THE QUALITY AND RELIABILITY OF FORM 990 DATA: ARE USERS BEING MISLED

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ABSTRACT

IRS Form 990 is the primary instrument for public accountability by tax-exempt organizations and its data are used not only by the IRS, but also by donors, grant-makers, watchdog agencies, the media, sector advocates, State Attorneys General, and local taxing authorities. Many argue, however, that the form is a poor vehicle for clear reporting of financial information and that its data are often inaccurate and misleading. To assess the quality and reliability of the Form 990 data, we compare the financial disclosures on the form with those in audited financial statements for 39 environmental organizations over their three most recent fiscal years ending in 2000. This comparison reveals numerous problems with the Form 990 data, including inconsistencies in revenue and expense recognition, incongruities between the reporting of gains and losses on investments and portfolio holdings, misstatements of functional expenses, discrepancies in the disclosure of program services, and errors attributable to differences in IRS Form 990 rules and not-for-profit GAAP. The usefulness of the data is further compromised by filings that are often one or two years out of date. Employment of an outside preparer, such as a major CPA firm, does not mitigate these reporting problems.

INTRODUCTION

No longer a mere information return filed with the IRS, Form 990 (Return of Organization Exempt From Income Tax) has become one of the most important financial reporting, marketing and public relations documents for tax-exempt organizations. With the widespread availability of the form on the Internet at the websites of GuideStar and the National Center for Charitable Statistics (NCCS), Form 990 is the primary instrument for public accountability by nonprofits, used for public policy purposes, comparative statistics for governance and management, sector advocacy, research, and marketing products and services by and to the sector (Quality 990, 2005b). Data on the form are used by donors, grant-makers, watchdog agencies, the media, and sector advocates. Additionally, the form is used by the IRS, State Attorneys General, and local taxing authorities in determining whether exempt organizations are in compliance with applicable laws and regulations.

Some members of the public rely on the IRS Form 990 as the primary or sole source of information about a particular organization. How the public perceives an organization in such cases may be determined by the information presented on its IRS Form 990 (Washington Secretary of State, 2005). In addition, many donors look first to page 1 of the IRS Form 990 in order to calculate the use of funds ratio; that is what part of a charity's expenses goes toward its actual services, versus how much goes to fundraising and general management of the organization (Charities Review Council, 2005). The significance of funds ratios is well documented in the Not-For-Profit literature. The Form 990 is also a crucial document in academic research. See Gronbjerg (2002) for the role of 990 in Nonprofit databases.

Unified Financial Reporting System for Not-for-Profit Organizations (2005) outlines five key roles the IRS Form 990 plays in Financial Reporting. First, Form 990 must be filed if a not-for-profit organization wants to retain its tax-exempt status. Second, Form 990 serves as the basic annual report to over thirty-five state charities offices. Third, Form 990 serves as the fundamental data source for not-for-profit sector research, and it provides data in a relatively uniform, consistent format. Fourth, the 990 provides information not found in audited financial statements of not-for-profit organizations. It covers both qualitative and quantitative data and, when prepared accurately, completely, and truthfully, is a treasure trove of information. Finally, Form 990 is a public report and potentially a powerful means of ensuring and demonstrating accountability. Not only must not-for-profit organizations file this report with the IRS, but they are also required to make it available to anyone who demands to see it. According to Froelich (1998), the 990 is becoming one of the most important sources of information about nonprofit organizations today, due to a combination of factors that include 1) regulatory and oversight groups, including the media, using 990 information to examine the potentially sensitive areas of management and fundraising expenses and the proportion of funds generated by fees or other commercial activity, 2) Financial information on the 990 being used by researchers who need numerical measures for their statistical studies, 3) Foundations and other grant-making bodies using entries from the 990 return as they strive to develop objective, defensible rationales for awarding scarce dollars, and 4) Many people find 990 returns more useful than annual financial statements, which are not public documents and must be obtained directly from each individual organization.

Despite the importance of Form 990, most exempt organizations consider its preparation to be a chore deserving of little time or resources (Quality 990, 2005a). This lack of priority can possibly explain the findings of several studies regarding errors or omissions in the form data. For example, a study by Moore and Williams (1998) found that 52 percent of Forms 990 containing errors failed to complete Schedule A, 17 percent did not have the signature of an officer, and 10 percent did not list the correct tax year. Similar errors appeared on Forms 990EZ and 15 percent of Form 990EZ filers should have filed Form 990. Another study by McLean et al. (1999) found that

18 percent of Forms 990 contained errors, 55 percent did not provide the required detail on key employee compensation, and 67 percent of those reporting depreciation expenses did not attach the required schedule. The study also found that incomplete or careless reporting was not restricted to small organizations – exempts with more than $10 million in revenue averaged 1.10 errors per form as compared to an error rate of .77 per return for all Form 990 filers.

Given the disturbing statistics regarding the accuracy and completeness of the Form 990 data, one might reasonably wonder why users do not instead rely on the disclosures in audited financial statements. Audited financial statements provide comprehensive financial information and offer the highest level of assurance by independent auditors. They contain reliable, comparable information useful in assessing an organization's objectives, strategies, activities, and achievements (Keating and Frumkin, 2003). But because many exempt organizations are either not required to have their financial statements audited or are not required to provide copies of their audited financial statements, statement users are typically limited to only the largest donors, grant-makers, partners, and suppliers. Many other users are limited to using the more readily available Form 990. Exempt organizations, other than federal agencies, religious bodies, organizations with gross receipts less than $25,000, and private foundations, are required by law to make their last three IRS filings available either upon request or widely accessible through other means. No similar requirement exists for financial statements.

