Chapter 4

Accounting Issues in the Social Purpose Enterprise

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All small businesses encounter challenges when they attempt to perform accounting and financial reporting according to Generally Accepted Accounting Principles (GAAP). Businesses owned and operated by nonprofit agencies exist in a hybrid world of commercial and nonprofit needs, and as a result, they encounter unique obstacles.

Background

One of the central issues raised in New Social Entrepreneurs is financial performance tracking and reporting. How have nonprofit enterprises reported on financial performance in the past, and how should their accounting and reporting change to provide more useful information, as well as conform to GAAP? This book's chapter on True Cost Accounting points out that in the past, most evaluations of nonprofit-run enterprises around the country employed traditional program evaluation techniques such as case studies and organizational summaries, but lacked standard business financial reports.

Our work with nonprofit agencies starting businesses supports this finding: most businesses started by nonprofit agencies do not have appropriate accounting systems in place when they launch their venture. Furthermore, business and agency managers encounter complex challenges in establishing such systems once a business has started. As a result, financial reports for these businesses generally are either nonexistent, or are not useful to the businesses' managers, boards, funders or employees.

The words "appropriate" and "useful"are important here. Most reputable nonprofit agencies are careful to account for the finances of all their programs, including their businesses. However, the information required by nonprofit managers, boards and funders to assess the success of a nonprofit organization is different from the information needed to track a business' performance. Nonprofit service organizations, for example, have traditionally measured the demand for their services by assessing program usage via client counts or hours of service provided, measures that are not reflected directly in the organization's financial statements. In businesses, such "demand" would show itself as revenue totals in the business' income statement."Revenue" on a business' income statement has different implications than it does on a nonprofit agency's statement. The systems nonprofit agencies use to account for, report on and interpret their organizational performance are not appropriate or useful for assessing business performance.

Nonprofit-run businesses in the Roberts Enterprise Development Fund (REDF) have met numerous challenges in bridging this nonprofit versus business accounting difference. In 1996, REDF began working closely with agency and business managers to ensure that each business in the portfolio had accounting systems and reports that met GAAP and provided the information needed by both agency and business managers. Each of the original REDF portfolio agencies' accounting systems have been particular to that agency's structure, history, board and staff capabilities,mission target population,as well as to the nature of the business in which the nonprofit was engaged. Nevertheless, there have been underlying issues common to all or most of the organizations and businesses. In the course of two years of intensive work with the portfolio's businesses, the issues and roadblocks have become clear and some solutions have emerged.

Underlying Issues

All organizations, whether for-profit or nonprofit, encounter common accounting system questions:

- Which system?
- Who sets it up?
- How is it structured?
- Who maintains it?
- What information should reports show?
- Who receives which reports?

Some of the issues underlying these questions, however, are unique in nonprofit-run businesses. These challenges fall into the following interrelated areas:

- Should accounting systems be integrated within the agency system, or autonomous to the business?
- Fund accounting or business accounting?
- How do we account for social costs and subsidies?
- How do we track ownership, assets and liabilities?
- Who are these reports for?

Underlying issue #1:
Integrated within agency system, or autonomous to the business?

REDF portfolio businesses were all started and remain as programs of their parent nonprofit agency. This structure, similar to a corporate divisional profit center approach,helps assure that the venture remains directly related to the mission of the organization and makes it easy for the parent agency to provide assistance and resources to its emerging enterprises. In addition, by structuring an enterprise as one of its programs,agency can maintain close fiscal control over the business. REDF portfolio agencies operate businesses in order to create jobs and training opportunities that carry out the organization's nonprofit mission. Appropriately, agency directors want to ensure that businesses under their purview accomplish their mission-driven goals.

All REDF portfolio businesses were started utilizing whatever accounting software the parent agency had in place for overall agency accounting, probably as a matter of convenience. However, issues of control surfaced when (during REDF's first few months of "venture financing" involvement) REDF requested that all businesses in the portfolio maintain standardized accounting systems and financial statements. Meeting strong resistance to this from agency directors, REDF modified its position and agreed that it would not concern itself with which system, staff and procedures were used to generate financial reports, as long as separate income statements and balance sheets could be produced for each business. The result was that all agencies continued using agency software and staff to generate monthly financial information for their businesses. In several cases, businesses used separate accounting packages or spread sheets to generate preliminary or parallel accounting information, but in all cases, comprehensive business financials came from the agencies' central accounting department.

While this integration of business accounting with agency accounting maintained some efficiencies and provided agency management with a sense of control, it also resulted in complex problems for most of the portfolio businesses. Two exceptions were Juma Ventures and Youth Industry, the two agencies whose primary activity is running mission-driven businesses as opposed to a number of other programs in addition to the ventures. We speculate that these two agencies avoided the complexities and conflicts encountered by other older, less specialized agencies because both of these agencies were relatively young, and their accounting software and procedures were set up using business accounting models geared to meet their businesses' information needs.

