

Much of what donors and regulators know about nonprofit organizations comes from public financial statements. Do charities track and report their expenses correctly?

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Current practices in allocation of fundraising expenditures

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NONPROFIT COST ACCOUNTING practices invite organizations to place or divide expenditures among three functional categories. These functional categories are program expenses, which relate to the services and activities of nonprofits; fundraising expenses, which relate to efforts to raise contributions; and management and general expenses, which relate to the administrative functions of the organization. To comply with generally accepted accounting practices (GAAP), nonprofit accountants, treasurers, and consultants tag expenses as one or another of these functional expenses.

The job of tagging and tallying functional expenses is complicated by the fact that some items and tasks span two or all three categories. For example, an organization may have one total for the paper, toner, electricity, and repairs associated with the copying machine. However, because the copying machine is probably used for program, administrative, and fundraising purposes, the copier costs should be divided in some reasonable way among these three functions. Another example is staff time for people who wear several hats. If an executive director is involved in service delivery,

administration, and fundraising, then her salary expenses should be proportionally divided and reported among these categories. Accountants have a technical term to describe the division of discrete expenses among several functional categories: allocation. Allocation of expenses across functional categories is a means of most accurately representing the total program, administrative, and fundraising expenditures of a nonprofit organization.

Correct allocation of costs to functional categories is important for three reasons. First, nonprofit managers need accurate information about how they are spending their money and how much different activities cost. Because staff salaries are a large portion of expenses for many nonprofit organizations, accounting for time spent on different functional tasks is critical. Executive management teams and boards of directors rely on this information to help plan the strategic future of their organizations. If financial accounting decisions generate bad information, managers may end up making bad decisions. Knowing how much money is spent on fundraising, administration, and programs is an important dimension of responsible management.

Second, research and policy professionals are making strides in mapping and understanding a growing nonprofit sector. Financial documents carry great weight in assessing the scope and dimensions of this sector. If inaccuracies creep in, the resulting picture carries those same inaccuracies. This problem hampers efforts to benchmark nonprofit financial characteristics as well as public policy efforts that rely on objective research.

Third, donors may be misled. Accurate accounting, especially the accurate allocation of functional expenses, matters because financial documents are a primary means by which donors assess whether a particular organization is a worthy recipient of contributions. Although the practice of assessing charities based on their spending in different functional categories (programs, fundraising, administration) is questionable, it is becoming firmly entrenched in the ratings and rankings generated by watchdogs, federated fundraisers, the popular media, researchers, donor-advised funds, foundations, and others with a stake in comparing charities against each other.

Sometimes charities have good reasons to make themselves look a particular way to their publics, even if it means that their accounting is not up to GAAP. In this chapter, I present a brief overview of the current practice of fundraising expense allocation, particularly regarding professional fundraising fees and the treatment of joint education-fundraising appeals. The chapter is presented in four sections. First, I note several resources that shape and guide current accounting policies regarding allocation. Second, I report on how nonprofit organizations are currently reporting professional fundraising fees on Form 990, the annual report required of most charities by the Internal Revenue Service. Third, I discuss the responses to several questions on the allocation of fundraising expenses asked on a recent survey of nonprofit organizations. Fourth, I provide a few concluding observations on the current practices of expense allocation by nonprofit organizations in the United States.

Where to look for the rules

Because most nonprofit organizations file Form 990 each year, and because Form 990 requires nonprofits to report all expenses in the three functional categories described above, most nonprofits have come face to face with the requirements and challenges of expense allocation. The Form 990 instructions, mailed each year to most U.S. charities, give some guidance on allocation. The instructions for Part II say that a “reasonable method of allocation may be used” and that the method of allocation should be documented in the organization’s records. The instructions also give additional guidance on allocation of indirect expenses and the treatment of “joint cost” expenses. Form 990 instructions are a primary point of reference for most nonprofits when the topic of expense allocations arises.

