The Administration Paradox: Granting as if Organizational Health Mattered

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Imagine that a couple has decided to remodel their kitchen. In preparation, they visit a tile store. A salesperson there works with them to choose the perfect backsplash. Everyone is happy with the final selection and the salesperson begins making arrangement for payment and delivery. Just then the husband pulls out a document from his folder.

“Listen,” he says. “We are really pleased with our selection and your service is great. But I happen to have your company’s financial statement here, and I’ve got some concerns.”

“Yes?” inquires the salesperson.

“Well, it says here you employ a bookkeeper. And there is a line here about office rent, and another for staff training, and something in here about a benefits plan. Now I don’t mind paying for the tile. But I don’t feel I should have to contribute to all this ‘administrative overhead.’ So, if it’s alright with you, we are happy to pay for the tile, less the administrative costs included in the price.”

This is, of course, an absurd scenario. Customers don’t have access to detailed financial information for most companies. Depending on the business, it would be difficult to distinguish between operations and administration. Most of all, it is assumed that leaders in the private sector will make good decisions about the best use of assets to ensure their business remains strong. If they don’t, the company will fail. It is what business administration schools are set up to teach.

So why do we expect something quite different from the charitable sector? Regardless of

mission or structure, it is commonly assumed that spending more than 15-20% on administration is a poor use of charitable funds. (Some would argue that 10-15% is too much.) But why has this benchmark been set? How should non-profits calculate it? And why is it such an important measure of organizational effectiveness?

The unintended detrimental impact that this benchmark can have on organizational decision-making, sustainability, and program delivery is seldom explored. Charitable organizations have little input into funder practice and many are hesitant to complain out of fear it might jeopardize future support. But the expectation that non-profits should not spent more on administration continues to impact their effectiveness and ability to deliver programs and services.

To understand the current climate, it is worth considering the origins of this dynamic. Our approach to charitable administration goes back a long way and is likely imbedded in the origins of the sector. "A common theme of the Tudor period, is the widespread belief that there were widespread breaches of fiduciary duty by trustees and officials of charitable organizations. When Henry VIII dissolved monasteries in the 1530s, his justification was based on opportunistic fiduciary behavior: the misuse and appropriation of charitable endowments" (Fishman, 29).

Efforts to codify what constitutes charitable activities led to the Charitable Uses Act of 1601, otherwise known as the Statute of Elizabeth, the preamble of which defined charitable activities and presented a warning to donors which has echoed through history. "Charitable funds have been and are still likely to be most unlawfully and uncharitably converted to the lucre and gain of some few greedy and covetous persons, contrary to the true intent and meaning of the givers and disposers thereof."

In New France, before secular charities become a major player, the voluntary sector in what was to become Canada was largely the responsibility of religious organizations, notes Carl Juneau, former director of policy in the Charities Directorate at Canada Revenue Agency. As Susan Manwaring, a partner at Miller Thompson LLP, notes about early Canadian charitable activities, "it was assumed at this time that most program delivery was undertaken by volunteers." If any administrative costs were incurred, they got absorbed by churches, synagogues, and other religious institutions.

In his work, US commentator Dan Pallotta makes the link to early Puritans, who tempered their success in business with active charity. This idea of social goods being delivered by faith-based volunteers working out of basements and at kitchen tables remains pervasive to this day. In most cases, it was not that there was no administrative burden, only that the parent organization absorbed this liability. This set an expectation that overhead expenses are a poor use of resources that should be avoided.

Though the seeds of this dynamic were planted much earlier, a good place to start the story in Canada is with amendments made to the Income Tax Act in 1976, which instituted a disbursement quota for all registered charities. Otherwise known as the 80/20 rule, it required a charity to disburse at least 80% of annual revenue for charitable activities. Benefits for charities within the tax system were not a given. For those who take these incentives for granted, it is important to recognize that at the time (and to some extent still today) there was debate over whether charities should receive any tax benefit.

Juneau notes that, according to official documents accompanying the 1976 legislation, the quota was intended as a mechanism to control excessive fundraising and administration costs and, to a lesser extent, to control conflicts between a charity's objectives and the private interests of persons not at arm's length with the charity. The Department of Finance discussion paper *Charities and the Canadian Tax System,* a consultative document that preceded the 1984 amendments to the disbursement quota for foundations (May 1983), provided a slightly different policy grounding for the quota. Regarding the legislative amendments proposed in the Paper, it said:

“The proposals seek to promote the long-standing public policy of providing a tax environment in which charities can thrive and make their valued and essential contribution to the health and well-being of our Canadian society. The proposals seek at the same time, to meet the public interest of ensuring that the charitable donations and investments being encouraged through substantial tax benefits are disbursed in fact for charitable purposes” (Department of Finance).