In the other eight agencies,[1] traditional non-business programs commanded a larger portion of total agency budgets than did the business(es). Perhaps more importantly, accounting staff appeared to regard the agency's traditional programs and funders as "the main show"around which the organization revolved. Understandably, as far as the accounting staff were concerned, the needs of these "central" elements took precedence over the needs of the agency's business(es) when tasks were being prioritized.

These factors all contributed to business managers' frustrated attempts to get timely, accurate, appropriate information about the performance of their businesses. Some felt that their ventures had a "problem stepchild"identity within the accounting department on which they depended. This situation also contributed to tensions between REDF and some of the organization' executive directors. The differing needs of the business managers included:

- Timing: Business managers needed reports more often and on more of an "on-demand" basis than did their parent agencies' managers. It was critical for most of the businesses to see financial performance updates monthly; many needed specific updates weekly or even daily. Nonprofit agencies' accounting department systems and procedures had been set up to accommodate the agencies' original needs and generally could not (or would not) generate reports on the schedule needed by business managers (and by REDF).

- Ways of categorizing information: Business managers needed financial performance data grouped into detail categories different from the categories nonprofit managers' accounting staff had set up. Thus the agencies' chart of accounts (which defines the categories in which data will be tracked) were inappropriate for business tracking needs. See Fund Accounting versus Business Accounting, below.

- Types of reports: Business managers needed reports that differed from those that nonprofit agency or department managers needed. For example, business managers in product manufacturing businesses needed detailed product or job cost reports in order to analyze progress in containing costs; agency managers had no need for such reports, but wanted detailed accounting of grant expenditures.

Underlying issue #2:

Fund Accounting or Business Accounting?

Nonprofit agencies must disclose which of their funds received and spent are restricted by donors to specific uses. They utilize fund accounting to do this. Fund accounting is an approach to organizing financial data into periodic reports. In fund accounting, each expenditure is allocated to a restricted project ("fund").One can imagine every expenditure, under fund accounting, carrying a little tag that names its donor or funder. Those expenditures with no "tag" or funding source, are pooled and must be covered by funding that is "unrestricted" (such as earned income, unrestricted grants, event revenue, etc.). Unrestricted funds are difficult to raise, and therefore pairing up funding sources with expenditures is central to financial management in nonprofit agencies.

By contrast, businesses receive income in return for goods or services. Once payment is received, business owners and managers decide how it will be spent. The source of the money does not determine its use. Pairing up sources of revenue with accompanying expenditures is not a focus of business financial management. What is of pivotal interest, however, is an expenditure's functional category (rent? utilities? direct labor? advertising?), and its monthly and year-to-date totals (both in absolute terms and as a percentage of total expenses or sales). These are measures that can be used to compare a business' performance to its past performance, to competitors and to industry benchmarks. While functional categories are generally budgeted and tracked by nonprofit managers, their importance is often overshadowed by a concern with funding sources.

Thus,a matter of paramount importance to nonprofit accounting staff is not particularly relevant to business managers and staff. And at the same time, information of paramount importance to business staff is of lesser or no importance to nonprofit oriented staff. Nonprofit agency accountants and managers ask "which funder/which fund will pay for this?" Business accountants and managers ask "which category does this fit in, and is the total for that category an appropriate proportion of the whole?" For eight of the REDF portfolio nonprofits, this difference in perspective created a continual disconnect between business managers and their parent agency's accounting staff.

This difference in perspective not only reflects two different ways of thinking about financial information; it is the basis for significant differences in the design of each accounting system's chart of accounts. To accommodate both needs, a chart of accounts must be designed with both in mind. The chart of accounts is an outline, a numbering system for all the categories into which financial transactions might fall. Most traditional nonprofit chart of accounts designate digits for labeling each expense by its funding source, but do not designate digits for labeling each expense by product category or by business location. Providing a numbering scheme that can do both requires design planning and an accounting system with room for the total digits needed. Some accountants articulate the need for this expanded capability as the need for a "three tier" chart of accounts, rather than the more limited "two tier" design.

Underlying issue #3:

How do we account for social costs and subsidies?

The challenge of tracking social costs and subsidies has been a major focus of REDF's work. Nonprofit-run businesses have costs not borne by "regular" for-profit businesses, and often receive revenue (subsidies) not received by "regular" businesses. All REDF portfolio businesses, for example, want to both create jobs and training opportunities for specific disadvantaged populations and to become profitable. Employing and training disadvantaged populations involves costs that businesses focused only on profit do not have. Subsidy revenue helps to offset these additional costs.

