Public Trust in the Public Face of Charities

By Mark A. Hager

One reason that we give our hard-earned dollars to charity is that we trust that charities can make a difference with these contributions. We hear about the ills of society, or the value of public association, and we trust that charities can effectively combat these ills or add to the aggregate value of community in some way. Many can and do, but many do not. Most of us give our trust blindly and do little to assess how well the charities we support are carrying out their missions. When we hear that particular charities (or the sector as a whole) are ineffective or unfaithful in some way, we feel betrayed.

We might feel less betrayed if we took the time to assess the charities we support and make wise giving decisions. However, especially for those givers who seek to exercise due diligence in their giving, assessment runs into two major roadblocks. One is the difficulty in gauging the effectiveness (and therefore the trustworthiness, or donation-worthiness) of charities. The other is the active management of the public face of charities in their efforts to attract contributions.

The effort to gauge the effectiveness of charities has long been a stumbling block for sector researchers and individual organizations alike. Even when particular organizations (like hospitals or theatre troupes) come up with reliable indicators of success, these indicators are invariably specific to the services or missions of unique varieties of nonprofits. And they should be. Using measures of hospital effectiveness to gauge the effectiveness of theatre troupes would be foolhardy. The lack of common measures of nonprofit effectiveness is a firm barrier for those who seek such measures to assess the donation-worthiness of charities.

Nonetheless, the market demands some kind of common measure. Inexplicably, we seem to have found them in the apparent sameness of financial reporting across otherwise wildly different nonprofit organizations. The *only* public document required of public charities in the United States is Form 990, the form that charities use to report their finances and activities to the IRS each year. The revenues, expenses, assets, and liabilities reported in this Form have become a substitute for evaluating the effectiveness of charities. Watchdog organizations espouse guidelines for ratios built from these financial reports, or base their watching primarily on the financial ratios of the organizations they assess. Media publications rank the donation-worthiness of charities according to these same financial ratios. Federated givers and donor-advised funds show these ratios in their donee profiles and assert that financial efficiency is a reliable indicator of how well charities carry out their missions.

Given the absence of other manageable ways to rank and rate the broad array of nonprofits requesting our contributions, perhaps financial ratios are a reasonable alternative. After all, donors say that they care about how much of their contributions are spent on programs, as opposed to administration or fundraising. However, this brings us squarely up against the second problem regarding the due diligence of donors: they are constrained to trust the self-reports of charities that seek their donations. Unfortunately, in many cases, this trust appears to be misplaced.

> Most of us *give our trust blindly and do little to assess how well the charities we support are carrying out their missions*

Should we trust the financial self-reports of charities? Ongoing research by the Urban Institute and the Center on Philanthropy at Indiana University (www.coststudy.org) indicates that many charities do not carefully track or accurately allocate their expenses, making it difficult for them to reliably report the sums that make up the ratios used by evaluators. Accounting rules are complicated and technical, and many contract accountants are not well-versed in details of nonprofit accounting. Many bookkeepers pay more attention to the immediate demands of their organization than the arcane details of cost accounting. Who can blame them? The IRS, funders, donors, and even most watchdogs do not scrutinize their financial reports, so charities are rarely motivated to comply with rules and standards. Consequently, financial reports do not always faithfully represent the internal workings of charities. The most famous example is that roughly two out of five charities that report public contributions also report zero total fundraising expenses. This issue has been the subject of both media and federal government scrutiny, but it has not deterred most users from taking Forms 990 at face value.

While ignorance, sloppiness, or lack of capacity might explain or excuse poor reporting by public charities, there is another more insidious force at work as well. That is, while charities are not given many incentives to accurately track and report their financials, they *are* faced with incentives to report inaccurately. Since Form 990 is the only public document required of charities, the Form has become increasingly available and its figures increasingly used to compare the donation-worthiness of charities. As a result, these same charities are faced with the prospect of managing what they report so as to look as positive as possible on the various measures of financial efficiency. Some give in to the pressure to fudge the numbers. Research by Ranjani Krishnan, Michelle Yetman and Robert Yetman compares Form 990 figures with state regulatory reports for a sample of California hospitals. On Form 990, the hospitals report that program expenditures represent 83 percent of total

Hager *Continued on Page 15*

Hager [*Continued from Page 9*]

spending, on average. However, on the less public regulatory reports, the same hospitals report average program expenditures at only 68 percent. They conclude that the disparity is explained by cost-shifting on Form 990 in an effort to demonstrate a more positive public image.

These findings call into question the extent to which we donors can trust the public face of nonprofits when we are struggling to make giving decisions. For better or worse, many donors have bought into the idea that financial efficiency is a reasonable proxy for mission effectiveness. In the next step, we trust that charities are accurate and accountable for their financial self-reports. The basis for this trust is suspect. As we increase our reliance on these financial reports, we increase the pressure for charities to mis-report. In too many cases, donors cannot trust the charities that solicit their contributions. However, charities can trust that donors will continue to make either poor or blind giving decisions, and they will resist efforts to regulate or improve their financial accountability.

Mark A. Hager, *Senior Research Associate, The Urban Institute*

Note: These ideas come from a chapter in *New Directions in Philanthropic Fundraising* (December 2003); and a forthcoming chapter (with Janet Greenlee) in *In Search of the Nonprofit Sector,* edited by P. Frumkin & J. Imber. On the subject of regulation of the problem described, see E. Keating & P. Frumkin, "Reengineering Nonprofit Financial Accountability," Jan/Feb 2003 *Public Administration Review.*