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Article

Misguiding donors and non-profit management by regulation: the role of 'overhead' costs

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Abstract

Overhead costs and the concomitant efficiency notion are frequently used both to measure non-profit organizations' performance in research and to select non-profit organizations worthy of donations. The main message of this article is that their concept and interpretation are not always correctly understood, even not by (influential) regulators imposing some potentially misleading disclosure rules. The arguments presented in this article depart from a short overview of the relevant cost concepts and their correct calculation, and contrast them with the indicators usually looked at in practice and research. The article closes with some recommendations for non-profit organizations, potential donors, and governments.

Key words

Non-profit organizations, overhead costs, cost calculation, cost disclosure.

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Introduction

Even though accounting is considered by most people as boring, if not as a way to convey a capitalistic state of mind, accounting figures are frequently used in day-to-day organizational decision making and empirical research, not only in the case of profit-seeking organizations, but also in that of non-profit organizations. As to the latter, a specific issue even draws from cost accounting (or managerial accounting) concepts, which, as will be argued in the present article, are not always correctly interpreted, partly because of what could be called Form 990 thinking.

In what follows the contradiction between correctly calculating costs and some cost concepts favored when discussing non-profit organizations' financial performance and efficiency will be elucidated. Then, practical implications of this contradiction will be discussed, based on the available academic literature. The article concludes with some recommendations for non-profit organizations, potential donors, and governments.

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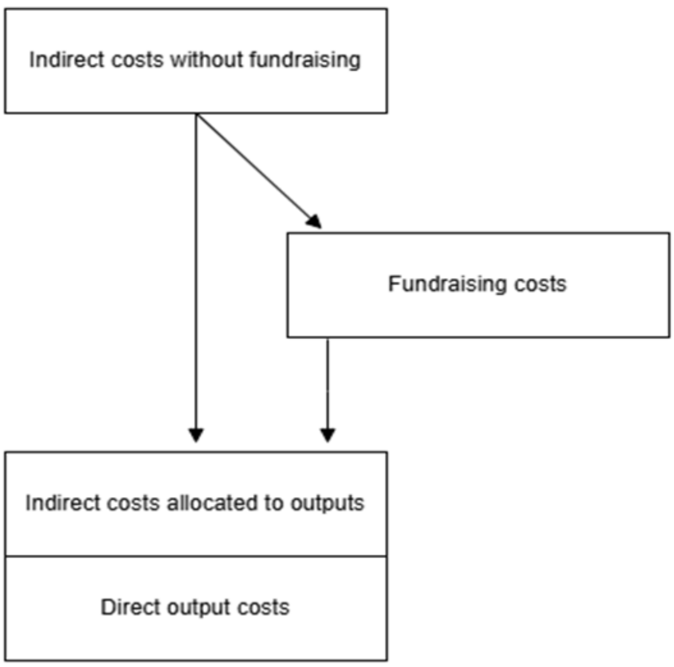
Basic concepts

Despite some lack of terminological agreement, the basic logic of a traditional cost calculation (such as described in [1]) is that for each product or service category provided two categories of costs can be distinguished: costs directly traceable to each category (the direct costs), and the costs incurred by the firm or organization not traceable to each separate category (the indirect or overhead costs). In order to find the total cost for each category the latter must be allocated to each of them following an allocation rule as much as possible reflecting the relationship between the production of each good or service. Note that this relationship will never be exact, because then the costs considered just will be direct costs. Note also that when only one category of goods or services is considered, all costs will be direct costs. Further, it should be clear that within this logic, costs (and for that matter also revenues) are measured on a periodic basis (mostly yearly), and not per-unit. Transforming the former into the latter is straightforward, as long as meaningful measurement units of output are available.

Non-profit costs

In the case of profit-seeking organizations there is a direct link going from costs over output to revenues and profits or losses. For a non-profit organization, revenues are not the eventual outcome sought, but output defined by the organization's mission. In fact, part of the costs are incurred to generate revenues which allow the organization to function. These costs are, in a literal and general sense, fundraising costs, including traditional fundraising activities and specific events, some of them taxable, other of them not. Leaving aside timing or what accountants call recognition issues, a generic costing frame for a non-profit organization might look as depicted in Figure 1.

Figure 1: Non-profit organization's generic cost structure



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A stylized example will, hopefully, further clarify the logical flow. Assume the organization's mission consists of three distinct outputs, for which direct costs of respectively 50, 30, and 75 are accumulated. Fundraising costs are 15, and the other indirect costs 25. A reasonable way to allocate the indirect costs to the three outputs and fundraising is to assign respectively 6, 6, and 8 to the three outputs, and 5 to fundraising, which now carries a cost of 15+5 = 20, which also has to be further allocated to the three outputs. Assume that a 10, 5, 5 split is reasonable. We therefore end with the following total costs for each output: 50+6+10=66, 30+6+5=41, and 75+8+5=88. Obviously, the sum of these must equal the sum of the originally disaggregated costs: 50+30+75+25+15 = 66+41+88 = 195. It is crucial to realize that the indirect and fundraising activities are meant to contribute to the organization's output, and that therefore their cost cannot be ignored when assessing the cost of the organization's output.

The Form 990 approach

The Form 990 is a twelve pages long form tax exempt (non-profit) organizations have to submit to the US Internal Revenue Service. It contains a lot of information (necessitating about one hundred pages of official instructions [2] on how to fill out the form), including detailed financial information. It goes without any doubt that the fact that these data were made widely available has sparked a stream of high-level research, a lot of them applying sophisticated econometrics, on a number of financial, governance, accounting, or auditing issues related to non-profit organizations, as well as to other topics the empirical analysis of which is (partly) based on Form 990 cost data. As to the latter, efficiency studies stand out. However, it also seems to have led to a specific way of looking at the organizations' cost structure and its implications.

