

100% GOES TO Charity?

A practical and philosophical look at what it takes for a nonprofit to deliver services. BY LEE DRAPER

The *Los Angeles Times* proclaimed “No administrative fees means all money goes to local charities” when it launched its 2002 holiday drive to raise funds for community services.

When the September 11th Fund was created by the New York Community Trust and the United Way of New York City a little more than a year ago, ads repeatedly emphasized that 100 percent of all donations would go directly to the victims of the terrorist attacks.

The American Red Cross’s Liberty Fund labeled its fundraising for the same purpose with a “100 percent goes to charity” banner.

There are countless other occasions when donors and nonprofit organizations similarly assert this intention to focus *all* contributed resources on direct services or programs.

But how can this be done?

Does the claim of “100 percent goes to charity” establish unrealistic expectations?

More important, is this approach a truly beneficial way to deliver services to fill vital public needs?

Erosion of Trust

It seems that few people stop to question how the *Los Angeles Times* could raise hundreds of thousands of dollars from a holiday appeal and then allocate the sum to charities throughout Southern California with “no administrative fees.” Nor was there much concern expressed out loud about how the New York Community Trust and United Way of New York City would finance the cost of processing the \$500 million in donations from all over the country, the cost of investigating requests for funding from hundreds of individuals or the cost of administering grant awards. (As for the latter, the September 11th Fund covered administrative costs by getting special grants from a cadre of foundations).

But the American Red Cross was soundly criticized for dipping into its \$1 billion Liberty Fund in order to replenish its contingency fund, to cover its substantial administrative expenses and to set aside money for long-term needs. This dipping led to claims of broken promises, mismanagement, the resignation of agency executives, and ultimately, the loss of public trust and reputation.

A recent poll by *The Chronicle of Philanthropy* found that 42 percent of Americans have less confidence in charities now than they did before the September 11 attacks because of the way charities have handled donations made for relief and recovery. Nearly 3 in 10 said that they would be less likely to contribute to all types of charities because of how funds were disbursed.

Is the culprit in public erosion of trust in the nonprofit sector the failure to meet the standard of “100 percent goes to charity” or is it the very claim itself?

While people are pleased to think that all of the money they give will go directly to fill urgent needs, should the public remain blissfully ignorant about what it takes to actually deliver services? Or should donors expect nonprofit organizations to operate without administrative or fundraising expenses?

The Purity Question

On the surface, “100 percent goes to charity” seems innocent and even a positive strategy to direct assistance where it is most needed. Donors want their contributions to do the most good for the people they





Glossary

What Exactly Do You Mean by That?

When the Support Center for Nonprofit Management (www.supportctr.org) in San Francisco conducted its important study—*Indirect Costs: Practices and Perspectives*—nearly a decade ago (1994), it found “a striking lack of consensus...on terminology in topics 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.” Furthermore, according to the same study, “the two most prominent national accounting standards differ in recommended treatment of indirect costs.”

While we acknowledge there may not be universal agreement on definition of all of the terms, we offer here a review of the best recent efforts to define the terms:

Direct Costs. Those costs that are clearly and easily attributable to a specific program. (see Alliance for Nonprofit Management, “How can we allocate indirect costs to programs?” www.allianceonline.org/faqs.html)

Indirect Costs. Those costs that are not easily identified with a specific program, yet are necessary to the operation of the program. The costs are shared among programs and in some cases, among functions (program, management and general fundraising). (see Alliance for Nonprofit Management, “How can we allocate indirect costs to programs?” www.allianceonline.org/faqs.html)

Overhead/Administrative Costs. (used interchangeably) All expenses, such as rent or insurance, that are not directly related to a particular part of the work or product. (see *Webster's Collegiate Dictionary*)

Management and General Expenses. These expenses are for the general functioning of the organization but not related to fundraising or programs.

