

**Broken Yardstick:
Administrative Cost Rates as a
Measure of Nonprofit Effectiveness**

Cassandra Benjamin, MNA

from a Master's thesis completed at the
Institute for Nonprofit Organizational Management,
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with support from
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NONPROFIT SERVICES

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Foreword

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Suppose a person went to a computer company and asked to buy a computer, but was willing to pay only the “direct costs”—the cost of the chip, metal, plastic and time spent building the computer—but not the “overhead”—the accounting costs, the insurance, and costs of management staff. The computer company would legitimately refuse to sell the computer for the reduced price, or quickly be forced into bankruptcy. Yet nonprofits often find themselves in the position of being told by donors and funders that *their* overhead—accounting, insurance, and management—represents illegitimate bureaucracy and inefficiency. What’s going on here?

Recently nonprofits have experienced a sea change in the demand for—and public access to—financial information about nonprofit organizations. With instant availability of IRS Form 990 data and heightened attention to nonprofit expenses by the state attorneys general, nonprofits are finding that their financial reports are being scrutinized by more constituents for evidence of both sound financial practices and fraud or misuse.

One “yardstick” used by such readers to measure financial efficiency is the “administrative rate,” “indirect cost rate,” or other amounts intended to measure overhead. In this study, Cassandra Benjamin undertakes an investigation of how nonprofits report these rates, and how readers of financial information interpret them. She suggests that in many cases nonprofits are finding their efficiency and donation-worthiness judged by a ratio that is anything but straightforward. In fact, with so many different definitions and methods of determination in play, the standards set by a funder or a watchdog group end up measuring nonprofits with a broken yardstick.

Cassandra's background makes her an ideal researcher for this work. As a development officer at Larkin Street Youth Center and now CEO of Shelter Network, both exemplary nonprofits working with the desperately poor, she has been on the front lines in managing to the highest impact and at providing the public with the highest level of accountability. All of us can be grateful that she chose this important topic for her Master's thesis at the Institute for Nonprofit Organization Management at the University of San Francisco, and that she prepared *this* report, based on her thesis, for wider use by nonprofits and everyone concerned with nonprofit accountability.

At CompassPoint Nonprofit Services, we view this report as timely and practical support to the management consulting and training work we do with nonprofit organizations. In particular, it underscores the need for the kinds of technical assistance tools and forums we are developing through our work in the national *990 in 2000 Initiative*. Cassandra's report helps to deepen the discussion about nonprofit accountability, and we are pleased to help bring it to a wider audience.

Executive Summary

Unlike for-profit organizations, nonprofits do not have an obvious bottom-line measure of their success. Determining whether a nonprofit is utilizing its financial resources wisely is a challenge for nonprofits and funders alike. The most commonly used method is to review the percentage of a nonprofit's overall expenses that are spent on administrative and fundraising costs, with the premise that lower percentages are always better. Despite the widespread use of this percentage as a measure of nonprofit efficiency, there is little standardization of administrative and fundraising cost definition or allocation. This lack of consistency greatly reduces the meaningfulness of the percentage on its own or in comparison to the percentages of other organizations.

To assess the difficulties and variation in practices used by nonprofits in determining administrative cost rates, a survey was conducted of San Francisco Bay Area nonprofit organizations. The survey sought to discover what the actual administrative cost percentages were for each organization, what definitions and methods were used to arrive at these percentages, and what independent organizational characteristics (such as size, maturity, or funding composition) affected either the administrative rates or the techniques used to calculate them.

First, it was important to examine how nonprofits arrived at their administrative cost percentages and what these percentages actually were. The study found a range of administrative cost rates, with a median rate of 14% of the annual budget going toward fundraising and administrative costs, which was well within funder and regulatory agency guidelines. It was also consistent with samples from other studies and listings.

Next, this study sought to determine how the rates were actually derived. More than 80% of the respondents utilized specific guidelines to help define and

allocate costs, with some organizations using as many as six different resources. Sixty-one (74%) of the respondents used one or more specific cost allocation methods, while 22 (26%) had no specific method for cost allocation. For those without a specific method, it is likely that their cost rates could fluctuate from year to year as different allocation formulas are used. Definitions of administrative and fundraising costs among organizations also varied widely – with some consensus around specific line items such as the audit (administrative), appeal letter (fundraising), and program director (programs) – although even for these, there were a few exceptions.

The findings of this study are consistent with those of previous studies by Buhl and Hoffman (1986) and Henderson and Masaoka (1994). As Henderson and Masaoka noted, “Differences in terms of which line items should be classified as indirect costs were quite significant among nonprofits. As well, a wide variety of methods were used to calculate and allocate indirect costs” (1994, p. 11). Overall, these two prior studies and the present study concur that nonprofit organizations use a broad range of methods, tools, and definitions to determine the indirect rate, bringing into question the meaningfulness of the actual rates.

In addition to differences in cost definition and allocation methodology, other authors have cited a number of organizational characteristics that might affect the process and rate. Therefore, this study sought to determine which of a number of possible factors, including organization age, mission, size, fiscal health, and funding source composition affected the indirect cost practices and actual administrative rates of nonprofit organizations.

This study found two factors to be statistically significant in affecting actual administrative rates: staff size, and government funding as a percentage of revenue. Both of these factors were negatively associated, meaning that the

higher the number of staff or percentage of government funding, the lower the indirect percentage rate was likely to be. Conversely, the lower the number of staff or percentage of government funding, the higher the indirect percentage was likely to be. The literature review and research by Buhl and Hoffman (1986) support these findings.

A positive association between the fiscal maturity of an organization (number of years maintaining a budget greater than \$500,000) and the number of guidelines used to define and allocate indirect costs was also found. The more fiscally mature an organization, the more likely that it used multiple guidelines and resources to define and allocate indirect costs. Younger organizations were less likely to employ multiple guidelines. The literature and previous studies also supported this finding.

