

Teaching Notes to Accompany Case: How Helpful are Charity Watchdog Ratings?

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The objective of this case is to provide students an opportunity to learn about nonprofit financial statements and perform a basic financial analysis. In performing the analysis, students will become familiar with the unique financial and operational challenges faced by nonprofit organizations (NPOs). The case is written for junior or senior level finance or accounting majors or for first-year MBA students.

CASE SYNOPSIS

NPOs are a major economic force contributing \$905.9 billion to the U.S. economy in 2014 and making up 5.3 percent of the U.S. GDP (Urban Institute, 2015). NPOs hold roughly \$4 trillion in assets and that number continues to grow (The National Center for Charitable Statistics, 2012). As donors increase contributions, additional oversight and accountability by charity watchdogs and stakeholders place increasing pressure on NPOs to ensure they fulfill their fiduciary responsibilities (Primoff, 2012). Furthermore, while the Sarbanes-Oxley Act requires increased financial oversight of for-profit firms it is also viewed by NPOs as best practice. Due to Sarbanes-Oxley compliance issues, corporate donations to NPOs often require more financial oversight than before. This, in turn creates a demand for finance and accounting graduates with an appreciation of the distinct financial and operational challenges encountered by NPOs. Given the growth of the nonprofit sector and the growing need for guidance on financial management and fiduciary responsibilities, it is likely that a significant number of graduates may be employed or serve on boards of these organizations. Unfortunately, most finance or accounting graduates receive little or no exposure to NPO financial statements. This case provides an opportunity for students to perform a financial and comparative analysis using publicly available information of two well-known NPOs, World Vision and Compassion International. Further, the teaching notes provide suggestions for discussion of additional challenges faced by nonprofits that differ from their for-profit counterparts.

The case is designed to take approximately two and a half hours of class time. The first half of the time could be spent discussing the case, introducing students to the financial statements, the ratios and discussing how they differ from for-profit statements. As homework, the students may be asked to put themselves in Maggie's place and prepare a report analyzing the financial strength of World Vision alongside Compassion. This should take students about three to four hours depending on how detailed a report is required. Alternatively, the instructor could provide students with all the ratio results given in Exhibit 1 at the end of the teaching notes and ask students to prepare a comparative report of the two NPOs. The second half of the class time could be used discussing the results and offering conclusions regarding the strengths and weaknesses of each organization. If time permits, another class period could be used to discuss some of the controversial issues raised in the case, such as misreporting problems that

are unique to NPOs, the administrative expense controversy, and material questioning how effective charity watchdog ratings are in measuring the financial strength of NPOs.

FINANCIAL RATIO COMPARISONS AND ANALYSIS

The comparative results of the financial ratios for Compassion International (CI) and World Vision (WV) are given below. CI consistently receives higher ratings in financial health than World Vision by Charity Navigator. It is useful to compare the ratios of CI and WV to see where some of the financial differences between the two organizations exist. This may provide some clues as to why Charity Navigator provides a significantly lower rating to WV and whether the different ratings seem justified. Encourage students to download the annual reports for both organizations so they can read the financial notes to determine whether the numerical differences are significant. The annual reports can be found at worldvision.org and compassioninternational.org.

The formulas for all the ratios are given in the case in Exhibit 2. The resulting calculations and a brief discussion are given for each ratio category and are also summarized for both organizations in Table 20.

TABLE 1
LIQUIDITY RATIOS

	2015	2014	2013	2012	2011
Current Ratio					
World Vision	2.48	1.63	1.38	1.28	1.89
Compassion	2.52	3.06	3.06	3.17	3.17
Net Working Capital					
World Vision	\$75,124,000	\$52,679,000	\$40,041,000	\$30,624,000	\$94,187,000
Compassion	\$110,985,992	\$134,425,234	\$127,850,625	\$112,640,561	\$110,307,496

The liquidity ratios indicate that WV has much less cash available to them than CI. General consensus indicates the current ratio should be between 2 and 4 (Berger, 2008). WV stays below the minimum acceptable current ratio, with the exception of 2015, while CI stays within the appropriate range during the entire 5-year period. Further examination of WV's Statement of Financial Position indicates the current ratio improved in 2015 primarily due to a decline in current liabilities. Total current assets for WV peak in 2011 and then trend down with a slight increase in 2013. The changes seen in the increasing current ratios for WV have more to do with the decline in current liabilities than an increase in cash or current assets. Specifically, WV decreased their obligations that fund World Vision International each year which dramatically decreased their total current liabilities. Referring to Note 7 of the annual report, this account represents a funding commitment and cash transfer made to World Vision International which allows the majority of WV programs to be carried out worldwide.

In summary, based on the current ratio and net working capital figures, we find that CI is more liquid than WV and CI stays within the recommended ranges. WV falls short in liquidity with a recent improvement in 2015. The net working capital numbers tell the same story. WV has much lower balances than does CI, even though arguably, based on total revenues, WV is a larger organization. This places WV in a riskier liquidity position.

