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The Effect of Alternative Joint Cost Allocation
Methods on Mailing Strategies of Nonprofit Organizations

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The Effect of Alternative Joint Cost Allocation Methods
on Mailing Strategies of Nonprofit Organizations


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Draft: Please do not quote without authors' permission. Comments welcome.

ABSTRACT

We have examined current and proposed standards for allocating the joint costs of mailings containing both a fund-raising appeal and a program message. We propose a model of the relationships between allocation methods, nonprofit managers' mailing strategies, reported expenses, and donors' contribution decisions. That model suggests the current requirement to charge all joint costs to fund-raising may provide some incentive for adopting inefficient split mailing strategies. Allowing allocation of joint costs may alleviate the split mailing incentive, but encourage padding fund-raising mailings with program materials. We discuss several research questions related to this initial research and suggest methodological approaches appropriate for addressing those questions.



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The Effect of Alternative Joint Cost Allocation Methods on Mailing Strategies of Nonprofit Organizations

We Americans are a generous people. Each year we donate some \$20 billion of our hard-earned money to charitable institutions. But what happens to our money? How much goes to the intended worthy cause and how much to glamorous and expensive fund raising efforts...? [Katz, 1974, flyleaf]

Harvey Katz's Give! Who Gets your Charity Dollar? was a harsh reminder to contributors and nonprofit organizations alike of the importance of expense classifications in the financial statements. "Good" organizations are those that minimize administrative and fund-raising costs, and we are advised to examine an organization's financial statements before contributing to determine how much of each dollar of revenue is used for the programs or services.

The public focus on fund-raising costs provides an incentive to nonprofit organizations to charge expenses to other categories, such as public service, whenever possible. In light of the attention paid to fund raising expenses, it is not surprising that both industry representatives (e.g., the National Health Council) and the FASB have addressed the problem of fairly allocating costs to this expense category. These standard-setters have attempted to provide unambiguous guidelines for making these allocation decisions to avoid the problems posed by the incentive to reduce reported fund-raising costs.

The purpose of this paper is to analyze possible effects of the accounting standards for allocating mailing costs of nonprofit organizations. After briefly reviewing past and proposed FASB cost allocation principles, we provide numerical examples of their effects on mailing costs and the relative

... of reported fund-raising and program expenses. We ... the types of mailing strategies organization managers might be expected to adopt in order to minimize fund-raising costs while following generally accepted accounting principles (GAAP). Based on our analysis, we conclude that both the current and the proposed principles may lead to inefficient mailing practices in certain circumstances. Finally, we discuss some additional research suggested by this initial investigation.

Mailing

"Mailing" (1) refers to an organization's mailings directly to individuals, either to provide information, or to solicit financial or other types of support. Several types of nonprofit organizations commonly use mailings for fund-raising, i.e., to solicit financial support from the recipient of the mailing. Voluntary health and welfare organizations are probably the most dependent on this source of funds, although other types of nonprofits, e.g., schools, hospitals and churches, also use it fairly frequently. These organizations also use mailings to provide information and education about the issues with which the organization is concerned and about the organization's recent activities and accomplishments, and to solicit non-financial support for these issues.

It is often practical and cost-effective to combine fund-raising and program-related information in the same mailing. In fact it may be difficult to differentiate between them. This paper examines current and proposed methods for allocating mailing costs between fund-raising and program expense

categories, and their potential effects on organizations' mailing practices.

Functional Expenses of Nonprofit Organizations

Financial statements which include a functional expense breakdown between 'program services' (the organization's social service activities) and 'supporting services' (management and general expenses and fund-raising expenses) are recommended by the AICPA [1974, p.24]. The breakdown between program and support expenses has been recognized as one important measure of organizational performance. This recognition was heightened by the exposure of some organizations that spent little of their donations on the programs for which they had been solicited. (See Katz [1974]).

Donors are presumed to want as much of their money as possible to go "to the cause" for which they have contributed it, rather than into "overhead". The percent of the expenses going to the supporting functions has become a measure that nonprofit organizations watch carefully.

There is even a magic formula: fund-raising costs should not exceed 25 percent of a charity's receipts.... the Civil Service Commission has given it government sanction by allowing only those charities that meet such a standard to solicit contributions from government employees. [Katz, 1974, p. 56]

In general, then, it would seem that organizations would want to decrease the percent of their total expenses reported as support services and increase the percent that is program services.

