

Methods, Management, and Misstatements: An exploration of Management and General Cost Allocations in the Non-For-Profit Sector.

Introduction:

Expectations of the Project:

This paper analyzes allocation methods of management and general costs related to a non-profit carrying out its mission related business. Specifically, the paper looks at the inconsistencies in the allocation of management and general costs within the non-profit sector, its causes and impacts.

It examines whether the lack of clarity in allocation guidelines and other pressures induce organizations to manipulate and or misclassify the costs related to these expenses.

The expectation is that this study will,

- Give a clear sense of where the problems are in this area using a sub-section of the industry as a sample looking at existing guidelines, organizational practices and donor attitudes.
- Give us a better road map for measuring the organization's expenses and communicate these to the donors.

Overview of the Study

The management and general costs (henceforth referenced as M&G costs) of a non-profit organization are not directly related to any activities but tend to support program activities in a board manner. To develop and understand the true cost of operating and delivering a service, it is important for the non-profit organization to spread these costs in a proportionate manner to ascertain the cost of carrying out its

mission related activities. It is also important for an organization to understand the true nature of these costs, to effectively plan for a infrastructure support system that adequately enables it to carry out its operations.

The M&G costs are broken out as a separate component in the non-profit financial statements. The three components of a non-for-profit financial statement consist of the statement of financial position (also referred to as the Balance Sheet), Statement of Activities (also referred to as the Income statement) and the statement of cash flows. Another optional but important component of the financial statements of a non-profit organization is statement of functional expenses which is an elaboration of the expenditures of a non-profit organization's expenditures showing all the programmatic categories of operations, its M&G costs and fundraising expenses. This is in some ways a numerical representation of the programmatic and other operations of a non-profit organization. This component is unique to the non-profit's financial presentation and does not have a for-profit counterpart. An accurate and detailed presentation in this statement however to a large degree is a starting step in clearer allocation of functional costs.

This paper will be focusing on the expenditure section of the statement of activities of the non-profit organization and the optional statement of functional expenses component of the financial statements and the IRS mandated Form 990 tax return. The corresponding counterpart of this section in IRS form 990, that is the non-profit tax return is Part I – Revenues, Expenses and changes in Fund Balance.¹ . I will be using information from both GAAP audited financial statements as well as the organization's form 990 alternately for the purposes of this study. The Form 990 is a

¹ IRS form 990, Return of an Organization exempt from Taxation, 2004. OMB 1545-0047

more easily available document for quick reference purposes since most organizations now have these forms available on the internet through the Guidestar² website. This however does not present all the relevant information that would help in completing this study and therefore cannot be the only source of information.

The focus of this paper will be on the expenditures section of the organization's statement of financial position. The program expenditures section of this statement is related to expenses directly associated with the satisfaction of the mission of the organization, while the M&G related to indirect costs of supporting the direct operations of the organization. For the purposes of this study, I would like to classify program service expenditures as direct operating costs and classify M&G and fundraising costs as supporting expenditures. These categories are lines 13-17 of the IRS form 990. The Urban Institute cost study (2001) defines these costs as "those costs associated with the overall function and management of the non-profit organization, and may include personnel costs, accounting and legal fees, and outlays for equipment and supplies," and also categorized these costs as essential to the "lifeblood of the organization".

Having worked in senior financial and administrative positions in the non-profit sector for close to two decades, I have personally been intrigued by the diversity in attitudes related to M&G costs and their allocation to the direct services of operation. Other than the fact, that these costs support the infrastructure of the operation their allocation is so critical in understanding the costs of programs and services. Direct program expenses tell only half the story and cannot be used as the only measure of

² www.guidestar.org: A searchable database of more than 1.5 million IRS-recognized nonprofit organizations.

understanding the cost of program operations. The diversity of methods of allocating costs as well as some of the built-in flexibilities allow for changes in financial performance presentation. Some of this is related to the nature of non-profit expenditure classification into restricted and unrestricted categories as well as how the distinction is being made between allocated program expenditures versus unallocated M&G expenses. This study does not look at fundraising cost allocation other than when it is incidental to the study of M&G costs.

Emphasis on understanding Management and General Costs within non-profits

Lately, there has been increased emphasis on trying to understand the way the supporting costs of the non-profit organization relate to the entire operation of its mission related activities.

There are two separate forces pushing the focus on looking at supporting cost allocations.

