1401 – Definition of Liability

An excellent place to start is by recalling what a liability is: a liability is a probable[1] obligation.

A probable obligation must meet two conditions before the financial statements show it as a liability:

1. It must be an obligation specific to the organization.

> *Example – Local Government Taxes*
>
> For instance, if the local government is probably going to raise taxes, there may be a probable obligation; yet, since the obligation is not specific to the organization, the Statements will not show it as a liability.

Figure 1 - Local Government Taxes

2. It must relate to a past transaction or event. The organization determines this "as of" the Statement of Financial Position (SFP) date.

> *Example – Unpaid Fine*
>
> For instance, an unpaid fine for a violation before the SFP date would be a liability.
>
> If the violation occurred *after the SFP date*, the unpaid penalty is not yet a liability because a fine for an action that occurs after the SFP date is not a fine for a past event as of the SFP date. The event occurred in the subsequent accounting period.

Figure 2 - Unpaid Fine

For clarity, the following situations do not affect the decision about whether to call an obligation a liability:

[1] "Probable" here means that there is more than a 50% chance of the organization having to pay the obligation.

1. Whether or not the organization will settle the obligation with money does not matter. In the Church, liabilities usually mean an obligation to pay money. There are, however, times when this is not the case.

Example – Unearned Tuition

For instance, a school might have an unearned tuition liability. The obligation is to provide classroom instruction, not to pay in cash.

Even if the unearned tuition is nonrefundable – the school never having to pay the obligation in cash – it is still a liability.

Figure 3 - Unearned Tuition

Two similar examples are accrued vacation pay and unearned rent payable.

2. Whether the claim has been asserted or not does not matter. Taxes are the best example of a situation where a liability exists even if the government has not yet requested the money.

3. A liability is still a liability even when an estimate is required to determine the amount owed.

Example – Lawsuit Liability

For instance, if it is probable that the organization will lose a lawsuit, it must estimate the loss and then record it as a liability.

Figure 4 - Lawsuit Liability

4. A liability is still a liability even if the debt is not contractual.

Example – Publishing House Sales Bonuses

For example, if the publishing house routinely provides sales bonuses to its top booksellers, it still must record a liability even if it doesn't have a legal obligation to pay them.

Figure 5 - Sales Bonuses

Example – Committee Actions

Committee Actions are another example as unpaid but voted appropriations are liabilities. The wording of the appropriation matters. If the committee votes the appropriation in 20x1, but the wording stipulates it as payable in 20x2, then it is not a liability until 20x2.

Figure 6 - Committee Actions

5. All loan guarantees create a liability. This chapter explains this thoroughly (see Section 1403.10).

Section 1402 - Current Liabilities

Once accountants determine that Financial Statements must show a liability, they must decide whether it is current.

Any of the following means a liability is current (see also Chapter 6, Section 602.02):

1. The organization expects to settle the liability in the normal operating cycle[2], or the liability results from trading transactions[3] with specific payment arrangements.
    - The practical implication is that most trade payables and unearned revenue are current liabilities regardless of payment terms.
2. The liability's due date for settlement is within twelve months of the SFP date or
3. The organization has no unconditional right to defer settlement for at least twelve months after the reporting period.

Section 1403 - Kinds of Liabilities

This chapter discusses significant kinds of liabilities. If material, these liabilities groupings must each get separate disclosure in the Financial Statements. Do this by giving each a line in the Statement of Financial Position or in the Financial Statement Notes.

- Accounts Payable
- Employee Payables (e.g., compensation absences such as sick pay and vacation pay)
- Interorganizational Payables
- Loans Payable
- Agency Liabilities
- Unrecorded Revenue
- Accrued Expense
- Pensions and Deferred Employee Benefit Liabilities
- Contingencies (Including Guarantees of Others' Liabilities)

The following sections look at each of these types of liabilities. Each discussion includes:

[2] The operating cycle is the time between the acquisition of assets (e.g., inventory, crop planting, book printing, etc.) and their realization in cash (i.e., collecting the resulting receivable). For most denominational organizations, the operating cycle is twelve months (one year).
[3] Schools and publishing houses are good examples of trading liabilities with specific payment arrangements.

1. Description of items that belong under that heading
2. Discussion of any special accounting considerations
3. Discussion about related accruals the organization must make before they prepare their financial statements
4. Description of any required disclosures

1403.01 Accounts Payable

Accounts Payable are often called Trade Payables. These result from recording expenses before the related payment. Examples include payables to:

- utility companies
- suppliers
- office cleaning companies
- repair shops.

Usually, these creditors expect payment within a month or two. If the period for repayment is more than a year or the debt is not for normal operating activities, the payable is not an account payable. It is a loan payable. This classification as loan payable is proper even if no one has signed a promissory note and no interest charge exists (See Section 1403.04).

1403.01.01 Accounts Payable Accounting Considerations

Accounts Payable involves three major accounting issues:

1. The monthly financial statements must show accounts payable.
    - Some organizations place bills from suppliers in a folder and make accounting entries to record expenses when they pay them. This delay in recording accounts payable is not a suitable practice.
    - This manual recommends that the organization record the payable when they receive the bill and then reduce the payable when they pay it.
    - An organization might not choose to record the payable when the bill is received, but at a minimum, all unpaid bills must be recorded at the end of the month.
    - In all cases, the SFP must show unpaid bills as accounts payable at month end.
2. Occasionally, a payable account has a debit balance. This debit balance often results from returns or store credits. It also happens when you pay for something in advance.
    - Show payable accounts with debit balances as a receivable in the asset section.
3. Accounts Payable are associated with operating expenses and supplies.

- Accounting systems should treat material amounts owed to employees for these types of purchases as Accounts Payable instead of Employee Payables.[4]
- This classification means some employees may have a regular Employee Receivable/Payable account for employee-related activities and an account payable for their purchasing activities.

1403.01.02 Accounts Payable Accruals

The organization must record expenses and their resulting liabilities in the correct month.

- Doing this may require delaying recording some bills if they belong in the next month. An example: in May, the organization receives a bill for June's insurance. It would not record this bill if it did not owe it until June.
- Usually, getting expenses and liabilities in the correct month means making accrual entries to record bills received in later months recorded as an expense and liability in an earlier month. For instance, an organization gets its May electric bill in June. It has a May expense and liability.
- The date the organization receives the bill is irrelevant to the decision about the month it shows the bill as an expense and liability. The expense and the liability belong to the month when the organization receives the good or service.
- A common requirement is the need to make accrual entries to record unrecorded past-due charges or interest on unpaid payables.

The organization must decide if an accrual would make a material difference in their reported liabilities. They do this considering the following questions:

- Would accruing or not accruing *the item* make any material difference in the reported expenses and debt, and
- Would the *aggregate decisions* about accrual make any material difference in the reported expenses and debt?

1403.01.03 Accounts Payable Disclosures

The Notes usually include statements such as, "Trade payables are due within one year and are measured at fair value." Fair value is typically the cost of settling the payable with the creditor.

[4] This prevents confusion between Payroll-related liabilities and liabilities relating to Nonpayroll-type liabilities. It also facilitates preparing a Cash Flow Statement using the Direct Method.

1403.02 Employee Payables

Employee Payables usually relate to unpaid wages and employee benefits. The organization must record these expenses in the month the employee worked. This principle means the organization has a liability if it does not pay the employee until the following month. If they pay a worker in May for April work, the salary expense is in April, and there is an employee liability at the end of April. It is incorrect to show the May payment as a May expense and not show the April liability.

1403.02.01 Employee Payables Accounting Considerations

1. As with Accounts Payable, it is essential to record payroll-related expenses in the month the employees did their work.
    - Payroll spreadsheets and payroll systems must record employee wages in the accounting period in which the employee earned the wages.
    - The period in which the organization makes the payment is not the deciding factor for recording the expense. However, it does affect whether there is an end-of-the-month liability. If it pays for June's work in June, there is no end-of-the-month liability. If it pays for June's work in July, there is an end-of-the-month liability.
2. The statements must show employee payables with a debit balance as an Employee Receivable.
3. As noted in Section 1403.01.01, the Statements should report material debts to employees related to acquiring supplies and reimbursing other expenses as Accounts Payable — not Employee Payables.
    - Keeping this distinction assists efforts to show compliance with policy and employee protection laws.[5]

1403.02.02 Employee Payable Accruals – General

Financial Statements must show employee-related expenses in the period in which the employees earn their salary and benefits. Payments made in advance require the creation of an asset (e.g., prepaid wages) until it is time to show the cost as an expense; however, it is more likely that an

[5] For example, many countries prohibit holding back employee wages in a dispute over missing receipts for purchases employees made on behalf of the organization.

organization pays salary and employee benefits in the month after the employee earned them. This delay creates a liability.

In monthly payrolls, this is not a significant problem. The effort is to get the expense for the month to correspond to the period when the worker earns their wages. This parsing of employee costs into the proper expense period is less clear with biweekly and weekly payrolls. In these cases, the payroll period may overlap the end of one month and the beginning of the next. This overlap requires the Statements to apportion the payroll between the two periods.

Example – Weekly Payroll Crossing Months

Consider a weekly payroll when three workdays are in June and four workdays are in July.

The Financial Statements must show three-sevenths of the salary and benefits as a June Employee Expense. It also shows that amount as a 30 June liability.

Note: Assessing the materiality of this kind of adjustment is tricky. In one month ignoring the adjustment may be immaterial but in another, it may not be. However, the distortion caused by doing it in the months where the adjustment is material and ignoring it in the immaterial months corrupts expense analysis. The same problem comes from doing it just at year-end for the annual audit and not for other months.

Figure 7 - Weekly Payroll Crossing Months

1403.02.03 Employee Payable Accruals – Compensated Absences

The previous section focused on the delay between an employee earning wages and their payment. One type of delayed payment is for paid vacations or annual leaves. Sometimes, there can be quite a delay between when the employee earns the vacation days and when they take them. During that delay, there is a liability.

The cost[6] of the benefits is an expense when the employee earns them, not when the organization pays for them. The required adjusting entry is straightforward and is illustrated in Volume 3 of the *Accounting Manual*. The critical information to maintain is each employee's period-end balance of unused days and their daily salary.

[6] This cost is the salary cost paid to the vacationer.

1403.02.04 Employee Payables Disclosures

Key Management Personnel
The financial statements must show the aggregate of the payables due to key management personnel. For clarity, this is a total for all key management personnel; the disclosure does not list individual employees.

Key Management Personnel includes anyone with the authority and responsibility for planning, directing, and controlling the organization's activities.

- This classification includes any employee on the organization's Executive Committee or Board.
- It also includes all officers regardless of whether they are on the Executive Committee or Board.

1403.03 Inter-organizational Payables

Inter-organizational Payables are operational liabilities related to routine debit and credit memo processing. The spirit of inter-organizational payables is that they are temporary and transactional, and the organization routinely pays off persistent balances. This classification does not include all possible inter-organizational liabilities. The Financial Statements will show inter-organizational agency liabilities as agency liabilities and other inter-organizational debt as loans payable. The sections on those topics further discuss these other inter-organizational payables.

Inter-organization payables include transactional accounts with local churches. Conferences can likewise have loans payable and agency liabilities with their churches.

1403.03.01 Inter-organizational Payables Accounting Considerations

Most Adventist accounting systems use a single inter-organizational account to track the transactional debit and credit memos. If that account has a debit balance, its Statements show it as an inter-organizational receivable. If the account has a credit balance, the Statements show it as an inter-organizational payable.

1. Organizations may use the inter-organizational account to promptly process remittances and payments of inter-organizational agency liabilities and inter-organizational loans; however, they should not leave inter-organizational agency liabilities and loans in the inter-organizational account but should move these liabilities to their proper classification.

Example – Inter-organizational Payable

Conference A's Union has given it a large advance to help it address a crisis. It receives the help via credit memo. The conference should move the balance connected to this loan from the inter-organizational payable account to a loan payable account.

Its Union should do a similar action, moving its inter-organizational receivable into a corresponding loan receivable account.

Figure 8 - Inter-Organizational Payable Example

Agency liabilities are another example of this situation.

Example – Agency Liabilities

Conference A may have an agency liability for offerings it has collected on behalf of its Union.

It will leave that debt in an agency liability account until it is ready to settle the debt. Then it can use the inter-organizational receivable/payable account to process the payment.

Figure 9 - Agency Liabilities Example

These provisions mean that the inter-organizational account would not have a significant ongoing balance.

2. The two organizations involved in inter-organizational receivable/payable accounts must reconcile their accounts with their sister organization.
    - They do this reconciliation each month before issuing Financial Statements.
    - The two organizations must resolve all disputed items within two months.

To achieve item 2, the two organization's chief accountants must ensure a clean cut-off of inter-organizational transactions at the end of each month.

1403.04 Loans Payable

Loans payable is a snapshot of the organization's borrowings. This category does not only include borrowing as the result of promissory notes. That is why this section does not call itself notes payable, but debts supported by promissory notes do fit in this category. Likewise, the loan payable does not need a stated interest rate or due date to belong to this section. Open-ended, interest-free loans belong here. Inter-organizational debt belongs here.[7]

All organizational borrowing belongs in this section. The organization's Executive Committee should approve all borrowing, but even if the borrowing is unapproved, it belongs under this heading.

1403.04.01 Below-market and Interest-free Loans

Loans with below-market interest rates (including interest-free loans) are common between affiliate Adventist organizations. Likewise, sometimes employee loans have a below-market interest rate. This subject was discussed from the perspective of the organization lending the funds and holding the receivable in Chapter 11, Section 1108. The flip side of this arrangement is the liability that exists in the accounting records of the organization that holds the liability.

In Chapter 11 it was noted that when below-market interest rates are offered in the loan documentation, the organization providing the loan has effectively granted the recipient of the loan a hidden appropriation. When the loan receivable is listed on the Statement of Financial Position (SPF) at fair value (i.e., the present value of future cash receipts), the loan will be discounted using the current market interest for similar loans and credit ratings. The difference will be an appropriation to the recipient organization. Volume 3 of this *Manual* provided an example of entries for a loan receivable at below market interest rate.

Likewise, the organization holding the liability has interest expense because the loan is discounted at the current market interest for similar loans and credit ratings. This interest expense is the flip side of the appropriation income granted by the loaning organization. The accounting is simply showing the appropriation (by the loan grantor) and interest expense (incurred by the loan recipient) in the proper periods over the life of the loan.

See Volume 3 of this *Manual* for an example of entries for a loan payable at below market interest rate.

1403.04.02 Loans Payable Without Due Date

If the loan does not have a due date, the question arises as to whether the loan is not actually an appropriation. Determining this goes beyond the Executive Committee calling it a loan. The accounting must look at substance over form:

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[7] Transactional debt that relates to the inter-organizational debit and credit system belong in the inter-organizational payables section. Advances and other loans belong in this section.

- Does the lender have the intention and ability to call (i.e., demand repayment of) the loan?
- Does the borrower have the intention and ability to repay it if the creditor calls it?

The existence of a mortgage may not settle this question.

> ***Example – Union Loan to Conference***
>
> Consider the Union that has made a loan to its Conference to assist in building the Conference's (also the Union's) largest church.
>
> As collateral, the Union records a mortgage on the church. On the surface, the loan appears secure, and the Conference will repay it; but it is unlikely that the Union would ever foreclose on the church.
>
> In this case, the existence of a mortgage does not settle the question of whether they should consider the loan an appropriation. The Conference and the Union need to routinely review whether this is a genuine loan or whether it needs to be considered an appropriation.

Figure 8 - Union Loan to Conference

Once the debtor and creditor honestly identify a loan as a loan and not an appropriation, both must consider a loan without a due date as a demand loan when deciding whether it is current.

1403.04.03 Loans Payable in the Plant Fund

If the loan is a mortgage or note collateralized by assets in the Plant Fund, the Plant Fund must account for the loan payable. This requirement includes capital leases.

Capital leases are loans payable like regular loans backed with the collateral of the leased vehicle or equipment. This manual's Chapter 13 - Land, Buildings, and Equipment discusses leases (See Section 1305.02). It describes how to identify and record the loan portion. That loan portion is a loan payable, and the accounting for it is no different than accounting for any other building or equipment loan.

1403.04.04 Loans Payable Accruals

As time passes, loan payable's interest expense and increasing debt silently occur. Each period must show all the interest expense that the passage of time has caused. These silent changes mean the accountant must study each debt to determine and record the amount of any unrecorded interest that belongs in that period. Accrual entries should capture those entries in the month when the interest occurs and not in the month the organization pays them.

1403.04.05 Loans Payable Disclosures

The loans payable disclosures are perhaps the most important financial statement disclosures. The disclosures assist its reader in determining the organization's financial risks. The Financial Statement Notes should give the details of each significant loan payable.

This disclosure should include the loan payables:

- Creditor's name and whether the creditor is another denominational entity.
- Face amount and carrying value (i.e., its book value) as of the Statement of Financial Position (SFP) date and for every other comparable period shown in the SFP.
    - Suppose a conference's SFP shows the current and previous year's loans payable. Then, the Statements must show each loan's face amount and carrying value for both years.
    - The easiest way to do this is within a Schedule in the Financial Statement Notes.
- Nominal interest rate.
- Repayment terms (e.g., due date and payment requirements.)
    - This disclosure includes stating if the loan is callable.
    - This manual classes loans without due dates as payable upon demand of the creditor.
- Description of the collateral.
- Identification of any loan guarantors.
- Disclosure of loan covenant requirements[8] and information on whether the organization is in breach of any loan conditions.

[8] Loan covenant requirements include such things as a requirement to keep a certain size Inventory or Working Capital.

1403.05 Agency Liabilities

Within the sisterhood of organizations making up the Adventist Church, it is common for one organization to hold money belonging to another.[9] These agency relationships result in an inter-organizational debt different from those discussed earlier in this chapter. These stewardship relationships require a duty of care and fidelity of a higher order than the typical debtor-creditor relationship.

In the Church, four commonly occurring agency relationships further illustrate this:

1. **Mission Grants Agency Liabilities**
   The denomination often makes mission grants (e.g., Global Mission funding) through the denomination accounts. The inter-organizational payable account (debit/credit memo system) is suitable if one organization is quickly passing the grant from one organization to another. But suppose, for some reason[10], one organizational level holds the grant before passing it to another. In that case, it must move the grant from the Inter-organizational payable liability system and place it in an agency liability account.
   - The holding organization must be able to identify the agency liabilities held in this fashion.
   - It must be able to identify the amounts belonging to a particular grant and keep the funds belonging to the grant separate from its own funds.
   - This segmentation includes the SFP showing the monies as agency cash and may require different bank accounts if the delay is long and the amount is relatively large.

2. **Donor Directed Agency Liabilities**
   These are amounts from donors who have not yet specified the project to be supported. They may even want to direct the gift to some other organization. The organization holds the amount as an agent waiting for the donor's instructions. Once the donor designates what project the organization should spend the money on:
   - It becomes revenue or an inter-organizational liability.
   - It is reclassified as revenue if the project is a project of the organization holding the money.
   - It is reclassified as an inter-organizational liability if it is another organization's project.
   - The organization no longer holds the amount as an agency liability.

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[9] Do not use the out-of-date name for these: Trust Funds. The term "Trust Funds" was replaced since both words of the name are misleading. Trusts are specific legal entities which hold money for others. Since the organization is not a Trust, it is incorrect to call it that. Also, the word "Funds" gives the impression that the money is somehow set aside to support this liability. Usually, this is not the case; so, calling it a fund when it is not a fund is misleading.
[10] This hold occurs if, say, a Union holds the grant for security reasons until the Conference gets organized to carrying out the grant requirements.

- It is improper to charge expenses directly to the agency liability account. Accountants should charge expenses (e.g., printing expense, rent expense, etc.) to their proper expense category without considering that the donation funded them.

3. **Tithes and Offerings**

   One of the marvels of Adventist finances is its tithe-sharing system. It starts with the steward-members who hold the tithe on behalf of God until they return it on a Sabbath. The conference then becomes the steward-agent who holds a portion of it on behalf of the union, division, and the GC. Church working policy clearly defines this steward-agent relationship. After the conference remits that portion designated by policy to the Union, the Union becomes a steward-agent holding a part for the division and GC. At each level, the organization serves as the agent for the higher levels. Offerings run the same path with the same agent relationship.

4. **Student Club Agency Liabilities**

   Often, schools hold funds raised by student clubs. The school does not routinely decide how to spend those funds. They keep them as an agent on behalf of the student club.

1403.05.01 Agency Liability Accounting Considerations

1. Financial Statements report agency payables separately from other liabilities.

2. Agency payables are, by nature, current liabilities.

3. The accounting may use the inter-organizational payable account to transfer the payables to other organizations; however, the organization must first record the liability in the agency payable liability account and then transfer the remittance to the inter-organizational payable account. If the remittance does not soon clear from the inter-organizational payable account, the organization must return the balance to the agency liability account. An example of accounting for this situation is included in Volume 3 of the *Accounting Manual*.

1403.05.02 Agency Liability Accruals

1. This *Manual* does not require the organization to record interest on agency liabilities. Doing this depends on the circumstances. Schools often want to pay interest on student club

deposits. Sometimes, organizations wish to record interest on the outstanding balances of donor-designated agency liabilities. If the organization is recording interest, it should accrue it up to the end of the period. The interest expense should reflect the interest related to that period.

2. Tithe accruals. A perennial challenge for treasurers is missing tithe and offering reports. Organizations should not prepare financial statements simply by ignoring missing reports. Instead, they must conservatively estimate and accrue the missing amount. They do this by studying giving trends and previous reports. The entry records a debit to an accrued tithe receivable for the total estimated tithe, and the entry credits tithe income for the organization's share and agency liabilities for the portion going to higher organizations.

1403.06 Unrecorded Revenue Liability

Accrual Accounting requires that revenue for a period be the revenue the organization earns. It does not earn revenue until it provides the goods (as in the case of publishing houses) or services (as in the case of schools or hospitals). If it collects payment before earning the revenue, it has a liability.[11] Showing revenue when the organization earns it matches its revenue and expenses so that monthly results are a better picture of its activity.

1403.06.01 Unrecorded Revenue Liability Accounting Considerations

Tuition and school fees are good examples of unrecorded revenue liabilities.

[11] This rule holds true even if the advance collection is non-refundable. For example, most schools do not refund tuition if the student drops out. Even in that case the collected tuition is a liability until the school earns it by offering the instruction.

Example – University Tuition and Fees

Suppose a university has tuition charges of 30,000 for the three-month semester.

The university records the initial student billing on September 1, 20xx:

Accounts Receivable	30,000	
Unearned Tuition and Fees		30,000

Then at the end of September, it records September's income:

Unearned Tuition and Fee	10,000	
Tuition Income		10,000

No shown here are the September faculty and staff salaries and other operating costs.

If the school showed all the tuition in September, September would show a whole semester's tuition revenue and only a month of salaries and operating cost; however, October would have no tuition revenue but would still have October salaries. Showing September revenue and expenses and October revenue and expenses matched gives a more accurate picture of a month's operating results.

Figure 9 - University Tuition and Fees Example

1403.06.02 Unrecorded Revenue Liability Accruals

Some additional areas which require revenue accrual are:

- Unearned rental income - as in the case of a landlord or school renting an apartment or building and collecting rent in advance. Money collected earlier than it is earned by the tenant having access to the apartment is a liability.
- Unearned insurance - as in the case of a hospital providing insurance-like services. Money collected before earning it during the coverage period is a liability.
- Unearned camp fees - as in the case of a conference collecting its fees before operating the camp. The money collected before earning it by holding the camp is a liability.
- Unearned interest income - as in the case of a lender collecting interest at the start of a loan. When they collect the interest, it is an unearned interest income liability. As they earn it, the liability decreases, and interest income increases.

1403.07 Accrued Expenses

The organization must show expenses in the period it receives a good or service. It makes this determination without considering when it receives or pays the bill.

Example – Attorney Fees

For example, an organization may use an attorney in June, receive the attorney's bill in July, and pay that bill in August.

It records the expense and liability in June.

Figure 10 - Attorney Fees

1403.07.01 Accrued Expenses Accounting Considerations

Some accountants have qualms about recording estimates, but it is better to record a reasonable estimate, even if the correct amount is not recorded, than to choose to record nothing and be 100% wrong.

Example – University Electric Accrued Expenses

Consider that University A is preparing its November financial statements. Currently, it has not received its November electric bill. Because of rate increases, this year's monthly bills are 5% higher than the corresponding month in the previous year. Applying that pattern to last November's bill, the University estimates this November's electricity cost to be about 20,000.

Using this estimate, it will record this November entry:

Electricity Expense	20,000	
Accrued Electricity Expense		20,000

It uses that estimated amount in its November Financial Statement. It is incorrect to issue the November statements with such a significant expense missing.

In December, the bill arrives; it is 21,000. Accounting estimate errors should be recorded in the period in which the estimate's error is discovered.

The University records the bill like this:

Electricity Expense	1,000	
Accrued Electricity Expense	20,000	
Accounts Payable		21,000

In January, when it pays the bill, it records:

Accounts Payable	21,000	
Cash In Bank		21,000

Figure 11 - University Electric Accrual Expense Example

1403.07.02 Expense Accruals

Almost any expense may need accruals. The typical examples have been discussed in earlier sections. For example, accrued salaries occur when some portion of the pay period is in the earlier month (see Section 1403.02.02). Accrued interest happens when the organization pays interest after the end *of the period*. It must record the interest expense and liability *as the amount owed grows*, not waiting until the maturing of the liability (see Section 1403.04.04).

1403.08 Pensions and Deferred Employee Benefit Liabilities

Post-retirement benefits include such items as pensions and retirement health plans. Recording a post-retirement benefit liability is such a major topic that this *Manual* devotes Chapter 26 – Pension Liabilities and Expense to this subject. This chapter mentions post-retirement liabilities as they are one more example of accrual accounting. Accounting for pension liabilities is an example of recording *all employee costs* in the period when the employee earns them. In this case, the expense can be huge, and decades may pass between when the employee earns the benefits and when the company pays them. However, despite their size and duration, the principles are the same as for other accrued expenses.

