Know Your Ratios? *Everyone **Else** Does*

by Jennifer A. Lammers

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My brother-in-law is addicted to consumer research reports. When he and my sister were in the market for a car, he scoured the Internet for information on every make, model and year. When determining which stroller, highchair and car seat to register for before my nephew was born, he could recite the price, durability and safety ratings for almost every item.

But when it comes to supporting a charity, my brother-in-law's need for pertinent information is stymied. He knows where to find an organization's IRS Form 990 and is even familiar with the major national charity watchdog sites and reports. He knows the various ratios and the rankings they use, but still he isn't satisfied: "What do these numbers really tell me about this organization? Is a higher program ratio always better? Does anybody measure effectiveness?"

He has a point. Many of the charity reports produced today give only part of the picture, emphasizing spending practices over effectiveness or program quality. Choosing which charity to support based only on financial ratios is a little like choosing a restaurant based on how much it spends on advertising and marketing versus food. You really don't know what you'll get.

Yet, like it or not, charity watchdogs are becoming increasingly popular with the information-hungry public, and the financial ratios they employ are being accepted as proxies for performance, quality and integrity. It is the wise nonprofit that knows the lay of the ratings agency land and is prepared to make sure its story is told as completely as possible.

Pros and Cons of the Ratings

Charity rating agencies ideally help donors avoid fraudulent organizations or outright scams and make it easier for the public to identify and support legitimate charities. By increasing access to information, watchdogs have the potential to demystify the workings of the nonprofit sector and to provide managers with valuable tools for monitoring and evaluating their own performance. The emergence of multiple recognizable and reputable sources for information on charitable organizations (see "National Charity Review Organizations" box) marks the further evolution of the nonprofit sector and, if managed properly, has the potential to improve the performance of nonprofits, increase public trust, and encourage informed and generous philanthropy in America.

But the ultimate impact of what is being called the ratings revolution has yet to be determined, and a number of potential problems remain to be worked out. The public, often in the form of the media, wants black/white, good/bad explanations that force watchdogs to act as judge and jury, despite many of their efforts to simply "inform the donor's decision." Increasingly, the information and reports provided by watchdogs are being used not to help donors weed out those groups that fail to meet minimum accepted levels of performance, but to "rank" well-performing charities against each other. "Why donate to an organization that spends 78 percent on programs when I can give to one that spends 82 percent?"

An over-emphasis on financial ratios is demonizing necessary administrative and management expenses and elevating the value of efficiency over effectiveness. The resulting pressure on nonprofit managers leads to increasingly creative allocations of expenses, further muddying the true performance picture. Even worse, some nonprofits adhere to bare-bones administrative budgets that actually jeopardize the organization's stability and hinder its ability to grow or respond to change.

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Getting Into the Game

So what's a nonprofit executive to do? Even if your organization is small or local enough to avoid being covered by one of the bigger, national watchdogs, you aren't out of the woods; the criteria they use will increasingly become the accepted industry standards. Donors and the media, which have easy access to your 990 through the online database GuideStar, can run the numbers on their own and make decisions about your performance.

Educating yourself, your staff and your board about watchdog organizations and their standards is the place to start. Incorporating the primary watchdog requirements into your organization's regular self-assessments will eliminate any surprises should you find yourself under one of their microscopes—and even if you never end up having a formal review, the internal monitoring of your compliance with these standards can yield valuable information.

Comparing your performance with that of other organizations in your community or field can open your eyes to possible inefficiencies or areas of unique success. Learning to "talk the talk" so you can explain your organization's performance in relation to that of other organizations—both those with similar programs and missions and those that differ greatly but compete for the same donor dollars—will help you establish creditability with donors and the media.

A Focus on Finances

While a number of the rating agencies report on a wide variety of operational practices, including governance, public disclosure/accountability, and fundraising activities, the media and donors give greatest attention to those standards and criteria dealing with the use of funds.

A failure to understand the financial ratios that watchdogs employ or what circumstances may affect a charity's performance against them puts some organizations at a disadvantage when they are evaluated—whether formally or simply by a reporter or donor with a calculator. At best, an organization's numbers may not be as favorable as others'; at worst, a good organization may actually fail to meet the minimum requirements, receiving a negative ranking or report.