Thus, the underlying intention of the quota system was to provide direction and reassurance of benefit without overly restricting the operations of charities and the benefit to their communities. However, as Juneau notes: “The policy intent of the quota was articulated differently, by different sources, at different times, and this only contributed to the confusion and complexity of the quota. The CRA's past practice has always considered the quota as a mechanism to control excessive fundraising costs. Nevertheless, the convolutions of the quota were such that it did not succeed in doing this and, in fact, actually allowed predatory fundraising to grow.”

Others echo Juneau’s concerns, suggesting that the system was not well received and that “the quota has turned into a cross between a math nightmare and an obstacle for the growth of small charities” (Aptowitzer, 2010).

Two other pervasive issues were identified regarding the 80/20 rule. First, for constitutional reasons, specific references and direction regarding fundraising and administration were avoided. Though income tax is the purview of the federal government, regulation of charities and fundraising are matters of provincial jurisdiction. Juneau says that the absence of details in the Act did not help matters. Secondly, the practice was discriminatory in that charities whose fundraising is dependent on donations faced greater spending restrictions than charities that receive government grants or fees for service (Aptowitzer, 2010).

The 2010 federal budget did away with the 80/20 rule, for the much simpler obligation to spend the equivalent of 3.5% of all assets not currently used for programs or administration, says Mark Blumberg, a Canadian charity and non-profit lawyer. (An approach which actually pre-existed the 80/20 approach.) However, the residue of the rule remained and found its way into decision-making amongst government funders and subsequently into the broader funding and granting community. It can be argued that this was the seed that led to the setting of the benchmark for expectations on how charities calculate administration costs and how much they can allocate for it in their budgets. The end result has been funding policies that vary greatly between government departments and other funding agencies. Cathy Taylor, executive director of the Ontario Nonprofit Network (ONN) says there is no common standard between ministries, noting most allow administration spending of between 8-15%. This lack of clarity and consistency on the part of government funders causes problems for organizations that receive funding from multiple sources.

At this moment it is important to note that, as far as limited research can tell, there is no specific rationale as to what the appropriate contribution to administration should be or what administration costs should include. Lacking independent analysis of best administrative practices for a wide range of charities, speculation on contributing factors includes: a) the baseline set by the 80/20 rule; b) an amount that hopefully allows for greatest impact of charitable purpose; c) one that will limit the potential for attention and criticism; d) benchmarked with other granting bodies; and e) feels right.

Those responsible for completing the annual T3010 Registered Charity Information Return will be familiar with current direction given for the calculation of administrative overhead, which is to include:

- Holding meetings of the board of directors;
- Accounting, auditing, personnel, and other administrative services;
- Purchasing supplies and equipment, and paying occupancy costs for administrative offices; and
- Applying for grants or other types of government funding, and/or for gifts from other qualified donees (usually foundations) (CRA).

Though at face value these appear to be reasonable categories, the devil is in the detail. How do you calculate for time spent by board members on program activities? How do you track office supplies and use of shared space? If a funding body does not contribute sufficiently to overhead, why would participating in their application process be considered administration? What documentation needs to be maintained for tracking purposes?

Blumberg knows of only one Canadian charity in the past 10 years that lost its status due to issues with administrative expenses. It may be one of several issues flagged in a review, but it is rarely the reason for suspension. In this sense, the issue seems to be one of perception, precipitated by the myth that charities are inefficient by nature.

Ranking organizations such as Charity Intelligence have also contributed to reinforcing this myth. Even though assessment of administration costs only represents 5% of the weighting of the Charity Intelligence ranking, many organizations take their ranking seriously as it can impact unrestricted donations. For Charity Intelligence, organizations which report administration of 2% or less lose points, charities with between 2% and 12.5% receive full points (about two thirds of those ranked). Those that report overhead at 22.5% or more receive no points. The system is clearly skewed to favour those organizations with lower administration costs.

