

## Toward a Theory of Organizational Fragility in the Nonprofit Sector

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**Abstract:** In recent years there has been increased concern about the effectiveness of nonprofit organizations, particularly in the US. Foundations in particular have increased investments in what they call “capacity building” and have formed an affinity group called Grantmakers for Effective Organizations. Much of their increased investment has gone to consultants in a wide variety of interventions such as board development, strategic planning and information technology. Such one-on-one approaches seem unlikely to have a sectorwide impact on organizational effectiveness. To have such impact, we need first to understand systemic factors that could result in organizational weakness sectorwide. The proximate cause of that weakness seems readily apparent as soon as we seek for it: it is the limited funding available for administrative or infrastructure costs. A systemic explanation will seek more deeply for a causal matrix underlying the apparent paradox: why do funders who want grantee organizations to be successful fail to fund their administrative or infrastructure costs at levels that would permit them to be effective? After documenting the proximate cause with anecdotal evidence, this paper will offer a hypothesis regarding this deeper causal matrix by drawing on a variety of prior research and consulting experiences.

### **Paper:**

In recent years there has been increased concern about the effectiveness of nonprofit organizations, particularly in the US. Foundations, for example, have increased investments in what they call “capacity building” and have formed an affinity group called Grantmakers for Effective Organizations. Much of their increased investment has gone to consultants in a wide variety of interventions such as board development, strategic planning and information technology.

Such one-on-one approaches seem unlikely to have a sectorwide impact on organizational effectiveness. That is, we are unlikely to find the cause of a sectorwide problem by examining and solving the issues individual organizations face. And even if we did find the cause that way, attempting to resolve it one organization at a time would be a very expensive and time-consuming way to do it. We suggest that sectorwide organizational capacity issues are symptoms of a systemic structure. To identify high leverage interventions that could have sectorwide impact, we need first to develop an understanding of the systemic structure that leads to and maintains organizational weakness throughout the nonprofit sector.

The first section of the paper reviews empirical findings that are the key facts the structure needs to explain. The second section briefly reviews approaches to building theoretical models of systemic structures. The body of the paper proposes such a structure, building it step by step. Brief conclusions end the paper.

### ***Empirical research into infrastructure funding, spending and reporting***

For the past three years, the Center on Nonprofits and Philanthropy at the Urban Institute and the Center on Philanthropy at Indiana University have been engaged in a national study of how nonprofits raise, spend and report funding for infrastructure costs, including management and general expenses and fundraising costs.

The study has had three major phases. In Phase I, extensive analysis was performed of IRS Form 990 data. Depending on the particular analysis performed, up to 220,000 different organizations were included. One of the major findings to emerge from this phase was that almost half of nonprofits that report income from contributions report zero fundraising costs. Additional analysis ruled out a variety of legitimate explanations for most of these organizations.

The second phase was a mail survey focusing on organizations reporting both fundraising revenue and costs. The 1500 responses received provide an important database into the suite of fundraising methods used by different kinds of nonprofits, how much they raise from each method, and some early information about the costs of different methods.

The third phase, which is still underway, is a series of case studies of approximately ten organizations. These case studies involve onsite interviews with the CEO, CFO and VP of Development probing all aspects of financial management, management of fundraising, as well as how they raise, spend and report infrastructure costs.

The five case studies that have been completed provide the bulk of the empirical findings used in this paper. Since the study is not complete, these findings are tentative. We note that four of the five are human services organizations, which may affect the generality of the conclusions. Elsewhere (Pollak, Rooney & Wing, 2003), we provide more detail on the cases themselves. Here, we limit ourselves to summarizing eight key generalizations that emerge from cross-case analysis:

