Special Issues in

NONPROFIT FINANCIAL REPORTING

A Guide for Financial Professionals

Nonprofit managers and their donors rely on functional expense reporting for both management and giving decisions. However, many nonprofit organizations misreport these expenses.

Research findings fall into four areas:

- Functional expenses
- Capital gifts
- In-kind donations
- IRS Form 990

Nonprofit Overhead Cost Project

This guide is based on information collected by the Nonprofit Overhead Cost Project. The goal of the 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 project is a collaboration between the Center on Philanthropy at Indiana University and the Center on Nonprofits and Philanthropy at the Urban Institute. For more information on the project, see **http://www.coststudy.org.**

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The many users that emphasize spending ratios are relying on the attestation of the auditor that these numbers fairly reflect the activities of the organization. Research suggests that in too many cases they do not.

Functional Expenses

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 expenses by functional classification (program, management and general, and fundraising).

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.

Such ratios are only as good as the numbers used to calculate them. Unfortunately, research shows that in many cases the numbers are not good at all, and that practices vary so widely that comparisons among organizations may lead to flawed conclusions.

A national survey of a representative sample of nonprofit organizations, for example, found that only 25 percent of nonprofits that get grants from foundations properly classify those proposal-writing costs as fundraising. Only 17 percent of nonprofits that get grants from government properly report those proposal-writing costs as fundraising.

In-depth case studies of nine nonprofits turned up gross errors in audited financial statements. One organization had a part-time employee who worked exclusively on fundraising. The executive director was involved in fundraising as well, and the organization also did some direct-mail fundraising. The Statement of Activities reported zero fundraising costs. Another organization's audited financials placed the Statement of Functional Expenses in with the supplemental information, despite the clear guidance of Statement of Financial Accounting Standards (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.

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.

Users of financial statements can draw a variety of erroneous conclusions as a result of the lack of distinction between monetary and in-kind items.

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.

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 the attestation of the auditor that these numbers fairly reflect the activities of the organization. Research suggests that in too many cases they do not, and in at least a few cases the errors are egregious.

Because users of nonprofits financials rely so heavily on reported expenses by functional classification, public accountants must begin to bring the same standards of practice to auditing these expense classifications that they currently apply to auditing assets, liabilities, revenues, and total expenses.

Capital Gifts

Without equity or earned revenue streams sufficient to service debt, nonprofits must raise special capital contributions to make large capital expenditures. According to SFAS 116, Accounting for Contributions Received and Contributions Made, contributions are generally recognized as revenue in the year the commitment is made. That results in the organization having a large reported annual surplus in the year a capital contribution is received, and a series of smaller annual deficits in the years following until the purchased asset is fully depreciated.

As an example, consider a food bank in our study that received a $60,000 grant to purchase two new refrigerated trucks. As shown in Exhibit A, their reported annual surplus that year was $50,000.[1] Not only was the organization's operating loss that year camouflaged by the capital gift, but the organization had such a large surplus, it apparently needed no additional funds. A number of the organization's funders didn't want to renew their grants. Fundraising staff with no financial training had to try to explain to foundation program officers with no financial training what had happened with the capital grant, and that they really did need the money, despite what the financials said.

SFAS 116 has a solution for this problem that needs to be more widely adopted. Under paragraph 16 of that document, nonprofits are permitted to adopt a 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. By recognizing a portion of the gift equal to depreciation each year, the organization eliminates any surplus or deficit associated with the gift. For physical assets that get depreciated, this is the approach we recommend. Exhibit B shows what the Statement of Activities would look like in the first year if this approach were adopted, assuming $5,000 of gift recognition and depreciation is appropriate for the partial year the trucks were in use. SFAS 116 requires that organizations adopting such a policy disclose the fact.

For gifts of assets that don't get depreciated, such as land, a different approach is preferable. Under paragraph 23 of SFAS 117, Financial Statements of Not-for-Profit Organizations, organizations are permitted to segregate operating and nonoperating items in the Statement of Activities. We recommend organizations take advantage of this flexibility to segregate nondepreciable capital gifts from operating items. This approach does not eliminate the large surplus in the year of the gift, but at least it allows readers of financial

[1]The numbers in all exhibits have been changed to protect the privacy of study organizations.