The first emphasis is from the private watchdog organizations monitoring the sector. Two of the major players in this field are Charity Navigator and BBB Wise Giving alliance. Charity Navigator's focus is primarily on fiscal health and viability of non-profit organizations, which the BBB Wise Giving Alliance looks at standards for overall governance. However both these organizations look at maximization of program spending as a measure of organizational efficiency. This has led to a general mindset of minimizing expenses in the M&G category. This also leads to general mindset of evaluating these ratios when analyzing a non-profit's financial or operating performance. In fact, this mindless obsession with a ratio, like the program ratio in BBB wise giving alliance guidelines, or other ratios used in the industry such

as administrative ratios and special events, thrown into a landscape this is otherwise more qualitative in its approach to performance results in people chasing an artificial number, attempting to keep this down to a certain percentage without import to the actual content and substance of these expenses. Some prior researchers have argued that undue emphasis on these ratios can tend to induce dysfunctional behavior in charities, including underinvestment in organizational infrastructure. (Letts, Ryan, Grossman, 1998). My concern here is that these very indicators themselves are not accurate since the methodology is not clear or consistent.

The two ratios that are referred to most consistently through this study are the program ratio (defined as Program Expenditures/Total Expenditures), and management ratio (M&G costs/Total Expenditures). The third ratio that often comes into play is the fundraising ratio (Fundraising Costs/Total Expenses).

With the increase of corporate scandals in the business landscape (Enron, Worldcom, etc) the public is generally paying more attention to financial information and what watchdog organizations are saying. The senate finance committee has focused its attention resulting in the non-profit panel (2005) convened by the Independent Sector, that makes several recommendations concerning problems and issues in the non-profit accountability and management. The expectation is that some of these recommendations will result in future legislation in the sector. Since the Sarbanes-Oxley Act of 2002 ³ has left the non-profit sector untouched, other vehicles will address regulation and accounting changes in the industry.

Several other bodies within the non-profit community attempt to make statements that in some form shape public opinion on whether there should be certain specific

³ Public Company Accounting Reform and investor reform act of 2002

numbers or guideline related to what the amount of fundraising costs should be. An example of this can be looked at as follows,

One of the FAQ's on the Council of Foundation's website are, "*What percentage of a foundation's budget should be allocated for administrative expenses?*" The response to this other than defining administrative expenses, cites, the following, "*According to Administering Corporate Giving 2002, corporate foundations and giving programs spent an average of 5.7 percent on administrative expenses as a percentage of grants in a year*"⁴

Statements like this when looked at out of context can be both confusing and misleading to people, since the M&G ratio or any expenditure ratio for that matter can vary significantly based on the organization's size, age, and nature of activities.

The second emphasis is from funding sources particularly foundations that still are reluctant to fund general support expenses beyond what they feel would be a sensible amount. This once again pressures the non-profit to find means to keep their administrative costs lower or find ways to move management costs into the program area. A study of the Open Society Institute and the Soros Foundation⁵, found that irrespective of the funding source (Private Foundation, Individuals, governments or membership) most donors had one thing in common, they were interested in supporting the organization's mission rather than building, managing and subsidizing the organization's support structures.

⁴ According to Administering Corporate Giving 2002, corporate foundations and giving programs spent an average of 5.7 percent on administrative expenses as a percentage of grants in a year.

⁵ The Quiet Revolution in Nonprofit Capacity Support, Jonathan Peizer, Open Society Institute Oct 31,2003.

In a call to the non-profit community to enhance the accountability and efficiency of non-profit organizations in its accountability brief the Independent Sector calls upon non-profit funders to pay for, “the fair proportion of fundraising costs necessary to manage and sustain whatever is required by the organization to run that particular project”⁶ when they are providing support for non-profit projects.