Since mailing is used both for the programs that the nonprofit is organized to carry out and for fund-raising, it

to be charged mailing costs incurred for program purposes to program functional expenses. Many costs are clearly directly related to one and only one functional category, but others are joint costs that cannot be clearly traced to one functional category. This leads to a classic joint cost allocation situation, but it is embedded in a somewhat different incentive structure than it is in businesses.

FASB Proposed Standards on Accounting for Mailing Costs

In October, 1984, the Financial Accounting Standards Board (FASB) released Proposed Technical Bulletin No. 84-e, Accounting for the Joint Costs of Direct Mailings Containing Both a Fund Raising Appeal and a Program Message (hereafter referred to as Bulletin 84-e). Its purpose is to address the question, "Is it appropriate for organizations that report fund raising as a separate functional expense category to presume that fund raising is in all cases the primary purpose of a direct mailing that has both an appeal for funds and a program message?" (FASB, 1984, p. 1). According to Bulletin 84-e, many CPAs and nonprofit accountants have interpreted the AICPA Industry Audit Guide on Voluntary Health and Welfare Organizations to require that all mailing costs be charged to the fund-raising functional expense category whenever a mailing includes an appeal for funds, no matter what other purposes it might be intended to serve, and even if fund-raising was not its primary purpose. This is not surprising, since the nonprofit industry publication, Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations, advocates this treatment.

Bulletin 34-e proposes that a portion of direct mailing costs can be allocated to program functional expenses if the following two conditions are both met:

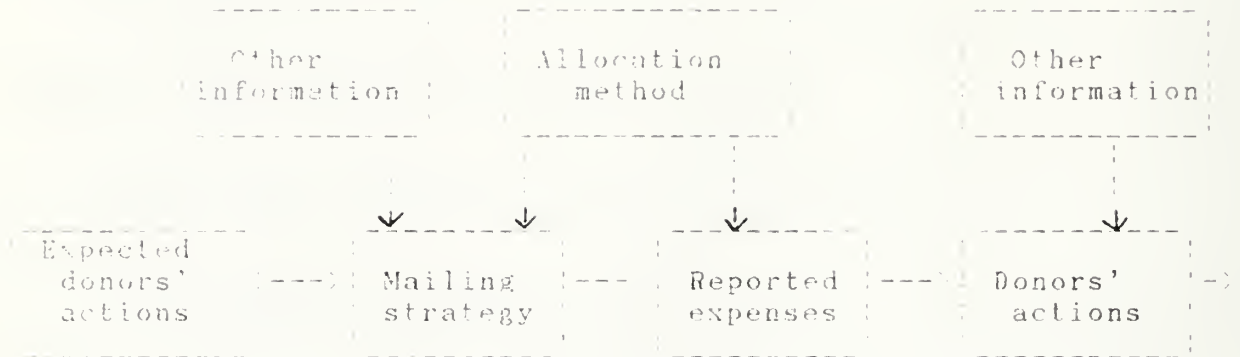
1. The program component of the mailing provides a bonafide program message meeting all the following conditions:
 - a. The message advocates that the recipient take specific action or describes specific programs from which the recipient can receive a benefit through participation.
 - b. The subject and action advocated by the program message are consistent with the purpose(s) for which the organization exists.
 - c. The program message is used in a significant manner in other material program activities in which there is no appeal for funds.
2. The mailing goes to a recipient recently demonstrating more than a general interest in the program activity by having done one of the following:
 - a. Contributed financial support
 - b. Volunteered time or services
 - c. Requested program materials
 - d. Been an employee of the organization.

If both conditions are met, the board states that joint costs should be allocated on a reasonable basis, but that no more than 50% can be allocated to program costs. Direct costs identifiable with either activity are to be charged accordingly (e.g., the costs of printing an educational brochure are charged to program expenses). If either condition is not met, all joint mailing costs must be charged to fundraising.

