



Myths and Truths about Not-for-Profits

Part II



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In our last article, we tackled some of the myths about the Sarbanes-Oxley Act, auditor rotation requirements, the IRS' view on not-for-profit organizations having a positive bottom line, reserves, and requesting extensions to file tax returns. This month, we'll continue to tackle a few more common beliefs and misperceptions about the financial management of not-for-profit organizations.

1. **"The higher the program expense percentage, the more effective a not-for-profit is."** Not-for-profit organizations are required to report their expenses in three functional categories: program, management and general, and fundraising, with the latter two being considered supporting expenses. The auditors ask for this presentation in order to present the financial statements in accordance with generally accepted accounting principles (GAAP); the IRS asks for it as a required schedule in the Form 990; the not-for-profit watchdog organizations and grant-making organizations ask for it and translate it to a percentage basis as a way to compare one organization to another. As a result, there is the general understanding that the higher the program expense percentage is, the more of the contributed dollars are going to serve the mission of the organization.

While this belief has its merits, it's not completely true. Here are some of the reasons why:

- Let's first take this to the extreme. Assume there is a not-for-profit organization that spends every penny of its operating budget on its sole program, which is a food bank. We'll call this Perfect NFP. Because Perfect NFP's program expense is 100% and not a penny is wasted on supporting expenses, we can say that it is the most effective organization, right? What this means is that Perfect NFP does not have an accounting function to pay its bills, keep track of its revenues and expenses, or file the necessary tax returns. It also means no one in the organization is managing the overall operations or raising the contributions that will pay for the program expenses. We can quickly imagine how Perfect NFP will not be able to get its food supply because it is not paying its suppliers; it might lose its tax exempt status for not filing a tax return with the IRS. Do we really think this model is sustainable as a continuing operation? The point here is that not-for-profit organizations do need to have adequate infrastructure, which may not be considered program expenses. Without those expenses, an organization cannot effectively operate its programs.

- Allocation of expenses by function is not an exact science. GAAP allows many ways to allocate the expenses. The most commonly used basis for allocating expenses are percentages of staff time spent on each of the functions or square footage of the space devoted to conducting each functional activity. Since most organizations don't ask their staff to log every minute of their work day to get to the exact number of hours, or measure the space down to the square inch, those drivers used to allocate expenses are estimates. Different organization will apply different methods in coming up with these estimates, so it would be difficult to compare one organization's percentage to another, as we might not always be comparing apples to apples.
- The size of a not-for-profit organization's operations or budget will impact the program expense percentage. Larger organizations are able to gain certain economies of scale. For example, the accounting function is typically considered to be a management and general expense. For an organization with a \$10 million operating budget, adding an accountant to its payroll may cause the program expense percentage to drop 0.5%, assuming the average salary is \$50,000. In contrast, a smaller organization with a \$2 million budget that hires an accountant at the same salary level would possibly reduce the program expense percentage by 2.5%. So is the smaller not-for-profit less effective simply because the necessary accounting function is a larger proportion of a smaller organization's overall budget? One can't make that judgment without knowing more about each of these organization's operations.

While the program expense percentage appears to be a quick and objective way of evaluating not-for-profit organizations, it should not be used as the sole measurement of the effectiveness of an organization.

2. **“Any gift is a good gift.”** The not-for-profit sector collectively spends millions of staff hours and funding annually raising money for its programs. Think about all the mail and email appeals, phone calls, billboards, auctions, and TV ads that are designed to encourage donors to write a check. So after all these efforts raising contributions, isn't anything that comes in the door a good thing? The answer is, not necessarily. Unrestricted cash gifts are probably always a good thing. However, a not-for-profit organization should think through the potential implications before accepting a restricted cash gift or a noncash gift.
 - Restricted cash gift: This is a contribution with “strings attached.” Those “strings” may include limiting the funds to be spent during a specific time period, for a specific program or purpose, or both. Once a restricted gift is accepted, the organization has a legal and fiduciary requirement to fulfill those restrictions. Before accepting such a gift, an organization should not only consider its ability to meet those restrictions from a programmatic perspective, but also consider the additional administrative burden associated with tracking and reporting on restricted gifts. For example, an organization accepted a gift a few years ago specifically to fund the printing of a particular brochure that the organization gives out to its program participants. Over the past years, although the organization has not changed its mission, it has changed its method of delivering its message from handing out paper brochures to web and social media based delivery. Therefore, the organization is no longer able to use those narrowly restricted funds, as it no longer prints those brochures. The option then is to go back to the donor for a change in the restriction or return those funds.

