NONPROFIT OVERHEAD COST PROJECT

FACTS AND PERSPECTIVES BRIEF NO. 4

CENTER ON NONPROFITS AND PHILANTHROPY, URBAN INSTITUTE
CENTER ON PHILANTHROPY, INDIANA UNIVERSITY

The Quality of Financial Reporting by Nonprofits: Findings and Implications

Financial information has become a popular ingredient in assessing the performance of charities. Donors, funders, and watchdog agencies make extensive use of audited financial statements and publicly available IRS Forms 990 as part of their assessments. Many users pay particular attention to the proportion of total expenditures used for administration and fundraising. They also look to annual surpluses and deficits as measures of the quality of financial management, or in some cases, financial need.

But how good are the numbers on which these assessments are based? When we examine them closely, do we find serious errors? What are the sources of inaccuracy? Do nonprofits face unique issues that ordinary accounting principles do not address? Will users who analyze the more readily available Form 990 data reach the same conclusions about an organization as those who review audited financial statements?

To study these issues in depth, we conducted detailed discussions with nine organizations. The organizations ranged in size from under $1 million to over $40 million in annual expenditures. They represented various fields of work, such as health, education, and the arts. This brief highlights five groups of findings relating to financial reporting that emerged from these case studies.

Functional Classification of Personnel Expense a Low Priority

In both audited financial statements and in reports to the IRS, nonprofits are required to state how much of their expenditures went to program, to administration, and to fundraising. These three areas are termed functional expense classifications. For most nonprofits, salaries are the largest single cost, yet our study revealed that *functional expense* tracking of personnel time is a low priority, due to the low perceived benefit of the practice. Only three of our nine sites had a paper or automated time-tracking system that could serve as the basis of functional expense classification, and only one of those used it for that purpose. However, even in that case, the development officer charged grantwriting time to the program for which the money was raised rather than properly accounting for the expense as fundraising. This nullified the purpose of tracking functional expenses. The other sites had no plans to begin time tracking. The people we interviewed saw little value to themselves or their organization in this particular accounting activity. At most sites, one or two staff members make a retrospective judgment once per year about how everyone spent their time, and this is the basis for the functional allocation of personnel costs that is required by both generally accepted accounting principles (GAAP) and the IRS. Because salary costs are such a high proportion of total costs, fundraising and administrative cost ratios are highly sensitive to these judgments, the accuracy of which is open to question.

> *"Because salary costs are such a high proportion of total costs, fundraising and administrative cost ratios are highly sensitive to retrospective allocation decisions, the accuracy of which is open to question."*

About the Project

The goal of the Nonprofit Fundraising and Administrative Cost Project is 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 has three 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.

Glaring Functional Expense Reporting Errors

Obvious functional expense reporting errors occur in audited financial statements and Forms 990 even when the documents are prepared by auditors and CPAs. Because approximately half of Forms 990 submitted to the IRS report zero fundraising costs, we included two such organizations in our case study group. Our study revealed that both reported zero fundraising cost on their Form 990 in error. In both cases, external financial professionals prepared the Form 990. In one case the audited financials showed fundraising expenses, but these expenses were not subsequently reported on Form 990. In the other, they showed all salaries as program expenses and reported no fundraising expense despite the existence of a part-time grantwriter and some direct mail fundraising.

Case study sites generally did not classify costs of getting government grants as fundraising costs. In almost all cases, government grants are contributions and the costs associated with raising contributions should be classified as fundraising costs.[1] In both audited financial statements and Forms 990, our sites did not include the cost of the time of top executives and senior program managers involved in securing government grants in their accounting of fundraising costs.

"Obvious functional expense reporting errors occur in audited financial statement and Forms 990 even when the documents are prepared by auditors and CPAs."

Nonprofits Responding to Pressure

Nonprofits are responding to perceived and explicit pressure to keep real and reported administrative and fundraising costs low. One agency was planning to change its functional expense allocation method because reported administrative and fundraising costs were higher than those reported by peer agencies. Another had been threatened with having its funding cut off by one funder because its overall administrative and fundraising cost ratio was too high. A third reported that maintaining a lean, low-cost administrative cost structure was important in maintaining ongoing funding support. Other sites noted that low overhead is a factor in winning public sector funding and that funders and donors are even more sensitive to the level of fundraising costs than they are to the level of administrative costs.