However, some organizations need more guidance, and a variety of printed resources are available that spell out allocation issues in clear language. Accountants and policymakers have spent a lot

of time thinking and writing about this issue. Two places to turn are the American Institute of Certified Public Accountants' (AICPA) *Audit and Accounting Guide for Not-for-Profit Organizations* (2003) and *Not-For-Profit GAAP*, (Larkin and DiTommaso, 2003). Both of these guides give clear explanations and examples for the rules laid out by the Financial Accounting Standards Board, the division of the Financial Accounting Foundation that outlines accounting principles for for-profit and nonprofit organizations. The Financial Accounting Standards Board (1993) issued its statement number 117, which provided a number of guidelines on nonprofit financial accounting, including the allocation of functional expenses. Another guiding document is Circular A-122 (see also A-21 on educational institutions) and its attachments, compiled by the federal Office of Management and Budget (1998). A-122 governs cost principles for nonprofit organizations that receive federal government grants and contracts.

These five resources also discuss a specific issue of cost allocation that is popularly referred to as joint cost allocation. Although any cost that spans functional categories is sometimes referred to as a joint cost, joint cost allocation has come to refer specifically to fundraising appeals that share space with program or administrative content. An example is a mailed flyer that describes the warning signs of breast cancer *and* makes an appeal for contributions to an organization with a mission of fighting breast cancer. The warning signs, as educational material, might legitimately be thought of as a program expense. The appeal, however, cannot legitimately be thought of as anything other than fundraising. Because many nonprofits feel pressure to minimize allocations to fundraising, some use the educational content as an excuse to account for the entire flyer as a program expense. This practice became common enough to catch the attention of policymakers and regulators.

The rules that govern fair allocation of joint costs as fundraising expenses are currently governed by one main document. Whereas the joint cost rules have applied to some kinds of nonprofit organizations since the late 1970s, the AICPA "Statement of Position 98-2" clarified and applied the rules to all public charities in 1998.

According to the statement, expenses of joint cost appeals must be tagged as fundraising unless they pass a series of tests that allow for allocation of part of the expenses to programs or administration. The rules are technical, however, and nonprofits, accountants, and policymakers have wondered how well and how often the rules are applied. Rules on joint cost allocation, like all rules of allocation, are good only if they are followed consistently by the charities to which they apply.

Form 990: Allocation of professional fundraising expenses

Public charities with gross receipts of at least \$25,000 in any given year are required by the IRS to file Form 990. This form is the only documentation of nonprofit finances that is publicly available. Consequently, the information in Form 990 provides the basis for benchmarks and watchdog standards on nonprofit financial performance. Proper benchmarks and proper evaluation of individual charities presupposes that the information provided in Form 990 is accurate, including an accurate allocation of joint cost and other expenses. However, observers have noted a high number of nonprofits that report substantial contributions and no associated fundraising costs. Although some organizations might legitimately report zero fundraising costs, the answer for many lies in misrepresentation of expenses or a lack of understanding about cost accounting rules regarding allocation of expenses. This concern underlies the investigations in the remainder of this chapter.

The statement of functional expenses is in Part II of Form 990, which is page two of the main form. In this part, nonprofits are asked to report program services, management-general, and fundraising expenses for eighteen different categories, with five extra lines for itemizing other expenses. Examples of expense lines are salaries and wages, supplies, printing and publications, and travel.

The line that most explicitly relates to fundraising is line 30, professional fundraising fees. (See Exhibit 3.1.) The instructions

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Exhibit 3.1. Form 990, parts II and III.

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Part II Statement of Functional Expenses		All organizations must complete column (A). Columns (B), (C), and (D) are required for section 501(c)(3) and (4) organizations and section 4947(a)(1) nonexempt charitable trusts but optional for others. (See page 21 of the instructions.)			
Do not include amounts reported on line 6b, 8b, 9b, 10b, or 16 of Part I.		(A) Total	(B) Program services	(C) Management and general	(D) Fundraising
22	Grants and allocations (attach schedule) (cash \$ _____ noncash \$ _____)				
23	Specific assistance to individuals (attach schedule)				
24	Benefits paid to or for members (attach schedule)				
25	Compensation of officers, directors, etc.				
26	Other salaries and wages				
27	Pension plan contributions				
28	Other employee benefits				
29	Payroll taxes				
30	Professional fundraising fees				
31	Accounting fees				
32	Legal fees				
33	Supplies				
34	Telephone				
35	Postage and shipping				
36	Occupancy				
37	Equipment rental and maintenance				
38	Printing and publications				
39	Travel				
40	Conferences, conventions, and meetings				
41	Interest				
42	Depreciation, depletion, etc. (attach schedule)				
43	Other expenses not covered above (itemize): a				
	b				
	c				
	d				
	e				
44	Total functional expenses (add lines 22 through 43). Organizations completing columns (B)-(D), carry these totals to lines 13-15.				