**TABLE 2
LEVERAGE RATIOS**

	2015	2014	2013	2012	2011
Debt Ratio					
World Vision	0.452	0.410	0.476	0.562	0.484
Compassion	0.314	0.395	0.385	0.347	0.359
Debt to Net Assets					
World Vision	0.826	0.696	0.908	1.282	0.938
Compassion	0.459	0.395	0.385	0.347	0.359

The debt ratio indicates that the proportion of debt to total assets is higher for WV than for CI. The debt ratio for CI has been trending upward and peaked in 2015 at 31.4% of assets. WV's debt ratio has fluctuated over the last 5 years with a high of 56.2% of assets in 2012 and a low of 41% in 2014. WV's debt has fluctuated over the 5-year period. Upon closer examination of the accounts in the Statement of Financial Position, the increases in the debt ratio for WV have more to do with a decrease in assets than an increase in liabilities. There is a very slight increase in liabilities in 2015 but otherwise liabilities have trended downward since 2012. It appears that WV is making an effort to reduce liabilities as its asset base is also declining. However, what may be troublesome is that one of the accounts that is experiencing a major downward trend is their commitment to World Vision International which is used to fund their international programs. Given that this liability funds part of WV's mission it is disconcerting to see this liability decline from almost \$81 million in 2012 down to a 5-year low of \$10.2 million in 2015. While declining liabilities is a positive trend given their high debt ratio and the subsequent risk that it poses for the organization, it is disturbing the reduction is taken from accounts that drive their mission.

Upon examination of CI statements it can be seen that a moderate increase in liabilities is driving their increase in the debt ratio. CI has successfully increased its asset base over the 5-year period. It has also experienced modest increases in liabilities but some of the increase in 2015 is simply due to increases in accrued liabilities while others are minor increases in various liability accounts. There is nothing exceptional in any of the account increases.

It is important to examine the level of debt as compared to the net assets held by the NPO. CI has experienced an increase in the debt to net assets ratio from about 36% to 46% over the past 5 years. CI's numbers can be explained by a modest increase in debt as well as small fluctuations in its total net assets. It is natural for total net assets to fluctuate from year to year but CI has managed to increase its total net assets each year from 2011 to 2014. In 2015 CI had a \$10 million decline in net assets (roughly a 5% decrease) which accounted for most of the change in the ratio for CI. On the other hand, WV not only keeps higher levels of debt to total assets but ratio results widely fluctuate throughout the 5-year period. In 2012, WV actually had a higher level of debt than it had in net assets resulting in a ratio exceeding 1.0. This signals a high level of financial risk for WV. The debt ratio should not be higher than 0.5 and the debt to net assets ratio should not exceed 1.0 (Coe, 2011). It is slightly encouraging that WV has reduced the ratio since 2012 but it is still high. If WV experiences any fiscal adversity then they are at risk of not being able to offer their programs or perhaps even make necessary interest payments.

Trends for total assets and total liabilities are very different for WV and CI. WV is experiencing a decrease in both its asset and liabilities over time while CI is experiencing an upward trend in both assets and liabilities. Also, CI is better able to manage its net assets to avoid major fluctuations while WV has not been able to do the same.

Functional Expense Ratios

TABLE 3
PROGRAM EXPENSE RATIO

	2015	2014	2013	2012	2011
World Vision	0.845	0.846	0.829	0.850	0.859
Compassion	0.818	0.840	0.836	0.843	0.833

The program expense ratio for both organizations are similar. WV generally has a slightly higher program expense ratio than CI but the difference is minor. The standard minimum acceptable range for the program expense ratio is 70%-85% (Lopatka, 2007) and both NPOs easily operate above that threshold. Generally donors like to see the program expense ratio as high as possible. It is rewarding to see a large proportion of donated dollars go directly to the mission of the organization. A study by Weisbrod and Dominguez (1986) indicates the better the financial results, the higher level of donations will be received in the future. Thus they conclude that private donors do care about the financial results of the firm and more specifically, that the majority of the money raised is spent on mission programs.

TABLE 4
ADMINISTRATIVE EXPENSE RATIO

	2015	2014	2013	2012	2011
World Vision	0.058	0.049	0.054	0.050	0.047
Compassion	0.074	0.065	0.066	0.067	0.072

The administrative expense ratios are steady for both NPOs, however WV tends to spend a lower proportion of their funds on administrative expenses than CI.

This may be a good time to ask students if they can see a possible downside to having a low administrative expense ratio. The NPO literature addresses this problem quite extensively. NPOs are aware that donors tend to focus on the program expense ratio. The NonProfit Overhead Cost Project (Wing, 2004) discusses the danger of an inadequate administrative structure. In an effort to maximize program expenditure ratios, NPOs succumb to the pressures of minimizing administrative expenses by either not hiring the best people or not hiring enough people to run the organization. This in turn, causes the NPO to run less efficiently. Perhaps if they had the administrative talent and an adequate number of employees needed to run the organization properly they would be better positioned to carry out their mission more effectively. The publication notes that during a visit to a number of NPOs, some were found to have nice facilities, state of the art technology and sufficient staff while other NPO's facilities had leaking roofs, outdated technology and staff with limited training. Chang and Tuckman (1991) support the notion that having a solid administration allows the organization to accomplish more. Furthermore, they argue that having a higher level of administrative expense provides a cushion in the event of an economic downturn. However, other studies (Callen, 1994; Posnett and Sandler, 1989; Tinkelman, 2004; Weisbrod and Dominquez, 1986) all find that donors care about the proportion of monies allocated to overhead expenses and they prefer to see that proportion low. In summary, their findings imply that donors shop for the best deal. In other words, if 85% of a dollar goes toward programs and only 15% goes toward administrative and fundraising as opposed to a similar organization where 78% of a dollar goes toward the mission and the rest to support expenses, then the charity that is able to put more of the dollar toward the mission is "a bargain" compared to the other NPO. In a sense, overhead expenses represent a price that has to be paid to attract donor dollars. The lower that price, the more donations the NPO is likely to procure (Bowman, 2006). Organizations that do not have the proper infrastructure to support the