Effects of Different Cost Allocation Alternatives

In discussing the possible effects of different allocation alternatives on mailing strategies, we assume that a nonprofit organization's management would want to present itself in the best way possible while still adhering to GAAP. To facilitate our discussion of the incentives created by current and proposed

the allocation of joint costs of combined mailings, we propose the following simplified model of the general process implicit in our analysis:



In this model, the imposed allocation method (accounting principle) and the expected donor reactions, along with other information, influence management's selection of a mailing strategy. The allocation method then interacts with the mailing strategy to produce reported expenses. The reported expenses of concern here are the total expenses and the components: program expenses, and supporting services expenses, which we confine to fund-raising expenses for this study. Reported expenses are presumed to provide information to potential donors who make a contribution decision based on that, and other, information. The donors' actions are reflected in their contributions, i.e., in an organization's revenues. Management is presumed to change (or change) mailing strategies that will produce reported costs that they believe will in turn help to produce desired donor contributions.

The position of the Civil Service Commission stated earlier

and the attention given cost allocations between program activities and fund-raising costs by standard-setters provide some evidence that potential donors may scrutinize these costs and that, even if they do not, nonprofit managers might expect them to do so. It further appears that primary attention may be on the proportion of total costs charged to fund-raising rather than on total costs because the program costs are considered to be a "positive" expenditure. These are the funds actually going "to the cause". Given these conditions, the nonprofit manager would be expected to prefer a mailing strategy to reduce or minimize the percentage of fund-raising costs to total costs. (We will refer to this as the "fund-raising percentage" hereafter.) Presented below is an analysis of the costs and the likely mailing strategies resulting from the current method of allocating all joint costs of combined mailings to fund-raising and from the proposed allocation between program and fund-raising costs.

Responses to Charging All Joint Costs to Fund-raising

Our discussion of the proposed model of nonprofit managers' mailing strategy decisions suggested that these managers would have some incentive to minimize the fund-raising percentage of total costs. Using an example, we will compare the effects of two mailing strategies, combined and split mailings, on reported cost components using different joint cost allocation methods. "Combined" mailings include materials serving more than one purpose. e.g., fund raising and public education, in the same mailing. "Split" mailings are separate mailings for each

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The following simplified example will be used to illustrate the nature and direction of the likely effects:

A nonprofit organization uses an annual letter soliciting contributions as its only appeal for funding. The agency's only program is an educational bulletin mailed to the general public once a year. The same mailing list of 10,000 is used for both mailings. Both the solicitation letter and the educational bulletin are prepared by an outside public relations agency and separately billed to the agency, as are outside printers' production costs. All personnel at the agency are volunteers, so the only costs are the direct cost of each item and mailing costs. Relevant costs are given in Table 1.

Component	Cost per Piece
Educational bulletin	\$ 0.400
Fund-raising letter	0.600
Envelopes	0.050
Postage	0.052

Table 1.
Component Costs:
Split vs Combined Mailing Strategy

In a combined mailing of the two documents, all costs except direct costs of program materials must be charged to fund raising under current GAAP. Thus, the sum of direct fund raising costs and all joint costs is charged to fund-raising. If this sum exceeds the cost of mailing the fund-raising materials alone, reported fund raising expenses will be higher using a combined mailing than they would be using a split mailing. Even if it costs the same to mail the combined materials as it does to mail the fund-raising materials alone (as we assume here), the program expenses (direct materials alone) and total expenses will be lower with the combined mailing. Thus, the effect of a combined

mailing on both fund raising expenses and on total expenses is to drive the fund-raising percentage up.

Table 2 shows the reported fund-raising and program expenses for a split mailing, a combined mailing with all joint costs charged to fund-raising, and a combined mailing with joint costs allocated 50% to fund raising, and 50% to program. While the combined mailing has lower total costs, fund-raising expenses are a higher percentage of total costs than in the split mailing. While this is admittedly too simple to be a realistic example of an organization, it clearly illustrates the possible incentive for inefficient behavior.

Functional Expense	Split		No Allocation Combined		50/50 Allocation Combined	
Program	\$7,020	58%	\$6,000	54%	\$6,510	59%
Fund Raising	5,020	42	5,020	46	4,510	41
Total	\$12,040	100%	\$11,020	100%	\$11,020	100%

Table 2.
Reported Expenses
Split vs Combined Mailing Strategy

The allocation of costs seems to provide a possible solution to the disfunctional situation discussed above. When allocation is allowed, the savings represented by a joint mailing can be reflected as a reduction of both program and fund-raising costs. Allocating 50% (the maximum proposed by the FASB) of joint mailing costs to program expenses, fund-raising expenses as a percent of total costs will not necessarily be driven higher, as occurs when all joint costs are charged to fund-raising.