1403.09 Provisions, Contingent Liabilities, Contingent Assets

Treasurers often overlook recording provisions and contingent liabilities. This omission is unfortunate because their Statements then lack critical information about the organization's financial position.

Here are some examples:

- Lawsuits - either as a plaintiff (perhaps resulting in a contingent asset) or as a defendant (possibly resulting in a contingent liability)
- Impending governmental fines
- Government takeover of organizational assets
- Warranties
- Loan Guarantees
- Oil tanks, asbestos, mold, and other hazards on the church property requiring specific cleaning and disposal.

A Provision liability, contingent liability, or contingent asset share these three traits:

1. The event giving rise to them must have happened before the end of the accounting period.

> *Example – Negligence Lawsuit*
>
> Consider a lawsuit for alleged maintenance negligence of a handrail. The handrail failed to prevent an elderly member's fall.
>
> If the fall occurred after the accounting period, it is not a provision or a contingent liability. It might be if the fall occurred before the end of the period (i.e., the SFP date).

Figure 14 - Negligence Lawsuit

2. There must be a specific uncertain event happening or not happening in the future.
    - The future event from the handrail example would be the lawsuit's outcome.
        - This requirement eliminates vague, uncertain future threats.
        - If the future event is wholly within the organization's control, it is not a provision or a contingency.

> *Example – Oil Tanks, Asbestos, Mold Expanded*
>
> To clarify this, consider the earlier mention concerning oil tanks, asbestos, or mold on church property.
>
> If the lack of clean-up only hurts the property's value but government regulations do not require the organization to clean it, it is not a provision or a contingency.[A] There is no specific uncertain event in the future.
>
> Note A: This decline in property value may be an asset impairment requiring a reduction in the property's carrying value.

Figure 15 - Oil Tanks, Asbestos, and Mold Expanded

3. The potential future threat and obligation must be specific to the organization.

Example – Oil Tanks

Consider a government that has changed its environmental rules concerning oil tanks.

It leaves many of the specifics to its environmental regulator. All property owners are unclear about if or how it will impact them. Even though the organization has an oil tank, this would not be a contingency.

Once the regulations clarify the organization's standing about the oil tank, it can become a contingent liability.

Figure 16 - Oil Tanks

1403.09.01 Provisions for Loss

Provisions for loss have the three characteristics discussed above, plus two more:

- Payment is more than 50% likely to occur.
    - Accounting literature refers to this as probable — more likely than not.
- The organization can reliably estimate its payment.
    - It is rare not to be able to make this estimate.

Usually, the organization needs its attorney to assist in meeting these last two characteristics.

The organization must record provisions as liabilities as of the end of the period.

1403.09.02 Insurance Reimbursement

There is a chance insurance will reimburse some of the loss:

- Do not reduce the amount of the provision by any potential insurance reimbursement.
- The Financial Statements may show the insurance as an asset only after it is certain that they will receive a reimbursement if they settle the obligation. For clarity, this reimbursement is not a reduction of the provision. There is an asset for the certain insurance reimbursement and a liability for the entire provisional loss.

1403.09.03 Multiperiod Provisions

Often, the loss uncertainty extends to the next accounting period. The organization must review and perhaps revise the provision at the end of each subsequent period. If the estimated payment increases in, say, the second period, this causes a second-period expense. Likewise, if it decreases, there is second-period income. If the likelihood falls below 50%, the organization reverses the provision.

1403.09.04 Contingent Liabilities

Contingent liabilities meet the first three requirements (see Section 1403.09), plus one more:

- Payment is possible.
    - Specifically, payment is less than 50% likely to occur and is not remote.
    - Accounting literature does not provide an exact definition of "remote", but the term "possible" does carry a meaning that makes remote a small probability.
        - Very rarely can someone say a contingency can't possibly cause a payment.
    - Take loan guarantees as an example.[12] It is rare to be able to say it is not possible that the organization will have to pay out on a loan guarantee. The bank wanted the loan guarantee in the first place because they thought it was possible that the debtor would not pay.

If the contingency meets all four criteria, the Statement Notes must disclose information about the contingency liability. There is no requirement to record the liability as a debt.

1403.09.05 Contingent Assets

Contingent assets meet the first three requirements (see Section 1403.09) plus one more:

- The inflow is more than 50% likely to occur.

If the gain continency meets all four criteria, *the Financial Statement notes* may disclose information about the contingent asset.

1403.09.06 Provisions Required Disclosures

The required disclosures for provisions are:

[12] U.S. GAAP requires all loan guarantees to be treated as possible losses. IFRS does not. IFRS requires disclosures about loan guarantees but does not call them contingencies. That distinction is only a matter of wording.

- A brief description of the nature of each obligation.
- The carrying amount of the provision.
    - This disclosed amount is for each year shown on the Statement of Financial Position (SFP).
    - Usually, this is the current and the comparable previous year.
- Additional provisions made during the year.
    - This additional amount results from increases in the estimated pay-out.
- Unused amount reversed during the year.
    - This reversed amount results from decreases in the estimated pay-out.
- Amount paid out of the provisions during the year.
    - For instance, payments to lawsuit claimants.
- The expected timings of the probable payments.

The Statements must show these six things for each provision. It is permissible to aggregate multiple provisions if they are indistinguishable from each other in substance.

1403.09.07 Contingent Liabilities Required Disclosures

The required disclosures for any contingent liabilities are:

- A description of each contingent liability.
- An estimate of the payments that the contingency may require.
    - It is rare for an organization not to make this estimate.
    - If they cannot, the disclosure must explain what makes it impossible and disclose as much information as possible to help the financial user estimate the risk.
- An indication of the potential timings of the payments.
- An explanation of the uncertainties related to the amount or timings of any payments.
- The possibility of any insurance or other reimbursements related to the contingency.

1403.09.08 Contingent Assets Permitted Disclosures

The permitted disclosures about any contingent assets are:

- A description of the contingent asset
    - This description may present a conservative estimate of the probability of the expected outcome.
- An estimate of its economic effects.

- This disclosure must present only the most conservative estimate.

1403.10 Loan Guarantees

Church organizations make loan guarantees. Organizations often do so to help employees get car or house loans and to assist sister organizations. Even though they are contingencies, IFRS accounting treats them with separate rules.

The organization must apply this treatment to all loan guarantees irrespective of the likelihood of having to pay on the loan.

There are three steps:

1. Record the Fair Value of the Loan Guarantee

   The first step occurs when the loan guarantee is first issued. An entry must record the fair value of the loan guarantee.

   The challenge is to calculate the guarantee's fair value. An example of how to calculate this fair value is provided in Volume 3 of the *Accounting Manual*.

2. Amortize the Loan Guarantee

   The second step amortizes the loan guarantee's liability at the end of each period. It does this using the straight-line method over the life of the loan.

3. Estimate and Record the Expected Credit Loss

   The third step requires an estimate of the expected credit loss of the guaranteed loan with the bank. Routinely, say annually, the organization needs to look at the credit risk associated with the guaranteed loan. To do the calculation, one must know how the loan fits into one of the following three categories:

   1. The conference is paying the union-guaranteed loan and is up to date.
   2. The loan is more than 30 days past due.
   3. The loan is in financial difficulty with the creditor. This difficulty is so severe the creditor has started collection activities.

- For category one, the calculation uses the loan payments due for the next twelve months. The assumption behind category one is that the bank may call on the union to help with a payment.
- For categories two and three, the calculation uses the total amount the bank can expect from the guarantor.[13]

Here is how to calculate the estimated credit loss for each category:

- Category 1 - The significant risk is that the union may have to step in to help with a missed payment.
    - The loan payments for the next twelve months.
    - Times the probability of default in the next twelve months.
    - Times the percentage of the loan payments that the union will have to pay. This estimate can consider the possibility of recovering something from the conference.

  Hopefully, all an organization's guarantees fall into this category, and each has a low probability of default.

- Category 2 - Here, the guarantor union may have to step in to pay the whole loan.
    - The expected value of the payment is:
        - The total that the bank can expect from the guaranteeing union.
        - Times the probability of default over its life
        - Times the percentage of the loan payments that the union will have to pay. This estimate can consider the possibility of recovering something from the conference debtor.

  Then, the organization discounts that expected payment to its present value using the Union's borrowing rate.[14] This discounted amount is the guarantee's expected credit loss.

- Category 3 - This is when the creditor is already making collection activities. Its calculation is the same as Category 2, but the calculation sets the probability at 100%.

[13] This includes fees and late charges and is limited if the guarantor's exposure is limited.

[14] The idea is that the Union will have to pick up the payments. The calculation would take the payments, times the probability of default. These payments would be discounted using the Union's borrowing rate.

At this point, the accountant has calculated the expected credit loss of the guarantee. Next, they should compare the expected credit loss to the carrying value of the guarantee's liability[15].

- What if the expected credit loss is less than the carrying value of the guaranteed liability? Don't do anything. The idea is that the organization is already showing enough liability to cover the expected loss.

- What if the expected credit loss is greater than the liability? Then, make an entry to increase the Financial Guarantees liability to the amount of the expected credit loss. This entry credits the Financial Guarantees liability and debits Financial Guarantees Expense.

What if the credit risk improves in future periods and the expected credit loss declines? Reduce the liability to recover the previously recorded extra amount.

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[15] This is the initial amount minus any amortization.

Chapter 15

Net Assets

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Chapter 15
Net Assets

This chapter begins by exploring the nature of net assets, differentiating them from "Owners' Equity" or "Capital". It moves on to discuss categories of net assets and allocations, as well as restricted and unrestricted donations.

Section 1501 - Nature of Net Assets

Statements of Financial Position (SFP) for in for-profit organizations have a section representing the owner's share of the company after subtracting liabilities from assets. For-profit organizations label this as "Owners' Equity" or "Capital." Both terms are unsuitable for non-profit reports since the non-profit has no identifiable ownership. Instead, non-profit accounting has adopted a different name for this section of the SFP: Net Assets.

From one point of view, this is a good name since it represents an organization's total assets after considering the liabilities it must pay from those assets. It is the net available to conduct the non-profit's mission.

From another point of view, the name is unfortunate. The name, net assets, gives a false impression that items in this section are assets. Net assets are not assets at all.

Example – Statement of Financial Position

To illustrate this, consider this simple Statement of Financial Position:

Assets		
	Cash	100,000
	Equipment	300,000
	Total	400,000
Liabilities		
	Payables	100,000
	Net Assets	300,000
	Total	400,000

An inexperienced reader could interpret this as 400,000 in regular assets and 300,000 in net assets and conclude that total assets are 700,000. In fact, the total assets are 400,000; creditors claim 100,000 of them. This reduction leaves the non-profit 300,000 in net assets with which to conduct its mission.

Figure 1 - Simple Statement of Financial Position

There is another difference between for-profit organizations' accounting equity and a non-profit's net assets. For-profit accounting uses the equity section to report the sources of its capital (i.e., common stock, preferred stock, retained earnings, etc.). Non-profit accounting uses this section to show how the organization has earmarked net assets for specific purposes (i.e., allocated, tithe, donor-restricted, etc.).

Sample Statements Excerpt

This excerpt from the sample statements illustrates this:

	Operating Fund	Plant Fund	Total 20X1
NET ASSETS			
Unallocated Tithe Function	3,041,556		3,041,556
Unallocated Non-tithe Function	3,462,935		3,462,935
Allocated Functions - Unrestricted	5,598,929		5,598,929
Allocated Functions - Restricted	2,200,000		2,200,000
Unexpended Plant Function - Unrestricted		1,043,890	1,043,890
Unexpended Plant Function - Restricted		200,000	200,000
Invested in Plant Function		3,975,856	3,975,856
Total Net Assets	14,303,420	5,219,746	19,523,166

The organization has a total of 19,523,166 in net assets. This amount is the hodgepodge of things it has for conducting its mission.

The Unallocated Tithe Function, 3,041,556, is the amount of assets earmarked for tithe-only uses. These unspent tithe donations have not been set aside for specific purposes.

The Unallocated Non-Tithe Function, 3,462,935, are unspent general donations and earnings that the executive committee has not allocated to any specific purpose.

The Allocated Function - Unrestricted, 5,598,929, is the amount of unspent tithe and unrestricted, non-tithe resources that the executive committee has earmarked for specific purposes.

The Allocated Functions – Restricted 2,200,000 is the amount of unspent restricted donations earmarked for specific purposes.

The Unexpended Plant Function unrestricted, 1,043,890, is any unspent general donations by the executive committee for buying new buildings and equipment.

The Unexpended Plant Function Restricted, 200,000, is unspent donations that the donors have earmarked for specific new buildings and equipment. Not illustrated is the possibility that there is an Unexpended Plant Fund Allocated. This would be for board designated equipment and building projects.

The Invested in Plant Function, 3,975,856, is the total of plant, property, and equipment (minus related debt). This amount is available to carry out its mission, but it is in the form of fixed assets, not spendable resources.

This illustration intentionally tries to show all the categories. It is doubtful an organization will have them all.

Figure 2 - Net Assets Sample

1501.01 – Net Assets and Liquidity

The categories discussed in the sample above show the assets on hand for the organization's ministry; however, users must be careful. The Executive Committee may have also authorized uses of the assets that interfere with their immediate availability for their designated purpose.

Example – Sample Statement Expanded

Consider the example shown in the sample Statement above:

There are:	7,798.929 Allocated to specific purposes (i.e., 5,598,929 + 2,200,000)
	1,243,890 earmarked for building and equipment purchases (1,043,890 + 200,000)
These total:	9,042,819

All is good if the organization has the cash and short-term investments to back up the allocation. Specifically, its liquid assets (e.g., cash, investments, etc.) minus current liabilities must be greater than its allocated net assets. If not, the organization does not have enough liquid assets to do the activity for which it has set aside the net assets. The assumption (and policy) of allocations is that the organization has and preserves enough liquid assets to satisfy the policy's minimum requirement and enough to cover the allocated net assets.

Figure 3 - Sample Statement Expanded

Section 1502 - Net Asset Categories

For-profit organizations acquire equity from owner investments and retained earnings. Non-profits' net assets only come from retaining their earnings.[1] These earnings can come from commercial exchange activities such as tuition or rental income. They can come from tithes, or donors may give unrestricted or restricted donations. Also, Executive Committees may allocate the tithe and offerings to specific projects. These distinctions mean a significant task of non-profit accounting is tracking the various labels donors and Executive Committees place on income.

One way to think about net assets is that they are unspent earnings that are either tithe or non-tithe, either allocated or unallocated, and either donor-restricted or not. These are overlapping

[1] Some donors may feel like they are making an investment in the non-profit, but their donations are revenue not direct capital investments.

designations; the same net asset can be tithe and allocated; all donor-restricted net assets are non-tithe.

Each of these categories is discussed below:

- Unallocated Tithe
- Unallocated Non-tithe
- Allocated Functions (both Unrestricted and Restricted). See also Chapter 2, Sections 202.03 and 202.03.01 for discussion of unallocated and allocated resources.
- Unexpended Plant Function (both Unrestricted and Restricted). See also Chapter 7, Section 701.02.
- Invested In Plant Function. See also Chapter 13, Section 1305, and Chapter 7, Section 701.02.
- Donor Restricted (see also Chapter 4, Section 402.03.02).

1502.01 – Unallocated Tithe Net Assets

This section holds assets earmarked for tithe-only uses. These net assets are unspent tithe donations which have not been set aside for specific purposes. They are available at the SFP date, and the organization must spend them for tithe purposes. GC Working Policy V 14, Use of Tithe, describes the proper use of tithe. Every Church leader should understand this policy's requirements.

1502.02 – Unallocated Non-tithe Net Assets

These net assets are unspent general donations and earnings that the executive committee has not allocated to any specific purpose. Examples include non-tithe income such as offerings and rent income.

1502.03 - Allocated Net Assets – Unrestricted and Restricted

Unrestricted allocated net assets are unrestricted, unspent, non-tithe resources that the donor did not restrict but the executive committee has earmarked for specific purposes.

Restricted allocated net assets are the donor-restricted donations earmarked for specific purposes by the executive committee.

A net asset account is required for the net depreciated value of land, buildings, and equipment minus any related debt. This amount is represented by a net asset account, Invested in Plant. This account is required whether the organization uses fund accounting or not. See Chapter 7, Section 702.02 for additional information on the Invested in Plant Fund account.

1502.03.01 How Much Can Be Allocated?

The tithe and the restricted designations come from those outside the organization, but the organization's Executive Committee and financial leadership control allocations. Showing allocated net assets in its Financial Statements is a statement by the organization that it has these resources available to conduct a particular purpose. Sometimes, organizations have shown these allocations without the backing resources, meaning they do not have the liquidity to enable payments for the activity. This practice is deceptive.

Liquid assets have three burdens on them in this order:

1. Pay off Current Liabilities
2. Meet the Church's liquidity requirements (GCWP S24.14)
3. Fund Allocations

If an organization does not have sufficient liquid assets to support its allocated net assets, it is financially derelict. This principle leads to three standards:

1. It is vital to carefully study the demands on liquid assets before allocating them.
2. It is crucial to consider isolating the supporting liquid assets in separate bank and investment accounts to prevent inadvertently spending them.
3. It is necessary for an organization to reverse the allocated net asset (i.e., unallocate) if it no longer has sufficient liquid assets to support its allocations.

1502.03.02 Allocations with Negative/ Debit Balances

There are two other accounting considerations relating to allocations:

Allocations are a project's claim on liquid assets. In double-entry bookkeeping, the asset (e.g., cash) has a debit balance, and the claim has a credit balance. Therefore, an allocated net asset with a debit balance is nonsensical. The organization should remedy this when preparing its annual Financial Statements.

Likewise, consider whether the unallocated tithe or the unallocated non-tithe has a debit balance. This debit balance means it has already allocated or spent more net assets than it has. Thus, if unallocated net assets have a debit balance, the organization must unallocate some previously allocated net assets to the extent necessary to restore the normal credit balance in unallocated net assets.

1502.03.03 - Allocated Working Capital Net Asset

An organization builds Working Capital by spending less than it earns.[2] When budgeting, many treasurers set up an allocated net asset, Working Capital. They transfer surpluses into this net asset to preserve them for future emergencies and to meet the Working Capital policy requirements (GCWP S 24.14). This has the advantage of segmenting off a part of the net assets for working capital.

1502.03.04 Allocation of Global Mission and 13th Sabbath Funding

As funding for these types of projects passes through the denomination, organizations have two kinds of relationships with the funding.

1. The first relates to flow-through organizations.
   - Flow-through organizations receive funding from one organization and pass it to another.
   - As explained in Chapter 14 - Liabilities, their SFP shows these in-transit grants as agency liabilities.

2. The second relates to operational organizations.
   - These organizations receive funding and do the project (e.g., do the outreach ministry or build the building).
   - Their incoming grant funding counts as revenue.
   - The operational organization must recognize the incoming funding as revenue and the related expenses in an allocated net asset.

1502.04 – Unexpended Plant Fund - Unrestricted

The Unexpended Plant Fund – Unrestricted holds any general donations which are unspent by the organization and its Executive Committee for buying new land, buildings, and/or equipment. See also Section 204.4 and Section 702.02.01

[2] Precisely, it builds working capital by having a surplus: revenue is greater than expenses. It can increase working capital by selling fixed assets. It decreases working capital by losses or buying long-term assets.

1502.05 – Unexpended Plant Fund - Restricted

The Unexpended Plant Fund – Restricted holds unspent donations that the donors have earmarked for specific new purchases of land, buildings, or equipment. Not illustrated is the possibility that there is an Unexpended Plant Fund-Allocated. This would be for board-designated equipment, building, or land purchases.

1502.06 – Invested in Plant Function

The Invested in Plant Function is the total of plant, property, and equipment (minus related debt). This amount, while used by the organization to carry out its mission, is in the form of fixed assets, not spendable resources. See also Chapter 7, section 702.02.02 and Chapter 13, Section 1305.

Section 1503 - Restricted and Unrestricted Donations

Chapter 4 - Account Structure - discussed the need to keep track of donor-restricted donations (see Section 402.03.02 and Chapter 2, Section 202.03.01). The organization restricts these donations to be a good steward and further ensures and documents that the gifts are spent properly. Organizations must show any unspent balances of restricted donations in the net asset section. This standard means organizations must delineate donor-restricted net assets from those that were not donor restricted.

A natural question arises. Are all restricted net assets also allocated? Donors restrict, and boards and executive committees allocate. So, definitionally, there is a difference. Sometimes Executive Committees call for treating all restricted donations as allocated, but in the financial statements all restricted net assets are reported as “restricted” rather than “allocated.”

Section 1504 - Statement of Financial Activity and Statement of Net Assets

This chapter has discussed the various net asset types as noted in Figure 2. The Statement of Financial Activity is also discussed/explained in Chapter 4, Section 401.01.02 and Chapter 6, Section 603.02.

The Statement of Changes in Net Assets is also discussed in Chapter 2, Section 202.02, Chapter 4, Section 401.01.03, and Chapter 6, Section 603.03.

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Chapter 16
The Statement of Financial Activity

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Chapter 16
The Statement of Financial Activity

This chapter gives an overview of the Statement of Financial Activity.

Section 1601 - Introduction to the Statement of Financial Activity

The Statement of Financial Activity (SFA) reports the changes in net assets without tracking the type of net assets that the activity changes. (This latter task is the job of the Statement of Net Assets.) The SFA follows the following order:

Operating Revenue

Contribution Revenue - including
- Tithe
- Offerings
- General Donations

Exchange Transaction Revenue - including
- Rent Income
- Interest Income
- Student Fees
- Patient Income, Etc.

Minus Functional Operating Expenses - including such things as
- Local Pastor Expenses
- Youth Camp Expenses
- Youth Ministries Expenses
- Other Departmental Expenses
- Administrative Expenses
- Interest Expense

Operating Income
- This amount is a measure of self-support.
- If, over time, positive amounts are greater than negative amounts, the organization is self-supporting.

Plus (or Minus) Appropriations

This amount is the net of received minus paid appropriations.

Plus (or Minus) Non-operating Income and Expenses – including:

- Donations for Fixed Assets
- Proceeds from the Sale of Fixed Assets

Plus (or Minus) Transfers

- The statement includes this for completeness
- The transfers between distinct types of net assets offset each other, so there are always zero net transfers for the organization.

Increase in Net Assets

1601.01 Contributions

Contributions are the first revenue listed in the SFA. Contributions have the following characteristics. They are:

- Transfers of cash or other assets
- Voluntary (Tithe theology aside)
- Nonreciprocal (i.e., the donor gets nothing of commercial value in return)
- Come from individuals or other organizations.
- Go to charitable, religious, or educational organizations.

1601.02 Contribution Revenue Timing

An organization shows contribution revenue when it has an unconditional right to the contribution. This principle causes concern in two directions:

1. The need to record revenue before the receipt of the cash (or other assets) and
2. The need to delay recording revenue after receipt of the cash.

1601.03 Contributions Receivable

Organizations should record revenue and its related contribution receivable whenever they have the right to a contribution – even if they have not yet received the cash. These often arise in two situations:

- Transiting Contributions - Often, donors in one part of the world give a donation, and it takes time for the contribution to arrive at the final recipient organization. The Church's network of organizations passes these contributions along as debit and credit memos.

Organizations may record a contribution revenue and a receivable to reflect contributions in transit through this system.

The contribution must make its way to the final organization without regard to the other inter-organizational debts. This example illustrates this necessary church standard:

Example - Contributions

Conference A receives a contribution for a Conference B mission project.

Conference A passes the contribution upward with a credit memo to Union A, then to Division AB, then down to Union B, who finally gives it to Conference B.

The contribution must make this transition in reasonable accounting time.

But suppose Union B has a substantial debt to Division AB or Conference B has a considerable debt to Union B.

Creditor organizations may not hijack the contribution to satisfy their debt. In addition to passing the memos, the actual funding needs to make its way through the system. This may mean that an organization transfers money to an organization which owes them money.

Not getting the money to the final mission purpose undermines donor confidence in the Church.

Figure 1 - Contributions

1601.04 Contribution-related Agency Liabilities

Chapter 14 - Liabilities introduces agency liabilities (see Section 1403.05). These are liabilities arising from an organization holding money as an agent of the money's owners. That chapter uses the example of a union's portion of the tithe collected by a conference but not yet remitted to its Union. The organization cannot use it at its discretion; it reflects the tithe as an agency liability.

This situation is an example of the organization getting the money before it is correct to recognize it as contribution revenue.

Example – Mission Sponsorship

Donor A would like to sponsor mission projects in Union A. His idea is that the Union's conferences prepare proposals, and he decides which proposals to fund. The conferences prepare proposals, but Union A also prepares a proposal for a project it would like to run. The accounting sequence follows:

Fred transfers 100,000

	Debit	Credit
Cash in Bank	100,000	
Donor A Mission Project		100,000
(This is an Agency Liability)		

Donor A approves Conference A's project for 30,000 and the Union's project for 40,000. The union makes this entry:

Donor A Mission Project	70,000	
(This is the Agency Liability)		
Conference A Liability		30,000
(This is the inter-organizational liability to Conference A)		
Donation Revenue		40,000

When paying for the project activities, the Union records expenses as usual (e.g., printer payments to printing expense, rent payments to rent expense, etc.). It is a serious error to charge the expense payment directly against the liability.

Figure 2 - Contribution-related Agency Liabilities

Notice that the entries do not record the revenue until the organization has unconditional control of the resources. It is sometimes hard to discern the difference between conditional control and restrictions. A restricted donation may channel the gift to specific purposes, locations, or timing. If the organization has control of the ultimate disposition, it is a restricted donation revenue, but if the donor has control, it is an agency liability. The organization records the revenue whenever the donor relinquishes that control.

