

# WISE GIVING™

GUIDE

BBB WISE GIVING ALLIANCE : SPRING 2013

## Can Mail Appeals also Educate or Advocate?

The controversy over joint cost allocation





A Publication of the  
BBB Wise Giving Alliance

The *Wise Giving Guide* is published three times a year to help donors make more informed giving decisions. This guide includes a compilation of the latest evaluation conclusions completed by the BBB Wise Giving Alliance.

If you would like to see a particular topic discussed in this guide, please email suggestions to [give@council.bbb.org](mailto:give@council.bbb.org) or write to us at the address below.

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# president's MESSAGE

**M**any years ago, I was a CPA at an accounting firm. A lot of work went into the audit reports we produced. We learned the value and significance of stating that a set of financial statements was prepared in accordance with generally accepted accounting principles (GAAP). In my current job, President of the BBB Wise Giving Alliance, those lessons have served me well in recognizing the significance of relying on charity audits as they generally provide the raw material for a variety of other charity financial reports, including the Form 990, the annual information return completed by charities for the IRS. If a charity does not have an audit, the derivative reports are similarly based on unaudited information.

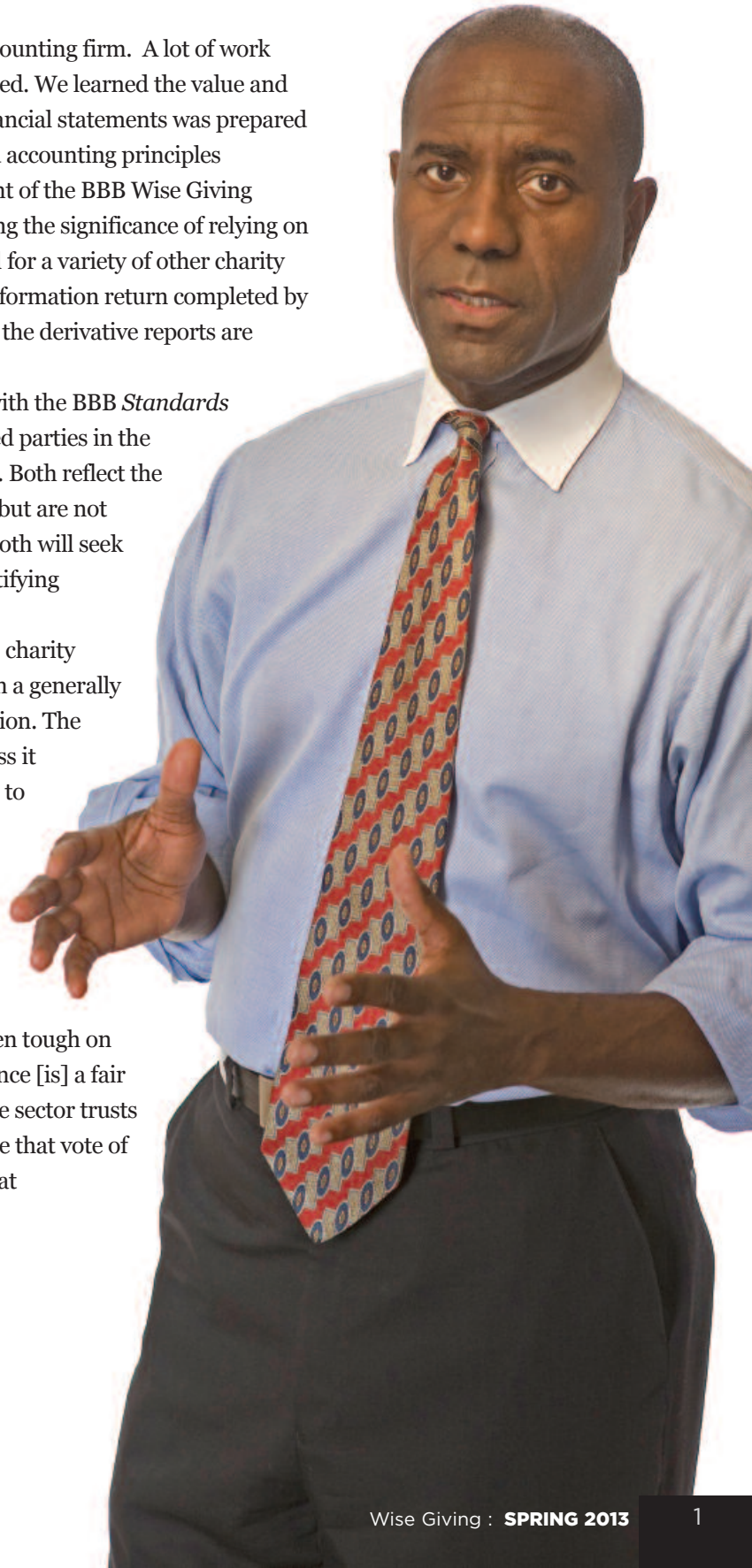
There are a number of qualities that GAAP shares with the *BBB Standards for Charity Accountability*. Both involve many interested parties in the development of standards used to produce their reports. Both reflect the organization's transparency and financial management but are not intended to imply a statement of approval. And finally both will seek to verify and substantiate the charity's practices by identifying questions and requiring supporting information.