The general trend therefore would appear that organizations would like to minimize their operating expenses. In fact, several organizations, mention this as a factor when making a statement about how well they use their donations. The study conducted by the Urban Institute related to the study of allocation of non-profit sector administrative overhead agrees with this assessment. Their study found that the most commonly used measure of administrative efficiency in the non-profit field was the measure of non-profit efficiency was the percentage of money being directed towards program expenses. Therefore the lower the administrative expenses the more likely it was that the non-profit would be considered an efficient non-profit. This naturally leads to pressure on part of the non-profit to try and reduce the amount of expenses being allocated to this category. In fact, anecdotal evidence suggests that non-profit organizations are trying to do this to appear efficient. The technical director for BDO Seidman, a national accounting firm, felt that the United Way of Bay Area, (UWBA) used “aggressive accounting methods to arrive at its claimed results of spending on 14c on every dollar for its \$42m in funds raised in 2002. There are other examples of misstatements alluding to the negligible amount spent during the delivery of services, The American Red Crosses Liberty Fund labeled its fundraising for the September

⁶ Statement on Guidelines for the Funding of Nonprofit Organizations, drafted by Paul Brest, president and CEO of the William and Flora Foundation.

11th attacks with a 100% goes to charity banner, this later causes a fair amount of unhappiness in the public when people realized that administrative costs related to the disbursement these monies were being funded from their donation. This has caused a level of mistrust in the community however there is also a general double standard amongst funders of non-profit organization, “one for effective business practices and another for the way nonprofit organizations are supposed to operate.” Draper, 2003. The assumption or point here being to provide effective business practices non-profits need to have a sound infrastructure, however the desire for a 100% commitment to program expenses is just the opposite of the same. All things being said, there is a tremendous attraction amongst the investing public for organizations that rightly or incorrectly (Unknown to the public) claim a very low operating expense. In the area of philanthropic ventures to India, an organization that is popular amongst the investing public and watchdog organizations (Charity Navigator) is ASHA for education. This organization uses a volunteer based model for management and therefore has practically minimal overheads and hence their claim, “All your money supports education.”

There is however an overall need to move the concept of supporting expenses from being viewed as ancillary to being able to quantify these expenses appropriately so that organizations can effectively steward their resources and fulfill their mission efficiently.

Anecdotal and research evidence also suggest that there is ambiguity and lack of clarity in the guidelines related to allocation of M&G costs, and therefore there is built in flexibility and opportunities for errors and manipulation.

In 1992 the Accounting Standards Executive Committee (AcSec) of the AICPA undertook a project in 1992 to provide clearer guidance in allocating costs for joint program and fundraising activities than was provided under SOP 87-2, Accounting for Joint Costs of Informational Materials and Activities of Non-Profit organizations that include a Fund-Raising Appeal.

The closest that the accounting standards have come to providing a definition for these expenses is as recent as 1993 (FAS 117), so this area is still new and underdeveloped. The new SOP 98-2 was issued in 1998.

In the past fifteen years of my professional experience I have seen several varied method of allocating these expenses all passing the audit muster. At the Lower EastSide Family Union in 1998, the organization clubbed its entire non-program expenses in the M & G category without allocating any of this to the program, this significantly impacted their financial performance since the organization since none of these costs were being charged out to the program funding sources appropriately. In 1999, revisiting this set-up the organization spread about 85% of the costs being allocated in this pool and charged this out to funding sources, this significantly changed the organization's operating performance and also in current terms made the organization appear more efficient. This interestingly enough is an example where the non-profit chose a method that did not project their expenses accurately or favorable illustrated that misallocations exist in both directions.

The study undertaken by the Urban Institute⁷ that looked at these components of non-profit spending tried to extrapolate the quality and methodology applied by non-profit

⁷ The overhead cost study project was a comprehensive study done of the supporting costs (both M&G and fundraising) in the non-profit sector. This was a collaborative study between the Center on

organizations, and in one example of non-profit salaries which was in their experience the largest component of non-profit expenses, found that the functional expense tracking of personnel time was a low priority due to the low perceived benefit of the practice.

The composition of the sources of funding in non-profit organizations also tends to affect the way the organization approaches how it allocated costs. Different organizational sources have different ways that they have their fundees allocate these costs this in turn affects the way the organization chooses to address the allocation of these expenses.

The “looseness” in guidelines also allows these costs to escape the radar of potential watchdogs such as the auditors. My personal experience on several audits is that auditors do not perform an in-depth testing of allocation methodology or look at any specific items in this category as long as the general allocation is “reasonable”. In a recent example a non-profit was allocating a uniform 15% of all expenses of the organization to the management and general category, which while as a percentage was not unusual the overall expenses such as salaries included direct program staff and therefore taking a percentage of salaries that included such expenses would be incorrect and generally misstate the M & G Allocations, despite being within a reasonable 15% range. This is just one example, I feel that M & G allocations can deviate largely from one spectrum to another and still appear to be “reasonable” and not need auditor intervention, since the financial statements according to any audit opinion are the “responsibility of the management”.

