REPORTING FUNDRAISING EXPENSES ON FORM 990

(1) “My foundation received a notice from the IRS stating that the IRS was reviewing the amount of fundraising expenses reported on Form 990. What is this about?”

Several community foundations have recently received “educational” letters from the IRS in connection with the reporting of fundraising expenses on the Form 990. The letter states, “… while your organization reports receiving contribution income, it reports little fundraising expenses in relation to the amount of contributions it receives.” It goes on to state, “… we will be reviewing your next Form 990 to see how you are reporting your fundraising expenses…”

The IRS is referring to Form 990, Part I, lines 13-15 and Part II – Statement of Functional Expenses, lines 22 through 44. All 501(c)(3) entities are required to complete these parts of the Form 990. The IRS Form 990 instructions provide general guidance on completing these portions of the return. Object expenses (e.g., salaries and rent) are required to be classified in three functional expense categories - (1) program services, (2) management and general, and (3) fundraising.

Please note that a response to the IRS “educational” letter is not required. This guidance is provided to assist your foundation in properly classifying its expenses into the three required functional expense categories, with specific emphasis on fundraising.

(2) “What steps does the foundation need to take to ensure that our fundraising expenses are properly stated?”

A review of a community foundation’s functional expenses on its Form 990 should consist of three steps. Financial and accounting personnel should:

1. review those publications that spell out the IRS requirements regarding functional expenses, supplemental guidance prepared by FAOG for complying with those instructions, and the guidance for functionalizing expenses in general-purpose financial statements (as opposed to the IRS form 990) set forth in generally accepted accounting principles (GAAP);
2. familiarize themselves with certain issues involved in the functional classification of expenses that are commonly encountered by community foundations; and
3. review, in some detail, the organization’s methods for determining functional expenses.

(3) “Does the IRS provide instructions for community foundations on how to classify expenses?”

The IRS does provide guidance for classifying expenses by function in the 990 instructions. However, this guidance is limited in scope and may not fully address your questions. The Accounting Practices Committee (APC) has developed the following guidance to supplement the IRS instructions. This guidance is intended to answer questions that are specific to community foundations.

(4) “Is there other authoritative literature available to provide guidance on the functional classification of expenses?”
In addition to the IRS instructions, there are several sources including FASB Statement No. 117, Financial Statements of Not-for-Profit Organizations, (FASB Statement 117) and the AICPA Audit and Accounting Guide, Not-For-Profit Organizations, (The NFP Audit Guide).

FASB Statement 117 requires financial statements to include functional classifications such as major classes of program services and supporting activities. Paragraphs 27 and 28 of this statement provide the following general definitions:

Par. 27 – “Program services are the activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the organization exists.”

Par. 28 – “Supporting activities are all activities of a not-for-profit organization other than program services. Generally, they include management and general, fundraising and membership-development activities.”

“Management and general activities include oversight, business management, general record keeping, budgeting, financing, and related administrative activities except for the direct conduct of program services or fund-raising activities.”

“Fund-raising activities include publicizing and conducting fund-raising campaigns; maintaining donor mailing lists; conducting special fund-raising events; preparing and distributing fund-raising manuals, instructions and other materials; and conducting other activities involved with soliciting contributions from individuals, foundations, government agencies, and others.”

Detailed guidance on how to characterize specific types of expenses and how expenses should be allocated to various functions is not addressed in FASB Statement 117, and, accordingly, is made subject to guidance developed by the AICPA in the NFP Audit Guide and other technical literature.

Sections 13.28 to 13.58 of the May 1, 2004 edition of the NFP Audit Guide include extensive guidance on functional reporting. The following is a summary of key points included in these sections as they relate to functional expenses:

- Since non-profits render different types of services, the nature and number of reporting classifications will vary. For some organizations a single functional reporting classification may be adequate. In most cases several identifiable services are provided and in such cases the expenses for program services should be reported by the kind of service function or group of functions.

- Direct identification of specific expenses is the preferable method of charging expenses to various functions. However, if direct identification is impossible or impracticable, an allocation is appropriate.

