BMWL Batts Morrison Wales & Lee Certified Public Accountants

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Let's Admit It – The Emperor is Naked: Functional Expense Reporting for Nonprofit Organizations is Voodoo

Measurement and Evaluation of an Organization's Performance Should Not Be Based on Subjective Expense Allocations

By Michael E. Batts

Some months ago, I received a call from the Secretary of one of Florida's state cabinet-level agencies. He called to ask my opinion on what constitutes a "normal" or "reasonable" overhead expense level for a nonprofit organization. He was interested because of the state's desire to ensure that nonprofit organizations it funds are appropriately efficient. I proceeded to provide him with some general observations about industry norms and expectations. I also shared with him the reality that the measurement of "overhead expense" is inherently subjective and can vary dramatically based as much or more on the accounting methods an organization uses as on its actual efficiency. In our conversation, I learned that some state-funded nonprofit organizations were reporting overhead expense ratios (overhead expenses as a percentage of total expenses) as low as six percent and that they were working to reduce that percentage in an effort to appeal to the state's desire for maximum efficiency.

The topic of my conversation with the Florida cabinet member was not unusual. For decades, evaluation and measurement of the performance of nonprofit organizations in America by many so-called "watchdog" organizations, grant-making organizations, and even some donors have centered on the concept of "efficiency" as measured by an organization's reported overhead and fundraising expenses as a percentage of its total expenses. In fact, one of the major charity-rating organizations in the United States bases the preponderance of its ratings system on this idea – to the delight of some and to the frustration of many.

A High Level of Precision? Not So Much

Many non-accountants incorrectly assume that such measurements are elements of precision. They do not realize that in many cases, the difference between the overhead ratios of two very similar organizations may be more a function of their accounting methods than of the substance of their operations. There are elements of accounting that are "hard" and that involve precision. (How much cash do we have in the bank? What is the balance of our mortgage?) And there are elements that are "soft." (How much of the president's salary is allocable to overhead and how much is a program expense?)

In the terminology of generally accepted accounting principles (GAAP), there are basically two functional categories for expenses – program expenses and supporting expenses. (Supporting expenses include "management and general" expenses [commonly referred to as "overhead"] and "fundraising" expenses.) Prevailing logic says program expenses are *good* and supporting expenses are *bad*. But what, exactly, are program and supporting expenses and how do you measure them?

According to current GAAP rules, program services (or activities) are "the activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the not-for-profit entity (NFP) exists. Those services are the major purpose for and the major output of the NFP and often relate to several major programs." Logically then, GAAP rules define supporting activities as "all activities of a not-for-profit entity (NFP) other than program services." Therein lies the primary authoritative guidance for determining what constitutes a "program" expense and what constitutes a "supporting" expense. Application of these very general guidelines is often where accounting ends and "voodoo" begins. What percentage of the president's salary *is* allocable to overhead? What portion of depreciation expense is related to program activities? Our organization's website serves program-related purposes and is also used for fundraising. How much of the costs of operating the website should be allocated to each? Should we allocate the cost of our IT function between program and supporting activities since all of our people rely on their services? Such questions are myriad, and there are no concrete answers. The only right answer used in the accounting profession is that the method must be "reasonable and consistently applied." Reasonableness, like beauty, is in the eye of the beholder. With apologies to George Orwell, we note that some organizations' accounting methods are more "reasonable" than others.

Overhead and Fundraising are Poor Measures of Organizational Effectiveness or Efficiency

Even if you ignore the issue of varying accounting methods, the fact that one organization's overhead and fundraising expense ratios are higher than another's does not necessarily mean that the organization with the higher expense ratio is less effective or less efficient, and it certainly does not mean that it is less worthy of a donor's support. An organization may have very valid reasons for relatively high overhead expenses (e.g., if it is in the development stage of its life cycle) and a mature organization with higher overhead expenses may actually be more effective.

