

**Statement of Opinion**

**The American Jewish Joint  
Distribution Committee**

**The fair allocation of costs relating to  
("Welfare for the Elderly ("Hessed**

**January 2006**

# Position paper

## The fair allocation of the costs of the "Hesed" sector out of all of the costs of the Joint organization

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## **1. General**

We were requested by the Joint Organization to perform an economic analysis of the expenses of the organization incurred in its activities in the Former Soviet Union (herein – the "FSU"), as part of the "welfare" area of activity (herein – the "**Area of Activity**"). The Area of Activity includes expenses incurred in respect of a variety of programs, including the following:

- Food distribution programs
- Medical assistance programs
- Winter relief programs

### **1.1 Objective**

The objective of this analysis is to properly allocate the costs relating to the Area of Activity. As part of this analysis, we will classify the costs relating to the Area of Activity, both direct and indirect costs, while recommending how these costs should be allocated as part of the Area of Activity.

### **1.2 Source of data**

In preparing this work, we based our findings on the following sources of data:

- Discussions with senior Joint management.
- Additional information, including from Internet websites of Joint.

## 2. Description of the organization

### 2.1 General

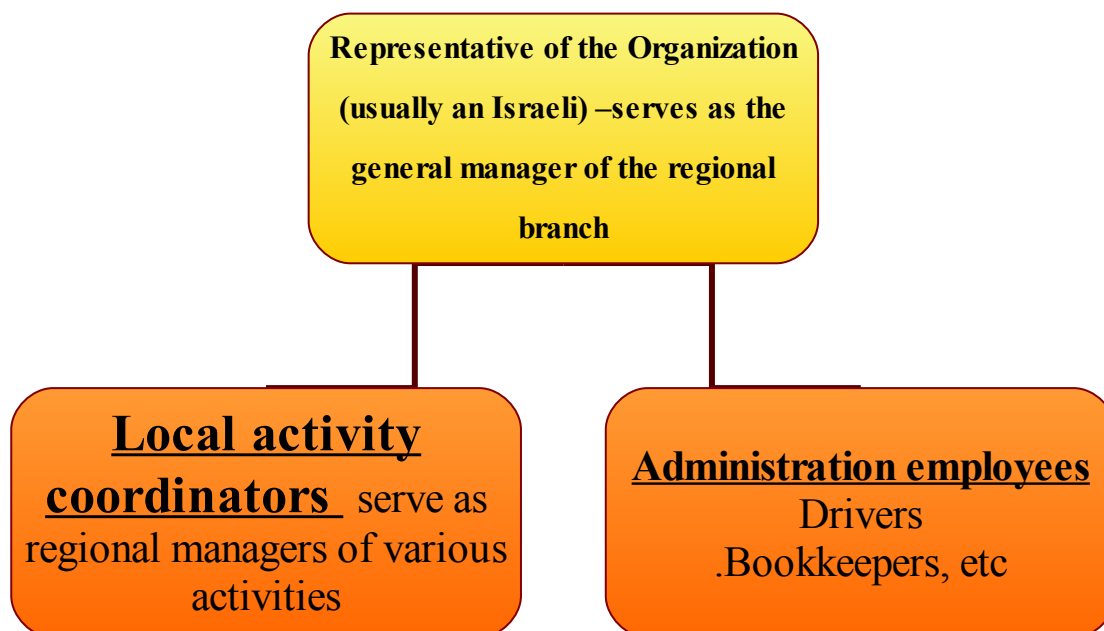
The F.S.U. unit, is a unit of the American Jewish Joint Distribution Committee (hereinafter – "**the Organization**"). The Organization is registered as a not-for-profit organization, in accordance with the laws of the state of New York, U.S.A.

### 2.2 Senior and general management

The allocation of the unit's financial resources is determined and controlled by the management of the Organization. At the request of the Organization, the unit's monetary transactions are carried out through the bank accounts which are managed by Joint (JDC) Israel, a private company limited by guarantee and registered in Israel. In accordance with specific instructions from the Organization and on its behalf, Joint (JDC) Israel employs professional and administrative staff in Israel to carry out the unit's activities in countries of the F.S.U.