- Expenses that relate to more than one program or supporting activity or to a combination of programs and supporting services should be allocated among the appropriate functions. For example:
  - Salaries of persons who perform more than one kind of service.
  - Rent expense of a building used for various programs and supporting activities.
Techniques used to allocate expenses are the same for not-for-profit organizations as for business enterprises. Reasonable allocations of expenses may be made on a variety of bases; the NFP Audit Guide does not require specific methods. However, objective methods of allocating expenses are preferable to subjective methods and allocations may be based on related financial or non-financial data such as square footage of space occupied by each program.

All costs of joint activities that include a fund-raising appeal should be reported as fund-raising expense if it cannot be demonstrated that a program or management and general function has been conducted in conjunction with the appeal for funds. A community foundation that includes an appeal for a gift to cover operational costs with the mailing of their annual report would have a joint activity. The costs of the mailing related to the gift request (a portion of the printing, postage etc.) should be reported as a fundraising expense, the balance would be program and/or management and general. If it cannot be clearly documented that the mailing had a programmatic or management aspect to it, the entire cost would need to be reported as fundraising.

There is also extremely detailed guidance regarding functional expenses in the Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations (i.e., “Black Book”). This guidance, which is published by the National Health Council and National Assembly, is primarily intended for operating charities in the health and welfare areas (e.g., The American Cancer Society and Salvation Army). It does, however, include a chapter on classifying expenses by function and an appendix on methods of expense allocation that accounting professionals in community foundations may find helpful.

(5) What types of expenses are included in each of the functional categories?

**Program Services**

The IRS Form 990 instructions define program services as “those activities that the reporting organization was created to conduct and which . . . form the basis of the organization’s current exemption from tax.”

For community foundations these expenses include costs connected with making grants and scholarships, providing non-grant services (such as philanthropic education or convening activities), and special projects.

**Fundraising**

IRS Form 990 instructions define fundraising expenses as “the total expenses incurred in soliciting contributions, gifts, grants, etc.” The NFP Audit Guide defines fundraising similarly: activities that “involve inducing potential donors to contribute money, securities, services, materials, facilities, other assets, or time.” Form 990 instructions also states “Fundraising expenses should not be reported as program related expenses even though one of the functions of the organization is to solicit contributions for other organizations.”

Development expenses are included in this category. Specific expenses included are:

- Publicizing and conducting fundraising campaigns
- Soliciting bequests
- Soliciting grants from foundations or other organizations
Preparing and distributing fundraising manuals, instructions, and other materials
Conducting special events that generate contributions (excluding the costs of direct donor benefits)
Maintaining donor mailing lists

**Management and General**

Form 990 instructions define management and general expenses as those that benefit the organization as a whole and cannot be assigned to program services or fundraising. The NFP Audit Guide’s definition is similar: “those (expenses) that are not identifiable with a single program, fund-raising activity, or membership-development activity but that are indispensable to the conduct of those activities and to an organization’s existence.”

In general, this category includes expenses of oversight, business management, general record keeping, budgeting, and financing. Specific expenses included are:

- Salaries and expenses of the chief executive officer and that officer’s staff
- Meetings of the board of directors
- Committee and staff meetings (unless held in connection with specific program services or fundraising activities)
- General legal services
- Accounting
- Auditing
- General liability insurance
- Office management
- Personnel administration
- Preparation, publication and distributions of annual report
- Investment expenses
- Costs of disseminating information to inform the public of the organization’s “stewardship” of contributed funds, announcements concerning appointments, and the annual report

If any of the above expenses, in part, relate to either program services or fundraising, the expense should be appropriately allocated as described in question 10.

(6) **How do the functional expense reporting requirements of the IRS differ from those required by GAAP?**

In general, IRS and GAAP requirements for reporting expenses by their functional classification are the same, although GAAP requires more detailed reporting than the IRS. The IRS requires that expenses be classified in one of three categories: program services, management and general or fundraising. GAAP requires more detailed classification. FASB Statement 117 states that “... a statement of activities or notes to financial statements shall provide information about expenses reported by their functional classification such as major classes of program services and supporting activities.” Program services expenses must be reported by the nature of the services provided. If the organization provides separate and identifiable services, program service expenses must be reported for each separate kind of service.