In recent months more attention has been drawn to charity financial statements because of controversy centering on a generally accepted accounting practice known as joint cost allocation. The cover story will describe this practice and how we address it in completing our charity reports. By requiring charities to adhere to GAAP, a watchdog's evaluations can be both rigorous and fair.

And, I am very pleased to note that others agree with our perspective. As noted in the April 1, 2013 edition of *The NonProfit Times*, the paper's editor, Paul Clolery, stated in an editorial about joint cost allocation that "The BBB Wise Giving Alliance (WGA) has long been tough on charities..." but also noted "...the BBB Wise Giving Alliance [is] a fair broker of nonprofit information... [and is] the service the sector trusts to provide fair and accurate assessments." We appreciate that vote of confidence and hope you the donor, will also confirm that conclusion after reading this edition's cover story.



H. Art Taylor, *President*



# Can Mail Appeals also Educate and Advocate?

## *The controversy over joint cost allocation*

*A retrospective on joint cost allocation by Bennett M. Weiner, Chief Operating Officer, BBB Wise Giving Alliance. Mr. Weiner has been involved with BBB charity accountability issues for over 30 years and currently serves on the Not-for-Profit Advisory Committee of the Financial Accounting Standards Board. This article reflects the Alliance's position on these issues and does not represent the opinions of either the Financial Accounting Standards Board or the American Institute of Certified Public Accountants.*

When you take the subway in London (known as the “Underground” or “Tube” by Londoners) you will see signs and hear announcements asking you to “**mind the gap**” which is a safety warning about the space between the train doors and the station platform. This message was first used in the late 1960’s and forty-five years later, commuters still hear this caution.

In applying its charity accountability standards, the BBB Wise Giving Alliance, in part, asks charities to “**mind the GAAP**.” This is not the gap on the station platform but *Generally Accepted Accounting Principles (GAAP)*. These are the accounting standards established by the Financial Accounting Standards Board (FASB.org) that must be met so that an organization can receive an unqualified or “clean” auditor’s opinion on its audited financial statements. (The American Institute of Certified Public Accountants — AICPA — was involved in setting *accounting* standards in previous years but that is now the sole province of FASB. However, AICPA continues to set *auditing* standards which address such issues as the auditor’s qualifications, required field work and other guidelines in preparing financial statements.)

**Under certain conditions, a charity can recognize some of the costs of a multi-purpose mail campaign as an advocacy or education activity and a portion as a fund raising expense.**

While there are many important accounting issues impacting charity financial statements, there is one matter that has been the subject of more attention, debate, controversy and misunderstanding than any



other: **joint cost allocation**. Very briefly, this accounting term refers to activities, such as direct mail, that might combine fund raising with another function such as education or advocacy. Twenty years ago, on July 8, 1993, I made a presentation on this subject at the First Annual AICPA National Not-for-Profit Conference held in Washington, DC. There were a few hundred CPAs attending from around the country. Today, that conference now brings in over 1,500 attendees. H. Art Taylor, President & CEO of the BBB Wise Giving Alliance, will be discussing this accounting issue at this year’s Not-for Profit AICPA conference on the 20<sup>th</sup> anniversary of the first national gathering.

### **What is joint cost allocation?**

Sometimes a charity is involved with a fund raising activity, such as direct mail, that is requesting contributions but is also seeking to accomplish something else. The letter may ask you to sign and return a petition, help the environment by carrying out recycling activities, or urge you to see a doctor if certain warning signs for disease are present. Under certain conditions, a charity can recognize some of the costs of a multi-purpose mail campaign as an advocacy or education activity and a portion as a fund raising

expense. This type of multi-purpose recognition of expenses is called joint cost allocation. While joint cost allocation can involve any method of development from telemarketing to telethons, it is most frequently associated with direct mail appeals which will be the focus of this piece.