1601.05 Contributions of Land, Buildings, and Equipment

The Church may, from time to time, receive donations of Land, Buildings, and Equipment. The organization records these "in-kind" donations as fixed assets at their fair market value.

Many of these donations require the organization to pay something to receive the donation. For example, the organization might pay the donor as illustrated below.

Example – Land Donation

The organization receives a piece of land worth 1,000,000 for a payment to the donor of 100,000.

This results in a journal entry that looks like this:

Land	1,000,000	
(This is the value of the land)		
Cash in Bank		100,000
(Paid to the donor)		
Donation Income		900,000

It is common for a land and building donation to require the organization to pay an attorney to record the transaction. The entry would be similar. That payment would increase the cost of the property.

Figure 3 - Contribution Example Journal Entry

1601.06 Contributions of Services

Organizations usually do not record the value of donated services; however, occasionally, there are donations of services that the organization would certainly have purchased if the lawyer, computer programmer, accountant, etc., had not donated their time. It is permissible to record these as donation income and expense (e.g., legal, IT, accounting expenses) at their fair market value.

1601.07 Online Giving

The advent of online giving and remote giving has caused two important accounting considerations:

1. **Bank Fees and Income**
   Banks and nonconventional accounts often record transactions net of a service fee. For example, banks usually take a small percentage for processing credit and debit card deposits. (See Chapter 9, Section 902.03 for further discussion and example.)

2. **Online and Offerings Collection**
   The Church holds tithe in particular regard (See Chapter 20). Many countries have moved to almost cashless economies; therefore, the Church is adapting by constructing cashless methods of giving tithes and offerings. See Chapter 9, Section 902.04 for discussion of

this subject. Of major emphasis is the requirement that the organization must show tithes and offerings in their entirety and not reduce them by any service charges.

Section 1602 - Exchange Transactions

The second type of revenue are exchange transactions. Exchange transactions come from the organization's regular commercial activities. Typical examples are:

- Interest Income
- Rental Income
- Student Tuition and Fees
- Patient Fees
- Camp Fees, etc.

IFRS requires organizations to follow full accrual accounting for these types of revenue.

Example - Contributions and Exchange Transactions

Deciding if something is a contribution or an exchange transaction can be challenging. Simply posting a sign "Contribution 5 Pesos" does not make it a contribution.

Here are some pointers:

The following are contributions if the donor/customer:

- Receives nothing of value, or
- Receives only value indirectly or incidentally
  - Examples would be good feelings, stars in their crown, a beautiful church to worship in, safe school for their kids, etc., or
- Receives something of value, but they do not give it in exchange for the payment.
  - Examples would be *Steps to Christ* sent to all the church members with the contribution solicitation, or
- Receives something of small value relative to the amount of the gift.
  - Examples of this are thank-you mugs, tee shirts, or hats.
  - A good rule of thumb is that the thank-you gift is less than 2% of the value of the gift.

The organization compares the value of the item or service given to the donor/customer to the amount they paid.

If the value of an item or service the organization gives is about the same as the amount of the payment it collects, it is an exchange transaction.

If the value of an item or service the organization gives is not about the same as the amount of the payment it collects, it must record the value of the item or service as an exchange transaction and any amount over as a contribution.

Suppose an organization collects 100 and gives a 30 meal. They record the 30 as meal income and 70 as a contribution.

Figure 4 - Differentiating Between Contribution and Exchange Transaction

Section 1603 – Functional Expenses

IFRS accounting requires organizations to show expenses by "nature" or by "function." Showing expenses by nature means that the organization shows them by such categories as salaries, depreciation, operating, and utility expenses. Showing expenses by "function" shows them by their purpose: local church pastor expense, youth camp expense, youth ministries expense. Schools may show such functions as upper division, lower division, cafeteria, and residential care. Industries may show expenses by such functions as production costs, selling costs, administrative costs, interest costs, etc. Reporting by function requires slightly more accounting since it requires distributing certain expenses (i.e., depreciation, rent) to the functions and more care in charging functions with their correct expenses.

This manual requires the Activity Statement to report expenses by Function. It also requires a Financial Statement Note showing the expenses by both Nature and Function in a table. This required table is illustrated below.

This manual does not prescribe a specific maximum or minimum number of functions, but it recognizes the need for balancing formatting and space considerations in the Statement of Financial Activity (SFA) when determining the number of functions shown.

Deciding what functions to show on the statements requires some professional judgment. It may be too cumbersome to show every function in the organization. Organizations with many functions should combine them until they have a manageable number.

For example, suppose a conference has fifteen functions:

		Percentage Of Total Expenses
• Local Church Pastors	(Including Ministerial Dept)	40%
• Christian Education	(Including Education Dept)	20%
• Youth Camp		10%
• Camp Meeting		5%
• Youth Ministry		5%
• Evangelism		5%
• Trust Services		<1%
• Religious Liberty		<1%
• Singles Ministry		<1%
• Woman's Ministry		<1%
• Family Life		<1%
• Stewardship		<1%
• Communication		<1%
• Administration		10%
• Interest		2%

To obtain a more manageable list of functions, use a summarizing category (e.g., Other Departmental Ministries) to summarize the financially smaller departments.

When creating the list of functions, the listing must always show the administrative and interest cost[1] functions as separate functions. The organization should not assign or allocate these costs to other functions.

[1] That is, if interest costs are material. If they are not, they could be shown as an administrative cost.

For this example, the Statement of Financial Position would show the following functional expenses:

- Local Church Pastors (Including Ministerial Dept)
- Christian Education (Including Education Dept)
- Youth Camp
- Camp Meeting
- Youth Ministry
- Evangelism and
- Other Departmental Ministries
- Administration
- Interest

An alternative presentation is to show details in the related table and a summary in the SFA. The following illustrates this:

Suppose the Statement of Financial Activity showed this:

Operating Expense	Operating Fund	Plant Fund	Total
Local Church Pastors	4,439,477		4,439,477
Christian Education	2,219,739		2,219,739
Conference Camp	1,053,870	110,000	1,163,870
Youth Ministry	535,935	10,000	545,935
Evangelism	650,121	5,000	655,121
Other Departmental Ministries	925,088	3,000	928,088
Administrative	1,039,859		1,091,868
Interest	54,594	52,009	54,594
Total Operating Expense	10,918,683	180,009	11,098,692
Increase (Decrease) before Approp.	(3,905,982)	(180,009)	(4,085,991)

The required financial statement notes could show this:

	Employee-related Expense	General Expense	Departmental Expense	Other Operating Expense	Depreciation	Total Operating Expense
Local Church Pastors	4,439,477					4,439,477
Christian Education	1,760,000		239,342	220,397		2,219,739
Conference Camp	712,958	111,043	119,671	110,198	110,000	1,163,870
Youth Ministry	320,478	100,522	59,836	55,099	10,000	545,935
Evangelism	384,573	127,626	71,803	66,119	5,000	655,121
Other Departmental Ministries						
Sabbath School	54,481	18,489	10,172	9,367	300	92,809
Religious Liberty	125,307	42,524	23,396	21,544	690	213,460
Singles Ministry	61,564	20,892	11,494	10,585	339	104,874
Woman's Ministry	70,826	24,035	13,224	12,177	390	120,651
Family Ministry	88,260	29,952	16,479	15,174	486	150,350
Stewardship	78,998	26,809	14,749	13,582	435	134,573
Planned Giving	65,376	22,186	12,206	11,240	360	111,371
Total Other Departmental Ministries	544,812	184,887	101,720	93,669	3,000	928,088
Administrative	640,956	169,034	119,671	110,198	52,009	1,091,868
Interest				54,594		54,594
Total 20X1	8,803,254	693,112	712,043	710,274	180,009	11,098,692

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Chapter 17
Accounting for Multiple Currencies

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Chapter 17
Accounting for Multiple Currencies

This chapter examines how the Church, which works in nearly every world currency, accounts for multiple currencies. It covers denominational policies about exchange rates, gains and losses, revaluations, restricted currencies, and hyperinflationary economies.

Section 1701 – Accounting in Multi-currency Environments

The Adventist denomination uses nearly every world currency. The GC and its divisions, as well as many unions, serve many countries. Also, many single-country organizations use various currencies in their daily activities and investments.

Financial reports and accounting in multi-currency environments are the convergence of economic activities, exchange rates, Church policy, and IFRS standards.

1701.01 Economic Activities

A multi-currency organization sees multiple currencies at three points in its economic environment:

- At the transaction level,
- At the account level, and
- At the reporting level.

Example – Economic Activities

Consider an Adventist University in Thailand serving the Southeast Asia Region.

To support its students' financial planning, it states its tuition rates and accepts payment in several currencies.

Transaction Level. One of their students from Malaysia pays her 10,000 Malaysia Ringgit fee in cash.

Account Level. The University deposits this money in its Thailand bank. The bank account is a US Dollar account.

Reporting Level. Finally, the University wants to prepare Financial Statements that reflect the money in the bank and the tuition income in Thai Baht.

This example illustrates:

- the Ringgit transaction currency,
- the US account currency, and
- the Thai Baht reporting currency.

Figure 1 - Economic Activities

1701.01.01 Transaction Currency

Transaction Currency is the currency the participants in the transaction give and receive. For instance, GC Investment account transactions are currently in US Dollars, and the GC makes general appropriations in the recipient's currency.

1701.01.02 Account Currency

Unfortunately, in accounting jargon, there is no distinction between the term "accounts," referring to the accounting system's general ledgers, and "accounts," referring to bank accounts and those with other organizations. "Account Currency" here uses this latter meaning.

Often, organizations have accounts with banks, other organizations, and even individuals denominated in a foreign currency.

Example – Multi-currency Union

For example, consider a union that commonly uses Pesos. It has a Euros account at the local bank that records in Euros and a Great Britain Pound account with the division that records its transactions in Pounds. It might also have a US Dollar Employee Loan account. Each of these bank and organization's accounts tracks transactions in its respective currency. The accounting system must convert them into the Financial Statement reporting currency.

Figure 2 - Multi-currency Union

1701.01.03 Reporting Currency

Reporting currency is the currency used in the Financial Statements. Typically, reporting currency is the currency the organization primarily uses.

Section 1702 - Exchange Rates and Denominational Policy

The accountant uses currency exchange rates to record and revalue transactions in different currencies. Denominational policy describes two types of exchange rates:

- Current Exchange Rates and
- Fixed Exchange Rates.

1702.01 Current Exchange Rates - Transactions

In many cases, the economic facts of the situation determine the exchange rate that the accountant uses. In the student example, the bank's current exchange rate set how many dollars the bank recorded for the Ringgit deposit.

Working Policy defines the current exchange rate as:

> The current rate is the rate at which the organization can buy local currency. It uses this rate to record:
>
> - Purchases by individuals or organizations, and
> - Personal funds transferred under International Service Employee Working Policy, 100.45, Transfer of Personal Funds. (GCWP T25.15 Bullets added).

For emphasis, notice that this would be the rate used for:

- Transactions with individuals such as employees, students, patients, or donors.
- Purchases of goods or services.
- Sale and purchases of currencies.
- Any other transactions for which policy and this manual do not explicitly require using the fixed rate.

1702.02 Fixed Exchange Rates –Transactions

The Church uses fixed exchange rates to ease accounting for transactions between Adventist organizations. Fixed rates are most helpful with inter-organizational accounts. They are exchange rates set "close to the interbank, or the official rate of exchange." (GCWP T 25:10.1). The GC and its divisions set them as often "as necessary to maintain a close relationship to the current rate of exchange." (GCWP T 25:10.2). Usually, they do this monthly.

1702.03 Fixed Rates – Use with Individuals

Transactions with individuals mostly use the current rate; however, Church policy requires organizations to use the fixed rate for all transactions (including those with individuals) if the fixed rate "varies considerably from an official governmental rate which does not realistically reflect the value of the currency" (GCWP T 25:10.3). This provision prevents organizations from using a favorable unofficial rate for denominational transactions and at the same time forcing individuals to use the unfavorable official current rate.

1702.04 Fixed Rates – Monthly Revaluation

In addition to their role in recording "inter-organizational transactions such as Appropriations, (and) the Remittance of Trust (Agency) Funds," organizations use fixed exchange rates in preparing "statistical information and balance sheets." This latter provision requires organizations to use the denomination's fixed rates to revalue foreign account currencies to the reporting currency.

> ***Example – Exchange Rates***
>
> Consider once again, the Malaysian student example above.
>
> In June, the student paid 10,000 Ringgit to satisfy her tuition bill. When the university made the deposit, the bank recorded 1,900 US Dollars. It would have done this using its current exchange rate for Ringgit to US Dollars (1USD – 5.2631 Ringgit).
>
> At the end of the month, the US Dollar bank account has a 5,000 US Dollar balance showing on its bank statement. The accounting records show this bank account has a 150,000 Thai Baht balance; however, the fixed rate of exchange voted by the division (1USD = 26 Thai Baht) indicates that the 5,000 US Dollars are only worth 130,000 Thai Baht, so it must record a loss to bring the accounting record balances down to the value of the US Dollar account revalued at the fixed exchange rates at month end.

Figure 3 - Exchange Rates

1702.05 Fixed Rate – Recap

The organization must use the denominational fixed rate for the following purposes (it uses the current rate for all other purposes):

- Transactions recording receiving or paying denominational appropriations and grants[1].
- Transmittal of tithes[2], and offerings,
- Transmittal of retirement plan contributions.
- International Service Employees' salaries, expenses, allowances, and retirement contributions.
- Transmittal of Inter-organizational charges, such as ARM fees.
- Transmittal of Global Mission and similar grants.
- Statistical reports.
- The organization uses the fixed rate to revalue its foreign currency accounts to their current local currency values.

[1] Such as Global Mission or Adventist World Radio grants.
[2] Including Tithe sharing percentages

- Here are some examples of accounts that it must revalue:
  - Foreign currency bank and investment accounts,
  - Foreign currency inter-organizational receivable/payables accounts and
  - Foreign currency employee receivable/payables.

Section 1703 - Exchange Gains and Losses

Recording foreign currency transactions and month-end revaluations can cause exchange gains and losses.

1703.01 Transaction Exchange Gains and Losses

Transaction Exchange Gains and Losses result from receiving or paying an amount different from the foreign currency account's carrying amount.

Example – Exchange Gains and Losses Entry

Suppose the Thai University owes an employee 1,000 US Dollars. Its accounting records show the payable as 30,000 Thai Baht. This Baht amount was correct when it recorded the 1,000 payables, but, when the organization paid the employee the amount owed, it used 27,000 Thai Baht to buy the 1,000 US Dollars needed to pay the debt.

Here is the entry:

Employee A Payable	30,000	
(This reduces the payable)		
Cash-In-Bank		27,000
Exchange Gain and Losses - Operating		3,000

If it had instead taken 33,000 Baht to pay the debt, it would have a loss recorded as:

Employee A Payable	30,000	
Exchange Gain and Losses - Operating	3,000	
Cash-In-Bank		33,000

(Note that both the entries use the same loss and the gain account. There is no separate gain account and a separate loss account).

Figure 4 - Exchange Gains and Losses Entry

Section 1704 - Foreign Currency Revaluations

Revaluations also cause exchange gains and losses.

Example – Revaluations

Consider a Thai Union that has a US Dollar bank account.

At the beginning of the month, the bank statement shows that the bank is holding 10,000 US Dollars. The accounting records for that account have a Thai Baht balance of 300,000 Thai Baht.

This month's transactions record a 1,000 US Dollars going into the account at a Baht value of 33,000.

This results in a pre-revaluation balance of 11,000 US Dollars on the bank statements and 333,000 Thai Baht in the accounting records.

The discussion above explained that organizations use the denomination's Fixed Rate in the month-end revaluations. The Fixed Exchange Rate is 1.00 USD to 34 THB, so calculation and entry is:

	USD	THB
Beginning of the Month	10,000	300,000
(10,000 x 30 THB last month's revaluation)		
This month's transactions	1,000	33,000 (1,000 x 33 THB)
Current Carrying Value	11,000	333,000
Current Value	11,000	374,000 (11,000 x 34 THB)
Needed Adjustment		41,000 Gain

Here is the journal entry:

Thai Bank	41,000	
Exchange Gain and Losses		41,000

The calculation results in a gain if the current value exceeds the carrying value; it is a loss if the carrying value exceeds the current value. If there were a 30,000 loss, the entry would be:

Exchange Gain and Losses –	30,000	
Thai Bank		30,000

Figure 5 - Revaluations

Section 1705 - Exchange Gains and Losses

As the previous chapter explains (see Section 1601), the Statement of Financial Activity has three significant sections:

- Operating
- Appropriations, and
- Non-operating items generally dealing with Property, Plant, and Equipment.

Each of these sections reports its own exchange gains and losses. This separation means that the accounting system must keep separate[3] exchange gains and losses for each section:

1705.01 Exchange Gains and Losses - Operating

Operating exchange gains and losses are the most common type. Exchange gains and losses - operating is for all exchange gains and losses that do not go under the other two types. The SFA shows this exchange gain and loss-operating amount in its revenue section. It does this even if the net of gains and losses is a net loss. This net loss reduces total revenue.[4]

1705.02 Exchange Gains and Losses - Appropriations

Appropriation exchange gains and losses relate to making and receiving operating appropriations.

[3] By separate accounts or other coding.

[4] This is to make it appear at the same place on comparative SFAs. If it were not for this rule, in years there is a net loss it would be in expenses and in the year of exchange gains it would be in revenue. This stability helps financial statement analysis.

Example – Exchange Gains and Losses – Appropriations

Suppose the Southeast Asia Union, using Singapore Dollars, budgets a 30,000 THB (Thai Baht) appropriation for its Thailand Mission. When it voted its budget, the exchange rate was 3 SGD (Singapore Dollar) to 30 THB so its budget showed an appropriation of 10,000 SGD.

When the time comes to give the appropriation, the Singapore Dollar cost to fulfill the appropriation has reached 12,000 SGD. Simply recording the full 12,000 SGD as an appropriation appears as if the treasurer transferred more than the 10,000 SGD voted budget amount. Instead, they record the Exchange Loss this way:

Appropriations	10,000	
Exchange Gains and Losses – Appropriations	2,000	
Inter-Organizational Receivable/Payable Thailand Mission		12,000

They would show Exchange Gains and Losses – Appropriations in the appropriations section of the Statement of Activities.

Figure 6 - Exchange Gains and Losses - Appropriations

1705.03 Exchange Gains and Losses – Capital Items

As a concept, Exchange Gains and Losses—Capital[5] is the same as exchange gains and losses—appropriations. The Exchange Gains and Losses slice out the gains and losses connected to capital-related exchange gains and losses. These exchange gains and losses – capital mainly result from capital appropriations; however, they may relate to other land, buildings, and equipment foreign currency transactions and account balances.

Here is a list of sample transactions and accounts that might have exchange gains and losses – capital:

- Donations that donors have restricted to land, building, and equipment purchases.
    - These would be the donations the donors recorded in one currency, but the organization had to translate them into its operating currency.
- Appropriations that organizations give or receive for land, building, and equipment projects.
- Exchange gains and losses on foreign currency cash and investments held for capital purposes.

[5] The term “Capital” here relates to the buying and selling of land, buildings, and equipment.

1705.04 Allocated Exchange Gains and Losses

As the earlier example illustrates, an organization’s exchange losses can devastate its efforts to stay within its budget plans. An allocated exchange gain or loss net asset gives a cushion to absorb the gain or loss without using the regular operating net assets. For this reason, Church policy strongly recommends that organizations set aside net exchange gains[6] as an allocated net asset. Then, there is a reserve that can absorb the losses instead of using the organization’s operating budget of unallocated net assets. The policy has several other provisions:

- In addition to setting aside all gains, it is valuable for the organization to allocate more funding to the allocated exchange gains and losses net asset to build reserves to absorb future losses.
- Once the allocated exchange gains and losses net asset has an adequate balance, the organization may make special appropriations from it for other purposes. The organization must use care to ensure the allocated net asset is large enough to absorb potential exchange losses.

[6] Gains minus losses.

Section 1706 - Restricted Currencies

Governments prohibit organizations from exchanging their currency for other currencies.[7] This prohibition creates a problem for local organizations[8] holding tithes and offerings that they must remit to higher organizations.

1706.01 Process for Managing Restricted Currency Exchanges

To manage this unfortunate situation, local organizations holding currency belonging to another organization must do the following:

1. Open a separate restricted currency bank account.
    - If possible, the account name should reflect its purpose.
        - Union A may open an account named "Union A – Division B Funds"
    - The local organization must confer with the higher organization on what bank and account type the lower organization should use for this purpose.
    - As with all bank accounts, the organization's governing committee must authorize the new account.
    - This account is an Other (Non-current) Asset.[9] It is not a current asset.
        - The Financial Statements must not show it as cash and cash equivalents.
2. Create a separate agency liability account to track the amount the organization holds for the higher organization.
    - This account must be distinct from the organization's routine tithe and offerings agency liabilities.
        - Union A may open an agency liability account named "Funds Held on Behalf of Division B"
        - This account is a non-current agency liability.[9]
        - *Take care: Agency Liabilities are usually Current, but this one is non-current. This non-current liability status matches the non-current asset status of the related bank account.*

[7] Some people call these currencies "Blocked Currencies" or "Frozen Currencies." This manual adopts the term "Restricted Currencies."

[8] This manual refers to organizations holding funds that they owe to another organization as a "Local Organization" and the organization owed the funds as the "Higher Organization." However, organizations in countries with restricted currencies will follow these principles even if the terms do not perfectly apply.

[9] **Occasionally, the organization may treat the bank account and the corresponding agency liability as current if the restricted currency is imminently becoming unrestricted.**

- The balance in the bank account and the agency liability account should be the same.

Section 1707 - Hyper-Inflationary Economies

Accounting and Financial Reporting make and report measurements about the organization. These accounting measurements are in the measurement units of the organization's currency (e.g., dollars, pounds, rubles, baht, etc.) Routine financial reporting ignores slight changes in these measurement units. The resulting imprecision is acceptable.

Example – Inventory Report

For instance, Financial Reporting measures the organization's inventory and presents it in a way users can compare with the previous year's inventory measurement. It does this comparison to help its readers decide if the inventory is increasing or decreasing.

In this case, rather than kilos or meters, the unit or measure is the organization's local currency.

Let us say one year the organization reports that inventories went from 100,000 to 200,000 the next. It is fair to think the organization might have doubled the amount of inventory it is holding, but for the first two decades of the 21st Century, most economies had 1 – 5% inflation. The typical reader knows that inflation causes a small amount (1 – 5%) of the increase, so the reader makes a fair conclusion that the organization has only nearly doubled the inventory items.

Figure 7 - Inventory Report

What happens when there are profound changes in the currency's purchasing power?

For example, in July 1946, Hungary's prices doubled every fifteen hours; in November 2008, Zimbabwe's prices doubled every 24 hours. In hyperinflation, routine accounting measurements fall apart, so accounting standards must have special provisions to address hyperinflation. The standard's focus is restating the accounting numbers to correct changes in the currency measurement unit.[10]

1707.01 When to Use the Rules

An important consideration is knowing when a country is experiencing hyperinflation and must follow these rules. Unfortunately, there is no simple calculation that serves as a yes-or-no indicator. Instead, professional judgment must look at several factors:

[10] The standards use the term "Restating" instead of "Revaluing", because their focus is the realignment of measurement units and not trying to capture changes in value.

- Do the country's people prefer to keep their wealth in other stable foreign currencies or non-monetary assets (e.g., land, art, handicrafts, car parts, etc.)?
- Do the country's people regard local monetary amounts in terms of a stable foreign currency instead of in terms of its local currency? For instance, are prices quoted in other currencies?
- Are interest rates, wages, and prices linked to a price index?
- Has the cumulative annual inflation rate been over (or nearly over) 100% for the past three years?

The organization must decide if these criteria describe their country's economy[11]. If they do, it must prepare price-level adjusted financial statements. The appropriate process to follow is explained in Volume 3 of this *Accounting Manual*.

[11] It is natural for the accountant to make the decision to restate or not to hope they do not need to do the added restatement work. However, the restated Financial Statements usually make the organization look much better, and the Statements themselves are much more relevant to the users, so the organization does this evaluation without bias, but the restatement process is easy, and anxiety about the process's difficulty should not bias the decision.

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Chapter 18
Reporting Entities

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Chapter 18
Reporting Entities

This chapter introduces the concept of "reporting entity". Its particular focus is on the need for and process of consolidating the financial reporting of related organizations. It explains the consolidation process. Sample consolidated statements are shown in Volume 3 of the *Accounting Manual*.

Section 1801- Introduction

In routine conversations, we may say, "The Conference did so and so," or "The Division did this or that." Usually, those terms, Division, Union, or Conference work fine, but they are not precise enough to describe the financial reporting entity. The phrase reporting entity means the exact organizational entity the financial statements report information about.

Example – Complex Conference Reporting Entity

To illustrate, consider this conference:

The conference office has two sets of accounting records:

- Unit 1- One set is for its Legal Association
  - This legal association holds title to the conference office building and its church properties.
  - It is the official debtor on all the conference mortgages.
- Unit 2 – The second set is Conference Operations
  - This set accounts for the conference's unincorporated operations.
  - It handles payroll for all conference employees (including pastors).
  - It performs departmental functions (e.g., Ministerial, Sabbath School, etc.).

Figuring out its reporting entity does not end there. The conference also runs three organizations, which may or may not be separately incorporated:

- Unit 3- A free-standing bookstore
- Unit 4- A summer camp, and
- Unit 5- An academy

Think about a bookstore customer objecting to a book the bookstore sells; a camper's parent with a child safety concern; and an academy student mistreated by a dean. At the first sign of trouble, all parties involved call the Conference President. Besides chairing the Conference Committee, he chairs the two committees that run the bookstore and the camp. He is the academy's Board chairperson. The Conference Treasurer also chairs the three Finance Committees. Many of the Governance Committee members are the same on all four committees.