Joint Costs. Check if you are following SOP 98-2. Are any joint costs from a combined educational campaign and fundraising solicitation reported in (B) Program services? **Yes** **No**
 If "Yes," enter (i) the aggregate amount of these joint costs \$ _____; (ii) the amount allocated to Program services \$ _____; (iii) the amount allocated to Management and general \$ _____; and (iv) the amount allocated to Fundraising \$ _____.

Part III Statement of Program Service Accomplishments (See page 24 of the instructions.)

What is the organization's primary exempt purpose? ▶ _____

	Program Service Expenses <small>(Required for 501(c)(3) and (4) orgs. and 4947(a)(1) trusts, but optional for others.)</small>
a	
b	
c	
d	
e	Other program services (attach schedule) (Grants and allocations \$ _____)
f	Total of Program Service Expenses (should equal line 44, column (B), Program services) ▶ _____

Form **990** (2002)

Internal Revenue Service, 2000, p. 2.

specify that nonprofits should enter on this line their fees paid to outside fundraisers who are paid primarily for solicitation campaigns they conducted or for consultation services connected with a solicitation of contributions by the organization itself. Given

these instructions, it is hard to imagine how an organization could think of these expenses as anything other than fundraising. Indeed, before 1997, Form 990 “blacked out” the program services and management-general expenses options, constraining nonprofits to report professional fundraising fees only as a fundraising expense. However, this constraint was removed in the 1997 form. Following a recommendation from the National Association of State Charity Officials’ Quality Reporting Task Force, the IRS allowed for allocation of professional fundraiser fees to program services and management-general.

An evaluation of whether this decision was a good one can be made from a focus on current practices of cost allocation on line 30. Consequently, I reviewed Form 990 information in the NCCS-GuideStar National Nonprofit Research Database (FY2000), housed at the National Center for Charitable Statistics at the Urban Institute in Washington, D.C. I was able to include just over 180,000 public charities that filed Form 990 in 2000. I learned that only about one-third of nonprofits (34 percent) report any fundraising expenses on their 2000 Form 990. Only 5 percent of nonprofits, just over nine thousand organizations, report professional fundraising fees.

How do these nine thousand organizations report these fees across functional categories? Two-thirds (67 percent) fully account for professional fundraising fees as a fundraising expense. However, a little more than one-quarter (26 percent) report *none* of these fees as fundraising expenses, instead reporting them as programs, management-general, or an allocation between these two categories. The remaining seven percent allocate some of the professional fundraising fees to fundraising but also allocate portions to programs or management-general.

If an organization has a legitimate cause to account for professional fundraising fees as something other than fundraising, these causes are probably rare, certainly less than a quarter of nonprofits that engage professional fundraising firms. Although the decision to allow nonprofit organizations to allocate professional fundraising fees to programs and management-general was no doubt made to improve the accuracy of reporting, this policy has

almost certainly had the opposite effect. In the fourth year after allowing nonprofits to report these fees as something other than fundraising, a substantial minority of organizations is improving their illusion of fundraising efficiency by hiding these costs in the non-fundraising categories of functional expenses.

Further explorations from a national survey of nonprofits

These kinds of observations of the reporting of fundraising expenses on Form 990 spurred further investigation of these issues in a national study of nonprofit financial reporting. The “overhead cost study” received 1,540 survey responses from U.S. nonprofit organizations in the fall of 2001 and winter of 2002.

Although fees to professional solicitors and consultation services are combined in line 30 of Form 990, my colleagues and I asked about them separately in the overhead cost study. First, we asked organizations if they had contracted with a professional fundraiser in the most recently completed fiscal year. We defined a professional fundraiser as a person or firm outside of the organization who is paid to actively solicit gifts, including professional or commercial solicitors. Eight percent of respondents answered yes to this question, higher than the 5 percent of nonprofits that reported professional fundraising *or* counsel fees on Form 990 in 2000.

