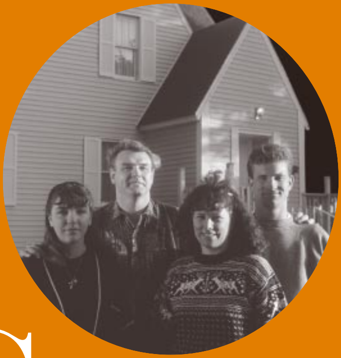

Lessons for BOARDS from the Nonprofit Overhead Cost Project

Many nonprofit organizations have problems accurately tracking and reporting their overhead expenditures in financial statements. Is your organization one of them?

This guide reviews major findings from a national study and makes recommendations in four areas:

- Financial controls
- Financial reporting
- Financial staffing
- Organizational effectiveness

Nonprofit Overhead Cost Project

This guide is based on information collected by the Nonprofit Overhead Cost Project. The goal of the project is to understand how nonprofits raise, spend, measure, and report funds for fundraising and administration, and to work with practitioners, policymakers, and the accounting profession to improve standards and practice in these areas. The project is a collaboration between the Center on Philanthropy at Indiana University and the Center on Nonprofits and Philanthropy at the Urban Institute. For more information on the project, see **http://www.coststudy.org.**

The Nonprofit Overhead Cost Project was supported by the Atlantic Philanthropies, the Ford Foundation, the Charles Stewart Mott Foundation, The David and Lucille Packard Foundation, and the Rockefeller Brothers Fund. Project researchers who contributed to the content of this guide are Kennard Wing, Mark A. Hager, Patrick M. Rooney, and Thomas Pollak.

Financial Controls

Perhaps the most basic responsibility of nonprofit boards is to safeguard the organization's assets and ensure money is spent in intended ways. The most important way they carry out this responsibility is to ensure that adequate financial controls are in place. Most boards do not directly develop the financial controls. Instead they hire staff or consultants who are financial professionals to develop them, and ask the auditor they hire to assess the quality of these controls annually.

The adequacy of financial controls arose during nine in-depth case studies performed as one phase of the Nonprofit Overhead Cost Project. In one organization, for example, the woman who ran the thrift shop routinely took the cash home at night. It is hard to imagine a more obvious risk of loss. The management letter the auditor sent to the board at another nonprofit spoke of missing cancelled checks and invoices, a variety of transactions entered improperly in the accounting system, and physical inventory scattered throughout the organization's facilities. These practices create a fertile field for fraud or other loss. Several organizations used temporarily restricted funds to meet current cash flow needs in violation of their agreement with the donor.

Smaller organizations often had only one person who handled financial matters. This makes is hard to implement separation of duties—a basic principle of financial control—such as having different people entering invoices, cutting checks, and signing checks. A staff person who wants to commit fraud is in prime position if he or she processes the whole transaction from start to finish. Another problem at smaller organizations was that the financial person was frequently a jack-of-all-trades who handled human resources, facilities, and other administrative tasks, and had little or no financial training. Such staff are generally unaware of the importance of financial controls or how to develop them.

We recommend that nonprofit boards, particularly at smaller nonprofits, initiate a special review of financial controls in their organiza-

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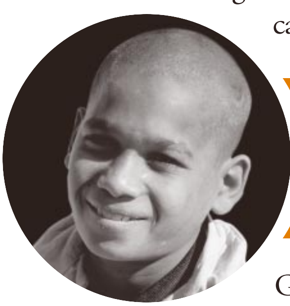
tions. This review is best performed by a financial professional who is an outsider to the organization. For nonprofits with auditors, we also recommend the board ask them to assess and report on the adequacy of financial controls annually. If the selection and hiring of the auditor is not currently done by the board, we recommend the board take over that responsibility.

The assessment, development, and implementation of financial controls will take scarce resources from an organization that likely cannot spare them.



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Given the fundamental importance of boards' responsibility to safeguard assets, however, adequate financial controls must be a board priority.

Financial Reporting

Related to its fiduciary responsibility, the board is also responsible for the quality of financial reporting, and ultimately responsible that such reporting adheres to legal and ethical standards. Many people rely on audited financial statements and Forms 990 submitted to the IRS, so their accuracy and quality is an important part of the organization's accountability and transparency to the public.

In our study, the biggest problem area in both kinds of financial documents was the reporting of functional expenses. Nonprofits are required by generally accepted accounting principles (GAAP) as well as the IRS to divide their total expenditures into three categories: program, management and general, and fundraising. Donors, funders, and charity watchdogs use this breakout in calculating program spending ratios and fundraising efficiency ratios, among other measures. The program spending ratio is program expenses divided by total expenses. The fundraising efficiency ratio is total fundraising costs divided by total contributions.

