

NONPROFIT OVERHEAD COST PROJECT

FACTS AND PERSPECTIVES

BRIEF NO. 5

CENTER ON NONPROFITS AND PHILANTHROPY, URBAN INSTITUTE
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THE PROS AND CONS OF FINANCIAL EFFICIENCY STANDARDS

Form 990, the reporting document required by the Internal Revenue Service for public charities with at least \$25,000 in gross receipts, has a roughly 60 year history. It was first required in the early 1940s, became a uniform reporting document for all states in the 1980s, and became widely available to donors via the World Wide Web in the late 1990s. Since nonprofit organizations are not legally obligated to divulge audited financial statements to the public, Form 990 is the only publicly available document that reports on the finances of the majority of nonprofit organizations.

The availability of Forms 990 and the accessibility of research datasets generated from these Forms have substantially increased the comparison of the finances of nonprofit organizations. While most people acknowledge that nonprofits should be evaluated on the merits of their programs, financial analysts have argued that relative spending on programs or overhead reflects “accountability” and that relative costs of fundraising reflect “efficiency.” Without reliable and comparable information on program results, media and charity oversight analysts have progressively turned to these financial measures as indicators of organizational legitimacy.

Financial comparisons gained currency in the 1960s and 1970s in response to highly publicized fundraising abuses. Such comparisons maintain an uneasy popularity today. Periodicals such as *Forbes*, *U.S. News and World Report*, *Worth*, and *Money* have ranked nonprofits according to spending ratios, asserting that organizations that spend more on programs or less on fundraising are more worthy of donations. Both Guidestar and the Combined Federal Campaign, two key entry points for information regarding giving, emphasize the financial position of nonprofits. The Better Business Bureau’s Wise Giving Alliance includes spending threshold ratios among its accountability standards; some watchdog groups, such as Charity Navigator,

develop profiles and comparisons of charities exclusively on financial information.

As financial comparisons become widespread and commonplace, critics have had more cause to list the shortcomings of the approach. This is a topic where the ground can be sharply divided between advocates of financial comparisons and those who see such comparisons as fundamentally misleading and even dangerous to the sector. In this brief, we summarize both sides of the argument. You decide.

The Pro Side: The Value of Financial Comparisons

In the wake of the events of September 11, 2001, Americans gave freely to the Red Cross, the United Way, and other charities soliciting donations to assist those affected by the terrorist attacks. These funds came under fire for how organizations chose to reserve or spend the contributions, including spending on management and administration. These events underscored the fact that many people care about the ways that nonprofit organizations spend their contributions. A 1988 public opinion poll found that *an adequate amount spent for programs* was the second most important factor in the decision to donate money to a nonprofit, a factor that was rated as important or very important by 82 percent of respondents.¹ In a 1998 poll, nearly half of respondents (and 62 percent of wealthy respondents) said that they care how much nonprofits spend on administration and fundraising.² In 2001, another poll asked Americans what kind of information is most important when making giving decisions. Nearly half of the respondents focused on *how the organization uses its money*. In contrast, only 6 percent cited *fulfills a genuine need or makes a difference* as the primary reason for giving.³

State legislatures have passed laws limiting fundraising and administrative expenses, while industry watchdogs have established standards to judge the reasonableness of how

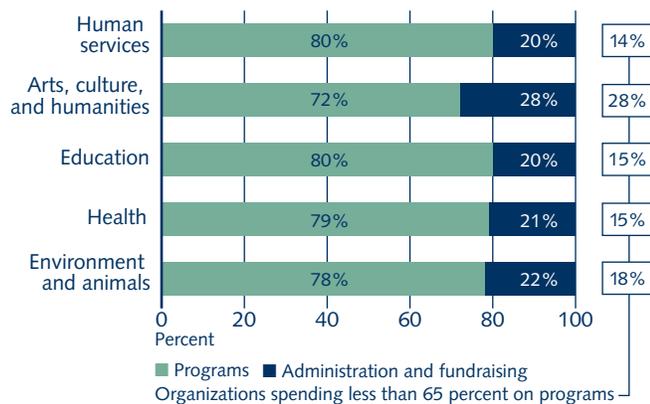
nonprofit organizations spend their money. Two common measures are sometimes referred to as the *program spending ratio* and the *fundraising efficiency ratio*. Both have emerged in response to donor demands for easily digested comparative information.

Program Spending Ratio

How much of a nonprofit organization's total budget should be spent on programs, and how much on fundraising and administration? While personal answers and industry standards vary, the evidence indicates that people care about the question. Consequently, proponents of financial analysis of charities frequently divide program expenses by total expenses to derive a ratio that can be used to compare the relative spending choices of different nonprofits. For illustrative purposes we investigate a standard of 65/35, meaning that a nonprofit is judged by whether it spends at least 65 percent of its total expenses on program activities and no more than 35 percent on administrative and fundraising expenses.