Such expenses include the salaries of the CEO and the CEO's staff for activities not related to fundraising or programs. Other costs include those associated with meetings of the board of directors or similar governing groups; legal services; accounting; liability insurance; office management; auditing; personnel; preparation, publication and distribution of an annual report; and investment expenses not related to programs or rental income. (see GuideStar, “Glossary,” www.guidestar.org) Consider also the slightly different definition of **Management and General Costs** found in another source, defined as “organizations' costs related to the essential activities identifiable with no one of their primary functions but indispensable to the conduct of all of them and to an organization's corporate existence.” (see National Health Council, National Assembly of National Voluntary Health and Social Welfare Organizations, and United Way of America, *Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations*. www.nhcouncil.org/pubs/pub_list.htm)

General/Operating Support. This is a grant made to further the general purpose or work of an organization, rather than for a specific purpose or project; also called an Unrestricted Grant. (see The Foundation Center, “Learning Lab: Glossary,” www.fdncenter.org)

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want to help: food going to the hungry, for example. Funders also want a direct connection to the people being served. By directing dollars to service delivery, they may feel a little closer to the target.

Behind this, however, is both ignorance and mistrust. Ignorance of how programs actually operate. Mistrust that nonprofit organizations do not function efficiently or honestly.

There is a deep-rooted suspicion among many donors about the legitimacy of administrative expenses and other indirect costs. Those expenditures are difficult to explain, let alone cost out or evaluate, in relation to the public benefit achieved. Media attention to high salaries for some nonprofit executives (albeit primarily at the country's largest nonprofits) have made many donors even more uncomfortable with funding administrative expenses, especially expenses for what they might consider excessive compensation and unnecessary amenities. As a result, the notion of “100 percent goes to charity” is attractive to many funders.

Proponents of this approach believe they are securing a “chastity belt of accountability”: restricting what they view as unnecessary or wasteful activities and promoting organizations' adherence to their charitable purpose. These donors hope that by limiting the resources applied to administration and fundraising, charities will be forced to be frugal and efficient in operations. They will have to be more focused on their missions and the services they provide. When funding is tight, foundations argue that providing restricted funding for programs will guarantee that the most important things get done. But is the restriction of “100 percent goes to charity” a good prophylactic for accountability to charitable purpose? After all,

history has shown how misguided and abusive the chastity belt was.

The strategy of “100 percent goes to charity” misses the bigger picture. It is a significant deterrent to effective and high-quality service delivery. It undermines the capacity of individual nonprofit organizations to address their constituencies today and in the long term. Let’s explore the dark side of the “100 percent to charity” approach, identify the significant benefits of underwriting the full costs of service delivery and outline an active role for foundations in increasing public understanding of nonprofit organizations.

Direct vs. Indirect

Behind every good program is a good organization. In other words, programs do not exist in isolation, but depend upon the organizational infrastructures in which they are housed. They are products of governance, management and fundraising. An organization’s ability to provide services relies on a host of indirect expenditures. Let’s examine this.

What are direct costs? The intrinsic costs of running a program are often referred to as *direct costs*—program staff salaries, program supplies and equipment.

What are indirect costs? The term *indirect costs* encompasses a broad range of expenses that enable the organization to offer the program, but are not specifically used to conduct program activities. Indirect expenses are typically the fixed costs of running the organization that benefit all of its programs: rent/mortgage, utilities, janitorial services, insurance, accounting, administrative and clerical staff and fundraising activities. (See “What’s Indirect,” page 36, for a list of common indirect costs). Indirect costs are also called *overhead*, *adminis-*

trative or management expenses, or *general operating costs* (see “What Exactly Do You Mean By That?” page 34, for a glossary of terms).

Indirect Costs Are Essential. Here it will help to use an example to explore the relationship between indirect costs and the ability of an organization to provide a program.

A foundation wants to support afterschool programs that enable at-risk children to be successful students. It is considering making a grant to the boys and girls club in an impoverished neighborhood for a new computer lab serving local children. The grant could

be restricted to cover the cost of acquiring computers and the first year’s salary of two tutors. However, it would be impossible for the club to offer the lab on an ongoing basis without such things as the club’s building (occupancy costs), insurance (of diverse types), overall staffing (receptionist, personnel administration, benefits program), financial accountability (bookkeeping, annual audit), institutional technology (cabling, networking, internet access), and quality control (licenses, evaluation, administrative oversight and coordination with the club’s other programs). The lab is also the result of institutional commit-



What’s a Good Indirect Cost Percentage?