### 2.3 Structure of the regional branch

We present below the typical structure of Joint's regional branches:



## 2.4 Areas of activity of the Joint Organization

The activities of the Joint Organization cover three areas:

- Welfare for the Elderly
- Jewish Renewal
- A Safety Net for Children

**The goal of the analysis covered by this report is the fair allocation of the costs of the Organization relating solely to the area of welfare. Accordingly, we will present a description only of the welfare activities.**

## **3. Welfare activities**

### 3.1 General

JDC provides essential relief to some 232,000 impoverished and socially-isolated elderly Jews in approximately 3,000 cities, towns and shtetls throughout the FSU.

This welfare is provided by the network of approximately 200 JDC-supported "Hessed" centers and other Jewish organizations which provide basic material and social aid in a Jewish atmosphere to elderly and needy individuals.

### 3.2 National coverage throughout the FSU

The centers are located in the following locations:

<u>Russia</u>	<u>Ukraine</u>	<u>Other Countries</u>
Moscow	Dnipropetrovsk	Belarus
St. Petersburg	Odessa	Georgia
Volga	Kharkov	Azerbaijan
Siberia & Far East	Kiev	Uzbekistan
North Caucasus		Kirgizstan
		Kazakhstan

The large centers of the Hessed organization are located in the central cities. By their very nature, the centers in the periphery are smaller. Most of the management activity is carried out from the offices in the central cities of each region.

### 3.3 Target populations

Most of the activities of the aforementioned programs are directed toward the Jewish elderly population or to people having different handicaps.

### 3.4 The objective of the Area of Activity

The objective is to assist every Jew who is in need of assistance, throughout the FSU. This assistance is provided to those in need through a number of programs, including the following:

- Food distribution programs – distributing food to the needy, both in their homes and in the Organization's centers
- Day center programs
- Repair workshop programs
- Medical assistance programs – providing medicine and medical treatment to those in need
- Winter cold relief programs – distribution of heating accessories and warm clothes
- Home care programs – taking care of the elderly in their homes, done by trained caregivers
- Urgent assistance programs - SOS
- Center activities programs
- Training programs

### 3.5 Financing the Area of Activity

The Area of Activity is financed mainly from two sources:

**1. Restitution grants:** Sources of funds designated for assistance to Nazi Victims. The restitution grants include the following:

- **Claims Conference:** The central organization that transfers assistance funds to Nazi Victims, money that derives mainly from the German government. This organization funds mainly the following programs:
  - Day Centers

- Mobile "Hessed"
- Repair Workshops
  
- Medical Equipment
- Food Packages
- Food Programs
- Winter Relief
- Homecare
- Medical Programs
- Center Activity
- Program Operation
- Training
  
- **(ICHEIC) International Commission on Holocaust Era Insurance Claims**: A commission that funds programs mainly through the Claims Conference, but carried out at the homes of the clients.
  
- **Holocaust Victim Asset Litigation Allocation – (Swiss Banks Settlement)**: A fund that finances programs such as:
  - Food Programs
  - Home Care
  - Winter Relief
  - Medical Programs
  - SOS
  
- **German Government Grant**: Grants through the Claims Conference in the houses of the clients.

**2. Non-Nazi Victims**: Sources of funds designated for assistance to people who are not victims of the Nazis. The sources for Non-Nazi

Victims include the Jewish Federations in the U.S. and various independent donor funds.

According to the budget plan of 2005 from October 2005, the total budget for welfare activities is US\$ 60 million. Of this amount, an amount of US\$ 41 million derived from restitution grants, mainly from the Claims Conference and the Swiss Banks Settlement.

### **3.6 Review and analysis of the programs**

1. The centers are located throughout the FSU and they can be found in the central cities and in the periphery surrounding them.

The expenses relating to the Hased activity derive mainly from programs expenses (food, clothing etc.), employee salaries, maintenance of the centers, treating the elderly, etc., broken down into the various programs.

**We did not receive data pertaining to the amount of expenses incurred per program.**

2. We present below a breakdown of the major programs and the expenses incurred in respect thereof, on the basis of the sample mentioned in Chapter 4 (3), as presented to us.