Both social costs and subsidy revenue need to be accounted for in looking at the overall finances of these businesses. Social costs (the premium each business pays to accomplish its social goals) should be differentiated from standard business costs and subsidy revenue should be differentiated from standard business revenue. Such differentiation enables business and agency managers, staff and investors to compare each business' performance to industry standards and allows us to quantify the cost of the extra support needed to bring disadvantaged populations into mainstream job markets.

Most REDF portfolio agency and business managers have agreed upon the need to differentiate and track social costs and subsidies. Initially, some found it challenging to report on social costs/subsidies within business income statements, as well as to satisfy traditional funders' reporting requirements without confusion and double counting. While identifying subsidies is generally not complicated, determining and allocating social costs can be very complex. Great variations exist, from one agency to another, in what types of social costs are incurred and how these costs are tracked if at all. Other chapters in this book review these issues in greater detail.

REDF has worked with portfolio business/agency staff to better codify the thinking and process of accounting for social costs. all REDF portfolio businesses are tracking social costs and subsidies and 17 of 23 business include them in a portfolio-wide income statement format which differentiates social costs and subsidies (providing the "second bottom line"). While this effort clearly distinguishes REDF's work from the field, the challenges of identifying, quantifying, tracking and codifying social costs need further thought and discussion.

Underlying issue #4:
How do we track ownership, assets and liabilities?

A balance sheet is one of two reports needed to understand a business' financial performance and position. It shows what the business owns and what it owes. At the time the REDF initiative began, no REDF portfolio business had a balance sheet separate from the overall agency balance sheet. In a manner comparable to corporate accounting for subsidiary businesses,[2] the parent agencies showed their businesses' balance sheet accounts as part of a consolidated agency balance sheet.

If set up appropriately, a business' account totals can be shown both separately and as part of the parent agency's overall balance sheet. However, agency management and accounting staff were resistant to separating their business' balance sheet accounts from the pooled agency accounts. Reasons for this resistance included:

- the staff time and cost it would take to do so,
- fear of decreased flexibility in managing cash flows if cash accounts were more clearly delineated, and
- a general lack of motivation to change.

With many other more immediate challenges at hand, REDF agreed to delay its requirement that each business generate a separate balance sheet. In the two years since its initial request, REDF has supported several portfolio businesses' efforts to produce and maintain individual company balance sheets. The effort has been undertaken on a business-by-business basis. In some cases, the lack of easily accessible asset and liability information became an untenable barrier to understanding a business' performance. In others, expansion financing has required it. Most of the REDF portfolio agencies are now moving toward changing their accounting procedures to enable creation of separate distinct business balance sheets for each enterprise.

The lack of individual balance sheets has hampered day-to-day financial management, strategic business analyses and projections for the social purpose enterprises. It has also made it difficult to determine a return on investment (ROI) or social return on investment (SROI) for each business and for the portfolio as a whole. This issue is discussed in other chapters of this book.[3]

Underlying issue #5:
Who are these reports for?

Assumptions about who the customers for financial reports are strongly influence the reports' form, content and timing. Business owners and managers use internal financial reports to help them in their day-to-day, week-to-week decisionmaking.[4] Financial performance is their key measure of success, the clearest way to get an "instant read" on the effectiveness of business activities. Financial reports are of primary interest to the business manager who knows how to use them.

In nonprofit agencies, financial performance is not the key measure of success (though it may be key to survival),nor is it the best way to determine whether an agency's mission is being accomplished. Thus nonprofit agency managers do not look to financial reports for timely feedback on the effectiveness of their efforts. Rather, agency financial reports (the timing of their issuance,their form and content) are designed to satisfy funders' requirements.

The difference between these two perspectives, each appropriate to the arena from which it emerges, can create friction between businesses run by nonprofits (their managers, staff and investors) and the agency managers and accounting departments to which they are intricately connected. Business reports may be issued on the same schedule and in the same format as agency reports adequate for management of a nonprofit agency, but severely inadequate for use in operating a growing business. At various points in the evolution of these agency-business systems, portfolio business managers have expressed extreme frustration with their agency accounting staff's inability to generate useful, accurate, timely financial reports. Operating without useful financial information has forced some managers to "fly blind."

Accounting Solutions That Work

As the previous narrative indicates, REDF portfolio agencies have tried several approaches to meeting nonprofit and business accounting needs that have not worked. These failed approaches can be summarized as:

- **Bad Idea #1:** Use two accounting systems (one run by the agency, one run by the business) that both track the business' performance but are not linked per GAAP. This description could be finished with "and spend hours and hours each month trying to reconcile the differences between the two." Agency and business managers will need to take advantage of their own social support services after subjecting themselves to this approach!

- **Bad Idea #2:** Track the business' performance with just one accounting system that is separate from the agency's system and not linked to it per GAAP. This description could be finished with "and hope for the best." Agency management will probably not have the correct perspective on business activity, or the assurance of financial system integrity that they would get from a linked system.