In the situation shown in Table 2, the fund-raising

percentage decreases from 42% in the split mailing to 41% in the combined mailing with 50/50 joint cost allocation. A 50/50 allocation of joint costs will not always cause the fund-raising percentage to decrease when moving from split to combined mailing. If direct program costs were lower than direct fund-raising costs, the fund-raising percentage would be higher for a combined than for a split mailing, but it would be relatively higher for a combined mailing when 100% of joint costs are charged to fund raising. Allocation of joint costs in proportion to direct costs would never make split mailings more attractive, in terms of fund-raising percentage, than a combined mailing. Bulletin 84-e, however, proposes that no more than 50% of joint costs can be charged to program expenses.

Our conclusions are based on the assumption that the joint costs of a combined mailing are no less than the costs of mailing the higher of the split mailings, and that the cost of mailing (e.g., envelopes and postage) both split mailings is no less than the joint costs of the combined mailing. In other words, it will cost at least as much to use split mailings as a combined mailing. Direct materials costs are assumed to remain the same, whether the mailings are split or combined.

We have identified the nature and direction of the likely effects of two mailing strategies using different accounting methods. The magnitude of the effects of the mailing strategies depends on the structure of mailing costs and their magnitude relative to other expenses of the organization. The smaller the cost of mailings relative to other fund-raising and program costs, the less powerful their effects on the fund-raising

percentage. Appendix 3 includes similar numerical examples illustrating different cost structures. We suggest future research relating to these issues later in the paper.

In this particular case, the favorable effect on the fund-raising percentage resulting from cost allocation should encourage the more efficient (i.e., lower total cost) combined mailing. In other cases, it might only diminish the incentive to split mailings. Different percentage allocation of the joint costs (presumably on some "reasonable" basis) would also have different effects, but any allocation of some joint costs to program expenses decreases the incentives for inefficient split mailings.

Multipurpose Documents

In the preceding example, two pieces of mailed material were clearly separate and distinguishable as fund-raising and educational program materials. Yet it seems likely that program material may be used primarily to obtain the support of potential donors. On the other hand, program material that includes any mention of where donations can be sent becomes a "combined purpose" document. In such cases, the costs of the documents themselves cannot be easily identified as direct costs of either programs or fund-raising. Mailings of such documents are combined purpose mailings which call for allocation of joint costs. However, the costs to be allocated are now larger, both in absolute magnitude and relative to total mailing costs.

It is beyond the scope of this paper to discuss the wide range of possible bases for appropriate allocation methods in

The potential problem associated with these findings, however, suggests another questionable mailing strategy that might be promoted by the requirement to allocate some joint mailing costs to program expenses.

Responses to Allocating Some Joint Costs to Programs

We have compared the more efficient combined mailing to split mailings of the same material. The possibility of joint cost allocation, however, may provide some incentive to add program material to a fund-raising mailing, even if a separate mailing of the program material would not otherwise be made. We will refer to this as a "padded mailing".

Adding an educational brochure to a fund-raising letter might cause donors to give more; but, even if it does not increase donations, the brochure allows some of the joint mailing costs to be allocated to the program category. This strategy causes total costs to be higher (by the amount of the program materials) but fund-raising expenses may be lower than they would be if only the fund-raising material was mailed.

Table 3 provides the component costs for an example of the possible result of a "padded mailing" in an organization that has program expenses of \$20,000 and fund-raising expenses of \$2,500 in addition to the mailing costs. The organization contracts for a solicitation letter costing \$.40 each to be mailed to 10,000 prospective donors.