Questions to be explored

The questions and issues that I would like to examine through the scope of this study would be the following.

Research Question 1: There is a presumed widespread misallocation of management and general costs within non-profit organizations that is a combination of factors such as intent, lack of resources, and knowledge.

Research Question 2: The presumption is that this misallocation varies based on size. Mission, staff and board oversight.

Research Question 3: The presumption is that there allocation, focus, diligence and records vary based on the composition of the funding sources with more manipulation among organizations receiving significant governmental funding.

Research Question 4. The presumption is that organizations generally want to shift expenses from the management and general category to the program expenses category to appear more efficient to the outside public.

Relevance and importance of the Non-profit sector and the study

The most recent statistics of the sector (2003)⁸, says that there are nearly 1.4 million 501© organizations. This paper focuses on the category of non-profits that are classified as 501 C 3 organizations. The IRS classifies these organizations as charitable organizations or foundations. There are exempt from federal income tax, and can collect tax-deductible contributions from individuals and businesses. To retain these benefits these organizations must operate, “exclusively for religious, charitable, scientific or educational purposes” and serve the common good.

⁸ The United States Non-profit Sector, A report by the National Council of Non-profit Associations

In 2003, there were 837,027 501 C 3 organizations in the United States. Between 1993 and 2003 the number of organizations filing a 990 tax form grew by 68%, making this the fastest growing sector of the economy. Expenditures by reporters totaled almost \$945 billion and accounted for almost 9% of the GDP of the United States in 2003. Assets held by these reporters also grew, from \$866 billion in 1993 to over 1.76 trillion in 2003.

Nearly 11 million Americans are employed by the NFP sector, about 7% of the workforce. (Salaman, 2005). In addition to creating employment opportunities, charitable organizations also create the space and opportunity for individuals to engage in volunteerism and become actively involved in civic life.

Non-profit organizations operate in all essential areas of critical services – education, medical care, social services and the arts and provide the essential services in the economy that cannot be outsourced to other countries.

The non-profits are in the business of doing good this is a serious business and need to be managed like any other business. The importance of non-profit organizations often goes unnoticed since unlike the business marketplace there is no consistent mechanism such as the stock market tracking the performance and returns of the non-profit market. Non-profits typically must satisfy two customer groups, their donors and the users of their products and services. The mission of many non-profits is to alleviate some of the most intractable problems of our society, this is far more difficult to achieve than maximizing shareholder wealth (Manzo, 1998) and even harder to quantify.

The issue on hand is extremely relevant since it looks at whether there is a proper level of accountability in this sector. Additionally, this paper will look at issues of comparability and relevance of using the program ratios as a measure of assessing non-profit efficiency. This is an area that is not really unique to this paper, there has been significant prior research that has looked at the appropriateness of financial tools being used to assess financial performance in the non-profit sector. Additionally, this paper hopes to identify the accuracy or lack thereof of measuring the costs of services in the non-profit sector.

This is probably an issue of singular relevance in the current climate of the non-profit operating landscape. More donors such as the Gates Foundation like to see clearly articulated measurements of what they are funding and expect the non-profits to deliver directly measurable products for their services, it is important for non-profits to be able to understand the exact costs of their services for them to be able to account for these services

According to the Independent sector project on building capacity, although there are generally accepted practices for accounting for overhead costs, they are not pervasively understood in the nonprofit sector; funders as well as grantee organizations often define these costs in nonstandard or idiosyncratic ways. Where a grantee organization does not employ generally accepted practices, or where the nature of the organization, grant, or other factors do not justify detailed cost accounting, funders should base overhead on the average costs for organizations of a similar sort, based on sector and size.

A non-profit organization like all other operational businesses needs to understand what the true costs of doing business are. Simply being in the business of doing good does not eliminate costs of space, insurance and other indirect costs related to delivering the good or services of doing good. Without knowing and understanding their costs of operation it is not possible for the organization to understand how much revenue is needed to accomplish the work on hand and break even. To this end it is important to understand the prevailing mechanisms and problems with existing cost allocation methodology.