Exhibit A
Capital Contributions Recognized Immediately, No Segregation

Nonprofit One Inc.
Statement of Activities

For the year ended June 30, 2003

	Unrestricted	Temporarily restricted	Permanently restricted	Total
SUPPORT AND REVENUE				
Contributions	$2,400,000	$232,000	—	$2,632,000
Special events	50,000	—	—	50,000
Program service revenue	4,000	—	—	4,000
Other revenue	3,000	—	—	3,000
	$2,457,000	$232,000	—	$2,689,000
Net assets released from restrictions	$175,000	$(175,000)	—	—
EXPENSES				
Program services	$2,475,000	—	—	$2,475,000
General and administrative	64,000	—	—	64,000
Fundraising	43,000	—	—	43,000
	$2,582,000	—	—	$2,582,000
Change in net assets	$50,000	$57,000	—	$107,000
Net assets, beginning of year	$258,000	$175,000	$7,000	$440,000
Net assets, end of year	$308,000	$232,000	$7,000	$547,000

statements to see the operating surplus or deficit separate from any capital items. Assuming Exhibit A includes a donation of land worth $55,000, Exhibit C shows how the financials would change with this approach.

Many nonprofit organizations lack skilled financial professionals either on staff or on the board. Particularly in those cases, it is incumbent upon the nonprofit's auditor to bring these methods to the attention of the organization's leadership.

Exhibit B
Capital Contributions Recognized over Life of Purchased Asset

Nonprofit One Inc.
Statement of Activities

For the year ended June 30, 2003

	Unrestricted	Temporarily restricted	Permanently restricted	Total
SUPPORT AND REVENUE				
Contributions	*$2,345,000*	*$287,000*	—	$2,632,000
Special events	50,000	—	—	50,000
Program service revenue	4,000	—	—	4,000
Other revenue	3,000	—	—	3,000
	$2,402,000	*$287,000*	—	$2,689,000
Net assets released from restrictions	$175,000	$(175,000)	—	—
EXPENSES				
Program services	$2,475,000	—	—	$2,475,000
General and administrative	$64,000	—	—	64,000
Fundraising	$43,000	—	—	43,000
	$2,582,000	—	—	$2,582,000
Change in net assets	*$(5,000)*	*$112,000*	—	$107,000
Net assets, beginning of year	$258,000	$175,000	$7,000	$440,000
Net assets, end of year	*$253,000*	*$287,000*	$7,000	$547,000

Note: *Italics* indicate differences from Exhibit A.

In-Kind Donations

Nonprofits also differ from for-profit corporations in their use of in-kind donations of goods, space, and services. Especially for smaller nonprofits, the value of these nonmonetary transactions can exceed that of all monetary transactions. We studied several such organizations in detail as part of the Nonprofit Overhead Cost Project.

Of particular concern are donated goods, which are capable of creating annual surpluses and deficits based on

Exhibit C
Capital Contributions Recognized Immediately, with Segregation

Nonprofit One Inc.
Statement of Activities

For the year ended June 30, 2003

	Unrestricted	Temporarily restricted	Permanently restricted	Total
Operations				
SUPPORT AND REVENUE				
Contributions	*$2,345,000*	$232,000	—	*$2,577,000*
Special events	50,000	—	—	50,000
Program service revenue	4,000	—	—	4,000
Other revenue	3,000	—	—	3,000
	$2,402,000	$232,000	—	*$2,634,000*
Net assets released from restrictions	$175,000	$(175,000)	—	—
EXPENSES				
Program services	$2,475,000	—	—	$2,475,000
General and administrative	64,000	—	—	64,000
Fundraising	43,000	—	—	43,000
	$2,582,000	—	—	$2,582,000
Change in net assets due to operations	$(5,000)	$57,000	—	$52,000
Capital transactions				
SUPPORT AND REVENUE				
Contributions	*$55,000*	—	—	*$55,000*
Change in net assets due to capital gifts	*$55,000*	—	—	*$55,000*
Total change in net assets	$50,000	$57,000	—	$107,000
Net assets, beginning of year	$258,000	$175,000	$7,000	$440,000
Net assets, end of year	$308,000	$232,000	$7,000	$547,000

Note: *Italics* indicate differences from Exhibit A.

inventory swings that have little to do with how well the nonprofit is being managed financially.