administrative obligations of the mission may appear financially efficient in the short-run but this may come at the expense of long-term efficiency which is difficult to measure.

To make matters worse, NPOs already pay below average salaries compared to their for-profit counterparts. Therefore, key positions are often filled with individuals that have insufficient training (Wing, 2004). Capable individuals may stay on because of the emotional attachment they have to the mission but often they move on to jobs that offer higher wages. When NPOs pay higher administrative salaries, it is noticed by many donors. One can quickly peruse the comments page for World Vision on the Charity Navigator site, http://www.charitynavigator.org/index.cfm?bay=search.comments&orgid=4768#.Vyd6z4_QrJD8 and read criticisms people post of the CEO's salary with some donors declaring they will donate resources elsewhere. Compare some of the CEO salaries of comparable sized for-profit firms and the NPO consistently pays significantly less than a similar sized for-profit firm.

**TABLE 5
FUNDRAISING RATIO**

	2015	2014	2013	2012	2011
World Vision	0.097	0.105	0.118	0.101	0.094
Compassion	0.108	0.095	0.097	0.090	0.095

The proportion of money spent on fundraising for the two NPOs is very similar. Both organizations spend roughly 10% of their funds on fundraising activities. Expenditures in this category are important to raise revenues for their mission.

**TABLE 6
FUNDRAISING EFFICIENCY RATIO**

	2015	2014	2013	2012	2011
World Vision	\$5.949	\$5.589	\$5.232	\$5.298	\$5.471
Compassion	\$9.104	\$10.514	\$10.481	\$11.330	\$11.066

The fundraising efficiency ratio is a measure of how much money is raised per dollar spent on fundraising efforts. The higher this ratio the better. Stakeholders don't mind seeing a larger proportion of money allocated to fundraising if they can see that those monies bring in significant revenue. We can see that CI manages to bring in almost twice as much revenue per dollar spent on fundraising than WV. These numbers suggest that WV is much less efficient in their fundraising practices. However, this inference will be re-visited again after a few more ratio results are discussed.

Charity Navigator includes the three expenditure ratios as well as a fundraising efficiency ratio into its formula as part of their evaluation of the financial health of an NPO. The higher the program expense ratio, the better. Charity Navigator uses a fundraising efficiency ratio similar to the more commonly used ratio presented in the case. Their results directly correlate to the results of the ratio used in this analysis. Specifically, they measure how much it costs to raise \$1 in donations. So, in this case, the lower the number the better. The functional expense ratios should bode well for WV with the exception of fundraising efficiency. WV slightly outperforms CI with their program expense ratio and largely outperforms CI with their administrative expense ratio.

This may be a good time to begin a dialogue with students about possible conflicts of interest in reporting for NPOs. Just as for-profit firms are sometimes incentivized to reallocate expenses to make earnings look more attractive, NPOs have similar incentives. For example, a for-profit firm may choose to amortize an expense that more appropriately should be expensed but amortization enables earnings to be larger. Research has shown that some NPOs are tempted to conduct similar activities. They, of course, are

not motivated to show a profit but rather are motivated to show the largest possible proportion of expenditures going toward program expenses rather than administrative or fundraising expenses (Gregory and Howard, 2009; Keating and Frumkin 2008; Krishman, Yetman and Yetman, 2006; Tuckman and Chang, 1998). Furthermore, if the proportion of monies spent on fundraising efforts can be decreased, it improves the fundraising efficiency ratio. Bhattacharya and Tinkelman (2009) conducted a study to determine how difficult it is for charities to meet the financial standards by Wise Giving Alliance. They collected data using Form 990s in year 2001 from Guidestar and found that roughly 75% of NPOs reported no fundraising or no administrative expenditures. Obviously, it is unrealistic to believe that large of a proportion of NPOs have no administrative or fundraising expenses. This implies the expenditures were at least partially classified as program expenses.

One factor that makes categorizing expenses sometimes difficult is when a particular expense can be classified in more than one category. For example money may be spent on public awareness which may be driven primarily from administrative expenses but its intent is to benefit fundraising. In cases such as these where an expense may cross more than one category, the NPO may utilize joint allocation cost and place an estimated portion of the expenses in the appropriate categories. WV reports their joint allocation cost expense in financial note number 15. Thus, they are being transparent to their stakeholders about processes used to allocate cost across categories. CI does not have a corresponding financial note implying either they just lump all costs in one category or it is possible that they do not have joint costs to allocate, although the latter is unlikely.