Because of the data's ready availability, most users calculate these ratios using Form 990 data. Analysis of over 220,000 Forms 990 found widespread reporting that defies plausibility in the functional expenses used to make those calculations:

- Thirty-seven percent of nonprofits with at least $50,000 in contributions report zero fundraising costs.
- One-fourth of nonprofits reporting $1 to 5 million in contributions report zero fundraising costs.
- Thirteen percent of nonprofits report zero management and general expenses.
- Seven percent charged all accounting fees to program and another 20 percent split them across more than one category despite the fact that Form 990 instructions give accounting fees as an example of what is meant by management and general expenses.

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As a follow-up to this analysis, we sent out 3,000 surveys and collected data from a nationally representative sample of over 1,500 nonprofits. We found that only 25 percent of nonprofits that get grants from foundations properly classify those proposal-writing costs as fundraising. Only 17 percent of nonprofits that get grants from government properly report those proposal-writing costs as fundraising.

In the third phase of our study, we performed in-depth case studies of nine organizations of varied size drawn from different parts of the non-profit sector. Two organizations were included that had reported zero fundraising costs on Form 990. We found that both reported zero fundraising costs in error. One had over $500,000 in actual fundraising costs, as shown on its audited financial statements. No one had noticed the zero until researchers asked about it, almost a year later. The other organization had a staff person who did nothing but fundraising, and they also did some direct mail fundraising. Despite this, both the audited financials and the Form 990 showed zero fundraising costs.

The program spending and fundraising efficiency ratios are also very sensitive to how personnel costs are spread across the categories of program, management and general, and fundraising. The accuracy of this allocation is important because personnel costs form the largest expense at many nonprofits. In our national survey, barely one-third of nonprofits said they track staff time by functional expense category for each payroll period.

That proportion squared with the case studies, where three of nine organizations had a paper or automated time-tracking system that was capable of serving as the basis for functional expenses tracking, but that was far from the whole story. Only one of those three used it for that purpose, and in that one case, the fundraising person charged grant proposal writing time to the program the money was for rather than properly accounting for it as fundraising cost. Most nonprofits stick the majority of their employees wholly into one category or another, and make a retrospective year-end judgment about how the few remaining ones spent their time—a method whose accuracy is open to question and that has not surprisingly resulted in low reported overhead costs.

Nonprofits that are made up of multiple, affiliated corporations have an additional Form 990 reporting issue. The majority of our case study sites, and five of the six that were over $1.5 million in annual revenue, consisted of such conglomerates. Unless the entities are covered by a group exemption letter, the IRS requires separate reporting for each legal entity. In three of our five larger cases, all or almost all management and general and fundraising costs were reported in a single entity's Form 990, leaving zero or very low non-program costs in the other entities. Given such practices, the overhead and fundraising costs of nonprofits with complex legal structures cannot be assessed using Form 990 data. We recommend that organizations allocate fair shares of management and general and fundraising costs to all reporting entities.

Aside from functional expense reporting, our study identified two situations that can make it hard to assess the financial condition of a nonprofit. First, the receipt of large capital gifts can lead to huge reported annual surpluses in the year the gift is received and, where the gift is used to purchase depreciable property, a series of annual deficits over its useful life. Second, organizations that receive extensive in-kind donations of goods, space, or services can have surpluses or deficits from inventory swings, their financial statements can lead users to draw erroneous conclusions about the financial condition of the organization, and such organizations can appear to have excessive overhead costs on Form 990. If your organization receives significant capital or in-kind donations, consult the publication *Special Issues in Nonprofit Financial Reporting: A Guide for Financial Professionals*, available at www.coststudy.org.

Analysis of over 220,000 Forms 990 found widespread functional expense reporting that defies plausibility.

Reporting problems were so widespread in this study that we recommend all boards initiate a review of financial reporting at the organizations where they have a fiduciary responsibility, and bring in outside experts to assist if necessary.

Our study suggests that organizations cannot simply rely on their auditor to raise these issues.

Financial Staffing

Boards have a responsibility to see that the organization has financial staffing that is adequate as to both amount and professional qualifications. The quality of financial controls and reporting at the nonprofits we studied was a direct reflection of the amount and qualifications of staff devoted to the work. It is an especially serious problem at smaller nonprofits. A long-time administrative director with no financial training told us, "I'm not an accountant, but I play one at work." At another organization where a person with similar background was replaced with someone with deep financial experience, we heard, "This is the first year we've known what the numbers are." Two of our case study organizations had significantly upgraded the quality of their financial controls and reporting over a period of several years. In both cases, the board was the driver and led the organization to invest in more and better qualified financial staff, and new hardware and software.