Issues Unique to Nonprofit Accounting

Capital gifts and in-kind donations raise unique issues for preparers and users of nonprofit financial statements. Without equity or earned revenue streams sufficient to service debt, nonprofits must frequently raise special capital contributions to make large capital expenditures. Under GAAP, contributions are generally recognized as revenue in the year the commitment is made. That means the organization has a large built-in annual surplus in the year a capital contribution is received, and a series of smaller built-in annual deficits in the years following until the capital item is fully depreciated. However, GAAP has a solution to this problem. The organization may adopt an explicit policy that gifts of long-lived assets (or cash to purchase them) have an implied time restriction that is satisfied gradually over the life of the asset.[2] By recognizing each year a portion of the gift equal to depreciation, the organization eliminates any surplus or deficit associated with the gift. For physical assets that get depreciated, this is the approach we recommend.

"Capital gifts make measures of surplus or deficit reported in financial statements unreliable."

Another approach available under GAAP is to separate operating and non-operating activities on the activities statement.[3] This approach does not eliminate overall surplus and deficits, but at least it allows readers of financial statements to see the operating surplus or deficit separate from any capital items. This is the best approach for capital gifts that do not get depreciated, such as cash or securities for endowment.

Unfortunately, neither of these two approaches appears to be widely used, making it difficult for users to rely on measures of surplus or deficit reported in financial statements. Neither of these two approaches was adopted at a food bank we studied, where the organization reported a large surplus the year it received funds to buy two new refrigerated trucks, which in turn meant staff had to explain to funders why they still needed to raise money when they had such a large "surplus." Why the auditor did not suggest one of the two approaches identified here is an open question.

"Nonprofits are responding to perceived and explicit pressure to keep real and reported administrative and fundraising costs low."

In-kind donations also create unique issues for nonprofit financial reporting. The same food bank also reported a $250,000 surplus one year, followed by a $250,000 deficit the next, despite the fact that its annual budget contains relatively steady and predictable cash expenses of around $500,000. That's because the annual budget is dwarfed by $2 million of in-kind food donations that are treated exactly the same as cash donations under GAAP and Form 990 rules. Changes in inventory of donated food, resulting from

a change in the timing of a food drive, accounted for the huge swings. We recommend cash and non-cash transactions be classified separately on the activities statement. This separation is permitted under GAAP.[3] Donated space and services do not give rise to inventory swings, but keeping them separate from cash items will make it easier for users of financial statements to understand the true financial condition of the organization.

IRS Form 990 Issues

Our case studies identified three reporting issues unique to Form 990. These concern affiliated entities, donated space and services, and restricted contributions.

Affiliated Entities. The majority of our case study organizations, and five of the six that were over $1.5 million in annual revenue, consisted of multiple affiliated corporations. GAAP requires consolidated reporting for such conglomerates, whereas the IRS requires separate reporting for each entity unless the affiliated entities have a group exemption letter. Affiliated entities are much more common than group exemptions, so most conglomerates are reporting to the IRS on a non-consolidated basis. In three of the five larger cases we studied, all or almost all administration and fundraising costs were reported in a single entity, leaving zero or low non-program costs in the other entities. The lack of a consolidated Form 990 complicates the practice of performing an overall assessment of organizations with multiple affiliated entities. The Forms 990 for the individual entities create a misleading picture of their administration and fundraising costs. A substantial number of nonprofits that get contributions report zero fundraising costs. The practice of reporting all or most administrative and fundraising costs in a parent or other sole entity may account for a significant share of these "zeroes."

Donated Space and Services. Organizations that leverage significant donated space and services can appear to have unusually high administrative and fundraising costs when Form 990 data are used as the basis of analysis because their value is not included with other expenses. One of our case study organizations was told by a funder that its grant would not be renewed because administration and fundraising were over 30 percent of total expenses. When the value of donated space and services was included in total expenditures—as it is in GAAP financial statements—the overhead portion dropped to a more acceptable 12 percent. When making an assessment of the level of spending on administration and fundraising, it is sounder to include donated space and services.

"The lack of a consolidated Form 990 complicates the practice of performing an overall assessment of organizations with multiple affiliated entities. The Forms 990 for the individual entities create a misleading picture of their administrative and fundraising costs."

Restricted Contributions. Our study revealed two very different ways in which restricted contributions are being reported. Most organizations report total contributions on line 1 of Form 990, but we also encountered the practice of reporting only unrestricted contributions on line 1, and reporting the changes in restricted assets on line 20 as an "Other Change in Net Assets." Such differences in practice reduce users' ability to compare the figures of one organization with another. In particular, fundraising cost ratios will not be comparable. This problem arises partly from ambiguity in the current instructions, and partly because Form 990 does not conform to GAAP presentation of restricted contributions in the Statement of Activities.

"Comparisons of organizational 'efficiency' based on simplistic overhead ratios calculated from Form 990 figures can lead to flawed conclusions."