Each month, the conference treasurer gives separate financial statements to the conference's Executive Committee for the Association, the Operations, the bookstore, and the camp. The academy business manager prepares the academy's financial statements and presents them to the academy board.

This chapter addresses the challenge of figuring out which of these five units belong in the Conference's financial statements.

Figure 1 - Complex Conference

The complex conference described in the above illustration shows why recognizing the boundaries of "The Conference" can be unclear. To answer the question about what makes up the conference's financial entity, it is easy to at once think about legal structure, accounting standards, or day-to-day operations. However, before jumping in those directions, consider what the conference's Financial Statements are trying to do.

Example – Conference's Statement of Financial Position

The conference's Statement of Financial Position tries to show its assets as well as its creditors' claims against those assets.

Consider an asset the school buys, but the camp could use in the summer: say, a van. How hard is it to move the vehicle from the school to the camp? If the Conference President, Treasurer, and Secretary think it would be more useful at the camp in the summer, how difficult would be for them to make this happen?

Or suppose a church does not make its mortgage payments, and the bank starts to foreclose. How hard would the bank's lawyers need to work to get at the school's Investment account to repay the church's mortgage?

Is it possible to get a correct picture of the conference's financial position without looking at all its units as a whole?

Figure 2 - Conference's Statement of Financial Position

This chapter uses the general word "unit" to include what the organization needs to consider as a candidate for the consolidated reporting. A unit can be a separate organization, corporation, department, – any type of entity. Unit names and legal structures are not important in deciding what to include as part of the reporting entity. This distinction means a mission might have to consolidate with a division, an academy with a union, or a corporation with a noncorporation.

Consider the conference described in Figure 1. Separating its five units into separate corporations with separate monthly Financial Statements and different operating committees may be administratively valuable[1], but the shared risk and overlapping management also call for a look at the complete risk picture. A Consolidated Statement of Financial Position does this.

The same is true for the other Statements. Only an aggregate Statement of Financial Activity would show how the overall conference is prospering with its activities. While it is useful to look at the Financial Activity of each unit individually, there is little consolation if the small conference is doing well while its academy, a member of the same risk pool, is in financial difficulty. Because of the shared risk, looking at the activity for the entire conference is equally important as looking at the individual units. The same goes for the Statement of Cash Flows.

[1] Frequently, conferences run their separate units in separate corporations. They hope to avoid sharing financial risk between the units. An individual is often unsuccessful if they try to hide money from creditors by using different corporations. In the same way, using separate corporations does not overly protect one of the entities from the bad financial decisions of another. This lack of mutual protection is especially true if the corporations have the same management. This chapter does not give legal advice, but organizations usually need more than separate corporations to protect one sister corporation from the actions of another.

Section 1802- Reluctance to Consolidate

Why do some organizations resist the idea of presenting Consolidated Statements? Here are a few reasons:

1. Their management does not see the unified financial risk the various operating units share. Besides a lack of clarity about the law, they may also hate the idea that trouble in one unit could endanger the prosperity of the whole. Usually, the law does not consider such concerns on the part of management.

2. Their management may think that consolidation will make their anxiety into a reality. By consolidating their units, they are admitting to any claimant that there is unified control and mutual risk. Organizations should exclude any unit that is not part of the risk pool. However, the same factors that mean an organization should consolidate recognizes they are in the same risk pool. Consolidation is not the cause of the risk.

3. Their management usually and properly partitions out leadership to each operating unit and struggles to keep one unit's committee on task and out of another unit's business.

> *Example – Consolidation*
>
> For example, the Conference administration may routinely want the regular Conference Committee to focus on the conference office and let the Academy Operating Committee take care of the school. They are afraid Consolidated Statements will confound these efforts. They see it making sense to prepare internal reports for the individual unit Committees.
>
> However, this is not an argument against looking at Consolidated Statements – at least annually. Segmenting responsibility can mislead Committee members into thinking they are not responsible for things for which they are responsible. The Committee responsible for the overall picture must realize that they are, indeed, responsible.

Figure 3 - Consolidated Statements

4. The treasurer may have worked hard to keep transactions sorted for all their units. They may have prepared excellent free-standing Statements for each unit. The Statements of Financial Activity clearly show the operating results of each separate unit. Tracking the activities of each unit is essential for good management, but this does not argue against consolidation.

5. The treasurer shrinks from the extra work of preparing the Consolidated Statements. This chapter will explain that it is extra work; however, an accountant with good spreadsheet

skills can do most of the work. Keep in mind that consolidated statements only need to be prepared once a year.

While these reasons are understandable, routinely looking at the all-inclusive financial picture at least once a year is overwhelmingly helpful and a worthwhile reflection. This combined perspective reminds the entire leadership team of the unified nature of their shared financial activities and risk.

Below are two considerations that may soften the impact of consolidating:

- Consolidated financial statements can show the sub-unit's details separately.

Example – Conference

Consider the Consolidated Statement of Financial Position (SFP). It shows all the assets, liabilities, and net assets for the combined reporting entity; it could have:

- A column showing the conference's primary activities.
  - This may be the information the Conference Executive Committee usually sees.
- A column showing the academy's activities.
  - This may be the information the Academy's Operating Committee usually sees.
- A column showing the bookstore's activities.
  - This may be the information the Bookstore's Operating Committee usually sees.
- A column for each sub-unit in the reporting entity.
- A far-right column giving the consolidated total for the entire organization.

The other statements (i.e., Statement of Financial Activity (SFA), Statement of Net Assets (SNA), and Statement of Cash Flows (SCF) use the same columnar structure.

Figure 4 - Consolidated Statements

- Alternatively, the main consolidated financial statements can show the consolidated summary information for the entire organization, with separate reports for the sub-units later in the financial statement booklet. The combined SFP would show the conference's consolidated assets, liabilities, and net assets, but would not show sub-unit details. The sub-unit detailed SFP can be shown later in the report. The Consolidated Financial Statements show the financial information for all consolidated units as if they were one unit. This unified perspective does not entirely hide the information for the separate units.

Example – Conference A

The conference would show a consolidated Statement of Financial Position (SFP) early in the statement booklet. This would be for the entire organization. Toward the back, it would have a SFP for the conference office, another for the bookstore, and a third for the academy.

All four types of statements would follow this structure. The Consolidated Statement of Financial Activity (SFA) would be at the front of the Consolidated Statements package. The SFA summarizes the entire group's financial activities. Later, three separate SFAs would give the activities for each sub-unit.

Figure 5 - Consolidated Statements

Example - Conference

To illustrate the above, our example conference's Consolidated Statements might begin with the Conference Consolidated Statement of Financial Position (SFP) followed by five SFPs - one for each of its five units. It would do the same for the Consolidated Statements of Financial Activity, the Consolidated Statement of Net Assets and Consolidated Statement of Cash Flows.

Alternatively, it could have the primary Consolidated Statements and their Notes, followed by comparable statements for each of the five units.

If the number of organizations to consolidate is small (e.g., two), one Consolidated Statement could show the details of both units in supporting columns.

Figure 6 - Consolidation Options

Section 1803- Units to Consolidate

What are the determining factors in deciding which units an organization should consolidate into its Statements? Accounting standards boil the answer down to a single word: Control. Does one organization control another? An easy word but understanding what "control" means is difficult. Recall the IFRS requirements for consolidation, introduced in Chapter 2 (Section 203.02):

- Can one organization significantly and directly affect the financial activity of another? If the answer is "yes," they must consolidate.
- Can one organization significantly influence the choice of another organization's management or governing committee? If the answer is "yes," they must consolidate.
- Does one organization have significant noncontractual risk related to its involvement with another? If the answer is "yes," the organizations must consolidate.
- The organizations' legal structure may not matter.

- The financial statements that committees routinely look at do not matter. Committees often see monthly financial reports of only one organization.
- The delegation of authority to the sub-unit's leadership does not affect the decision.
- Common practice does not matter.

The following examples illustrate these requirements:

Example – Directly Affects Financial Activity and Choices of Another Organization

The Conference Bookstore Committee votes to open a new downtown branch store.

- Can the Conference's Executive Committee make the bookstore change its plans?
- Can it block the bookstore from issuing new debt?
- Can it prevent the bookstore from hiring a new employee?
- Does the Conference Executive Committee select the bookstore's operating committee?
- Does it select its management team?

The question focuses on "can".

It is not whether they use the power, but ***whether they have the power***. If they have the power, they must consolidate the organizations.

Figure 7 - Consolidated Statements

- Does one organization have significant noncontractual risk related to its involvement with another?
    - If the answer is "Yes", the organizations must consolidate.

Example – Significant Noncontractual Risk

If the bookstore fails to pay its debts, is Conference (the parent organization) obliged to do so? If Conference is obligated to pay, they must consolidate the organizations.

See Chapter 2, Section 203.02 for a more complete discussion of "contractual risk".

Figure 8 - Consolidated Statements

Certain things are not part of the decision about whether to consolidate:

Example – Organization Legal Structure

Suppose the Conference operates in three separate charitable corporations:

- Primary conference activities
- Bookstore activities
- Academy activities

Organizational documents say the Conference Committee selects the operating committees for the other two organizations. Maybe the documents say the Conference Treasurer serves as treasurer for all three entities. The legal structure itself does not bypass the IFRS rules. If there is still significant influence or shared risk, they must consolidate.

Figure 9 - Consolidated Statements

Example – Financial Statements Routinely Reviewed

The Conference's statements may go just to the Conference Committee; or the treasurer presents all the distinct organizations' statements independently at various times throughout the year.

This separate reporting may be an excellent monthly management tool. It is ***not*** part of the decision about consolidation.

Figure 10 - Consolidated Statements

An Executive Committee may focus on the parent organization. Further, it may assign other groups the job of managing the sub-units. This influence can be over the decisions themselves. Examples include spending or debt limits on the lower boards' authorization authority. The Conference Executive Committee may be able to significantly influence who can be sub-unit managers or members of the sub-unit's committee. If it has retained this kind of influence, it must consolidate.

Example – Delegation of Authority

The Conference Executive Committee may delegate the job of managing the academy to the Academy Board. The Bookstore Committee may be assigned the task of managing the bookstore. This delegation of authority is a suitable way to manage the day-to-day operations.

However, if the Conference Executive Committee retains significant influence, it must consolidate.

Figure 11 - Consolidated Statements

- Common practice does not matter.

The IFRS rules focus on one organization's ability to influence the other's activities. That is the overriding question. It does not matter what other organizations may do. The question is whether the organization has the ability to influence the other's activities.

Other considerations for determining whether consolidation is appropriate include:

1. Could one organization's leadership move, sell, or mortgage another organization's assets?

2. Are there enough barriers to protect one organization's assets from another's creditors?

The legality of these distinctions varies by country. Still, the distinctions may be less related to corporate legal entities and more about the impression given to constituents and creditors. If they perceive joint control, the joint liability may be there. For example,

- Constitutions, by-laws, and other organizational documents often determine if there is control, but if there is a practice of exerting control, it is control even if the law or organizational documents do not explicitly provide for it.
- Contracts, both written and verbal, can establish control.
- Local law matters. Many places have a broad view of what constitutes control and one organization's financial responsibilities for sister organizations.
- Perceptions matter. Church members may so expect an organization to be responsible for a sister organization that there is a practical sharing of assets and liabilities, even if the law does not demand it.
- Regional differences matter. Some regions have entirely different concepts of church hierarchy than others. For example, in one region, a union may readily and often review decisions made by one of its conferences. In another, the conference works without any engagement with its union.
- Simply sharing the same constituency does not mean control, but a constituency can unwittingly establish control of one organization over another through its election processes and practices.
- Seeking broader legal counsel is valuable. The legal advice must address the issue of shared risk.

An organization must carefully determine what units it must include in its Consolidated Financial Statements. The bias should be toward including organizations instead of excluding them.

Section 1804- Financial Statement Note 1

This chapter has already discussed the legal and member confusion about the units that are part of any Adventist organization. This confusion highlights the need for Financial Statements to say clearly which units they include. The first Financial Statement footnote does this. The organization may prepare special reports that exclude units that they should consolidate. If they do, their first footnote must explain which units they excluded and why they excluded them. See Chapter 6, Section 605 for a discussion of footnote requirements and Chapter 2, Section 203.02.01 for a discussion of Special Purpose Statements.

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Chapter 19

Post-Employment Benefits (Pensions, Retiree Health Care, etc.) Liability and Expense[1]

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1 The authors of this manual acknowledge that this chapter is an initial attempt in reducing an extraordinarily complex topic to a workable solution for the diverse worldwide Adventist community of organizations.

Chapter 19
Post-Employment Benefits (Pensions, Retiree Health Care, etc.) Liability and Expense[2]

This chapter describes post-employment benefits, including the GC Working Policy guidance. It compares Defined Contribution and Defined Benefits Plans. It then moves on to how accrual accounting, actuarial assumptions, and the time value of money work together to estimate pension liabilities and expenses. It ends with a discussion of multi-employer plans.

Section 1901 – Introduction to Post-Employment Benefits

Pensions and other post-employment benefits are a big challenge. The challenge comes in two parts. The first is how to pay for them. There are a lot of forces at work. Changing demographics means that the ratio between working pastors and retirees is shifting. Younger church members are immigrating, leaving fewer working members to support more retired church workers. The excellent Adventist lifestyle means retirees are living longer. Several unions have more retirees than working pastors. Unfunded pension plans are a major concern.

GC Working Policy (GCWP Z 05 05) gives essential guidance:

> *Each division of the General Conference shall make provision for its retired and disabled employees, including international service employees sent from that division, in harmony with legal requirements.*

It further says an organization can meet these obligations by using and combining "government-sponsored pension or social security systems, defined benefit or defined contribution retirement plans, (and) insurance coverage."

Worldwide, this has taken a variety of shapes that raise a challenge for church treasurers and accountants. For instance, some divisions run a division-wide retirement system, and others decentralize them to their unions (and even conferences). Many have plans that pay a specific benefit when the person retires, and others make a specific contribution as the worker is working - but have no responsibility after that. Some pay benefits of a certain amount and then assume

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2 The authors of this manual acknowledge that this chapter is an initial attempt in reducing an extraordinarily complex topic to a workable solution for the diverse worldwide Adventist community of organizations.

the government pension is an added benefit. Others calculate an overall pension amount and then deduct the amount the government pension pays. Some try to merge the challenge in a union-wide central plan, and others administer it centrally but disperse the responsibility to the participant organizations. This diversity of practices makes sense in a complex world, but it makes it difficult to define procedures in a denomination-wide accounting manual.

At a minimum, church treasurers worldwide should be acquainted with the jargon and distinct types of plans and be fully aware of their financial reporting responsibilities.

Pension accounting is a complicated topic, and it is easy for readers to embrace the most effortless reporting responsibility to avoid the challenge. For example, a treasurer may, with relief, conclude they have a Defined Contribution Pension Plan and have an easier challenge and do not realize they have a Defined Benefit Retiree healthcare plan.

Further, consider the treasurers that pay a specific percentage of payroll into a union-run complex Defined Benefit Plan. They may feel relieved not to have to deal with pensions directly. However, the treasurers of these conferences likely sit on the Operating Board of the union's plan. This dual role means that while they may avoid the complexity in their own organizations, they face it in their leadership role in the multi-employer plan. So, as said, all knowledgeable treasurers must have a working knowledge of the jargon and financial reporting issues of the various kinds of plans.

Section 1902- Defined Contribution Plans

In a Defined Contribution Plan, the employer (and often the employee) contributes a percentage of their salary to a third party (e.g., another organization, a bank, or an investment firm). At this point, the employer withholds the employee's part from their paycheck and pays the employer and the employee's contribution to the third party. The employer's part is an expense of the period in which the employee worked. This process does not need any actuarial estimates or present value considerations.

The receiving third party (another Church entity or an outside bank or investment company) holds and invests the retirement contributions until the employee retires. It then pays the employee the original contribution and earnings according to the plan's requirements.

1902.01 Defined Contribution Plan Disclosures

Even the most well-constructed Defined Contribution Plans present some risk to the employer organization; its financial statement readers need to understand the status of these plans. For that reason, financial reporting requires some Financial Statement disclosures.

Here are the minimum disclosures for Defined Contribution Plans:

- A description of the pension plan.
    - This description includes required employee and employer contributions.
- A description of the effect of any changes in the pension plan during the reporting period. This reporting period includes the current year and the comparable years.
- If the organization is holding the plan assets, it must disclose:
    - A statement of net assets available for benefits.
    - A statement of changes in net assets.
    - A summary of significant accounting policies relating to the assets.

Section 1903- Defined Benefit Plans

Defined Benefit Plans promise to pay their retirees specific (hence the "defined") pension benefits. For example, they commonly promise to pay a certain percentage of the employee's ending salary or promise to provide health insurance after the employee retires. These promises are part of the incentives given to the employees to get them to work for the organization.

The promise to employees to pay such benefits means the employer has a future obligation that the employer must fund. To get the funding right, leadership must understand the size of the unfunded pension problem. Providing this estimate is where financial reporting makes its contribution. Its job is to quantify the extent of the problem. It answers the question, how much should we have set aside now to meet our post-employment obligations (i.e., pensions, etc.)? That is, what is our liability? It also answers the question as to whether the Church is making headway in its efforts to cover this obligation:

- How much did our obligations increase because of this year's employees, and how much did it change because of changing demographics?
- What is this year's expense? What caused it? What came from current employees? What did changing demographics cost us?

1903.01 Other Post-Employment Benefits

Pensions are the most significant part of this issue. However, the financial reporting challenge extends to all post-employment benefits. It is common for organizations to give health care and health insurance to their retirees and their families. Retirement benefits are a prominent part of calculating actual employee costs. This chapter may appear to focus on pensions, but the current year's expenses and liabilities must reflect all post-employment benefits – not just pensions.

Section 1904- Collision of Accrual Accounting, Present Value, and Actuarial Calculations

Accounting for post-employment benefits (primarily pensions and retiree healthcare) engages a full-bodied mixture of accrual and present-value accounting. These are concepts familiar to well-seasoned accountants. Accounting for post-employment benefits adds a strong dose of actuarial assumptions to the calculation. Accountants may be less familiar with these assumptions. This section looks at these three concepts in the pension context. It especially takes an accountant's look at actuarial assumptions.

These three factors work together in calculating two needed amounts: The pension liability at the end of the accounting period and the pension expense for the period. The following discussion explains how each factor affects the calculation of those two amounts.

1904.01 Accrual Accounting

This *Manual* has previously discussed Accrual Accounting (see Chapter 2, Section 201.04 and Chapter 12, Section 1201). Recall that in the context of expenses, it is about getting expenses recorded in the period where they occurred. Often, this involves creating a liability.

Example – Salaries

Take, for instance, salaries. If you paid for work done in December 20XX in January 20XY, it is a December 20XX expense. This means you need an unpaid salaries liability.

Particularly notice the interaction between the expense shown and its related liability. The cause-and-effect works in both directions. It is equally fair to say either:

- In December 20XX, the worker earned 4,000, which is unpaid. So, I have a Liability of 4,000. Or,
- At the end of 20XX, we owe the worker 4,000 for work done in December, so we need a 20XX Expense.

Pension accounting focuses on the liability at the end of each period and figures that the Pension expense is the difference between the beginning and ending liability.

Figure 1 - Salaries

Accrual accounting often deals in brief time horizons. A typical accrual example worries about sorting the salary expense of a pay period that overlaps a year-end. But this *Manual* has already seen accrual accounting spanning decades. Depreciating a building's cost over thirty years is applying accrual accounting over a long time. Instead of the Statements showing it as an expense when the organization pays for it, they show it as an expense over its thirty-year estimated life.

Pension accounting is more of the same, but the opposite. In the case of the building, the cash outlay is in advance, and the expense is over the next 30 years. With pensions, the payment might be decades away, but the expense belongs to the year the employee worked.

1904.02 Present Value Concepts

It does not take much analysis to see that money has a time value. Would you rather get your paycheck today or a month from today? What about thirty years from today? So, getting 1,000 in retirement pay 30 years from now is different from getting 1,000 now. The organization sees it the same way- but the opposite. It considers an obligation to pay 1,000 thirty years from now as a liability, but it does not see its liability now as a regular 1,000 debt. Using present value jargon, it discounts the future 1,000 it must pay thirty years from now to a present value of something much less. That present value would be what it would need to put in the bank today, earning interest, and allowing it to draw out 1,000 to pay its future obligation thirty years from now.

The time value of money makes a substantial difference. Suppose the funds consistently earn 4% interest over lengthy periods. At first, this seems like a low interest rate, but it sustains this rate over 30 years. At a 4% rate, it would need a present amount of 300 in the bank to have 1,000 thirty years from now. Its Statement of Financial Position shows a 300 liability, not a 1,000 one.

Let us look at a more elaborate but still simplified example.

Example – Present Value Pension Funding

Suppose an organization promises to pay a monthly retirement check of 1,000 for 20 years (240 months) after the employee retires. The person will work for the next 30 years before retirement. To recap: they will work for 30 years and then be retired for 20 years. At retirement they will get 1,000 payment each month. Remember this is a simplified example.

This example has two present value calculations in play. The first asks, what amount does the organization need in the bank at the start of the retirement? This present value is the amount it needs at the start of retirement, earning 4% Interest, so allowing it to withdraw 1,000 each month for 240 months. Plug this into your favorite present value calculator calculating the present value of an annuity: 240 payments, monthly interest rate of .33% (that's 4%/12), of 1,000 per month.

The total payments over the 240 months are 240,000. The amount it needs at the beginning of the retirement is about 165,000[A]. But this is just the first of the two present value calculations.

Recall that the worker must work for 30 years to retire. We are interested in just this first year's share (1/30th) of the total requirement. Roughly speaking, we want this year to cover 1/30 of the 165,000. That is 5,500. But that is 30 years from now. What amount is this year's share now cost at its present value? That is about 1,660[B]

To summarize: if it put about 1,660 in the bank, earning 4% Interest for 30 years, it would end up with 5,500 – this year's share of the pension cost. If it faithfully did this calculation and deposited the calculated result for each of the remaining 29 years, it would end up with the needed 165,000. Then having this amount in hand at the start of the retirement, it would be able to pay the retirement annuity for the next 20 years.

Note A. That's 165,021.92 But don't get too carried away with a false sense of accuracy. The interest rate estimate makes the result just a rough estimate. Any time you estimate something in a calculation, all its results are just estimates.
Note B. That's 1659.88. Ditto.

Figure 2 - Pension Funding

Section 1905- Actuarial Assumptions

A casual reading of the previous two sections will raise as many questions as it answers.

Here are three obvious questions:

1. Should the calculation consider that the worker may not continue to work for 30 years? They may quit or even die.

2. Pensions do not work like the example. They pay until the worker dies, or usually, they pay until the worker and their spouse die.

3. Pension amounts increase during the person's career because of promotions and inflation. Actual pension payments will go up with inflation.

Actuarial assumptions are estimates of average life expectancy, salary increases, and interest rates. Actuarial assumptions/estimates enable the calculation to move from the hypothetical example in the last section to a full-bodied estimate.

1905.01 Actuarial Estimates and Accountants

Accounting attracts many newcomers because it gives them a sense of accuracy. There is nothing more fulfilling than reconciling a bank account to the penny or balancing a balance sheet, but as exact as it might seem, accounting is not nearly as precise as it appears.

A simple-sounding amount, like an organization's total assets, is the product of estimating bad debts, asset lives, and market values. With liabilities, accountants estimate whether contingencies are probable and an estimable amount (and so they need to record it as a liability) or are they not probable (and they do not record them). Accounting prefers to work with its best estimates and roughly tell the truth rather than not working with estimates and being precisely false. This concept particularly applies to using estimates in calculating the pension liability and expense.

The accountant does not make the needed pension estimates directly. For example, almost every country publishes life expectancies for its men and women. Estimates of long-term interest rates closely follow the interest rates of corporate long-term bond sales. A country's central bank often publishes the market's estimate of long-term inflation.

Accountants should take their estimates seriously but not too seriously. Here is why:

1. You revise them every year.

- You can adjust for past errors as you gather more information and experience.
- Starting on the estimates with an attitude of continuous improvement is best. Sometimes because of the fear of getting a number wrong, the accountant does nothing. Remember that a good faith estimate is better than no estimate at all.

2. The estimates are estimates of averages.

    - The estimates are estimates.
    - Take, for example, the need to estimate life expectancy. It might be hard to estimate how long a particular person may live, but it is not so hard to estimate how long an average employee might live.
    - This averaging takes the pressure off the individual calculation and makes it easier to depend on generally available demographic and economic information.

3. It is good to estimate as accurately as possible.
    - Also, if there is an estimating error, it should be in the direction that overstates the estimated liability.

Example – Estimates

To illustrate this, consider that a country's statistical office estimates a male's average life expectancy to be seventy-three years[A]. But with reflection, your estimate adds a seven-year Adventist Premium[B]. This increases the pension liability. But giving leaders a slightly overstated Liability and Expense is better than not giving them any measurement. The process encourages conservative estimates. This expected conservatism makes it easier to make estimates in the first place.

Note A https://www.worlddata.info/life-expectancy.php#by-population
Note B Adventist Health Studies. (2023, November 24). In Wikipedia. https://en.wikipedia.org/wiki/Adventist_Health_Studies

Figure 3 - Estimates

4. The accountant should be comfortable estimating the liability because, over time, the estimate is self-healing.
    - Each year, the estimate is for each employee as of the end of that year.
    - The expense is the difference between the two year-end calculations.
    - This year's estimate absorbs the estimating error of previous years. And next year's estimate will absorb this year's estimating error.

This self-healing, combined with the conservative nature of the estimates, is very empowering. Over time, excessively conservative estimates will self-heal as the organization has the clarity and experience to make more exact estimates.