It is important to understand these organizations must go through an accounting audit which serves as a check to prevent financial misreporting. However, research suggests that NPOs have a much larger incidence of accounting irregularities than that of a for-profit firm. Burks (2015) found that NPOs report error rates 60% higher than that of publicly traded for-profit firms. When comparing NPOs to for-profit firms of similar size, the errors are roughly twice as high. Burks investigated the type of errors that most commonly occur. Of the 465 errors detected in the study, the two largest categories were revenues and expenses. Twenty-six percent were revenue errors and 17.8% were errors in recording expenses. Burks also found that those NPOs that used a “Big Four” accounting firm, or second-tier auditors had a significantly lower number of errors. This suggests that the errors are not necessarily intentional but may be due to lack of training or infrastructure. Only a small proportion of NPOs hire large firm auditors due to the expense. Unfortunately, this is another consequence derived from the pressure of NPOs to keep administrative costs low. This creates a self-perpetuating cycle as financial statement misreporting tends to generate losses in donations for the NPO (Greenlee, Fischer, Gordon and Keating, 2007). Burks suggests that financial reliability could be improved by investing in staff training throughout the organization to help prevent or recognize events, develop procedures to allow those events to be communicated to accounting and hold regular reviews to detect recognizable events. However, this requires a considerable amount of administrative expense that most NPOs, especially the smaller ones, would be hesitant to divert from their program expenses. WV and CI both use KPMG, LLP as their auditing firm which provides stakeholders with more confidence regarding the quality of their financial reports.

Revenue Ratios

This ratio group allows stakeholders to examine the various revenue streams and determine whether the NPO relies heavily on a single revenue stream to fund its programs. NPO revenues can come from several sources. Some NPOs get most of their revenue from income received for services rendered or for products sold. A hospital that charges for healthcare it provides for patients would be a good example. Other NPOs rely more on the philanthropy of individuals and corporations to get most of the revenue necessary to fund their programs. NPOs often attempt to supplement private donations with government (public) funding usually in the form of grants which is generally a stable source of income (Luksetich, 2007). Other possible sources of revenue available to some NPOs may include membership dues, and in-kind contributions that can come in the form of donated items from corporations such as food, clothing and other supplies. Volunteer time donated for professional services such as physician services and

attorney services may also show up in the notes as an in-kind donation and can save the NPO considerable money for services they would otherwise have to purchase. Finally, NPOs may also receive investment revenue in the form of interest and dividends earned on investments. Generally, it is best to have as many self-sustaining revenue streams as possible. For example, investment income, service and product revenues and membership fees are generally more self-sustaining and less volatile than revenues from private sources. Donations from the private sector tend to decline during a recession and other economic shocks. Having a diversified revenue stream is likely the best way to stabilize revenue streams and minimize fluctuations.

**TABLE 7
CONTRIBUTIONS REVENUE RATIO**

	2015	2014	2013	2012	2011
World Vision	0.570	0.580	0.610	0.556	0.526
Compassion	0.996	0.996	0.996	0.995	0.997

Between 50 and 60% of revenues for WV come in the form of contributions from donors. CI is nearly 100% dependent on donor contributions for their income. Studies have shown that having more sources of income reduces the risk of revenue volatility. Thus it is good that WV has a little more than half of their money coming from one source. Private contributions may come from individuals or companies but individuals make up 85% of private contributions (Boris, 1998). Because of this, private contributions are highly volatile since any type of economic distress tends to impact contributions. This makes it very difficult to project budgets for NPOs that rely primarily on these contributions (Gronbjerg, 1993). Thus, CI appears to be at higher risk than WV due to the level of dependency on these revenues.

**TABLE 8
IN-KIND CONTRIBUTIONS RATIO**

	2015	2014	2013	2012	2011
World Vision	0.254	0.224	0.200	0.255	0.275
Compassion	0.001	0.001	0.001	0.001	0.001

Twenty to twenty-five percent of WV contributions come in the form of in-kind donations. Financial note 13 in the 2015 annual report describes the types and value of in-kind donations WV receives which include pharmaceuticals, clothing and household goods, books, building supplies, office supplies, and medical supplies. In-kind contributions are almost non-existent for CI.

**TABLE 9
INVESTMENT REVENUE RATIO**

	2015	2014	2013	2012	2011
World Vision	0.005	0.008	0.009	0.018	0.012
Compassion	0.002	0.003	0.003	0.004	0.002

Investment income is minimal for both organizations. Both WI and CI obtain less than 1 percent of their income from interest and dividends on their investments. The only exception was in 2011 and 2012, WV received a bit more in investment income but it was still an insignificant portion of their overall revenues.

**TABLE 10
GRANT REVENUE RATIO**

	2015	2014	2013	2012	2011
World Vision	0.172	0.188	0.182	0.171	0.188
Compassion	---	---	---	---	---

CI did not report any public donations or government grants during the 5-year period. WV consistently received 17%-19% of their total revenues from public sources. Note 12 of the annual report provides a breakdown of the various sources of grant money obtained. It appears that the majority of their grant revenue comes from USAID with another significant portion coming from the World Food Program.

