Resource Allocation for Nonprofit Organizations

We often hear the question from Executive Directors: “What percentage of total expenses of the organization should be tied directly to the program?” While asking the question illustrates that these leaders have a strong sense of stewardship, there is no simple answer given the many types of organizations represented in the nonprofit world.

This Topic of the Month will outline the groups that provide guidelines, principles, and/or make judgments as to an organization’s proper allocation of resources. Such concepts will serve to better assist an Executive Director in understanding an organization and how it presents itself to the world. The guidelines discussed are provided by three groups:

1. The Internal Revenue Service and state governments.
2. Charity watchdog groups.
3. Industry regulations.

The Internal Revenue Service and state governments.

With exception of a few federally chartered charities such as the American Red Cross or Boy Scouts of America, most nonprofit organizations in the United States are organized and operated under the state law rather than the federal government. For most states, this is organized under the jurisdiction of the state’s Attorney General’s office or a Charities Registration Bureau. Jurisdiction falls to the Internal Revenue Service to determine if the organization is exempt from tax under the organization’s activities as a nonprofit organization. Most states have specific expenditure regulations. Nonprofits should look to see what policies are in place in the respective state that it is registered.

The IRS, because it is not a policy-making body, has not taken steps to outline specific standards for expense allocation for nonprofits. It has only addresses specific systemic problems brought to its attention. As a result, guidelines have been outlines relative to specific circumstances that do not apply to most nonprofits. The nonprofit organization should seek counsel from its tax advisor and/or legal counsel to determine whether such circumstances apply.

All nonprofits should keep in mind that the IRS has placed upon the organization the concept of fiduciary responsibility regarding nonprofit activities that would include allocation of resources toward the mission. These can be divided into three

1. Duty of Care: The director performs her duties in good faith and with that degree of diligence, care, and skill which ordinarily prudent persons exercise under similar circumstances in like positions. There is no specific guidance as to how the director should execute responsibilities, but 43 States have adopted duty of care provisions in nonprofit statues.
2. Duty of Loyalty: The Board acts in a manner that does not harm the corporation and avoid using their position to obtain improperly a personal benefit or advantages which
belong to the organization. The Board is required to place the interest of organization ahead of personal gain, make decisions objectively, to refrain from participation in relationships that impair their objectivity.

3. Duty of Obedience: The purposes of the organization must be carried out as expressed in the articles of association or certificate of incorporation.

Charity Watchdog Groups
While nonprofits have always felt the pressure to report low fundraising or overhead costs, the existence of charity watchdog groups that act as rating agencies like Charity Navigator or Better Business Bureau Wise Giving alliance has put even more intense pressure on nonprofits to operate within “standards” promulgated by these groups. This is compounded by a plethora of magazines that an issue annual to rating the “best nonprofits” based on input ratios found on the IRS 990.

This section takes a look at Charity Navigator and the BBB Wise Giving Alliance to examine each group’s methodology of ranking/ratings a specific charity. Such information can serve as a useful guide for an organization to understand its own current allocation as well as how other organizations, foundations, donors, and watchdog groups may understand their activities.

Charity Navigator (www.charitynavigator.org)
Charity Navigator has an extremely thorough analysis process that begins with breaking down each organization into a broadly defined category to more narrowly define its cause. For example, an animal rights group would be defined first into the category of ‘Animal’ and then further defined in the ‘Animal Rights, Welfare, and Services’ group. After this, the site rates charities by evaluation of the organization’s efficiency, capacity, and overall operations.

In regards to resource allocation, Charity Navigator’s organizational efficiency rating focuses on the operations of the organization as it is reported by the organization on the IRS 990. As the site correctly states, nonprofits that are more efficient spend less money to raise more and fundraising efforts fall in line with the scope of the respective program. Charity Navigator understands this through examining the following:

1. Program expenses. These should encompass the majority of the organizations total expenses. Charity Navigator divides the nonprofit’s program expenses by its total functional expenses.
   a. Charity Navigator’s standards call for at least 65% of an organization’s annual revenue to be spent on program.
   b. A ratio score of 0 is awarded to any organization that spends less than 33% of its annual revenue on program.
   c. The higher the percentage, the stronger the ranking – to a point. Having a 99.9% ratio would raise red flags on accuracy of reporting.

2. Administrative expenses. Administrative expenses are a necessity, but can also serve as a bone of contention for some perspective donors. Salaries paid to the staff should be reasonable and in line with the organizations total functional expenses. Charity Navigator understands this allocation through the ratio of admin expenses to total expenses.
   a. Charity Navigator: A 7.5/10 will be granted for those organizations that spend 15-20% on administrative expenses.
   b. Separate standards are set for Food Banks, Food Pantries, Food Distribution, Fundraising Organizations, Community Foundations, and Museums.
3. Fundraising expenses. Charities should ensure that fundraising expenses stay in line with the charity's total functional expenses. Thus, Charity Navigator divides the organization's fundraising expenses by its total functional expenses to determine what overall spending is due to fundraising expenses.
   a. Charity Navigator: A 7.5/10 rating is provided to organizations that spend 10-15% of their expenses on fundraising.
   b. Separate standards are set for public broadcasting and media organizations.

4. Fundraising efficiency. It goes without saying that nonprofits must spend money to raise money. Charity Navigator calculates how much an organization spends to garner $1 of contributions by dividing fundraising expenses by the total contributions received.
   a. Charity Navigator: A 7.5/10 rating is provided to organizations that spend $0.10-.20 to raise $1.
   b. Separate standards are set for Food Banks, Food Pantries, Food Distribution, public broadcasting, and media organizations.