1905.02 Good Actuarial Estimates

What makes a good actuarial estimate?

Here is a list to start the discussion:

1. They should be unbiased. There is no value in trying to understand (or even overstate) the pension liability problem.

2. They should be conservative.
    - If there is an error in estimating the liability, it should be in the direction of overstating it rather than understating it.

3. Facts should support them.
    - The accountant's professional judgment is about judging facts and not extracting estimates from thin air.
    - These facts include demographic estimates by government agencies, economic trend data, and the organization's experience.

4. You must document the underlying facts and experience. This support must be auditable.

1905.03 Auditors and Actuarial Estimates

It is particularly challenging for auditors to express an unmodified (clean) opinion on pension liabilities and expenses. They, too, struggle with what makes up reliable estimates and complete computations. Organizations and auditors may avoid the issue by passing the liability and expense calculations on to expert actuaries. An organization may use expert actuaries to make the estimates periodically, say, every 3 or 5 years, and use them as a basis for doing their own calculations in the interim periods.

Hiring experts is a remedy for well-off organizations, but it might not be a viable choice for organizations unable to afford it. An unmodified audit opinion on pension liability and expense is best. In many cases, the second best is for the organization to estimate the liability and expense and accept that the amounts may be unauditable. The least desirable situation is for the organization not to try.

Section 1906- Recap

To recap what has been covered so far:

1. Post-employment benefits include any benefits given to retired workers based on their work history.

    - Post-employment benefits include pensions and pensioner's health insurance coverage.

2. The accounting focuses on recording the actuarial present value of the future benefits when the employee earns them – not when they receive them.

    - Accrual accounting drives this process, which shows expenses when the organization uses a service or other asset.
        - The focus is getting the retirement cost of the employee in the accounting period the employee worked.
    - The calculation discounts the liability of future pension costs to the present.
    - This accrual accounting requires actuarial estimates such as the employees' (and their spouses') life expectancy, future interest rates, and salary inflation rates.

Section 1908- Other Post-Retirement Benefits

As mentioned, the discussion here focuses on pensions, but organizations usually offer other post-retirement benefits, such as health care, to their retirees. These benefits require the organization to follow the same principles already discussed in this chapter:

- For a retiree health care plan, the organization must estimate the cost of the present and future retiree's health care.
    - Assessing this would require making the same actuarial assumptions as the pension calculation.
- Just like the pension calculation, the calculation discounts the future retiree healthcare cost to the present using a discount rate.

- The cost of the provision would be a current expense shown in the same categories as the pension expense.

Many organizations with Defined Contribution Plans continue a Defined Benefit Plan for their health care. They still need to make similar calculations as if they had a Defined Benefit Pension Plan.

1908.01 Post-Employment Defined Benefit (e.g., Pension) Disclosures

Organizations must make the following disclosures for their Defined Benefit programs. This may be done by creating a footnote or alternatively, the Statements can show the information in the primary Statements. Also, it does not require a narrative – a listing might do just as well.

Defined Benefit Plan disclosures

- A concise description of the pension plan.
    - This description would include information about vesting and the amount of Pension payments.
- A description of approved changes in the pension plan.
- A schedule of estimated pension payments for the next ten years.
- The amount of the actuarial present value of the plan benefits.
    - This present value is the liability this chapter describes earlier.
- The amount of plan assets, including naming the trustee holding them.
- The amount designated for pensions by the Board or Executive Committee.
- The pension expense, showing the components covered in this chapter.
- Service costs, prior service cost, gains, and losses from changes in actuarial estimates, gains, and losses on changes in Plan assets.

Section 1909- Multi-Employer Plans

Often, a division or a union may set up an organization to manage pensions for all its employers and their employees. Ideally, participating employers set up a separate organization for this purpose, but often, it is simply a higher organization that, unfortunately, carries the pension obligation along with its other responsibilities.

Many treasurers appreciate multi-employer plans since they seem to remove the pension responsibilities from their organization to the multi-employer plan. However, multi-employer plans have their problems.

Example – Multi-employer Plans

Consider the case of a union-run multi-employer plan. It provides Defined Benefits to retirees from its seven conferences and three schools.

The agreement is that all the participant organizations will cover the plan's costs.

At the concept level, a conference has an ongoing obligation. It could estimate and record a liability. However, it could only do this for its own employees. That is not helpful, since it is responsible for its share of the cost for all the employees in the plan – not just its own. This provision makes estimating a participant organization's actual pension liability impossible.

International reporting standards acknowledge this and do not require an organization to record a pension liability and to treat payments to the plan as expenses.

This means the employers have a Defined Benefit Plan they account for like a Defined Contribution Plan. It requires clear disclosures to inform the Financial Statement users of this potential risk.

Figure 4 - Multi-employer Plans

1909.01 Employer Organization's Disclosures

A participating organization in a multi-employer plan (a conference or school in the above example) must disclose the following in their Financial Statements. It can make these disclosures as a narrative, or it can simply list the information.

- It must disclose that it is taking part in a multi-employer Defined Benefit Plan.[3]
- It must describe how the plan calculates its contribution.[4]
- It must describe the extent to which it is responsible for other organizations' pension obligations.
- It must describe any obligations it has to share when the plan distributes a deficit (or surplus) if it withdraws from the plan or the plan ends.
- It must describe why, even though it is a Defined Benefit Plan, it cannot estimate the pension liability.
    - In the example above, the employers could not estimate the liability because they could not estimate the likelihood and the impact of a participating organization failing.
- It must disclose an estimate of its contribution to the plan in the next reporting year.
- It must disclose the plan's funding deficit (or surplus).
- It must describe how the plan determined the deficit or surplus.

[3] They are still a defined benefit plan even though they use defined contribution plan accounting.
[4] This description includes information about any required minimum funding.

- It must discuss how the funding deficit might affect future contributions.
- It must describe its level of participation in the plan compared to the involvement of other entities.
    - This disclosure includes its percentage share of contributions and, if possible, its share of present employees, vested ex-employees, and pensioners.

The multi-employer plan should help their participating organizations in meeting this requirement.

1909.02 Other Multi-Employer Plan Considerations

There are some additional concerns that treasurers (and their auditors) must consider, such as:

- Is the organization managing the pensions sufficiently separate from the employing organization? (See Chapter 18 for a discussion of the composition of a reporting entity.)

    - First, setting up a genuinely independent multi-employer plan is a legal challenge beyond the scope of this manual. However, the employing organization must do more than create a separate legal entity.
    - Under IFRS rules (IAS37)[5], liabilities exist when an organization's constituency reasonably expects it to pay, even with a legal barrier designed to mean it did not have to (see Chapter 18, Section 1803).

  Suppose the employees have a general and reasonable expectation that their employing organization is responsible for a Defined Benefit Plan. In that case, its pension liability may be there even if the organization has made some legal efforts to structure it as a separate multi-employer plan or a Defined Contribution Plan. The process involves creating the correct legal structure, employee education, plan disclosures, and employee notifications.

- In some cases, what seems to be a multi-employer plan is only a servicing organization.

[5] "A constructive obligation is an obligation that derives from an entity's actions where: (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and (b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities." IAS 37

Example – Servicing Organization

Consider the case where there is Unionwide plan. It receives contributions from the Conference's employers, makes investments, and pays pensioners. The conferences pay in a set percentage of their Payroll. However, there is a dark twist.

The understanding between the Union and the conferences is that the conferences must make up for any funding shortfall for their employees. If so, the conferences have a Defined Benefit Plan, not a multi-employer plan and not a Defined Contribution Plan. Conferences cannot sidestep their unfunded pension responsibilities using other entities in a Pension shell game. All the employers must share the funding responsibility before it is a genuine multi-employer plan.

Figure 5 - Servicing Organization

- This chapter discusses other post-retirement benefits.
  - An example of this is the retiree health plan.
  - Sometimes, multi-employer plans provide pensions but leave the health care plans with the employers.
  - If so, the employer has a regular Defined Benefit Plan for the pensioner's medical care.

- The accounting rules related to accounting for contingencies apply. If an employing organization will probably pay an allocation to cover the shortfall caused by another organization and can estimate the amount, it needs to record a contingent liability. If it cannot estimate the amount, it must disclose that the payment is likely, but it cannot estimate the amount.

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Chapter 20

Tithe-Supported Organizations: Conferences, Mission, Unions, Etc.

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Chapter 20
Tithe-supported Organizations: Conferences, Missions, Unions, etc.

This chapter begins by explaining the organizations that fall into the tithe-supported category. It moves into a discussion of the proper use of tithe and non-tithe. Then, it covers appropriations and salary returns.

Section 2001 – Financial Management for Tithe-Supported Organizations

The previous *Accounting Manual* chapters focused on accounting issues applicable to all Adventist organizations. This chapter is the first in a series of chapters focusing on specific kinds of organizations (e.g., conferences, schools, hospitals, publishing houses, etc.).

This chapter deals with tithe-supported organizations: conferences, missions, fields, sections, unions, union missions, unions of churches, divisions, and the General Conference. It refers to them collectively as tithe-supported organizations.

Using this collective term does not minimize the substantial differences in the financial management problems these types of organizations have. For example, many conferences have more employees than the General Conference has, and the General Conference has more international money transfers than a conference; however, they share common accounting challenges. This chapter will address those challenges.

2001.01 Tithe

The Bible and the Church consider tithe sacred and give specific guidance about how the Church should collect, hold, and spend it. An entire chapter of the Church Working Policy, GCWP V, addresses the subject from a spiritual, practical, and administrative perspective.

It is not the purpose of this chapter to cover that policy chapter; however, all leaders of tithe-supported organizations should be deeply interested in its contents. They must clearly understand the requirements concerning the local conference's role as the storehouse and what it says about tithe sharing, the proper use of tithe, and tithe rebalancing (formerly referred to as tithe exchange).

2001.02 Local Conference as the Storehouse

The Church specifies the local conference (i.e., conference, conference mission, section, or union of churches) as the storehouse referred to in Malachi's famous verse about bringing all the tithe into the storehouse (Malachi 3:10). This storehouse role for the local conference has several implications:

- It further defines the role of the local church treasurer as the agent/steward of the conference in collecting and forwarding the tithe.
- It further defines the local conference as the caretaking steward to ensure it spends its part according to the policy constraints about its proper use.
- It defines the local conference treasurers as agent/stewards of the higher organization as they collect and forward some of the tithe to higher organizations.

Section 2002 - Proper Use of Tithe

The Bible and Church policy define how the Church may spend tithe. The Bible directs tithe toward support for ministers. Church policy attempts to establish what that means in the modern worldwide economy in which the Church works. Since the purpose here is not to rehash the Church Tithe policy (GCWP V 14), this section limits its focus to the implications of the policy on accounting and financial reporting.

The policy specifies how organizations can spend tithe. To accomplish this proper use, the accounting system and financial reports must monitor, track, and report tithe transactions separately from non-tithe transactions. This separation enables the accounting system to serve as a feedback loop for decisions about tithe spending, so if an organization inadvertently misspends tithe for non-tithe purposes, the system should quickly show the mistake so the organization can correct its error.

To do this feedback role, the accounting system must record and report tithe income and expenses separately from non-tithe income and expenses. In addition, it must label transfers to other organizations as either tithe or non-tithe so that the other organization can also faithfully oversee the tithe. Both organizations must have a clear transaction labeling system so that an outside observer can vouch for their faithfulness.

2002.01 Tithe Use Accountability – Use of Tithe Report

To further the idea that the Church must responsibly manage tithe, Church policy (GCWP V 20) requires each tithe-supported organizations to track how it uses the tithe and report their compliance annually. The accounting system must capture enough detail to make this report possible. (See Chapter 4, Section 402.03.01 for initial discussion of the Use of Tithe Report.)

The organization must report the following[1]:

1. Tithe Received – The report must include:
   a. Tithe received from members
   b. Tithe percentages received from lower organizations
   c. Tithe appropriations received from higher organizations
   d. Tithe received from any other source
   e. Less tithe percentages sent to higher organizations.
      - (For purposes of this report, this should not include Retirement Fund contributions. They are part of Operating Expenses. The Use of Tithe section shows Retirement Fund Contributions.)

2. Use of Tithe – The report must show Tithe used to support:
   a. Pastors, evangelists, and front-line workers in the field
   b. Headquarters operating at the conference/mission/field/union/division and General Conference
   c. Education – broken into amounts at the Elementary, Secondary, and College/University levels.
   d. Direct Evangelism
   e. Media Outreach
   f. Literature Evangelism
   g. Retirement Fund Contributions
      - The report should show these contributions, part of Employee Cost, under separate categories (paragraphs a. through f. and h.) based on where the individuals involved are employed.
      - This section shows the retirement fund contributions if the contributions are not specifically identifiable by category.
   h. Other uses - Give a breakdown if it exceeds five percent of Tithe.

As mentioned, the account structure enables the preparation of the Use of Tithe Report. The policy requires organizations to prepare the Use of Tithe Report after the accounting year. By then, unfortunately, it is too late to remedy any errors in the use of tithe during that past year. The best practice is for financial leadership to review these reports progressively during the year. This practice

[1] This discussion facilitates the explanation. The current GC policy manual shows the current categories.

allows them to spot and rectify inadvertent mistakes before the end of the year. It cuts down on the chance of having to submit embarrassing year-end reports.

2002.02 Alignment of Tithe to the Work

Many Christian denominations use the tithe collected at the local church to support the pastoral staff at the church that gave it. The Seventh-day Adventist Church takes Christ's Great Commission's marching orders seriously and sees tithe broadly supporting that world-wide mission. Therefore, conferences use tithe collected at large churches to help smaller churches. Likewise, unions use their share of the tithe collected in one conference to support work in a weaker part of the union's region. This tithe alignment happens at the General Conference. It redirects much of the tithe it receives from its more prosperous areas to countries with fewer resources with the goal of delivering the Gospel everywhere.

Two parts of Church policy are fundamental to aligning the tithe from where the Church collects it to where it is doing the work. This manual refers to those policies as:

- Tithe Sharing and
- Tithe Rebalancing

2002.02.01 Tithe Sharing

Return to the idea that the local conference serves as the Church's designated "storehouse." The conference collects tithe and sends the union the part belonging to the union, the division, and the GC. These organizations use this shared tithe for their operations and redistribute portions to less prosperous regions.

For the share of the tithe an organization collects for another organization, they function as the agents/stewards of those other organizations. For example, the conference receives tithe from its local church treasurers. The receiving organization receives the tithe but may not make decisions about its use. Therefore, that part of the tithe received is not conference revenue, and the share it moves to other organizations is not an expense. If it originally recorded the collection as revenue, it must record the share moved to the higher organization as a reduction of that revenue.[2]

[2] They may do this by crediting the collected revenue in a gross tithe account and debiting the part going to the higher organization in a contra-revenue account.

The part owed to other organizations is an agency liability. This *Manual's* Chapter 14 - Liabilities discusses the special treatment given to agency liabilities.

The principle that the tithe sent to the higher organization is not the revenue of the collecting organization is a main difference between Church and local government regulators' accounting. Perhaps government charity regulators want to see all the charitable contributions showing as revenue of the regulated charity. Their regulation would cause the need for two sets of financial statements: one set for the regulators showing the entire amount as revenue and the amount shared upward as an expense, and one set for the Church showing the revenue net of the part shared upwards. The Church uses this for Church reporting only. This dual reporting does not mean that the conference keeps dual accounting systems. It simply means that they show the same accounts in two ways.[3]

2002.02.02 Tithe Rebalancing (Formerly Tithe Exchange)

Even with tithe sharing, organizations may end up with a mismatch between the tithe and non-tithe net assets they have and the type of net assets they need.

Example – Tithe Rebalancing

Consider Conference A and Conference B.

Conference A has lots of tithe funds but needs to build churches. Working Policy does not allow it to use tithe funds to build churches. On the other hand, Conference B receives plenty of non-tithe funds from their many nursing homes. Conference B can use its non-tithe Income to pay pastors.

In a sense, Conference A has a mismatch in one direction and Conference B has a mismatch in another direction. The two can cooperate to solve their mutual tithe/non-tithe misalignment. They can align the types of net assets they have with the needs by swapping tithe and non-tithe net assets. The tithe swap with non-tithe gets them to where they need to be.

Conceptually, Conference B transfers non-tithe money to Conference A in exchange for Conference A paying them an equal amount in tithe money. In practice, moving cash is unnecessary. Conference A's Committee agrees to reclassify a part of its tithe as non-tithe with the understanding that Conference B's Committee will reclassify an equal amount of non-tithe net assets as tithe. Usually, a higher organization helps with the swap to ensure both organizations properly do this.

Figure 1 - Tithe Rebalancing

[3] This manual's first chapter discusses how the Church appreciates the role of Charity Regulators and urges full compliance in addition to meeting the Church's requirements. (See Chapter 1, Section 102.03.)

Section 2003 – Non-tithe Resources

Offerings are a significant source of non-tithe resources for conferences. Offerings fall into two broad categories:

- Offerings collected on behalf of other organizations.
- Offerings collected for the organization's use.

2003.01 Offerings Collected for Other Organizations

Offerings collected for other organizations include such things as:

- World Mission Offerings
- Union or Division College Offerings
- Hope Channel Offerings.

The conferences collect and hold these offerings as agent/stewards for the offering's ultimate owner/spending organization.

The conference collects the offering, and intermediary organizations move the offering to the final owner/spending organization. They must record these offerings as agency liabilities. This *Manual's* Chapter 14 – Liabilities discusses how agency liabilities differ from regular liabilities. Only the final owner/spending organization counts the offering as revenue.

2003.02 Offerings Collected for the Organization's Use

This *Manual's* Chapter 4 - Accounting Structure explains the difference between donor-restricted and unrestricted donations (see Section 402.03.02). That explanation focuses on the donor making an explicit restriction such as, "Use this donation for the evangelism of the Igbo of Southeast Nigeria." As a reminder, donor-restricted donations are restricted by the donor. The restriction limits the Executive Committee to using those donations within the boundaries of that restriction.

Restrictions also happen when donors respond to appeals that restrict the use of the money donated in that offering. So, it matters how the conference words an appeal.

Example – Fundraising Appeal Texts

Notice the differences in wording of fundraising appeals:

- "Please donate to the new Academy Administration building,"
- "Please donate to Academy building projects."
- "The conference has several building projects. For example, there are plans to build a new Academy Administration building. Please donate to conference building projects."

Each of these wordings produces less restrictive restrictions.

Figure 2 - Fundraising Appeal Text

The conference's accounting system has two goals when tracking restricted donations:

- The organization must ensure it spends the donations/offerings according to the restriction.
- The accounting system and the financial reporting must show that the organization spent the offering according to the restriction.

Good agent/stewards can both do right and prove it.

Difficulties moving restricted funds through the denomination or financial problems elsewhere in the organization must not thwart the restricted purpose. An excellent example of this is the denomination's Ingathering efforts.

The Church Working Policy has a chapter on Ingathering (GCWP X). In brief, the policy states:

- The General Conference (and its divisions) Sabbath School and Personal Ministries Departments produce the Ingathering solicitation material (e.g., literature, videos, etc.). The material specifies that Ingathering is for humanitarian projects and may give some specific projects that the donations will support.
- The Divisions handle organizing and deploying the program.
- Members do the solicitation along with the other spiritual efforts outlined in that chapter in the Working Policy.
- The local conference and union move the money to the division.
- The division then distributes the raised donations faithfully fulfilling the obligation set by the fundraising materials.
- Usually, this means it gives a part to specific humanitarian projects and sends some back to the conferences for their humanitarian projects.

Each level of the organization keeps the Ingathering money separate from other funds. For example, recording it as a liability or an allocated net asset but using the cash to cover financial troubles elsewhere in the organization is a severe breach of agent/steward ethics. Likewise, entrapping the funds in troubled inter-fund receivables and payables is unethical.

Example – Ingathering

Consider Conference A owing Union B a large amount of unremitted tithe. Unrelated, Division C sends Conference A 10,000 of Ingathering Reversion funds for humanitarian projects.

It is unethical for the Union (or even the Conference) to offset the Ingathering moving toward Conference A against the tithe it owes to Union B. Snagging the Ingathering Reversion this way means the Church used the contributions made for humanitarian purposes to solve its own financial problems. Instead, the Church must faithfully move and use the money according to the humanitarian purposes by which the Ingathering materials raised it.

This requirement may mean keeping separate bank accounts, making money transfers to settle inter-organizational accounts, and spending the money for its intended purpose despite financial troubles in the organization.

An example would be a Conference disbursing Ingathering funds while also scrambling to garner enough cash for payroll.

Figure 3 - Ingathering Example

This small section focuses on Ingathering (GCWP X); its principles apply equally to any program where one organization raises funds that move through the Church, and another distributes them to other organizations. Examples are the Disaster and Famine and Relief offering and the Global Mission Program, with its Annual Week of Prayer offering.

Section 2004 - Appropriations

The denomination makes extensive use of appropriations. The accounting is straightforward; the system must support the sender and the receiving organization's efforts to communicate and protect the type of funds organizations are sending. For example, it should be clear if the funds are tithe or non-tithe or if donors had restricted them to a specific purpose (e.g., evangelism, education, etc.)

The sending organization can also add its restrictions. The ability of an organization to add restrictions to their appropriations means a division may send a conference general non-tithe funds but restrict it to building a youth camp, or it may send tithe funds specifying that the conference must use it to hire a conference evangelist. The Division and Conference's accounting systems must communicate, record, and faithfully monitor appropriations to ensure both organizations responsibly manage and account for the distinctions between tithe or non-tithe net assets and donor restrictions.

All Church administrators superintend the proper use of tithe. As a practical matter, this falls most heavily on tithe-supported organizations and less so on schools and hospitals.

Example – School and Tithe

For example, policy limits how a school may spend tithe (e.g., deans, chaplains, and Bible teachers' salaries). The conference complies by considering that restriction when it is making its tithe appropriation to its Academy. It is incorrect to make a tithe appropriation to the school without considering if it can spend it according to the limits.

Figure 4 - School and Tithe

Section 2005 - Salary Returns

So far, this chapter has dealt chiefly with accounting for revenue; however, there is also an expense issue that often involves conferences. It is common for one Church organization to be the legal employer of a worker serving another organization.

Example – Salary Returns

Consider Conference A as the legal employer of a worker serving in Church School B.

Church School B will reimburse some or all the employee's cost to Conference A.

Accounting and financial reporting implications are straightforward:

- Conference A (the hosting organization) records all employees in their personnel expense accounts (e.g., salary, allowances, payroll taxes, etc.)
    - This includes employees who work for them directly and those hired as a courtesy to other organizations.
    - That way, Conference A's personnel expense accounts match information they report to their government's tax agency.
    - They record reimbursements other organizations give them as a "contra-expense" account. This account reduces the total personnel expense shown on the Conference's financial statements.
    - Conference A must accrue all costs associated with the employee as expenses of the accounting period the employee is working.
        - For instance, many countries' laws require an employer to pay a substantial severance pay when the employee retires or when the employer discharges them from employment. The host organization accrues and collects these costs from the reimbursing organization when the employee does the work. This protects the hosting organization in the event the reimbursing organization is no longer around years later to cover these end-of-employment costs.
        - It is incorrect to delay recording end-of-employment costs as an expense of the year the employee leaves employment. The courtesy employee arrangement makes such accruals an even more critical consideration.

Figure 5 - Salary Returns

Example – Accommodation Payroll

The conference makes these entries for the store employees:

Salary Expense	30,000	
Employee Allowances Expense	10,000	
Provision for Pension Expense	10,000	
Employee Payable		40,000
Pension Payable		10,000
Due from Bookstore	50,000	
Accommodation Salaries for Bookstore		50,000

This last account, accommodation salaries for bookstore, is a contra-expense that reduces the conference's total expenses. The salary expense and the employee allowances expense will combine with other conference employees in the summary earnings reports that the conference gives to the government to support its payroll taxes.

The bookstore records the expense:

Salary Expense	30,000	
Employee Allowance Expense	10,000	
Provision of Pension Expense	10,000	
Due to Conference		50,000

Now suppose the conference decides it wants to help the bookstore with its pension cost. The conference makes this entry:

Appropriation to Bookstore	10,000	
Due from Bookstore		10,000

The bookstore makes the corresponding entry:

Due to the Conference	10,000	
Appropriation from Conference		10,000

It would be incorrect for the conference not to record the receivable and the subsidy expense for the part of the costs it absorbed. It would be wrong for the bookstore to not capture its expense and the subsidy income.

Figure 6 - Accommodation Payroll Example

Table of Figures

Chapter 21
School Accounting and Reporting

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Chapter 21
School Accounting and Reporting

This chapter begins with an introduction to the Seventh-day Adventist education system. It discusses several types of student-related revenue and fees. It then looks at Church appropriations, subsidies, and bad debts. It moves on to faculty upgrading and then accounting and reporting for revenue and cost centers. It ends with a discussion of cost analysis.

Section 2100 – Introduction to Adventist Education

The Adventist education system has ten thousand schools, one hundred thousand teachers, and two million students. They present a formidable accounting challenge that deserves special consideration in this manual.

Two accounting issues are particularly important to schools:

1. Reporting income and expenses in the proper accounting period.
    - Student Revenue
    - Church Appropriations/Subsidies
    - Student Receivables
    - Faculty Upgrading

2. Revenue and Cost Centers.

Section 2101 – Accounting and Reporting Student Income and Expenses in the Proper Period

Schools have several challenges in getting student revenue and expenses into the correct accounting period. Recall the general rule: revenue goes in the period the school earns it, and expenses show in the period they help produce the revenue.

2101.01 Student Revenue

The first task for the school is to record tuition and other fees in the accounting period in which the school earns them. This manual has often mentioned the need to record revenue in the accounting period in which the organization earns it. An organization that records revenue only when it collects the cash is incorrect. This principle is particularly important for schools.

Consider this tuition billing example:

Example – Student Bills

Consider Ace Adventist School.