It is actually important for organizations to be able to work towards a landscape where they can educate their funders about the true costs of delivering a certain service so that we can have a climate where rather than attempting to shift costs the non-profit can manage their indirect costs in a sensible manner. In particular this is important for smaller non-profits since these organizations often tend to be unable to refuse grants that do not completely support their overhead expenses but continually stretch their boundaries to deliver these services. The meaningless measure of looking at program ratios for these non-profit organizations may often lead to an organization appearing to look very efficient since their administrative costs are unusually low, but this is misleading since the barebones administrative costs often do not support adequate infrastructure for this organization to deliver the services in an efficient manner.

Management and General Costs in non-profit organizations is still a misunderstood area in the non-profit landscape. With non-profit reporting needs and responsibilities becoming increasingly complex, there has been a significant increase in the quality

and professional training of non-profit administrative staff. The same funding sources that are reluctant to support infrastructure are often the sources requiring increased reporting and accountability. It is extremely important for non-profit organizations to be able to understand and account for what the right costs of supporting these needs and providing critical program services are. It is important for the industry to understand the correlation between effectiveness and adequacy of support structures.

It is an important concept to look at the diversity of allocation methodology and acknowledge the diversity and lack of comparability of non-profit financial information. The diversity of the non-profit industry is a facet that is encountered at various different spheres, this is something scholars and practitioners grapple with all the time when trying to establish standards or understand the functioning of the industry. This is yet another manifestation of the problem which sheds light on why it is difficult to generalize overhead expenses in absolute terms for the entire sector.

This is a timely issue since there is a somewhat changing trend in the non-profit sector about the understanding of this issue, non-profits are moving away from the earlier focus of the lesser the cost of supporting services the better to, the more effective the overhead structure the better. There are also several players in the non-profit marketplace such as the non-profit finance fund⁹ who are strong advocates for an organization not to accept program funding if this does not come with the support needed to administer the services requested by the funding sources. This is as much an issue of requesting timely unrestricted support as it is an issue of building in the correct amount of financial overhead expenses into grant request applications.

⁹ www.nonprofitfinancefund.org provides capital and advice to non-profit organizations achieve their mission, improve their capacity to deliver services and strengthen their communities.

Foundations such as the Kellogg foundation, are trying to fund change and effectiveness in the field. This issue is a combination of building capacity, effectiveness and transparency in the non-profit landscape. The objective of this would be to help the individuals and institutions supporting the organizations understand the components needed to deliver the services and have the organizations themselves understand what they need from their supporters to carry out these services.

M&G costs are an important component in the functional classification of expenses and their accuracy affects the accuracy of the financial statements as a whole. The effective cost allocation provides us with a basis to “understand the economic resources of an enterprise, the claim to these resources, and the effects of these transactions, events, and circumstances that change the resources and associated claims.”¹⁰

Contribution to Existing Research

Despite the importance of supporting costs in looking at non-profit efficiency and well as the importance placed on these expenses by non-profit watchdog organizations, there is still somewhat little emphasis placed on these costs from a research perspective.

The Overhead Cost Study project by the Urban Institute is one of the first and most comprehensive studies done in this field. This study has also stated that M & G Costs in non-profit organizations have managed to, “largely escape the lens of researchers” (Pollack, Rooney, Hager, 2001). The existing research also has separated Management and General costs and fundraising expenses and has focused alternately

¹⁰ Statement of Financial Accounting Concepts No 1 Paragraph 5-8”.

on one aspect or another of expenses in the non-profit landscape. This paper in identifying methodology and understanding the indirect expenses in the non-profit landscape has combined these as supporting expenses and looked at them together. While this study uses a convenience sample¹¹, rather than a geographically diverse sample, this study will be engaging both qualitative and quantitative method to obtain a detailed analysis of how supporting costs function with non-profit organizations. This study will therefore significantly enhance findings in an aspect of non-profit operations that is relevant but still not widely researched or conclusively documented. The study will look at variables like the sophistication and quality of accounting staff, board commitment and specific allocation examples such as that of the executive director's salary to try to get closer to the problem. Most studies in this area have extrapolated general assumptions looking a relatively narrow sample in an in-depth manner, this study proposes to add breadth and hopefully find certain problem areas to pinpoint. The case studies and fieldwork to reach the conclusions will incorporate several more organizations than has been done in any study to date. This study should provide a resource to both non-profit and funders in understanding how to assess and evaluate non-profit organization costs. Some variables such as the board oversight component and specific personnel expenses components will be built into this research that will also broaden existing work done in this area. Finally, this study will be using the audited financial statements of the organizations being studied as the main informational source as opposed to 990 data, which all prior studies have highlighted have several errors and have information in very condensed form.

