

Functional Expense Reporting for Nonprofits: The Profession's Next Scandal?

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Opening Factoid: 37 percent of nonprofits reporting over \$50,000 in contributions report zero fundraising or special event costs to the IRS.

Enron and subsequent corporate scandals sent a shock wave through the accounting profession that has yet to subside. The profession has been working hard ever since to overcome the damage to its prestige and to the public's trust in it. The last thing CPAs need is a new scandal.

Unfortunately, nonprofit financial reporting is a ticking time bomb just waiting to explode. The Nonprofit Overhead Cost Project (see sidebar) found serious and widespread errors in IRS Forms 990 and audited financial statements prepared or attested to by CPAs. The dollar values may be lower than for large publicly traded companies, and the errors less likely the result of malfeasance, but these errors can and ought to be corrected. This article shows you where the problems are, and what you can do about them.

The Importance of Functional Expense Reporting

The most widespread and serious problems concern expenses by functional classification (program, management and general, and fundraising). Absent good, comparable information about the relative mission effectiveness of various nonprofit organizations, donors, funders, and charity watchdog organizations have placed undue

reliance on financial indicators, many of which are based on reported functional expenses.

Two common financial indicators are the program-spending ratio and the fundraising- efficiency ratio. The program-spending ratio is calculated by dividing total program expenses by total expenses. The fundraising-efficiency ratio is calculated by dividing fundraising costs by total contributions. Articles in major media and websites aimed at donors frequently use these ratios as their primary basis for evaluating and ranking charities. Such ratios are only as good as the numbers used to calculate them, which tend to come from Forms 990 filed with the IRS.

IRS Form 990

In the corporate world, audited financial statements are public documents, while the tax return is a private matter between the corporation and the IRS. It's the opposite for nonprofits. Form 990 is a public document. Nearly 2.4 million have been imaged by the IRS and made available at www.guidestar.org. In contrast, audited financial statements are required to be released by only a minority of state charity registration offices.

Because of the data's ready availability, most donors, funders, and charity watchdog agencies calculate program-spending and fundraising-efficiency ratios using Form 990 data. Our study found widespread reporting that defies plausibility in the functional expenses used to make those calculations. Just a few examples:

- 37 percent of nonprofits with at least \$50,000 in contributions report zero fundraising costs.

- One-fourth of nonprofits reporting \$1 to 5 million in contributions report zero fundraising costs, as do nearly a fifth of those reporting over \$5 million in contributions.
- 13 percent of nonprofits report zero management and general expenses.
- 7 percent charged all accounting fees to program and another 20 percent split them across more than one category despite the fact that Form 990 instructions give accounting fees as an example of what is meant by management and general expenses.

Because of the large number of cases of zero reported fundraising cost, we included two such organizations in a set of nine in-depth case studies we performed. One organization also reported zero fundraising costs in its audited financials, and both were erroneous. The organization had a part-time employee who worked exclusively on fundraising. In addition, the executive director was involved in fundraising and the organization did some direct-mail fundraising. In the second case, the tax professional at the audit firm prepared a Form 990 with zero fundraising cost despite the fact that the financials behind the opinion letter of the audit team showed over \$500,000 in fundraising expenses. When our research team asked about it almost a year later, no one inside the organization had noticed, and all were bewildered as to how such a reporting error could have occurred.

For a limited number of organizations, including those where we performed in-depth case studies, we took a close look at Form 990 reporting. Aside from the functional expense problems, we found several other issues.

Our case studies turned up two different ways nonprofits are reporting restricted contributions in Part I of Form 990. Users rely on reported contribution amounts to

calculate the fundraising-efficiency ratios they use to compare nonprofits. Those ratios may lead them to draw false conclusions if organizations don't all report contributions the same way. Most organizations report the total of unrestricted, temporarily restricted, and permanently restricted contributions on Line 1d. Yet we also found the practice of reporting only unrestricted contributions on Line 1d and reporting the change in restricted net assets on Line 20 as an Other Change in Net Assets. Review of Form 990 and the instructions suggests that this problem arises because the form does not provide separate blanks for unrestricted, temporarily restricted and permanently restricted revenue. We recommend that all contributions be reported on Line 1d.