We also asked how organizations report professional fees or commissions on their financial statements. We gave options of fundraising, general or administrative, and program expense and invited respondents to check as many as applied. Because financial statements do not always rely on the same functional categories advocated by GAAP, we also included an “other” category and asked respondents to specify the nature of this category. Several organizations did not answer this question, so the results in Table 3.1 represent the 7 percent of respondents who say they contracted with a professional fundraiser and opted to tell us how they report the expenses.

More than half of the organizations in the study reported professional fundraiser fees exclusively as a fundraising expense. Con-

Table 3.1. How the 7 percent of U.S. charities report their professional fundraiser expenses

<i>Expenses</i>	<i>Percentage</i>
Fundraising only	55
Management or general only	15
Program services only	4
Other only	11
Fundraising and management or general	5
Fundraising and program	2
Fundraising and other	2
Management or general and program	3
Fundraising, management or general, and program	2
Fundraising, program, and other	1

sistent with the findings from the Forms 990, however, a substantial minority reports these fees purely as administrative or program expenses. A substantial number opted out of these functional categories, noting that they categorize professional fundraiser fees as advertising expenses or professional or consultant fees.

Fifteen percent of respondents allocate professional fundraiser fees across multiple categories. In all but 3 percent of cases, one of these categories is fundraising. Given the differences between Form 990 and survey responses, the results of the survey can possibly be thought of as how respondents *believe* their expenses should be classified rather than how they actually are classified. If this is the case, then a substantial number of nonprofits believe that professional fundraiser fees are a fundraising expense. However, given accounting rules and guidelines, a surprisingly high number consider at least a portion of these costs to be something other than fundraising.

In addition, we asked respondents if their organization had contracted with fundraising counsel in the most recently completed fiscal year, with fundraising counsel defined as a person or firm outside of the organization who is hired to advise specifically on fundraising. For this question, 10 percent of respondents answered affirmatively. We similarly asked this group how they report fundraising counsel expenses on their financial statements. Table 3.2 summarizes the responses.

The distribution of responses in Table 3.2 is similar to the distribution of responses for professional fundraiser fees in Table 3.1.

Table 3.2. How the 10 percent of U.S. charities report their professional fundraising counsel expenses

<i>Expenses</i>	<i>Percentage</i>
Fundraising only	51
Management or general only	21
Program services only	4
Other only	10
Fundraising and management or general	6
Fundraising and program	1
Fundraising and other	1
Management or general and program	3
Fundraising, management or general, and program	1
Fundraising, program, and other	1
Management or general, program, and other	1

One difference is that the percentage of organizations that think of fundraising counsel as a pure fundraising expense is a bit lower than the proportion that think of fundraising counsel this way, although the fundraising-only camp is still more than half of the relevant cases. The difference is mostly made up of organizations that think of fundraising counsel as purely an administrative expense, a group constituting one of five cases. The “other” category includes such labels as professional services and capital campaign expenses. Several indicated that fundraising counsel was donated or paid for by others.

Taken together, these two tables largely corroborate the results from the analysis of Forms 990. A substantial minority of nonprofit organizations are accounting for fundraising expenses as program services or administrative expenses, a practice that minimizes their reported fundraising expenses and maximizes their associated fundraising and program efficiency ratios.

As discussed above, a second functional expense item that is clearly tied up with fundraising is the allocation of joint costs. Form 990 asks organizations if they reported any program service expenses from any activities that combined an educational campaign with a fundraising solicitation. Less than 1 percent of filers of year 2000 Form 990 answered yes to this question, about a thousand nonprofit organizations in the entire country. In the overhead

cost study, we asked our survey respondents if their organization combines educational campaigns (or other program activities) with fundraising activities. Over one-quarter of the nonprofits in the study say that they do. For those that answered yes to this question, we asked if their organization allocates portions of the costs to both programs and fundraising. One out of ten organizations was unsure, and just under four in ten say that they do not allocate joint costs across different functional categories. However, just more than half of organizations that say they combine program and fundraising activities also say that they allocate costs across categories of programs and fundraising. In raw numbers, more than 200 of the 1,540 respondents claim joint allocation of costs for fundraising activities that have a programmatic component.