Consider the same food bank that bought the refrigerated trucks. One year, they moved up the date of a major food drive that historically had taken place just after the end of the fiscal year, to just before. As a result of the increase in inventory of donated food from the end of the previous fiscal year, they reported an annual surplus of $200,000 (see Exhibit D). Again, their funders couldn't understand why an organization that was so flush was still submitting grant proposals. Fundraising staff with no financial training had to explain to foundation program officers with no financial training the accounting rules for in-kind gifts, and that they could not pay salaries or rent with canned green beans. The next year, the food drive again fell after the end of the fiscal year. As a result, the organization reported a $200,000 deficit (see Exhibit D). Funders normally take large deficits as a sign of poor financial management, and avoid supporting such charities. Fundraising staff with no financial training had to explain to foundation program officers with no financial training the concept of inventory profits and losses.

In-kind donations create a second problem. With no distinction between cans and cash, the organization in Exhibit D appears to be a $2.5 million operation, all of it fungible. The reality, though, is that 80 percent of that is donated food, and the scale of monetary operations at this organization is closer to $500,000. Users of financial statements can draw a variety of erroneous conclusions as a result of the lack of distinction between monetary and in-kind items. This second problem occurs with all types of in-kind donations valued under generally accepted accounting principles (GAAP), whether of goods, space, or professional services.

SFAS 117 has a solution for both these problems that needs to be more widely adopted. The same paragraph 23 we relied on to segregate operating and capital items can also be used to segregate monetary and nonmonetary transactions. Exhibit E shows this approach applied to the financial statement in Exhibit D. With the inventory swings reported in a separate section, we can see both the true scale of monetary operations and their resulting surplus or deficit. Although donated space and services are not shown in this example, they should also be included with other in-kind donations.

Preparers of financial statements could also help by using the direct method to present the Statement of Cash Flows, because in-kind revenues and expenses do not appear. The indirect presentation is understood by few and fails to illuminate the true nature of operations like that of the food bank we studied.

Exhibit D

No Segregation of In-Kind Donations

Nonprofit Two Inc.
Statement of Activities

For the year ended June 30,	2003				2002			
	Unrestricted	Temporarily restricted	Permanently restricted	Total	Unrestricted	Temporarily restricted	Permanently restricted	Total
SUPPORT AND REVENUE								
Contributions	$2,155,000	$327,000	—	$2,482,000	$2,555,000	$165,000	—	$2,720,000
Special events	50,000	—	—	50,000	45,000	—	—	45,000
Program service revenue	3,000	—	—	3,000	3,500	—	—	3,500
Other revenue	2,000	—	—	2,000	2,500	—	—	2,500
	$2,210,000	$327,000	—	$2,537,000	$2,606,000	$165,000	—	$2,771,000
Net assets released from restrictions	$175,000	$(175,000)	—	—	$225,000	$(225,000)	—	—
EXPENSES								
Program services	$2,475,000	—	—	$2,475,000	$2,520,000	—	—	$2,520,000
General and administrative	64,000	—	—	64,000	61,000	—	—	61,000
Fundraising	43,000	—	—	43,000	45,000	—	—	45,000
	$2,582,000	—	—	$2,582,000	$2,626,000	—	—	$2,626,000
Change in net assets	$(197,000)	$152,000	—	$(45,000)	$205,000	$(60,000)	—	$145,000
Net assets, beginning of year	$258,000	$175,000	$7,000	$440,000	$53,000	$235,000	$7,000	$295,000
Net assets, end of year	$61,000	$327,000	$7,000	$395,000	$258,000	$175,000	$7,000	$440,000

