

# Understanding and Using the MinistryWatch.com 5 Star Financial Efficiency Rating System

Many ministries and donors contact us with questions about the 5 Star Financial Efficiency Ratings that we publish on MinistryWatch.com. Although we have provided other articles that describe in detail the underlying philosophy and mechanics of this system, these articles are sometimes too technical for many users who only want to understand the system at a high level. This article has been written with these users in mind and will focus on the three most important characteristics of the 5 Star Financial Efficiency Ratings system that any user should know before incorporating its results into their process for making a giving decision. These characteristics are:

1. The system measures financial efficiency, and that's all.
2. The system is relative, so someone always has to score high and someone always has to score low.
3. The system rewards organizations that fund programs today rather than save for tomorrow.

There are likely many donors out there who would say that one, two, or all three of these characteristics are undesirable for a good nonprofit rating system. If you are one of these donors, then this rating system probably will not be as useful to you. However, we believe that our system still provides an excellent starting point for those who wish to compare the finances of a large number of organizations using a common criterion. The ratings that result from this system can help donors to quickly identify areas about which they would like to ask good questions of the ministries they are interested in. Without a service such as MinistryWatch.com to provide this kind of information, donors would have to invest valuable time and resources to gather their own information or risk making an uninformed decision. With the goal of donor empowerment in mind, let's look a little closer at each of the three characteristics that are important for every donor to understand.

1. **The system measures financial efficiency, and that's all.** Anyone who looks at the 5 Star Ratings should know both what they are and what they are not. First of all, let's talk about what they are not. The 5 Star Financial Efficiency Ratings do not provide a measure of integrity, stewardship, transparency, program effectiveness, or financial strength. These are noble goals for any ministry, but only one of these other goals (financial strength) could be measured using data obtained from the financial statements of an organization. Incidentally, we chose to measure financial efficiency instead of financial strength because we believe that donors are more interested in how quickly their donations contribute to the mission more than how good a ministry is at building up a reserve of excess funds. That having been said, a rating system that measures financial strength would be something that could be added in the future. The important point here is that since the 5 Star Financial Efficiency Ratings are calculated using ratios that focus on a particular characteristic, financial efficiency, it would be inappropriate to use the system to draw conclusions about a ministry's integrity, stewardship, transparency, program effectiveness, or financial strength.

So then, what is this financial efficiency characteristic that the system does measure, anyway? Financial efficiency refers to an organization's ability to take the resources it receives and apply them immediately to the programs that accomplish its mission with as little spending as possible on asset building, overhead, or fundraising. Although not everyone will agree that this is a goal ministries should embrace, it is one that we believe is important to many donors who desire for their contributions to have an immediate impact on the mission. It is with this definition in mind that we encourage donors to utilize our rating system. Doing so will allow a donor to gain valuable insight into an organization's financial performance.

2. **The system is relative, so someone always has to score high and someone always has to score low.** This may seem like a strange characteristic to build into a rating system, but it makes sense if you think about the purpose of creating a rating system in the first place. That purpose is to facilitate donors *comparing* organizations to one another. Many ratings systems establish an independent scale against which each organization is measured. This kind of system is only useful for those donors who want to

ensure that an organization is meeting the *minimum* threshold, or standard, for a particular financial characteristic. However, under these kinds of absolute systems it is quite possible that every organization (or no organization) will meet the minimum standard and so the rating system becomes useless for distinguishing one organization from another.

Additionally, absolute rating systems require someone to decide arbitrarily what the minimum standard for a particular financial characteristic should be, which may or may not be consistent with what a particular donor believes it should be. Under a relative system, there is no need to choose arbitrary standards for each financial characteristic because organizations will simply be ranked against one another and then assigned a rating based on their ranking. The Star Rating that our system applies at the end of the calculation process is simply an easy (and admittedly arbitrary) way to divide up all of the organizations that have been ranked against one another. Although the ranges for each Star Rating are arbitrary, the ranking is what really determines the rating. Using a ranking system guarantees that donors will always be able to distinguish one organization from another regardless of what their own minimum standard would be for a particular financial characteristic.