Amid this frequent substitution of Form 990 data for that of audited financial statements is a growing concern that users are being given the mistaken impression that the form offers a fair presentation of an organization's financial results and that its data can be relied upon when assessing and comparing the performance of different exempt entities (Prives, 2000; Wing and Hager, 2004). Largely in response to this concern, the AICPA (2004), National Association of State Charity Officials (2004), NCCS (2003), and National Council of Nonprofit Associations (2004) have called for substantial revisions to the form and the IRS is considering new reporting requirements (IRS, 2004a; IRS, 2004b). Additionally, both the Better Business Bureau Wise Giving Alliance (2003) and the Finance Committee of the U.S. Senate (2004) have recommended that Form 990 be reviewed by independent auditors and that audits of the financial statements be required for exempt organizations with over $250,000 of gross receipts.

This study assesses the quality and reliability of the Form 990 data by comparing it to the financial disclosures in audited statements for a sample of 39 environmental organizations using their most recent three fiscal years ending in 2000. The study differs from prior research in this area that has looked for gross errors in Form 990 preparation, (e.g., Abramson, 1995; Froelich 1997; McLean et al., 1999) concentrating primarily on missing information, math errors, failure to have proper party sign, omission of a schedule, wrong fiscal year, etc. Another stream of research has compared figures from IRS data sets derived from 990 returns to other data sets (Gantz, 1999), information collected from the tax-exempt organization (Froelich and Knoepfle, 1996), or financial statements (Froelich et al., 2000; Fischer et al., 2002). This paper is the first to identify the reasons for the differences in the reported numbers. In addition, by analyzing the revenue and expense reconciliations on Form 990 and tracing reconciling items to the financial statements, this study provides insight with respect to the incidence of systematic differences between not-for-profit GAAP and IRS Form 990 reporting rules. Our paper reports explanations for these differences while earlier studies have simply reported that differences exist.

Similar to earlier studies, our analysis reveals several problems with the Form 990 data, including incomplete preparation and failure to comply with Form 990 instructions. However, we also find inconsistencies in revenue and expense recognition, incongruities between the reporting of gains and losses on investments and portfolio holdings, misstatements of functional expenses, discrepancies in the disclosure of program services, and errors attributable to differences in IRS Form 990 rules and not-for-profit GAAP. Taken together, these reporting problems suggest that Form 990 users may be misled if they believe the data are a substitute for that in audited financial statements or if they lack a clear understanding of the data's limitations. Further, they are likely to reach erroneous conclusions if they attempt to compare the financial performance of different exempt organizations or calculate assessment measures solely on the basis of Form 990 data. The usefulness of the data is also compromised by filings that are one or more years out of date, and employment of an outside preparer does not mitigate the reporting problems.

DIFFERENCES IN TAX REPORTING AND GAAP

Form 990 was designed primarily to be used by the IRS and state charity regulators to ensure that organizations are not spending their funds in a way that might cause them to lose their charitable, tax-exempt status. Because the filing requirements are based on the concept of "gross receipts," revenue is presented in considerable detail by source. In addition, certain types of revenues, such as from sales of merchandise, special events, and rental activities, are netted against related expenses, rather than being reported as separate revenue and expense components as under GAAP. (For example, the value of a dinner received by a donor at a fundraising event is reported separately on Form 990 from the amount of the contribution in excess of the dinner's value, and the exempt organization's cost of the dinner is reported as an expense against the dinner portion of the contribution. Likewise, rental expenses such as interest, maintenance, and depreciation are reported as deductions against the rental revenue received from investment property). This detailed breakdown of revenues and expenses is important for informational purposes in documenting the public support criteria used to distinguish public tax-exempt organizations from private foundations.

The same level of detailed reporting, however, is rarely found in audited financial statements, making the reliability of the Form 990 data difficult to assess. Disclosure differences also often lead to the use of estimates in the Form 990 data since the accounting systems of many not-for-profit organizations are designed to track only those items reported in the audited financial statements, or alternatively, the Form 990 is prepared on the basis of information in the audited financial statements (Froelich et al., 2000).

Other key differences in disclosure on Form 990 include mission and program services, compensation, subsidiary ownership, lobbying and political activities, and certain types of transfers or transactions. For example, Form 990 requires exempt organizations to report the compensation of officers, directors, trustees, and key employees. Schedule A further requires disclosure of the compensation of the five highest paid employees (other than officers, directors, and trustees) and the five highest paid independent contractors for professional services (if more than $50,000). Questions on other parts of the form and associated schedules serve as indicators of potentially inappropriate activities.

In contrast, audited financial statements require greater disclosure of accounting methods and principles, revenues and expenditures associated with restricted funds, the amounts, timing and conditions associated with such funds, and the basis for allocating joint costs to program activities rather than to administrative or fundraising activities. Audited financial statements also require inclusion of a statement of cash flow and, in the case of voluntary health and welfare organizations, a statement of functional expenses. For IRS informational reporting purposes, only an abbreviated statement of functional expenses is required.

Despite their differences in certain disclosures, the accounting practices of Form 990 and audited financial statements are remarkably similar, largely because Form 990 was revised in response to the major changes in not-for-profit accounting and reporting embodied in SFAS Nos. 116, 117, and 124 (FASB, 1993a, 1993b, 1995). However, two major differences still exist. First, under IRS guidelines, donated services and use of facilities are not included in contributions on Form 990, although amounts may be reported in other sections of the return. In comparison, SFAS No. 116 allows for the recognition of donated services when the services create or enhance nonfinancial assets or involve specialized skills that would need to be purchased if not provided by donation. Additionally, SFAS No. 116 requires the free use of facilities to be recognized as both revenue and expense in the period received and used.