## Why should donors be concerned about accounting rules?

While we strongly encourage the donating public to consider much more than charity finances as demonstrated by our broad standards, we recognize that most contributors want to know how their donated dollars are spent. If so, then learning more about the joint cost allocation issue will help you:

- Identify potential concerns in charity financial statements.
- Learn how this issue touches upon the definition of a charity's program service activities.
- Understand more about the financial summaries appearing in BBB Wise Giving Alliance reports on national charities.
- Find out how this might impact the interpretation of financial ratios.

## BBB Wise Giving Alliance approach to joint cost allocations

While the Alliance approaches charity evaluations with the skepticism required to conduct them rigorously, we do believe that the vast majority of charities operate free of fraud, seek to be transparent and are deeply concerned about achieving the mission for which they were established. Therefore we do not assume that all charities that use joint costs do so improperly. We accept these cost allocations as long as our evaluations find evidence that they are properly recognized per GAAP.

For the national charities currently evaluated by the BBB Wise Giving Alliance, the data referenced towards the end of this article shows that about 21% of nationally soliciting charities listed in the *Wise Giving Guide* engage in joint cost allocation. While there are certainly questionable allocations among these organizations, these are the exceptions and not the majority. Accordingly, the BBB Wise Giving Alliance focuses its attention on those that claim large amounts of joint costs (more than 50%) being allocated to program services. In those instances we request additional information

including copies of appeals. We then conduct a very rigorous review of the appeal content to verify whether it substantiates the allocations made in accordance with GAAP. If not, the subject charity will not meet Standard 13 which calls for charities to accurately report the charity's expenses, including any joint cost allocations, in its financial statements.

## In the beginning... differences abound

Once upon a time, there were no formal industry-wide accounting and reporting practices for charitable organizations. Prior to 1964, not-for-profit accounting had significant differences not only in how the information was presented but also in the definition of certain terms. Donors and other financial statement users were faced with the accounting dragons of a lack of **comparability, usefulness, relevance and clarity**.

...about 21% of nationally soliciting charities listed in the *Wise Giving Guide* engage in joint cost allocation.

To help battle these dragons, two nonprofit organizations came together in 1964 (National Health Council and National Human Services Assembly\*) to produce a charity accounting guidebook that became known as "The Black Book." A third organization, the national office of United Way (now known as United Way Worldwide) participated in preparing revised editions. Soon after, the accounting profession via the AICPA (American Institute of Certified Public Accountants) produced formal accounting guides for charities which have evolved over the years to become the current GAAP requirements along with the accounting standards issued by FASB. It has taken almost half a century of accounting developments to produce not-for-profit GAAP.

## The Primary Purpose Rule — direct mail is primarily fund raising

The 1964 Black Book also introduced something that became known as the **primary purpose rule**. If a charity was carrying out an activity that combined fund raising and program services (such as including an educational pamphlet within a fund raising mailing) the

\* Note: The current president of the National Health Council serves on the BBB Wise Giving Alliance Board of Directors and the current president of the National Human Services Assembly previously served on this board. The full title of the Black Book is "Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations."

added cost for printing the pamphlet could be recognized as a program, while the cost of such things as postage, printing the fund raising letter and envelope would be *fully* recognized as a fund raising expense.

In other words, a charity's direct mail campaign would be a fund raising expense except for any incremental costs for including a program function (such as inserting an educational pamphlet in the fund raising mailing). As a result, for the vast majority of charities, the expenses of mail campaigns were mostly recognized as fund raising expenses in the charities' financial statements. This accounting recognition sounds fairly straightforward, but it didn't stay that way for long.

## The sentence that began the joint cost revolution

Some questioned the above mentioned primary purpose rule and claimed it did not accurately recognize a charity's fund raising expenses because it treated the programmatic expenses of the joint activity as if they were incidental. So, the AICPA issued a Statement of Position in 1978 that opened the door to something that became known as joint cost allocation through the appearance of a single sentence in the accounting publication quoted below.

*“If an organization combines the fund-raising function with a program function (for example, a piece of educational literature with a request for funds), the costs should be allocated to the program and fund raising categories on the basis of the use made of the literature, as determined from its content, the reasons for its distribution, and the audience to whom it is addressed.” (AICPA SOP 78-10, paragraph 97)*



## The direct mail appeal should motivate its audience to take some action other than providing financial support to the organization.