Internally, when used as baseline, minimum performance criteria, the financial ratios used by watchdogs have been proven to be generally valid guideposts. A failure to meet these benchmarks should set off warning bells for an executive director or board members and lead to an analysis of your organization's spending and financial presentation. There may be valid reasons why your organization is not generating the same numbers as other charities, but knowing how and why is key. By becoming familiar with the ratios, the rating agencies and their reports, managers can benchmark their organization's performance against that of other charities in their community, field or revenue bracket. Such information can be powerful when trying to attract donors or negotiate with outside service providers, like fundraisers.

The Most Common Calculations

Almost every rating agency employs a "fundraising ratio" to calculate the amount of revenues or related contributions spent on fundraising. This calculation is designed to answer the perennial donor question: "How much of my donation actually goes to…feed the poor, teach adults to read, preserve American folk art traditions, etc.?"

In using this ratio, it is first important to note whether the fundraising percentage being used is calculated based on the percent of *total revenues*, percent of *total expenses*, or percent of *related contributions*. Related contributions can be defined as only those revenues derived directly from fundraising activities. They do not include interest or earned income. Some watchdogs actually calculate multiple forms of the fundraising percentage to determine a charity's ultimate ranking, so it is important when comparing the fundraising percentages among different organizations to make sure the same formula is used. In general, fundraising percentages based on total revenue will be smaller than those calculated using related contributions or expenses, because most organizations have revenue sources over and above contributions and, hopefully, spend less than they earn in a given year.

According to The Wise Giving Alliance's 2001 Donor Expectations Survey, 80 percent of adults think that no more than 30 percent of their donation should go toward fundraising.[1] The agencies that set acceptable fundraising percentage limits say that on average an organization's fundraising expenses throughout the year should not represent more than 35 percent of the donations raised, and most organizations come in signifi-

cantly below that benchmark. It is important to understand that a particular fundraising activity, such as a gala or telemarketing campaign, may yield returns much lower than the 35 percent-on-a-dollar target. These expensive fundraising activities are not prohibited by the watchdogs, but they should be coupled with lower-cost fundraising activities such as grant writing or soliciting Internet contributions to keep an organization's fundraising ratio below an *average* of 35 percent for the year.

Newer organizations may be expected to have higher fundraising costs, as donor acquisition is more expensive than donor renewal. Additionally, some watchdogs believe charities that champion unpopular causes may understandably have higher fundraising ratios. The experience of early AIDS organizations is often cited as anecdotal proof to support this belief.

However, simple differences in financial presentation can affect an organization's fundraising percentage as well. For example, if an organization deducts the costs of any direct benefit to the donor (such as the greens fees at a golf outing) from special event revenues, as is allowed by generally accepted accounting principles, both total contribution revenue and total fundraising expenses will appear lower than those of an organization that simply presents the gross revenue and full expenses. In most cases, using net event revenue when calculating the fundraising ratio will result in a lower percentage.

Adding to the confusion, many organizations erroneously deduct all related expenses from event proceeds, reducing their fundraising expenses and corresponding fundraising percentage. If this error is not taken into account when calculating an organization's ratio—and it can be hard to spot, even for the watchdogs—an organization can unfairly be elevated in comparison to other, more conservative charities.

Measuring Program Expenses

Another popular ratio employed by the rating agencies involves a "program expense" calculation. In most cases, the total amount allocated and spent on programs—as opposed to administrative overhead or fundraising—is divided by the total amount spent by the organization during the fiscal year to give a "program percentage." While different watchdogs require different minimum program allocations for compliance or a favorable rating, the range generally falls between 60 and 70 percent of total expenses.

It is widely accepted that new organizations (younger than three years) may spend less on their programs than older, more established charities because of the administrative and fundraising efforts involved in launching an organization.

Although most organizations, regardless of size or field, spend 70 percent or more of their total revenue on their programs and services, the program percentage may be affected by a variety of factors. For example, an environmental or community development organization that regularly buys land or buildings in pursuit of its mission—for redevelopment or to establish wildlife habitats—may not be getting credit for these capital expenditures because they don't show up on the 990 or in the Statement of Activities as program expenses. However, most donors would not be alarmed or disappointed to know that their donation was going toward these mission-driven purchases.