A second major difference involves accounting for most investments in equity and debt securities. SFAS No. 124 requires such investments to be measured at fair value and the resultant change in value from one period to the next (e.g., unrealized gain or loss) reported as an item of revenue. Form 990, however, allows only realized gains and losses to be included in revenue.

Other differences between Form 990 and audited financial statements may be attributable to differences in interpretation or reporting practices within particular NTEE-CC categories (the National Taxonomy of Exempt Entities - Core Codes (NTEE-CC) are used by the IRS and others to classify not-for-profit organizations into categories sharing similar activities or program missions. The codes were developed by the NCCS). Expenses for colleges, universities, hospitals, and similar organizations, for example, historically are classified according to functional categories such as instruction, research, public service and institutional support. In contrast, most other not-for-profit organizations report both natural and functional expense categories, generally with the functional expense categories presented on the statement of activities and the natural expense categories reported in the notes or on a statement of functional expense. Form 990 recognizes these differences and allows for the use of indirect cost allocations for certain types of entities and alternative classifications of certain items. Likewise, not-for-profit GAAP accommodates a variety of reporting formats. But with this flexibility comes a measure of incomparability, even for those organizations operating within the same NTEE-CC categories. Table 1 summarizes the principal differences in disclosure and accounting requirements for Form 990 and audited financial statements.

Table 1: Differences in Disclosure and Accounting Requirements for Form 990 and Audited Financial Statements

	Form 990	Audited Financial Statements
General Disclosures		
Entity description	Not required	Required
Mission and program services	Required	Optional
Compensation of officers, directors, trustees, employees and independent contractors	Required	Not required
Compliance with legal requirements	Required	Not required
Ownership of taxable subsidiaries	Required	Not required
Type of audited opinion	Not required	Required
Accounting Disclosures		
Accounting methods	Required	Required
Accounting principles	Not required	Required
Cash flow statement	Not required	Required
Functional expense statement	Required	Required for voluntary health and welfare organizations; recommended for others
Revenues and expenditures associated with restricted funds	Not required	Required
Amounts, timing, and conditions associated with restricted funds	Not required	Required
Basis for allocating joint costs	Not required	Required

Table 1: Differences in Disclosure and Accounting Requirements for Form 990 and Audited Financial Statements		
	Form 990	**Audited Financial Statements**
Accounting Practices		
Netting of certain revenues and expenses	Required	Allowed only for incidental activities
Recognition of donated services and use of facilities	Not allowed other than for supplemental reporting	Allowed for certain contributions
Recognition of unrealized gains and losses on investments	Not allowed	Required

METHODOLOGY

Sample

To minimize reporting differences across organizations in different NTEE-CC categories, the sample selected for this study was restricted to environmental organizations. Within this category, 31 organizations were rated by the National Charities Information Bureau (NCIB) in May, 2000. (Seven of the 31 organizations also were rated by the Better Business Bureau Philanthropic Advisory Service (PAS) and 16 had Forms 990 available on the GuideStar website. The overlap in coverage by NCIB and PAS is one of the reasons for the recent merger of the two rating organizations into the Better Business Bureau Wise Giving Alliance. The GuideStar website is sponsored by Philanthropic Research, Inc. and it does not employ a rating system). An additional 16 environmental organizations were randomly selected by searching the GuideStar database for organizations with revenues in excess of $1 million.

Letters were sent to the 47 selected organizations requesting annual reports and Form 990 for the three most recent fiscal years. The letter asked that an audited financial statement, if not included in the annual report, also be sent for the same periods. A check for $10 was included with the request to help defray the costs of providing the information. Non-responding organizations were sent follow-up letters and/or emails bimonthly, resulting in a total of 108 letters and email messages.

Responses were received from 44 of the 47 organizations. Ten of these organizations provided annual reports, audited financial statements, and Forms 990 in response to the first letter. Thirteen organizations provided all of the requested information after a second letter, while 16 organizations required more than two letters and/or emails. The remaining five organizations provided incomplete data and were not included in the study. Although the request asked for documents for the three most recent fiscal years, many of those received were one or more years outside that time range. The final sample, therefore, consisted of 106 observations for 39 organizations: three observations for fiscal years ending in 2000, 38 observations for 1999, 36 observations for 1998, and 29 observations for years ending in 1997. The final sample of 39 organizations was comprised of 27 organizations rated by NCIB and 12 non-rated organizations. It took an average of 2.52 letters to get information from the rated organizations as compared to 2.08 letters from the non-rated organizations.

Across the 39 sample organizations considerable diversity existed, both with respect to size and operations. For example, total assets ranged from $422,000 to $2.4 billion and revenues ranged from $745,000 to $775 million. On average, contributions provided 79 percent of total revenues, but non-governmental contributions provided as little as 23 percent or as much as 98 percent. Philanthropic missions ranged from the preservation of specific forms of wildlife, plants, or forests to conservation and environmental advocacy. Operations spanned regional, national and international dimensions. Table 2 provides descriptive data on the 39 sample organizations. Appendix A lists the organizations by name.