Overall, this study served to highlight the continuing problem of the lack of industry standards for determining nonprofit administrative rate percentages, with the resulting problem that these rates cannot measure nonprofit effectiveness or efficiency on either an absolute or comparative scale. To increase nonprofit accountability and effectiveness, definitions and methods for calculating administrative rates must be standardized, so that the rates can be used for meaningful comparison of organizations. Moreover, funders, nonprofits, and the public at large must learn to consider additional performance measures besides the administrative rate, such as number of people served or long-term program results, when evaluating nonprofit effectiveness and efficiency.

USE OF TERMS

For the purposes of this study, *administrative costs* are defined as the non-program expenses incurred by nonprofit organizations. Fundraising, administrative and management costs all fall within this definition. The IRS 990 form classifies functional expenses of nonprofit organizations into three categories: programs and services, management and general, and fundraising. Administrative costs incorporate the latter two categories. The *administrative cost rate or percentage* is the percentage of the overall operating expense budget allocated to administrative and fundraising costs.

Another term widely used for administrative costs is *indirect costs*, in opposition to *direct costs*. Direct costs are those costs that can be directly attributed to a specific project. Indirect costs are those costs that are incurred by two or more projects and cannot easily be attributed to specific projects. In most cases, the term *indirect cost rate* is interchangeable with *administrative cost rate*. The term *overhead* is also often used to describe administrative or indirect expenses.

Background on the Issue

The Quest for Accountability

In recent years, the public has placed increasing scrutiny on the accountability, or the alleged lack thereof, in the nonprofit sector. This growing focus on the operations of nonprofits stems largely from recent scandals and increased government regulations. As a 1996 *Nonprofit Times* article states, "Nonprofits face ever-increasing challenges from all perspectives. In contrast with the past abundance of public goodwill and charity, organizations must now operate in a more strident arena of public scrutiny and skepticism" (Capin, 1996, p. 42). The public wants to feel that nonprofits are wisely using the public and private funds they receive, and are contributing to the greater good, but they are unsure if this is actually the case.

However, measuring the effectiveness of nonprofit organizations can be extremely difficult. According to Regina Herzlinger, a professor of business administration at Harvard University, the problem of nonprofit accountability stems from the fact that nonprofits lack the three basic business measures of their for-profit counterparts: self-interest, competition, and bottom-line profit. While business financial responsibility focuses on the amount of wealth accumulated (profit), nonprofit financial responsibility must be measured by how effectively the funds are used to fulfill an organization's mission — a much more difficult measure to obtain (Herzlinger, 1996).

As Herzlinger explains, "There is little disclosure of performance information for nonprofit organizations, especially measures of effectiveness" (1996, p. 101). This problem leads to an intensified focus on the limited data that is available. One performance measure that is widely available and *appears* to be easily measurable is the administrative cost percentage, or the proportion of a nonprofit

organization's budget that is allocated to administrative and fundraising costs, as opposed to direct program costs. Donors want to be sure that their charitable contributions go directly to helping people in need, rather than to excessive administrative costs. According to the National Charities Information Bureau (NCIB), the three areas of particular concern to donors are the amount spent on fundraising, excessive executive compensation, and overhead expenses (Stark, 1996). Thus a nonprofit with a lower administrative cost percentage is perceived to be a more efficient and effective organization.

While some look at these indirect cost percentages as only one factor to be used in evaluating charities, many treat them as the single best indicator of nonprofit performance. Ultimately, because indirect cost numbers are measurable and available, and other performance data often are not, indirect cost percentages have become the most frequently used rating criteria for nonprofit performance.

A number of popular magazines, including *Money*, *Kiplinger's Personal Finance*, and *U.S. News & World Report*, publish annual articles on charitable giving to help donors identify worthy nonprofit organizations. Many of the articles have a negative slant, as though charities are intentionally inefficient or seeking to collect funds for personal gain. With few exceptions, these articles focus on evaluating nonprofits according to the percentage of funds spent on administration and fundraising. In fact, every year *Money* ranks charities solely according to what percentage of their total income is spent on programs, with the highest-ranked charities spending the greatest percentages of income on programs.

On a more formal level, a number of regulatory agencies, particularly the Philanthropic Advisory Service, the National Charities Information Bureau, and the American Institute of Philanthropy, have established regulations or guidelines

regarding nonprofits' financial accountability. They publish nonprofits' "scores" on these measures in order to help potential donors choose organizations worthy of support. Again, much of the focus of these guidelines has been on charities' use of funds, which the regulatory agencies generally report to be the number-one concern expressed by donors.

The Better Business Bureau's Philanthropic Advisory Services (PAS) was founded to promote ethical standards within the charitable community, provide information to the public about charitable organizations, and educate individual and corporate donors about wise giving. Specifically, PAS requires that:

A reasonable percentage of total income from all sources shall be applied to programs and activities directly related to the purposes for which the organization exists (at least 50%). A reasonable percentage of public contributions shall be applied to the programs and activities described in solicitations, in accordance with donor expectations (at least 50%). Fundraising costs shall be reasonable, not exceeding 35% of related contributions. Total fundraising and administrative costs shall be reasonable, not exceeding 50% (BBB-PAS, "Standards," 1996).

Similarly, the National Charities Information Bureau (NCIB) has developed standards to guide donors in their philanthropic choices. The NCIB has its own specific guidelines regarding the use of funds, which state:

The organization's use of funds should reflect consideration of current and future needs and resources in planning for program continuity. The organization should spend at least 60% of annual expenses for program activities; insure that fundraising expenses, in relation to fundraising results, are reasonable over time; and not have majorly excessive or deficient net current assets (NCIB 1996, June).

Comparability

Despite donors' and regulatory agencies' emphasis on administrative cost rates, these percentages are problematic as measures of nonprofit performance. First of all, the premise that a lower rate is necessarily better, or is even a measure of organizational effectiveness, has not been substantiated. As one commentator explains, a higher administrative rate

may simply mean the charity must spend more to raise a dollar because it has a low profile or is championing a cause that isn't exactly mainstream... If a charity has extraordinarily low administrative costs, donors might think they've found a group of selfless toilers who thrive on little more than hope and prayer. They might also have stumbled upon a charity staffed mainly by volunteers without the time or skills to do big picture planning (Silver, 1995, p. 81).