1. **Functional expense tracking of personnel time is a low priority, with low perceived benefit.** Despite the fact that both the Financial Accounting Standards Board (FASB) and the IRS require expenses to be broken down by functional expense category (program, management and general, and fundraising) only one of our five sites has any employees fill out timesheets that would permit them to inform functional expense classification and the other four had no plans to do so. The one case was required to do so by its auditor, and even so, the development officer charges grantwriting time to the program the money is for instead of fundraising, nullifying the purpose. The people we interviewed saw little value to their organizations in this particular accounting activity.
2. **Glaring functional expense reporting errors occur in audited financial statements, and in 990s even when the forms are prepared by auditors and CPAs.** The two organizations that reported zero fundraising cost on their 990 both did so in error. In both cases, financial professionals prepared the 990. In one case, the audit showed fundraising expenses. In the other, the audit charged all salaries to program and showed no fundraising expense despite the existence of a 0.6 FTE grantwriter and limited direct mail fundraising.

3. **NPOs are responding to perceived pressure to keep real and reported Management and General (M&G) but especially fundraising costs low.** One agency was planning to change its functional expense allocation method because reported M&G and fundraising costs were higher than those reported by peer agencies. Another agency had been threatened with having its funding cut off by a particular funder because its overall administrative and fundraising cost ratio was too high. A third reported that maintaining a lean, low cost administrative cost structure was important in maintaining ongoing funding support. The CEO of a fourth noted that low overhead is a factor in winning public sector funding. A development officer reported that funders and donors are even more sensitive to high fundraising costs than management and general costs.
4. **Personnel costs in fundraising are generally not tracked.** None of our five sites tracked personnel time by fundraising method. In addition, only one site tracked the fundraising time of personnel who work on program or management and general as well. Salary costs of dedicated fundraising staff were charged to fundraising in two of three relevant cases.
5. **NPOs generally classify government funding as direct public support on the 990, but do not classify costs of raising those funds as fundraising costs.** Funds received from government can be reported on two different lines on the 990. They may be reported as contributions or as fee income. In general, the costs associated with raising contributions should be classified as fundraising costs. Our sites reported government funds as contributions, but saw fundraising expense as limited to the development officer or department. The time of the senior executives involved in securing this funding was not included in fundraising cost in our case study sites.
6. **It is hard to raise adequate funds for administrative infrastructure at all sizes.** All sites reported that these are among the most difficult funds to raise. Although larger organizations were able to raise significantly more administrative dollars than smaller ones, they were not able to raise proportionately more, and sometimes proportionately less, so that unmet administrative needs exist at all sizes.
7. **NPOs are responding with varying mixes of paying low salaries and doing without.** Smaller organizations in particular rely on paying low salaries as a way of coping with inadequate funding for both program and administration. In addition, organizations at all sizes do without a wide variety of administrative capacity including bench strength for critical roles, some roles altogether and a wide variety of basic and productivity-enhancing tools.
8. **“You get what you pay for” with infrastructure (approximately).** The strategies nonprofits use to deal with inadequate funding for infrastructure have consequences. While they are sometimes able to find highly qualified people willing and able to work for below-market wages, this is not always possible. Positions are often filled with very junior people or generalists with little relevant training or prior experience. When they do gain the experience, they often move on to better paying jobs. In a few cases where sites have found good long-term employees, executives worry they could never replace these staffers at anything like current salary. The physical plant and tools nonprofits

work with also show the consequences of neglect. Rain came through the roof during one site visit and the CEO grabbed a push broom to sweep it outdoors. Another site had to get “new” cast-off furniture when it was forced to move, because the mover refused to move the old, broken-down furniture they had using for years. Three sites struggled with poor fundraising software solutions because of the cost of upgrading; the other two have yet to invest in any.

As the presentation of this list already begins to make clear, these findings are not unrelated to each other, but exist in some as yet unclear relationship of influence and causation. At the same time, these findings seem directly relevant to the issues and concerns with organizational capacity that have been at the forefront of discussions in the nonprofit sector for several years. An understanding of the systemic structure within which they are connected may provide insights that could lead to high leverage interventions with the potential to enhance organizational capacity and effectiveness throughout the nonprofit sector.