- Food program – the breakdown of the expenses of the Food Programs is as follows:

<b>Expense</b>	<b>Breakdown in %</b>
Food	85%
Transportation, salaries, and others	15%

- Winter Relief – the breakdown of the expenses of the Winter Relief Programs is as follows:

<b>Expense</b>	<b>Breakdown in %</b>
Heating materials and warm clothes	90%
Transportation, salaries, and others	10%

- Home Care program – the breakdown of the expenses of the Home Care Programs is as follows:

<b>Expense</b>	<b>Breakdown in</b>
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	%
Home care workers	75%
Directors and security guards	15%
Transportation, salaries, and others	10%

- Medical program – the breakdown of the expenses of the Medical Programs is as follows:

<b>Expense</b>	<b>Breakdown in %</b>
Medical assistance and medicines	90%
Security guards, pharmacists, materials, and others	10%

Information pertaining to the breakdown is taken from the breakdown of expenses of 3 centers, as provided to us by the finance department of the Organization headquarters.

In addition the Hased activity also include expenses incurred for purposes of financing SOS activity, incurred in emergency situations in order to save life. The costs include salaries, medicines, drivers, etc.

#### **4. Methods of costing and cost allocation – theoretical aspects**

Every activity in any organization includes both direct and indirect expenses.

##### **4.1 Direct costs**

**Direct costs** relate to a particular cost object and can be traced to it in an economically feasible (cost effective) way. For example, the cost of the cans or bottles is a direct cost of a Pepsi soft drink. The cost of the cans or bottles can be easily traced to the Pepsi soft drink. The term cost tracing is used to describe the assignment of direct costs to the particular cost object.

##### **4.2 Indirect costs**

**Indirect costs** of an object are related to the particular cost object but can not be traced to it in an economically feasible (cost effective) way. For example, the maintenance costs of the head offices of the company in the U.S. will not be considered as a direct cost of a can of Pepsi. Unlike cans or bottles, it is difficult to trace quality-control personnel costs to a specific Pepsi soft drink.

The term cost allocation is used to describe the assignment of indirect costs to the particular cost object.

### **4.3 Traditional costing**

The traditional cost accounting method is a simple method. Developed in the 1920s, it was suitable for the manufacturing environment of the time, which entailed mass production of a relatively small number of products, and the taking advantage of economies of scale and learning processes. Direct labor was the major component of the cost of the product, and indirect costs were relatively few. They were allocated to the products on the basis of direct labor or some other variable of volume, such as machine hours.

Commencing at the end of the 1980s, researchers and business already reached the conclusion that the traditional costing method was no longer relevant.

It is possible to point to a number of major factors that caused the traditional method to lose its relevancy:

#### **1. A change in the cost structure**

There was a change in the relative weight of indirect costs. When the classical method of costing was developed, indirect costs comprised between 5% to 10% of the cost of manufacturing and services, whereas, at present, indirect costs comprise between 50% to 80% of the overall cost of a product. The major increase in indirect costs took place in the costs of support and operation, such as planning, supervision, coordination, engineering and quality control. Additional indirect costs that developed are in the fields of information systems, marketing systems, financing, human resources, etc.

#### **2. A change in the nature of payroll costs**

In the past, these expenses were considered variable, whereas, at present, these costs are considered to be mainly fixed. As a result, allocation of costs on the basis of direct labor may lead to distorted results.

#### **3. A deepening of the variety of products and services**

Technological progress and the desire to adapt products and services to the needs of customers have brought about a significant increase in the variety of products and services currently being rendered. The cost and managerial accounting systems have to provide relevant information in support of this area. The traditional method of cost accounting cannot provide a proper response to the complex challenge in the manufacture of products, the development of prototypes, and the rendering of a variety of services.

We would like to emphasize that the problem of costing services is even more acute, since in this type of activity, it is extremely difficult to identify the direct cost of the service being provided, since we are not dealing with a tangible product. Therefore, it is all the more important to use a costing method that is capable of identifying and properly reflecting the appropriate costs of rendering the service.

#### 4.4 Activity-based Costing Systems (ABC)

One of the best tools for refining a costing system is activity-based costing. ABC systems refine costing systems by focusing on individual activities as the fundamental cost objects. An activity is an event, task, or unit of work with a specified purpose; for example, designing products, setting up machines, operating machines, and distributing products.

ABC systems calculate the costs of individual activities and assign costs to cost objects such as products and services on the basis of the activities undertaken to produce each product or service.