Consider the following example. Assume that Charity 1 and Charity 2 are both organizations that operate after-school programs for children in urban areas. Both have annual contribution revenue of $5 million. Charity 1 has an overhead expense ratio of 18% and Charity 2 has an overhead ratio of 40%. Using prevailing logic, charity ratings organizations would give Charity 1 high marks and Charity 2 would receive very low marks. But what if you knew that Charity 1 relies almost entirely on paid staff and Charity 2 relies very heavily on volunteer workers? What if you knew that Charity 1 serves 1,000 children in a typical year and that Charity 2 serves 4,000 children during the same period? Sadly, few people will look past the expense ratios or the organization's rating by a "watchdog" group to learn more about the details of each organization's operations.

It is understandable that watchdogs, grant funders, donors, and others want to grasp onto something that will allow them to compare nonprofit organizations to each other using mechanical yardsticks. The reality, however, is that functional expense reporting is not a precise science, and it is certainly not a valid basis for using a mechanical yardstick across the nonprofit sector. Folks in the accounting profession don't like to admit that there are elements of the reporting model that border on incantations. But there are. The emperor is not wearing new clothes. He is naked.

Thinking Outside the "We've Always Done It That Way" Box

More thought is being given to this reality by thinking people. In testimony before the Subcommittee on Oversight of the House Ways and Means Committee on July 25, 2012, attorney Eve Borenstein (who was introduced by Chairman Boustany as the "Queen of the Form 990") recommended elimination of the statement of functional expenses from the Form 990, indicating that such information "was ill-documented, unbelievably subjective, and all too-often geared to a desire to appease donors or meet aspirational criteria employed by charity watch-dog groups." In a September 14, 2012 article entitled "*Charities Must Battle Public Misconceptions About Overhead Costs*" in *The Chronicle of Philanthropy*, Dan Palotta wrote, "…what all of us in charitable works fail to acknowledge is that donors believe low overhead costs are good because we have never challenged this misperception."

Some thought is being given to alternative ways to evaluate nonprofits. The most commonly suggested idea is to focus on "outcomes" and to attempt to compare those across the nonprofit sector. The prevailing wisdom says that we need to be able to evaluate one organization against another and develop mechanical, competitive measurements to determine which one is better. The underlying premise is misguided, however. Nonprofit organizations are as unique as the human beings that lead them. Many organizations cannot reliably measure "outcomes" but that doesn't mean they are not effective. And the definition of an "outcome" can certainly vary. What is an "outcome" for a homeless shelter? The number of people served in the shelter or some measure of the number of people served who later live more productive lives? What is the "outcome" of a missionary organization sharing its message across the world? The number of people it shares the message with or the number of people who eventually accept it?

Helping Donors See What Really Matters

One organization, Charting Impact, a collaborative effort of BBB Wise Giving Alliance, GuideStar USA, and Independent Sector, fosters and facilitates communication by nonprofits of key information about their effectiveness by encouraging them to issue reports that answer five fundamental questions:

1. **What is your organization aiming to accomplish?**
2. **What are your strategies for making this happen?**
3. **What are your organization's capabilities for doing this?**
4. **How will your organization know if you are making**
5. **progress?**
6. **What have and haven't you accomplished so far?**

For examples of reports following this model, see http://www.chartingimpact.org/participants/sample-reports/.

Conclusion

Rather than attempting to rate or evaluate organizations against each other, donors should look at whether an organization is effectively carrying out its own mission. Donors should also look at other attributes, including an organization's commitment to effective board governance, financial integrity and appropriate accountability. These are issues that warrant attention – more sophisticated attention. It seems that a good starting point for the focus of effective philanthropy and stewardship is this: nonprofit organizations should publicly identify and publicize their missions, purposes, and goals and report on how effectively they are carrying them out. Donors should identify organizations with missions, purposes, and objectives that match their philanthropic motivations and evaluate how the organizations are doing in carrying out those objectives. Donors should also assess the financial integrity, accountability, and overall credibility of an organization they are considering as a recipient of their giving. Such an approach seems to be a much better model than relying on artificial ratings, subjective expense allocations bordering on voodoo, or a one-size-measures-all yardstick that may have little relationship to an organization's true effectiveness.