Additionally, the treatment of donated goods and services in calculating an organization's total expenses may affect its program percentage. Proper accounting requires an organization to count the value of certain donated goods and/services as donations. If a charity has these types of donations, there must be a corresponding expense when the good or service is used. For example, a food reclamation program that receives $100,000 in donated restaurant foods and packaging would indicate that it received $100,000 in in-kind contributions and spent a corresponding $100,000 on its programs feeding the poor.

In practice, not all organizations include in-kind donations of goods or services in their financial statements, and some rating agencies deduct them from their calculations, citing irregularities in the way these gifts are valued. This practice means some rating agencies are excluding the expenditure of in-kind gifts from program expenses, even though a lot of donors view the use of donated services and products as a creative way to maximize the impact of cash contributions.

And because the 990 does not account for in-kind donations in the same way as financial statements, those watchdogs that use either the 990 or financial statement when reviewing an organization may not always be presenting "oranges-to-oranges" comparisons.

Even if your organization is small or local enough to avoid being covered by one of the bigger, national watchdogs, you aren't out of the woods; the criteria they use will increasingly become the accepted industry standards.

Making Your Case

If your organization finds itself under review by a watchdog, challenged by a reporter or questioned by a donor, it's important that you understand both the numbers and your organization's circumstances. "I don't know" or "You'll have to speak with our auditors" are not the answers that will best serve your organization.

When dealing with the watchdogs, provide the most complete information possible. Failure to respond to requests for information automatically gives your organization a black mark with many rating agencies. Take advantage of the opportunity to submit supplementary information for publication online and for reporting services like GuideStar. In the eyes of the suspicious public, the more information available on your organization, the better.

If you believe your organization's numbers are legitimately different from other charities' or you know that a unique situation might unfairly skew your review, take the time to include an explanation of the facts before the watchdog issues its finding. If a rating agency issues a report you disagree with, ask for a meeting to discuss its findings or for an opportunity to submit an explanation and supplemental information in writing. Many of the watchdogs will amend their reports based on additional information, and some will even include an explanation from the charity in the report.

You may head off donor or reporter questions by including information on your spending practices in your annual report and on your Web site. Sharing your spending ratios shows that you have nothing to hide and that you believe the number are legitimate reflections of the work your organization does. If your numbers appear lower than those of similar organizations, you may wish to consider including a simple explanation of how the numbers are calculated and what factors may be influencing them. Providing this explanation to any staff or board member who might be questioned about it may prevent problems, since they will have a ready and well-reasoned explanation for your organization's performance.

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Inaccurate Reporting Hurts the Sector

The argument is often made that an organization's allocation of expenses between program, administration and fundraising is, ultimately, arbitrary, and that the emphasis on financial ratios rewards the aggressive or deceptive and punishes the conservative or modest.

By calling what is essentially a direct-mail fundraising campaign "public education," an organization can shift expenses from fundraising to program, often with an air of legitimacy. The allocation of a percentage of the cost for professional fees or staff development activities among various programs hides these very necessary administrative costs. By getting one or more major funders to cover administrative costs, some charities claim to other funders that "100 percent of *this* donation will go to our programs" when soliciting donations. Accounting rules, by the way, no longer find this practice allowable.

While these allocation games can raise program percentages and lower the appearance of administrative costs, and result in better rankings, there are consequences. By giving in to the "no administrative costs" pressure, managers legitimize unrealistic donor expectations and affirm the mistaken belief that administrative costs are frivolous. This sector-based support for these harmful misconceptions makes it harder to make the case for reasonable administrative expenses like professional development, software upgrades or marketing consultants. Individual charities and the sector as a whole are better served when nonprofits make an effort to understand the ratios and how their organizations' unique circumstances may affect them.

Real numbers and careful explanations are powerful tools when discussing your organization's performance with donors, reporters or the watchdogs themselves.

Endnotes

1. BBB Wise Giving Alliance Donor Expectations Survey, 2001.

About the Author

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National Charity Review Organizations

American Institute of Philanthropy

Web Site: www.charitywatch.org

Charities Covered: Generally national organizations or those receiving media attention.