It bills tuition for its fall terms. The term is 15 weeks long.

In the Fall of 20X1, the school sends tuition bills which total a convenient 15,000.

Initially the school should record the entire billing as an Unearned Student Tuition, a liability account. As the term progresses, they move the earned portion from liability to revenue.

Here are the entries:

When the student bills are sent:

Student Receivables	15,000	
Unearned Student Tuition		15,000

Three weeks later, at the end of September, to show the portion of the tuition earned, the following entry is made:

Unearned Student Tuition	3,000	
Tuition Revenue		3,000

Figure 1 - Student Bills

As illustrated above, when one initially records revenue as a liability, one retains the amount earned in the liability account until it is moved to the proper income account(s). But one may choose to initially record the student billings in the revenue account(s). In this case, one needs to move the unearned portion in total to a liability account at the time adjusting entries are prepared.

There are two additional observations:

- What if the tuition is non-refundable?

- Does this apply to all student fees?

2101.01.01 What if the Tuition is Non-refundable?

Some argue that since the student cannot get a refund, the tuition belongs to the school, so it should be revenue when they collect it.

If the school records all the tuition as revenue in September, then September would show a considerable surplus: a whole term's revenue and only three weeks of expenses. The rest of the months would show significant losses: no revenue and a month of expenses. Showing revenue in the periods in which the school does the teaching matches revenue to the expenses that produce it. The school must still follow the accrual process even if the tuition is non-refundable. This rule gives a better measurement of the operating results.

2101.01.02 Does this Apply to all Student Fees?

These principles apply to all term-based student fees – not just tuition. For example, schools should treat registration, book, dorm, and activity fees similarly. This idea does not mean the recognition period should be the same for all fees. For example, a fee billed for a field trip would show in revenue in the period in which the field trip occurs.

2101.02 Discussion of Specific Types of Fees

2101.02.01 Cafeteria Revenue

Schools have many ways to charge for their cafeteria, including:

- Flat cafeteria fee for the term.
  In that case, the revenue recognition is like recognition of tuition revenue:
    - Record the initial billing as a liability: unearned revenue liability.
    - Each period, as the term progresses, move a portion to revenue.

- Minimum cafeteria fee for the term; when the student takes food, the school charges its cost against that minimum.

    - Record the initial collection as unearned revenue liability.
    - As the student takes food, reduce the liability and recognize cafeteria revenue.

With this approach, the reports match the cafeteria's revenue to its expenses.

At the end of the term, schools can move forfeited unused balances from the unearned revenue account into their own revenue account: unused cafeteria minimums. This separate account holds a history of unused cafeteria minimums.

2101.02.02 Textbook Rentals, Sales, and Buybacks

Like tuition, schools must recognize book revenue rentals over the rental period.

- If the students rent the books for nine months, each month gets one-ninth of the rental income.

What about book sales revenue?

- If the school sells the books without an obligation by the school to repurchase them, the school records the revenue and cost of sales in the month the sale occurs.
- If the school sells the books with an obligation by the school to repurchase them, the school shows the difference between the sales and buyback prices[1] as book rental income over the rental period.

2101.02.03 One-off Charges

Schools have many one-off charges: Transcript fees are a good example.

- The school will show them as revenue whenever they deliver the service.
- The school still needs to consider the correct reporting period for one-off charges since when they deliver the service may differ from when it collects the cash.

[1] This can be the agreed upon or an estimated amount.

Section 2102 - Church Appropriations/Subsidies

Schools depend on both tuition revenue and appropriation/subsidy income. Schools must also be careful to show appropriation income in the proper period. Recording it as income only when the school receives the cash is incorrect.

Often, the school's sponsoring organization (e.g., conference, union, division, GC) Executive Committee votes for an annual budget for its appropriation to the school. This vote means the school gets one-twelfth (or some other pattern) of the total each month. If the school is confident that it will get the appropriation, it should record a monthly receivable to reflect that month's appropriation. When they receive the money, they reduce the receivable. This process gets the appropriation revenue in the proper period.

2102.01 Less Obvious Appropriations/Subsidies

In Chapter 20, Tithe Supported Organizations, this *Manual* discussed accommodation salaries. (See Chapter 20, Section 2005). For schools, these occur when a conference pays teachers on behalf of the school, and the school reimburses the conference for the cost. The school would report the employee costs as school expenses and initially record a liability to the conference, which would subsequently be paid.

If the conference does not expect the school to reimburse it for the teachers' cost, the conference, in the conference accounting records, will follow the entries illustrated in Chapter 20, Section 2005. However, instead of recording a debit to the receivable from the reimbursing organization (i.e., the school), it will record a debit to appropriation expense and credit Accommodation Salaries for School.

Correspondingly, the school debits an employee expense and credits appropriation income. This process gives a clearer picture of the school's self-support level.

This principle illustrates that the school should record any in-kind help from the sponsoring organization as an expense and appropriation income. The rule of thumb is that the school does this for any material cost it would have had to pay if the sponsoring organization had not provided it.

Here are some examples the school might need to record:

- the use of the conference attorney
- shared landscape services
- insurance

- material usage of a conference vehicle
- shared employees

Here are some examples of things that the school is not likely to record:

- devotional speakers from the conference
- the Educational Director's time engaging with the principal
- occasional teaching by conference staff.

Section 2103 - Student Receivables

The previous discussions focused on getting revenue in the period in which the school earns it. Proper accounting also requires accountants to show expenses in the same period as the revenue they produce. A major area of necessary matching for revenue and expense for schools is in recording and collecting student tuition receivables.

Example – Student Receivables

Consider the Grace Adventist School.

Principal A admits Student A. During the 20X1-2 school year, the school sends bills and records Student A's tuition; he attends classes, uses other school resources, but only partially pays his school bill. Each month the Principal A shares an accounts receivable aging report with the school's Finance Committee, showing Student A getting further and further behind in paying his bill.

For the 20X2-X3 school year, Principal A is replaced by Principal B. Because of Student A's unpaid bills, Principal B does not allow him to attend that school year. During the 20X2-X3 school year the Finance Committee writes off Student A's account as uncollectable.

In which school year should the school show the expense of Fred's failure to pay his bills? Does it belong in the 20X1-X2 school year or in the 20X2-X3 school year?

Like the insurance example above, the expense belongs to the year it produces revenue. This process requires an estimate of the bad debt expense for each year.

The entry to record the estimate for the 20X1-X2 school year is:

Uncollectible Accounts Expense	xxx,xxx	
Allowance for Uncollectible Accounts		xxx,xxx

The expense reduces the income for the 20X1-X2 school year. That is proper, since it shows the uncollectible accounts expense in the same year the statements show the related revenue. It also reduces total accounts receivable. The resulting balances also make sense. The school is not likely to collect all the receivables, at least according to the estimate.

Recording this estimate makes sense even if it is impossible to specify which student will not pay at the time of entry. The process sets up the allowance to manage the uncollectible accounts as they appear uncollectable.

In the 20X2-X3 school year, this entry records the actual write-off of Student A's account:

Allowance for Uncollectible Accounts	2,000	
Accounts Receivable – Student A		2,000

Notice that this puts the expense in the 20X1-X2 school year, not in the 20X2-X3 school year when the account was written off.

Figure 2 - Student Receivables

For additional information, see the discussion of Accounts and Loans Receivable in Chapter 11, Sections 1101 and 1102.05, and the discussion of the Allowance for Doubtful Accounts in Chapter 11, Section 1104. Additional information on Student Accounts Receivable is found in Chapter 11, Sections 1104.01, 1104.02, and 1105.

Section 2104 - Faculty Upgrading

Schools often wisely invest in their teachers by sponsoring them to attend advanced degree programs. In return, it is typical for the school to require the teacher to work for them for a specified period. These agreements and policies often use the accounting term: "amortize" and "amortization". Usually, the agreement specifies that the employee reduces their debt to reimburse the school for its out-of-pocket cost by, say, one-fifth for every year they work after finishing their degree; so, if the teacher stays five years, they fully amortize their debt.

Schools may continue to enter into agreements with teachers, the IFRS has said that employers must expense these costs as they pay them. This standard means that employers show the payments on behalf of the employee as upgrading expenses when they pay them. It is not appropriate for the financial statements to show the upgrading expenses as receivables. Since the financial statements have already shown the entire outlay as an expense, they do not duplicate the expense by any further amortization. See also the discussion of Employee Educational Loans in Chapter 11, Section 1109.

Section 2105 – Revenue and Cost Centers

Church accounting is about more than producing statements that comply with International Financial Reporting Standards (IFRS). Those standards relate to reporting information to outside stakeholders such as creditors, donors, and constituency members; however, Church accounting has much to do with providing information to the school's management group[2]. Gathering and reporting the information the school needs to manage its operations is a creative process that depends on its unique information needs.[3]

[2] In the Church system, this includes a broad group including leaders employed by the school and the school's governing committee.
[3] This school chapter discusses management accounting because it is so relevant to schools. However, the principles and ideas covered here apply to all church organizations.

2105.01 Cost Analysis

School financial managers must understand the nuances of their costs. School costs come in three varieties:

- Fixed Costs – the cost stays the same when the number of students fluctuates.
    - Examples include:
        - Interest
        - Depreciation
- Variable Costs – the cost fluctuates as the enrolment fluctuates.
    - Examples include:
        - The cost of cafeteria food
- Mixed Costs – a basic cost would exist even if there were no students; however, a part increases as the number of students grows.
    - Most school costs are mixed costs

2105.01.01 Relevant Range

The relevant cost range helps to determine which of the above categories is appropriate for a given cost. For example, interest is a classic example of a fixed cost. As a practical matter, it is a fixed cost: it does not fluctuate if enrollment fluctuates. However, at the other extreme, it is variable. If there are no students, the school would sell its building and repay its loans, and so, as a notion, it is variable because it falls if the number of students decreases to zero enrollment.

The opposite is also true; if student enrollments triple, the school would borrow money to build more classrooms and dorms. Interest costs would perhaps triple; however, unless the above extremes are a given school's experience, whether a cost is fixed, or variable depends on its behavior within the school's likely enrollment range. This likely enrollment range is called the "Relevant Range."

2105.01.02 Using Cost Analysis

Understanding your expense's cost behavior is helpful in financial planning and budgeting. It is useful for finance managers to understand the cost's behavior so it can inform their more intuitive daily decision-making about taking on or shedding costs. Most schools have a high proportion of fixed costs that do not change within the relevant range of enrollment fluctuations. In this situation, finance managers are hesitant about taking on more fixed costs that they will have to continue to pay even if enrollment goes down.

2105.02 Revenue and Cost Centers

Management accounting requires both creating and understanding operations from the point of view of its various revenue and cost centers. This creating and understanding begins with determining what revenue and cost centers[4] are essential to the school.

2105.02.01 Revenue Centers

Revenue Centers are the school's different revenue-producing activities. Examples of Revenue Centers include:

- the dorms
- the cafeteria
- the primary school
- the farm

Besides finding the various essential revenue streams, the school should exclude possible centers where activity is immaterial to the overall operations of the school.

> ***Example – Revenue Streams***
>
> For instance, the school's Pathfinder program may be critical to the school's spiritual mission and may generate a little revenue, but it may not be worth the effort to call it a Revenue Center and separately track its revenue and expenses.

Figure 3 - Revenue Streams

Once we have identified the Revenue Centers, we will configure the accounting system[5] to capture the Revenue Center's revenue and any direct costs that helped produce that revenue.

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[4] Revenue and Cost Centers often seem the same as departments, but they do not need to be parallel. One department may be financially insignificant and not call for identification as a Revenue or Cost Center. Also, one department may house several Cost Centers. For example, an entrepreneurial librarian may run a café and sell media design services in addition to having a public, non-student, library membership project. Each of these might require the tracking of revenue and their direct costs.

[5] Recall from Chapter 2 – Overview of the Accounting System that the accounting system includes the software, the paper flow, the people, and everything else with doing the accounting.

Dorm Revenue Center would receive credit for the dorm fees, and the system would charge it with its expenses for electricity, maintenance, paper products, cleaning supplies, and hall monitor salaries. The difference between the Revenue Center's revenue and its direct cost is the Revenue Center's gross margin or gross contribution. It is how much the Revenue Center contributes to the school's financial success.

2105.02.02 Cost Centers

Cost Centers are the same as Revenue Centers, except they do not produce revenue. Financially, they play a supporting role to Revenue Centers. Examples of Cost Centers include:

- Housekeeping Department
- Maintenance Department
- Finance Department

The accounting system accumulates the expenses of a Cost Center to enable management to make decisions about the department's operations. The Cost Center's expenses are the Revenue Center's indirect costs.

2105.02.03 Allocating Cost Centers to Revenue Centers

Some financial managers distribute the Cost Center's indirect cost to the Revenue Centers. This process allows management to view the total increase in net assets (its profit) by the Revenue Center that produced it. Other financial managers consider allocations of indirect costs as both arbitrary and capricious and not helpful to management decisions.

2105.02.04 Revenue and Cost Centers on Financial Statements

As previously mentioned, for many schools, the Financial Statements serve as the leaders' only source of financial information. Therefore, including Revenue and Cost Center information in the Financial Statements is helpful. This manual calls for the Statements to show revenue and direct costs for tuition, dormitories, cafeterias, and industries.

2105.03 Variable Budgets

Most church leaders think a budget sets a fixed amount for that year's expenses. The expectation is that the school will work below that amount. This idea makes sense with fixed costs but less with variable costs. Budgeting a variable (or even a mixed amount) is proper for certain expense items. A good example is the cost of cafeteria food. With that, it is better to approve a budget that fluctuates based on enrollment or some other varying amount, such as meals served.

Section 2106 - Conclusion

This *Manual* does not deal further with Managerial Accounting topics. There are many books on the subject – and nothing unique about Adventist schools requires special consideration. This section was only to whet the financial manager's interest in reading more about using managerial and cost accounting techniques in their school.

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Chapter 22
Retail Stores Financial Reporting

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Chapter 22
Retail Stores Financial Reporting

In addition to the familiar SDA tithe-supported organizations, the Church owns and runs many retail-based organizations, including book and health food stores. This chapter deals with the accounting needed for these organizations. The chapter discusses the Statement of Profit/Loss and Other Comprehensive Income, then moves on to stores as separate reporting entities. It discusses Financial Statement Note 1 in the retail context. It ends by touching on miscellaneous topics relating to retail accounting.

Section 2201 – Introduction to Retail Accounting/Reporting

So far, this *Manual* has focused on organizations that are dependent on tithe and offerings for their support.[1] In contrast, the Church's 100+ book and health food stores concentrate on supporting themselves through their sales. This distinction does not mean that conference or union appropriations for their support are improper or that they are any less important as a vital church ministry. It means there is a difference in their financial reporting.

Financial reporting for conferences and unions, and to a lesser degree, schools, focuses on the charitable resources they can garner and reports how the organizations use them for their charitable purpose. The idea is that there is a general match between the resource's inflows and outflows. Their increase or decrease in net assets (comparable to a store's net income) is not their sole focus. The bigger question is how much they raise to conduct their ministry and how their spending advances that ministry.

The bookstore and health food store ministry also focuses on placing spiritual materials, books, and health food into people's homes. However, they follow a commercial rather than a nonprofit model to conduct this ministry. Their financial reporting reflects this difference.

Even with that distinction, this *Manual* only explains the essential concepts relevant to retail sales. The first nineteen chapters apply to retail organizations to the extent they are appropriate. For instance, the chapters on Accounts Receivable (Chapter 11) and Inventory (Chapter 12) are critical to understanding how a store deals with these transactions in its accounting.

[1] This manual includes schools in the category that depend on tithe and offerings for their support. They usually receive large subsidies and depend on fund raising for student sponsorships and their capital projects.

Section 2202 - Statement of Profit/Loss and Other Comprehensive Income

The Financial Statement where the most differences between for profit and non-profit organization occur is the retail store's Statement of Profit and Loss and Other Comprehensive Income. This title is the IFRS's term for the organization's Income Statement. The first phrase of the title, "P & L," may be familiar to accountants. The IFRS adds the "Other Comprehensive Income" to the name to emphasize that the Statement reports such things as:

1. Appropriations coming from other organizations and
2. Gains and losses from asset sales and investments

This broad definition means the Statement of Profit and Loss reports more than just the profit and loss of running the store. This manual highlights some critical aspects of this P & L Statement.

2202.01 Multistep Statement of Profit/Loss and Other Comprehensive Income

The Statement has a multistep presentation showing sales, cost of goods sold, gross profit, operating expenses, and other income and expenses. It concludes with net income. The illustrative Financial Statements in Volume 3 of the Accounting Manual show these elements.

2202.02 Accrual Accounting

Retail stores are interested in their profit. Church-related stores might not be thinking about making an earning distribution to their owners, but the Church is highly interested in its store's self-sufficiency. The store can only prove that it is self-supporting by carefully measuring its profit.[2] To carefully measure profit, it must apply all aspects of Accrual Accounting as Accrual Accounting is the only way the store's P & L Statement gives a clear picture of whether the store is supporting itself with its sales.

1. This means accounts receivable, as well as sales revenue must reflect only items the store has delivered to the customer. Usually, this means the store has shipped or given them to

[2] Cash flow is a poor substitute for assessing self-sufficiency. The store can be accumulating delayed payment for expenses that eventually the store or its conference will have to pay for, thereby temporarily increasing its cash balance. Accrual Accounting calls for the recording of these unrecorded expenses in the period in which they arise.

the customer. The store should not record unshipped orders as revenue or as accounts receivable.

2. This also means that cost of goods sold should reflect only the items the store has sold through in-store sales or has shipped to the customer. When a store purchases books or health food, it must record the purchase as inventory. The cost of the purchase moved to cost to the cost of goods sold account when the item ships or is given the customer.
3. Careful Accrual Accounting calls for an accurate month-end cut-off so the Financial Statements only show the sales and cost of goods sold in the period the store delivers the products to its customers.
4. The store should use Accrual Accounting with all its operating expenses. This means it carefully records accrued salaries, pensions, taxes, rental payments, etc.

2202.03 Conference-Supported Salaries and Other Costs

Accommodation Payroll is when the conference treats the store employees as its legal employees and passes the payroll costs to the store for reimbursement. Chapter 20 - Tithe Supported Organizations, Section 2005 illustrates the accounting for this, so that information is not repeated here. The conference should record the total cost of the employee, including such accruals as pension and vacation costs. The conference then passes the expense to the store and the store then captures the total cost of the employees as their expense. If the Conference decides to subsidize the store by absorbing some of the payroll costs, the store will record the subsidy as revenue. It will not record the subsidy as a reduction of payroll expense.

2202.04 In-Kind Assistance

The above-mentioned principle applies to any in-kind cost any other organization absorbs for the bookstore. Legal fees, vehicle costs, and rental costs are all excellent examples. The store must capture the expense for any in-kind help that it would otherwise have to pay for. It is excellent and proper for the conference to support the bookstore by absorbing these costs. However, the store needs to record them as expenses and a subsidy income to aid its efforts in measuring its profitability.[3] See Chapter 24, Section 2404 for an extended discussion and guidance for handling in-kind assistance transactions.

[3] An exception to this may be help coming from publishing houses and other suppliers. Discounts, free shipping, and other help from the store's suppliers are normal commercial activities and not in-kind donations.

Section 2203 - Stores as Separate Reporting Entities

Usually, conferences (or unions) run the book or health food stores. One persistent question is whether the conference's Financial Statements should include the store's assets, income, cash flow, etc. The question can be complicated, but the answer is most often affirmative. For guidance and a series of pertinent questions and examples explaining this concept, see the extensive discussion of which entities should be consolidated in Chapter 18, Section 1803 of this *Manual.*

Note that the decision that the conference must include the store in its general-purpose Financial Statements does not prevent the store and the conference from preparing separate internal management-only Financial Statements for their routine management activities.

Section 2204 - Financial Statement Note 1

Chapter 2, Section 202, discusses the five parts of a set of Financial Statements. The first four are the primary statements, and the fifth is the Notes to the Financial Statements. These Notes are as crucial as the primary Statements; organizations should not treat them lightly. The first Note explains the reporting entity about which the Statements report.

The discussion above shines a spotlight on the importance of this first Note.The first Note needs to clarify what segments of the entity the Statements include and what they exclude.

Example – Conference Bookstore

Suppose a bookstore belongs to the conference. A complete set of Conference Financial Statements should report the financial information for the conference and its bookstore. However, the conference wants to prepare monthly reports separating the two for management purposes. This is proper. However, the reports must include a Note that explains this. It is incorrect for the conference's Executive Committee, looking routinely at the conference-only report, to get the idea that they are not also responsible for the bookstore. A Financial Statement Note on its management-only reports that clarifies the entity situation will avoid this misunderstanding.

Figure 1 - Conference Bookstore

Section 2205 - Retail Accounting – Miscellaneous Topics

This section addresses several other topics that are unique to Retail Accounting.

2205.01 Credit Card Sales

Consider a store that takes credit cards for payment. Typically, the credit card processor charges a merchant discount rate of 1-3 percent of the amount charged, so the credit card sale of 100 may net the store 98. The store must record the book sales at 100 and the credit card fee as an expense of 2.

2205.02 Subscription Sales

If the bookstore sells subscriptions and its responsibilities end at that point, it may record the sales commission at the time of sale. Suppose the periodical may claw back some of the commission if the subscriber cancels the subscription. In this case, the store must record this possibility with an estimate and an allowance like the allowance for uncollectable accounts.

2205.03 Cost Accounting

This *Manua*l focuses on financial reporting to the store's constituents; however, savvy store managers are well-read in retail store Cost Accounting. A sound Cost Accounting system will show the gross profit from each product, product line, and store branch.

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Chapter 23

Door-to-Door Sales

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Chapter 23
Door-to-Door Sales

This chapter discusses the accounting/reporting requirements for the SDA Church's extensive network for publishing and distributing Christian literature. It starts by explaining the related GC Working Policy and the variety of organizational structures used for this work. A discussion of the various aspects of sales follows, and the chapter ends with a discussion on calculating the compensation for the Literature Evangelist.

Section 2301 – Introduction to the Publishing/Distributing Network

The Seventh-day Adventist Church has a well-developed worldwide publishing ministry for distributing Christian literature. It does this work with its army of literature evangelists (LEs). GC Working Policy (GCWP FP) allows many organizational and distribution arrangements to conduct this program. These are subject to the policies of the GC divisions. Administrators of organizations engaged in such activity should know these policies well.

Chapters 1 to 19 of this *Manual* cover general accounting guidance relevant to all Church organizations. The current chapter discusses matters unique to the literature ministry. The standards presented here apply to any SDA organization that distributes subscriptions, literature, and related products to the public, whether it sells them for cash or by installment payments. Policy and practice allow the publishing ministry to use various organizational structures. In some places, conferences and unions hire and deploy literature evangelists. In other places, publishing houses employ them. Sometimes, the Church sets up special-purpose organizations expressly for this ministry. Because of this structural flexibility, this chapter uses the term Literature Evangelism Organization (LEOs) to refer to any organization fielding literature evangelists.

Section 2301.01 - Relationship to Senior Organizations

Every LEO will be an extension of some senior organization, whether a union or local conference, publishing house, or a combination of such entities. Because the nature of this relationship may vary from one LEO to another, the LEO's constitution and by-laws must spell out such details as:

1. the membership of the LEO Governing Committee,
2. the membership and duties of any Executive or Operating Sub-committee,

3. the titles and responsibilities of all LEO officers or administrators,
4. and the delegation of authority to set prices, commissions, and benefits.

Section 2302 - Sales and Related Accounts

2302.01 Sales Cycle

The purpose of an LEO is to sell or distribute literature and related products, so the primary focus of its accounting system (and this chapter) will be its sales cycle. A secondary focus will be on commissions and other selling expenses.

For an LEO that sells installment contracts, its sales cycle includes the following:

1. accounting for contracts prepared by literature evangelists (LEs),
2. processing and shipping Inventory,
3. accounting for returns, adjustments, and write-offs,
4. and collection and valuation of accounts receivable.

For LEOs that sell primarily on a cash basis, the sales cycle includes the following:

1. accounting for total sales made by LEs,
2. processing inventory,
3. and accounting for movements of cash and inventory to and from the LEs.

2302.02 Sales Categories

The LEO may want to account for sales activity by:

1. type of merchandise (i.e., children's books, health books, bible study books, etc.)
2. sales regions
3. type of sale (cash, installment, etc.)

To do this, they must expand the account structure enough to account for the sales, the cost of goods sold, and direct selling expenses in categories that match those of the desired analysis dimensions. This detailed structure will allow management to analyze the profitability of each sale category.

2302.03 Weekly LE Reports

Most LEOs work with the LEs on a weekly cycle. There is a definite deadline for the end of the sales week and for sending in completed sales documents to the LEO. The LEO then processes sales documents, makes shipments, and computes LE settlements on a fixed schedule. This set routine:

- allows the LEs to follow an organized plan of operation,
- allows the LEO to schedule its various functions most efficiently,
- and gives the LEs the security of weekly settlement of their accounts.

It also helps ensure that the LEO records all sales promptly.

2302.03.01 Sales Processing

The LE sends in a sales report with supporting sales documents to the LEO. The LEO's first step must be to check sales documents against the summary report and to check cash received against the individual sales documents and the report summary. The processing of the money the LEO receives should follow the guidance in Chapter 9 - Cash and Cash Equivalents.

The processing personnel should sequentially number all sales documents they receive from every LE, and this number should carry through to all later transactions relating to that specific sale. This numbering process must occur at the beginning of the processing cycle to enable the tracing of any sales document throughout the accounting system.

2302.03.02 General Processing Sequence

The steps followed to record sales documents and process merchandise may vary from one LEO to another. A chain of activity is set in motion as soon as it verifies and numbers the sales documents.

