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Accounting Irregularities: Regulators Zooming In

04.24.19 | Linda J. Rosenthal, JD

The editors of *The Nonprofit Times* recently published a warning to charities around the nation: More than ever, state regulators are taking aim at certain accounting practices they assert are misleading and improper. In particular, they are focusing on two issues: (1) allocation of joint costs and (2) valuation of gifts in kind (GIK); that is non-cash donations.

While – so far – the regulators' positions on these accounting principles have not yet been reviewed by any court, organizations that engage in them are clearly in the cross-hairs of these enforcement agencies. "By taking the time to understand and properly apply these accounting principles, organizations can reduce their risk of being the target of regulatory scrutiny."

In the past, charities have worried the most about a possible audit by the Internal Revenue Service. More recently, though, the enforcement power and focus have shifted to the state officials. There are several reasons for this change. First, since the early 2000s, state regulators have ramped up their enforcement interests and capabilities to run somewhat concurrently with federal regulators' activities. Second, the IRS has suffered from severe budget cutbacks and staffing shortages, and otherwise has been hamstrung by Congressional negativity toward the agency.

Accounting Irregularities

Key states – especially, California, New York, and Michigan – have brought high profile enforcement actions in recent years alleging that "as a result of an incorrect allocation of joint costs, the organization […under scrutiny…] has, in effect, made materially false statements in the financial documents they submit as part of their required state reporting." California has also recently taken aim at "similar false statement allegations" related to "GIK valuations."

In *Charity Issues of Concern to CA Attorney General* (October 24, 2017), we mentioned a July 2017 conference in Northern California where Elizabeth Kim, the Supervising Deputy Attorney General, told nonprofit leaders and professional advisers about the primary areas of concern on the radar of that state's officials. In particular, she pointed to (1) Gifts in Kind (misleading donors in ways including over-valuing gifts, or acting only as a pass-through); and (2) Joint Cost Allocation (misleading donors by artificially reducing or mischaracterizing fundraising expenses).

We've covered one such enforcement sweep in 2018 by the California Attorney General, based on allegations of improper gift-in-kind valuations that seeped into misleading fundraising solicitations, reaching prospective donors around the nation including in California. AG Xavier Becerra argued that California has jurisdiction in cases of fraudulent interstate solicitations.

Gifts-in-Kind

In *CA Issues Cease-and-Desist Orders to Out-of-State Charities* (May 3, 2018), we tackled explaining why certain gifts in kind raise the hackles of regulators, noting that the Attorney General's plain-English Complaint against the four charities in question did an admirable job of it.

The government explained that the four cases [joined in the action] are similar – though, otherwise, apparently unrelated, in that they involve a consistent fact pattern. Each is part of a chain of distribution of soon-to-be-expired pharmaceutical drugs, donated by the drugmakers, to the developing world. The gist of the AG's claims is that the targeted organizations (1) used an accounting ploy that is, itself, wrongful because it's misleading; and (2) touted these inflated figures to support fundraising appeals in California for additional (and, in at least one case, nonexistent) projects.

The Nonprofit Times editors suggest that "leaders at organizations who want to accept and use GIK donations" learn about and understand the rules; that is, the "use of donated goods in compliance with an organization's mission, valuation of the donated goods, recognition of revenue and expenses and financial statement disclosures." In particular, donations "should be properly valued at fair value as of the date of the donation."

Joint Cost Allocations

The danger in improper joint cost allocations is that "organizations are unfairly stating their expense ratios in their charitable solicitation materials for the purpose of skewing the percentage of program versus fundraising expenses."

An example is the "popular use of the program vs. fundraising/administration [figures] included in many direct mail solicitations." The state regulators claim that "these ratios can misrepresent the size or complexity of a charity's business operations." This is viewed as a deceptive fund-raising practice that violates state charitable solicitation laws.

Generally, under the joint cost-allocation rules, organizations may list expenses associated with a fundraising activity as a program expense if there is a "call to action" within the fundraising campaign. For instance, "an antismoking organization … might send a mailing that asks for a donation, but also includes various tips on how to quit smoking."

There are three frequent mistakes:

- “Allocating when the solicitation has no call to action”; merely describing the organization, its mission, and programs is not a call to action sufficient to justify it
- “Over allocating” in circumstances that are inappropriate
- Audience selection “based on ability or likelihood to contribute,” rather than on the “audience’s reasonable potential to use the call to action or the ability to carry” it out

Conclusion

There’s an important caveat: Experts disagree about the correctness of the expansive position by the attorneys general on recent gift-in-kind cases. “One of the challenges for organizations is that the government regulators’ interpretation of GAAP does not, in all cases, align with published guidance interpreting GAAP ….”

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