Another area that requires special consideration is accepting endowment gifts. Any organizations with endowment funds are required to comply with the Uniform Prudent Management of Institutional Funds Act (UPMIFA), and account for those funds in accordance with the specific GAAP rules related to endowments. There is a certain level of complexity with managing and accounting for endowment funds. So before accepting those gifts, an organization needs to consider whether the size of the gift justifies the additional administrative burden as the result of the gift. For example, having 50 different endowment funds with a balance of \$100 each would be a complicated accounting exercise that may not be worthwhile.

- **Noncash gifts:** This type of gift can be in many forms: securities, real estate, goods and materials, and professional services, just to name a few. Before accepting these gifts, an organization should consider the cost of accepting and maintaining the gift. If the gift is a stock publicly traded on a U.S. major stock exchange, it's fairly simple. The cost would likely only be the brokerage fee for liquidating the stock. However, if a donor wants to make a gift of her holding in a limited partnership registered in the Cayman Islands, or her shares in a U.S. S-corporation, the cost would be much higher. Holding a foreign investment or shares in an S-corporation would potentially require a not-for-profit to file additional tax forms with the IRS, as well as potentially subject it to unrelated business income tax. Since most not-for-profit organizations do not have in-house tax accountants, the cost of compliance with these additional tax filing requirements should be researched first.

If the gift is real estate, further consideration needs to be made related to any liens or possible environmental remediation costs that may be required. For example, are the costs of cleaning up the oil tank under the house being gifted to you and the internal costs of managing such a cleanup and selling the house something you are also willing to accept? While the benefit of accepting such a gift might outweigh the cost of administering and managing the gift, it requires resources to perform the necessary due diligence.

Not-for-profit organizations should have a well thought out gift acceptance policy. The policy should provide guidelines on restricted gifts and noncash gifts, including the following:

- Minimum dollar of a restricted or endowment gift – The larger the minimum, the less proportional burden it will be to account for it.
- The level of restriction that a donor can place – Is it at a broad strategy level, program level, or does it get too specific?
- The type of noncash gifts that the organization will accept – Some organizations do not rule out any categories of noncash gifts, but require unusual types of gifts to be reviewed by a committee and due diligence performed before they are accepted.

3. **“Depreciation is not a real expense.”** An organization that provides childcare services has had a negative net income for years. When anyone raises concerns over the financial health of the organization, the CFO's explanation has always been “Well, if you back out the depreciation expense from the net income number, we basically break even.” What this CFO believed was that since depreciation is not a cash outflow of the organization, it's not really an expense that the organization needs to be worried about. A few years down the road, the organization's facilities are in need of major repairs that the organization cannot afford, and the organization's ability to provide childcare services is in jeopardy. It is in a real financial crisis. Buildings, furniture, and equipment don't last forever. After a certain period of usage, they either will need major repairs or need to be replaced. Although depreciation expense is not one of those expenses that you write a check for, it is an estimate of the wear and tear on your fixed assets. It is important to understand the mechanics of calculating and tracking depreciation for financial reporting purpose, but it's even more crucial to have a strategy to fund depreciation, which is really a strategy for funding major repairs and replacement of fixed assets. There are basically two strategies:

- **Funding depreciation with operating income:** Selecting this strategy means budgeting depreciation expense as a real cost of the operation. So if the not-for-profit organization strives to have a balanced budget, its operating revenues need to be enough to cover both the cash costs and the noncash depreciation costs. This means, on a cash basis, the organization needs to have a surplus, which can then be spent on current capital replacements, or set aside to be used for future investments in fixed assets.

- Funding depreciation with outside sources: This strategy will typically involve debt financing, a capital campaign, or both in the future. The outside sources will provide the organization with the funds it needs to repair or replace the fixed assets. Many not-for-profit organizations have used this strategy successfully. However, those that are successful are often the ones that have deliberately chosen this strategy and have laid the ground work for debt financing and/or a capital campaign early on. The organizations that default to using this strategy when they are in immediate need of funding for fixed assets are not necessarily always successful. Neither a capital campaign nor debt financing can be completed without careful advance planning.

For the not-for-profit organization that is largely dependent on its physical facility and equipment to provide its programs, depreciation is real. Organizations should have a strategy to fund future major fixed asset repair and replacement needs. Not-for-profit organizations should consider depreciation expense as an approximate measure of the cost of the wear and tear of fixed assets that need to be funded in the future.

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We would be happy to assist you with any of your questions. Please call us at 941-365-4617 or email Rob Lane at rlane@kbgrrp.com or Patricia Entsminger at pentsminger@kbgrrp.com.