We found that donated space and services are not always properly reported. Organizations that leverage significant amounts of such in-kind donations can appear on Form 990 to have unusually high overhead because their value is excluded from revenue and expenses (unlike donated goods). One of our case study organizations was told by a funder reviewing its Form 990 that its grant would not be renewed because overhead was over 30 percent of total expenses. Based on GAAP financials, overhead consumed only 12 percent. Donated space and professional services accounted for the difference. Given the importance of overhead reporting to public users, it is important for preparers of Form 990 to include the value of these in-kind donations in the appropriate places. It should appear in Parts IV-A Line b(2) and IV-B Line b(1) where the Form 990 values are reconciled to the audited financials. This value, plus any other donated services not valued under GAAP, should also be reported in Part VI Line 82(b).

Form 990 reporting for nonprofits comprising multiple, affiliated, legal entities also makes overhead and fundraising cost analysis problematic for users. The majority of

our case study sites, and five of the six that were over \$1.5 million in annual revenue, consisted of such conglomerates. Unless the entities are covered by a group exemption letter, the IRS requires separate reporting for each entity. In three of our five larger cases, all or almost all management and general and fundraising costs were reported in a single entity's Form 990, leaving zero or very low non-program costs in the other entities. Given such practices, the overhead and fundraising costs of nonprofits with complex legal structures cannot be accurately assessed using Form 990 data. Our case studies suggest this is not an unusual situation for large nonprofits. The best thing for users would be a switch by the IRS to consolidated reporting, such as required by GAAP. Until then, tax professionals can make Form 990 information more accurate and useful by allocating fair shares of management and general and fundraising costs to all reporting entities.

In addition to these problems with Form 990, our case studies also turned up a few gross errors in audited financial statements. The organization whose Statement of Activities erroneously reported zero fundraising costs, referred to above, is one such error. Another organization's audited financials placed the Statement of Functional Expenses in with the supplemental information, despite the clear guidance of SFAS 117, Financial Statements of Not-for-Profit Organizations, that it is a required part of the core financial statements for this type of organization.

Problematic Accounting Methods

Upstream from the implausible functional expense numbers reported on Forms 990 and financial statements lie accounting methods that range from inadequate to incorrect. Our national survey of a representative sample of over 1500 nonprofit

organizations, for example, found that only 25 percent of nonprofits that get grants from foundations properly classify those proposal-writing costs as fundraising expenses. Only 17 percent of nonprofits that get grants from government properly report those proposal-writing costs as fundraising expenses.

Personnel costs form the largest expense at many nonprofits, and how those costs are allocated across the categories of program, management and general, and fundraising can make a huge difference in their program-spending and fundraising-efficiency ratios. In our national survey, barely one-third of nonprofits said they track staff time by functional expense category for each payroll period. Similarly, in our case studies, three of nine organizations had a paper or automated time-tracking system that was capable of serving as the basis for functional expense tracking. Unfortunately, only one of those three used it for that purpose, and in that one case, the fundraising person charged proposal-writing time to the program the grant was for rather than properly accounting for it as fundraising cost. Interestingly, this one site had only adopted its timesheet system at the urging of its auditor.

At the other eight sites, the vast majority of employees were classified as falling wholly within one of the three functional expense categories. For the handful of remaining employees, one or two staff members made a retrospective judgment at year-end about how they had spent their time, and this was used to allocate their personnel costs across the functional categories. The accuracy of such judgments is open to question, and given the emphasis that users place on low overhead, and low fundraising costs, it is not surprising that such judgments tended to result in low percentages for management and general, and especially fundraising.

Root Causes

Uniformly, our case study sites reported that they used a CPA firm with a regional practice and at least one partner who specialized in nonprofits. Typically, the same audit firm had been used for some years and was familiar with the structure and finances of the organization. Most Forms 990 were prepared by a tax professional at the audit firm. Thus our findings cannot be readily explained away by lack of experience at these public accounting firms.

Our research suggests a number of factors are contributing to the current situation:

- Many nonprofits, especially small ones and those with a majority of donor-restricted funds, do not have adequate accounting staff and systems.
- The overemphasis on overhead expenses by donors, funders and charity watchdogs gives nonprofits a big incentive to underreport overhead.
- The accounting profession continues to think of the audited financials as the public document, and hasn't brought its audit and attest standards to the Form 990 the public is relying on.
- The accounting profession has not considered the method by which expenses are allocated into functional classifications to be an important audit issue.

Although the first two of these are primarily the responsibility of the nonprofit's board and management, clearly the public accounting profession is responsible for the latter two and has a role to play in addressing the first pair. The underreporting so widespread in the nonprofit sector could not exist without the tolerance of the auditing profession. And

many nonprofits rely on their auditors to tell them where their accounting needs to improve.