Such guidelines can be very useful in comparing charities. In addition to looking at how charities stack up against arbitrary standards, one can also see how they compare with industry averages, a practice known as "benchmarking." To demonstrate, we analyzed the reports of more than 56,000 organizations in five broad subsectors. A nonprofit was included in our analysis if it reported at least \$50,000 in contributions and at least some fundraising expenditures on Form 990 submitted to the Internal Revenue Service in 2001.⁴ Figure 1 shows both industry benchmarks for the program spending ratio as well as how many satisfy the 65/35 threshold. Nonprofits in the human services and education subsectors spend an average (mean) of 80 percent on programs. The mean is somewhat lower for nonprofits in the arts, culture, and humanities subsector, which spend an average of 72 percent on programs.

FIGURE 1: Average Program Expenditures of Nonprofits, by Subsector



Most nonprofits conform to the 65/35 standard, but some do not. The arts, culture, and humanities subsector has the largest proportion that do not meet the standard, with more than one in four organizations reporting that program expenditures constitute less than 65 percent of total expenditures. These benchmarks are useful because individual nonprofits (or their boards of directors) can easily calculate their own program spending ratio and see how they compare with both a common standard and an industry benchmark. Such a comparison can help them make management decisions about whether they should alter their spending habits to better conform to averages and expectations.

Fundraising Efficiency Ratio

Economics tells us that rational organizations should keep spending money on fundraising until it costs \$1 to raise each additional \$1. However, most donors do not see it that way. Most donors want as much of their contribution as possible to go toward the mission of the organization, not toward raising additional donations. One way to gauge how efficiently an organization raises funds is to compare its expenses in fundraising to the amount of contributions it brings in. Typical standards say that nonprofits should spend no more than 25 to 50 percent of contributions on fundraising. For illustrative purposes we choose a standard of 35 percent, meaning that a charity might be taken to task for spending more than \$0.35 to raise each dollar.

Knowing what proportion of contributions nonprofits plow back into fundraising is helpful to donors who care about how their donations are spent. To see how the typical nonprofit stacks up on this standard, we returned to our 56,000 Form 990 filers and calculated the ratio.⁵ Figure 2 shows the results. The average nonprofit in each subsector spends less than 35 percent of total contributions on fundraising. By this standard, those in the environment and animals subsector are most efficient, spending \$0.15 for each dollar raised. Education groups are least efficient, spending an average of \$0.24.

These numbers may be useful to donors when they are making giving decisions. While the average charity meets an arbitrary standard of 35 percent, a substantial number would not be in compliance. Roughly one in four education nonprofits would not meet this test, which indicates that charities in this subsector may have a harder time raising donations. This is good information for donors to have, so that they can take into account the situation that particular nonprofits are in when evaluating whether to hold charities accountable to a particular standard. Other factors like the size of the organization and how established it is in the community may also influence its fundraising efficiency ratio,

FIGURE 2: Average Amount Spent to Raise \$1 in Contributions, by Subsector



and donors should make their decisions with these forces in mind. Almost all advocates of the use of efficiency ratios agree that absolute standards need to be balanced with a case-by-case assessment of an organization's specific situation. The financial ratio, in context with a standard or an industry benchmark, is one more useful piece of information that donors can use to determine whether charities are worthy recipients of their hard-earned dollars.

In sum, financial indicators of program spending or fundraising efficiency are directly responsive to the demands of donors to understand how nonprofit organizations spend their money. Just as people use financial ratios to help them make decisions about which stocks or mutual funds to invest in, such ratios also help people make decisions about which charities will be the most efficient stewards of their charitable donations.

The Con Side: The Danger of Financial Comparisons

Although program spending and fundraising efficiency ratios attract a fair amount of scrutiny from regulators, media, academics, and some donors, most accept these measures uncritically. This is a mistake because these measures exhibit a range of technical flaws and threaten to lead to a host of undesired outcomes.

Technical Flaws

The fundraising efficiency ratio is not a measure of efficiency at all. It documents the sunk costs associated with cultivating donors. Once this cultivation has taken place, the costs of raising additional donations may be much lower than the costs of raising initial donations. The true measure of efficiency is in how much cost is associated with raising the next contributed dollar. Money already spent tells us

nothing about the efficiencies the organization has achieved through its spending. Only at that point where the costs of fundraising exceed its revenues should we worry that an organization is not being efficient in its fundraising.

Arbitrarily limiting a nonprofit in how much it can spend to raise its needed operating revenues is counterproductive and unfair. After all, all organizations have different mixes of fixed and variable costs, so different nonprofits will have different points at which they are most efficient. An organization with investments in computers and mail-inserting machinery will be more efficient in mailing 100,000 letters than a smaller organization with no such investments and an all-volunteer staff. Yet the smaller organization is likely to be more efficient mailing out a small number of letters to its committed donors. Efficiency cannot be wrapped up in a single standard. Efficiency means different things to different organizations.