As noted, there are no set guidelines for defining and calculating administrative costs. Because of the unique circumstances of individual charities ranging in size, scope, focus, and structure, it is hard to imagine universal rules. This allows for wide perception of what constitutes an administrative cost and, as a trailing indicator, leaves organizations vulnerable to audit if they innocently allocate administrative expenses to programs (or vice-versa), notes Juneau. There is a fair amount of variability in the way in which Canadian charities complete their T3010s, which provide the source for most data on this and other metrics. Regardless, the number – whether 8% or 18% – is taken at face value with some expectation of equivalency.

What impacts does this have on charities?

Ironically, determining administrative costs adds another layer of overhead to the operations of charities. Unlike fundraising expenses, where direction has been provided, charities are given a great deal of discretion as to how they account for administration. Realizing their significance to public perception, most charities are diligent in tracking administration costs – in many cases overcompensating for the detail required. Calculations can involve the breakdown of salaries of senior management between program and administrative activities. Tracking the use of space for programs and the equivalent percentage of rent, heating, hydro, etc. can also be burdensome tasks for smaller organizations. As can keeping records of board expenses not directly related to program activities, not to mention bookkeeper time spent keeping track of time spent preparing proposals.

"Unfortunately, rather than debunk a purported 'myth' related to the usefulness of charity spending ratios, *The Overhead Myth* actually spreads a myth by claiming that the money charities spend on training, planning and evaluations must be classified as overhead. In fact, much of the spending in these areas can legitimately be classified as charitable program expenses. For example, when a relief charity pays for training its staff to administer first aid, the training cost is a program expense. When a charity plans how it will relieve suffering in response to a disaster and later evaluates the effectiveness of its response, the expenses related to this planning and evaluation are also charitable program expenses, not overhead" (Charity Watch).

Blumberg, who has written extensively on this topic, also makes an important point about his experience with charities, noting that good tracking and record-keeping costs money and those charities that show on the low end of administrative expenses may actually be the less efficient and effective organizations.

"I recently . . . attended a lecture on measurement and effectiveness of charities. The presenter pulled from Guidestar two charities that operate in the same sector and the same city – charity A which spent 25% on overheads and charity B which spent 10% on overhead. The presenter asked the audience if they were a donor or a funder which charity they would support. Almost everyone raised their hand to support charity B, except for myself who raised my hand to support charity A with the high overhead. The presenter looked towards me and asked me to explain myself. I said jokingly that in all likelihood the only real difference between charities A and B is that charity B spends more on accountants and takes more time to massage the books to make their financial statements look better. Everyone laughed. The next slide from the presenter was more information on charities A and B and how the low overhead charity was not nearly as effective, had no reserves, had low staff morale, was in financial trouble and was considering its options for merger or being wound up. Now which charity are you going to support? (Blumberg, 2008).

Blumberg is clear that good tracking and transparency are critical, both from an internal management and stakeholder perspective. There are situations where bureaucracy within charities and inefficient practices need to be identified and addressed. For this reason, he suggests that clearer guidance can only help.

The impact on day-to-day organizational decision-making is subtler but equally important. To begin, from a fundraising perspective this means that one dollar is not necessarily equal to another. Organizations pushed by restrictions on contributions to administration will naturally spend more of their energy on fundraising discretionary dollars: often smaller gifts with few or no restrictions. These gifts can require more effort and be more expensive to generate,

subsequently increasing fundraising expenses. But organizations will pursue them nonetheless to make up for restricted funding, in order to maintain their operations.

Restrictions on administration may also contribute to decisions that limit or decrease efficiency. Examples might include delaying computer hardware and software upgrades or a new database system, which may save time in the long-run but cost more up-front. How about something as seemingly mundane as a new office chair? Capital improvements – many quite minor – are forgone, some with consequences to health and safety. Even though greater efficiencies could be achieved, these would all increase the percentage of administration costs.

Human resources also suffer. Aside from compensation levels, administration can include employee benefits, pension plans, and staff training and professional development opportunities. Once again retention of good, well-trained, and happy staff would most definitely contribute to the effective delivery of programs and services to clients. However, efforts to improve employee satisfaction are often foregone to minimize administration.

Finally, there is reason to be concerned that the distinction between administration and program costs leaves charities more vulnerable to cuts. Given the current climate in many jurisdictions, there is potential for political leaders to focus on the administrative portion of grants to justify reductions in funding. Budgets can be reduced in this way with "no impact on service delivery." A 10% benchmark can easily be changed to 5% with no consideration as to how this might be accomplished or its actual impact – all under the guise of increasing efficiency. It is a constant threat with the potential for placing greater burden on other donors and reducing capacity and impact.

