

Management and General Expenses

The Other Half of Overhead

by Thomas H. Pollak and Patrick Rooney

The substantial portion of organizations reporting that either 0 percent or 100 percent of their budgets fall into M&G expenses suggests serious reporting problems.

Management and general (M&G) expenses along with fundraising expenses constitute an organization's overhead costs. The proportion of these costs to overall budget, as discussed in a number of other articles in this issue, is under increasing scrutiny, at least by watchdog organizations. Local United Ways and government agencies have, of course, monitored these costs on a more longstanding basis. Elsewhere in this issue you will find an article on ratio setting by the watchdog groups and another on the accuracy of fundraising cost reporting.

This article is based upon the largest study to date of overhead costs in the nonprofit sector. The study, performed by the Center on Nonprofits and Philanthropy at the Urban Institute and the Center on Philanthropy at Indiana University, combines analyses of data drawn from IRS Form 990s, our survey of the overhead costs and accounting practices of more than 1,500 randomly selected nonprofit organizations, and a small number of case studies. This article focuses on the first phase of our work.

It is worth noting that although M&G expenses are almost always a part of a well-managed organizational budget, feelings about them are not always value-neutral. There are at least two perceptions of M&G expenses:

Evil M&G: It's the large proportion of the money that donors give that doesn't help intended beneficiaries or pay for artistic production. It's the bloated bureaucracy at the big nonprofit's fancy new headquarters and the cushy salary of the organization's executive.

Good M&G: It's the reasonable proportion of the money that provides the underpinnings for a well-managed, accountable organization with, to

use the language of auditors, strong internal controls and well-managed risks.

These two concepts often do battle in the context of individual agency reporting practices. Despite the obvious benefits of a healthy level of M&G spending, many individual nonprofits have a number of incentives to report M&G expenses at the lowest possible levels. These incentives are covered in other articles in this issue. Here we want to address some of the striking variations we have found in 990 reporting.

M&G Variations Defy Plausibility

For better or for worse, the 990 instructions appear consistent with the Generally Accepted Accounting Principles (GAAP). The instructions state that M&G includes "expenses for overall function and management, rather than for its direct conduct of fundraising activities or program services.... Overall management usually includes the salaries of the chief officer and that officer's staff...[when not] directly supervising program services and fundraising activities."

M&G, according to the IRS, also includes costs such as general legal services, accounting, general liability insurance, office management, auditing, personnel, and other centralized services, investment expenses, board meetings and general staff meetings, annual reports, as well as auditing, personnel and other centralized services.¹

While these instructions still leave plenty of room for differences in reporting among reasonable people, our study has exposed that there are 990 reporting variations that defy plausibility (and therefore might call your credibility into question) and often don't even appear to be in the best interest of the groups reporting those

M&G Expenses as a Percentage of Total Expenses

Expense Level & Mission	Number	Median
\$1 - \$500,000	86,480	13.9
Arts, culture & humanities	8,614	8.7
Education	8,972	12.3
Health	7,813	14.4
Human services	25,451	13.2
\$500,000 - \$1 mil.	15,816	14.0
Arts, culture & humanities	1,367	19.5
Education	1,784	15.1
Health	2,209	13.6
Human services	6,667	13.1
\$1 mil. - \$5 mil.	21,673	13.2
Arts, culture & humanities	1,403	18.0
Education	2,772	15.8
Health	4,631	13.7
Human services	8,786	12.2
\$5 mil. - \$10 mil.	5,185	12.6
Arts, culture & humanities	233	17.0
Education	753	16.6
Health	1,713	13.5
Human services	1,755	11.0
More than \$10 mil.	6,871	12.2
Arts, culture & humanities	204	13.3
Education	1,200	13.7
Health	3,420	13.1
Human services	1,329	10.1

Source: NCCS/Urban Institute-GuideStar National Nonprofit Research Database, 1999

figures. You may wish to review your own reporting in light of the issues we have surfaced.

Findings About Reporting Practices

More than one in five (21 percent) of small organizations with annual budgets of under \$500,000 (comprising approximately two-thirds of the sector) have reporting anomalies: 1.5 percent failed

to report their functional expenses; 3.4 percent reported 100 percent of their expenses as M&G; and 16.3 percent reported no M&G expenses.

Although we cannot rule out variations due to organizational structure and activity for individual cases, the substantial portion of organizations reporting that either 0 percent or 100 percent of their budgets fall into M&G expenses suggests serious reporting problems. For organizations in the \$500,000-\$1 million range, one in 10 appear to have reporting problems. Reporting does appear to get better, albeit not perfect, as budget size grows.