### ***System dynamics and theory building***

Peter Senge’s Fifth Discipline (1990) remains an excellent introduction to systems thinking. Beginning with simple positive and negative feedback loops, Senge showed how these could be combined in different ways to model the behavior of complex human systems. Eight such combinations were shared in the book, and Senge illustrated how widely varying situations might have the same underlying systemic structure.

While these generic structures, or archetypes as he called them, were tantalizing in their simplicity, they are not exhaustive. Senge at one point mentioned the existence of another eight generic structures, but made no claim that all such structures had been found. In addition, no real guidance is provided on how one can determine whether one of the existing generic structures is appropriate for a particular empirical situation under study, or if so, which one. We are given excellent information about the building blocks of systemic theory and images of what “finished” theories look like, but no process for constructing our own from a given empirical situation.

Coming from a different tradition, Goldratt (1994) provides hints and partial illustrations of such a process. In the Goldratt approach, a list of undesirable aspects of a current situation is generated first. A logical implication of causality is then identified between any two of the items on this list. Additional precursors and implications are added to the initial pairing until all items on the original list are included in an overall causal map. During the process, additional assumptions or premises are added, as well as intermediate steps. Each link in the map must satisfy the demands of logic and the added premises must be empirically true for the model to have validity. The cascading syllogisms of this approach enter the territory of systems theory because causal loops are permitted within this approach. While Goldratt’s book makes no distinction between positive and negative feedback processes, we are free to interpret them as such.

Contrasting the two approaches highlights two other interesting differences. In the Senge generic structures, there is very little that is exogenous to the model. Except for the desired or goal levels in the negative feedback loops, all named actions, decisions and events are part of a circle of causality. In Goldratt’s examples, a variety of premises may lead to but not be caused

by any system dynamic. In his approach, these are the root causes or core problems. A second difference is that Senge's loops focus on a single primary influence that leads to the next event on the circle. Goldratt's examples typically include multiple factors that lead to a result, similar to the producer-product dynamic identified by Singer (1959).

Each of the approaches offers something of value, yet each appears to be incomplete. In this paper, therefore, we shamelessly borrow from both and intermix.

### *Actors*

Senge's examples frequently focus on a set of actors, the decisions they make, and how those decisions interact. Following this, our first step is to identify the actors in our system. Our most important actor is the leadership of the nonprofit organization (NPO). We treat that here as a unitary entity, even though we know in practice that it is a complex system in itself consisting of multiple board members and staff managers. The other important actors are the funders. Since nonprofits are responsive in different ways to large funders than small donors, we will work with two generic actors: the major funder and the small donor. For our purposes, a major funder could be a government agency, a foundation or an aggregate. The small donor could be an individual who sends in a check in response to the annual appeal, a local business, or someone who comes to a special event. Our final actor is a minor player in our story: the auditor of the nonprofit organization.

Our research has focused primarily on the nonprofits themselves. We have little empirical data to draw upon in mapping the dynamics of the thinking of funders, donors and auditors. Thus our model must treat them as something of a "black box" for now. This is acceptable provided we can identify the transactions of influence between them and our nonprofit organization. As long as the loop is closed, we will be able to identify whether it is positive or negative feedback loop.

We begin, then, by attempting to link together the empirical findings within the nonprofit organization.

### *Inside the Nonprofit*

We start with the finding that "it is hard to raise adequate funds for administrative infrastructure at all sizes." The typical NPO does not generate a surplus on its program activity. As a result, it can only spend what it can raise. This leads to our next finding: "NPOs are responding with various mixes of paying low salaries and doing without." This is not without consequences, however. Our case study sites spoke to the impact on their organizational effectiveness of staff turnover, using relatively junior or untrained people in key positions, understaffing, or failing to provide tools and supports to staff. We may lump these together as "organizational effectiveness." These consequences in turn, may influence the ability of the organization to raise funds from major donors. Either because its overall effectiveness is limited, or because it has not invested in adequate data collection and evaluation infrastructure, the NPO may not be able to demonstrate to major funders that it is a worthy recipient. This would make it harder to raise funding in general, including funding for administrative infrastructure. The link between organizational effectiveness and difficulty raising funds is not directly supported by our immediate study, however, the emphasis within the field in recent years on outcomes suggests that this link has been becoming stronger over time. Figure 1 shows the positive feedback loop we have just constructed.