Procedures

To assess the quality and reliability of the Form 990 data, the financial disclosures on the Forms 990 of the 39 sample organizations were compared with those in the audited financial statements. Before beginning the comparison, a draft instrument and set of procedures to facilitate consistent data collection and coding were developed. This instrument was then tested by scoring one year's data for five of the sample organizations. Revisions were made to the instrument by adding variables and clarifying instructions so as to improve consistency among scorers. For nonquantitative items, a binary coding system was employed: an item received a score of "1" if it was present and otherwise a score of "0." Other items were scored by dollar or percentage amounts. To ensure consistency, each organization's data were scored by multiple researchers and these scores were subsequently spot checked by a different researcher. Any discrepancies in coding or data collection were resolved by consulting the original Forms 990 and audited financial statements.

RESULTS

Twenty-four financial variables reported on Form 990 were compared to the financial data in the audited financial statements. Table 3 shows the comparison of key variables from the statement of financial position (Balance Sheet, Part IV of Form 990) and Table 4 shows a similar comparison of selected variables from the statement of activities (Revenue, Expenses, and Changes in Net Assets or Fund Balances, Part I of Form 990, and Statement of Functional Expenses, Part II of Form 990). Examination of the differences between the Form 990 data and that in the audited financial statements revealed no significant variation by year.

TABLE 2
Characteristics of Sample Organizations[a]

Panel A	Count	Percent
Type of Mission		
Advocacy and legal	8	20.5%
Parks and preserves	6	15.4
Specific wildlife	6	15.4
General wildlife	6	15.4
Rivers and aquatic habitat	5	12.8
Specific plants and forests	5	12.8
Sustainable development	3	7.7
	39	100.0%
Breath of Operations		
Regional	3	7.7%
National	17	43.6
International	19	48.7
	39	100.0%

Panel B	Mean	Standard Deviation	Minimum	Maximum
Financial Data[b]				
Total assets	$114,200	$379,856	$422	$2,366,673
Total liabilities	15,003	36,475	0	183,249
Unrestricted net assets	70,368	289,498	13	1,807,883
Temporarily restricted net assets	17,463	37,565	0	203,794
Permanently restricted net assets	11,366	34,264	0	171,747
Total revenues	49,030	125,913	745	774,912
Total expenses	30,267	62,500	889	362,194
Utilization of Assets				
Investments to total assets	4.9%	4.5%	0.0%	21.0%
Net plant, property and equipment to total assets	12.9	15.4	0.0	53.0
Permanently restricted net assets to total assets	9.7	15.1	0.0	82.0
Sources of revenue				
Government grants and Contributions	9.7%	16.6%	0.0%	56.0%
Other contributions	69.5	22.7	23.0	98.0
Investment income	9.5	16.7	1.0	96.0
Other revenues	11.3	24.0	-83.0	58.0
Expense ratios				
Program expense	80.4%	7.8%	60.0%	96.0%
Management and general	8.7	5.1	2.0	28.0
Fundraising	10.9	7.4	1.0	32.0

[a] Sample characteristics are for the most recent fiscal year.
[b] All dollar amounts are in thousands.

Balance Sheet

Given that many organizations prepare their Form 990 using data from the audited financial statements (Froelich and Knoepfle, 1996) it was expected that the balance sheet amounts for total assets, liabilities and net assets on the form would agree with that in the financial statements unless the organization was part of a consolidated or combined group. The results confirmed this expectation, with 89 returns (84 percent) reporting the same amount for ending total assets, 96 returns (90.6 percent) reporting the same total liabilities, and 91 returns (85.8 percent) reporting the same total net assets. The number of returns with differences in one or more of these amounts was under 14 percent and the size of most differences was less than one percent.

Analysis of the differences between the Form 990 and audited financial statements revealed that eight returns (7.5 percent) reported smaller amounts of total assets, liabilities and/or net assets on the form than in the statements because they were part of a group that consolidated or combined its financial reporting, while filing separately with the IRS (Table 5, Panel A). The inclusion of the terms "consolidated" or "combined" in the title of the audited financial statements did not necessarily indicate that the statements would fail to match the Forms 990. Eleven of the 19 consolidated or combined financial statements reported total assets, liabilities and net assets that agreed with the Forms 990. When the financial statements did not include a "consolidated" or "combined" designation, 78 of 87 statements reported total assets, liabilities and net assets that matched the Forms 990. Unexplained differences in the balance sheet totals, therefore, existed on only nine returns (8.5 percent).

Comparison of other balance sheet accounts (Table 3) showed similar correspondence, with 88 returns (83 percent) or more reporting the same amounts on the Form 990 and audited financial statements. Two exceptions to this high rate of correspondence were the amounts reported for net pledges receivable and investments. Variation in the first of these, net pledges receivable, most often appeared to be the result of reporting grants receivable as either a separate receivable or as a component of the pledged amount. Similarly, the variation in the amount reported for investments generally resulted from differences in the classification of temporary investments, security investments, property investments, other investments, and other assets. In contrast to the variation in the amounts reported for these two accounts, the amount reported as the allowance for doubtful pledges agreed on 103 returns (97.2 percent), largely because most organizations did not provide for uncollectible pledges. For the most recent year's reports, 12 organizations (30.8 percent) stated that no provision for uncollectible pledges was required and eight (20.5 percent) disclosed non-zero amounts. The remaining 19 organizations (48.7 percent) did not discuss the issue or otherwise provide for uncollectible pledges.