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Given their responsibility, we recommend the board have within its membership individuals qualified to perform an assessment of the amount and professional qualifications of financial staff. For organizations with an auditor, we recommend that the board, on an annual basis, ask the auditor whether financial staffing is adequate.

Smaller organizations may not be able to justify even one full-time financial professional. We recommend such organizations explore alternative approaches, such as contracting out, to ensure financial roles are performed adequately.

Organizational Effectiveness

Another important board responsibility is to ensure that the organization has adequate resources to fulfill its mission.

One of the important findings of the Nonprofit Overhead Cost Project is that overhead, far from a "necessary evil," is the basis for mission effectiveness. Our nine case study sites formed something of a naturally occurring experiment in this regard, varying widely in the strength of their organizational infrastructure. By organizational infrastructure, we mean accounting, fundraising, information technology, human resources, physical plant, and other common organizational elements that stand behind and support a nonprofit's mission and program.

Some of our sites had very nice facilities, the latest computers and software, as well as highly experienced and adequate staffing in supporting functions. At other sites, rain came through the roof during our visit, computers were mismatched hand-me-downs, software was make-do, and key support staff had limited training or experience for their role, or were part-time because that's all the organization could afford.

The limitations in organizational infrastructure at these latter sites had real consequences for organizational effectiveness. Nonprofits in the arts, community development, and human services described how their development efforts were hindered by inappropriate donor database software. One site described the unproductive downtime and frequent maintenance associated with “free” but mismatched, outdated computers. In agencies where key positions either did not exist or were filled with junior staff, the executive director was overly involved in routine tasks such as preparing financial reports or writing grant proposals, to the detriment of her own leadership role. Sites without experienced finance staff had only rudimentary financial reporting and had limited ability to involve program managers in financial management, perform more sophisticated analysis, or identify financial issues for the board and senior management. Backup for key roles was nonexistent, leaving basic functions like payroll, benefits, and network support dependent on a single person in even the largest nonprofit we studied.

Spending on overhead, far from a “necessary evil,” is the basis for mission effectiveness.

Low, noncompetitive salaries for administrative positions had consequences for effectiveness as well. While nonprofits are sometimes able to find highly qualified people willing and able to work for below-market wages, this is not always possible. Key positions are often filled with junior people with little relevant training or prior experience, or long-term employees that grew up with the organization but lack relevant professional training and credentials. When junior staff gain the requisite experience, they often move on to better paying jobs. In a few cases where sites have found good long-term employees, executives worry they could never replace these staffers at anything like their current salaries.

End-of-useful-life facilities also have consequences. The CEO who grabbed a push broom to sweep out the rain that was coming through the roof during our visit was unable to use that time to think strategically or foster new relationships. Ditto for the CEO who had to scramble to get “new” cast-off furniture when forced to move because the mover refused to accept the liability of moving the old, broken-down furniture they had been using for years.

Far from making them good stewards of the contributions they receive, the excessively low overhead at many nonprofits, especially smaller ones and those receiving significant public

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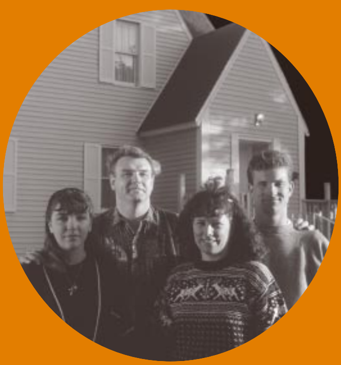
sector funding, is hampering their overall effectiveness. To meet their responsibility, boards must find ways to provide for adequate organizational infrastructure to support organizational effectiveness.

Our study suggests that nonprofits of $1 million or less find it difficult to afford adequate infrastructure. Boards of these organizations may wish to consider alternatives such as growing or merging to a scale where adequate infrastructure is affordable, outsourcing infrastructure services, or perhaps even restructuring to a smaller, more volunteer-centered organization where infrastructure issues are less critical.

Boards hold the ultimate responsibility for protecting the assets of the organization, being accountable to the public through accurate financial reporting, and ensuring that the organization has the infrastructure it needs to be effective at fulfilling its mission. The Nonprofit Overhead Cost Project suggests that boards at many nonprofits need to take a closer look at how well they are carrying out these vital responsibilities, and to invest in needed changes.



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