The greatest difference between IRS and GAAP reporting may not arise from the methodology used for classifying expenses by function, but rather, from the different entities included in each
Many community foundations may consist of several related entities, for example, a trust form, a corporate form, and supporting organizations. When these related entities meet specific criteria, GAAP requires that the community foundation prepare a single set of consolidated financial statements. However, except in limited instances, the community foundation must file a separate Form 990 for each legal entity. While in the aggregate the expenses and functional classifications are the same, the reconciliation from the consolidated financial statements to the separate Form 990’s can present some challenges. The differences created by the “entity” issue sometimes gives rise to the absence of fundraising expenses in the 990 report of a related supporting organization – a condition that has triggered the IRS letters as noted in Question & Answer 1.

(7) Our Foundation does not actively solicit funds or hold fundraising events; do we need to classify any expenses as fundraising? If so, what types of expenses should be in this functional category?

If the foundation is not actively soliciting funds or holding fundraising events, at first glance, it may appear that the foundation has no fundraising expenses. However, in most instances, after a thoughtful and deliberate review, one will find that the foundation does in fact have expenses that should be classified as fundraising.

Some foundations may not have dedicated development staff and therefore conclude that they have no fundraising expenses. However, fundraising expenses can be incurred without dedicated staff and without holding “fundraising events”.

Today, most foundations have publications that describe the various products and services that they provide i.e. brochures on how to establish a donor advised fund or how to leave a bequest through the foundation’s legacy society. The expenses associated with the development and production of these brochures should be classified as fundraising expenses.

Several foundations have created professional advisory groups to help with the development of a fundraising strategy and the identification and cultivation of new donors. The cost associated with convening the professional advisory groups should generally be classified as fundraising expenses.

A foundation that is in a start up phase might obtain their initial funding from a grant proposal that was written and submitted to a potential funder. The expenses associated with preparing the proposal should be classified as fundraising expenses, i.e. the portion of the salary of the individual preparing the proposal. If the proposal was written by an outside consultant, the consulting fee should be classified as fundraising.

Many foundations today have development or advancement departments. In addition to providing services to existing donors, a major part of their responsibility is to continue to cultivate these donors so that they will continue to make contributions as well as refer new donors to the foundation. A portion of the salaries, benefits and other related expenses associated with staffing your development or advancement departments should be classified as fundraising.

While some foundations may consider their overall mission to be fundraising and consider these costs to be program related, the IRS, FASB, and the AICPA all have given specific guidance
which prohibits fundraising expenses to be reported as program expenses.

(8) **“Is it possible for a supporting organization to have no fundraising expenses?”**

Yes. As discussed in Question and Answer 6, some foundations have multiple tax reporting entities including supporting organizations. Many supporting organizations do not incur any fundraising expenses either directly or indirectly through their related community foundation. Some examples of supporting organizations that may not have fundraising expenses would be those that have converted from a private foundation or those created by a family or an individual where solicitation of additional contributions is highly unlikely.

This type of supporting organization may note directly on their Form 990 the reason why they did not incur or report any fundraising expenses.

(9) **Should the foundation have concerns that fundraising expenses and gift recognition may not fall within the same fiscal period?**

Fundraising efforts within a community foundation are similar to research and development expenses in a business enterprise; you don’t know when or how they will pay off. Consequently, it is quite common for a community foundation to incur fundraising expenses in one year while the resulting contribution revenue may not be received until some years in the future. A ratio commonly used in evaluating charities calculates the amount of expenses incurred on fundraising during a fiscal or calendar year to the amount of contribution revenue received. If an organization’s contribution revenue is unusually high during a year due to a major gift (e.g., a bequest) that is not expected to recur in future years, the ratio in the year of the bequest will look quite favorable. In comparison, the ratio in the following year will not be as favorable due to the absence of a similar size gift in that year. To some rating or watchdog agencies the change will appear unfavorable, even though the ratio in and of itself is at a reasonable level. To deal with this problem, community foundations should be consistent in applying their classification methodology, actively calculate these ratios and proactively explain unusual fluctuations.