Additionally, some types of organizations simply need to spend more to raise awareness of their causes and thereby increase the donations that follow from this awareness. Some nonprofits might be meeting a new need in innovative ways, but in a community that does not yet recognize the importance of such work. Organizations operating in rural or poverty-stricken areas or organizations with a focus on ethnic communities might be dealing with factors that increase their costs relative to donations raised. In such circumstances the nonprofit cannot benefit from the cheaper resources enjoyed by better located or more widely recognized organizations.

Another important point is that program spending ratios are not measures of organizational effectiveness, although they are often taken as such. Nonprofit organizations can provide highly effective programs and at the same time have a comparatively high cost of administration and higher than average cost of fundraising. Indeed, an organization may be effective in service delivery precisely because of its spending on administration and costly investments in raising donations! The program spending ratio can distract us from quality services and lead us toward charities that value thrift over excellence.

Also, technical accounting and reporting problems compromise our ability to make true comparisons of accountability and efficiency. The easiest way for an organization to appear thrifty is to underreport its fundraising or administrative costs. A large number of organizations that report substantial contributions also report no fundraising costs. Consequently, those organizations with favorable ratios include both the thrifty and those that do not accurately represent their costs in financial statements. Another accounting issue is determining an adequate period over which

administration and fundraising costs should be evaluated. The choice of one year as the basis for evaluation discourages longer-term investments in the capacity of the nonprofit organization to grow and take advantage of the economies that come with larger size.

Unintended Consequences

Program spending and fundraising efficiency ratios do not do a good job of measuring what they seek to measure. However, more than being poor measures, their use threatens to lead to unintended consequences. The most prominent concern is that a focus on these ratios encourages competition in a market that rewards low costs of administration and fundraising. While this may be precisely the aim of watchdogs and regulators that advocate the measures, such competition induces nonprofit managers to underinvest in good governance, planning, compliance and risk management, collection of data for service performance evaluations, and staff training. Similarly, it encourages focus on short-term returns from fundraising activities at the expense of the establishment of longer-term relationships. The result is an underdeveloped nonprofit sector and a loss of community trust and confidence in philanthropy.

Thirdly, the market for winning the low-cost-of-administration-and-fundraising-ratio “badge of honor” maintains an unlevel playing field. Strict financial ratio standards favor larger organizations, longer-established organizations, and those with popular causes. They discriminate against those nonprofits that are newly established, support relatively unpopular or unknown causes, or do not have an established “top-of-mind” position amongst potential donors.

Finally, since program spending and fundraising efficiency ratios are not useful indicators of fraud or dishonesty, the focus on these ratios shifts the gaze of regulators and commentators from dishonest charities to those who are disadvantaged in the market for lower costs. That spotlight falls on worthy charities that can least afford negative publicity and the increased costs of fundraising that follow. The resulting environment provides incentive to those that have comparatively unfavorable ratios to use their lawful discretion to minimize the levels of administration and fundraising costs in their disclosures. The market becomes a competition in creative accounting favoring the large, the well established, and the sophisticated.

In sum, use of financial ratios to evaluate charities is not only misleading, but can be harmful to nonprofits and the nonprofit sector as a whole. The undue emphasis on financial ratios diverts attention and resources from the development of more meaningful measures that address perfor-

mance against mission and programs objectives. Watchdogs, regulators, and donors would do well to focus on the question of how well nonprofits deliver their services rather than dwell on the issue of how they choose to spend their money.

Postscript

While strong advocates for either side of this debate are easy to find, many people straddle the uneasy ground between the two sides. Understanding the limitations of the information and the way it can or cannot be interpreted is important in making wise use of financial ratios. Like them or not, financial ratio standards and benchmarks are increasingly common. We hope that knowledge of the limitations and caveats of these approaches will become equally common so that users will always be aware of the dangers of and potential for misuse.

Further Details

The project’s lead researchers are Mark A. Hager, Thomas Pollak, and Kennard Wing (Center on Nonprofits and Philanthropy) and Patrick M. Rooney (Center on Philanthropy, Indiana University). Ted Flack, Center of Philanthropy and Nonprofit Studies at Queensland University of Technology in Brisbane, Australia, contributed substantially to the development of this brief. For more on these and other issues, visit <http://www.coststudy.org> or call (202) 261-5709 (Urban Institute) or (317) 236-4912 (Indiana University).

Acknowledgments

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¹Reported in J.S. Glaser, *The United Way Scandal: An Insider’s Account of What Went Wrong and Why*. New York: John Wiley, 1994.

²Reported in V. Stehle, “Study: Americans Confident in Charities’ Integrity.” *The Chronicle of Philanthropy*, September 10, 1998, p.5.

³Princeton Survey Research Associates, *Final Report: BBB Wise Giving Alliance Donor Expectations Survey*. Princeton, NJ: author, 2001.

⁴Five percent of the records are for 2000, cases for which our data included a 2000 but not a 2001 return. Also, our sample includes only charities that operate their own programs, excluding those whose primary purpose is to support the programs of another organization.

⁵The fundraising efficiency ratio can be calculated several different ways. Our numerator is the sum of fundraising and special events expenses. Our denominator is the sum of direct and indirect private contributions, government grants, and gross revenues from special events.