Another key finding of our study was that NPOs feel pressure to keep infrastructure costs low. Having low infrastructure costs was perceived as a competitive advantage when seeking funding from major donors. Funders get their knowledge of the level of infrastructure costs when they review audited financial statements and IRS Forms 990. In Figure 2, we add these elements to the model. Pressure for low infrastructure costs leads to low infrastructure costs. Low infrastructure costs leads to low reported infrastructure costs, which in turn increases the ability of the organization to raise funds. Since a portion of these funds may be for infrastructure, infrastructure spending may increase. This is a negative feedback process.

In the process of Figure 2, NPOs must strike a balance. Overemphasizing organizational effectiveness may require infrastructure cost levels that violate funder norms and hurt the NPO's funding prospects. Overemphasizing low infrastructure cost may compromise organizational effectiveness and also hurt the organization's funding prospects.

One way out of this bind is underreporting. Having low infrastructure costs is not the only way to have low reported infrastructure costs. By underreporting infrastructure costs, NPOs could appear to have lower costs in funders' eyes, while avoiding the organizational effectiveness consequences of those lower costs. Our research found a significant amount of underreporting. For example, approximately half of all IRS Forms 990 reporting contributed income reported zero fundraising cost. Our case study research found only one organization engaged in time tracking sufficient to routinely assign or annually allocate personnel costs appropriately to program, fundraising and M&G. In particular, the time of senior executives was frequently not charged to fundraising, and in one case even the grantwriter wasn't charged to fundraising. NPOs did not consider time spent obtaining government funding as fundraising and did not report it as such.

In our cases, the underreporting appeared to stem from two quite different sources. On the one hand, the kind of time tracking and allocation accurate reporting would require is a luxury for most NPOs where staff for basics like payroll, accounts payable, volunteer management and network support are stretched thin or lacking. In a similar vein, few NPO staff have detailed knowledge of FASB or IRS reporting rules. On the other hand, we also found evidence that NPOs were conscious that their infrastructure costs were under scrutiny, and sought to increase the percentage allocated to program, while reducing that reported for infrastructure costs.

In Figure 3, we add these elements to the model. Both conscious and inadvertent underreporting reduce reported infrastructure costs, thus increasing the ability of the organization to raise funds. At the same time, underreported amounts are actually spent on infrastructure, aiding organizational effectiveness. These new links create two new negative feedback loops. In the first, underreporting allows additional spending for infrastructure, which permits increasing staff, salaries and supports, which may lead to improved functional expense tracking, which in turn would reduce inadvertent underreporting. In the second loop, underreporting increases the ability of the NPO to raise funds, increasing spending for infrastructure, which may make it possible to improve functional expense tracking, thus reducing inadvertent underreporting.

Considered in isolation, neither of these new loops appears to be particularly strong empirically, since we see little evidence of change in the quality of functional expense tracking or

underreporting. Since functional expense tracking is not a priority for NPOs, the additional funds underreporting makes available are not spent there.

### *Enter the Major Funder*

Despite our efforts to limit our focus to the NPO, the major funder has already made several implicit appearances in our theory. In Figure 2, the major funder is the perceived source of the pressure to keep infrastructure costs low. In addition, the major funder mediates between the level of reported infrastructure costs and the ability of the NPO to raise funds.