- Suppose the LE does not give the merchandise to the customer.
    - In that case, the LE should give a copy of each sales document or some other kind of authorization form to the shipping department so they can send the inventory to the customer.

- Suppose the sale is on a time-payment plan.
    - In that case, the LEO enters information about the customer and the sale in the accounting records.

  - This triggers accounts receivable activity and LE commission and benefits computations.
  - The system should produce weekly reports summarizing all sales processed, whether manual or computerized. This summary should include sales document numbers, sales amounts (by product type, LE, and territory), amounts financed, and cash received.
  - The person responsible for reconciling cash and bank accounts should use this report of money received to compare with the sales document processor's record of weekly cash received and the record of bank deposits.
  - If the original sales document is the time-payment contract, the processing office should keep a copy of it in the processing office since it is an essential legal document.

- In many LEOs, most sales are by cash rather than a time-payment plan.
  - Even though sales may be on a cash basis, the LEs should send weekly reports with supporting sales documents.
  - The weekly LE report will have a receipt or invoice to support each sale.

- The LEO should keep track of the inventory in the LEs' custody.

2302.04 Cash Sales to Resellers

In some places, LEs are legally, and by policy, independent contractors. Still, the record-keeping should be as diligent as the organization would have if they were employees. However, the amount the LEO records as a sale is different.

In these places, the LEO sales revenue is not the retail amount the ultimate buyer pays. Instead, sales revenue is only the amount the LE pays the LEO. The LE is buying the inventory from the LEO and is reselling it.[1]

In some areas, the distinction between employee and independent contractor results in vastly different tax and reporting requirements for the LEO, as well as potential penalties for making the wrong distinction. LEOs should understand the laws and regulations of their territory and work to ensure compliance with all legal obligations.

[1] This would usually be at a wholesale, not retail, amount.

2302.05 Cost of Goods Sold

A basic accounting principle requires recording the reduction of Inventory and the corresponding cost of goods sold only when the organization records sales. If LEs take inventory from the LEO to district or branch locations, the LEO still classifies the merchandise as inventory until it records a sale. In addition to tracking inventory kept at the LEO central office, it should use separate inventory accounts or transaction coding to keep track of inventory in its various remote locations. When it records sales, it should only then reduce the inventory account.

2302.06 Credit for Returns and Corrections

The LEO should tightly control credits for adjustments, returned goods, errors in billing, etc.:

- The LEO should not credit customer accounts without approval by specific individuals that LEO policy appoints as able to approve credits.
- The LEO would only record a credit for returned books when it has received them back into inventory.
- In the case of returned goods, the LEO would debit a separate contra-account for returns and allowances. It would not debit the sales account for the reduction in sales. It would credit either customer accounts receivable or refunds payable.
- On the other hand, the LEO would use the regular sales account to record adjustments to customer accounts for accounting errors in billing.

2302.07 Repossessed Merchandise

Books that the LEO repossesses from customers are again LEO property, and they must be rerecorded in the LEO inventory. Upon receipt of these items, the LEO should examine their condition and place a value upon them consistent with that examination. The value set on the books should provide a margin for the necessary expenses of resale and a reasonable profit if the books are resold. The entry debits the value to a specific inventory account for repossessed merchandise and credits the cost of goods sold.

2302.08 Sales Tax / VAT

Sales tax (or value-added tax or similar names) requires special consideration. If the LEO adds a sales tax to the sales price, the debit to cash (or accounts receivable) will, of course, equal the total merchandise price plus the sales tax. There will be two credits. One credit to a Liability account records the sales tax payable, and the other to sales income records the sales price. The LEO is acting as a collection agent for the government. The LEO should know the tax regulations in each jurisdiction it works in. It must ensure all LEs abide by the governing tax regulations.

Section 2303 - Literature Evangelist Compensation

The division, union conference, local conference, and publishing house share in setting policies, training, and supervising the LEs. The LEs are usually associated with a local conference or a publishing house. Their compensation usually consists of two elements:

1. a commission based on an agreed-upon formula applied to actual sales and
2. the health care and other benefits the conference or union provides to eligible LEs.

2303.01 Computation of Commission

Sometimes LEOs develop complex or creative commission systems to encourage LEs to be productive. Any formula that works is acceptable if:

1. it applies the commission formulas fairly and consistently to all its LEs, and
2. the LEO records all components of the sales commissions in the accounting records as commission expenses.

Because commissions are a form of compensation to the LEs, the LEO must report all components of commissions to the proper government agencies. Further, since commissions are often the basis for pension contributions, the LEO should ensure it uses the correct amounts to calculate its pension contributions.

Chapter 24
Industries

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Chapter 24
Industries

The SDA Church runs a wide variety of industries and this chapter discusses the accounting/reporting requirements for those industries. After introducing the types of industries in the Church, there is a section on IFRS industry reporting concerns. After discussing Transfers To/From and inter-organizational receivables, the chapter moves to in-kind transactions and related party disclosures. The final two sections focus on cost accounting for industries and accounting for agricultural assets.

Section 2401 – Adventist Industries

The Seventh-day Adventist Church runs many industries[1] – both large and small. At one end of the spectrum is Australia's giant Sanitarium Health Food company; at the other end are dozens of small dairies, bakeries, and retreat centers. Besides a range of sizes, Adventist Church industries consist of various business types, including retirement homes, hotels, translation centers, call centers, and even gravel mines.

The Church organizes some industries as free-standing corporations, while others are departments of their parent organizations. Some have their own corporate board. In some, their parent's executive committee governs them directly. The parent's Executive Committee sometimes manages the industries through an appointed administrative group. Because of this complexity, this manual focuses only on the basic principles that standardize general financial reporting.

The first nineteen chapters of this manual are still relevant, and most of the issues they cover also apply to industries. To the degree the topics are relevant, industries should follow the principles those chapters discuss. For example, the discussions on auditing, current assets, and the relationship between this manual's requirements and government requirements apply to industries. Other topics do not. For example, the discussion on restricted donations and fund accounting are not applicable. An accountant in an industry should read the applicable chapters and use all the principles that apply to their organization.

[1] This Church calls any business it runs to primarily make income or give employment an "industry." So, this chapter includes guidance to service businesses such as call centers, translation centers, and travel agencies.

Section 2402- IFRS Accounting: Business, Church Policies, Denominational Elections of IFRS Alternatives

IFRS accounting standards form the solid foundation of this manual. Church industries must follow those standards that apply to their business – even if the manual does not explicitly mention them.

This *Manual's* first nineteen chapters include a few requirements added to IFRS to enhance compliance with Church policy (e.g., the Working Capital policy and the tithe policy) or good non-profit accounting (e.g., Fund and Restricted Donation Accounting). These additional requirements are less relevant in Church industry accounting.

Other topics covered in the first nineteen chapters still apply. For example, Church policy (GCWP S04 25-35) places the responsibility for internal controls squarely on the industry's governing committee's shoulders. GCWP S 29 05 requires audits of all organizations, and GC S 60 15 requires insurance on all denominational property. These requirements apply to all Church organizations, including their industries.

Likewise, this *Manual* prescribes the denomination's election in the case of IFRS alternatives. These elections apply to denominational industries. For example, IFRS provides the accounting option of valuing buildings at current market value or at depreciated historical cost; however, this manual sets depreciated historical cost as the standard for denominational accounting. Organizations should apply denominational policy and this *Manual's* standards as faithfully as possible within their business situation.

2402.01 Function and Nature of Expenses

IFRS accounting requires organizations to show expenses by "nature" or by "function." Showing them by nature means that the organization shows them by such categories as salaries, depreciation, operating, and interest expenses. Showing them by "function" shows them by their purpose: production costs, selling costs, administrative costs, interest costs[2], etc. The second method results in slightly more accounting work since it requires distributing certain expenses (i.e., depreciation, rent) to the functions and more care in charging functions with their correct

[2] Under both methods, IFRS requires the financial statements to show interest/financing costs separately from other costs.

expenses. This *Manual* requires the Activity Statement to report expenses by Function. It also requires a Financial Statement Note showing the expenses by both Nature and Function.

Example – University Bakery

To illustrate these two requirements, a University Bakery's Activity Statement may have an expense section that looks like this:

University Bakery
Statement of Activity
For the Year Ending 20x2 and 20x1

Income
…
Expenses (See Note 1x):

	20X2	20x1
Production	130,000	120,000
Marketing	10,000	5,000
Distribution	3,000	4,000
Administration	10,000	11,000
Interest	5,000	3,000
Total Expenses	**158,000**	**143,000**

and in the Financial Statement Notes:

Note 1x Expenses by Function and Nature

	Functional Expense Categories					
	Production	Marketing	Distribution	Administrative	Interest	Total
Personnel Expense	70,000	5,500	1,700	7,800		85,000
Operating Expenses	10,000	4,000	1,000	2,000		17,000
Depreciation	20,000	500	300	200		21,000
Changes in Inventory	30,000					30,000
Interest					5,000	5,000
Na Total Expenses	130,000	10,000	3,000	10,000	5,000	158,000

Figure 1 - University Bakery Example

Section 2403- Industry Reporting Entity Concerns

Chapter 18- Reporting Entity, deals with the complex problem of determining the proper reporting entity (see Section 1803). Often, a parent organization owns and (ultimately) governs the industry.

Example – University Dairy Farm

For example, an Adventist University may run a dairy farm; the University's Board appoints the dairy's Administrative Committee and has veto power over the Administrative Committee's decision. In this case, the University's Comprehensive Financial Statements would include the dairy farm's assets, liabilities, and operating results. However, this does not mean those Statements must completely obscure the difference between the University's two types of activities:

1. Primary University Operations and
2. University Dairy Farm

Refer to Chapter 18, Section 1803 for a list of questions and illustrations to identify when to consolidate these separate activities into the University's financial statements. Volume 3 of the *Accounting Manual* illustrates options for how to prepare the financial statements for both the University and the industry when consolidation is required.

Figure 2 - University Dairy Farm

2403.01 Transfers To/From Other Adventist Organizations

While this *Manual* encourages preparing Consolidated Financial Statements that capture the entire reporting entity, it recognizes that organizations may want to prepare separate, special-purpose financial reports.

Two accounting challenges occur when the Financial Statements of the organizations are not consolidated, as when special purpose, internal-use Statements are prepared:

1. Inter-organization Receivables and Payables
2. Inter-organization Transfers

2403.01.01 Inter-Organization Receivables and Payables

Are receivables and payables between the parent organization and its industry genuine receivables and payables, or are they really permanent capital contributions or income distributions? How do you estimate and record a proper allowance for uncollectable accounts receivable for receivable/payables between closely held organizations? Preparing Consolidated Financial Statements for the entire reporting entity avoids such awkward questions by eliminating inter-organization payables and receivables.

2403.01.02 Inter-Organizational Transfers

Another accounting challenge of preparing special purpose, internal use-only Statements is where to show income distributions from the industry to the owner organization and capital contributions from the owner organization to the industry. Should the industry show their payments to the owner organization as dividends, or should they show them as transfers-out? Should the parent organization show the income as dividend income or should they show them as transfers-in? Consolidated Financial Statements avoid this confusion by eliminating interorganizational transfers.

A significant purpose of the industry's Activity/Income Statement is to provide the reader insight into the industry's operating results (i.e., profit & loss); thus, this *Manual* requires the reports to clearly distinguish between the industry's operating results and transactions with its parent. The industry's handling of transactions from or to the parent owners must not obscure the operating results.[3]

Section 2404- In-Kind Transactions

It is common for there to be some "in-kind" interaction between an industry and its parent/owning organization (See also Chapter 22, Section 2202.04). The dairy may use electricity or office space without charge, or the University may use the dairy's trucks to haul the university students to various activities, such as Harvest Festival hayrides.

As mentioned, the Financial Statement's goal is to capture the industry's profitability truthfully, so its Financial Statements must reflect material in-kind transactions. Here are a few indicators of whether the industry should record an in-kind good or service it gives or receives:

1. Would the industry or parent/owning organization otherwise pay for the good or service?

[3] Organizations must routinely evaluate loans between the Industry and the Owning organization. Suppose the borrower is not repaying them, either because it is unable to repay, because it lacks the intent to repay, or because the creditor lacks the intent to collect. In that case, both should reclassify them as owner contributions or distributions to owners.

- Suppose the dairy would have to pay for the electricity if it did not get it unmetered from the parent. It should install a meter or estimate its electricity costs and record them as expenses.

2. Does the goods or service add to the marginal cost or reduce the marginal revenue of the provider?
    - For example, access to the industry may be on roads owned and maintained by the parent. If the parent already needs to maintain the road, allowing the industry to use them does not add to the parent's cost. Recording access to the road as an in-kind benefit would not be required.

3. Is it a routine or just a neighborly act on the part of the provider?
    - Routinely using the dairy's trucks to collect the campus garbage would show a need to record an in-kind expense at the University and in-kind revenue (or cost reduction) at the dairy.
    - The once-a-year hayride for the University students would likely not justify in-kind transactions.

4. It is irrelevant whether the provider of the in-kind service will require payment for the good or service.[4]

Section 2405- Related Party Disclosures

The rest of this chapter relates to IFRS requirements that may apply to Church Industries. These reporting requirements are critical to the Church's transparency and accountability efforts. The industry's Financial Statement Notes must show receivables, payables, sales, and expenses with related parties separately from regular receivables, payables, sales, and expenses. For example, they must show receivables from officers separately from other receivables.[5]

For an extensive discussion of related parties, see Chapter 2, Section 203.03 of this *Manual.*

Who are an industry's related parties?

- The industry's leadership would be related parties.
    - o Anyone on the industry's Operating Board is a related party.

[4] This is a modification of the 2011 accounting manual.
[5] This can be on the face of the Statement of Financial Position or in the footnotes. This *Manual* does not require specific mention of what related party the transaction is with.

- The industry's parent organization and its officers are related parties. As Chapter 2, Section 203.03 mentions, the threshold of an organization to be a related party is lower than the threshold that requires consolidation.
    - An organization is a related party if it can influence the industry's operations.

Section 2406 - Church Industries: Cost Accounting, Cost of Goods Sold, Inventories

This *Manual* focuses on external financial reporting, so it is beyond its scope to focus on cost accounting, but an industry's cost accounting practices can affect its financial reporting. It is helpful for Church industries to apply proper cost accounting techniques in their operations. However, they should be careful to use these techniques in a fashion that does not overstate inventories and operating results.

Example – Church Furniture Industry

For example, consider a Church furniture industry that applies overhead and other indirect costs to its Work-in-Progress and finished goods inventory. Exuberantly doing this may overstate the value of the inventory and net income.

Figure 3 - Church Furniture Industry

Many Church publishing houses have discovered that misapplying overhead and other indirect costs to inventory accounts distorts their operating results, especially if there is low Inventory turnover.[6] In response, they avoid applying overhead and indirect costs to their inventory. This manual encourages good cost accounting practices and urges that industries conservatively use it to avoid inflating the industry's operating results.

IFRS requires that all organizations value their inventory at the lower of either:

1. Cost or
2. Net Realizable Value[7].

[6] Realistic, conservative, inventory valuations can also mitigate this.
[7] Net realizable value is what you can sell the inventory for minus selling costs (e.g., commissions, delivery fees, etc.).

Organizations must faithfully follow this principle. This is especially important if its cost accounting system assigns fixed costs and overhead to its Work-in-Process and Finished Goods inventory.

Section 2407- Agricultural Assets

Many Church industries involve farms. These farms have agricultural assets. Fruit trees, dairy cows, beef cattle, chickens, and sheep present an inventory and fixed asset valuation challenge. It is beyond the scope of this *Manual* to thoroughly discuss the IFR standard. Here is a summary.

A farm's Statement of Financial Position

- Shows agricultural land as part of the industry's property, plant, and equipment.
- Shows biological assets (e.g., poultry, livestock, or fruit trees) as non-current assets.
    - They are distinct from other property, plant, and equipment assets.[8]
- Shows these biological assets at their fair value[9], less estimated selling costs.
    - This valuation will result in a gain or loss if the asset's purchase cost is more or less than its fair value on the SFP date.
- Shows produce or products harvested from biological assets as inventory.
    - This requirement means the unsold products increase operating income when harvested instead of when the farm sells them.
- Shows these Inventory items at their fair value, less estimated selling costs – at the harvest date.
    - The organization will later adjust them if there is an impairment loss.
- Shows the added processing costs to prepare the harvested items for sale as added inventory costs (not expenses).
    - This inventory costing is like accounting for any manufacturing process.
    - These added processing costs include such things as grinding grain into flour or processing milk into butter.

[8] If a school purchases land with fruit trees, it will split the total cost between the part attributable to the land and the part attributable to the fruit trees.

[9] If the organization cannot reasonably and reliably measure fair value, its SFP shows the biological asset at its accumulated cost, less any recognized impairment loss. A footnote must fully describe the asset and explain why the organization cannot determine a value for it. If the organization cannot value it, the requirement to reduce the cost value by any impairment requires focused attention.

The Statement of Financial Activity:

- Shows the increase or decrease in the fair value of biological assets from one period to the next as a gain or loss.
- Shows the costs of developing and maintaining the biological asset (e.g., fertilizer, water, feed) as operating expenses.

Section 2408 - Conclusion

In summary, this *Manual* expects Church industries to:

1. Follow International Financial Reporting Standards (IFRS). This includes the standards:

    - Requiring Accrual Accounting
    - Disclosing receivables, payables, and expenses with related parties (e.g., officers and parent organizations).
    - Determining and reporting for the proper reporting entity.
    - Valuing inventory at the lower of cost or fair value minus selling costs.

2. Follow General Church Policy

    - This requirement includes following insurance, audit, and internal control policy requirements.

3. Follow *Accounting Manual* requirements that the industry can apply in their circumstance.

    - This requirement, notably, excludes Fund Accounting.

4. Prepare Activity Statements reporting expenses by Function and Notes showing both functional and natural expenses.

5. Separate operating results from transactions with the owning organization.

Table of Figures

Chapter 25
Health Care Entities

This chapter will be added at a future time.

Chapter 26
Retirement Plans

Table of Contents

Chapter 26
Retirement Plans

The chapter begins with an introduction to IFRS standards for retirement plans. It discusses types of retirement plans and gives a refresher on Defined Benefits and Defined Contribution Plans. It details financial reporting issues relevant to retirement plans, with a deeper look into the problems unique to Defined Benefit and Defined Contribution plans.

Section 2601 – Introduction to Retirement Plan Reporting

The International Accounting Standards Board has set International Financial Reporting Standards (IFRS) for retirement plans. Most countries have adopted these standards. They serve as the basis for the rules and illustrations in this manual.

Chapters 1-19 deal with accounting standards that apply to all denominational organizations. For example, an important consideration is accounting and reporting retirement plan investments. IFRS requires that Financial Statements report Investment Assets at fair value. This manual's Chapter 10- Investments explains how to do this and that guidance applies to retirement plans.

Chapters 20-26 look at the International Financial Reporting Standards (IFRS) that apply to specific organizational types, such as conferences and schools. Similarly, this chapter covers the specific rules relating to retirement plans.

Because of governmental, financial, and social factors in various countries, it is not practical for the denomination to run one global retirement plan. Working Policy (GCWP Z 05 05) requires each division to provide post-employment care for their retirees. One way they do this is with retirement plans. This chapter presents the financial reporting requirements for these plans.

Historically, each division sets up at least one Defined Benefit Retirement Plan to serve its region's employees. Some divisions have several plans to accommodate the needs of their Union territories. Some divisions have replaced their Defined Benefit Plans with Defined Contribution Plans.

Section 2602 – Retirement Plan Types

2602.01 Multi-employer Plans

Whether the plan is a Defined Benefit or a Defined Contribution Plan, the denomination usually structures its retirement plans as multi-employer plans. That means denominational entities within a union or division contribute to one plan, and all retirees within that territory get benefits from that plan. The participating employers jointly share the risks for all the participating employees.

This jointly shared responsibility is the heart of the definition of multi-employer plans. It is conceivable that several employers might work together to use a pension plan as a cost-sharing effort but do not share responsibility for any other employees but their own. This arrangement is not a multi-employer plan. Instead, it is several separate plans sharing costs – but not risk. Each plan in this cost-sharing arrangement must make its own set of Financial Statements.

2602.02 Government Plans and Regulations

Some plans run in countries with mandatory government-sponsored retirement plans. These plans must follow applicable regulations. This *Manual* discusses reporting requirements for retirement plans other than government-sponsored plans. Also, almost all organizations work within countries or regions with government-required reporting standards. This *Manual* expects compliance with its reporting standards only to the extent an organization can follow them within those government standards.

2602.03 Division Responsibility

GCWP Z 10 15 places ultimate responsibility for plan administration on the division's Governing Committee. Plans often work in multiple countries, so unions or missions usually make the pension payments, and then the plan reimburses them. This delegated process does not reduce the division's responsibility to ensure the payments comply with its retirement plan requirements.

Section 2603- Defined Benefit / Defined Contribution Plans Refresher

Chapter 19 – Pension Liability and Expense covers the employer's pension reporting requirements. Chapter 26 discusses financial reporting for the plans themselves. Chapter 19 (and its accompanying Volume 3 material) extensively discusses the differences between Defined Benefit and Defined Contribution Plans (see Chapter 19, sections 1902 and 1903).

As a reminder, Defined Benefit Plans pay pensions based on years of service and remuneration factors. The plan finances the benefit payments through investment income and contributions from participating employers and (occasionally) employees. The plan looks at various factors to decide what participating employers must contribute.

Any employer's contribution does not affect any specific employee's benefits. Chapter 19 explains that the Defined Benefit Plan focuses on promised future benefits. The plan uses accrual accounting, present value concepts, and actuarial techniques to calculate the discounted present value for those benefits. This discounted present value is the plan's pension liability.

In contrast, Defined Contribution Plans gather contributions from employers and employees. It invests them (with employee guidance) and, during retirement, pays the employee the accumulated contributions and investment earnings.[1]

Section 2604- Financial Reporting for Retirement Plans

IFRS requires the following Financial Statements and disclosures for each retirement plan.

- A Statement of Net Assets available for benefits
- A Statement of Changes in Net Assets
- A Statement of Changes in Net Assets, summarizing activity in each Function account or group.
- A summary of significant accounting policies
- A description of the plan and the effect of any changes in plan provisions.
- A note for investments showing cost, fair value, and the valuation account balance.

In addition to these general requirements:

[1] Some plans make lump sum payments, while others make periodic payments.

For Defined Benefit Plans

- IFRS requires a Statement or Note showing the actuarial present value of the future benefits and information about the actuarial assumptions used in its calculation.
- This manual requires a schedule of benefit expenses, summarizing benefits by both type and territory, and
- a comparison of actual net assets by Function or group to the balances recommended by policy.

For Defined Contribution Plans

- IFRS requires a Note showing the carrying value and investment return for each type of participant-directed Investment.
- Further, this *Manual* requires a schedule of contributions by territory or type of entity.

An organization should present these Statements and Notes in a comparative format, showing the current and prior years.

The following sections discuss these Statements' content and format. For sample Financial Statements and Notes illustrating the accounting principles and disclosures, see Volume 3 of this *Manual*.

2604.01- Statement of Net Assets Available for Benefits

The pension plan's Statement of Net Assets Available for Benefits is like a Statement of Financial Position. It presents the plan's assets, liabilities, and net assets at a particular date. It has a heading that shows the sponsoring organization, the name of the plan, and the statement title. It shows the Statement dates (e.g., As of 30 June 20xx and 20xw)[2].

But unlike a Statement of Financial Position, the focus is on paying future benefits; therefore, the Statement of Net Assets Available for Benefits uses a different format. It shows total assets minus total liabilities. The remainder after this subtraction is net assets available for benefits.[3]

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[2] Not: "For the year ending 30 June 20xx and 20xw".

[3] The customary Statement of Financial Position has a format that reflects this accounting equation: Assets equal Liabilities plus Net Assets. The Statement of Net Assets Available for Benefits has a format that reflects: Assets minus Liabilities equal Net Assets Available for Benefits.

Like standard Statements of Financial Position, this Statement of Net Assets shows net assets that are unallocated and allocated.

2604.02 Unallocated and Allocated Net Assets

Usually, all of a plan's net assets are available to pay benefits to all employee participants. That does not prohibit a plan from allocating its net assets into net asset categories. For example, its governing committee may allocate net assets according to the type of employer, geographic territory, or some other meaningful groupings. Such an allocated structure helps management monitor funding deficiencies.

However, allocations shown in the net assets should not give a false impression concerning the jointly shared responsibility of all the plan's employers for all the plan's employees. Allocating by employers may give the false impression that an employer is only responsible for their allocated net asset. If net assets are allocated based on employer entity, the Statements and Schedules should make it abundantly clear that all the employers are jointly responsible for all funding shortfalls.

The underlying accounting system may allocate net assets by each employer to track employer contributions vis-à-vis their share of the liability; the fund's management might study reports based on this. A plan can use allocated net assets for internal management reports without the Financial Statements showing the allocation.

2604.03 Statement of Changes in Net Assets

This Statement is like a Statement of Financial Activity (SFA). It also presents the plan's financial activity over a time period. It has a heading that names the sponsoring organization, the plan's name, and the Statement title. Like an SFA, the header gives the periods (e.g., For the Years Ended 30 June 20xx and 20xw).

The Statement's revenue section must have a subtotal showing "Total Employer Contributions," and its expense section must have a "Total Benefits to Retirees" subtotal.

The Statement shows employer contributions along with other income minus benefits (paid and accrued) and other expenses. This results in the familiar subtotal: net asset increase (Decrease). The Statement then combines this increase or decrease with beginning net assets to arrive at ending net assets.

2604.04 Exchange Gains and Losses

Many of the Church's Defined Benefit Plans work in multiple countries. This manual describes how Working Policy (GCWP 25 25 5) encourages organizations to record exchange gains in a specific "Exchange Fluctuations" allocated net asset. The idea is that it would accumulate a balance that the organization would later use to absorb exchange losses. However, this practice may interfere with multi-employer plans using allocated net assets to measure subgroups of participating employer's contributions, costs, and net assets. If so, it is proper to charge the exchange gain or loss directly to the related subgroup of employer's allocated net asset.