Basis for Evaluation: Gives letter grade rankings based on spending practices, and then provides information on public disclosure and salaries.

Financial Ratios and Targets Used: *Program ratio* (program expenses/total expenses) should be equal to or greater than 60 percent; *fundraising ratio* (fundraising expenses/related contributions) should be equal to or less than 35 percent. Reserves should not exceed three years. An automatic "F" is given if reserves exceed five years.

Also Note: Generally excludes donated goods and services from its calculations. Provides two program percentages for organizations that jointly allocate the cost of direct mail to programs and fundraising, one allowing for the split allocation and one allocating all joint costs to fundraising. Indicates when organizations fail to provide information for review.

BBB Wise Giving Alliance

Web Site: www.give.org

Charities Covered: National groups or those that fundraise in multiple states. Selection is determined by the number of inquiries about the charity. Smaller, local organizations may be covered by their local Better Business Bureau. About 30 local BBBs have charity review programs.

Basis for Evaluation: Produces a multi-page report based on compliance with standards governing a wide range of operational practices, including public accountability, governance, use of funds, solicitation. New standards require organizations to assess their effectiveness and set requirements for protecting donor privacy.

Financial Ratios and Targets Used: *Program ratio* (program expenses/ total expenses) should be equal to or greater than 65 percent; *fundraising ratio* (fundraising expenses/related contributions) should be equal to or less than 35 percent; *unrestricted net asset* should not exceed three times current operating budget.

Also Note: Invites organizations to submit additional information to help in assessing the validity of an organization's spending practices if they do not meet the minimums set in the standards. Will adjust information provided in an organization's IRS Form 990 or audited financial statements should it disagree with the presentation of allocations made. Indicates when organizations fail to provide information for review.

Charity Navigator

Web Site: www.charitynavigator.org

Charities Covered: The largest national charities based on income, with additions to "diversify" the type of organizations covered.

Basis for Evaluation: Provides an overall rating based on a four-star system designed to measure the organization's short-term spending practices and long-term sustainability.

Financial Ratios and Targets Used: CN does not set specific financial targets, instead basing its ranking on the performance of other organizations. In general, when looking at short-term spending practices, CN rewards: a low *fundraising ratio* (fundraising/related contributions AND fundraising/total expenses); a high *program ratio* (program expenses/total expenses); a low *administrative ratio* (administrative expenses/total expenses). An organization's short-term spending score will be adjusted down if it has a combined deficit over the most recent three years. Score reduction is based on the size of the deficit in relation to the organization's total functional expenses. When looking at long-term sustainability, CN looks for: increasing average annual operating revenue, based on the previous 24 months; annual growth of programs and services, measured by program expenses over the previous 24 months; significant working capital, based on net liquid assets.

Also Note: CN relies solely on an organization's Form 990, which does not generally include the level of detail included in audited financial documents. It does not notify all the organizations it reviews.

GuideStar

Web Site: www.guidestar.org

Charities Covered: All nonprofit organization that have filed Form 990s.

Basis for Evaluation: Provides Adobe Acrobat versions of Form 990s for public charities required to file the document. Also provides general information summaries based on the information contained in the 990 or submitted by the organization. For a fee, GuideStar will provide donors with analyst reports, including ratios for fundraising, contributions, programs, debt, and investment income as well as peer group comparisons based on focus or location and historical comparison.

Financial Ratios and Targets Used: Analyst reports may include the following ratios: accounts payable aging indicator (accounts payable x 12/total expenses); *contributions and grants ratio* (contributions + grants/total revenue); *debt ratio* (total liabilities/total assets); *fundraising ratio* (fundraising expenses/total expenses); *liquid funds indicator* (net assets - permanently restricted land - buildings and equipment x 12/total expenses); *program ratio* (program service expenses/total expenses); *savings ratio* (total revenue - total expenses/total expenses).

Also Note: Posts Form 990 as it was filed, including typos, omissions and mistakes. Not all charities may be listed on the site or have most recent 990s available. Encourages organizations to submit additional information and complete optional sections.

—Jennifer A. Lammers