- **Bad Idea #3:** Use the agency's accounting system software, staff and procedures to track business performance even though it does not generate adequate business information. This description could be finished with "but it'll just be a matter of time." It will just be a matter of time before agency management gets some sort of surprise vis-à-vis the business—a surprise from which the nonprofit may never recover! Business managers may "have the sense" that costs are up, or that sales are down, or that a new market niche has promise. But because the business' financial reporting is inadequate, no one may know the extent of these trends until it is too late to do anything about them.

Accounting Solutions That Work

Is there any way to address the significant differences in accounting and financial reporting needs and perspectives between nonprofit agencies and the businesses they are spawning? What approaches can meet the needs of both nonprofit agency and market-based business? Here are a few that can work:

- **Good Idea #1:** Creation of a nonprofit agency solely dedicated to social purpose enterprise venture creation

As noted previously, those agencies whose primary programs are businesses employing disadvantaged individuals have oriented the set-up and maintenance of their accounting systems around their businesses' needs and thus have encountered few differences in agency and business requirements. Social cost accounting however, not a concept found in standard business accounting systems, is still uncharted water.

- **Good Idea #2:** Organization-wide accounting system/procedures that serve both agency and business needs

Several important changes have been instituted by agency-business duos, using the parent agency's accounting system, procedures and staff for generating the business(es)' financial reports. These changes include:

- Accounting software that has features needed by for-profit businesses (for example, the ability to issue reports prior to month-end closing). Modules required for the particular business (for example,manufacturing businesses will need an inventory module) must be provided. If the agency's accounting software cannot adequately support the business' needs, it must be replaced or this organization-wide approach will not work

- Augmentation or complete re-design of original chart of accounts to allow for categories needed by the business; a "three-tier" chart of accounts, rather than "two-tier" will provide the best, least cumbersome, long-term solution to meeting both agency and business needs.

- Hiring or appointing a dedicated accounting staff person(s) for the business' accounting processes. This person should not have to juggle other priorities and should be responsible for meeting the business' ongoing reporting schedule needs. This individual must report (at least partially) to the business manager(s).

- Clear delineation of policies, procedures, timing and responsibilities for all the agency accounting department tasks that involve business data.

- **Good Idea #3:** Business-specific accounting system/procedures, separate from but linked to the parent organization

In this approach, the business(es)' accounting transactions are tracked separately from its parent agency's. The business' accounting software may be industry-specific, and therefore require less customization. It is linked, via automatic export/import or via manual procedures, to the parent agency's software. Thus, period-end totals are entered in the parent agency's system and are subject to that system's double entry "checking" (these checks are built into both systems). This linking of two separate systems is being implemented by several REDF portfolio agencies.

Important steps in implementing such a system, and key system features are:

- A view of long-range agency and business plans should be available to accounting system designers

- Step-by-step planning of systems' linkage procedures prior to implementation;careful testing of demo software if the linkage is to be automatic

- Parallel operation of new (linked) system with old system until correct operation is assured

- Set-up and review of the system to ensure it meets GAAP (and review, in particular, of journal entries or other links between the business and the parent agency) by a CPA experienced in both nonprofit and private business accounting

- Education of business and nonprofit managers in reading and using financial reports

- Monthly review of business financials by appropriate agency staff (i.e. separation of systems does not need to limit agency managers' involvement and oversight)

Conclusion

Business accounting is an integral part of running a business responsibly. A business' financial reports are management's window onto what the business is doing and how it is performing. Without these reports, intelligent, proactive guidance of the business is impossible. Businesses have financial reporting needs that differ in some significant ways from those of nonprofit organizations. Therefore, any nonprofit agency planning to run a successful business must take special steps to ensure that these very specific reporting needs are met.

Footnotes

1 Asian Neighborhood Design, Barrios Unidos, BOSS, CVE, Golden Gate Community, Goodwill Industries, Jobs Consortium, Rubicon Programs.

2 Note that while corporations commonly use consolidation of financial statements across subsidiary businesses, they are not required to do so if consolidation does not provide improved disclosure. Consolidation is often not practiced when the asset and liability structure of a subsidiary is substantially different from that of its parent because doing so would make it difficult to understand the financial position of either.

3 Please see Chapters 8 and 9 for a more detailed discussion of these points.

4 It is true that many small privately owned businesses do not generate regular financial reports at all: often the only financial report a business owner has is a year-end income statement and balance sheet created as part of the business' annual tax statement. It is also true that many small businesses fail each year. Nonprofit run businesses, as part of organizations that receive public monies, must conduct more sophisticated financial reporting than typical small businesses. In addition, REDF and its portfolio businesses attempt to apply accepted business management and analysis techniques to increase the chances of success for each business.