Implications

These findings have important implications for users of nonprofit audited financials and IRS Forms 990. Below, we briefly sketch these for donors, charity watchdogs, boards, senior management, funders, finance professionals, and policymakers.

For donors and charity watchdogs

Donors and charity watchdogs rely on Forms 990 to evaluate the finances of nonprofit organizations because their public availability makes them a ready source of financial information. However, comparisons of organizational "efficiency" based on simplistic overhead ratios calculated from Form 990 figures can lead to flawed conclusions. Nonprofits may not be comparable because of variations in functional expense tracking of personnel costs, the allocation of overhead costs to affiliated entities, and unreported values for donated space and services. Additionally, comparisons of annual surplus or deficit based on Forms 990 are also questionable because of issues related to capital contributions, affiliated entities, and differences in the treatment of temporarily restricted contributions. In our study, consolidated GAAP financials tended to give a more complete picture of organizational finances, although a number of reporting issues remained even when GAAP was fully satisfied.

For boards and senior management

Boards and senior managers are responsible for the financial reporting of their nonprofits. Our study suggests that small nonprofits are at risk of devoting inadequate resources to accounting. As a result, the quality of their financial reporting suffers. In two cases where organizations invested in and dramatically improved the quality of their financial reporting, the leadership for these changes came from the board. Because of the high incidence of accounting problems encountered in our study, boards and senior managers would do well to initiate a review of financial reporting and controls in the organizations where they have a fiduciary responsibility.

For finance professionals

Financial professionals inside nonprofits and external auditors have special responsibility for the accuracy of financial information. In cases where nonprofits have limited financial acumen inside the organization, external auditors should acquaint their clients with requirements and standards, and suggest appropriate reporting methods to deal with issues such as capital contributions and in-kind donations. The profession may also wish to take the lead in suggesting changes to accounting standards or IRS rules to address the accuracy and consistency issues identified by this study.

For funders

That virtually all the errors our study uncovered in functional expense reporting had the effect of understating the organizations' administrative and fundraising cost is no coincidence. Nonprofits are clearly responding to pressure from public and private sector funders to keep real and reported overhead costs low. In addition, nonprofits may be adapting to funder policies against funding adequate levels of overhead costs by classifying some such costs as program costs. Funders with strict policies limiting the funding of overhead to unrealistically low levels, or with explicit or implicit funding criteria that reward low overhead percentages, may wish to rethink those policies and practices if they want to see more accurate financial reporting by nonprofits.

"Virtually all the errors our study uncovered in functional expense reporting had the effect of understating the organization's administrative and fundraising cost. Nonprofits may be adapting to funder policies against funding adequate levels of overhead costs by classifying some such costs as program costs."

For policymakers

Policymakers can have two important influences on nonprofit behavior. First, the public sector is a major funder of nonprofits. Our human services sites in particular reported that public sector funders tend to favor nonprofits with low reported overhead costs. This practice appears to have encouraged both underinvestment in organizational infrastructure and underreporting of overhead costs. Policymakers concerned about accurate reporting may wish to reconsider current funding criteria.

Second, IRS reporting is a creature of public policy. Recognizing that many members of the public rely on Form 990 for financial information, policymakers may wish to change Form 990 rules to address problems concerning affiliated entities, in-kind donations, and restricted contributions. We recommend Form 990 follow GAAP except where a clear public purpose is served. Since GAAP financials are prepared and reviewed routinely by nonprofits, this will also improve accuracy and compliance. Providing for segregated reporting of capital and non-cash transactions will also make the information more useful to the public. Policymakers may also wish to devote additional resources to Form 990 audits as a way of identifying additional problem areas and encouraging compliance.

Further Details

The project's lead researchers are Mark A. Hager, Thomas Pollak, and Kennard Wing (Center on Nonprofits and Philanthropy) and Patrick M. Rooney (Center on Philanthropy, Indiana University). For more on these and other issues, visit **http://www.coststudy.org** or call (202) 261-5709 (Urban Institute) or (317) 236-4912 (Indiana University).

Acknowledgments

The Nonprofit Overhead Cost Project is supported by The Atlantic Philanthropies, the Ford Foundation, the Charles Stewart Mott Foundation, The David and Lucille Packard Foundation, and the Rockefeller Brothers Fund.

---

[1]Costs associated with securing government grants (contributions) are fundraising expenses. On the other hand, government contracts are fees for service rather than contributions, and the costs of efforts associated with securing them are administrative (management and general) rather than fundraising expenses.

[2]See *Statement of Financial Accounting Standards 116, Accounting for Contributions Received and Contributions Made*, paragraph 16.

[3]See *Statement of Financial Accounting Standards 117, Financial Statements of Not-for-Profit Organizations*, paragraph 23.