We emphasize that “major funder” means one whose current or potential level of support is high enough that the NPO must be responsive to that funder’s preferences. In Figure 4, we add the major funder’s preferred level of infrastructure spending to the model. Through a variety of implicit and explicit means, this preferred level is communicated to the NPO and perceived as pressure to keep infrastructure costs down. At the same time, the level of reported infrastructure cost and the funder’s preferred level interact to generate the funding decision, which is the flip side of the NPO’s ability to raise funds.

These additions by themselves do not alter the structure of the system. There are no new loops. The additions do lead us to ask, however, where the preferred level of infrastructure spending at the major funder comes from? We are not aware of any research that has addressed this question. Nevertheless, there has been speculation. Without passing on the validity of these explanations, we review them and consider what their impact, if they were true, would be on the systemic structure.

**Trying to make limited dollars go farther.** This is what one of us has called the “peanut butter” approach to funding. If funders believed that they could achieve more of their goals by maximizing the proportion of their dollars going to program, that would explain a preference for low infrastructure costs. This is an exogenous explanation with no systemic interaction with the rest of our model.

**Ideas of administration as “waste” that were more appropriate during an earlier, all-volunteer era.** One idea that has been offered as an explanation of limited funding for administrative cost is that people do not see the value of it. One CFO we interviewed was frustrated because program people in the organization saw no value in accounting. Some have suggested that these perceptions have their basis in rules-of-thumb regarding how much should be spent on program that emerged during the early years of the sector when it was primarily staffed by volunteers. Again, this is an exogenous explanation with no impact on the systemic structure of our model.

Since our concern is building systems theory here, we would like to propose two new explanations that do have systemic implications: underreporting and sector values.

**Underreporting of infrastructure costs by NPOs suggests they need even less than they actually spend now.** The errors that we found on 990s and in audited financials tended to result in nonprofits reporting less spending on administration and fundraising than was in fact the case. This could lead users of this financial information, such as major funders, charity watchdogs and others, to believe that nonprofits need less than they are getting now. Such mistaken conclusions

could lead major funders over time to lower their preferred level of infrastructure funding. This possibility is illustrated in Figure 5. The additional link between underreporting and the major funder's preferred level of infrastructure funding creates a positive feedback loop where underreporting could lead to reduced infrastructure funding which could lead to additional underreporting. The two hash marks across the arrow indicate that the new link happens only with a delay.

**Working in an environment driven by major funder preferences, NPO staff come to internalize a value for low infrastructure costs, which they retain when they are recruited by foundations.** Our case studies revealed that many NPO executives hold a value of keeping infrastructure costs down. Anecdotal evidence suggests that many foundation program officers are recruited from among NPO staff. We would expect that they would bring their values with them when they joined the foundation. The systemic circularity would occur if the NPO values were themselves the result of internalizing and valuing an imperative coming from major funders. This would also create a positive feedback loop, and again, since value formation and career development are long term processes, there would be significant delays in such a structure. Given that NPOs compete with each other for funding, it would not be surprising if they came to form a positive value around maintaining low infrastructure costs, which they believe help them obtain funding, whether that funding criterion is explicit or implicit.

### *The Small Donor*

According to our definition, the small donor is one who, at least individually, cannot influence the behavior of the donee NPO. Small donors are primarily made up of individuals, but for a particular NPO corporations or foundations could be small donors. Again, our study did not investigate the attitudes and behavior of small donors, however, we can follow the implications of our data and theory and see if we can create some testable propositions.

In our case study sites, major funders generally provided primarily program funding. Only a portion of the limited infrastructure at our sites was covered by major funders. Mail appeals to individuals, special events, faith communities, small unrestricted grants and United Ways were the most common sources of unrestricted funds to cover infrastructure costs.