When one looks at reporting for particular types of expenses, the inconsistencies are even more stark. Most staffed organizations, except perhaps the very largest, should be able to distribute their staff salaries across M&G and program areas (and possibly fundraising). However, one-quarter of the organizations reporting personnel costs may be failing to do so. More than 12 percent categorized all of their personnel costs as M&G expenses, and another 13 percent entirely as program.

Less than half of all reporting organizations reported anything on the line designated for key staff (executive director, chief operating officer, chief financial officer). Again in this category, where there generally is a clear rationale for distributing costs across categories, more than one-third of those reporting on this line categorized all of these costs as M&G, while 12 percent allocated these costs entirely to program expenses.

Sixty-five percent of organizations report accounting fees. Of those, only three-quarters categorized all of these fees under M&G; 7 percent categorized the full amount as a program expense, and the remainder distributed it among multiple categories.

In addition to vague rules and guidelines for the categorization of expenses, the lack of internal cost and time accounting systems contributes to nonprofits' reporting weaknesses. Barely one-third of the 1,500 randomly selected nonprofits completing our overhead cost survey reported tracking staff time by functional expense category for each payroll period. For small organizations, the percentage was only 22 percent. With personnel costs accounting for nearly half of total M&G expenses, inadequate tracking of these expenses presents a major hurdle for consistent reporting.

Our study has exposed that there are 990 reporting variations that defy plausibility (and therefore might call your credibility into question) and often don't even appear to be in the best interest of the groups reporting those figures.

Arts, culture and
humanities
organizations tend
to have higher M&G
expenses with
respect to median
total expense; in
health and human
service organizations
these expenses tend
to be lower;
and education
organizations
generally fall in
the middle.

Nonprofits do a better job of tracking invoices and bills by functional expense category, but there is still much room for improvement. Nearly one-quarter of the organizations in our survey do *not* code invoices or bills by functional expense category. The rates range from nearly 24 percent of smaller organizations to 14 percent of organizations with budgets over \$10 million.

Size and Other Variables

An organization's size and the field within which it functions drive some of the differences in management and general expenses. One can make conceptual arguments for why large organizations should spend proportionally less on M&G—they can distribute their costs among a wider pool of programs and there are economies of scale—but one can also argue that smaller organizations should have proportionally lower costs because they often pay their executive staff substantially less and may be likely to invest less in management infrastructure, be it office space, photocopiers, legal services, or insurance. Our analysis supports the first argument. As the table on page 31 shows, larger organizations report lower proportions of M&G than smaller ones.

The same sorts of conceptual arguments can be made about why different fields should have proportionally different levels of M&G spending. What the 990 data show is this: In general, arts, culture and humanities organizations tend to have higher M&G expenses with respect to median total expense; in health and human service organizations these expenses tend to be lower; and education organizations generally fall in the middle. For instance, in mid-size organizations (with expenses of \$500,000 to \$1 million), the median rate of M&G expenses was 19.5 percent for arts, culture and humanities, 15.1 percent for education and, at the low end of the scale, 13.1 percent for human services.

More sophisticated analysis using multiple regression techniques shows there is a range of factors that help explain some of the variations in levels of M&G expenses among different types of organizations. Factors such as the level of an organization's dependence on government grants, the proportion of revenue from direct private contributions, and the amount of assets that an organization must manage are all positively associated with higher M&G costs. However, much remains unexplained, and will

be the subject of future research.

Ultimately, we would like to be able to get beyond the reporting problems to understand the real costs for managing an organization and why they vary. Are there best practices that can be identified? Are there target ratios that an organization's board and executives should aim for, given the characteristics of the organization and its environment? This is the promise of this type of analysis.

General Recommendations

There are serious inconsistencies in the current reporting of M&G expenses. The extent to which reporting problems are due to nonprofits' failure to follow existing standards, to the lack of precise standards, or to insufficient scrutiny by auditors is a question we are not prepared to answer. However, at least two recommendations emerge:

First, clarification of the GAAP and 990 rules would be a major step toward improving the quality of reporting. Until reporting is improved, the value of financial statements and 990s (not to mention the surveys that are based on either of these two documents) for benchmarking and comparisons will be limited.

A second recommendation is for nonprofits to work harder to build cost accounting systems—coding invoices, tracking employees' time on a regular basis—that not only will lead to better public disclosure but also will help organizations better understand and manage their program costs.

Endnotes

1. 2001 IRS Instructions, p.21
Research and resources from the Fundraising and Administrative Cost Project are available at www.coststudy.org.

About the Authors

Patrick Rooney is director of research in the Center on Philanthropy at Indiana University and associate professor of economics and philanthropic studies at Indiana University-Purdue University Indianapolis (www.philanthropy.iupui.edu).

Thomas H. Pollak is senior research associate at the Urban Institute's Center on Nonprofits and Philanthropy and assistant director of the National Center for Charitable Statistics, a policy research organization in Washington D.C. (www.nccs.urban.org).