It may be interesting to ask the class why they think WV seeks grant funding and CI does not. The pursuit of grant funding absorbs administrative costs, however, WV administrative expenses are not out of line. Also, there is research that suggests that government grant funds “crowd out” donations by the private sector (Bernheim, 1986; Roberts, 1984; Warr, 1983). The idea is that once private donors see that an NPO’s fund needs are met then private donors can divert their funds elsewhere. Other research (Andreoni, 1990; Payne, 1998; and Steinberg, 1987) found that although some crowding out may exist, it is not a dollar for dollar exchange thus NPOs can still benefit by seeking public grant revenues.

Not only do public funds provide an alternative source of revenue but research suggests grant revenue as having greater stability than private donations. A multitude of studies indicate that government grant revenues are much less volatile than private money (Gronbjerg, 1993; Kingma, 1993; Kramer, 1981; Reiner, 1989). The results of these studies provide support for WV’s efforts in seeking this type of funding. It also implies that given that public funds make up a significant portion of their revenue stream, this in turn, helps to stabilize WV’s revenues and perhaps subjects them to less business risk.

**TABLE 11
SERVICE REVENUE RATIO**

	2015	2014	2013	2012	2011
World Vision	0.007	0.007	0.009	0.009	0.009
Compassion	---	---	---	---	---

CI does not receive any revenues from services provided. WV reports a very small service revenue stream that is consistently under 1% of their total revenues.

Financial Stability Ratios

This group of ratios is intended to measure the risk incurred by an NPO with regard to its revenue streams, and how well an NPO is positioned with surplus funds and assets so the NPO is able to continue operations in the event of a revenue shortfall.

**TABLE 12
REVENUE CONCENTRATION INDEX**

	2015	2014	2013	2012	2011
World Vision	0.42	0.42	0.44	0.40	0.39
Compassion	0.99	0.99	0.99	0.99	0.99

The Revenue Concentration Index (RCI) is a measure developed by Tuckman and Chang (1991) intended to measure the degree of diversification an NPO has within its revenue intake. Heavy reliance on

one or two revenue streams places an NPO in a vulnerable position and would cause a major financial shock if one of those revenue streams were to decline dramatically (Carroll and Stater, 2009; Trussel, Greenlee and Brady, 2002). As previously discussed, some revenue streams are riskier than others. Public donations tend to be the most volatile while others tend to be more stable. Fees for services or products obtained from the NPO tend to be less correlated with economic condition as are government grants. The more diversified the NPOs revenue stream, the less risk the NPO faces in the event on an unexpected change in one of its revenue streams. The RCI measures the diversity of the NPOs revenue stream and can range from 0 to 1. An RCI closer to 1 indicates heavy reliance on a single revenue stream whereas an RCI closer to 0 indicates the organization has access to several revenue streams. Thus, NPOs should strive for the lowest RCI attainable.

WV has a much lower RCI than does CI. This reduces the “business risk” of WV substantially since it does not rely on one source of revenues to meet its program and support expenditures. As seen in the previous ratios, WV has done an excellent job of diversifying its revenue stream with the majority of revenues coming from donors but also relying significantly on in-kind contributions and grant revenues. A small proportion of their revenues come from investments and service fees. Conversely, although CI ratios register strong in other areas of analysis, they have a weak RCI due to the lack of diversification in revenue sources. This places a high degree of business risk on CI.

**TABLE 13
SELF-RELIANCE RATIO**

	2015	2014	2013	2012	2011
World Vision	0.005	0.008	0.009	0.017	0.012
Compassion	0.002	0.003	0.003	0.004	0.002

This ratio measures the level of expenses that the NPO is able to cover from revenues generated by the NPO rather than reliance on public or private donations. Both WV and CI have a very low self-reliance ratio and are heavily dependent on donations generated from outside sources. However, this is typical for NPOs classified as voluntary health and welfare organizations (VHWO) since they provide services at no charge.

**TABLE 14
OPERATING PROFIT MARGIN**

	2015	2014	2013	2012	2011
World Vision	0.009	0.009	0.011	(0.043)	(0.020)
Compassion	(0.013)	0.006	0.021	0.022	0.052

The operating margin measures the percentage of revenue remaining after all operating expenses have been deducted. The operating margin for WV was negative in 2011 and 2012 indicating that operating expenses exceeded revenues. While it did improve slightly in the three most recent years, it still remains very low. CI had a 5% operating profit margin in 2011 with a declining margin thereafter and a negative margin in 2015.

NPOs and for-profit businesses view operating margins differently. For-profit firms strive to minimize their operating expenses and maximize their operating margin in an effort to boost their net profit margin. Rather than trying to make a profit, NPOs try to breakeven and use all funding to support their mission. Thus NPOs generally have low operating profit margins which indicates that they are spending almost all monies on programs and support services. However, NPOs attempt to avoid negative margins. Obviously, as they forecast budgets they are not able to project revenues and expenses with

perfect accuracy. As the fiscal year ends they generally prefer to have some operating profit left to cover non-operating expenses and perhaps even accumulate a small surplus.