Component	Cost per Piece
Educational Bulletin	\$ 0.200
Fund-raising Letter	0.400
Envelopes	0.050
Postage	0.052

Table 3.
Component Costs:
Single vs Padded Mailing Strategy

As shown in Table 4, sending the fund-raising material alone would cost \$5,020, all of which would be charged to fund raising expenses. This would lead to total fund-raising expenses of \$7,520, and fund-raising would be 27% of total expenses for the year. For an additional \$2,000, the organization can also include an educational brochure with no increase in other mailing costs. Inclusion of the brochure allows the \$1,020 "joint" costs of envelopes and postage to be allocated between programs and fund raising. If these costs are allocated 50-50, total expenses are \$29,520, which is \$2,000 higher than if the educational brochures are not included, and the fund-raising expenses are lower both in dollars and as a percentage (24%) of total expenses.

Functional Expense	Split	No Allocation Combined	50/50 Allocation Combined
Program	\$20,000 73%	\$22,000 75%	\$22,510 76%
Fund Raising	7,520 27	7,520 25	7,010 24
Total	\$27,520 100%	\$29,520 100%	\$29,520 100%

Table 4.
Reported Expenses
Single vs Padded Mailing Strategy

... of manipulates the costs reported in the financial statements and the padded mailing consumes more resources than the full mailing alone would have. However this "padded mailing" strategy does have one possible real benefit, unlike the split mailing strategy discussed above. A padded mailing at least has the potential of serving some program purpose for the additional cost.

Suggestions for Future Research

Our hypothetical model suggests a linkage between GAAP for mailing cost allocation, nonprofit organizations' mailing strategies, reported functional costs, and donor actions. We have pointed out possible effects of different mailing strategies on functional expenses and possible incentives to adopt strategies to minimize fund-raising costs. This study is by no means conclusive. Instead, it suggests a variety of additional research questions that appear amenable to several methodological approaches.

Accounting standard-setters [e.g., FASB, 1978] have called for research on the "economic consequences" of accounting standards. To date, most of this type of work relates primarily to the private sector. We believe that there should be at least equal concern for the effects of accounting standards on the nonprofit sector. In order to encourage such work, we provide a somewhat more extensive coverage of possible future research than is typical. Our discussion centers around three general questions that seem to emerge from the relationships among these components in the model of donor/nonprofit organization

behavior, mailing strategies, reported costs, and donors' allocations.

The first research question is:

What are the effects of different mailing strategies and allocation methods on actual reported functional and total expenses?

This question can be addressed in much the same way as we did above, with the important difference of using "real" data from actual organizations. While individual managers may be able to easily perform such analyses for their organizations, researchers may have difficulty getting the needed data, especially from a broad base of organizations. A few case studies, or a small sample of organizations might prove particularly feasible and useful in this situation. The examination of specific examples could be complemented by analytic techniques that more precisely specify the relationships among the various allocation alternatives, mailing strategies, and cost structures.

The second research question is:

Do managers select different mailing strategies and cost allocation methods because of their effects on reported expenses?

There are a number of ways to address this question. One is by controlled laboratory experiments in which managers make mailing strategy and reporting decisions using hypothetical organizations, cost structures, and allocation alternatives. Manipulation of various factors could yield insight into how managers choose mailing strategies and how important different factors are in those choices.

Surveys could be used to ask managers whether, and if so, how and why, cost allocation alternatives have affected their mailing

strategies. Data on organizations' costs and cost structures might also be gathered using this approach. Case studies and/or in-depth interviews, combined with analysis of organizational data, could be used to address the same issues. The more intensive researcher involvement provides richer data and a basis for more effective later survey design.

If the proposed technical bulletin is adopted, there will be an opportunity to use post-hoc analysis of information reported in financial statements to attempt to discern relations between reported costs and the change in accounting standards. This method does not explicitly address the processes by which the effects might occur, but looks directly for observable effects. All of these methods have proved useful in assessing the economic consequences of standards in the private sector.

From a normative perspective, we need to address the question of the "reasonableness" or appropriateness of various possible allocation methods in specific situations. Expert judges, representing both donors and nonprofit organization managers, could yield valuable insight into the relation between allocation methods and the intent or perceived purpose of various types of mailings. A group consensus method such as a Delphi panel, might be useful in such tests.

Once management has taken actions and reported the results thereof using the imposed allocation method, donors (may) receive the reported financial information and (may) react differently to it than they would have reacted to the reported results of other possible actions and/or allocation methods. This leads to our third and final research question:

Do, or would, donors respond to the differences in reported costs?

This question could be addressed by approaches analogous to those proposed for the preceding question.

