

Coping With Ugly Ratios

By Dennis Walsh, CPA

In this era of increased emphasis on nonprofit transparency, donors and other stakeholders commonly look to metrics such as your program efficiency ratio as an indicator of good stewardship. The program efficiency ratio is calculated as total program expense divided by total expenses. Similarly, calculation of the percentages of expenditures applied to management and fundraising activities helps interested persons evaluate your use of resources.

Unfortunately, ratios don't tell the whole story. Absent further explanation, many nonprofits are unfairly viewed in a negative light. For example, small organizations that must incur substantial fixed management costs, such as a CPA audit, may see a significantly higher management expense ratio compared to a larger organization with a similar mission. Or, an organization that retains a development consultant may show a high fundraising expense ratio until program expenditures from new grants and contributions are reflected in future reporting periods.

And this effect is compounded for many volunteer-intensive community nonprofits that receive a substantial amount of their support in the form of donated services that typically do not qualify for financial statement inclusion under Statement of Financial Accounting Standard (SFAS) No. 116 and can never be included as revenue and related program expense on IRS Form 990. Thus, omission of revenue and offsetting program expense from donated services tends to understate the program efficiency ratio as the result of a lower program cost numerator.

The purpose of this update is to review some fundamentals about cost assignment and provide a few tips to help you reduce the likelihood that your organization is judged unfairly as the result of a cursory evaluation of your financial statements or Form 990.

Functional Expenses & Cost Allocation

Most non-membership organizations define three functional expense categories: program, management & general, and fundraising. Management and general serves as the "catch all" category for any cost that cannot be directly associated with a program service or is not a fundraising cost. Costs that relate solely to one of these three areas are assigned directly. Other costs that benefit more than one functional area must be allocated (i.e. shared) if practicable.

There are many potential bases for cost allocation, also referred to as cost drivers. The method selected for a particular cost must be reasonable and used consistently.

For example, you might select square footage for the portion of a building used for program activities to calculate the portion of facilities costs to be allocated to program services. Mileage might be used to allocate vehicle costs. And time spent on specific duties is usually used to allocate staff related costs between program, management, and fundraising activities, based on time logs.

When it comes to shared costs that include fundraising expenses, referred to as joint costs, you must satisfy very stringent requirements to be able to allocate any portion of the cost to program or management activities. These special rules come into play, for example, if you conduct a program activity that includes a solicitation or appeal for funding. If the technical requirements of FASB SOP 98-2 are not satisfied, the entire expense must be treated as fundraising, even though the cost may have significant program or management elements.

You should review each of your natural expense categories from time to time (e.g. human resource costs, facilities, supplies, transportation, etc.) to determine which have shared components that need to be allocated. And from there you should review that the allocation method is reasonable and rational, i.e. that it makes sense.

Direct Costs of Special Events

An accounting rule relating to fundraising costs provides that certain direct costs of special fundraising events, referred to as direct benefits to donors, may be subtracted against the revenue produced and the net income is typically reported as a single line item in the statement of activities. In such case, direct costs of fundraising events such as food and facility rental are not included in the fundraising expense category and can help lower the ratio of fundraising expenses reported in the statement of activities.

IRS Form 990 follows this reporting as well. The instructions specifically provide that your direct costs of special events are reported in Part VIII, Statement of Revenue, Line 8(b) direct costs of fundraising events. Any indirect costs associated with the event, such as the portion of staff cost attributable to preparing for the event, would be included with fundraising expenses reported in Part IX, Statement of Functional Expenses.

Bear in mind that when researching your organization, stakeholders most often initially turn to your Form 990 available free at GuideStar.org or 990 data reported by other charity evaluation services. It is likely that far more persons will view your 990 than your financial statements prepared under generally accepted accounting principles (GAAP).

Donated Services

In order to recognize the value of services donated by your volunteers in your financial statements, the services must be of a specialized nature and meet certain criteria set forth in SFAS 116 as explained in an article appearing in Blue Avocado <<http://blueavocado.org/content/tracking-volunteer-time-boost-your-bottom-line-complete-accounting->> . Federal tax law does not permit the value of donated services to be included with other revenue in the IRS Form 990, even donated services that meet the SFAS 116 criteria for financial statement inclusion.

However, you can summarize and report information about your volunteers and the estimated value of their service in the optional Schedule O of Form 990. Again, many potential donors and other interested persons look at the 990 and this is your opportunity to tell the world about the great volunteer support you get. You may find it helpful to state on Schedule O what your program, management, and fundraising ratios would be if the value of your volunteers were included in your functional expenses reported on Form 990.

You can also help mitigate potential negative inferences from your management and fundraising ratios by adding a narrative description of your volunteer inputs to the financial statement footnotes, such as types of volunteer service, hours contributed, and estimated value. SFAS 116 encourages this for services that do not meet the criteria for financial statement inclusion.

In addition, you can include volunteer services in your internal budget, fundraising materials and annual reports to help give management, board, and external stakeholders a more complete picture. Remember, it's up to you to tell your complete story and show interested persons that you're exercising good stewardship and have the human resources in place to accomplish your important mission objectives.

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