(10) **“Are there instances where an expense(s) of the foundation will relate to more than one functional area?” “If so, how are costs allocated?”**

Some expenses of the foundation will directly relate to and can be assigned to a single functional category. For example, grant expense should be charged directly to Program Services. However, for many community foundations the classification of expenses into the functional categories will not be straightforward. Many of the expenses will relate to more than one function and require that the expense be allocated among the appropriate functional categories. Salaries and occupancy cost are prime examples of expenses that usually will relate to more than one functional category. For example, the salary of the vice president of finance will generally be allocated across the three functional categories. The obvious allocation would be to management and general. However, many vice presidents of finance also assist the development staff with structuring new gifts and meeting with new and or potential donors. In addition, they may provide assistance in the program area, i.e. assist with the review of complex grant proposals.

In instances where expenses can be specifically identified with a function, the expense should be assigned to that functional category. For example, travel costs incurred by program staff during the evaluation of a grant proposal should be charged to program services.
However, many expenses of the foundation will require an allocation technique because direct identification is impossible or impracticable. A variety of allocation methods are available. Objective methods of allocating expenses are preferable to subjective methods. The cost allocation methodology used should be rational and systematic, it should result in an allocation of joint cost that is reasonable, and it should be applied consistently given similar facts and circumstances.

The allocation may be based on related financial or nonfinancial data. For example expenses associated with occupancy cost, i.e. rent, insurance, depreciation, utilities, and maintenance, can be allocated based the actual square footage occupied by the various programs/functions of the organization (objective) or an estimate of the square footage occupied by the various programs (subjective).

Salaries and benefits can be allocated based on actual time records (objective) or based on managements’ estimates of how staff time is utilized (subjective).

In instances where the foundation may incur joint costs, for example, where fundraising activities are conducted with activities related to other functions, such as program activities or management and general activities, the joint costs should be allocated between the functional categories.

(11) Are there instances where expenses are allocated across related organizations that file separate Form 990’s? How is proper allocation achieved?

There may be instances where expenses are paid by one legal entity and shared with a second, related entity through an administrative fee or some other means of reimbursement or assessment. The instructions for Form 990 provide no clear guidance on the proper mechanics to reflect this allocation.

The related entity that is being assessed an administrative fee should use the direct and indirect allocation methods described above and allocated the fee between program services, management and general, and fundraising. If it is not possible to determine a reasonable allocation, it may be appropriate to use the allocation percentages of the Supported Organization or the “Parent Company” which assessed the fee. The administrative fee can be reflected on the blank lines of 43b through 43e of Part II of Form 990.

Alternatively, some foundations allocate the object expenses (i.e. salaries and rent) directly to the supporting organization and the expenses are displayed on lines 22 – 42 of Part II of Form 990. Again, the expenses should be allocated between program services, management and general, and fundraising using the direct and indirect allocation methods described above.

(12) How should the foundation document its classification of expenses by function?

Form 990 instructions do not specify what documentation an organization should maintain to support how it classifies expenses. However, the instructions do make clear that the method used to allocate expenses should be documented in an organization’s records.

Documentation should include:
Expenses that are directly assigned to functional expenses categories
Explanation of the allocation method(s) used for classifying
expenses that relate to more than one functional classification
The organization’s rational for selecting the allocation method(s)
Worksheets showing actual calculations used to allocate the expenses

In addition to documenting the process, management should evaluate the expense allocation methods periodically. The allocation methods should be reviewed and revised when necessary to reflect significant changes in the nature or level of the organization’s current activities. The evaluation may include a review of the time records, the use of space, and the consumption of supplies and postage.

Prepared by the accounting Practices Committee of the Community Foundation's Fiscal and Administrative Officers Group

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