Furthermore, a relative rating system is able to maintain balance in the final results without having to constantly adjust a standard. Because the final ratings are based on percent rank, there will always be as many 1 Star organizations as there are 5 Star organizations. Similarly, there will always be as many 2 Star organizations as there are 4 Star organizations. The largest percentage of organizations (35%) will receive an overall rating of 3 Stars.

With this understanding in mind, how should a donor interpret the 5 Star Financial Efficiency Ratings an organization has received? If the organization has received a rating of 5 Stars, the donor should realize that this means the organization has scored higher than at least 90% of the organizations in that particular financial characteristic. It also means that an organization receiving only 1 Star has scored lower than at least 90% of the organizations that have been measured. This does not mean, however, that a 1 Star organization has necessarily scored below what would be minimally acceptable to a particular donor. Since every donor's minimum standards for a particular financial characteristic may be different, it would be up to the donor to decide if an organization that received only 1 Star were still one to which he or she would consider making a contribution. However, the donor would at least be aware that a 1 Star organization did score lower than most other organizations with regard to that particular financial characteristic. The rating that is perhaps most often misinterpreted is a 3 Star rating. Many users see 3 Stars on a 5 Star scale and think "mediocre" or "average". Although technically the word "average" does describe a 3 Star rating accurately, it is also correct to say that a 3 Star ministry scored comparably to the largest percentage of ministries in the database. For someone that is only looking to support ministries that are among the most efficient without regard to any other giving criteria, a 3 Star Rating may be unacceptable. However, to a donor who simply wants to make sure that a ministry is *not significantly less efficient than most other ministries*, a 3 Star Rating may be quite acceptable. Other factors such as mission, philosophy, and theology may then enter into this donor's decision about which ministry to support. The important point here is that a rating assigned using a relative system must be looked at differently than a rating assigned using an absolute system. We encourage donors to consider this important point when using the 5 Star Financial Efficiency Rating system to help make a giving decision.

- 3. The system rewards organizations that fund programs today rather than save for tomorrow.** As mentioned previously, the 5 Star Financial Efficiency Rating system does not measure the financial *strength* of an organization. It measures financial *efficiency* as we have defined it. This definition considers money spent on asset build-up, overhead, or fundraising as a diversion of funds away from current programs. Therefore, the ratios used by the system are constructed in such a way that investments in buildings, endowments, or excess reserves would actually detract from the organization's efficiency measure. Organizations that score the highest using this system would be those that have lean balance sheets relative to their annual spending, and those that do not allocate much spending towards overhead or fundraising activities. This characteristic of the system often receives the most passionate criticism because there are clearly times when investments in assets, overhead, and fundraising can benefit an organization in the long run. We do not dispute this claim.

However, we believe that there are also times when these kinds of “investments” are not significantly benefiting mission accomplishment in the long run, but are simply growing the size of the operation. Since it is impossible to determine from the financial statements alone whether these “investments” are in fact benefiting long-term mission accomplishment, we must simply treat them all the same in order to form a consistent model for measuring financial efficiency. This model looks at program spending as the closest representation of mission accomplishment, and so all other uses of funds are considered to represent “inefficiencies.” Donors who use the system should be aware of this built-in assumption so that they can understand better what might be driving a particular rating received by a ministry. If a donor determines that a low rating is determined by a relatively large “investment” by the ministry in assets, fundraising, or overhead, then the donor could contact the ministry to learn more specifically about whether those “investments” seem to be good or necessary ones.

Because we will never have perfect information, we will never be able to create a perfect rating system. However, decisions made using information that is less than perfect are still better than ones made using no information at all. That is why we have created the 5 Star Financial Efficiency Rating system; to improve the quantity and quality of information that donors have to help them make informed giving decisions. We believe that the system we have constructed helps donors to compare the finances of a large number of organizations, and equips them to then ask ministries good questions about their financial performance. The goal of this entire exercise is to increase the ability of donors to practice Biblical stewardship. Since no rating system can perfectly reflect the values of every donor, we believe it is critical to let donors know what values underlie the system we have created. That is the purpose of this article and of the other articles about our rating system that can be found at [MinistryWatch.com](http://MinistryWatch.com). Our hope is that in the future this system can be improved and even expanded to consider other financial characteristics of ministries, which will only add further to the good information that is available to donors.