For example, if a direct mail appeal requested donations (fund raising) and also included an education or advocacy message (such as sign a petition or see a doctor if you have these health symptoms), the charity financial statements could now allocate or divide much more of the joint or common expenses (costs of postage, printing, envelopes, etc.) of such a mailing between fund raising and program services expenses within the charity financials.

## Joint cost allocation in the accounting spotlight

There were inconsistencies appearing in charity financial statements about this issue since one audit guide recommended the primary purpose rule and another cited joint cost allocation. To address this, the AICPA issued broader accounting guidance in 1987 that applied to **all** charities: “AICPA Statement of Position 87-2: Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations that Include a Fund-Raising Appeal.”

This accounting position statement established three common criteria for joint cost allocation to take place:

- 1. Purpose:** The charity should have evidence (e.g., board minutes, written instructions to fund raisers) that it intended for the direct mail appeal to carry out a public education or advocacy objective.
- 2. Content:** The direct mail appeal should motivate its audience to take some action other than providing financial support to the organization. The shorthand for this requirement is a “call to action” message.
- 3. Audience.** If the audience of the direct mail appeal is selected based on its ability to donate without consideration of its need for the “call to action” message, the appeal cost should be allocated to fund raising.

As this new accounting guidance was put into practice by a growing number of charities, particularly those involved in national direct mail campaigns, the following problems were observed:

- **Lack of “call to action” in appeals**

Some charity financial statements were reporting joint cost allocation as applicable when a review of appeals did not show any *call to action* asking the recipient to do something other than make a gift.

- **Over-allocations to program service expenses**

Even if the appeal contained a *call to action*, some charities were claiming a much larger portion of the direct mail campaign costs were a program expense than appeared to be justified by the content of the appeals.

- **Are all three of the joint cost accounting criteria required?**

Some questioned if a charity needed to meet **all three** criteria (purpose, content and audience) in order to joint cost allocate.

- **No note in audited financial statements**

Less common, but a problem nonetheless, was that some charity financial statements had joint cost allocations but did not include any of the required explanations (via a note disclosure) in the audited financial statements.

- **Lack of guidance on how to properly joint cost allocate**

In terms of direct mail, there was a lack of clear guidance about what methodology to use. How was an organization to determine how much of the appeal campaign expense should be recognized as a program expense?

- **Accounting inconsistencies**

As a result, inconsistencies in audited financial statements were still taking place. To some extent, it was as if a new set of problems were exchanged for the ones that existed prior to 1987.

## **Back to the drawing board: revised AICPA rules issued in 1998**

To address growing concerns, AICPA issued revised rules in 1998: *AICPA Statement of Position 98-2 Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising* (AICPA SOP 98-2). It weighs in at a hefty 50 pages as opposed to the 10-page joint cost position statement issued in 1987.

Some charities were understandably overwhelmed by this new, longer and more complex set of rules for joint cost allocation. There was a lot more to learn and follow in order to be fully compliant. A now famous flow-chart summary appearing in AICPA SOP 98-2 has an eye-straining 23 arrows and 18 boxes.



**All three criteria required.** The revised rules now required that the three criteria of purpose, audience and content must **all** be met.

### **Expanded purpose criteria:**

If the charity’s appeal includes a *call to action* message, additional factors would need to be considered as well to meet the purpose criteria:

- **Commission based fund raising.** If the joint cost activity is carried out by either charity staff or hired firms that receive a majority of their compensation based on the amount of money raised, the purpose criteria is not met and joint cost allocation is not allowed.

*continued*



- **Similar education activity conducted without fund raising.** If the charity carries out the education or advocacy activity without asking for funds using the same medium (i.e., direct mail) on a similar or larger scale, that would help demonstrate the purpose criteria is met.
- **Measuring results of education or advocacy activity.** If the charity does not conduct a similar education activity without fund raising, other criteria can be considered. One example of other criteria would be: does the charity measure the program results or accomplishments of the joint cost activity?

#### Expanded audience criteria:

- **Audience verification.** The audience criteria are met if the audience was selected based on one of the following conditions: (a) the audience’s need for the call to action message and/or (b) the audience’s ability to take the specified action.
- **Prior Donors.** If the audience for the mail appeal includes prior donors or is selected based on the likelihood the recipients will contribute, the charity is not allowed to joint cost allocate. But this restriction can be overcome, in certain circumstances, specified in the accounting guidance.

For some appeals, a charity’s claim of an *implied* call to action may not be clear to others reading the same solicitation.