¹¹ Mainly umbrella organizations that I have managed to gain access to – United Way of CT, United Way of Westchester County and the Business Council of Westchester.

It will also focus in depth on the category of M&G expenses, as opposed to both fundraising and management and general expenses. It will also incorporate changes in the accountability landscape since the cost study has been done, such as legislation in several states attempting to look at feature of the Sarbanes-Oxley act that would be relevant for the non-profit landscape.

While it will be outside the scope of this dissertation, the study can easily be expanded to a more comprehensive study at a national level providing us a study of the not-for-profit sector at a national level.

Additionally, I feel studies like this have a practical importance in letting the funding public know about the importance of Management and General costs and why they should be funded. Their perceived reluctance in funding these costs prevent organizations from adequately accounting for, or documenting these costs, thereby either affecting quality of service or information and at certain instances both. This study would make a case of better clarification and potential support of these expenses to potentially enhance the quality of services and information.

Other than the importance to providing cost information and assisting the donor community, this research can assist non-profit organizations understand the dependency between indirect and direct costs better and understand the interdependency and therefore function better operationally.

Organization of the Research

The paper is going to be divided into six sections that begin with this introduction.

The first section provides an overview of the research, its relevance and what the scope of this dissertation project is hoping to accomplish. The second section discusses the prior research in this field and how this research is builds and contributes to this area. The third section presents the research questions and describes the parameters and methodology that will be used to explore these questions. The fourth section presents the data sample, questionnaire and the data screening process. The fifth section discusses the findings of the exploration process and finally the sixth section presents the conclusions and discusses the future actions that can be developed from this research.

Section II: Prior Research on Management and General cost allocations in the Non-Profit Sector.

Defining Management and General Costs

The first aspect of this paper is to first understand what “M&G” costs are and then look at methodology and guidelines available to define these costs.

The logical place to start might be accounting rule setting bodies or looking at GAAP, the definition here is fairly broad, and defines this as “expenses for overall function and management, rather than for its direct conduct of fundraising activities or program services” and defines overall management salaries as including that of the chief executive officer and that officer’s staff when not directly supervising program services and fundraising activity”. Certain specific highlighted costs also include costs such as accounting and legal fees, insurance, investment expenses, and centralized services (Hager, Pollack, and Rooney)

When looking at definition the first publication that clearly specified the allocation in 1993, was the Financial Accounting Standards Board (FASB) statement 117, where they required expenses to be reported by “their functional classification such as major classes or program services and supporting activities.” Section 27 of FASB Statement no 117 describes program serves as “the activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the organization exists. Those services are the major purpose for and the major output of the organization and often relate to several major programs.” The definition of program services are important since supporting services are defined as the opposite of these services, in specific terms they are

defined as in paragraph 28 of this section as “all activities of a non-profit organization other than program services. Generally, they include management and general, fundraising and membership development activities”, This definition may be somewhat unclear at best, since it might be argued that even conventionally accepted supporting services such as accounting are needed to distribute the goods and services to the beneficiaries. The AICPA audit and accounting guide for non-profit organizations (AAA-NPO guide), clarifies the definition in section 13:33 as saying, “management and general activities are those that are not identified with a single program, fund-raising activity, or membership development activity but are indispensable to the conduct of those activities and to an organizations existence...” There is extensive detailing of the categories of expenditures that fall into this category as examples in the rest of this paragraph.

Although outside the traditional accounting (AICPA) guidelines, we have some guidance from “the black book” the accepted name for the Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations ¹² but this does not offer no additional clarity or direction on this topic.

The Office of Management and Budgets, in their OMB circular 122¹³ offer some suggested methodology for the allocation of indirect costs. In its section A, subsection 4 (3) it discusses “allocable costs” as being costs that, are “necessary to the overall operation of the organization, although a direct relationship to any particular cost objective cannot be shown. “Indirect costs” provided as “Indirect costs are those that

¹² The first edition of this publication in 1964 well predates anything put forward by AICPA literature and was one of the first authorities on this topic. This once again highlights that this is still an emerging field with a fair amount of clarity needed for sound standards development.