In particular, Section IX of the Form 990 requires organizations to disaggregate their expenses (note that no formal distinction is made between costs and expenses: e.g. "Direct costs are expenses … " [2, p. 42]) in three categories labeled program service expenses, management and general expenses, and fundraising expenses. In fact, given the definitions of each of them in the official instructions, these categories correspond to the direct output costs, the indirect costs without fundraising, and the fundraising costs defined above (see also Figure 1). The stylized organization described above would report in its Form 990 respectively 155 (being the sum of 50, 30, and 75), 25, and 15.

Efficiency and performance measurement

Maybe because calling the direct output costs program costs gives the impression that all the other costs are not program related, the latter have been considered to be as much as possible avoided, as if they would detract the organization from pursuing its objectives. Hence the inclination of many to call the program ratio, being the share of program costs in the total costs, as a performance and/or efficiency measure for non-profit organizations. Examples of this logic are ([3], [4], [5], [6], [7], [8], [9], [10]).

There are, however, at least four major problems with using the program ratio or related measures as a performance or efficiency indicator (see also [11]).

The first one is that it should be obvious that non-profit performance should not be expressed in terms of money spent, but in terms of activities leading to the fulfillment of the organization's mission.

The second one is that efficiency measures are conceptually of the structure output divided by input, while only looking at (shares of) costs implies outputs as such are ignored. In case of our example organization above: saying that direct output costs are 155 does not say anything on how much is done.

The third one is that one cannot imagine non-profit organizations properly functioning without managerial support (and in most cases also without fundraising), leading to the conclusion that well-run organizations should spend some amount of indirect costs, implying the amount observed can be too high to be optimal, but also too low [12].

The last issue is even more worrying in terms of validity (and is in line with the previous issues). It boils down to the observation that using program ratio related measures ignores interactions between program costs and overhead costs. A simple illustration, again for our example organization: as described above, the program ratio is 155/195 = .79 . Now assume that by increasing some general expenses (e.g., by hiring a better but more expensive CEO) with 10, we can decrease the direct output costs (program costs) by 12, delivering the same amount of output. The program ratio now becomes a lower (155-12)/(195+10-12) = .74. The standard interpretation would be that performance/efficiency deteriorates, whereas total costs for the same level of output decrease.

Are (potential) donors misled?

Although we safely can assume potential donors first an foremost take non-financial elements into consideration before (not) making a contribution ([13] is seminal on this; see also [14] or [15]), a legitimate question is whether also financial elements play a role, and if so, in what way.

In the light of the above, it is rather surprising to observe that most of the research on this question tests whether program ratio-based variables, mostly presented as the price of donations, are related to donations. Older literature reviews ([16],[17]) and a recent meta-analysis [18] establish a weak but significant effect, suggesting donors might be partly guided by a misconceived logic when making donation decisions. The misconception interpretation is lend credence by research results indicating that donations by sophisticated donors are substantially less correlated with program ratio-based indicators ([18], [19]).

Misleading the misled?

The above-described relationship might, at least partly, be explained by the fact that it appears that (US) watchdog agency ratings have a positive effect on donations ([20], [21]), while program ratio-based thresholds, together with other parameters, are used to group organizations according to their level of excellence. Especially in the US, a substantial group of potential donors consults watchdog ratings before (not) making a donation [22].

The consequence of potential donors being affected, directly or indirectly via watchdog ratings, is that organizations might been incentivized to embellish program ratios to be disclosed [23]. Empirical research indeed shows that this is happening in ways leading to program ratios being deliberately increased ([24],[25], [26], [27], [28]).

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Conclusion and recommendations

The conclusion of the above is that it frequently happens that statements and decisions are made based on flawed conceptualizations of performance or efficiency. Hence the following recommendations.

For non-profit organizations: rational decision making should not be guided by the idea that lower overhead ratios are a priori better. Too low overhead expenses indeed result in goal pursuing activities to be constrained instead of enhanced, an effect commonly called the starvation cycle (for a history of the concept, see [29]). This, however, does not imply that in terms of external communication overhead aversion [30] experienced by some categories of potential donors or watchdog agencies should be ignored, even if that would require some accounting creativity, especially in terms of indirect cost allocation mechanisms, as long as this stays within (regulatory) reason. Note that, e.g., reasonableness, without any further specification, is in the Form 990 instructions the only criterion to assess the lawfulness of indirect cost allocations in case the organization's accounting system does not allocate: " … the organization can use any reasonable method of allocation …" [2, p. 43].

For potential donors: even though it has been established that potential donors primarily consider organizations' activities and achievements, it cannot be denied that most data also reveal an impact of overhead aversion, especially in the case of smaller and/or less sophisticated potential donors. The recommendation for these is not to be led by simple (and wrong) financial performance/efficiency measures, be it directly or indirectly (via watchdog ratings). In fact, this recommendation extends to watchdog organizations, which should not use these measures in an unnuanced way to derive their excellence scores.

Finally, in line with the above recommendations, government should refrain from imposing disclosure rules that are, from a conceptual perspective, potentially misleading the users of the disclosed information, especially those who lack the technical background to correctly interpret the data made available. Under these conditions, regulations would be welfare enhancing, as it would enable potential donors to better match their preferences with the organization(s) to donate to.

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