When government entities contract out services to nonprofit organizations, they negotiate an indirect cost rate. This rate can vary from less than 10 percent to more than 50 percent (frequently for university research). A few private or community foundations allow a flat indirect cost rate for all organizations (such as The California Wellness Foundation’s Guidelines for Proposals which allows indirect costs up to 15 percent of the total direct costs).

But is there one *best* rate? Some programs may have more indirect expenses than others. Sometimes the difference is related to the work an organization does. For example, a community clinic will probably have greater indirect costs than a mentorship program because of greater investments in facilities, equipment and coordination of a complex range of services, licenses and risk management protocols. A new organization may have higher indirect costs because design, system development and implementation are all involved. An organization experiencing growth or transition will often be applying more resources to infrastructure or system development, and thus, have higher indirect costs.

On the other hand, a larger, well-established organization may have a smaller rate because it is able to achieve economies of scale.

Given those varying factors, providing a flexible rate for indirect costs seems beneficial. The negotiation between a funder and a nonprofit to find the most appropriate rate can stimulate open communication and present opportunities to learn more about how a nonprofit does its work. It can also open the door for the funder to identify other ways of supporting the nonprofit, such as making connections to business experts, pro bono services, grantees that have faced similar issues or other resources.

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Many functions essential to the operation of a nonprofit organization and all of its programs fall into the category of indirect expenses. Here is a basic menu:

Financial

- Bookkeeping and accounting
- Annual independent audit
- Bank charges
- Grants administration

Occupancy

- Facilities lease or mortgage
- Utilities
- Maintenance and sanitation (janitorial, grounds, trash removal)
- Security
- Capital improvements

Administration

- Executive staff
- Clerical and support staff
- Personnel administration (executive search, benefits programs, staff orientation, retreats, employee recognition)
- Insurance
- Office equipment (copiers, fax machines, etc.)
- Office furnishings
- Telephone system and reception function
- Technology (computers, information management)
- Office supplies
- Internal agency communication and coordination

Resource Development and Marketing

- Development staff
- Fundraising expenses
- Donor acknowledgment and reports for funders
- Marketing and community outreach
- Website design and management
- Annual report and agency newsletters

Governance

- Strategic planning
- Board governance and development
- Legal counsel

Program Quality Control

- Licenses, permits, accreditation process
- Professional development and staff training
- Membership fees, subscriptions and professional conferences
- Evaluation

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ments involving: priority setting as part of strategic planning, board investment, fundraising and visibility (community outreach and cooperative relations with local schools).

These indirect costs are essential to the organization's capacity to provide the afterschool program, but they also support all of its community programming. They cannot be attributed to a single program. However, a portion of those expenses should be allocated to each of its programs to clearly identify the true costs of running the program.

Given these factors, the foundation decided to incorporate a 20 percent supplement in its program grant in order to contribute to the indirect expenses involved in running the computer lab (see "What's a Good Indirect Cost Percentage," page 35, for appropriate amounts). The foundation board concluded that this type of support would increase the chances that the club could effectively operate the lab for years.

Organizations House Programs.

Solid infrastructure and financial solvency are crucial to an organization's ability to deliver services. If an agency is having problems with aspects of its overall administrative functions, the quantity and quality of services will suffer. If an organization is unable to meet its own needs—pay the rent, retain an executive director, keep accounting up-to-date or provide a safe and clean working environment—it cannot be a vital resource to meet the current needs of at-risk children. Nor can it continue to contribute to the well-being of the community.

Furthermore, funding indirect, as well as direct, costs contributes to cost effectiveness, reinforces professionalism, provides capitalization for new programs and increases long-term sustainability of nonprofit organizations.

The Double Standard

Who pays for indirect costs? Unfortunately, few foundations, corporations or individuals embrace this type of support, even as a portion of their contributions. This reluctance reveals a double standard that plagues the nonprofit sector.