¹³ This standard is only applicable to organizations that receive beyond a certain percentage of governmental funds, either directly or as a pass-through.

have been incurred for common or joint objectives and cannot be readily identified with a particular final cost objective.

The Independent Sector defines these costs as, “*Administrative expenses*, also known as *management & general expenses* are costs associated with sustaining the operations of a nonprofit organization. *Fundraising expenses* are costs incurred in raising contributions. Administrative and fundraising expenses constitute an organization's *overhead*.”

It may be fair to say that all these definitions somehow suggest that these costs are ancillary or secondary to the essential programmatic services. I would argue that the problems with M&G expenses begin at this point, where the general feeling is that these costs are somewhat tangential and non-essential.

In today’s atmosphere where significantly higher accountability is expected from all members of the business community including the third sector, this definition other than being vague might not be the best way to define these costs. They are different from program costs, but it is wrong or inaccurate to categorize them as less important. In some ways it may be fair to say that behind every successful program there is a successful organizational infrastructure. While the FASB term labels these as “supporting costs” which is a better term, the more commonly accepted term is “M&G” costs.

“Perhaps we need a new term that communicates the relevancy and importance of these activities. *Indirect costs*, *overhead*, and *administrative expenses* do not convey the correlation of the expenditures to the quality and quantity of programming.

Instead, insert a budget line item for *infrastructure expenses, core agency support* or *organizational investment* to solidify the link.” (Draper 2002).

Existing Guidelines for Identifying Management and General Costs

The next aspect is looking at methodology and where it is defined and finally how much of this is being implemented in a consistent manner. Starting with the accounting guidelines, the first source that I refer to for offering clarity in this context is the AAA-NPO guide which discusses the “Classification of expenses related to more than one function” in section 13:36. It offers two methods of allocating these costs namely the direct method where each cost is traced to the activity that it belongs to and the cost is assigned to this activity, and the indirect method where the costs are grouped in a pool and allocated in some reasonable manner. Most of the issues create problems with M&G costs are because of the generalization of the indirect method. The guidelines suggest the use of a objective method as opposed to a subjective method and to use the method consistently across all programs. There are suggested methods within the guide such as saying “expenses associated with occupying and maintaining a building, such as depreciation, utilities, maintenance and insurance, may be allocated based on square footage space occupied by each program and supporting service”.

There are other secondary publications such as Statement of Financial position 98-2 that attempts to provide some guidance on how to categorize and allocate joint costs specifically related to mailings to donors or members that combine programmatic and administrative content by using a “three-part” test.

The guidelines provided for allocating joint costs in the context of the non-profit organizations are considered to be “a tool that must be used in good faith”. (Yogus, 1998). The general premise one again is that the guidelines have several qualitative component to them which therefore subject to interpretation. The SOP 98-2, Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Entities that Include Fund-Raising issued in 1998, replaced SOP 87-2.

The expectation was that this would allow independent auditors a higher and more consistent level of scrutiny of a not-for-profit's allocation methods and rationales. However it is critiqued as follows,98-2 does not prescribe nor prohibit any allocation methods. It includes a discussion to help users determine whether an allocation is reasonable and provides some illustrations. [The SOP] is vague and full of loopholes. It's still open to creative interpretation. The complexity of the new rules may be dangerous. If charities have trouble following the nuances of the new policy, accountability in the non-for-profit world could be eroded. It fails to require charities to use a specific allocation method. (Yogus 1998)

The OMB circular 122, is very detailed in its required methodology for the allocation of costs for any non-profit organization receiving funds under this guideline. The problem however is that this circular pertains only to the former category of non-profit organizations.

The five methods identified by the circular are, general, simplified allocation method, multiple allocation base method, direct allocation method and special indirect cost rates.

There are extensive descriptions of these methods but in summary this is similar to the required descriptions in the guide. This circular is also fairly detailed about the audit parameters to be used when auditing a grantee's costs and whether accepting the costs as legitimate. It may be fair to say that while this is not a perfect document, it is one of the most rigorous in this area, its scope however is limited to the organization directly or indirectly receiving federal funds above a certain amount.

These regulations may apply to as many as one-third of the 160,000 non-profit organizations filing the Form 990 (not the 990-EZ which can be used by organizations with \$100,000 in gross receipts). (Pollack, Rooney and Hager, 2001). This however substantiates the presumption that organizations receiving a significant portion of their funding from governmental sources should be looked at separately.