#### Expanded content criteria:

- **Educating about causes is fund raising.** As stated in this 1998 publication, “*Educating the audience about causes* [i.e., conditions, needs or concerns that the charity is designed to address] *or motivating the audience about causes is not a call for specific action by the audience that will help accomplish the entity’s mission. Such activities are considered in support of fund raising.*” In the BBB Wise Giving Alliance’s experience, this is a factor that is often misunderstood by charities. Some charities claim that describing what the charity does and its accomplishments is an education activity that can be recognized as a program expense. The above excerpt says otherwise.

#### Sample allocation methods included.

- The 1998 revised rules included three examples of allocation methods and provided examples. While the door was still open to other methodologies to calculate joint costs, the recommended methods provided guidance where none previously existed.

#### More detailed note disclosure required.

- The revised joint cost rules now required a more detailed note in the audited financial statements that would provide readers with additional details about what types of multi-purpose activities were conducted (direct mail, special events, telethons, etc.) and the amounts allocated to each program activity, administration and fund raising.

#### Reasons why the joint cost allocation controversy continues

There also were a number of factors that led to the joint cost allocation controversy that are still being seen today:

##### • Subjectivity

By its very nature, there are subjective elements to joint cost allocation. For some appeals, a charity’s claim of an *implied* call to action may not be clear to others reading the same solicitation. In turn, not everyone may agree on what specific audiences will benefit from the intended message.

##### • Donor interest in charity finances

Some charities are seeking to satisfy public concern about charity finances by reporting the lowest fund raising expense possible. Direct mail campaigns, particularly those carried out on a national scale, can be quite expensive.





The significant drop in the prevalence of joint cost allocation indicates this may not be as significant an influence on charity financial statements as it once was.

- **More charities, more competition**

Some charities include prominent mentions of their financial expense ratios as a means to encourage donations. Reporting lower fund raising costs than a competitor is one way to attempt to best a charity raising money for a similar mission.

### Do charity financial statements frequently involve joint cost allocation?

In the experience of the BBB Wise Giving Alliance, joint cost allocation is a subject that is most often seen in the audited financial statements of nationally soliciting charities, particularly those that engage in direct mail campaigns. In contrast, joint cost allocation is rarely a matter that comes up in the reports on locally soliciting charities produced by 54 of the 114 Better Business Bureaus nationwide that conduct charity evaluations.

In 1994, we looked at the financial statements of 150 of the most asked about national charities to see how many had a joint cost allocation note. Half of them, 75 organizations, had such a notation.

Almost 20 years later, in 2013, we found that a review of about 900 national charity audited financial statements showed that only 21% of them, 190 organizations, had a joint cost allocation. If one also considers the remaining 365 charities in this *Guide* that did not disclose requested information, the Alliance estimates about 20% engaged in joint cost allocation. The combined total would be 263 joint cost allocation circumstances out of 1,265 listed organizations.

Although this is not a scientific sampling, these are the national charities that are the subject of public inquiry at the Alliance. The significant drop in the prevalence of joint cost allocation (50% to 21%) indicates this may not be as significant an influence on charity financial statements as it once was. There are several possible explanations for this. It is possible that the more stringent joint cost allocation criteria established by the AICPA in 1998 may have impacted the number of eligible charities. Or, some organizations may have been cautious about being involved in an



**We believe it is up to the donor to decide if those activities are worthy of their support. Nevertheless, donors may not be aware that the charity is carrying out some of its advocacy or educational programs in conjunction with appeals.**

accounting practice that has been the subject of criticism, even though it is permissible by GAAP. Or, there may be a core group of national charities that engage in joint cost allocation. When the Alliance expanded its report volume, it found that most of the added charities did not participate in this accounting practice.

### **How much of the joint cost allocation is allocated to program services?**

As indicated above, the study we completed in 1994 identified 75 national charities that joint cost allocated in their financial statements. The cumulative total of all these joint cost allocations was \$339 million. Of this amount, 47% (\$160 million) was allocated to program services, 4% (\$44 million) to administration, and 49% (\$167 million) to fund raising.

For 2013, a review of the latest national charity audited financial statements that we have on file show that 190 had a joint cost note. The cumulative total of all these joint cost allocations was \$1.5 billion. Of this total 50% (\$755 million) was allocated to program service expenses, 6% (\$88 million) to administrative expenses, and 44% (\$665 million) to fund raising expenses. While these numbers are large, to put this in perspective, the \$755 million that was allocated to program service expenses represented only 6% of the total cumulative program service expenses (\$13.3 billion) of these charities.