All of these research methods have strengths and weaknesses. Used in combination, however, they could provide considerable evidence on the expected behavior of nonprofit managers and donors, the magnitude of the potential problem of joint mailing cost allocation, and the results of a change in the accounting principles for joint mailing costs.

Conclusion

We have examined the current and the proposed standards for allocating the joint costs of mailings containing both a fund-raising appeal and a program message. We proposed a model of the relationships among allocation methods, nonprofit managers' mailing strategies, reported expenses, and donors' contribution decisions. Based on that model, we concluded that the current requirement that all joint costs be allocated to fund-raising may provide some incentive for adopting inefficient split mailing strategies. We further concluded that allowing allocation of joint costs may help alleviate the split mailing incentive, but encourage padding of fund-raising mailings with program materials. We finally suggested several research approaches to determine whether additional evidence would support the hypothetical model relating allocation methods, mailing strategies, reported costs, and donor behavior.

Footnotes

[1] The industry term for mailing, as used in this paper, is "direct mail." The term is not used in this paper because of the possible confusion with direct costs of mailing and because, as Katz points out, "direct" is really a misnomer. In this form of fund-raising, he explains, the organization is actually most removed from the potential contributor. [Katz, 1974, p. 60]

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Appendix A

Table A-1 shows the reported component costs, and Table A-2 shows the fund-raising and program expenses for four different cost structures under the following four mailing strategy and cost allocation combinations:

- split mailing (no allocation necessary)

- combined mailing:

- all joint costs charged to fund-raising

- joint costs allocated 50% fund-raising, 50% program

- joint costs allocated in proportion to direct costs

Cost structure A is the same as the structure discussed in the body of the paper, and is repeated here for convenient reference.

Component	Str. A Per piece	Str. B Per piece	Str. C Per piece	Str. D Per piece
Fund-raising letter	0.400	0.600	0.400	0.600
Educational Bulletin	0.600	0.400	0.600	0.400
Envelopes	0.050	0.050	0.050	0.050
Postage-split mailing	0.052	0.052	0.052	0.052
-combined mailing	0.052	0.052	0.080	0.080
# on mail. list	10,000			

Table A-1
Component Costs

Functional Expense	Split		No Alloc. Comb.		50/50 Alloc. Comb.		Proportional Cost Alloc. Comb.
Program	\$7,020	58.3%	\$6,000	54.4%	\$6,510	59.1%	\$6,612 60.0%
Fund Raising	\$5,020	41.7%	\$5,020	45.6%	\$4,510	40.9%	\$4,408 40.0%
Total	\$12,040	100.0%	\$11,020	100.0%	\$11,020	100.0%	\$11,020 100.0%

Structure A

Functional Expense	Split		No Alloc. Comb.		50/50 Alloc. Comb.		Prop. Cost Alloc. Comb.
Program	\$5,020	41.7%	\$4,000	36.3%	\$4,510	40.9%	\$4,408 40.0%
Fund Raising	\$7,020	58.3%	\$7,020	63.7%	\$6,510	59.1%	\$6,612 60.0%
Total	\$12,040	100.0%	\$11,020	100.0%	\$11,020	100.0%	\$11,020 100.0%

Structure B

Functional Expense	Split		No Alloc. Comb.		50/50 Alloc. Comb.		Prop. Cost Alloc. Comb.
Program	\$7,020	58.3%	\$6,000	53.1%	\$6,650	58.8%	\$6,780 60.0%
Fund Raising	\$5,020	41.7%	\$5,300	46.9%	\$4,650	41.2%	\$4,520 40.0%
Total	\$12,040	100.0%	\$11,300	100.0%	\$11,300	100.0%	\$11,300 100.0%

Structure C

Functional Expense	Split		No Alloc. Comb.		50/50 Alloc. Comb.		Prop. Cost Alloc. Comb.
Program	\$5,020	41.7%	\$4,000	35.4%	\$4,650	41.2%	\$4,520 40.0%
Fund Raising	\$7,020	58.3%	\$7,300	64.6%	\$6,650	58.8%	\$6,780 60.0%
Total	\$12,040	100.0%	\$11,300	100.0%	\$11,300	100.0%	\$11,300 100.0%

Structure D

Table A-2
Reported Expenses

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