2604.05 Notes to the Financial Statements

The plan must present any appropriate Notes as specified elsewhere in this manual. For example, most plans have Investments. Chapter 10- Investments, requires specific Notes relative to investments (see Section 1005.01). This requirement would apply to the pension plans.

Chapter 6- General Use Financial Statements, specifies that Note 1 must describe the reporting entity (see Section 605.02). This Note should show the plan's general structure and operating characteristics. It should describe the relationship of the retirement plan to the division and its participating employers. Likewise, Note 2 summarizes the plan's significant accounting policies. This Note describes the standard items such as the plan's accounting method, multi-currency environment, and investment accounting method.

However, pension plans require more disclosures vital to understanding the plan's financial situation.

Section 2605- Reporting Issues Unique to Defined Benefit Plans

2605.01 Actuarial Present Value of Future Benefits

The Financial Statement must show the actuarial present value of the liability for future benefits. Chapter 19- Pension Liability and Expense, Section 1904, thoroughly explains this liability. It can make this disclosure in a separate Statement or in the Notes to the Financial Statements.

2605.01.01 Vested and Non-vested Benefits and this disclosure

Many pension plans have a vesting period. It is the period the employee must work before the plan entitles them to receive a pension. The plan refers to employees as vested, meaning they have completed the vesting period, and non-vested, meaning they have not.[4]

The disclosure of the pension liability must separately show the actuarial present value of the vested and the non-vested benefits.

2605.01.02 Actuarial Disclosures

In addition to showing the liability, the Standards require that the plan list what actuarial estimates it used when it calculated the liability. Actuarial estimates, for example, are the calculation's discount rate, its estimated wage inflation rate, and the retiree's life expectancy. A table can neatly show the values for the current period and the comparison years.

If a plan uses actuarial experts, its Notes will include information about them and the Financial Statement dates for which they made their estimates. Organizations often use expert actuaries every few years, say, every three to five years, and when there is a notable change in the plan. Then, in the intervening periods, they apply the expert's estimates to the current data in the intervening periods. This practice is acceptable, but the disclosures should explain the pattern.

The actuarial disclosures include information about the impact of any changes in the actuarial methodology.

Example – Estimated Liability Calculation

For example, one year's estimated liability calculation may use the government statistical office's life expectancy estimates. The following year's estimate may adjust the government figures to reflect Adventists' longer life expectancy. The Note must disclose the impact of this change on the liability.

Figure 1 - Estimated Liability Calculation

[4] Often, a plan has graduated vesting periods. For example, in the first five years of employment, the employee may not have the right to a pension. Then, after the fifth year, they have a right to one-fifth of a pension. After the sixth year, they have a right to two-fifths of the pension, after the seventh, three-fifths. After the tenth year, they have the right to some sort of pension without further employment at the organization.

Section 2606- Reporting Issues Unique to Defined Contribution Plans

The employees in a Defined Contribution plan choose which financial instruments will hold their contributions – both their own and their employer's, so Defined Contribution Plans have individual accounts for each employee. The plan invests the contributions according to the employees' choices and tracks their contributions and earnings in their retirement accounts. The plan accounts for its investments in a way that allows it to report the balance, contributions, earnings activity, and withdrawals related to each account. The plan may engage an investment management firm to do this detailed individual account record-keeping.

2606.01 Revenue from Both Employers and Employees

Defined Contribution Plans typically receive contributions from participating employers and employees. Employees vest at once in their own contributions, so the IFRS requires plans to show employer and employee contribution revenue separately.

2606.02 Accounting for Investment Income and Expenses

A Defined Contribution Plan accumulates investment resources and tracks them with individual employee accounts. It records a participant's direct income, expenses, gains, and losses in their account. It records the individual's share of interest and dividends earned, realized gains and losses on sales of investments, unrealized gains and losses in fair value of the investments, and investment portfolio management fees. The balances and activity shown in the Defined Contribution Plan's Financial Statements are the investment-related accounts and the corresponding balances and activity from all the participants' accounts.

2606.03 Transfers From /To Other Plans

Often countries allow employee-managed plans like the ones this chapter discusses, and similar plans that brokers, banks, and insurance companies offer, to be tax deferred—that is, they allow employees to defer paying taxes on contributions until they withdraw money from the Defined Contribution Plan. In such cases, a country's tax authorities often regulate the plan. This means the tax authorities regulate transfers from one plan to another. A transfer can happen when an employee changes employers or when an employee wants to roll a bank-offered plan into an employer's plan.

The Financial Statements must show transfers separately from ordinary revenue and expenses. Transfers should not confuse the reporting of total contributions, benefits paid, and calculating the plan's rate of investment return.

Table of Figures

Chapter 27
Glossary of Terms

24.01 Denominational Terminology - The SDA Church uses many terms that have particular meaning within the denominational context. Many of those terms are described below, in alphabetical sequence.

Allocated	resources whose use has been designated for a particular purpose by the governing committee, with the authority to change it at any later date
Appropriation	a budgeted or authorized payment of money from a larger geographic organizational unit to a smaller geographic organizational unit or to an affiliated specific-purpose entity
Capital Activity	transactions related to acquisition and disposal of land, buildings, and equipment
Church or Congregation	an organized group of individual believers in a local geographic area
Constituents	individuals or entities to whom an entity is ultimately responsible for governance
Distributed	expense total, such as depreciation or health care, which has been divided among a number of functions or departments on a systematic and rational basis
General Conference	the largest organizational unit, comprising all union conferences/missions, and divided into Divisions for administration in defined geographic areas
Local Conference, Mission, or Field	an organized group of churches or congregations in a defined geographic area
Non-operating Activity	financial activity that is not related to an organization's primary mission or routine functions (includes items that are infrequent or unusual)
Non-tithe	all sources of revenue for denominational activities, excluding tithe; for example, school tuition and fees, sales of various goods and materials, donations designated by the donor for use in specific projects or programs
Operating Activity	financial activity related to an organization's primary mission or routine functions (such as tithe or tuition income, remuneration expense, etc.)
Remittance	a payment from a smaller geographic unit to a larger geographic unit, consisting of donated resources received for use and distribution according to denominational working policy
Restricted	resources that are provided by donors or other outside providers, with specific instructions to use them for a particular purpose or project
Tithe	the primary source of revenue for church ministry operations, received in the form of donations from individual church members
Trust Fund	an obsolete term for resources held for use under the direction of individuals or entities that are not directed by the reporting entity (see Agency Account for the new term)
Unallocated	resources that are available for the general purposes of the organization, without any designation by the governing committee
Union Conference or Mission	an organized group of local conferences, missions, and fields in a defined geographic area
Unrestricted	resources that are available for the general purposes of the organization, without any designation placed upon them by donors or other providers
Recommended Working Capital	a minimum amount prescribed by denominational working policy, which organizations are expected to maintain for current operations and liquidity
Working Policy	an authorized set of procedures to be followed by all denominational entities within a defined geographic area

24.02 Professional Standards Terminology - All organizations use certain terms that have meaning within the context of professional accounting and reporting standards. Simplified definitions of some of these terms are given below, in alphabetical sequence. More complete definitions are given in related sections of this Manual.

Accounting Records	documents that give evidence of financial transactions that have taken place and then summarize those transactions, whether prepared manually or electronically
Agency Account	a liability related to resources held by the entity subject to directions for use from those who provided the resources, who are not under the direction of the reporting entity
Appreciation or (Decline) in Value	the difference (whether positive or negative) between cost and fair value of a marketable financial instrument held as of the end of an accounting period
Assets	things an organization owns, possesses, or has control over the use of
Audit	an examination of an entity's financial records, with the goal of rendering an opinion on whether they are fairly presented in accordance with the reporting framework
Cash Equivalents	financial instruments, such as time certificates, that are due to be converted to cash within three months or less from the date they were acquired
Current	assets that are available for use or for conversion to cash, and liabilities that will be paid, within the immediate operating cycle, usually the next 12 months
Expense	a class of transactions, separate from "gains" or "losses," which arise from the normal activities of the organization and which represent decreases to net assets, such as payroll, utilities, supplies, etc.
Fair Value	the amount for which an asset could be exchanged, or a liability settled, between knowledgeable willing parties in an arm's length transaction
Financial Instrument	any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity
Financial Reports	documents that portray the financial condition of an entity at a given date, and the performance or activity of the entity over a stated period of time
Fraud	an intentional act involving the use of deception to gain an illegal or unjust advantage at the expense of an organization (fraud can consist of either misappropriation of assets or misrepresentation of data in financial reports)
GAAP	generally accepted accounting principles, the official pronouncements of accounting standards by designated standard-setting organizations
Gains and Losses	a class of transactions, separate from expense, which relate to distinct non-recurring transactions, such as the sale of specific assets or other unique events
General Ledger	an accounting record that gives beginning balance, activity for a period, and ending balance for each account within a set of financial reports
Impairment	a condition that results in the recoverable amount of an asset being less than its carrying value
Internal Control	policies and procedures used by an entity to ensure the orderly and efficient conduct of its activities and to safeguard its assets
Investments	resources held for production of passive income, rather than for active use in current operations (including but not limited to financial instruments)
Liabilities	obligations of an organization to pay or give assets to another entity
Material Weaknesses	matters noted by the auditor which represent deficiencies in an entity's internal control such that there is a reasonable possibility that a material misstatement of the financial statements will not be prevented, or detected and corrected, on a timely basis
Net Assets	the residual of resources available to an entity after subtracting its liabilities from its assets; also referred to as Fund Balance or as Equity

Noncurrent	assets that will be used over more than one operating cycle, usually more than 12 months, and liabilities that are due to be paid after more than 12 months
Realized Gain or (Loss)	the difference between sale proceeds and carrying value (whether positive or negative) resulting from the sale of financial instruments
Revenue	a class of transactions, separate from gains and losses, which arise from the normal activities of the organization and which represent increases to net assets, such as donations, sales, fees, etc.
Significant Deficiencies	matters noted by the auditor which represent deficiencies in an entity's internal control that are less severe than material weaknesses, but important enough to merit attention by those charged with governance
Source Documents	original documents related to individual transactions; which could be kept on paper or in electronic media
Subsidiary Ledger	an accounting record that gives balance or activity details for selected groups of accounts that add up to a single "control" account in a general ledger
Unrealized Gain or (Loss)	the net change (whether positive or negative) in the balance of Unrealized Appreciation or (Decline) in value of investments from the end of one accounting period to the end of the next accounting period
Working Capital	an amount that represents discretionary resources available for operations, calculated simply as the result of total current assets minus total current liabilities

24.03 List of Acronyms and Abbreviations - This Manual makes reference to many organizations or publications. To minimize repetition, the following abbreviations (listed alphabetically) are used:

AICPA	American Institute of Certified Public Accountants; the national body in the USA responsible for standards on auditing related to services performed for entities which are not publicly-traded
CFO	Chief Financial Officer; the individual primarily responsible for direction, control, and reporting of the finances of an organization (title varies: treasurer, vice president, controller, etc.)
CPA Canada	Chartered Professional Accountants of Canada; the standard-setting body in Canada that is responsible for all standards on accounting, financial reporting, and auditing
FASB	Financial Accounting Standards Board; the standard-setting body in the USA responsible for standards on accounting and financial reporting related to non-publicly-traded entities
FASC	FASB Accounting Standards Codification, which redrafted and replaced FAS and SOP accounting standards effective after September 15, 2009
FAS	Statement of Financial Accounting Standards, issued by the FASB
GCAS	General Conference Auditing Service; preferred provider of audit services for the SDA Church
IAASB	International Audit and Attest Standards Board; the body responsible for issuing international standards on auditing and attestation services, with headquarters in London, England
IASB	International Accounting Standards Board; the body responsible for issuing international standards on accounting and financial reporting, with headquarters in London, England
IAS	International Accounting Standard, issued by the IASB (before January 1, 2001)
IFRS	International Financial Reporting Standard, issued by the IASB (after January 1, 2001)
IS	Information Systems; the processing of financial information through a computerized system
GC	General Conference of Seventh-day Adventists
ECD	General Conference of Seventh-day Adventists, East-Central Africa Division
ESD	General Conference of Seventh-day Adventists, Euro-Asia Division
EUD	General Conference of Seventh-day Adventists, Inter-European Division
IAD	General Conference of Seventh-day Adventists, Inter-American Division
NAD	General Conference of Seventh-day Adventists, North American Division
NSD	General Conference of Seventh-day Adventists, Northern Asia-Pacific Division
SAD	General Conference of Seventh-day Adventists, South American Division
SID	General Conference of Seventh-day Adventists, Southern Africa-Indian Ocean Division
SPD	General Conference of Seventh-day Adventists, South Pacific Division
SUD	General Conference of Seventh-day Adventists, Southern Asia Division
SSD	General Conference of Seventh-day Adventists, Southern Asia-Pacific Division
TED	General Conference of Seventh-day Adventists, Trans-European Division
WAD	General Conference of Seventh-day Adventists, West-Central Africa Division
xxxWP	Working Policy of the GC or xx Division, such as GCWP, ECDWP, NADWP, etc.

This guide is a highly-condensed presentation of international accounting and financial reporting standards generally accepted by the Seventh-day Adventist denomination. For further guidance, refer to the referenced IFRS authoritative sources or the section of this volume.

The Objective of Financial Statements
Relevant reliable information, about financial position and performance of an entity, useful to various readers in making economic decisions.
Source: IASB Framework
Section 105

Accrual Basis
Use of the accrual basis of accounting produces the most relevant reliable information.

Recognise the effects of transactions and events when they occur (not merely when cash is received or paid).

Record transactions in accounting records of the period to which they relate.
Source: IASB Framework
Section 201.04

Recognition
Recognise items in the accounting records if both:

1. it is probable that future economic benefits associated with the item will flow to or from the entity, and

2. the item has a cost or value that can be measured with reliability.
Source: IASB Framework
Section 503

Required for General-use Financial Statements
Financial Position
Financial Activity
Changes in Net Assets
Cash Flows
Notes to the Statements
Source: IAS 1.8
Section 202

Assets
The resources an entity owns, possesses, or has the right to use or control.
**Assets represent potential to create inflows of cash.

Liabilities
The obligations of an entity to transfer assets, or to provide other economic benefits, to another entity.
**Liabilities represent potential outflows of cash.

Net Assets
The resources that remain available to an entity after subtracting its total liabilities from its total assets.
Definitions:
Source: IASB Framework
Section 27.02

Income
Revenue from normal operations, and gains (both realized and unrealized).
**Income increases assets or provides economic benefits.

Expenses
Outflows or depletions of assets from normal operations, and losses (both realized and unrealized).
**Expenses decrease assets.

Normal Operations
Activity related to the entity's primary purpose or reason for existence, defined by the entity, applied consistently.

Definitions:
Source: IASB Framework
Section 27.02

Current Classification
Classify assets as current if:
They are cash equivalents, or
They are expected to be sold or consumed in the entity's normal operations within the next fiscal year.
Source: IFRS 18.99
Section 24.02

Classify liabilities as current if they are expected to be settled in the entity's normal operations, or if they will require the use of cash, within the next fiscal year.
Source: IFRS 18.101
Section 24.02

Financial Position
Current Assets
Land, Buildings, & Equipment
Other Assets
  Total Assets
Current Liabilities
Other Liabilities
  Total Liabilities
Net Assets – Unallocated
Net Assets – Allocated & Restricted
  Total Net Assets
  Total Liabilities & Net Assets
Section 602

Financial Activity
Income:
  Revenue from Operations
  Net Gains and Losses
Expenses:
  Employee-related Expense
  Administrative Expense
  Other Operating Activity
Appropriations:
  Received
  Disbursed
Capital Activity
Net Increase (Decrease)
…………..Section 603

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Cash

Cash is: Currency, coin, and instruments that can be deposited in a bank account.

Source: IAS 7.6
Section 901.01

Cash Equivalents are: short-term, highly-liquid, financial instruments, convertible to cash in three months or less from the date acquired.

Source: IAS 7.6, 7.7
Section 901.02

Classify and report cash and cash equivalents as current assets, unless the account is held for other than operating purposes, such as for plant acquisition.

Source: IAS 7.7, 7.48
Section 901.03

Classify accounts that are held for either agency or fiduciary purposes, which would otherwise be cash and cash equivalents, as current assets, but report them on a separate line as cash held for other purposes, apart from cash and cash equivalents.

Source: IAS 7.48
Section 901.04

Disclose the components of cash and cash equivalents in the notes to the financial statements.

Source: IAS 7.45, 7.48

In accordance with accrual basis of accounting, record cash receipts & disbursements as of the accounting period in which they occur.

Source: IAS Framework
Section 201.04

Investments

Investments consist of many types of financial instruments that are not cash equivalents.

Source: IAS 32.11
Section 1001

Place all investments into one of the following three categories:
1. Amortised cost
2. Fair value adjustment through profit or loss
3. Fair value adjustment through other comprehensive income

Source: IFRS 9.4.1.1

Value and report investments of each class at either fair value or amortised cost.

Source: IFRS 9.5.2.1
Section 1002

For investments carried at fair value, record the difference between fair value and cost in separate valuation accounts; typically called “Unrealised Appreciation or (Decline).”

Section 1004.04

Record the net change in the valuation account each period as “Unrealised Gain or (Loss)” in the statement of activity.

Source: IFRS 9.5.2.1
Section 1004.04

For each type of financial instrument, disclose:
Cost,
Fair value and valuation amount,
Concentrations, and
Other risks,
in the notes to the financial statements.

Source: IFRS 7

Accounts Receivable

If it is probable that a receivable is collectible, recognize it as an asset.

Source: IAS Framework

If it is probable that a receivable has become uncollectible, recognize net realizable value by use of a valuation account. Record increases to this valuation account as expense.

Source: IAS Framework

This valuation account is typically called “Allowance for Uncollectible Accounts.”

Sections 1104.01

Loans Receivable

Loans are financial assets which can be measured at amortised cost which are held for collection instead of traded on an open market, and have fixed or determinable payments.

Source: IFRS 9.4.1.2

Report appropriate portions as current and as noncurrent, according to the payment terms of the loan instruments.

Source: IAS Framework

Record risk of uncollectibility similarly to the process for accounts receivable.

Source: IFRS 9.5.2.1
SDAAM Section 1104

In the notes, disclose:
Valuation method applied.
Amounts due from affiliated entities and key employees.
Changes in the allowance.
Impairment loss, if any.
Total interest income.

Source: IFRS 7

This guide is a highly-condensed presentation of international accounting and financial reporting standards generally accepted by the Seventh-day Adventist denomination. For further guidance, refer to the referenced IFRS authoritative sources or the section of this volume.

Inventory
Things that have been acquired or produced to be sold or transferred to other entities or individuals.
Source: IAS 2.6
Section 1203

Value inventory at the lower of cost or net realizable value. Include in cost all elements necessary to acquire and bring the item to its present location and condition.
Source: IAS 2.9, 2.10
Section 1203.06.01

When inventory is sold or disposed of, remove its carrying amount from assets, and record the amount as cost of goods sold or as expense, as of the same period in which the related revenue is recognized.
Source: IAS 2.34
Section 2202.02

In the notes, disclose:
The valuation method.
Carrying amount by type.
Amount charged to expense
Source: IAS 2.36

Prepaid Expense
Goods or services acquired or produced for the purpose of the entity's own consumption or benefit over time.
Section 1201

Remove from prepaid, and record as expense, portions used during the period.
Source: IAS Framework
Section 1201

Property & Equipment
Property and tangible things that are held by the entity for:
**Use in the production or supply of goods or services,
**Rental to others, or
**Administrative use, and
**Are expected to be used during more than one year.
Source: IAS 16.6
Section 1304.01

Recognise the cost of an item as an asset if:
*A. it is probable that future economic benefits from the item will flow to the entity, and
*B. the cost of the item can be measured reliably.
Source: IAS 16.7

Include in cost all elements necessary to acquire and bring the item to the location and condition for it to be placed in service.
Source: IAS 16.16
Section 1304

Distribute cost of buildings and equipment to periods of use by depreciating it on a systematic basis over the item's useful life.

Record depreciation taken each year as expense.
Source: IAS 16.48, 16.50
Section 1306

In the notes, for each class of plant asset, disclose:
**Measurement basis, useful life, and depreciation method.
**Balance at beginning and end of period, and additions and deletions, for cost and accumulated depreciation.
Source: IAS 16.73
Section 1311.02

Current Liabilities
In accordance with accrual basis of accounting, record obligations that relate to the reporting period but which have not yet been paid.
Source: IAS Framework

Current liabilities consist of:

Accounts payable
(Obligations incurred, currently payable, but not yet paid.)

Accrued payables
(Obligations incurred, currently payable, but not yet invoiced.)

Agency accounts
(Money provided by others to be used only as directed.)

Current loan payments
(Scheduled payments on loans which are due over the next twelve months.)
Source: IAS Framework
Chapter 14

Loans Payable
Loans payable consist of:
Formal notes payable
Informal loans payable
Loans from affiliated entities
Source: IAS Framework
Section 1403.04

Report as noncurrent, the portion of scheduled loan payments which are due after more than twelve months.
Source: IAS Framework
Section 1402

In the notes, disclose the terms of all loans payable.
Source: IFRS 7

This guide is a highly-condensed presentation of international accounting and financial reporting standards generally accepted by the Seventh-day Adventist denomination. For further guidance, refer to the referenced IFRS authoritative sources or the section of this volume.

Net Assets
International accounting standards allow entities to create categories within net assets that are useful for the financial statement readers.
Source: IAS Framework
Section 1501

For the SDA denomination, net assets are separated into the following categories:
Unallocated Tithe
Unallocated Non-tithe
Allocated (by committee)
Allocated (donor restricted)
Unexpended Plant
Invested in Plant
Illustrated: Chapter 15

Financial Activity
International accounting standards require entities to classify financial activity into one of five categories – operating, investing, financing, income taxes, or discontinued operations.
Source: IFRS 18.47

For the SDA denomination, financial activity is reported in two different statements:

**The statement of financial activity reports income, expense, and other activity in an overall summary form.

**The statement of changes in net assets reports income, expense, and transfers for each unallocated and allocated net asset function.
Source: Section 603

Multiple Currencies
Standardized terminology:
Functional (Base) Currency
Foreign (Account) Currency
Presentation (Report) Currency
Spot (Current) Exchange Rate
Average (Fixed) Exch. Rate
Source: IAS 21.8
Chapter 17

Record transactions by applying to the foreign currency amount the current exchange rate between it and the functional currency as of the date of the transaction.
Source: IAS 21.21
Chapter 17

The date of the transaction is the date on which it first qualifies for recognition.
Source: IAS 21.22

At financial position date, convert all monetary items from foreign currency into functional currency using exchange rate at that date.
Source: IAS 21.23

At financial position date, convert all non-monetary items measured at historical cost in foreign currency into functional currency using exchange rates from original underlying transactions.
Source: IAS 21.23
Chapter 17

Record as exchange gain or loss the effects of changes in exchange rates between original transaction dates and financial position date.
Source: IAS 21.28
Chapter 17

Disclosures
In addition to the various disclosures mentioned earlier, disclose the following in notes to the financial statements.
Section 605

A description of the reporting entity, including its location, organizational structure, and the nature of its operations.
Source: IFRS 18.116

A summary of the significant accounting policies used in preparing the entity's financial statements.
Source: IFRS 18.115

A summary of management assumptions and judgments about balances that represent estimates or uncertainty.
Source: IFRS 18.17

Information that enables users of the financial statements to evaluate the significance of financial instruments on the entity's financial position and financial activity.
Source: IFRS 7

Information that enables users of the financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the financial statement date.
Source: IFRS 7

On the face of the financial statements, cross-reference to relevant information in the notes to the financial statements.
Source: IFRS 18.114

This page of the guide is a highly-condensed presentation of specific USA accounting standards for not-for-profit entities, generally accepted by the Seventh-day Adventist denomination, which differ from international financial reporting standards generally accepted by the Seventh-day Adventist denomination.
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Investments

Place all debt and equity securities into one of the following three classes.

*A. All debt securities
*B. All equity securities for which fair value is readily determinable
*C. Equity securities that are not traded on an open market

Value and report investments of each class as follows.

*A. Fair value, using quoted price or best estimate
*B. Fair value, using quoted price or best estimate
*C. Equity method or consolidation

Source: FASC 958-320
FASC 958-321
FASC 958-325

Net Assets

Financial activity and related net assets are classified according to the absence or presence of donor restrictions.

Source: FASC 958-210-45

For the SDA denomination, net assets are separated into the following categories:

Without Donor Restriction
  Unallocated
    Tithe
    Non-tithe
  Allocated:
    Operating
    Unexpended Plant
    Invested in Plant
With Donor Restriction
  Temporary:
    Operating
    Plant
    Other Funds
  Permanent

Specific accounting and reporting standards for beneficial interest in split-interest agreements

Source: FASC 958-30

Financial Position

Current Assets
Land, Buildings, and Equipment
Other Assets
  Total Assets
Current Liabilities
Other Liabilities
  Total Liabilities
Net Assets:
  Without Donor Restriction:
    Unallocated
    Allocated
    Invested in Plant
  With Donor Restriction
    Temporary
    Permanent

Source: FASC 958 -210

Financial Activity

Income:
  Revenue from Operations
  Net Gains and Losses
  Released from Restrictions
Expenses:
  Programs and Services
  Supporting Functions
Non-operating Activity
Increase (Decrease) in
  Unrestricted Net Assets
Increase (Decrease) in
  Temporarily Restricted Net Assets
Increase (Decrease) in
  Permanently Restricted
Increase (Decrease) in
  Total Net Assets

Source: FASC 958 225