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NONPROFITS: FUNDRAISING & DEVELOPMENT

Joint-Cost Allocations: Pitfalls to Avoid

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Ratings organization CharityWatch has, yet again this holiday season, issued an important reminder for the nonprofit sector ahead of the year-end fundraising hustle and bustle.

Section 501(c)(3) organizations should steer clear of an all-too-common accounting sleight of hand; namely, improper "joint cost allocations." See *Joint Costs: Avoid This Popular Charity Accounting Trick!* (December 9, 2022), *charitywatch.org*, including link to a helpful explainer video featuring the organization's executive director, Laurie Styron: https://youtu.be/5fUzGig-V1Q.

The reporting of program and fundraising costs together is an accounting practice that can be done correctly or – all too often – abused in a way that can land a 501(c)(3) organization squarely in the bull's-eye of state regulators. See our earlier discussions in *Charity Issues of Concern to CA Attorney General* (October 24, 2017) and *Accounting Irregularities: Regulators Zooming In* (April 24, 2019).

The second of these two posts linked to *Accounting Under Regulatory Scrutiny* (January 22, 2019), *The NonProfit Times*. "State charity regulators," those authors wrote, "have been increasing scrutiny of nonprofits' financial statements, the Internal Revenue Service (IRS) Form 990s and solicitation materials in a number of key ways" including "… nonprofits' allocation of joint costs …. Many state regulators believe that charities are improperly using these accounting principles to hide their fundraising costs by unfairly inflating their program expenses."

The *NonProfit Times* writers cautioned: "Several states, including New York, Michigan and California, have brought enforcement actions alleging that as a result of an incorrect allocation of joint costs, the organization has, in effect, made materially false statements in the financial documents they submit as part of their required state reporting."

The California Attorney General's office has published a 3-page advisory pamphlet that lays out the problem in a simple, plain-English format. See *Abuse of Joint Cost Allocation – Misleading Donors by Artificially Reducing Fundraising Expenses*. "This accounting treatment," warns the AG's office, "can be abused to reduce reported fundraising expenses. If a charity spends most of its money to fundraise, you probably would not donate to that charity ….The improper use of Joint Cost Allocation results in a false report of a charity's finances and misleads potential donors and others into believing that the charity operates more efficiently than other charities."

What's the Issue?

"Joint costs" – as that term is used in nonprofit financial reporting – are "the funds spent on telemarketing, direct mail, or other solicitation activities that also include an "action step" or "call to action."

The applicable accounting guidelines for the reporting of joint costs "…do not prescribe or mandate a specific method for allocating the expenses between fundraising and charitable program services, nor are any allocation methods prohibited." But the allocation method selected should be "reasonable" and "applied consistently given similar facts and circumstances."

The problem with 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." State regulators explain that this practice 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."

However, there are several scenarios which are cited by regulators as "mistakes" to avoid:

- "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; and
- 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."

CharityWatch offers two examples of joint-costs reporting that may not pass muster with government authorities. For instance, a fundraising letter from a genetic-disorder charity may include "educational information for the potential donor about healthy eating and exercise." But if that organization tries to "prepare and send that fundraising letter as a charitable program expense because the solicitation includes an educational component about healthy eating and exercise," it may be improper. "When most donors think about how their contributions are used for the programs of a genetic disorder charity, they probably hope that this includes areas such as patient care or research—not educating potential donors on diet and exercise, which seemingly would have very little, if any, influence over whether one actually becomes afflicted with the genetic disorder."

Similarly, "… an alcohol abuse charity applying joint costs because of a 'don't drink and drive' call to action that is included with a direct mail campaign received by individuals who rarely consume alcohol and/or usually rely on public transportation" may likewise be a tough sell to regulators. "Is such a joint solicitation truly an effective promotion of an alcohol abuse charity's mission to the extent that a portion of the expenses should apply to program activities? Or as a potential donor, would you rather see your contribution being spent towards bona fide program efforts such as increasing the law enforcement of drinking and driving offenders, or even towards sending such a call to action to a targeted group of recipients with a history of driving under the influence?"

What Are The Rules?

The California Attorney General's pamphlet asks and answers this key question simply and clearly (albeit from the perspective of a prospective donor deciding whether to make a contribution).

"What is Joint Cost Allocation?" It "… recognizes that solicitation materials may serve a joint purpose: to solicit your donation and encourage you take a specific action that furthers the charity's programs. The charity may apportion and report solicitation expenses as program expenses in its IRS Form 990 only if it meets specific criteria under Standard of Position 98-2 (SOP 98-2) (now ASC 958-720-45). This is called Joint Cost Allocation."

More specifically, proper "…Joint Cost Allocation requires that the charity demonstrate that the solicitation campaign meets three tests: the purpose, the audience, and the content tests. Otherwise, all the campaign costs must be reported as fundraising expenses."

Conclusion

"By taking the time to understand and properly apply these accounting principles," the *NonProfit Times* authors explained a few years ago, "organizations can reduce their risk of being the target of regulatory scrutiny."

That advice certainly continues to be important.

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