Without further context and additional programmatic measures of how effectively an organization carries out its mission, the administrative cost rate cannot reveal whether a nonprofit is using funds wisely or functioning effectively.

But beyond the question of whether a lower rate is always better, there is a more fundamental problem with published administrative cost rates. Within the nonprofit sector, there is great variation in the definitions of terms related to administrative costs, as well as in the methods used to calculate the administrative cost percentages. Often, it is impossible to discern from the available information, including annual audits or tax forms, what definitions or methods an organization used to arrive at its published rate. As a result, the published administrative cost rates cannot easily be compared between organizations, and mean little on their own when the calculation methods used are unknown. As Olgeirson and Quinn explain in their 1994 *Denver Business Journal* article on nonprofit accounting, "While the amount of money nonprofits spend on fundraising and overhead compared with the programs is generally accepted as a good guideline for calculating efficiency, the lack of industry-wide bookkeeping standards complicates efforts to negotiate the accounting labyrinth of nonprofits" (p. 37A).

To help nonprofits find their way through this "labyrinth," a number of agencies and organizations provide resources and accounting guidelines. The Federal Office of Management and Budget (OMB), Financial Accounting Standards Bureau (FASB), and the American Institute of Certified Public Accountants

(AICPA) provide a number of resources to help nonprofits determine their indirect rates. Textbooks on nonprofit financial management and program evaluation that discuss cost allocation methods are also available. However, the techniques they suggest are varied and sometimes contradictory, and the definitions offered are often, by necessity, somewhat vague or inconclusive.

The first step in calculating an administrative cost percentage is to define administrative/indirect costs versus program/direct costs. Existing literature provides fairly clear, although very broad, definitions of these terms. Direct costs are those that can be attributed to a specific project, while indirect costs are those that cannot easily be attributed to one or more projects (Gambino & Reardon, 1981; OMB, 1980; Austin et. al., 1982; and Kettner, Moroney, & Martin, 1990).

Several texts mention that the term "indirect cost" is often considered synonymous with the term "overhead," because indirect costs usually involve support activities (Herzlinger & Nitterhouse, 1994; Gambino & Reardon, 1981). Reference materials such as these also provide examples of direct and indirect costs, while stressing that specific line items will vary from organization to organization. Some of the examples of "direct costs" include: caseworker salaries; telephones used by caseworkers; salary and wages, including overtime, for staff who work on only one program; materials, supplies, services and related transportation charges; travel expenses; communication expenses; and equipment purchased for one program. Some of the examples of "indirect costs" include: depreciation or use allowances on buildings and equipment; costs of operating and maintaining facilities; general administration expenses, such as the salaries and benefits of executive officers, agency directors, business managers, receptionists, secretaries, personnel administrators, accountants, bookkeepers,

and fundraising staff; and building rents, utilities, janitorial services, telephones, and auditing costs.

The above examples are quite broad and occasionally contradictory (telephones for example are considered both direct and indirect costs depending on the reference source), and leave room for multiple interpretations depending on the individual nonprofit agency.

Once direct and indirect cost categories have been established, an allocation method must be chosen. Simply put, cost allocation consists of placing all indirect costs into an indirect cost pool, and then totaling them and apportioning them among the programs. Three primary methods for allocating indirect costs have been developed:

1. Total direct cost method: Determine each program's direct costs; total all direct costs; find each program's relative percentage share of the overall agency direct costs; and then allocate the indirect pool to each program using the derived percentages.
2. Total personnel cost method: Determine each program's salary, wages, and fringe benefit totals; find each program's relative percentage share of the overall agency direct personnel costs; and then allocate the indirect pool to each program using the derived percentages.
3. Conversion of indirect costs to direct costs method: Find a unique measure or base from which to allocate each indirect cost item. In this method, each line item has its own rationale. For instance, to allocate accounting costs, calculate the number of transactions for each program and allocate accordingly; or for telephone costs, allocate according to how many phones per program; or for janitorial services, calculate according to how many square feet of office space per program and allocate accordingly.

Clearly, there is no best method — each has benefits and drawbacks in terms of appropriateness to a particular organization's structure, accuracy, and ease of implementation. One guiding principle, when selecting a method, is to ensure that each program is allocated its fair share, and that the total program costs

represent, as accurately as possible, the real costs of providing services. Many organizations use a combination of methods, converting easily calculated items into direct costs, and then allocating the remaining indirect costs by the total direct cost or total personnel cost methods.

Broken Yardstick

With this wide range of accepted accounting practices, it is hardly surprising that nonprofits' reported administrative cost percentages can vary greatly. *The Nonprofit Times* publishes an annual listing of America's 100 largest nonprofit organizations with summary financial data. In 1996, among the 98 organizations with available data reporting the percentage of total income they spent on administration and fundraising, the median percentage was 14.06%, with 6.93% spent on administration and 4.98% on fundraising. The administrative cost rates varied widely, with total "overhead" spending ranging from 0.81% to 56.18%. Administrative percentages varied between 0.11% and 50.66%, and fundraising from 0 to 19.87% (Clolery, 1996). The 1998 report (Clolery, 1998) showed similar results, with an increased percentage spent on fundraising. The 10 organizations that spent the most on fundraising spent between 16.2 and 37.5% of their income on fundraising. Overall, the administrative and fundraising rates for large nonprofits tended to be lower than the rates of smaller groups. This is partly due to economies of scale, but it is also because a number of national organizations included in the top 100 have local chapters, where most administrative and fundraising costs are actually incurred.

Besides the confusing profusion of definitions and allocation methods, an additional factor affecting administrative cost rates is the tremendous pressure nonprofits feel to keep administrative costs as low as possible to appeal to potential donors. As the American Institute of Certified Public Accountants (AICPA) states in its guide for auditing not-for-profit organizations, "An attempt to appear as efficient as possible may increase the likelihood of misstatement of the

allocation of costs between program services and supporting activities. Because some financial statement users view program expense more favorably than supporting services, some not-for-profit organizations have incentive to report costs as program rather than as supporting services" (AICPA, 1996, p. 28).