TABLE 5
Analysis of Differences Between Form 990 and Audited Financial Statements

Panel A – Statement of Financial Position	Count	Percent
Balance Sheet Totals		
Match	89	84.0%
No match because entities are consolidated in financial statements but reported separately on Form 990	8	7.5
No match with no explanation	9	8.5
	106	100.0%
Panel B – Total Revenues		
Revenue Reconciliation		
Part IV-A reconciliation corresponds with financial statements	86	81.2%
Part IV-A reconciliation completed, but does not correspond to financial statements because entities are part of a consolidated or combined group	8	7.5
Part IV-A reconciliation completed, but does not correspond to financial statements	8	7.5
Part IV-A reconciliation not completed	4	3.8
	106	100.0%
Nature of Reconciling Revenue Items		
Unrealized gains on investments	74	42.1%
Donated services and use of facilities	35	19.9
Investment expenses	4	2.3
Rental expenses	9	5.1
Cost of goods sold	18	10.2
Fair value and other adjustments for split interest agreements	8	4.5
Other	28	15.9
	176	100.0%

TABLE 5 (continued)
Analysis of Differences Between Form 990 and Audited Financial Statements

Panel C – Total Expenses	Count	Percent
Expense Reconciliation		
Part IV-B reconciliation corresponds with financial statements	94	88.7%
Part IV-B reconciliation completed, but does not correspond to financial statements because entities are part of a consolidated or combined group	7	6.6
Part IV-B reconciliation completed, but does not correspond to financial statements	1	0.9
Part IV-B reconciliation not completed	4	3.8
	106	100.0%
Nature of Reconciling Expense Items		
Unrealized losses on investments	2	2.2%
Donated services and use of facilities	36	39.1
Investment expenses	4	4.3
Rental expenses	9	9.8
Cost of goods sold	18	19.6
Other	23	25.0
	92	100.0%
Returns reporting expense differences	63	59.4%
Average number of reconciling items per entity reporting differences	1.5	

Panel D – Unrealized Gain/Loss on Investments	Count	Percent
Proper treatment	68	64.1
No investments	9	8.5
Error	29	27.4
	106	100.0%
Nature of Reporting Errors for Gain/Loss on Investments		
Included unrealized gain/loss in investment income on Form 990	7	24.2%
Included unrealized gain/loss in realized gain/loss on Form 990	3	10.4
Treated total gain/loss as unrealized gain/loss on Form 990	4	13.8
No unrealized gain/loss reported on Form 990, but reported in audited financial statements	5	17.2
No gain/loss reported on Form 990 or audited financial statements, but maintains portfolio of investments	5	17.2
Other	5	17.2
	29	100.0%

TABLE 5 (continued)
Analysis of Differences Between Form 990 and Audited Financial Statements

Panel E – Change in Net Assets	Count	Percent
Match	78	73.6%
No match because entities are consolidated in financial statements but reported separately on Form 990	8	7.6
No match because prior period adjustment on Form 990	6	5.7
No match because of change in fiscal year	1	0.9
No match because of payments to affiliates	1	0.9
No match with no explanation	12	11.3
	106	100.0%

Panel F – Functional Expenses	Count	Percent
Program Services, Management and Fundraising		
Match for 3	38	35.8%
Match for 2	20	18.9
Match for 1	7	6.6
No match	41	38.7
	106	100.0%
Four Largest Program Service Expenses[a]		
Match for 4	31	29.2%
Match for 1 or more	34	32.1
No match	41	38.7
	106	100.0%
Four Largest Program Service Categories[b]		
Match for 4	58	54.7%
Match for 1 or more	11	10.4
No match	37	34.9
	106	100.0%
Joint Cost Allocation		
Match	102	96.2%
No match	4	3.8
	106	100.0%

[a] Comparison considers both dollar amount and program service description.

[b] Comparison considers only program service description without respect to dollar amount.

Revenues, Expenses, and Change in Net Assets

Correspondence between the amounts reported on the Form 990 and audited financial statements for total revenues, expenses and change in net assets (Table 4) was considerably lower than for the balance sheet amounts, a finding that is consistent with Froelich et al. (2000). Many of the differences, however, were attributable to the earlier discussed difference in presentation, by which certain costs are reported as deductions from revenue on the Form 990 while under GAAP they are presented as separate expense components.

With respect to specific sources of revenue, a surprising lack of correspondence between the Form 990 and audited financial statements was found in the reporting of nongovernment contributions. In part this lack of correspondence was attributable to missing data, in that 31 of the audited financial statements did not distinguish between government and nongovernment contributions. Our coding scheme classified the contributions reported on these statements as nongovernment while indicating that data on government contributions were missing. This classification consequently led to the high number of returns missing data on government contributions, as well as the large number of returns showing smaller nongovernment contributions on the Form 990 than the audited financial statements.

A similar problem existed with the reporting and coding of gains and losses on investments. Since SFAS No. 124 does not require separate disclosure of realized and unrealized gains and losses on investments, such amounts were combined on 37 of the audited financial statements. Unless the amounts were desegregated in the notes to the statements, our coding scheme classified the total gain or loss as unrealized while indicating that data on realized gains and losses were missing.

Data were also missing on many of the financial statements for grants and salaries. But unlike the missing data on realized gains and losses or government contributions, the omissions were not due to the coding scheme but rather the fact that the source of this data is the statement of functional expenses and SFAS No. 117 does not require such a statement except for voluntary health and welfare organizations. Although 31 organizations (80 percent) voluntarily provided the statement, its format tended to combine salaries with other fringe benefits and to aggregate grants to affiliated and nonaffiliated entities, leading to a prevalence of overstatements of 10 percent or more on the audited financial statements as compared to the Form 990.