Of course, nonprofits emphasize program uses of funds in their fundraising appeals. This understandable decision could be exacerbating the infrastructure funding problem. Here's how:

1. If most small donors would prefer that their donations go towards program rather than fundraising or administrative costs, then nonprofits will emphasize program uses of funds in their fundraising appeals.
2. If small donors cannot afford to investigate how the nonprofits they donate to are spending their donation, then small donors cannot place meaningful restrictions on their donations.
3. If small donors cannot place meaningful restrictions on their donations, then they must make unrestricted donations, even though they want their donations to go to program.

4. If sources of major funding for nonprofits have restrictions that limit support for infrastructure to inadequate levels, then nonprofits must use unrestricted funds to pay for infrastructure.
5. If sources of major funding for nonprofits have restrictions that limit support for infrastructure to inadequate levels and small donors must make unrestricted donations, then small donors are a major source of unrestricted funding.
6. If small donors are a major source of unrestricted funding and nonprofits must use unrestricted funds to pay for infrastructure, then nonprofits must use the donations of small donors to pay for infrastructure.
7. If nonprofits emphasize program uses of funds in their fundraising appeals and most small donors would prefer that their donation go towards program rather than fundraising or administrative costs and nonprofits must use the donations of small donors to pay for infrastructure then nonprofits cannot tell small donors truthfully how their donations are being spent.
8. If nonprofits cannot tell small donors truthfully how their donations are being spent, then nonprofits are violating their public trust.
9. If nonprofits are violating their public trust, then we can expect a regular series of scandals relating to how nonprofit funds are used.
10. If there is a regular series of scandals relating to how nonprofit funds are used, donations from small donors will be negatively affected.
11. If donations from small donors are negatively affected, major funders will increase in importance.
12. If major funders increase in importance, their values and requirements will determine the level of infrastructure spending in the sector.

Thus the practice of major funders in limiting their funding for infrastructure may lead to strengthening their ability to establish such standards.

### ***The Auditor***

The auditor plays an interesting minor role in the drama we have laid out so far. There is an apparent paradox between their roles as financial experts and independent attesters of financial statement fairness and the amount of underreporting of M&G and particularly fundraising that our research revealed. At this point, we have not studied nonprofit auditors directly. All we can say is that apparently, many nonprofit auditors provide wide latitude to nonprofits in classifying functional expenses, even beyond the supposed limits set by FASB and the IRS. How important their imprimatur is to major funders is not something we can presently speak to. To the extent that it is, auditors are implicated in the systemic structure we have laid out.

### *The Generic Structure*

Figure 5, with three positive feedback loops and three negative feedback loops, is a very complicated systemic structure. It would be desirable if it could be simplified, and even more desirable if the structure turned out to be one of the generic structures or archetypes that are so familiar.

Eliminating the underreporting dynamic from Figure 5 is a bit too drastic (see Figure 6) but reveals what remains as the familiar Limits to Growth generic structure. In this model, the major funder's preferred level of infrastructure spending is the limiting condition on organizational effectiveness. While this has the advantage of suggesting the key leverage point for improving the performance of the system, the model provides no guidance on how to go about doing this, since these preferences are exogenously determined in this model. The model has one other key limitation.

Based on our research, underreporting is too big an issue to leave out of the model altogether, but perhaps we don't need all the complexity of Figure 5. As noted above, additional infrastructure funds are unlikely to be spent to improve the quality of functional expense tracking. Thus we can prune that branch, eliminating two of our negative feedback loops. The resulting model, shown in Figure 7, is not one of the generic structures mentioned by Senge (1990). In this model, underreporting of infrastructure costs by NPOs is part of the causal process by which the preferences on levels of infrastructure spending held by major funders get set. We believe the theoretical model of Figure 7 strikes the best balance between comprehensiveness and simplicity, while squaring with the empirical data we have to date.

### *Conclusion*

Based on our research, NPOs are clearly struggling with inadequate administrative and fundraising infrastructure and it is having an impact on their organizational effectiveness. NPOs clearly implicate the funding preferences of their major funders as part of the causal matrix. If the analysis were to stop there, we would be left with a paradox: Why would funders who want their grantees to be effective, continue to engage in funding practices that limit the effectiveness of their grantees? The theory building that has been the task of this paper offers a potential explanation suggested by our empirical data: these practices are reinforced by the underreporting behavior that NPOs routinely engage in.