What to Do

Given the public nature of Form 990, the profession must reorient its thinking, and begin to apply the same standards to that document that it does to audit and attest work. That's the first step. The second is to recognize the importance that users place on expenses by functional classification and make that an important audit issue.

At that point, the auditor is going to come square up against both the inadequate accounting systems and the client's incentive to underreport overhead expenses. The desire to maintain a positive working relationship with the client is going to be in conflict with the need to maintain public reputation and trust. As the Enron/Arthur Anderson case shows, public reputation and trust is the more valuable asset at risk here. Nevertheless, a graduated response is possible.

In some cases, the auditor will be able to identify misallocations across functional classifications and can require adjusting entries to correct the problem. In other cases, the auditor will recognize weak accounting methods that "happen to" result in underreported overhead, but will be unable to determine the appropriate allocation of expenses after the fact.

The minimum level of response in these cases is to use the management letter to identify and raise concerns about the quality of accounting for functional expenses. If the same problems persist the next year, the next level of response would be to consider insisting on disclosures in the Notes to Financial Statements regarding methods of accounting for overhead. This is less effective in the nonprofit world than the corporate

world because the Notes aren't tied to the public Form 990, but it should succeed in getting the leadership of the client organization to solve the problems.

If the problems remain the third year, the third level of response to consider is to provide a qualified opinion letter that narrowly focuses on problematic allocation of costs among functional categories. This will likely upset the client tremendously, but is the best way to protect the audit firm's public reputation and trust. Unfortunately, there is currently no way for a CPA to offer a similarly qualified opinion of the numbers on Form 990.

In the order listed, these solutions are increasingly problematic for the individual practitioner to implement independently. Ideally they would be adopted by the profession as a whole. This could be accomplished through the profession's state and national accounting societies.

Conclusion

All nonprofit organizations are required by SFAS 117 to report expenses by functional classification. The many users that emphasize program-spending and fundraising-efficiency ratios are relying on these numbers, assuming they fairly reflect the activities of the organization. Taken collectively, the findings of the Nonprofit Overhead Cost Project suggest that this information—often prepared by or attested to by CPAs—is in many cases incomplete, misleading or inaccurate.

Members of the public accounting profession must respond in three ways. First, recognize the emphasis the public places on functional expense classification and make it an important audit issue. Second, recognize that Form 990 is the major public financial document in the nonprofit sector and apply the same standards to it that you do to your

audit and attest work. Finally, confront the weak accounting and underreporting at your nonprofit clients through the graduated response suggested here.

Practical Tips to Remember

- Many users of nonprofit financials place primary emphasis on expenses by functional classification, so treat the allocation of expenses by functional classification as an important audit issue.
- Urge clients to adopt staff timesheets and use them for functional cost allocation.
- In the corporate world, audited financial statements are public documents, while the tax return is a private matter between the corporation and the IRS. It's the opposite for nonprofits, so bring the same public standards to Form 990 that you do to your audit and attest work.
- Report all contributions on Line 1d of Form 990, regardless of whether unrestricted, temporarily restricted or permanently restricted.
- Report the value of donated space and services in Part IV of Form 990 so clients won't appear to have excessive overhead.
- For nonprofits comprising multiple, affiliated, legal entities that are not covered by a group exemption letter, allocate fair shares of management and general and fundraising costs to all reporting entities on Forms 990.
- Use the management letter to identify and raise concerns about the quality of functional expense accounting. If the client doesn't respond, protect yourself by insisting on notes in the financial statements. Finally, if the client still doesn't respond, consider a qualified opinion letter.

The Nonprofit Overhead Cost Project

The goal of the 5-year project was to understand how nonprofits raise, spend, measure, and report funds for fundraising and administration, and to work with practitioners, policymakers, and the accounting profession to improve standards and practice in these areas. The overall study had three major phases: analysis of over 250,000 IRS Forms 990, in-depth case studies of nine organizations, and 1,500 responses to a survey of U.S. nonprofits. An exploratory survey of nonprofit auditors was also conducted. The project was supported by The Atlantic Philanthropies, the Ford Foundation, the Charles Stewart Mott Foundation, The David and Lucille Packard Foundation, and the Rockefeller Brothers Fund.

Resource

www.coststudy.org contains a variety of publications from the Nonprofit Overhead Cost Project, resources for nonprofit financial management and useful links related to nonprofit accounting

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