**TABLE 15
SURPLUS MARGIN RATIO**

	2015	2014	2013	2012	2011
World Vision	0.039	0.004	0.003	(0.047)	(0.015)
Compassion	(0.013)	0.012	0.019	0.023	0.057

The surplus margin ratio measures the proportion of revenues left after all operating and non-operating expenses have been paid. This ratio is directly analogous to the net profit margin for a for-profit firm. WV claimed its highest surplus margin in 2015, just under 4%. The years prior to 2014 indicate a very low or negative margin. The opposite is true for CI. The surplus margin is highest in 2011 at nearly 6% and declines each year ending with a negative margin in 2015.

This may be a good time to ask students what would happen if an NPO consistently had low to negative surplus margin ratios. Would students think it is better to see high surplus margin ratios? Why or why not? The nonprofit literature discusses how surpluses are viewed by the public. Donors and stakeholders prefer to see some surplus funds held by the NPO. These funds can provide security in case of a revenue shortfall or if expenses are higher than expected (Greenlee and Trussel, 2000; Trussel, 2002; Tuckman and Chang, 1991). Administrators must be careful to balance what may be considered a sufficient number of surplus funds as opposed to too much or too little. Too many surplus funds may send a signal to donors that the NPO has more money than they need to fund programs, while very low levels may indicate financial risk.

**TABLE 16
DEFENSIVE INTERVAL RATIO**

	2015	2014	2013	2012	2011
World Vision	8 Days	7 Days	8 Days	6 Days	6 Days
Compassion	38 Days	50 Days	52 Days	48 Days	55 Days

The defensive interval ratio is an indication of the internal buffer the NPO has access to continue funding its programs in the event all revenues were to discontinue. WV has a very low level of reserves compared to CI. If revenues were to suddenly stop then WV would only be able to continue to offer its programs for 8 days. This is up from 6 days in 2011. CI would be able to continue to offer its programs for 38 days. Their buffer has declined over the years with a high in 2011 of 55 days but in 2015 they are still positioned with a much higher level of reserves than WV. However, one thing worth noting is that it would be highly unlikely for all of WV's revenue streams to suddenly stop which may justify a lower defensive interval ratio for WV. Given CI's dependence on one source of revenues, they appear to be strategically aligned to have a higher defensive interval.

**TABLE 17
EQUITY RATIO**

	2015	2014	2013	2012	2011
World Vision	0.121	0.138	0.131	0.107	0.140
Compassion	0.257	0.288	0.302	0.310	0.312

Net assets to an NPO is analogous to equity to a for-profit organization. In essence net assets are the equity base the NPO has available to them if monies are needed to fund programs, make capital investments or for other financial needs. However, a major difference is that not all NPO net assets are accessible for liquidity needs. Those assets that are temporarily restricted cannot be liquidated until the restrictions expire and those that are permanently restricted cannot be liquidated at all. Only unrestricted assets can be liquidated if needed.

However, all net assets are considered in this ratio because even if many of the assets are restricted, NPOs can often obtain loans using restricted assets as collateral thus providing another form of liquidity. WV consistently has proportionally less than half of the equity ratio than does CI. This places WV at higher risk once again in the event they need to access additional funds.

This is an opportune time to ask students that now, after carefully going through the financials for WV and CI, do they think the financial strength of the NPOs are fairly represented by the ratings? Why or why not? The overall comparative analysis of the two NPOs will differ among student but makes for rich discussion. Some of the issues that may arise are the differences in the liquidity and equity ratios. Some students may be concerned by the low numbers in both of these areas for WV. Others may argue that given the diversity of revenues that WV has (as indicated by the low RCI) successfully diversified its risk and therefore does not need to hold high levels of liquid assets or net assets. On the other hand, CI is solely reliant on donor contributions, placing them in a riskier position in the event of a financial shock. To protect their programs, CI must hold higher levels of liquid assets and net assets in order to stabilize program offerings. So, it is possible to argue that both organizations are well managed and the differing management styles are reflected in the RCI, net working capital balances and net asset balances.

Some other ratios may be more difficult to defend. WV has a very high level of debt compared to CI. Arguably this could be a more aggressive strategy since again, they may feel more confident in their diversified cash flow streams and impressive in-kind contributions. However, a global economic downturn could impact several of their cash flow streams including, private donations, in-kind donations and possibly public grants. This could potentially place WV in a situation where they would not be able to provide funding for programs and meet their liability payments without dipping into asset reserves, which are comparatively thin. Some may argue that this places WV in a position whereby they may have to severely cut program expenses in the event of a global recession. Undoubtedly WV bears more financial risk than does CI.

Another important factor is what appears to be the inefficiency of WV fundraising activities. As seen earlier, they are only able to raise roughly half as much per dollar spent on fundraising as CI. Fundraising activities and expenses vary considerably across differing types of NPOs. However, one might assume given these two NPOs are so similar in mission, much of their fundraising efforts should also be similar. Recall that about 17-18% of WV revenues come from public grants. In order to obtain the grants, resources have to be used to write the grant proposals (Luksetich 2008). If the money spent on grant development is allocated at least in part to fundraising expenses and the money raised is not included in the formula to compute fundraising efficiency then it makes WV's fundraising efforts appear inefficient. If it were assumed that fundraising dollars were used to prepare proposals for public grants then it would be appropriate to reflect the public donations as part of the funds raised in the fundraising efficiency ratio. The revised outcome would look like this:

TABLE 18
FUNDRAISING EFFICIENCY RATIO
(Adjusted to Include Grant Revenues)

	2015	2014	2013	2012	2011
World Vision	\$7.740	\$7.403	\$6.794	\$6.929	\$7.424
Compassion	\$9.104	\$10.514	\$10.481	\$11.330	\$11.066

The inclusion of grant revenues noticeably improves WV's fundraising efficiency but they still fall significantly below CI. While it is reasonable to expect some difference in efficiency, WV should continue to work to improve its fundraising strategy. It has trended slightly upward since 2012 while CI has trended slightly down in the same period but CI still impressively outperforms WV.