These problems of inconsistency and inaccuracy are as frustrating for nonprofits as for potential donors or funders. While struggling to choose the appropriate definitions and allocation methods for their own organization, nonprofit staff may also feel as though the publication of another nonprofit's low overhead rate means nothing more than a creative accountant on staff and speaks little for the organization's actual efficiency. But despite the misleading nature of such statements, nonprofits know that they will be judged by these standards because most donors only consider the printed percentage and not the possibility that it lacks merit or accuracy. As Tobin (1994) found in a study involving more than 100 interviews with Jewish philanthropists who gave \$10,000 or more per year, "donors may be apprehensive about the use of their donation, but they do not spend much time investigating actual overhead" (p. 102).

Previous Research

Two major studies have been conducted on nonprofit indirect costs to date, one published by the Council of Foundations (Buhl & Hoffman, 1986) and the other by the Support Center for Nonprofit Management (Henderson & Masaoka, 1994). These studies support the conclusions found above: that administrative costs are of concern to everyone but are defined and calculated very inconsistently, and therefore the comparison of percentages becomes meaningless.

Buhl and Hoffman's 1986 study was prompted by government cutbacks in nonprofit funding during the 1980s, which occurred at the same time that foundations were switching their focus to funding only specific projects. The result of these concurrent trends was that the nonprofit sector had difficulty

obtaining funds for general operating expenses. The Council of Foundation's task force, led by Buhl and Hoffman, had four specific goals:

To clear up confusion in terminology and in the conceptual thinking about indirect costs; spell out some of the implications for grantees of grantmaker decisions about indirect costs; relate indirect costs to the larger theme of responsible budget-making and budget management; and promote clearer communication between grantmakers and grantseekers relative to indirect costs — indeed, relative to fiscal matters in general (Buhl and Hoffman, 1986, p. 9).

Buhl and Hoffman conducted telephone interviews with representatives from 28 nonprofits and 32 foundations. The survey included questions regarding the definitions of indirect costs and problems associated with them; practices for allocating and recovering indirect costs in grants; policies regarding indirect cost payment at foundations; and the effects of foundation policies on grantees.

Buhl and Hoffman's study also found that the primary factors influencing nonprofits' attempts to recover indirect costs included: the policies of the foundations that the nonprofits dealt with; the size of the nonprofits; the overall financial status of the nonprofits; the availability of alternative sources of funding for the nonprofits; and the nature of the nonprofits' work. Larger organizations were more likely to use aggregate indirect cost rates, as were those which received federal funds. Nonprofits with other sources of income tended not to request funds for indirect costs, because they felt less pressure to do so. Educational and research organizations were more likely to use indirect cost rates, as were advocacy and service organizations, while arts groups were not. A final factor affecting indirect cost recovery was the background and experience of the nonprofit's staff. Less experienced staff tended not to use indirect rates.

Upon completing their study, Buhl and Hoffman (1986) concluded that indirect costs ought to be considered within the context of fiscally responsible grants and nonprofit management, but that they were not useful as a sole criterion of

nonprofit efficiency or effectiveness. They asserted that “determining indirect costs, whether by aggregated formula or by project-specific computation, is an act with no necessary relationship to the administrative efficiency of the grantee” (p. 22). In fact, they often found indirect cost rates and organizational efficiency to be completely separate — and that factors such as the structure of an organization, its size, the type of work it does, and the nature of its services were much more decisive in determining the level of the indirect rate. As Buhl and Hoffman summarized, “An organization’s efficiency can only be measured through a look at a broad range of variables” (p. 32).

Henderson and Masaoka's 1994 study, *Indirect Costs: Practices and Perspectives*, was published by the Support Center for Nonprofit Management in San Francisco. The authors conducted a survey of San Francisco Bay Area nonprofit grantmakers and grantseekers to assemble their definitions, practices, and opinions regarding indirect costs. Sixty-five grantseekers (nonprofit agencies directly providing services to the public) and 20 grantmakers responded to the written questionnaire. Through a review of existing literature and their discussions with grantmakers and grantseekers, Henderson and Masaoka identified three key problem areas: indirect cost definitions, indirect cost allocation methods, and acceptable rates of indirect costs. They also found “a striking lack of consensus or even agreement on terminology involving indirect costs, including a definition of ‘indirect costs,’ whether various line items should be classified as indirect costs, and on appropriate percentages for indirect costs” (Henderson and Masaoka, 1994, p. 1). Grantmakers and grantseekers alike tended to use definitions of overhead, common costs, fixed costs, administrative costs, management and general costs, and indirect costs fairly interchangeably (p.3).

Henderson and Masaoka found more than 20 different indirect cost rates were obtained by nonprofit agencies from government funding sources, ranging from 1% to 100%. The authors found that most nonprofits in their survey did not have a federally negotiated indirect cost rate and were unable to use a single rate with different funders. Conflicting definitions of which line items to classify as indirect costs were a significant problem among the nonprofits they surveyed.

Henderson and Masaoka found that nonprofits used a wide variety of methods to calculate and allocate indirect costs. These methods included using “9 or 12% of the total of Personnel and Operating Expenses; a percentage of total expenses; all non-medical expenses; 25% of grants received; individual line items by usage and specific budget amounts; percentage of personnel allocated to a project; and a percentage of program costs to total program costs” (p. 11).

As Henderson and Masaoka also discovered, the issue of indirect costs was not much clearer from the grantmakers' side. Not one of the foundations had written guidelines regarding what an acceptable indirect rate was, but more than 75% of them employed informal guidelines. Among the guidelines used were: 10-12% of program costs; 11% of program costs; up to 15% overhead; 15-20% of project/grant purpose; 17.5% of project costs; or a flexible percentage of total budget, variable depending on type of project or program (p. 12). Overall, the study highlighted the many differences in indirect cost allocation that exist among individual nonprofits, individual grantmakers, and nonprofits and grantmakers as a whole.