##### The advantages of the ABC method

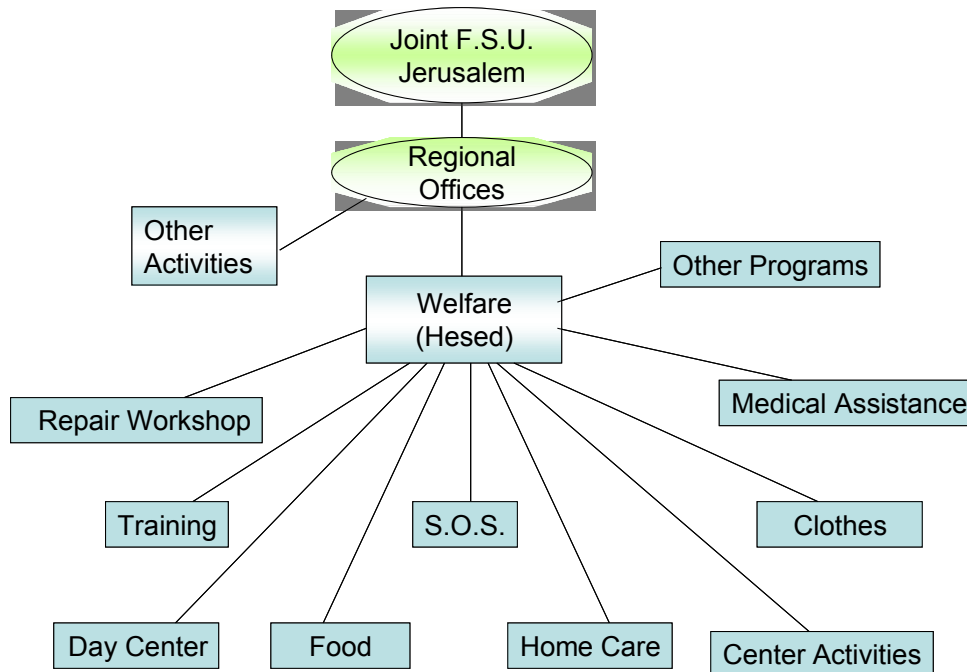
1. This method of costing produces reliable data which all levels of management are prepared to use for purposes of making decisions and assessing levels of performance.
2. In a decentralized organization, it is possible to implement ABC-based transfer pricing.
3. This method of costing exposes the cost of complexity of the manufacturing which derives from a broadening of the variety of products, and from a change in the structure and composition of the operating costs. In many organizations, it is the indirect costs that constitute the major costs of operation and it is this costing method that is designed to contend not only with a more proper allocation of these costs, but also and mainly to bring about a better understanding of the factors that generate these costs (those costs which are the generators). In this context, it would appear that this method of costing is a fundamental pre-condition to effective management.
4. Traditional costing was unable to contend with "non-productive" costs such as marketing and distribution. This was due to the fact that, under generally accepted accounting principles, these costs are not part of the cost of the products.
5. This method of costing is relevant, not only to industrial plants, but also to a wide variety of service providers. Take for example, the report on implementation of this method of costing in the banking

system, telecommunications companies, the health system, and public government entities.

**This method is the most modern and the most correct method, which properly reflects the appropriate cost of all organizational activity.**

We would like to emphasize that this method is the one recommended by most of the leading consulting firms, including those connected to the large CPA firms.<sup>1</sup>

## 5. Analysis of the current situation



### **Current allocation by the organization of the various expenses to the Hesed programs**

At present, the Organization allocates expenses to the various Hesed programs in a manner similar to the traditional costing method.

In other words, only the direct cost of materials and direct labor are allocated to the programs, and all of the rest of the costs are allocated in a general manner on the organization's areas of activity, but not specifically to programs. Allocating costs in this way results in a distortion of the presentation of the appropriate costs of the various plans as part of the area of welfare activity.

We present below a number of examples of the allocation of expenses to the programs:

#### • Food Programs:

<sup>1</sup> Sources: "It Costs Me More" – Making Management, Costing, and Company Improvement Decisions, Professor Yoram Eden, Professor Boaz Ronen, 2002. "Cost Accounting" - A Managerial Emphasis, Horngren, Foster, Datar, 1999.

The cost of the food portions, salary of the food distributors, salary of the program manager, cost of transportation in distributing the food, etc.