Regardless, of which assessment students prescribe, it remains apparent that Charity Navigator ratings do not take all financial factors into account. Charity Navigator calculates their financial rating by examining the following metrics: The proportion of funds spent on 1) program expenses, 2) administrative expenses, 3) fundraising expenses, 4) fundraising efficiency, 5) primary revenue growth, 6) program expense growth, 7) working capital ratio.

The first three metrics are calculated using the same formulas given in the case. The fundraising efficiency ratio is positively correlated to the alternative and more common formula given in the case. Whereas the common fundraising efficiency ratio measures how much money is raised for every dollar spent on fundraising, Charity Navigator calculates the inverse; how much does it cost to raise \$1 in donations. The working capital ratio used by Charity Navigator measures much the same thing as the defensive interval ratio given in the case and measures how long they can remain liquid in extreme adversity. Finally, they examine the growth of revenues and program expenses:

**TABLE 19
GROWTH OF REVENUES AND PROGRAM EXPENSES**

	2015	2014	2013	2012	2011
Revenue Growth					
World Vision	(0.0314)	0.0538	(0.0361)	(0.0375)	-
Compassion	0.0655	0.0936	0.0987	0.0846	-
Growth of Program Expenses					
World Vision	(0.0334)	0.0795	(0.1087)	(0.0265)	-
Compassion	0.0640	0.1064	0.0937	0.1382	-

CI certainly has better revenue growth than WV. However, their program expense growth is outpacing the revenue growth in all years except 2015. This begins to catch up with CI as can be seen in the Statement of Activities. As growth in expenses outpace growth in revenues, each year the surplus between revenue and expenses shrink steadily until the difference becomes a large \$10,084,227 deficit in 2015. Comparatively, with the exception of 2014, WV experienced declines in revenues but they also managed declines in program expenses. WV has achieved a decline in program expenses that outpaced the decline in revenues so they were able to reverse the deficits they ran in 2011 and 2012 and run small surpluses in recent years. Obviously cutting program expenses is not desirable. However, the cuts are necessary especially for WV given their level of leverage. It would be fiscally irresponsible for them to run a long-term deficit. Perhaps with changes in fundraising efforts, WV can work to increase the efficiency of those activities and increase their donations, allowing them to increase program expenditures and pay down a portion of their debt.

Charity Navigator does not have a metric that captures the diversity of revenues which research has shown to be an important factor in financial stability. Furthermore, their fundraising ratio does not include money received through grant revenue. Thus, while Charity Navigator attempts to be objective by applying the same formulas across all organizations, sometimes the results may be unintentionally misleading. The metrics used by Charity Navigator tend to highlight the negatives of WV and miss several positive aspects as previously discussed. On the contrary, the metrics highlight CI's positive aspects but misses some weaknesses that the NPO literature deems important, like revenue diversity. This is not to say that CI does not deserve a higher rating than WV but rather this is more of a statement

on how the ratings may oversimplify the financial status of the organizations. Given that donors pay attention to these numbers, it could cause misguided financial consequences for some organizations.

HOW MUCH DO CHARITY WATCHDOG RATINGS MATTER?

Roughly 70% of households donate to at least one NPO in any given year (Tinkelman, 2006). A number of sources indicate that donors care about NPO finances and they particularly care about the proportion of funds that are directed to the programs related to the NPOs mission (Callen, 1994; Posnett and Sandler, 1989; Tinkelman, 2004; Weisbrod and Dominquez, 1986). So how do donors decide which charity to fund? Do they rely on charity ratings or do they use another means? How important are charity ratings?

The Wise Giving Allowance surveyed a sample of 2003 adults and found that rather than obtaining information from charity rating agencies, donors prefer to first obtain information on their own for the charity. Information and opinions from friends and family rank second, followed by rating agency ratings. Recommendations from friends and family are biased ways of choosing a charity but it begs the question, what factors lead an individual to recommend a certain charity? Do they look at charity ratings and make a decision? Are they attracted to the mission of the organization? If several organizations have similar missions, what determines the charity they chose to support? Many feel that charity rating agencies reduce information asymmetry and provide an unbiased source of ratings. Dismissing them as a valuable source of information for donors, board members and other stakeholders may be misguided.

