

APPENDIX A: Feed the Children (Donations in-kind)

As previously indicated the valuation of some gifts-in-kind can be very difficult absent an actual transaction in a market. Some nonprofits attach a zero value to a gift until such time when the item is sold for cash. Accuracy in the valuation of gifts-in-kind can be increased if one waits to do the valuation until such time when an estimable market event is expected to take place. This is a conservative approach to take and often a correct approach. Consider the footnote excerpt in Figure 2.A.1. Goodwill of Northern Michigan (and most other Goodwill chapters) is uncertain of the exact value of a gift-in-kind at the moment it is given. The value of the contribution is defined as the difference between the sales value less all of the cost necessary to bring it up to saleable condition. In a moment we shall see that problems can occur when the gift-in-kind never becomes involved in a real market transaction.

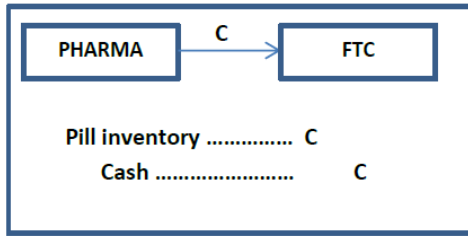
Figure 2.A.1: Goodwill Industries of Northern Michigan Financial Statement Note Excerpt

<p style="text-align: center;">GOODWILL INDUSTRIES OF NORTHERN MICHIGAN, INC. AND SUBSIDIARY</p> <p style="text-align: center;">NOTES TO CONSOLIDATED FINANCIAL STATEMENTS</p> <hr/> <p><u>Contributions</u></p> <p>Contributions received are recorded as increases in unrestricted, temporarily restricted, or permanently restricted net assets, depending on the existence and/or nature of any donor restrictions. All donor-restricted contributions are reported as increases in temporarily or permanently restricted net assets depending on the nature of the restriction. When a restriction expires (that is, when a stipulated time restriction ends or purpose restriction is accomplished), temporarily restricted net assets are reclassified to unrestricted net assets and reported in the consolidated statement of activities as net assets released from restrictions. Restricted contributions whose restrictions are met in the same reporting period are reported as unrestricted contributions.</p> <p>Donated goods for resale are recorded as contributions at their estimated fair value at the date of donation. This merchandise requires the addition of program-related expenses/processes before it reaches its point of sale. For the years ended September 30, 2009 and 2008, Goodwill recognized contributed merchandise with a fair value of \$1,898,162 and \$1,430,823, respectively, as contributions revenue. Fair value is estimated to be that portion of retail sales which exceeds the cost of preparing the merchandise for sale.</p>

In order to illustrate the problems and difficulties that can arise with certain in-kind donations let us first consider the following set of simple examples which will help frame the problem. We will then move to an example of a group of charities with large medical gifts-in-kind to see what can happen when large in-

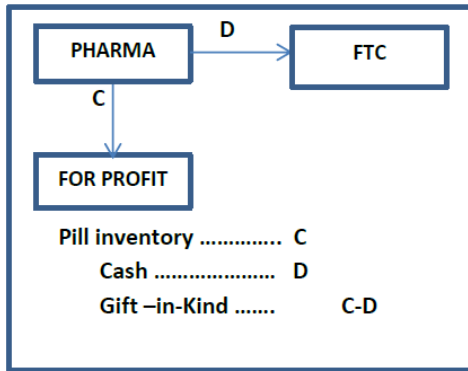
kind-contributions occur and are difficult to value because there is not a definitive market transaction to use to define value. We will then look at the financial statements of Feed the Children, the recipient of large amounts of in-kind contributions of pills. First, consider the following set of simple examples which will serve to frame the issues. In all examples assume FTC, as part of its charitable mission, will distribute the pill free of charge to needy individuals in the countries in which it operates.