- Winter Relief Programs:

Cost of heating accessories (radiators, heaters, etc.), cost of warm clothes, salary of the distributors of the items, salary of the program manager, cost of transportation in distributing the accessories, etc.

- Medical Programs:

Cost of medicines and medical equipment, salaries of doctors and nurses, salary of the program manager, cost of transportation in distributing the items, etc.

Expenses of employees working on the programs from the regional offices, for example, were not allocated to the programs, but rather were allocated in a general manner to the areas of activity, such as Hesed, Jewish Renewal, etc.

## **6. Methodology for the fair allocation of expenses relating to the Area of Activity**

### **6.1 Economic analysis of the Hesed area of activity**

For purposes of formulating our position, we used the expense reports of the regional offices for 2004 (hereinafter – the "**Reports**") which were prepared on the cash basis. We were furnished with these reports by the bookkeeping department at organization headquarters in Jerusalem.

The Reports are broken down into a number of activity centers, as follows:

#### **A. The Hesed area of activity in the large cities**

The Reports include the expenses incurred in respect of the centers for the elderly and the various programs in the Area of Activity. In addition, the Reports include operating expenses directly attributable to the Hesed Area of Activity.

The Reports include most of the direct expenses in respect of the implementation of all of the programs of the Hesed, as mentioned in Chapter 3 above. These expenses include the cost of purchasing food for distribution, medicines, winter equipment, the salaries of the caregivers, the salary of the food distributors, the salary of doctors, etc, as well as the overhead expenses of the buildings in which the Hesed is run, the salary of the managers of the areas of activity and the various programs, salary of coordinators, etc.

#### **B. The area of activity of the Heseds in the periphery**

The Reports include the expenses incurred in respect of the centers for the elderly and the various programs in the Area of Activity in the small cities and villages surrounding the major cities. These expenses are similar in nature to the expenses reported in respect of the Hesed activity in the large cities, with the main difference being that the reports of the periphery include joint expenses in respect of buildings that serve the Hesed Area of Activity as well as other areas of activity.

C. Regional office activity

The Reports include general expenses of the regional offices in the large cities that were not allocated by the Organization to any area of activity.

## **6.2 Sample**

The reports we used cover three major areas – Minsk, Kiev, and Dnipropetrovs'k – located in different areas of the FSU.

Since we were informed that the areas of activity in most of the regions are similar to one another, we found it proper to use the data of these three centers as a sample.

## **7. Recommendations for the implementation of a cost allocation method for the organization**

### **7.1 General**

We were requested to find the most appropriate method of cost allocation for a number of programs that are included the welfare area of activity, in order to properly reflect their appropriate cost.

In our opinion, the recommended method for allocating the costs within the framework of the welfare area of activity is on the basis of the various programs of the organization, in accordance with principles of the ABC method mentioned in Chapter 3 above.

The various programs, i.e., Food, Medical Treatment, Winter Relief, Home Care, etc., are the major "objectives" of the welfare organization. From the standpoint of their position in the organization, they can be compared to products manufactured by an industrial concern, or to services rendered to customers by a service organization.

Therefore, just as a factory and/or a service provider would allocate costs to their products and services, so in our opinion, should the welfare organization allocate its costs.

**We would like to emphasize that we are not advocating a complete costing under the ABC method (costing by activity), since that is not the**

**objective of this work. We will use this method to make a fair allocation of the costs of the programs, based on the principles that form the foundation of the aforementioned costing method.**

We based ourselves on the principles of this method which creates a mechanism that properly reflects the appropriate costs of all of the programs in the welfare area of activity.

In this manner, we are able to allocate different costs to the programs which would not necessarily have been allocated under the traditional costing method, notwithstanding the fact that there is a direct economic relationship between them and the programs. An example of such a cost would be the salary of the manager who, in addition to his work on the program, is involved in other things as well. Without a doubt, the proportional share of his work in connection with the program is a cost having a direct economic impact on the programs and, therefore, must be allocated to those programs.

## **7.2 Defining the costs**

We reviewed the expenses recorded in the data base and identified costs incurred only in respect of specific programs (the direct costs of those programs), costs that served a number of programs (joint costs that can be defined as direct or indirect costs depending upon the circumstances) and general costs that cannot be directly attributed to the various programs (indirect costs).