Research Methodology and Findings

Purpose of the Current Study

Clearly, administrative cost percentages are widely used to evaluate nonprofit organizations, yet debate continues about the utility of currently published administrative cost percentages as measures of cost-effectiveness, efficiency, and financial accountability among nonprofits. This study aims to inform the debate by collecting and analyzing empirical data relating to nonprofits' actual administrative rates and their methods of determining those rates, and by looking for organizational characteristics that affect either the administrative rates themselves or the techniques used to calculate the rates. The results help provide a more comprehensive picture of current nonprofit accounting practices and the factors that influence their selection and implementation.

Methodology

A written survey questionnaire was developed which covered three primary areas: general characteristics of each organization such as mission and year of founding; specific characteristics of each organization's financial status such as financial health, size, maturity, and number and type of funding sources; and specific questions regarding each organization's definition, practices, and actual percentages of administrative costs.

The study population was drawn from nonprofit organizations located within the nine-county Bay Area of California (Alameda, Contra Costa, Marin, Napa, San Francisco, San Mateo, Santa Clara, Solano, and Sonoma counties). All organizations included in this survey were self-described as welfare organizations that benefit individuals, as defined by the California Registry of Charitable Trusts, and all had annual operating budgets of more than \$500,000 but less than \$10,000,000. Of the 315 surveys mailed, 84 valid surveys were returned, for a response rate of 27%. See the Appendix for a sample survey.

General Characteristics of Survey Respondents

The respondent organizations represented a fairly diverse sample in terms of mission and target population, size, and age. The organizations' missions covered a full range of health, welfare, and social services. The staff size ranged from 7 to 300 employees, with a median size of 44 full- and/or part-time employees. The typical organization participating in this study was an independent, general social service agency, with 25 or fewer employees, which had been in existence between 16 and 30 years.

The financial characteristics of the organizations surveyed were also fairly diverse. The current operating budgets for a majority of respondents fell into the \$1 million to \$2.49 million range. Most organizations were fiscally mature, having maintained operating budgets of more than \$500,000 for more than 10 years. Overall, the 84 responding organizations were financially quite healthy, with 61% finishing the last fiscal year with a surplus, 22% breaking even, and only 16% ending the year with a deficit. The long-term financial outlook for the respondents was also generally positive, as 89% of the organizations had a reserve fund, fund balance, or net assets available for future operations.

Responses were quite varied concerning the organizations' specific sources of funding, with some organizations reporting 100% government sources, while others relied primarily on private funding or on program fees or other revenue-generating enterprises to fund their organizations. Overall, government funding (federal, state, county, and city) made up the largest percentage of agency budgets, with a range of 0% to 100% and a median of 63%. More than half (56%) of the respondents were heavily dependent upon a single primary funding source, receiving 50% or more of their total revenue from that source.

The survey also investigated the amount of funding and number of funding sources subject to restrictions for each organization. Restricted funds can only be used for very specific line items within a particular program, while unrestricted funds can be allocated wherever the budgetary need is greatest, so the number and percentage of restricted funds may have a significant impact on an organization's financial systems and administrative cost procedures. The distribution of budgetary restrictions among respondents was very wide (from 0% to 100% restricted), with a majority of respondents reporting either mostly restricted or mostly unrestricted budgets. The typical number of separate restricted funding sources also varied, with a majority of organizations reporting 10 or fewer sources.

Research Questions

This survey sought to answer three basic questions about the surveyed nonprofit organizations: 1) What are the actual and reported administrative cost percentages for each organization? 2) What definitions and allocation methods were used to arrive at these percentages? 3) What organizational characteristics influenced the percentages or the methods used to calculate them? To answer these questions, an analysis was conducted of the respondents' organizational characteristics and administrative cost practices, as well as potential correlation among them.

Administrative Cost Rates

The administrative cost rates listed by respondents fell within a relatively wide range, but virtually all were well within the range generally required by funders, with a median rate of 14%. The administrative rates found in this study are consistent with data from other studies, including *The Nonprofit Times* Top 100 (Clolery, 1996; Clolery, 1998) that reported a median rate of 14%, and a Bay Area study of homeless service organizations (Arab, 1990) that reported a median rate of 17%. Moreover, in all but one case, the survey respondents

easily met the spending guidelines established by the regulatory agencies (PAS, NCIB, and AIP) which call for directing at least 60% of the overall budget to programs and services, and spending no more than 35% of the budget on fundraising. Only one respondent failed to meet these standards, spending only 36% of its revenue on programs and services. The highest proportion of revenue that any respondent spent on fundraising was 19%, indicating that most organizations can readily comply with the regulatory agencies' guidelines for fundraising.

Expense Types as a Percentage of Operating Expenses

Expense Type	Range	Mean	Median
Program	36-96%	83%	85%
Administration	3-32%	12%	12%
Fundraising	1-19%	4%	3%
Other	0-21%	1%	0%

Most organizations also reported having a target rate for their administrative and fundraising costs as a percentage of their overall budget. Of 83 respondents, 64% reported that they had established a target percentage, with the majority of the target percentages falling between 11 and 20% of revenues. The target percentages for these 53 respondents were very close to their actual rates.

Only 12% of respondents had a negotiated federal indirect rate. Of those that did, the rate varied widely, ranging from 8% to 55%, with a median of 20%. This finding is similar to that reported in Henderson and Masaoka's 1994 study, which found that only 7% of respondents had a federal indirect rate.

Even though the majority of organizations did not have official federal indirect rates, 34 of the 83 respondents (41%) reported that their funders specified percentage limits on indirect costs that should not be exceeded. These limits ranged between 5% and 43%, with most in the 15-25% range. The funders most likely to have stipulated indirect cost limits were government funders, with a median rate of 15%, and the United Way, with a median rate of 25%. In general, the organizations' actual and self-determined indirect cost rates were equal to or lower than rates proscribed by their funders.

Even many funders without official indirect cost limits expressed interest in the administrative cost rates. Fifty-three of the 83 respondents in this study (64%) reported that their funders asked about their organizations' administrative cost rates. Foundations, local government, and the United Way were the most likely to have requested this information. Despite this interest on the part of funders, only 41 of 84 respondents (49%) actually regularly published their administrative rates, most commonly in their annual reports.