If our model is close to correct, then nonprofit sector is facing a very troubling situation, in which the level of infrastructure spending preferred by major funders is a key driver of NPO effectiveness, but the particular level preferred is not set with reference to a level of desired effectiveness, but through a fundraising dynamic where NPOs in effect compete on price for funding by having low infrastructure costs, and exacerbate the problem by reporting even less than the minimal amounts they actually spend.

How much should NPOs spend on infrastructure? What level of infrastructure spending ought major funders to prefer? No study by itself can answer these questions, but these appear to be the important questions for the sector. NPOs and major funders need to begin a serious conversation about infrastructure spending and its effects with the goal of improving NPO effectiveness sectorwide.

Research can inform that conversation in several valuable ways. By providing accurate information about what NPOs spend and what the organizational effectiveness consequences of that level of spending are, research could end the distortion caused by underreporting and help ground funding decisions in organizational effectiveness criteria. Research could identify NPOs that do invest more in infrastructure, and document the effectiveness of that practice. For example, bigger investments in development, volunteer management or finance could conceivably pay for themselves. Research could also compare levels of infrastructure spending in the nonprofit sector with the private sector.

Beyond this focus on NPOs, there are important questions to be answered about the behavior and decision calculus of the major funder, the small donor and the auditor. For example, it would be fascinating to study foundations and government agencies to identify their preferred level of infrastructure funding, how those preferences are communicated and how they originated.