Of course, the Form 990 findings and the survey findings cannot both be true. We know from Forms 990 that few organizations allocate the kinds of joint costs described in AICPA's "Statement of Position 98-2." We interpret the survey findings not so much as how organizations actually account for and allocate their costs but, rather, how they believe that their costs should be allocated given the circumstances of their organization. If this is a reasonable interpretation, then fewer organizations are accounting for joint costs than should be accounting for them. Consequently, contrary to the rules spelled out in "Statement of Position 98-2," many organizations are likely still using educational content in fundraising appeals as a means to account for such appeals as program services rather than fundraising expenses.

Conclusions

In this chapter, I point out two ways in which a substantial number of nonprofit organizations come up short on reporting fundraising expenses. Analysis of both Form 990 data and independent survey data reveals that professional fundraising fees are routinely tagged as non-fundraising expenditures. These data resources also suggest that joint costs between educational materials and fundraising

appeals are not being documented as fundraising in the ways spelled out by current guiding documents. These findings, taken together with other findings regarding the accounting of functional expenses, suggest that America's nonprofit sector is weak on financial accounting. However, if issues of expense allocation do not enter into the daily trappings of most nonprofit organizations, perhaps they can be forgiven for it. After all, nonprofits have enough to think about, and most would rather spend their time focusing on the delivery of quality programs rather than arcane issues of accounting. Also, the rules do not always apply in obvious ways to some nonprofits, where fundraising, communications, education, and strategic planning often mix in the same processes. So, some organizations fail to invest in the details that would cause them to account for and report their transactions according to the letter of the law. Because the costs of misreporting are low, many nonprofits have little incentive to learn the rules that would bring their accounting practices into compliance with GAAP.

For some other nonprofits, though, fudging financial reports is likely due as much to strategy as to ignorance. Savvy nonprofits know that they are judged on how many of their total dollars they can put toward programs, and they know that donors want to believe that a minimum of their contributions is being used for administration and fundraising. So they find ways, some legitimate and some not, to represent as many of their expenses as programmatic expenses as they can. The social costs of such practices are low for most organizations, and the returns can be counted in accolades about efficiency and the dollars that such accolades bring in.

Whether the result of ignorance or strategy, the pervasive misstatement of fundraising costs sets impossible standards for all charities. If the average charity "officially" spends 75 percent of its annual dollars on programs, then honest charities find themselves possibly chasing a goal that they find to be impossible. Punished by donors, they either compromise on administrative costs or find ways to join their colleagues in reporting functional costs in ways that do not measure up to GAAP. They join a circular sys-

tem that produces new benchmarks based on questionable accounting.

Although individual nonprofit organizations win in the short run, the bigger picture points to a variety of losers. As discussed in the introduction, expense allocation to functional categories is an opportunity for nonprofits to faithfully represent how money is spent in nonprofit organizations, an issue that has implications for managers, policymakers, and donors. When individual organizations consistently misaccount for expenses, managers get an unclear picture of the costs of programs and the costs of fundraising. Consequently, they run the risk of making choices about strategic direction that are not in the best interests of the organization. Policymakers, who rely on self-reports of nonprofit organizations, generate research that inherits all the flaws attached to the financial documents they study. Consequently, they run the risk of making public policy decisions that are not in the best interests of the nonprofit sector. Finally, donors make giving decisions based on the limited information they can garner on the efficiency and effectiveness of charities that seek their contributions. Although this creates a game wherein individual charities gain from illusions of financial efficiency, donors run the risk of putting their dollars to work in ways that are not in the best interests of their communities.

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Further Reading

Financial reporting is beginning to attract attention from a variety of nonprofits researchers. Several informative treatments of the topics discussed in this chapter are currently unpublished but available from their authors. Ranjani Krishnan, Michelle Yetman, and Robert Yetman explore the question of how some nonprofit organizations overreport program expenses on Form 990. Their article is titled “Financial Disclosure by Nonprofit Organizations” and is available from Robert Yetman (rjyetman@ucdavis.edu). Andrea Roberts (robertaf@mail1.bc.edu) provides a thorough discussion and analysis of joint cost reporting in “The Implications of Joint Cost Standards on Charity Reporting.”

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