Administrative Cost Definitions and Allocation Methods

Forty-one of the 84 survey respondents (49%) reported that funders or other outside organizations supplied them with regulations regarding the definitions or classifications of administrative and fundraising costs. Of these, 68% received regulations from federal funding sources, 42% from state sources, 42% from county sources, 27% from the United Way, and 24% from their auditors.

The majority of respondents (89% of 79 responses) utilized one or more guidelines to help them define and allocate administrative and fundraising costs. The guidelines most commonly used were those published by the Federal Accounting Standards Board (52%), American Institute of Certified Public Accountants (49%), and the Office of Management and Budget (47%). Other reporting guidelines respondents utilized were those developed by the Internal

Revenue Service (16%), the United Way (13%), and miscellaneous other resources (11%).

Sixty-two of the 83 respondents (74%) reported using one or more specific method(s) for allocating costs. The most popular of these methods, reported in use by 27 of the respondents (44%), was the personnel method, using total personnel costs as the base for allocating indirect costs. The cost conversion method, used by 25 of the respondents (40%), converts indirect costs into direct costs. Twenty-three of the respondents (37%) reported using total direct costs as the base for allocation. Six of the respondents (10%) reported using other specific cost allocation methods.

A number of organizations utilized additional tools to assist in the allocation of costs. Twenty-six of the respondents (33%) employed the AICPA's joint allocation method for allocating fundraising costs, while 46 of the respondents (57%) used personnel time sheets to allocate direct and indirect costs. The low percentage of organizations employing joint allocation for fundraising costs is consistent with a 1993 thesis study that found that only 34% of Bay Area advocacy organizations used this new accounting convention (Fierberg, 1993).

This survey also found significant variation in the types of costs organizations typically classified as fundraising or administrative costs. The responses varied greatly, with some organizations classifying a particular expense line item as 100% administrative while others charged 100% of the expense to programs. For instance, a few organizations classified the executive director as 100% program cost, while others classified the position as 100% administration and fundraising.

Despite the wide range of responses, there were some definite trends, which showed up in an analysis of the modal responses to each question. These responses showed that the following expenses were very frequently classified 100% as administrative or fundraising expenses: audit, executive director, fundraising staff, newsletter, fundraising appeal letter, accounting staff, legal fees, and special events. Fifty percent of the receptionist salary was most often classified as an administrative and fundraising cost. Moreover, 15-20% of the following expenses were generally considered administrative: office supplies, computer equipment, telephone, liability insurance, office rent, and depreciation. Finally, the program director and janitorial service line items were almost always classified 100% as program expenses.

Organizational Characteristics and Administrative Cost Rates

Two organizational characteristics were found to have a statistically significant negative association with the actual administrative cost percentage: the number of full-time staff (a measure of organizational size) and the percentage of government funding. Thus the higher the number of staff or percentage of government funding, the lower the indirect percentage rate was likely to be. This correlation supports the hypothesis that larger organizations would have lower indirect rates, due to economies of scale and more experienced finance staff.

The government funding percentage correlation was even stronger, and when the government funding percentage was correlated with the percentage spent on fundraising (one component of the administrative rate percentage), the correlation became even clearer. This correlation supports the idea that the more government funding an organization has, the less it spends on fundraising, thereby decreasing its overall indirect rate. This finding also contradicts the alternative hypothesis that high amounts of government funding would result in higher financial accounting and reporting costs, which would offset the fundraising savings.

A positive association was also found between the fiscal maturity of the organization (number of years maintaining a budget greater than \$500,000) and the number of guidelines used to define and allocate indirect costs. Thus the more fiscally mature the organization, the more likely that it used multiple guidelines and resources to define and allocate indirect costs. This finding supports the hypothesis that more mature organizations would have more systematic approaches to defining and determining administrative costs.

Conclusions and Recommendations

According to published guidelines and standards, the nonprofit organizations surveyed for this study had administrative rates well within the range generally required by funders, with a median rate of 14%. These rates appear quite reasonable, but the lack of consistency in definitions and allocation methods makes them both impossible to compare and largely meaningless without further context. Three different organizational characteristics were shown to have a statistically significant influence on the methods used to determine the administrative rate or the rate itself, providing support for the hypothesis that indirect cost rates cannot be compared fairly for organizations with different sizes, ages, or fiscal characteristics.

Without specific information regarding an organization's cost definitions and practices, the indirect rate alone is not an accurate measure of whether the organization is using its financial resources wisely. Furthermore, the premise that a lower rate is necessarily better, or is even a measure of organizational effectiveness, has not been substantiated. In fact, an organization could be spending so little on its administration and fundraising that it lacks the ability to sustain itself in the long term, thereby reducing its effectiveness.

In order for administrative cost percentages to be used as an accurate measure of nonprofit efficiency, consistent regulations for cost definition and allocation must be developed and implemented. Funders must agree on these definitions and regulations in order to reinforce the use of consistent methods. Currently, nonprofits are forced to use different definitions for each funder and comply with a variety of administrative cost limits, making the use of consistent methods impossible. With agreement from funders and nonprofits alike, consistent

definitions, methods, and standards can be developed to make administrative cost measures a more accurate tool.

Industry standards then need to be determined that take into account the range of other factors, such as organization type, size, and funding source composition, that can affect administrative cost percentages. Such standards would enable organizations to use consistent methodologies and be compared to other like organizations, establishing a much more meaningful measure of efficiency. This is a common practice in the for-profit world, which assigns agreed-upon target financial ratios for the banking, retail, and manufacturing industries.

Equally critical, however, is the need to encourage both funders and the general public to consider other factors besides the administrative cost rate when evaluating nonprofit organizations' effectiveness. The misperception by the public that an administrative cost percentage is an accurate measure, and that lower administrative percentages are always better, needs to be corrected.

