Joint Costs: The Right Way to Allocate

With so much attention these days paid to fundraising ratios, many nonprofits feel pressure to minimize their fundraising expenses. This makes allocating joint costs — costs associated with activities that have both fundraising and other functions — appealing. But before you take that step, make sure you're familiar with some frequently misunderstood accounting rules.

The Allocation Issue

Nonprofit organizations may combine program (or management) and fundraising activities to achieve efficiencies. For example, an organization whose mission includes improving individuals' health might send out a mailing with tips on how to stop smoking, along with a donation solicitation.

In this scenario, the organization would probably prefer to assign most of the cost to program expense, on the basis that the fundraising part of the mailing is relatively minor. But charity watchdogs often allege that this overstates the program component, skewing the organization's fundraising ratio.

Three Essential Criteria

The costs of a joint activity can be allocated between fundraising and other functions, rather than charged entirely to fundraising, but only if three criteria are met:

1. Purpose. This criterion is satisfied if the activity is intended to accomplish a program or management purpose. A program purpose requires a specific call to action for the recipient to help further the organization's mission — other than making a donation. In the above mailing example, encouraging recipients to improve their health by quitting smoking would qualify. Calls to action also might include urging recipients to contact public officials about an issue, become involved in a community or religious cause, or participate in a study.
2. Audience. If the audience for the joint activity includes prior donors or is selected based on its ability or likelihood to contribute, it's assumed that this criterion isn't met. But you can rebut that assumption if, for example, the audience was selected because of its need or reasonable potential to use the call to action — in our example, people identified as smokers.
3. Content. The content criterion is satisfied if the activity actually supports program or management functions. If not obvious, the activity must describe the need for and benefits of the action it calls for. Note that the purpose criterion focuses on intention while the content criterion considers execution, including a call to action.

The Crux of the Matter

Accounting standards provide that for any costs to be allocated to program (or management), rather than fundraising, a threshold test must be met.

The threshold test is based on how those receiving information or attending an event, referred to as the audience criterion, are selected or invited. Accounting standards discuss special events and provide the following:

> A rebuttable presumption exists that the audience criterion is not met if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute to the nonprofit; that presumption can be overcome if the audience is also selected for one or more of these reasons:
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> a. The audience's need to use or reasonable potential for use of the specific action called for by the program component of the joint activity
> b. The audience's ability to take specific action to assist the nonprofit in meeting the goals of the program component of the joint activity

In determining whether that presumption is overcome, nonprofits should consider the extent to which the audience is selected based on its ability or likelihood to contribute to the nonprofit and contrast that with the extent to which it is selected for one or more of the reasons (above).

For example, if the audience's ability or likelihood to contribute is a significant factor in its selection and it has a need for the action related to the program component of the joint activity, but having that need is an insignificant factor in its selection, the presumption would not be overcome.

The source of the names and the characteristics of the audience should be considered in determining the reason for selecting the audience. Also, the characteristics of those on the lists may indicate the purpose or purposes for which they were selected.

So care must be taken to consider and document how the audience criterion is met.

All criteria must be met to allow allocation of any costs to program (or management). It is noteworthy that certain groups, including Charity Navigator, recast any costs that are allocated to program or management as fundraising, even if they are allocated in accordance with accounting standards.

Allocation Method

Accounting rules allow you to allocate costs using a systematic methodology, applied consistently, that results in a reasonable allocation. The most common method is based on physical units, with costs proportionally allocated to the number of units of output.

In the case of a mailing, the units could be lines or square inches of print. If you engage in a year-long mailing campaign with bimonthly mailings, each mailing (and each component of that mailing, such as envelope, insert, and premium item) must be analyzed on its own.

Other approaches include the relative direct cost and stand-alone joint cost allocation methods. The former uses the direct costs that relate to each component of activity to allocate indirect costs. The latter determines proportions based on how much each component would cost if conducted independently.

Allocating costs of special events based on the time used can be more challenging, and methods may not result in a reasonable allocation. Allocating costs related to time used merits considering the purpose and content criteria, weighted in light of the audience selection criterion. For example, if the audience is not selected based on its capacity to give but rather its need for the program, and the program component is conducted without the fundraising element, a higher allocation to program would seem reasonable.

Don't Forget the Disclosures

You must make certain disclosures about joint cost allocation in your financial statements, including whether joint activities comply with the three criteria, and include a disclosure on your Form 990. If you have any questions about allocating joint costs, please contact us.

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