Managing Restricted Funds

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Unique accounting standards require that nonprofits report contributed income in one of three categories: unrestricted, temporarily restricted, or permanently restricted. These income classifications are determined by either the absence or the existence of donorimposed restrictions on the use of funds. This resource aims to define unrestricted, temporarily restricted, and permanently restricted income and give nonprofit leaders the tools to record, report, and effectively manage contributed income and net assets.

Definitions

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

Unrestricted

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

Temporarily Restricted

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

Permanently Restricted

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

	UR	TR	PR
An individual sends a check for $3,000 to support the nonprofit's work.	X		
A foundation awards a grant for $15,000 for a computer system.		X	
A foundation awards $60,000 over three years for general operating support.	X	X	
An individual gives $2,500 to pay for five students to participate in a camp run by the organization.		X	
An individual gives $100,000 to provide scholarships for campers in perpetuity from the interest and investment earnings.			X

Accounting Requirements

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

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sheet for the fictional nonprofit Family Advocacy Network (FAN) – illustrate how these rules work.

Income Statement

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

Accurate accounting is especially important for restricted contributions and grants that are intended for use over a multi-year period. In the example shown below, FAN receives a three-year, $60,000 grant to support a new program for the years 2014, 2015, and 2016. When the award letter is received, FAN records the full $60,000 as temporarily restricted grant income on the income statement. A portion of the grant will be released from restriction in each year of the three-year grant period. The example income statement for 2014 shows $20,000 being released from restriction, while the remaining $40,000 remains in the temporarily restricted column. The same release of $20,000 will occur in future years two and three of the grant award.

The FAN example demonstrates the impact on the income statement of a multi-year grant. Accounting rules require a nonprofit to record all the income of a multi-year grant in the year it is received. If an organization’s income statement shows just total income and expenses without separating the restricted dollars, inflated surpluses can appear in year

Family Advocacy Network (FAN)
Income Statement
For the Twelve Months Ending 12/31/14

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

one of the grant period, along with possible artificial deficits in the remaining years of the grant period. In the FAN example, the total column for 2014 total income shows the full $60,000 multi-year grant and reports a surplus of $40,325. For practical purposes, only $20,000 could be used to support the program during this year. The unrestricted column is the most valuable tool for monitoring the current year financial activities.

Balance Sheet

The example below is the balance sheet for FAN. This format also delineates temporarily restricted funds from unrestricted funds. By focusing on unrestricted net assets, organizations are given the most accurate and relevant picture of the net assets available for use. For the purpose of analysis, planning, and decision-making, it is important for an organization to understand their unrestricted net asset position.

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

Family Advocacy Network (FAN)
Balance Sheet
12/31/14

	Unrestricted	Temporarily Restricted	Total
ASSETS			
Cash & Investments	24,758	40,000	64,758
Accounts Receivable	3,000		3,000
Leasehold Improvements	8,000		8,000
Equipment & Furniture	14,000		14,000
Total Assets	49,758	40,000	89,758
LIABILITIES & NET ASSETS			
Liabilities			
Accounts Payable	4,375		4,375
Accrued Expenses	1,100		1,100
Equipment Loan	9,000		9,000
Total Liabilities	14,475	0	14,475
Net Assets			
Beginning of Year	34,958	0	34,958
Change in Net Assets	325	40,000	40,325
Total Net Assets	35,283	40,000	75,283
TOTAL LIABILITIES & NET ASSETS	49,758	40,000	89,758