Exhibit E
Segregation of In-Kind Donations

Nonprofit Two Inc.
Statement of Activities

For the year ended June 30,	2003				2002			
	Unrestricted	Temporarily restricted	Permanently restricted	Total	Unrestricted	Temporarily restricted	Permanently restricted	Total
Monetary transactions								
SUPPORT AND REVENUE								
Contributions	*$355,000*	$327,000	—	*$682,000*	*$355,000*	$165,000	—	*$520,000*
Special events	50,000	—	—	50,000	45,000	—	—	$45,000
Program service revenue	3,000	—	—	3,000	3,500	—	—	$3,500
Other revenue	2,000	—	—	2,000	2,500	—	—	$2,500
	$410,000	$327,000	—	*$737,000*	*$406,000*	$165,000	—	*$571,000*
Net assets released from restrictions	$175,000	$(175,000)	—	—	$225,000	$(225,000)	—	—
EXPENSES								
Program services	*$475,000*	—	—	*$475,000*	*$520,000*	—	—	*$520,000*
General and administrative	64,000	—	—	64,000	61,000	—	—	$61,000
Fundraising	43,000	—	—	43,000	45,000	—	—	$45,000
	$582,000	—	—	*$582,000*	*$626,000*	—	—	*$626,000*
Change in net assets, monetary	$3,000	$152,000	—	$155,000	$5,000	$(60,000)	—	$(55,000)
In-kind transactions								
SUPPORT AND REVENUE								
Contributions	$1,800,000	—	—	$1,800,000	$2,200,000	—	—	$2,200,000
	$1,800,000	—	—	$1,800,000	$2,200,000	—	—	$2,200,000
EXPENSES								
Program services	$2,000,000	—	—	$2,000,000	$2,000,000	—	—	$2,000,000
	$2,000,000	—	—	$2,000,000	$2,000,000	—	—	$2,000,000
Change in net assets, in-kind	$(200,000)	—	—	$(200,000)	$200,000	—	—	$200,000
Net assets, beginning of year	$258,000	$175,000	$7,000	$440,000	$53,000	$235,000	$7,000	$295,000
Net assets, end of year	$61,000	$327,000	$7,000	$595,000	$258,000	$175,000	$7,000	$240,000

Note: *Italics* indicate differences from Exhibit D.

The Financial Accounting Standards Board (FASB) lists seven objectives for nonprofit financial reporting in Concept Statement No. 4, which can be simply summarized: portray economic reality without misleading the user. Again, many nonprofit organizations, especially smaller ones, lack skilled financial professionals either on staff or on the board. Auditors are in an excellent position to help their clients present their financial results in ways that will avoid misunderstanding and confusion on the part of financial statement users. They should bring the methods described here to the attention of the client organization's leadership.

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 readily available at www.guidestar.org, but in most states audited financial statements need not be released. To meet their professional obligations in this environment, public accountants need to bring the same standards to the Forms 990 they prepare that they do to their audit and attest work.

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:

- Thirty-seven 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.
- Thirteen percent of nonprofits report zero management and general expenses.
- Seven 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 our case studies. One, referred to above, also reported zero fundraising costs in its audited financials, and both were erroneous. In the other organization, the tax professional prepared 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.

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.

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.

We found three different reporting problems in Parts IV-A and IV-B of Form 990, where the numbers reported on Form 990 are to be reconciled with the audited financial statements. The first was to simply leave it blank. The second was that the numbers supposedly taken from the audited financial statements were not the correct numbers. The third was to place all the reconciliations in a single figure in the "Other" line, while referring to a numbered statement that was attached. Typically, this statement contained the same single number, offering no real information about the reconciliation.

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 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 of ambiguity in the instructions and because the form does not correspond to the multi-column format for the GAAP Statement of Activities. Until the form and instructions can be revised, we recommend that all contributions be reported on Line 1d.

We found that donated space and services are not always properly

In one case study, the tax professional prepared 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.

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. One of our case study organizations was told by a funder using 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 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 nonprogram 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.

Finally, our case studies turned up one case of a public charity incorrectly filing Form 990-PF, intended for private foundations.

Financial Controls

The adequacy of financial controls was not a specific focus of the Nonprofit Overhead Cost Project; however, we became aware of certain issues in the course of our case studies. In one organization, for example, the woman who ran the thrift shop routinely took the cash home at night. The new executive director who ended this practice said, "I think the auditor was asleep at the wheel." The management letter at another site spoke of missing cancelled checks and invoices, a variety of transactions entered improperly in the accounting system, and physical inventory scattered throughout the organization's facilities. Several organizations used temporarily restricted funds to meet current cash flow needs. Smaller organizations usually had only one person who handled all financial matters, and that person frequently had little or no financial training. These organizations had limited scope for separation of duties, and less understanding of the concept.

Many nonprofit organizations lack skilled financial professionals either on staff or on the board.

Conclusion

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.

Taken collectively, the findings of the Nonprofit Overhead Cost Project suggest that users are relying on information prepared by or attested to by CPAs, and in many cases the information is incomplete, misleading, or inaccurate. In particular, public accounting needs to bring higher standards to expense reporting by functional classification and to preparation of IRS Form 990. Beyond this, the field will provide a service if it will recommend the approaches to reporting capital gifts and in-kind donations that have been laid out here, and help their nonprofit clients improve their financial controls.

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