Example A1: FTC, a nonprofit charity, buys a pill from a pharmaceutical company (PHARMA) for C cents. PHARMA sells the same pill to all for-profit and nonprofit customers



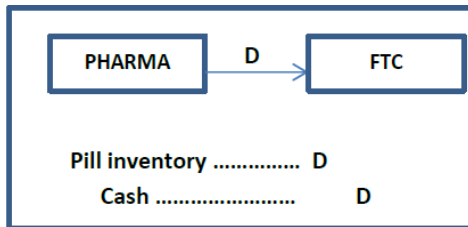
at this price. This is just the standard journal entry to record the purchase of inventory which is valued at its acquisition cost. The cost, C, is the fair market value of the item purchased.

Example A2: FTC obtains a pill from PHARMA for D cents which is at a discount from what PHARMA routinely sells pills to for-profit customers for C cents. In this case PHARMA is offering a lower price to FTC because it has donative intent; it wishes to provide the pill at a lower cost to FTC because it is a nonprofit. In this instance the fair market value of the pill is indeed C cents as for-profit customers are routinely paying this price to obtain the pill. So the amount of the discount to FTC, C-D, in this case can be thought of as a donation from PHARMA to FTC. In this case there is clear market evidence that the value of the pill is C cents and FTC can value the inventory at C cents and show an in-kind contribution valued at C-D.



In this case there is clear market evidence that the value of the pill is C cents and FTC can value the inventory at C cents and show an in-kind contribution valued at C-D.

Example A3: FTC obtains a pill from PHARMA for D cents. PHARMA only sells to nonprofits and charges every nonprofit D cents for this pill. Suppose there is no evidence that Pharma has any donative intent. That is, its business model is to sell to nonprofits and to make a profit doing that. In this case the purchase of the pill is just that, a purchase. The value of the inventory should be recorded at the cost to acquire it and there is no recognition of a gift in-kind.



In this case the purchase of the pill is just that, a purchase. The value of the inventory should be recorded at the cost to acquire it and there is no recognition of a gift in-kind.

Example A4: Suppose FTC buys a pill from PHARMA, a for-profit company that only sells to nonprofits. Suppose that the pill is purchased for D cents and is to be distributed in Country X. The pill is not approved for sale in the US at the dosage purchased by FTC from PHARMA. Suppose FTC values all donations of pharmaceuticals by reference to the *Red Book*, a wholesale pricing guide provided by US manufacturers of pharmaceuticals which are sold in the US market. The price listed for a lower dose pill sold in the US is P cents. This pill is virtually never purchased in the US because the ailment addressed by the pill is rarely present in the US population. Suppose FTC records this purchase as follows:

Inventory.....	P
Cash.....	D
Contribution revenue.....	P-D

Example A4 in essence was the way the acquisition of certain drugs was accounted for by many nonprofits. Several issues call the appropriateness of this accounting into question. First, the donative intent of the manufacturer is questionable. In this case PHARMA was set up as a for profit company with the intent of selling to nonprofits as its primary market. Secondly, this is less a contribution than it is a straight purchase of an item for inventory and as such it should probably be treated as in Example 1 above.

Prior to 2010 the guidance for valuation of gifts in kind, particularly for pharmaceuticals, was vague. It became accepted practice to value pills by reference to the previously mentioned Red Book. While this practice produced reasonable value for most medications it was grossly inadequate for valuing pills for distribution outside of the US and for medications distributed outside the US which were not approved for use in the US by the FDA. In 2010 nonprofits were required to apply SFAS 157 to the valuation of gifts in kind (see Figure 2A.2, taken from Feed the Children's 2010 annual report).

Figure 2.A.2: Feed the Children Note on SFAS 157, Fair Value Measurements

Fair value: FTC adopted SFAS 157, *Fair Value Measurements* (ASC Topic 820-10) for its financial assets and liabilities on July 1, 2008 and on July 1, 2009 for its nonfinancial assets and liabilities. The adoption of this standard defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is determined based on a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value which are as follows:

Level 1	Quoted prices in active markets for identical assets or liabilities.
Level 2	Observable inputs other than Level 1 prices, such as quoted prices for similar assets; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets.
Level 3	Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets. Level 3 assets include investments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

In the 2009 financial report Feed the Children described their valuation of donated medicines in a note in their financial statements (presented in Figure 2.A.3, Gift-in-Kind Valuations).