These statistics are suggesting a couple of conclusions about joint cost allocations:

- The majority of national charities are not involved in joint cost allocation. *Cumulatively*, it represents a small portion of total program service expenses.
- In terms of total cumulative amounts allocated, in the past twenty years, there has not been a dramatic shift to lower fund raising expenses from joint cost activities being allocated in charity financial statements.

### **Are advocacy and educational programs carried out in appeals worthy of donor support?**

Charities are formed to achieve a multitude of goals. While it is vital that a charity clearly express its mission, we do not believe it is our role to comment on the worthiness of that mission or the mediums a charity employs to accomplish it. A charity may use other mediums to distribute the exact same message.

We believe it is up to the donor to decide if those activities are worthy of their support. Nevertheless, donors may not be aware that the charity is carrying out some of its advocacy or educational programs in conjunction with appeals. If so, charities should consider being more transparent about their intentions. For example, if a majority of a charity's programs are carried out in conjunction with appeals, shouldn't the solicitation reveal that material fact?

### **Are there needed improvements to joint cost allocation rules?**

There are a number of areas that can be addressed to improve practice. For example, it would be helpful if the accounting guidance narrowed the possible methodologies to calculate joint costs. Currently, there

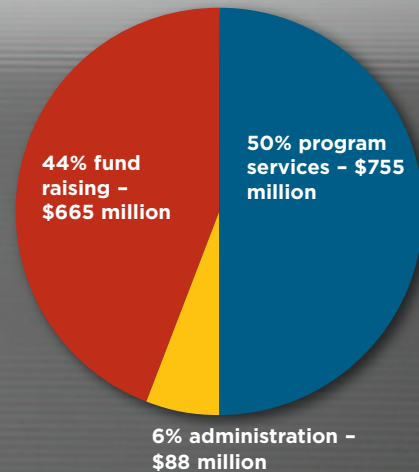
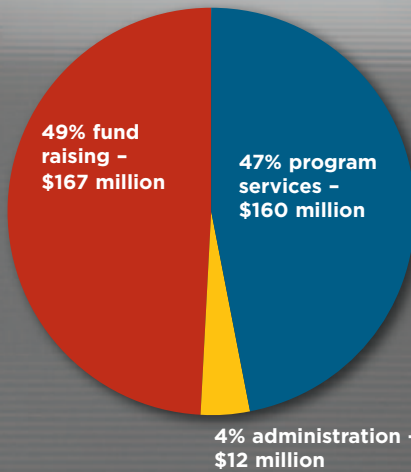
**While it is fair to debate decades old accounting practices, rejecting joint costs without studying them for accuracy and compliance is unfair both to charities that follow those rules and to donors who rely on these financial statements.**



# Joint Cost in 1994 and 2013

1994: How \$339 Million of Joint Cost Allocations Appeared in 75 National Charity Financial Statements

2013: How \$1.5 billion of Joint Cost Allocations Appeared in 190 National Charity Financial Statements



The above chart shows how 75 nationally soliciting charities allocated \$339 million of expenses using joint cost allocation. While most of these expenses involved direct mail, some other types of fund raising are included. This data was collected in 1994.

The above chart shows how 190 nationally soliciting charities allocated \$1.5 billion of expenses using joint cost allocation. While most of these expenses involve direct mail, some other types of fund raising are included. The data was collected in 2013. The \$755 of program service expenses represents 6% of the total cumulative program service expenses (\$13.3 billion) of the 190 organizations.

are no restrictions on the methods used to allocate. The most popular method to allocate costs is the line by line method. One counts the lines in the appeal and identifies which are fund raising, program or administration. If the accounting profession could provide some sample appeal copy and show the recommended line allocations, that would help clarify present practice. In addition, with the advent of new ways to reach audiences that were not contemplated in 1998, like the use of mass email and social media, the expanded audience and content criteria of the 1998 accounting guidance may need to be revisited.

## Mind the GAAP

Some charity critics conclude that all joint cost allocations should be considered a fund raising expense and that they do not represent a true program service

activity. While it is fair to debate decades-old accounting practices, rejecting joint costs without studying them for accuracy and compliance is unfair both to charities that follow those rules and to donors who rely on these financial statements. It also could lead to inconsistent charity financial presentations covering the same set of circumstances.

Certainly some charities can do a better job at ensuring that they are following GAAP in making joint cost allocations and some auditors may need to make sure allocations have an appropriate basis. The joint cost allocation train, however, already left the station decades ago. Those seeking to pull the emergency cord will certainly get attention but won't be able to stop the joint cost train from using both the advocacy and fund raising tracks. ■