Part IV-A of the Form 990 requires organizations to reconcile the revenue reported on the form with that reported in the audited financial statements. As shown in Table 5, Panel B, Part IV-A was completed on 102 returns (96.2 percent) and on 86 of these returns the reconciliation corresponded with the audited financial statements. For the most recent year's reports, 12 organizations (30.8 percent) stated that no provision for uncollectible pledges was required and eight (20.5 percent) disclosed non-zero amounts. The remaining 19 organizations (48.7 percent) did not discuss the issue or otherwise provide for uncollectible pledges. The reconciliations on another eight returns did not correspond with the audited financial statements because the organizations were part of a group that consolidated or combined its financial statement reporting. Among the most commonly reported reconciling revenue items were unrealized gains on investments and donated services and use of facilities. Other items, such as cost of goods sold, rental expenses, and investment expenses represented costs netted against revenues on the Form 990, but reported as expenses in the audited financial statements. Not all organizations started the Form 990 reconciliation with "total revenue, gains, and other support per audited financial statements" as required by the IRS instructions. Instead, some started with "total unrestricted revenue," "operating revenue," or similar measures. Regardless of the starting measure, a return was considered to be properly reconciled if both the starting and ending numbers matched numbers reported in the financial statements and Form 990.

Part IV-B of the Form 990 requires a similar reconciliation of the expenses reported on the form with that reported in the audited financial statements (Table 5, Panel C). As with the revenue reconciliation, Part IV-B was not completed on four returns (3.8 percent). However, of the remaining returns, 94 of the reconciliations corresponded with the audited financial statements, seven did not correspond because the organizations were part of a consolidated or combined group, and one did not correspond for unexplained reasons (nineteen returns indicated that they were part of a consolidated or combined group. Of these, eight contained reconciliation differences between the Form 990 and audited financial statements with respect to balance sheet totals, revenues and change in net assets, whereas only seven contained reconciliation differences with respect to expenses). Reconciling expense items generally were the flip-side of the reconciling revenue items, although one return erroneously reported donated services as a reconciling revenue item attributable to unrealized gain on investments while properly classifying it as an in-kind contribution on the Form 990 expense reconciliation. Donated services, including the free use of facilities, can be recognized as both revenue and expense on the statement of activities if specific criteria in SFAS No. 116 are met. These amounts, however, must be backed out of revenue and expense on Form 990. For the most recent year's reports, 25 of the 39 organizations reported receiving in-kind contributions (Form 990, Part VI, Line 82a) but only 11 supplied an optional dollar amount (Form 990, Part VI, Line 82b), while 16 reported in the notes to their financial statements the amount they had recognized as in-kind contributions.

Because Form 990 and SFAS No. 124 differ in their treatment of unrealized gains and losses on investments, a separate analysis of this item was conducted. As shown in Panel D of Table 5, 68 of the 97 returns with investments treated unrealized gains and losses correctly. Errors in reporting were identified on 29 of the returns and appeared to be attributable, in part, to the fact that SFAS No. 124 only requires not-for-profit organizations to report the total gain or loss on investments, rather than separating realized from unrealized amounts. The most common error on the Form 990 was to include unrealized gains or losses as income from dividends or interest. Incongruities between the Form 990 data and that in the audited financial statements were also observed, with 10 returns reporting no gains or losses on the form despite differing information on their financial statements.

Other errors included reporting the total gain or loss as unrealized or, conversely, reporting the total gain or loss as fully realized through sale of investments.

One frequent measure of an organization's financial health is the change in its net assets. A growing surplus typically suggests a strong financial position, whereas a decline in net assets or a growing deficit may indicate that the organization is facing financial difficulty. Table 5, Panel E, shows that of the 106 sample returns, 78 (73.6 percent) agreed with the audited financial statements in the reporting of the total change in net assets. Eight returns did not agree because they were part of a consolidated or combined group, six differed because of prior period adjustments, one differed due to a change in fiscal year, and another because of payments to affiliated organizations. Reasons for the difference in the amounts reported on the 12 remaining returns were not apparent from examination of either the Form 990 or audited financial statements.

Functional Expenses

Many donors, grant-makers, and other philanthropic sponsors are interested in the proportion of expenses dedicated to providing programs that fulfill an organization's mission. Additionally, watchdog agencies like the Better Business Bureau Wise Giving Alliance and the American Institute of Philanthropy have standards as to the minimum percent of expenses that should go toward performing program services and the maximum percent that should be spent on fundraising. Exempt organizations therefore face incentives to report high program services and low fundraising expenses.

Comparison of the functional expenses reported on the Form 990 and audited financial statements revealed a large number of differences, with 45 returns (42.5 percent) reporting higher program services on the Form 990 than the audited financial statement and 16 (15.1) of these returns overstating the amount by 10 percent or more (Table 4). Correspondingly, the amount reported on the Form 990 for fundraising was less than that on the audited financial statement on 23 returns (21.7 percent) and all but three of these returns understated the amount by 10 percent or more.

Many of the differences noted on the returns appeared to result from the allocation of indirect costs and the classification of member-related services. While the IRS encourages exempt organizations to allocate indirect costs among the three expense classifications (program services, management and fundraising), it fails to specify an appropriate allocation method. Likewise, SOP No. 98-2 (AICPA, 1998) offers only limited cost allocation guidance. As such, exempt organizations can exercise wide discretion in favorably allocating indirect costs. Classification of member-related services affords a similar opportunity. Faced with little guidance, exempt organizations are allowed to retrospectively categorize activities such as producing a publication for distribution to members as program services, management, or fundraising depending on the most favorable interpretation.

Panel F of Table 5 presents additional detail on the differences noted for functional expenses. With respect to the three key categories, only 38 returns (36 percent) reported the same amounts for each of these three items on the Form 990 and audited financial statement. In contrast, 41 returns (38.7 percent) reported different amounts for all three.