Figure 2.A.3: Feed the Children 2009 Note on Gift-in-Kind Valuation

FTC receives donations of food, medical supplies, clothing and other goods for use in its ministry programs. The fair value of the donated goods is based upon estimated wholesale value of gifts received which management believes is the best estimate of the selling price of the contributed inventory. Several methodologies are used in the determination of estimated wholesale value, including values provided by the donor, published industry pricing guides, internally-researched values, and internal average values for like-kind items. Donations of medicine which are restricted to certain international countries are generally valued based on the most recent *Red Book* value, adjusted for international pricing statistics and factors applicable to lesser-developed countries. Regardless of the methodology, the condition and utility for use of the donated materials is taken into account for valuation purposes. Donated inventories received with restrictions, such as the provision that they cannot be distributed within the United States, are considered to have purpose restrictions and are therefore reported as restricted contributions.

Essentially they were using Red Book wholesale prices to value all donated pills, including deworming pills which were not FDA approved for use in the US for the dose level of the donated pills received. After the 2010 change in accounting guidance, Feed the Children explained their methodologies for valuation of gifts in kind and deworming pills in particular as described in the note in Figure 2.A.4.

Figure 2.A.4: Feed the Children 2010 Note on Gift-in-Kind Valuation

Donations of gifts-in-kind that are legally allowed to be used in the United States are valued at their estimated wholesale value in the United States, determined as discussed above.

Donations of gifts-in-kind restricted from use in the United States (currently limited to certain pharmaceutical donations) are valued based upon the estimated wholesale market value of the items within the countries that represents the principal market of use. The estimated wholesale value of these donations is obtained from market price data compiled from wholesale commercial transactions within this non-United States principal market.

As discussed above, FTC adopted SFAS No. 157 for its nonfinancial assets and liabilities as of the beginning of its fiscal year ended June 30, 2010. FTC receives donations of deworming pharmaceuticals for use in its international programs, which are restricted from use in the United States. Due to the significant difference in prices between pharmaceuticals in the United States and in FTC's principal market for the use of deworming medication, the adoption of this new standard had a material effect on the recognized gift-in-kind revenues and FTC's international pharmaceutical donations restricted from use in the United States. Program expenses are affected as the related items are used.

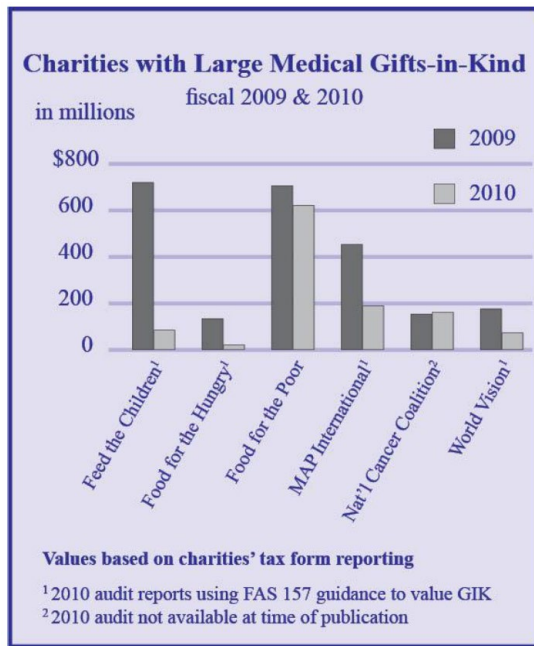
The provisions of SFAS No. 157 are required to be adopted prospectively as of the beginning of the fiscal year; retrospective application is not allowed. During fiscal 2010 approximately \$23 million of related contributions of deworming pharmaceuticals were recognized under this new standard. During 2009, under the accounting standards that were required to be used at that time, FTC recognized contributions of deworming pharmaceuticals of approximately \$544 million. Had the provisions of SFAS No. 157 been applied at that time, and had the 2009 contributions been valued at the same amount per dose as the 2010 contributions, 2009 contributions of deworming medication would have been recognized at approximately \$21 million.

Essentially they were using prices from the principle market for deworming pills to value donated pills. This “principal market” did not necessarily correspond to the market they distributed the pills in.