Prior Studies and Findings related to the Management and General Costs in the Non-profit Sector.

One of the most comprehensive studies of the sector with a focus on non-profit management and general costs was performed by the Urban Institute, an economic and social policy research organization in collaboration with Indiana University resulting in several working papers and 6 overhead briefs in this area. Factors like mission, size, age, sources of revenues and/or accounting practices can help explain variations in management and general costs in non-profit organizations. (Pollack, Rooney and Hager, 2001)

They also conclude that 37% of the non-profit organizations reporting fundraising expenses of \$50,000 and more in contributions reported zero fundraising expenses. This is not inconsistent with a survey of the NCCS digitized data sample looking at

over 400,000 organizations and finding more than 150,000 of these organizations reporting zero fundraising expenses but non-zero fundraising expenses. (Bhattacharya, Tinkleman 2006). These preliminary findings would indicate that non-profit organizations have misallocations in their functional classifications in their cost categories and since these cost categories are interrelated the effect on M&G expenses would be to presumably understate or overstate these expenses thereby misstating operating costs.

Other findings from the study focused on how smaller non-profits were able to invest less in infrastructure and consequently had less ability to be effective. It might be interesting to note however if we look at some of the workings with numbers the simple percentages and ratios do not accurately reflect this lack of resources, (ie - \$50,000 in accounting expenses would be a 10% expenses on a budget of \$500,000, but this might not be adequate to do the job). It also begs the question whether there is a critical size component before which a non-profit can function in an effective manner. The very small non-profits are extremely important since there is a fair percentage of non-profit organizations (5%) that fall in the under \$100,000 bracket and these are not required to have any audits and organizations below \$25,000 in revenues are not needed to file a form 990. This is based on the premise that any form of reporting poses too much of a burden. While it is true that small private companies have less cumbersome reporting needs than larger public organizations, all non-profit organizations are eligible to receive external funding and therefore should have some formal method of accounting for their revenues.

There is general consensus within the industry that the existing guidelines in evaluating non-profit organizations are limited, despite claims by certain watchdog organizations to the contrary. In looking at some of the tools available to people for evaluating non-profit performance, I start with standards established by charity watchdog organizations that are private organizations looking an enhancing non-profit reporting transparency. These organizations attempt to incorporate both qualitative and quantitative standards and are increasingly becoming important to donors. In justifying the usefulness of the numbers, Charity Navigator¹⁴ states that, "numbers help in a crowded marketplace, they tend to be reliable and useful". Unfortunately with the flexibility present in the methodology of non-profit cost allocations these numbers are very subjective and therefore it might be a stretch to count on their reliability. Additionally, most of the non-profit being evaluated by watchdog organizations are subjecting themselves to a voluntary evaluation.

The most comprehensive tool that is available to donors is the form 990, that is the IRS mandated tax filing. In looking at this tool some of the issues that have been pointed out are the fact that this tool has several errors, there is an oversimplification of the data on this document and the fact that this offers the public a mistaken impression that this is a reliable tool. Other problems with non-profit financial reporting guidelines are the inconsistencies within the form 990 and GAAP accounting rules and finally the variance in degrees of oversight in the board oversight component (Keating, Frumpkin, 2003). The importance of board oversight cannot be overstated in the context of non-profit financial report, one of the reasons

¹⁴ Charity Navigator is an independent private evaluator of charities using several non-profit qualitative and quantitative yardsticks that offer guidance on the financial health of charities.

that aspect is being looked at as a separate variable in this study. There is a lot of excitement in the industry about the increased transparency related to the availability of scanned IRS form 990's, "Scanned images of all IRS Forms 990 filed by public charities, an essential and widely used source of information on the sector, are now easily and instantly accessible on the Internet." (Lampkin, 2006). This is a great step but a large number of people do not still understand how to synthesize the form 990 in a simple manner and since it does not have the footnotes accompanying the financial statements of an organization a lot of the detail in the organization's financial performance is not readily available. This also is still voluntary, while a large number of organizations do this there are several organizations that opt out or do not have the most current data listed. All of this highlights the general lack of oversight this aspect of non-profit organizations have received from both management and auditors and it has been described as a "potential ticking time bomb for the profession."

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