A study by Sloan (2009) used the ratings of Wise Giving Alliance and found that positive ratings increased donors' contributions but negative ratings did not seem to reduce donor revenues. When ratings are good, NPOs often place the badge of approval on their website. Thus positive rating information is disseminated by perusing the primary web page of the NPO. If an organization receives a poor rating, then the badge simply does not appear on the website. Ask students to find the website for CI and scroll to the bottom of their home page and they will see an endorsement from Charity Navigator rating displayed along with other charity watchdog badges of approval. Then ask them to go to the website for WV and you will not find any information about Charity Navigator's 3-star rating. Charity Navigator had given WV a 2-star rating each year from 2011-2014 and WV just barely passed the threshold to an overall 3-star rating in 2015. However, their financial health still only earned a 2-star rating. Thus, it is possible that donors may simply not be aware of the ratings. Sloan also suggests that it may also be that potential donors simply do not care about the ratings. Perhaps other factors drive donations, such as the mission of the organization. However, if Charity Navigator, only one of several charity watchdogs available has traffic of approximately 7 million inquiries, then that alone seems to suggest that many people are interested in the ratings.

A more recent survey by Finch (2014) found that 55% of the respondents reported they either always or sometimes looked for rating seals on charity websites when determining whether or not to donate. So if the rating approval appears on the website, does that guarantee a contribution? Thirty-two percent reported that it would greatly impact their likelihood to donate, 20% of those that looked for seals of approval said it would moderately increase their likelihood to donate and another 20% reported it would slightly increase the likelihood with the remaining 28% stating it would not make a difference. Of those that reported that they looked for a rating seal, 66 percent of them said that if the NPO did not show the seal of approval, it would "greatly" decrease the likelihood that they would donate to that organization. Thus, the absence of a charity endorsement seems to have a strong impact on the confidence that some donors place in the organization.

Charity ratings appear to have at least some influence on donor behavior. Perhaps a good question to end the discussion is to ask students how they feel about charity ratings? Would they be more likely to donate to a 4-star charity rather than a 3-star charity with similar missions? Would they consider any additional factors? Opinions will be diverse with some perhaps arguing while rating agencies are imperfect, they do help with information asymmetry. Others may feel that they have less confidence in the ratings now that they have performed their own analysis.

TABLE 20
FINANCIAL RATIOS FOR WORLD VISION AND COMPASSION INTERNATIONAL

	2015	2014	2013	2012	2011
Current Ratio					
World Vision	2.48	1.63	1.38	1.28	1.89
Compassion	2.52	3.06	3.06	3.17	3.17
Net Working Capital					
World Vision	\$75,124,000	\$52,679,000	\$40,041,000	\$30,624,000	\$94,187,000
Compassion	\$110,985,992	\$134,425,234	\$127,850,625	\$112,640,561	\$110,307,496
Debt Ratio					
World Vision	0.452	0.410	0.476	0.562	0.484
Compassion	0.314	0.395	0.385	0.347	0.359
Debt to Net Assets					
World Vision	0.826	0.696	0.908	1.282	0.938
Compassion	0.459	0.395	0.385	0.347	0.359
Program Exp. Ratio					
World Vision	0.845	0.846	0.829	0.850	0.859
Compassion	0.818	0.840	0.836	0.843	0.833
Admin. Exp. Ratio					
World Vision	0.058	0.049	0.054	0.050	0.047
Compassion	0.074	0.065	0.066	0.067	0.072
Fundraising Ratio					
World Vision	0.097	0.105	0.118	0.101	0.094
Compassion	0.108	0.095	0.097	0.090	0.095
Fundraising Efficiency					
World Vision	\$5.949	\$5.589	\$5.232	\$5.298	\$5.471
Compassion	\$9.104	\$10.514	\$10.481	\$11.330	\$11.066
Contributions Ratio					
World Vision	0.570	0.580	0.610	0.556	0.526
Compassion	0.996	0.996	0.996	0.995	0.997
In-Kind Gifts Ratio					
World Vision	0.254	0.224	0.200	0.255	0.275
Compassion	0.001	0.001	0.001	0.001	0.001
Investment Revenue					
World Vision	0.005	0.008	0.009	0.018	0.012
Compassion	0.002	0.003	0.003	0.004	0.002
Grant Revenue					
World Vision	0.172	0.188	0.182	0.171	0.188
Compassion	---	---	---	---	---
Service Revenue					
World Vision	0.007	0.007	0.009	0.009	0.009
Compassion	---	---	---	---	---
RCI					
World Vision	0.42	0.42	0.44	0.40	0.39
Compassion	0.99	0.99	0.99	0.99	0.99

TABLE 20
FINANCIAL RATIOS FOR WORLD VISION AND COMPASSION INTERNATIONAL
(Continued)

Self-Reliance Ratio	2015	2014	2013	2012	2011
World Vision	0.005	0.008	0.009	0.017	0.012
Compassion	0.002	0.003	0.003	0.004	0.002
Operating Margin					
World Vision	0.009	0.009	0.011	(0.043)	(0.020)
Compassion	(0.013)	0.006	0.021	0.022	0.052
Surplus Margin					
World Vision	0.039	0.004	0.003	(0.047)	(0.015)
Compassion	(0.013)	0.012	0.019	0.023	0.057
Defensive Interval					
World Vision	8 Days	7 Days	8 Days	6 Days	6 Days
Compassion	38 Days	50 Days	52 Days	48 Days	55 Days
Equity Ratio					
World Vision	0.121	0.138	0.131	0.107	0.140
Compassion	0.257	0.288	0.302	0.310	0.312

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