Feed the Children was not the only nonprofit charity using questionable valuation techniques prior to 2010, In a Charity Watch article¹ several charities were noted to have large medical gifts-in-kind with substantial valuation shifts between 2009 and 2010 when accounting guidance changed. The largest drops in valuation occurred for charities that had large gifts-in-kind of deworming pills. (see Figure 2.A.5).

While the majority of charities using these accounting techniques were quick to defend them as being consistent with GAAP, there are several practices that seem to be not “in the spirit” of what the accounting intended. An example of a questionable practice would be for the charity to *purchase* deworming pills in India for 2 cents each, ship them to a European company

Figure 2.A.5: Medical Gifts-in-Kind



for packaging who then *donates* the pills to the charity, at which time the charity recognizes an anonymous donation of deworming pills now valued at much higher European prices. Another bad practice is simply to purchase the pills in India (from a supplier whose business is to sell exclusively to nonprofits) and to revalue them at the unrealistic Red Book prices.

Why would a charity choose to use such suspect accounting? On some measures of nonprofit performance such transactions will make the nonprofit look better. Figure 2.A.6 and figure 2.A.7 show the activity statements for Feed the Children for 2009 and 2010. One very obvious result is that charitable contributions seem larger than they would

be if the donations of deworming pills were recorded at the true lower market prices. Because the

¹ The Alice in Wonderland World of Charity Valuation, 08/01/2011, charitywatch.org

Figure 2.A.6: Feed the Children 2009 Activities Statement

Feed The Children, Inc. and Subsidiaries			
Consolidated Statement of Activities For the Year Ended June 30, 2009			
	Unrestricted	Temporarily Restricted	Total
Support and Revenue:			
Gifts-in-kind	\$ 800,632,046	\$ 276,600,694	\$ 1,077,232,740
Contributions	111,412,667	15,719,209	127,131,876
Donated services	208,041	-	208,041
Grants	225,915	-	225,915
Investment loss (Note 3)	(8,784,703)	-	(8,784,703)
Gain on disposition of assets	59,346	-	59,346
Other revenues	2,996,514	-	2,996,514
	<u>906,749,826</u>	<u>292,319,903</u>	<u>1,199,069,729</u>
Net assets released from restrictions:			
Satisfaction of purpose restrictions	360,935,204	(360,935,204)	-
Satisfaction of time restrictions	19,296,961	(19,296,961)	-
Total support and revenue	<u>1,286,981,991</u>	<u>(87,912,262)</u>	<u>1,199,069,729</u>
Transportation service revenue (Note 1)	5,731,911	-	5,731,911
Total revenue	<u>1,292,713,902</u>	<u>(87,912,262)</u>	<u>1,204,801,640</u>
Expenses:			
Program services:			
Childcare, food and medical	992,263,363	-	992,263,363
Disaster relief	14,105,982	-	14,105,982
Education and community development	163,180,583	-	163,180,583
Total program services	<u>1,169,549,928</u>	<u>-</u>	<u>1,169,549,928</u>
Supporting activities:			
Fund-raising	65,451,702	-	65,451,702
Management and general	25,088,083	-	25,088,083
Total supporting activities	<u>90,539,785</u>	<u>-</u>	<u>90,539,785</u>
Transportation service expenses (Note 1)	5,541,841	-	5,541,841
Total expenses	<u>1,265,631,554</u>	<u>-</u>	<u>1,265,631,554</u>
Change in net assets	27,082,348	(87,912,262)	(60,829,914)

value of the pills is overstated, the value of the services provided to the population it serves is overstated. In figure 2.A.7 we see that in 2007 gifts-in-kind made up 89.9% of Feed the Children's revenue stream. This went down to 81.1% in 2008. A dramatic decrease because of the lower deworming pill valuations (which one could argue weren't even donations but purchases, and as such should be left out of the revenue stream altogether). We can observe that childcare, food and medical expenses decreased from \$992 million in 2009 to \$617 million in 2010 (this would have been a larger decrease were it not for the fact that some of the higher valued deworming pills were still in inventory at the end of 2009 and used up in 2010). The ratio of program services expense to total expenses dropped from 92.4% in 2009 to 89.5% in 2010.