## **7.3 Direct costs**

The direct costs of certain programs are defined as costs of a product or a service that can be directly attributed to the program itself and identified by cost unit (e.g., cost of materials, labor, etc.).

Whenever a direct causal relationship can be seen between the expense incurred and the program itself, such an expense was defined to be direct.

### **Examples:**

1. **Administrative expenses:** Various expenses of the programs such as food for distribution, medicines, clothes, salaries of caregivers, etc., are obvious direct expenses. But administrative expenses, such as managers' salaries, organization, learning, storage, etc. constitute a direct cost of the activity, since there is a direct economic connection to the program and such expenses were actually incurred for the program.
2. **Storage costs:** Instead of storing the various items in warehouses, the Organization could have arranged for the suppliers to supply the items directly to the recipients, thereby saving storage costs. In such a situation, there would have been no doubt that the cost of distributing the items to the recipients was a direct cost. Therefore, the cost of storage, which should be viewed as an alternative method of operation and probably a more feasible one as far as the Organization is concerned, is also a direct cost. **Even if the cost is a joint one, it should still be viewed as a direct cost.**

3. **Salaries of managers:** The proportional share of the manager's work on the program should be considered a direct cost to that program, since the alternative for the Organization would have been to employ a manager in a partial position for each program. Had the Organization acted in that manner, there is no doubt that the salary of each manager would be considered as a direct cost of the specific program for which he worked.

The following costs, among others, are defined as direct costs:

Expenses incurred by the "Hessed":

- Cost of direct materials for the various programs, such as:
  - Food
  - Medicines
  - Clothing
- Transportation and distribution costs of the programs
- Cost of storing the goods and equipment
- Costs of professional consulting for the programs
- Salaries of employees and managers who were directly involved in the program activities, such as:
  - Salary of caregivers
  - Salary of food distributors
  - Salary of direct managers
- **Sundry direct administrative expenses** which can be identified with certainty with the activities of the various programs, such as:
  - Direct administration expenses – As part of these expenses, the following administrative expenses were allocated: salaries of various employees, learning expenses, etc.
  - Direct maintenance costs – Expenses in respect of water, electricity, security, etc., where there is certainty that the expenses were incurred in respect of the activity of the various programs, such as: maintaining the lunch room in which food is distributed, maintaining a clinic for treating the needy, etc.
  - Direct transportation expenses – travel of managers and employees directly related to the programs.
- **Other costs**

#### Expenses incurred by the local Joint:

- Cost of professional consulting in respect of the programs
- Cost of training workers for specific programs (some of the expenses are paid by training institutes)
- Salary of coordinators
- Other direct administrative expenses which can be identified with certainty with the activities of the various programs, such as:
  - Direct administration expenses – As part of these expenses, the following administrative expenses were allocated: salaries of various employees, learning expenses, etc.
  - Direct maintenance costs – Expenses in respect of water, electricity, security, etc., where there is certainty that the expenses were incurred in respect of the activity of the various programs, such as: maintaining the lunch room in which food is distributed, maintaining a clinic for treating the needy, etc.
  - Direct transportation expenses – travel of managers and employees directly related to the programs.

#### 7.4 Indirect costs

Costs which cannot be clearly identified as having a direct connection with the various programs were defined by us as indirect costs of the programs.

In an identical manner, various maintenance and administrative costs were defined as indirect costs if they were not incurred in respect of specific programs. These include the overhead of the regional offices, bookkeeping at the regional offices, computerization, salaries of general employees, etc.

#### 7.5 Shared costs

These are costs incurred in respect of a number of shared programs / areas of activity and not just in respect of one program / area of activity. The Organization has a number of costs defined by us as shared costs:

#### Expenses incurred by the Hesed:

- Cost of **building maintenance and overhead** where the buildings serve projects as well as other areas of activity. For example, if there is a building that serves the activities of the Hesed as well as other activities, the costs will be divided on the basis of some pre-determined ratio.
- Cost of **purchasing merchandise to be used jointly by a number of programs** – something that happens infrequently, such as the purchase of food portions.