With respect to charitable accomplishments, Part III of the Form 990 requires most exempt organizations to describe their four largest program services, as measured by total expenses incurred. For 31 of the returns, the same amounts and service categories were shown on the form and audited financial statements. But as with the three key functional expenses discussed above, 41 returns did not agree.

To assess whether the differences in charitable accomplishments were attributable to differences in classification, the four largest program service categories described on Form 990 were compared to those listed in the audited financial statements. Even though such a comparison did not require the amounts to match, 37 returns (34.9 percent) still did not show any correspondence between the Form 990 and audited financial statements.

An additional analysis looked at joint cost allocations. Comparison between the Form 990 and audited financial statements showed a remarkable consistency in reporting, with 102 returns (96.2 percent) disclosing the same total amount of joint costs and percentage allocated to program services as in the notes to the statements. Of the four returns disclosing different amounts and/or percentages, one appeared to be a simple transcription error, two appeared to result from misinterpretation of information in the financial statement notes, and the other could not be explained.

Preparer Accuracy

To investigate whether the reporting differences noted on the Forms 990 were related to the type of preparer, a one-way analysis of variance (ANOVA) was computed using the mean number of differences per return for three preparer types. Prior research has found a positive relationship between not-for-profit entities' compliance with GAAP and auditor size (Krishnan and Schauer, 2000). Our analysis, therefore, was intended to provide information as to whether a similar relationship exists between the accuracy of the Forms 990 data and the preparer type.

Preparers were classified into one of three types: in-house or non-CPA preparers, major CPA firms (for the years examined in this study, the major CPA firms included Arthur Andersen, Deloitte & Touche, Ernst & Young, KPMG, and PricewaterhouseCoopers) and other CPA firms. Of the 106 returns included in the study, 12 had the preparer's name blacked out and 19 indicated that they were part of a consolidated or combined group. As the earlier analysis revealed, however, only eight of these 19 returns contained reconciliation or correspondence differences between the Form 990 and audited financial statements. Thus, in composing the sub-sample for this analysis these eight returns plus the 12 returns without preparer information were omitted. The remaining sub-sample consisted of 86 returns of which 18 were prepared by major CPA firms, 54 were prepared by other CPA firms, and 14 were prepared in-house by the organization's staff or other non-CPA preparers.

To create a manageable dataset, differences in the reporting of seven key areas were identified according to a binary coding scheme. This coding scheme ignored the magnitude of the difference and instead counted only its presence or absence (any attempt to measure the magnitude of the differences would have required the use of a scaling procedure to reduce the correlations between the magnitude of the differences, the size of the organizations, and the type of preparer). Such a scaling procedure, however, would have introduced other statistical problems such that interpretation of the results would have been tenuous. An ANOVA was then employed to test for significance in the mean number of differences per return for the three preparer types. See Table 6, the ANOVA did not detect a significant effect of the preparer ($p = .06$), possibly because of the small number of observations within the groups representing major CPA firms and in-house and non-CPA preparers ($n = 18$ and 14, respectively). Thus, our results suggest that the use of an outside preparer, such as a major CPA firm, does not mitigate problems with the Form 990 data.

CONCLUSION

This study examined the quality and reliability of the data reported on Form 990 by comparing it with data in the audited financial statements. Our objective in making this comparison was to address concerns that the financial data on Form 990, as reported by exempt organizations, fail to fairly present the financial condition and operations of these entities and, in so doing, misinform users. The results of our study show that Form 990 data contain numerous preparation errors, ranging from mathematical and transposition mistakes to omissions of required information. More important, the form data often disagree with that in the audited financial statements for reasons unrelated to differences between IRS Form 990 reporting rules and not-for-profit GAAP. Our comparison of 106 exempt returns detected numerous instances of inconsistent revenue and expense recognition and incongruities between the reporting of gains and losses on investments and portfolio holdings. The comparison also found that many organizations' presentation of functional expenses is not only unreliable, but potentially misleading in that certain key financial indicators used by watchdog agencies are misstated. Disclosures of program service categories were also found to be problematic, rendering it difficult in some cases to determine what major activities an organization conducts that qualify it for exempt status.

Form 990 is widely accessible and many donors, grant-makers, regulators, journalists, and researchers rely upon its data. A study by Quality 990 (2005a), for example, found that two out of three grant-makers ask for Form 990 and one out of three use its data in making their final decisions. Our results, however, suggest that such reliance is misplaced. In addition to the presentation and reporting problems noted above, we also found that many exempt organizations fail to provide users with timely data, evidenced by the fact that several of the forms we received were one or more years out of date. While lax enforcement by the IRS may exacerbate some of the problems we observed, others are more likely the result of dual reporting and filing standards, broad discretion in the allocation of expenses, and pressure from nonprofit watchdog agencies to meet certain efficiency measures (Keating and Frumkin, 2003). Moreover, the use of an outside preparer, such as a major CPA firm, does not appear to reduce the number of reporting problems.

TABLE 6

Analysis of Reporting Differences by Type of Preparer

	Type of Preparer			
	Major CPA Firms	**Other CPA Firms**	**In-house and Non-CPA Preparer**	**Totals**
Observations	18	54	14	86
Type of Difference				
Balance sheet totals	5	4	0	9
Revenue reconciliation	4	5	3	12
Expense reconciliation	3	2	0	5
Unrealized gain/loss on investments	6	16	2	24[a]
Change in net assets	7	12	1	20
Program service categories	9	21	7	37
Joint cost allocation	0	0	1	1[b]
Mean differences per return[c]	1.89	1.11	1.00	1.26
Standard deviation	2.08	1.04	0.56	1.30

[a] Of the 29 identified errors in reporting unrealized gain/loss on investments (Table 5, Panel D), three were on returns having the preparer information blacked and two were on returns of entities filing as part of a consolidated or combined group.