Does all this mean that charities should be "let off the hook" regarding tracking and managing their administrative expenses? Certainly not. Any leader, regardless of whether they run a tile business or a homeless shelter, should know the costs of running their operations. Without this information they cannot make good decisions on what investments can be made and which activities are contributing most to the fulfillment of their missions.

In this sense, many charities could be doing more to calculate and present the true cost of their program activities. ONN's Cathy Taylor encourages members to take a holistic outcome-based approach. This works backwards from the end goal of the charity to ensure all the pieces are in place to achieve the desired outcome. So, if the goal is to ensure that young people living in poverty complete high school and enter post-secondary studies, the program includes front-line educators and youth workers, along with all the systems necessary to keep them working well and efficiently. Understanding and articulating the real cost – and value – of services is essential to good stewardship.

As they have with fundraising, the CRA Charities Directorate could provide clearer guidance on administration (Imagine Canada would also be well-positioned for such an effort.) The challenge would be to not add to the reporting burden, but to make it clearer and simpler for organizations to track their activities. It would also help to provide some amount of equivalency to data being used to evaluate and benchmark the sector.

This would go some way in helping donors who are fixated on administration costs. However, as Blumberg notes, there will always be those who focus on administration as a key measure for charity effectiveness. He advises those individuals and organizations to consider two important

points. First, be clear up front: if administration is an issue, explain your policy early on, rather than in a final funding agreement, so as to give the charity time to plan and seek out other unrestricted gifts. Secondly, appreciate that it is one thing to have 10% of donors who set low limits regarding their contribution to overhead and administration; it is another thing completely if the trend moves to 80-90%. The donor community should be aware of their cumulative impact and heed warnings from their charitable partners.

Additionally, donors should not place expectations on recipients that they are not prepared to match. Thus, funding should include a sum for administration that is at least equivalent to the percentage a foundation reports on its own T3010 (based on a limited sample, in the order of 15%).

There are those in the sector who have taken a more holistic approach. Within granting strategies, they set aside specific resources dedicated to organizational development with the understanding that this can only contribute to desired outcomes. Efforts involve funds or programs for professional development, fellowships, flexibility in granting budgets, and capacity grants for program expansion and dissemination. If a charitable program is worthy of growth and dissemination, it is vital to ensure the organization has a strong foundation. Underfunding administration may be a key reason why funders do not achieve dissemination of worthy programs.

Taking a leap of faith is another strategy. Given strong leadership, good fundamental organizational practices, and tangible outcomes, unrestricted donations can be manna from heaven. Unrestricted gifts put faith in the leadership of recipient organizations to achieve the best outcomes they can, with the resources available. This is not to abdicate responsibility of donors to be good stewards of their resources. Rather, the funding is based on a thorough assessment of an organization and its leadership that leaves the donor feeling their recipient has the skills and integrity to make the best decisions in a constantly changing environment.

The debate around what is a reasonable amount for charities to invest in administrative activities is not going away any time soon. What is clear is that any organization, whether a tile company or a homeless shelter, needs to invest a certain amount in operating its back office. We are not yet agreed on what should be included, or not, in these calculations and whether there is an ideal level after which returns diminish. The existing approach needs to be altered because it is burdensome and undermines effective organizational functioning without providing good information on the health of the sector.

Afterthought

While sitting in a packed waiting room at my doctor's, editing this paper, a commercial for Unicef came on the TV. "Ha!" the elderly man sitting next to me said to his daughter. "I'd never give them money. They take like 90% for administration." If I had been thinking at the time, I would have gone online to the Unicef T3010 reporting and provided him with a more accurate figure (9% for administration and 22% for fundraising). Clearly in addition to improving approaches in the sector, we have an important leadership role to play in addressing this myth in the public mind.

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I am grateful for the input from interviews and email exchanges as well as review provided by the following individuals:

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Carl Juneau, former director of policy in the Charities Directorate at Canada Revenue Agency, (Retired).

Susan Manwaring, charities lawyer, partner and national chair of Miller Thomson's charities and non-profit group.

Cathy Taylor, executive director of the Ontario Nonprofit Network.

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