Moreover, administrative cost rates should not be examined in a vacuum. To make wise social investment decisions, funders must consider how well an organization fulfills its mission and meets program objectives, in addition to how efficiently it uses its funds. Data on the quantity, quality, and ultimate effectiveness of services is key to determining how effectively an organization is performing. In recent years, there has been a heightened focus on program outcomes at nonprofit agencies, and this information must be coupled with relevant financial information to measure overall nonprofit performance.

Nonprofits need to lead the way in developing standards and measures of efficiency and effectiveness to promote public confidence in their accountability. Otherwise, outsiders less familiar with the nonprofit world will continue to

prescribe standards and methods that are often unrealistic or inaccurate. A few current projects led by the nonprofit sector – the Quality 990 Project (www.qual990.org) and the Guidestar website (www.guidestar.org), for example – are encouraging signs that nonprofit organizations are taking action toward developing meaningful standards of their own.

Unquestionably, nonprofits play a vital role in American society – they feed the hungry, cure the sick, educate the young, and shelter the homeless – and it is in everyone's best interest to continue to increase nonprofits' effectiveness. Nonprofit organizations, regulators, legislators, auditors, funders, the public at large, and most importantly, the clients served by nonprofit organizations, all benefit from increased nonprofit accountability and accurate measures of efficiency. But as with many important issues, solutions cannot be found in a quick sound bite (“the less spent on overhead, the better”), but rather require a collaborative effort on the part of all involved to ensure the development and implementation of meaningful measures. Together, it is possible to develop standards that will increase nonprofit accountability and ensure that the public's assets are being used efficiently and effectively to help better society.

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Appendix- Survey Instrument

1) What is your organization's primary purpose? *(please select ONE only)*

- | | | | |
|--------------------------|---------------------------------|--------------------------|---------------------------------|
| <input type="checkbox"/> | 1. Animal welfare | <input type="checkbox"/> | 7. Housing |
| <input type="checkbox"/> | 2. Child and/or youth welfare | <input type="checkbox"/> | 8. Job training |
| <input type="checkbox"/> | 3. Child care | <input type="checkbox"/> | 9. Legal aid |
| <input type="checkbox"/> | 4. Disaster relief | <input type="checkbox"/> | 10. Physical/mental health care |
| <input type="checkbox"/> | 5. Domestic violence prevention | <input type="checkbox"/> | 11. General social services |
| <input type="checkbox"/> | 6. Education | <input type="checkbox"/> | 12. Other |
-

2) What is your organization's target population? *(please check ALL that apply)*

- | | | | |
|--------------------------|--------------------------------|--------------------------|----------------------------|
| <input type="checkbox"/> | a. Animals | <input type="checkbox"/> | g. Senior citizens |
| <input type="checkbox"/> | b. Children | <input type="checkbox"/> | h. Substance abuse clients |
| <input type="checkbox"/> | c. Disabled | <input type="checkbox"/> | i. Veterans |
| <input type="checkbox"/> | d. Homeless | <input type="checkbox"/> | j. Women |
| <input type="checkbox"/> | e. Mental health clients | <input type="checkbox"/> | k. Youth |
| <input type="checkbox"/> | f. People living with HIV/AIDS | <input type="checkbox"/> | l. Other: |
-

3) Is your organization an affiliate of a national organization? *(for example - Planned Parenthood, American Red Cross, Sierra Club, etc.)*

0. NO
 1. YES

If YES, please answer all questions for your local organization or chapter ONLY.

4) Approximately how many paid staff do you currently have?

- a. Full-time: _____ b. Part-time: _____

5) In what year was your organization/local chapter founded? _____

6) For approximately how long has your agency maintained an annual operating expense budget of \$500,000 or more?

- | | | | |
|--------------------------|-------------------|--------------------------|---------------------|
| <input type="checkbox"/> | 1. 1 year or less | <input type="checkbox"/> | 4. 6-10 years |
| <input type="checkbox"/> | 2. 2-3 years | <input type="checkbox"/> | 5. 11-15 years |
| <input type="checkbox"/> | 3. 4-5 years | <input type="checkbox"/> | 6. 15 years or more |

FINANCIAL CHARACTERISTICS

7) What is your organization's estimated operating budget for the current fiscal year

- 1. \$500,000 - \$999,999
- 2. \$1,000,000 - \$2,499,999
- 3. \$2,500,000 - \$4,999,999
- 4. \$5,000,000 - \$7,499,999
- 5. \$7,500,000 - \$10,000,000
- 6. Other: _____

8) Approximately, how many separate, **restricted** funding sources, including public and private grants, does your organization currently have?

- | | | | |
|--------------------------|------------|--------------------------|-----------------|
| <input type="checkbox"/> | 1. 1 - 5 | <input type="checkbox"/> | 5. 21 - 30 |
| <input type="checkbox"/> | 2. 6 - 10 | <input type="checkbox"/> | 6. 31 - 40 |
| <input type="checkbox"/> | 3. 11 - 15 | <input type="checkbox"/> | 7. 41 - 50 |
| <input type="checkbox"/> | 4. 16 - 20 | <input type="checkbox"/> | 8. 51 and above |

9) Approximately what percentage of your annual revenue/income is restricted?
_____ %

10) Approximately what percentage of your annual revenue comes from:

- | | |
|---|---------|
| a. Federal Government | _____ % |
| b. State Government | _____ % |
| c. County/City Government | _____ % |
| d. Foundations (include Corporate Foundations) | _____ % |
| e. Corporations & Businesses | _____ % |
| f. United Way (include grants & donor designations) | _____ % |

- g. Individuals _____ %
 - h. Program Fees _____ %
 - i. Other: _____ %
- Total** 100%

11) Approximately what percentage of your annual operating budget is spent on:

- a. Programs & Services _____ %
- b. Administration _____ %
- c. Fundraising _____ %
- d. Other: _____ %

12) At the end of the last fiscal year, was your organization's total revenue:

- 1. equal to expenses (approximately)
- 2. greater than expenses
- 3. less than expenses

13) At the end of the last fiscal year, did your organization have a reserve fund, fund balances, or net assets that were available for future operations?

