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The role of the paid preparer in nonprofit reporting quality

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ABSTRACT

The purpose of this paper is to examine whether the preparer of the Form 990 influences the Form 990 reporting quality. Currently, the Form 990 is the only widely available source of governance and financial information for nonprofit organizations. The leading rater of nonprofit organizations, Charity Navigator, relies primarily on information from the Form 990 in developing their ratings. We identify misreporting by utilizing five measures of reporting quality. We find organizations that hire an outside accounting firm to prepare the Form 990 report higher quality financial information than organizations that choose to prepare the Form 990 in house. Interestingly, the size of the accounting firm is not associated with the quality of Form 990 reporting with the exception that paid preparers who are sole proprietors are more likely to misreport. Further exploration reveals that paid preparers who file more returns are less likely to misreport indicating that specialization is associated with more accurate reporting on Form 990. Our study contributes to the literature by using multiple reporting measures to examine the impact of paid preparers on the reporting quality of 990s. Furthermore, our study is the first to consider how specialization affects the accuracy of 990 returns.

1. Introduction

Nonprofit organizations currently are free either to prepare their Form 990 in house or to contract with an accounting firm of their choosing to assist in the preparation of the Form 990. The IRS is not likely to audit the Form 990, and instead appears most concerned with ensuring that nonprofits file their Form 990 on a timely basis. However, the lack of focus on *how* the Form 990 is prepared allows for substantial variation in the quality of Form 990 reporting. The purpose of this paper is to examine whether the characteristics of the preparer of the Form 990 influence the Form 990 reporting quality.

Specifically, we examine whether or not paid preparers increase the reporting quality of the Form 990. We also investigate whether or not the size of the paid preparer matters using various measures of size. Finally, we examine whether or not the number of returns prepared by a paid preparer affects the quality of Form 990 reporting. Surprisingly, we find that size of the paid preparer does not matter except for sole proprietors who are more likely to misreport. We also find that firms who prepare Form 990 more frequently are less likely to misreport, suggesting that specialization is more important than size of the paid preparer with respect to the reporting quality of the Form 990.

Prior literature has found that misreporting on the Form 990 is associated with multiple dimensions of governance including: the type of financial statement auditor, the size of the board, having an A-133 audit, and the state of location (Yetman & Yetman, 2012). This article builds on prior findings to consider whether the preparer of the Form 990 is associated with misreporting on the Form 990. The distinction between the Form 990 preparer and previously considered governance dimensions is an important one for at least four reasons: First, having a financial statement audit does not necessarily lead to more reliable Form 990 reporting. Several studies find significant discrepancies between the numbers reported on an organization's audited financial statements and the Form 990 (Froelich, Knoepfle, & Pollak, 2000; Gordon, Khumawala, Kraut, & Meade, 2007; Krishnan, Yetman, & Yetman, 2006). Second, the nonprofit can elect to prepare the Form 990 in house or personally select an outside firm to prepare the Form 990. Since the IRS allows discretion in who prepares the Form 990, an organization that wishes to "manage" numbers on the Form 990 may elect to prepare the Form 990 in house or strategically hire a paid preparer who will allow for such "managing". Third, for organizations that have a financial statement audit, they can still elect to prepare the Form 990 in house or hire an accounting firm other than the audit firm to prepare the Form 990, thus mitigating the influence of a high quality financial audit firm (Internal Revenue Service, 2012). Fourth, while many nonprofits are not required to have a financial statement audit, most nonprofits are required annually to file a Form 990.[2]

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[2] All tax exempt organizations with greater than $50,000 in gross receipts are required to file a Form 990 with the IRS annually. Religious organizations are exempt from this requirement. Financial statement audit requirements come primarily from the state and external lenders (i.e., banks), and it is not a stretch to say that more nonprofits file a Form 990 than contract for a financial statement audit in a given year.

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Table 1
Sample selection.

Criteria	Number of observations
1. Number of 501(c)(3)[a] organizations in California for 2003	29,023
2. Less: education organizations, religious, grant making, certain types of healthcare organizations and unknown organization types[b]	(11,031)
3. Less: gross receipts below two million dollars[c]	(16,679)
Total sample before collecting 2005 data	*1313*
4. Less: Missing 2005 financial information[d]	(48)
5. Less: Not domiciled in California or required to file in California in 2005	(44)
6. Less: Incomplete financial information for analysis[e]	(144)
7. Less: Unable to identify Form 990 preparer	(241)
8. Less: Observations with missing or negative leverage	(2)
Total sample	*834*

[a] This IRS code section provides for an exemption from federal income tax and allows donors to these organizations to deduct their donation on their federal income tax return. To qualify for 501(c)(3) exemption, an organization must be organized to operate exclusively for one or more of the following purposes: charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, and/or the prevention of cruelty to children or animals.

[b] Education Organizations, Religious, and Grant Making are not required to comply with the audit requirements of the Nonprofit Integrity Act of 2004, therefore organizations listing these NTEE types have been excluded from our analysis. Certain healthcare organizations such as hospitals and medical research are also exempted and excluded from the sample while other types of healthcare organizations such as health advocacy groups are subject to the audit requirements and therefore are included in the sample.