Expenses incurred by the local Joint:

- **Cost of certain employees that are involved in a number of programs / areas of activity.** This situation is more prevalent in the periphery cities in which areas of activity are usually managed from joint buildings and in which there are a large number of employees who are involved in 2 areas of activity. An example of this is the Joint coordinator who works both in the Joint and in the Hesed and his salary is allocated to the Hesed programs on the basis of the relative time he spends on those programs.

We would like to emphasize that the fact that a certain cost was defined to be joint has no affect on its being defined as direct and/or indirect. Joint costs can be considered as both direct and indirect costs. The classification of the cost is made on the basis of the guidelines for determining direct and indirect costs, as described above.

The Organization also has costs in the headquarters in Jerusalem. On the surface, it would seem that most of the costs in Jerusalem are indirect costs of activities and it is not possible to allocate most of the costs directly to any specific programs.

## **8. Implementation**

### **8.1 General**

In our opinion, the current method of allocating costs to the Organization's welfare programs does not provide an adequate response to the issue of cost allocation, since it does not properly reflect the appropriate costs of the welfare programs. In actuality, the current method it reflects only part of the costs – those of direct labor and direct materials.

In our opinion, the cost allocation method that is based on the principles of the ABC costing method, as defined in Chapter 3 above, is the most appropriate method for costing the expenses of the programs. This is because under this method, the programs themselves are the basis upon which the various costs should be allocated.

**We present below a table that summarizes the types of costs and the allocation that we feel would be the most proper, in accordance with the principles described above:**

## 8.2 Hesed

<b>Cost</b>	<b>Type of cost</b>	<b>Proposed allocation</b>	<b>Current allocation</b>
Direct materials of the programs (e.g., medicines, clothing, food, etc).	Direct	All of the costs are to be allocated to specific programs	All of the cost is allocated to a specific program
Direct labor of the projects (e.g., caregivers, food distributors, direct managers)	Direct	All of the costs are to be allocated to specific programs	All of the cost is allocated to a specific program
Maintenance expenses, such as: building maintenance, storage, security, maintenance of lunch room, clubs, etc., that can be identified with certainty as serving the various programs	Direct	All of the costs are to be allocated to specific programs	As general cost allocated in a manner among the various areas of activity (Hesed, Jewish Revival, Youth and Others)
General and Administrative expenses, such as: salaries, bookkeeping, computer, legal, auditing.	Direct	All of the costs are to be allocated to specific programs	As general cost allocated in a manner among the various areas of activity (Hesed, Jewish Revival, Youth and Others)

## 8.3 Regional Offices of Joint in FSU

<b>Cost</b>	<b>Type of cost</b>	<b>Proposed allocation</b>	<b>Current allocation</b>
Overhead and administrative expenses, such as: general administration, bookkeeping, computerization, regional office maintenance, that cannot be identified with certainty as serving the various programs	Indirect	As overhead cost allocated in a general manner among the various areas of activity (Hesed, Jewish Revival, Youth and Others)	As overhead cost allocated in a general manner among the various areas of activity (Hesed, Jewish Revival, Youth and Others)
Sundry expenses of the	Direct	All of the cost is	As overhead cost

offices that can be identified with certainty as serving the various programs, such as: salaries of managers, counselors, supervisors, coordinators and costs involving their activities, data collection and processing for the programs, operating internal auditing, external auditing, etc.		allocated to a specific program	allocated in a general manner among the various areas of activity (Hesed, Jewish Revival, Youth and Others)
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#### 8.4 Joint Jerusalem

<b>Cost</b>	<b>Type of cost</b>	<b>Proposed allocation</b>	<b>Current allocation</b>
Costs at the Joint headquarters in Jerusalem that are not connected directly with the various programs, such as: salaries of general employees, overhead, etc.	Indirect	As overhead cost allocated in a general manner among the various areas of activity (Hesed, Jewish Revival, Youth and Others)	As overhead cost allocated in a general manner among the various areas of activity (Hesed, Jewish Revival, Youth and Others)
Costs at the Joint headquarters in Jerusalem that are connected directly with the various programs but not to any specific geographic location, such as: salaries of employees involved in the organization of a specific program	Indirect	As overhead cost allocated in a general manner among the various areas of activity (Hesed, Jewish Revival, Youth and Others)	As overhead cost allocated in a general manner among the various areas of activity (Hesed, Jewish Revival, Youth and Others)