- 0. NO
- 1. YES

b. If YES, was it equal to:

- 1. less than 1 month of the annual operating budget
- 2. 1 to 3 months of the annual operating budget
- 3. 3 to 6 months of the annual operating budget
- 4. 6 months to 1 year of the annual operating budget
- 5. more than 1 year of the annual operating budget

ADMINISTRATIVE COSTS

14) Does your organization have target goals regarding the amount of administrative and fundraising costs as a percentage of overall budget?

- 0. NO

1. YES

b. If YES, approximately what percentage of administrative & fundraising costs do you strive for?

- 1. 1 - 5%
- 2. 6 - 10%
- 3. 11 - 15%
- 4. 16 - 20%

- 5. 21 - 25%
- 6. 26 - 30%
- 7. 31 - 40%
- 8. Other:

%

15) Do you have an approved federal indirect cost rate?

- 0. NO
- 1. YES

b. If YES, what is it:
_____ %

16) Do any outside organizations supply regulations regarding target or mandated goals for the amount of administrative and fundraising costs as a percentage of overall budget?

- 0. NO
- 1. YES

If YES, which organizations suggest or mandate regulations for your agency and what percentage do they suggest or mandate?

- a. Federal Funding Source _____ %
- b. State Funding Source _____ %
- c. County/City Funding Source _____ %
- d. United Way _____ %
- e. Parent Organization _____ %
- f. Accreditation Organization _____ %
- g. Auditor _____ %
- h. Other: _____ %

17) Do any outside organizations supply regulations regarding the definitions or classifications of administrative or fundraising costs?

- 0. NO
- 1. YES

If YES, which organizations suggest or mandate regulations for your agency?

(please check ALL that apply)

- a. Federal Funding Source
- b. State Funding Source

- | | |
|--------------------------|-------------------------------|
| <input type="checkbox"/> | c. County/City Funding Source |
| <input type="checkbox"/> | d. United Way |
| <input type="checkbox"/> | e. Parent Organization |
| <input type="checkbox"/> | f. Accreditation Organization |
| <input type="checkbox"/> | g. Auditor |
| <input type="checkbox"/> | h. Other: _____ |

18) Which of the following does your organization classify as administrative (management & general) or fundraising costs? For each YES answer, please list the approximate percentage of the cost that is classified as administrative or fundraising.

Administration and/or Fundraising Costs _____ %

a.	Annual Audit	NO	YES →	_____ %
b.	Executive Director Salary	NO	YES →	_____ %
c.	Fundraising Staff Salary	NO	YES →	_____ %
d.	Computer Equipment	NO	YES →	_____ %
e.	Office Supplies	NO	YES →	_____ %
f.	Program Director Salary	NO	YES →	_____ %
g.	Agency Newsletter	NO	YES →	_____ %
h.	Fundraising Appeal Letter	NO	YES →	_____ %
i.	Accounting Staff Salary	NO	YES →	_____ %
j.	Telephone	NO	YES →	_____ %
k.	Liability Insurance	NO	YES →	_____ %
l.	Office Rent	NO	YES →	_____ %
m.	Legal Fees	NO	YES →	_____ %
n.	Special Event Expenses	NO	YES →	_____ %
o.	Janitorial Services	NO	YES →	_____ %
p.	Receptionist	NO	YES →	_____ %
q.	Depreciation	NO	YES →	_____ %

19) When determining the definition or allocation of indirect costs, which of the following guidelines do you utilize? *(Please check ALL that apply)*

- 122)
- a. American Institute of CPA's (AICPA) Guidelines
 - b. Federal Accounting Standards Bureau (FASB) guidelines
 - c. Federal Government Guidelines of Indirect Cost Allocation (OMB A-
 - d. IRS Guidelines
 - e. United Way Guidelines
 - f. Other: _____
 - g. None

20) Do you allocate indirect costs to programs?

- 0. NO
- 1. YES

If YES, which allocation methods do you use? *(please check ALL that apply)*

- a. Personnel Method: Allocate indirect costs based upon the program's relative percentage share of overall **personnel costs** and allocate that percentage of total indirect costs to the program.
- b. Total Direct Cost Method: Allocate indirect costs based upon the program's relative percentage share of overall **direct costs** and allocate that percentage of total indirect costs to the program.
- c. Convert Indirect Costs to Direct Costs Method: Allocate some or all indirect costs by finding a **unique base** by which to allocate each line item. For instance, allocating costs by square footage, number of full-time employees, or equipment usage.
- d. Other:

21) Do your time sheets contain multiple cost centers by which staff time is allocated?

- 0. NO
- 1. YES
- 2. Other:

22) Do you jointly allocate the costs of your newsletter, fundraising appeals, and/or other public education/fundraising activities to both program expenses and fundraising expenses?

- 0. NO
 - 1. YES
 - 2. Other:
-

d. If so, please include your name and address:

Please feel free to include any other comments or thoughts you may have regarding this subject on the other side of this page. THANK YOU VERY MUCH for your time and assistance. Mail survey to: Nonprofit Survey, 6302 Broadway Terrace, Oakland, CA 94618 or fax to (510) 652-0404.

FUNDERS INTEREST

23) Have funders or potential funders asked about your administrative costs?

0. NO
 1. YES

If YES, which funders have inquired? *(please check ALL that apply)*

- | | |
|--|--|
| <input type="checkbox"/> a. Federal Government | <input type="checkbox"/> e. Corporations |
| <input type="checkbox"/> b. State Government | <input type="checkbox"/> f. United Way |
| <input type="checkbox"/> c. County/City Government | <input type="checkbox"/> g. Individuals |
| <input type="checkbox"/> d. Foundations | <input type="checkbox"/> h. Other: _____ |

24) When asked by funders what percentage of your budget goes toward administrative costs, what do you tell them?

_____ %

25) Is this information included in your agency's fundraising and public awareness documents? *(check all that apply)*

- a. Brochure
 b. Newsletter
 c. Annual Report
 d. Fact Sheet
 e. Other: _____

26) a. What is your title?

b. Would you be willing to be contacted, if I have further questions regarding your responses?

If so, please include your name and phone number:

c. Would you like a copy of the study results sent to you?
