

Financial

R A T I O S

for not-for-profit organizations

By Michael A. Peer, CPA

Not-for-profit organizations have an obligation to manage their resources responsibly as a condition of their tax-exempt status. Some have compared this obligation to that of a public company's relationship with investors. Members of management, the board of directors, granting agencies and donors have a need to monitor the performance of the organization. One tool available to these parties is the use of financial ratios.

I was recently contacted by a not-for-profit organization concerned because they had received notification that a granting agency would begin calculating financial ratios. The person was worried that some of the ratios may not reflect favorably on the organization when presented without other information. Among the difficulties in using comparative ratios with financial data of not-for-profit organizations is the variation in the missions they support, as well as variations in financial reporting treatment.

Situations to consider using financial ratios

Financial ratios can be a valuable tool when analyzing an organization's financial health as they are arithmetic computations that are easy to use for internal and external reporting. They also provide a method

of communicating financial information in a concise format. In the following situations, ratios are very helpful:

- The ratios will be used to identify trends with the organization's own financial statements.
- The ratios will compare the organization to another with a similar mission, similar size or program offerings, and similar geographic area.
- The organization you need to benchmark against is a vastly different size and comparing dollars alone is not meaningful.
- The user requires information to be summarized very briefly.

Weaknesses of using financial ratios

As noted above, the primary downside of using financial ratios is the variation in the types of not-for-profit organizations when comparisons are made. Due to organizational mission and current circumstances, incorrect conclusions can be reached by looking at financial ratios alone. One very popular ratio, program ratio, computes the program expenses to total expenses. A portion of contributors immediately consider anything under a specified percentage to indicate inefficiencies or private benefit on the part of management employees. The truth is that

Common ratios for not-for-profit organizations:

Contributions and grants ratio

$(\text{Contributions} + \text{grants}) / \text{total revenue and support}$

This ratio indicates the organization's dependence on voluntary support.

Program ratio

$\text{Program service expenses} / \text{total expenses}$

This ratio measures the amount of expenses devoted to carrying out the mission.

Debt ratio

$\text{Total liabilities} / \text{total assets}$

This ratio measures the solvency of the organization.

some organizations require more management time and may require 20 cents of each dollar to be spent on management and general expenses. Another organization may be run by volunteers, and spending 10 cents of every dollar on management expenses is excessive. The true measure of a not-for-profit is how well the mission is accomplished.

If organizations with similar mission exist in the same geographic area, comparisons of financial ratios will lead to meaningful results. If there are not similar organizations locally, consider expanding to other similar geographic markets and then to a national level.

Another consideration is if the organizations are using the same basis of accounting to compute selected ratios. For example, a not-for-profit health care organization is required by the industry audit guide to include and exclude specific expenses in the operating margin. Thus,

when multiple not-for-profit health care entities compare this ratio, the conclusions reached are meaningful. On the other hand, a not-for-profit social service agency does not have the same specific guidelines regarding operating margin and may compute the amount differently than the health care organization (perhaps depreciation is not included). In this instance, even if the two organizations are of comparable size, the difference in accounting basis leads to inaccurate conclusions.

Finally, if comparative organizations do exist, are you able to get the information in a reasonable amount of time? If the sole source of data is 990s, the benchmarks will be 18 to 24 months old. Benchmarking of this type may provide a meaningful historical perspective but not affect current decisions.

Conclusion

To analyze the financial health of your organization, first decide what ratios are important for long-term success. Present those ratios over three to five years to arrive at a trend line for the organization. Finally, decide if good comparative organizations exist and if financial data can be obtained within a reasonable time frame. If comparable data exists, benchmark the organization against the average of the other organizations and the best of the group. Use of financial ratios in this manner will enable financial statement users to make better decisions regarding your organization.

MICHAEL A. PEER, CPA is shareholder of health care services at Kolb+Co. in Brookfield. He can be reached at 800-461-8843 ext. 287 or mpeer@KolbCo.com.

TAX AND TAX ADVOCACY



Frederic J. Brouner
608-252-9341

Capitol Square Office
fjb@dewittross.com



Douglas H. Frazer
262-754-2850

Metro Milwaukee Office
dhf@dewittross.com

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Capitol Square Office 2 E. Mifflin Street, Suite 600, Madison, WI 53703

Metro Milwaukee Office 13935 Bishop's Drive, Suite 300, Brookfield, WI 53005

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