[b] Of the four differences identified in the joint cost allocations reported on the Forms 990 and financial statements, three were on returns having the preparer information blacked out.

[c] ANOVA for difference in means is significant at $p = .064$ ($F = 2.85$).

Despite the data problems, Form 990 is usually the only source of several important information items, including employee compensation, subsidiary ownership, lobbying and political activities, and certain types of transfers or transactions. For some organizations, it also may be the only source of information about the composition of functional expenses. Building on these strengths, we recommend that the IRS, as it contemplates redesign of the form, expands the content to include items from the financial statements that are not currently disclosed. Key among these disclosures we believe should be cash flows from investing and financing activities and donor restrictions on net assets.

Two other changes we believe would improve the quality and reliability of the Form 990 data are to minimize differences between IRS Form 990 reporting rules and not-for-profit GAAP and to provide common standards for filing Form 990. Together, these two changes would supply users with consistent and comparable financial data by reducing input errors and managerial discretion. The changes also would effectively subject the Form 990 data of larger exempt organizations to the review of an independent auditor, while improving the financial disclosures of smaller organizations. Any special financial data needed by the IRS, such as that used in distinguishing public exempt organizations from private foundations, could be provided on supplementary schedules.

One final recommendation is for exempt organizations to revise their accounting and reporting systems. Currently, many exempt organizations lack adequate systems for tracking and classifying contributions, gains, losses, and functional expenses (Wing and Hager, 2004). As a consequence, the reporting of many of these items suffers from subjective, retrospective judgments. Efforts to strengthen these accounting and reporting systems would go a long way toward improving the quality and reliability of the Form 990 data.

An important limitation of this study is the representativeness of the sample. The sample consisted of only 39 environmental organizations, many of which were among the largest within that NTEE-CC category. The results, therefore, may not generalize to the smallest environmental organizations or those operating in other NTEE-CC categories. Tax-exempt hospitals and universities, for example, have unique characteristics and follow specialized reporting practices. Any attempt to extrapolate the results of this study to such organizations would be fraught with risk.

An interesting extension of this study would be to investigate how donors and grant-makers evaluate and react to differences between the financial data on the Form 990 and audited financial statements. Would donors and grant-makers, when presented with conflicting information on the Form 990 and financial statements, attempt to identify the causes of the differences or would they instead discredit the entity and its data as unreliable? Our study identified material misstatements on the Form 990 as compared to audited financial statements, but it did not address the behavioral aspects associated with the discovery of such misstatements. Examination of decision-makers' actions in response to data differences would provide further insights regarding the usefulness of financial disclosures by not-for-profit organizations.

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APPENDIX A
Organizations Included in Study

	Rating Organizations[a]			Year Tax-exempt Status Obtained
African Wildlife Foundation	NCIB			1962
America the Beautiful Fund	NCIB		GS	1973
American Farmland Trust	NCIB			1985
American Forests	NCIB		GS	1943
American Rivers, Inc.	NCIB		GS	1984
Center for Marine Conservation, Inc.	NCIB		GS	1972
The Conservation Fund				1985
Conservation International Foundation	NCIB		GS	1987
Defenders of Wildlife	NCIB		GS	1948
Ducks Unlimited, Inc.	NCIB		GS	1956
Earth Island Institute, Inc.			GS	1984
Earth Justice Legal Defense Fund	NCIB	PAS		1971
Environmental Defense Fund	NCIB			1969
Forest Service Employees for Environmental Ethics, Inc.			GS	1996
Friends of the Earth	NCIB		GS	1974
Greater Yellowstone Coalition				1984
Green peace Fund	NCIB			1979
International Crane Foundation, Inc.				1973
Isaac Walton League	NCIB		GS	1985
Massachusetts Audubon Society, Inc.			GS	1951
Mountain Institute, Inc.				1971
National Audubon Society	NCIB			1972
National Parks & Conservation Association	NCIB			1959
National Wildlife Federation	NCIB	PAS	GS	1943
Natural Resources Defense Council	NCIB	PAS	GS	1970
Nature Conservancy	NCIB	PAS	GS	1954
Peregrine Fund, Inc.				1970
Rails to Trails Conservancy	NCIB			1986
Rainforest Action Network	NCIB		GS	1991
Save the Manatee Club, Inc.				1993
Save the Redwoods League	NCIB			1921
Sierra Club Foundation	NCIB	PAS	GS	1962
Trout Unlimited National Office			GS	1972
Trust for Public Land	NCIB		GS	1978
Union of Concerned Scientists, Inc.	NCIB			1974
Wilderness Society	NCIB	PAS		1942
Wildlife Conservation Society			GS	1939
Woods Hole Research Center, Inc.			GS	1985
World Wildlife Fund	NCIB	PAS	GS	1991

[a] At the time the sample was selected, both the National Charitable Information Bureau (NCIB) and the Philanthropic Advisory Services of the Better Business Bureau (PAS) maintained ratings of not-for-profit organizations. Recently, however, the two organizations have merged into the Better Business Bureau Wise Giving Alliance. The GS notation indicates that a full report was, at the time the sample was selected, available at the GuideStar website sponsored by Philanthropic Research, Inc. GuideStar does not employ a rating system.