The combined ratings make up the organization’s Charity Navigator efficiency rating. The same type of process occurs for the organizational capacity rating (how well it has and will sustain its programs) and the overall operations rating, that of combining both scores. It is important to note that in our discussion with Charity Navigator, the watched dog expressed that its ratings are not rankings, but rather a qualitative designation based on information provided. A complete list of all Charity Navigator’s ratings tables can be found here: http://www.charitynavigator.org/index.cfm/bay/content/view/cpid/48.htm

BBB Wise Giving Alliance (http://www.bbb.org/us/charity/)
The Better Business Bureau Wise Giving Alliance for Charity Accountability was formed in 2001 through the merger of the National Charities Information Bureau with the Council of Better Business Bureaus’ Foundation. As with Charity Navigator, the organization’s purpose is not to rank charities but rather “assist donors in making informed judgments about charities soliciting their support.” The result is a set of accountability standards developed in collaboration with “professional and technical assistance from representatives of small and large organizations, accountants, grant making foundations, corporate contributions officers, regulatory agencies, research organizations and the Better Business Bureau.” The group also commissioned significant independent research on donor expectations to be sure the views of the public were represented.

With a wide perspective, BBB Wise has created 20 standards of accountability ranging from organizational governance, resource expenditures, how truthful they are in the representation of their activities, and their level of transparency.

In speaking with BBB Wise, Cathedral noted several standards that apply directly to resource allocation:
1. Standard 8: A nonprofit should spend at least 65% of its total expenses on program activities.
2. Standard 9: Spending should be a maximum of 35% of related contributions on fund raisings, where related contributions include donations, legacies, and other gifts received as a result of fund raising efforts.
3. Standard 10: Organizations should avoid accumulating funds that could be used for current program activities. To meet this standard, a nonprofit’s unrestricted net assets
available for use should not be more than three times the size of the past year’s expenses or three times the size of the current year’s budget.

It is important to note that nonprofit organizations evaluated by BBB Wise voluntary provide information in an effort to become more transparent. In our discussions with the watchdog group, the watchdog stressed that BBB Wise also understands the variances in organizational size and industry and thus allows the organization to provide evidence that demonstrates the use of funds is reasonable even if standards are not met. A complete list of the 20 standards can be found here: [http://www.bbb.org/us/Charity-Standards/](http://www.bbb.org/us/Charity-Standards/)

**Industry Regulation**

Depending on the services and/or mission of the organization, some industry regulations or credibility standards may apply that directly affect the allocation of resources. For example, Habitat for Humanity may spend more money to ensure its houses meet health and housing codes. Or, a school may have to meet accreditation standards, of which may dictate how certain portion of funds should be allocated. The organization should seek legal counsel to determine whether these and/or other operational regulations apply.

**Falling into Compliance and Cost Accounting**

That which is monitored has a tendency to improve. Thus, an organization that desires to achieve a specific standard must do so by accurately reporting and monitoring its activities so that they fall into the range of desired compliance. This can be achieved through cost accounting. For example, cost accounting allows nonprofits to break down a salary into percentage of use for administrative, program, and fundraising expenses based on time spent on those activities. The fundamentals of cost accounting are explained in a Cathedral Topic of the Month webinar found here: [https://www1.gotomeeting.com/register/829662944](https://www1.gotomeeting.com/register/829662944)

It is important to note that the American Institute of Certified Public Accountants (AICPA), a national professional organization that sets ethical standards for the accounting profession and audits of enterprises including nonprofits, has established an official Statement of Position as to whether an activity can be deemed a bona fide program activity when it is not directly related. According to Statement of Position 98-2,¹ the expense can be declared program activity as long as it adheres to the law, is fairly described in the organization’s financial statements, and adheres to criteria according to the purpose, audience, and content of the expense. If being audited, the organization must be able to demonstrate, to their auditor’s satisfaction, that the three criteria are met, otherwise the costs default to a fundraising expense.

1. **Purpose** - Did the reason for doing the activity include bona fide accomplishment of a program function, i.e. something that will help achieve the mission of the organization (whatever that mission is)? As this is a somewhat judgmental criterion, it lists some indicators that may be useful in making that judgment. These include: “the activity is conducted without a fundraising component, the program-related results and accomplishments of the activity are measured, the activity is conducted by persons whose expertise is in the program area.” Negative indicators include: “the activity is conducted by persons whose expertise is in the fundraising area, the persons

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conducting the activity are compensated (at least partly) based on the amount of contributions raised by the activity."

2. **Audience** - Did the activity target mostly rich people, or prior donors? If so, there is a presumption that it is primarily a fundraising activity. "This presumption may be overcome by demonstrating that the target audience also has the potential for benefiting in a substantive way from the program component of the activity."

3. **Content** - Is the content of the activity genuinely program-oriented? Any 'educational' material must actually be of educational value. There must be the call to action described earlier.

Lastly, it is important that the nonprofit seek counsel from its accountant to ensure its reporting reflects the requirements and restrictions imposed under current law. For example, the detailed guidance provided in IRS Publication 463: Travel, Entertainment, Gift and Car Expenses should serve as a guide for managers of charitable organizations in avoiding lavish, extravagant or excessive expenditures.

The key point is that a nonprofit should know how to properly allocate salaries, supplies, etc. while keeping a close eye on where money and resources are being spent. After having accurate and reliable cost accounting, monitoring the ratios highlighted in the watchdog groups will aid an organization’s ability to better serve its mission. Familiarizing oneself with this accounting and cost management will allow an organization to know which levers to pull to meet the standards, thus turning the conversation to how to make day-to-day *qualitative* spending decisions.

**Articles for Further Reading**

1. Critical Issues in Financial Accounting Regulation for Nonprofit Organizations  
2. Accounting for the differences in profit and nonprofit accounting  
   [http://www.charityvillage.com/cv/research/rim34.html](http://www.charityvillage.com/cv/research/rim34.html)

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