Figure 2.A.7: Feed the Children 2010 Activities Statement

Feed The Children, Inc. and Subsidiaries			
Consolidated Statement of Activities For the Year Ended June 30, 2010			
	Unrestricted	Temporarily Restricted	Total
Support and Revenue:			
Gifts-in-kind (Note 1)	\$ 408,506,268	\$ 23,001,817	\$ 431,508,085
Contributions	77,354,274	16,547,966	93,902,240
Donated services	-	133,076	133,076
Grants	21,375	88,517	109,892
Investment income (Note 3)	5,349,355	-	5,349,355
Loss on disposition of assets	(225,996)	-	(225,996)
Other revenues	1,500,932	-	1,500,932
	<u>492,506,208</u>	<u>39,771,376</u>	<u>532,277,584</u>
Net assets released from restrictions:			
Satisfaction of purpose restrictions	301,645,392	(301,645,392)	-
Satisfaction of time restrictions	8,527,767	(8,527,767)	-
Total support and revenue	<u>802,679,367</u>	<u>(270,401,783)</u>	<u>532,277,584</u>
Transportation service revenue (Note 1)	5,608,342	-	5,608,342
Total revenue	<u>808,287,709</u>	<u>(270,401,783)</u>	<u>537,885,926</u>
Expenses:			
Program services:			
Childcare, food and medical (Note 1)	617,025,207	-	617,025,207
Disaster relief	35,283,710	-	35,283,710
Education and community development	155,841,045	-	155,841,045
Total program services	<u>808,149,962</u>	<u>-</u>	<u>808,149,962</u>
Supporting activities:			
Fund-raising	53,761,721	-	53,761,721
Management and general	34,906,890	-	34,906,890
Total supporting activities	<u>88,668,611</u>	<u>-</u>	<u>88,668,611</u>
Transportation service expenses (Note 1)	5,063,371	-	5,063,371
Total expenses	<u>901,881,944</u>	<u>-</u>	<u>901,881,944</u>
Change in net assets	(93,594,235)	(270,401,783)	(363,996,018)

One efficiency measure often computed is the ratio of fundraising expenses to total contributions (cash contributions plus gifts-in-kind). With the change in accounting for deworming pills this ratio increased dramatically, almost doubling, going from .054 in 2009 to .102 in 2010. A more meaningful measure in this case might be the ratio of fundraising expenses to cash contributions which went from .52 in 2009 to .57 in 2010 as cash contributions likely decreased because of unfavorable press. Since much of gifts-in-kind are "purchased" deworming pills they should be left out of the ratio anyhow.

Administrative expenses as a fraction of total expenses increased from 3.4% in 2009

to 4.5% in 2010 and administrative expenses plus fundraising expenses as a fraction of total expenses rose from .086 to .105 over the same period. So we see a degradation in some of the standard efficiency measures for nonprofit spending.

The point of this short appendix is to indicate the need to dig deeper when reading a financial report of a nonprofit when a large percentage of its revenue is from gifts-in-kind. Be sure to understand the valuation techniques **Figure 2.A.8: Feed the Children: Selected Ratios**²

Ratio	2009	2010	2013
Program Services/Total Expenses	.924	.895	.916
Fund raising expense/Cash Contributions	.52	.57	.53
Fund raising expenses/contributions + GIK	.054	.102	.061
GIK/Total revenue	.899	.811	.820
Administrative expense/Total expense	.034	.045	.029
Fund raising expenses/Total expense	.052	.060	.055

used as there is no market, arms length transaction involved in the process (as with Goodwill Industries). In the case of Goodwill the activities statement shows us the proceeds from the sale of donated items exceeds the contribution revenue associated with the donated goods.

Gifts-in-kind, while not unique to nonprofits, are much more prevalent in nonprofits than in for profits and oftentimes in very large amounts relative to their other revenues.

² Ratios for 2013 are shown along with the 2009 and 2010 ratios to show what the ratios look like in more normal times.