In the for-profit sector, executives would be fired for mismanagement or would soon run their businesses into the ground if they did not incorporate indirect costs such as occupancy expenses, research and development, upgrading technology, administrative and financial management and advertising into the cost of goods and services. Yet foundations and corporate giving programs frequently review grant proposal budgets and slice out items—such as a percentage of the executive director's salary, fundraising expenses or agency overhead—when they make their final award. Arguments for removal include: "They can get that elsewhere," "These are not really part of the program," or "These are not essential expenses." Here we see two standards: one for effective business practices and another for the way nonprofit organizations are supposed to operate.

Despite much criticism that nonprofits are not operating like businesses, funders undermine nonprofit organizations capacity to do so whenever they omit indirect costs from their grants.

Another double standard is reflected in the calculations for foundations' minimum payout rate. A host of indirect costs contribute to a foundation's 5 percent distribution calculation, including administrative costs, trustee compensation, travel, professional development, clerical staff and other overhead expenses. These are included because they are seen to contribute to a funder's ability to fulfill its grantmaking mis-

When Should a Foundation Designate 100 Percent to Program?

sion and goals. Yet, many foundations restrict grant funding to direct expenses for charitable organizations. Nonprofit organizations, often having the least amount of unrestricted income, are held to a different standard than what foundations apply to themselves. However, for nonprofit organizations to sustain programming, they require revenue streams that match the realistic expenses of the organization, just as foundations and for-profit businesses do.

Too frequently, funders also maintain two standards for what we say is important and what we will pay for. Foundations increasingly require high levels of financial accountability, evidence of strategic planning and evaluation documentation, all of which help funders make informed decisions and enable nonprofit organizations to maintain quality and efficiency.

However, those activities are costly. Planning involves significant investments of staff and board time as well as funding. Evaluation often involves retaining outside professionals and involvement of staff resources. While independent audits are more important than ever, they can cost anywhere from \$10,000 to \$50,000.

Unfortunately, nonprofit organizations have learned donor preferences too well. Many nonprofit managers likewise do not account for all the costs that contribute indirectly to their ability to offer programs. Program staff sometimes view fundraising professionals or administrators as a separate realm and do not see the interconnectedness of their work. Even those nonprofit managers who know the relationship of core operating expenses and direct program costs often do not assert the need for this type of support to funders. Nonprofits are not in a strong negotiating posture

There may be specific situations where a funder might not want to support the indirect costs of an organization. Chief among them:

- Many colleges and universities apply a *standard overhead charge* to all grants and contracts received. Sometimes the rate is quite high. While this is appropriate in most cases, a small foundation may wish to negotiate with the university so that none of its small grants bear the overhead rate.

- Sometimes foundations want to support a program that carries out its mission even though the organization as a whole does not. For example, a church may sponsor an adult literacy program for local immigrants. A foundation that does not provide support to religious or sectarian institutions might want to make a *restricted program grant* and not provide administrative support.

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when requesting a grant to keep their programs in operation.

Back to the question of who pays for the broad range of administrative and indirect costs. Nonprofit organizations commonly fund those expenses by charging fees to the clients they are serving or by holding fundraising events that yield unrestricted income. More often than not, they starve the administrative side of the organization or have to forego investing in their infrastructures altogether. This can have a detrimental impact on quality, efficiency, modernization, staff retention and sustainability.

Embracing the Essential

The foundation and corporate giving community has a remarkable opportunity to shape public understanding of how nonprofit organizations operate. By abandoning the “100 percent to charity” mantra and embracing indirect costs as essential to service delivery, we can promote the effective operation of nonprofit organizations and encourage public trust in nonprofit management.

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.

Indeed, foundations and corporations can play a primary role in educating themselves, the public and nonprofit organizations about the central importance of indirect costs. They could lead by example simply by suggesting to potential grant recipients that they include a percentage for indirect costs in their proposal budgets, and then, actually providing funding for this line item. Nonprofit managers, for their part, need to quantify the actual costs of running programs and include indirect expenses in project budgets. They need to articulate what those costs are and champion how interrelated they are to service delivery. Through this leadership role, foundations and nonprofit organizations can begin dissolving the climate of suspicion surrounding administrative and fundraising costs and raise a standard of nonprofit sector sustainability. **FNC**

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