[c] Government grants and contract income are removed from the calculation of gross receipts.

[d] Financial information was not available in the Core File for 2005 and the Form 990 for 2005 was not available on GuideStar.

[e] Financial information available on Core File for 2005 but Form 990 not available on GuideStar.

Currently, the Form 990 is the most commonly used data source concerning nonprofit organizations (Quality 990, 2011). Nonprofits are not required to make audited financial statements publicly available and often do not (Behn, DeVries, & Lin, 2010). Furthermore, along with balance sheet and income statement information, the Form 990 provides detailed compensation and governance information not available on the audited financial statements.[3] GuideStar, a leading provider of nonprofit data for all tax-exempt organizations, provides links to the Form 990s for the organizations in their database (GuideStar, 2011). This is in contrast to the limited access to audited financial statements, which are generally not available on an organization's website or similar public venue (Gordon, Khumawala, Kraut, & Neely, 2010). The leading rater of nonprofit organizations, Charity Navigator, currently relies primarily on information from the Form 990 in developing their ratings.[4] In addition, Form 990 information is provided to donors in their giving decisions either directly (through public access to the Form 990 itself) or indirectly through giving campaigns utilizing the information off the Form 990.[5] Finally, academic researchers rely heavily on Form 990 data in their research studies (Baber, Roberts, Visvanathan, Daniel, & Roberts, 2002; Jones & Roberts, 2006; Roberts, 2005; Neely, 2011; Baber, Roberts, & Visvanathan, 2001, among others).

While states in recent years have strengthened the financial statement audit requirements for nonprofit organizations (Neely, 2011), nonprofits intent on misreporting their financial information can simply manage the information on the Form 990. Several studies (Keating, Parsons, & Roberts, 2008; Krishnan et al., 2006) document misreporting on the Form 990 with respect to fundraising expense and professional fundraising activities respectively. Additionally, executive compensation on the Form 990 has been shown to be inaccurately reported (Neely, 2011). Discrepancies between the Form 990 and the audited financial statements (Froelich et al., 2000; Gordon et al., 2007) as well as between the Form 990 and Form 990T (Yetman, Yetman, & Badertscher, 2009) have been documented by prior literature.

Currently, the Internal Revenue Service (IRS) allows nonprofits the option to prepare the Form 990 in house or hire an outside accounting firm to prepare the Form 990 (Internal Revenue Service, 2012). Since the Form 990 is an informational return with no tax due, oversight of the Form 990 reporting quality is lax, with approximately 1.35% of nonprofits subject to a review of their filings (Internal Revenue Service, 2013). The focus of the IRS appears to be on ensuring nonprofits file their Form 990 annually. Organizations failing to file their Form 990 for three consecutive years are subject to a revocation of their tax exempt status. In addition, penalties accrue to organizations failing to file their Form 990 on time, filing an incomplete return, and/or filing an incorrect return. The penalties for filing fraudulent returns are more severe and include fines and/or imprisonment. The IRS explicitly notes that the use of a paid preparer does not alleviate the organization's responsibility for filing a complete and accurate return. In general, the aforementioned IRS penalties do not relate to the quality of the Form 990 reporting (Internal Revenue Service, 2012).

Utilizing a large sample of organizations representing multiple sectors and concentrated in one state (California), we find that misreporting on the Form 990 is associated with the type of preparer. Comparing organizations with a paid preparer to those organizations without a paid preparer, we find that organizations hiring a Form 990 preparer report fewer incidences of misreporting professional fundraising fees, executive compensation, and failing to comply with having a financial statement audit than organizations preparing the Form 990 in house. Comparing organizations hiring one of the largest 15 public accounting firms to organizations hiring non top 15 public accounting firms, we find no significant difference in number of incidences of misreporting across all measures of reporting quality. However, when we compare accounting firms that specialize in preparing Form 990s to accounting firms that do not specialize in preparing Form 990s, we find that specialist firms are associated with fewer incidences of misreporting. Overall, we conclude that hiring a paid preparer and an accounting firm that specializes in preparing Form 990s is associated with greater reporting quality.

The findings from this study contribute to the literature in at least three distinct ways. First, we extend prior literature on the role of the paid preparer by considering multiple dimensions of misreporting on the Form 990. Prior literature focused on the discrepancies between the Form 990 and Form 990T (Yetman et al., 2009). This study considers five distinct misreporting elements found on the Form 990. Second, this is the first study utilizing a multivariate framework to consider how the

[3] Specifically, the Form 990 provides detailed compensation information for officers, directors, and key employees. The governance information currently provided includes information about governing bodies and policies.

[4] Prior literature has documented a positive association between the rating received by an organization and charitable contributions (Chen, 2009; Gordon, Knock, & Neely, 2009; Silvergleid, 2003; Sloan, 2009). However, contrary evidence exists that donors are not influenced by these ratings (Szper & Prakash, 2011). The effectiveness of the rating organizations is an ongoing debate.

[5] The author has personally received material from a giving campaign. The literature from this campaign, directed at all University employees, reported overhead expense ratios derived from the Form 990 for each organization presented in the campaign literature. A similar request made to municipal employees in Texas has also been observed.

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