### ***References***

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Figure 1

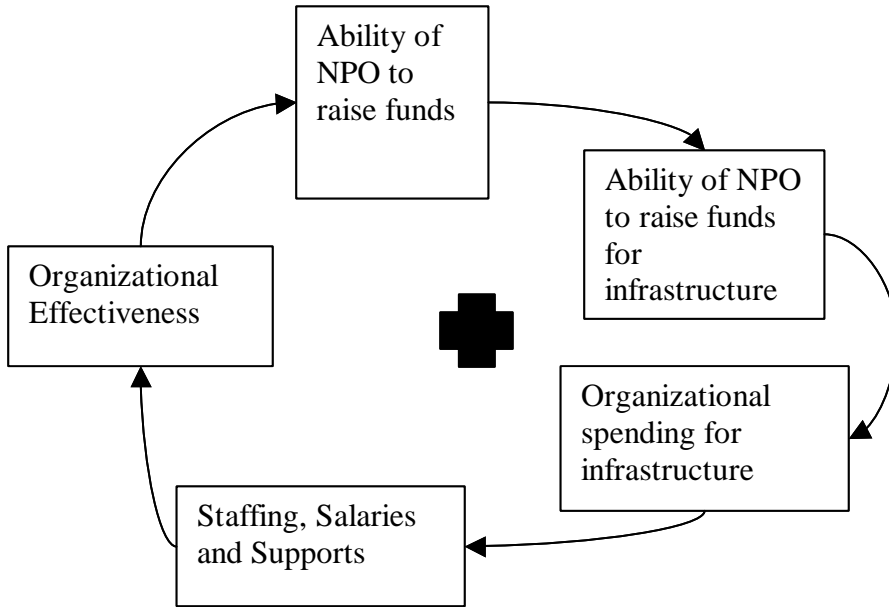


Figure 2

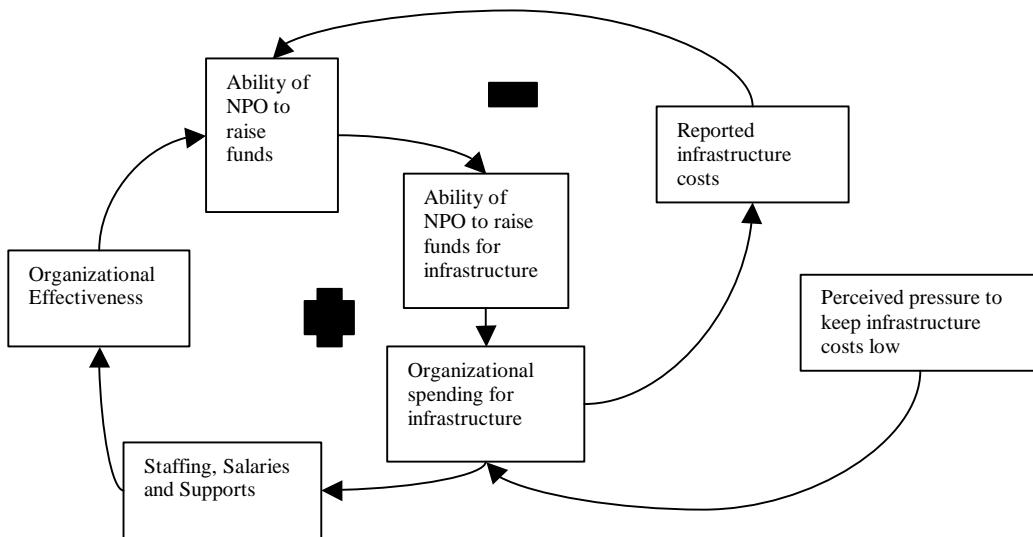


Figure 3

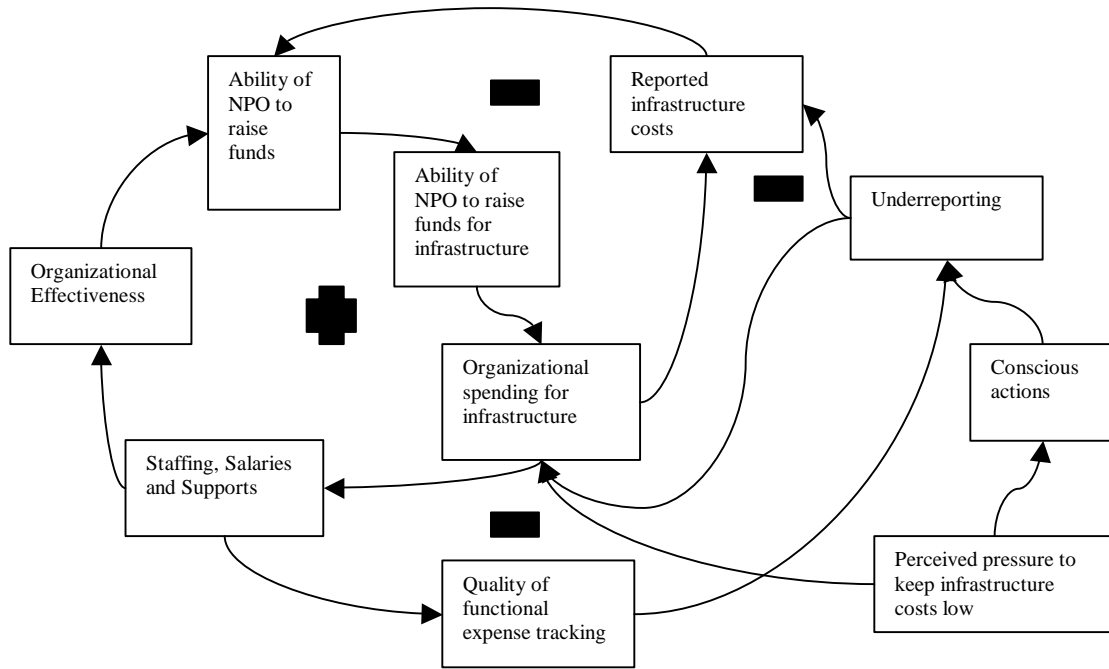


Figure 4

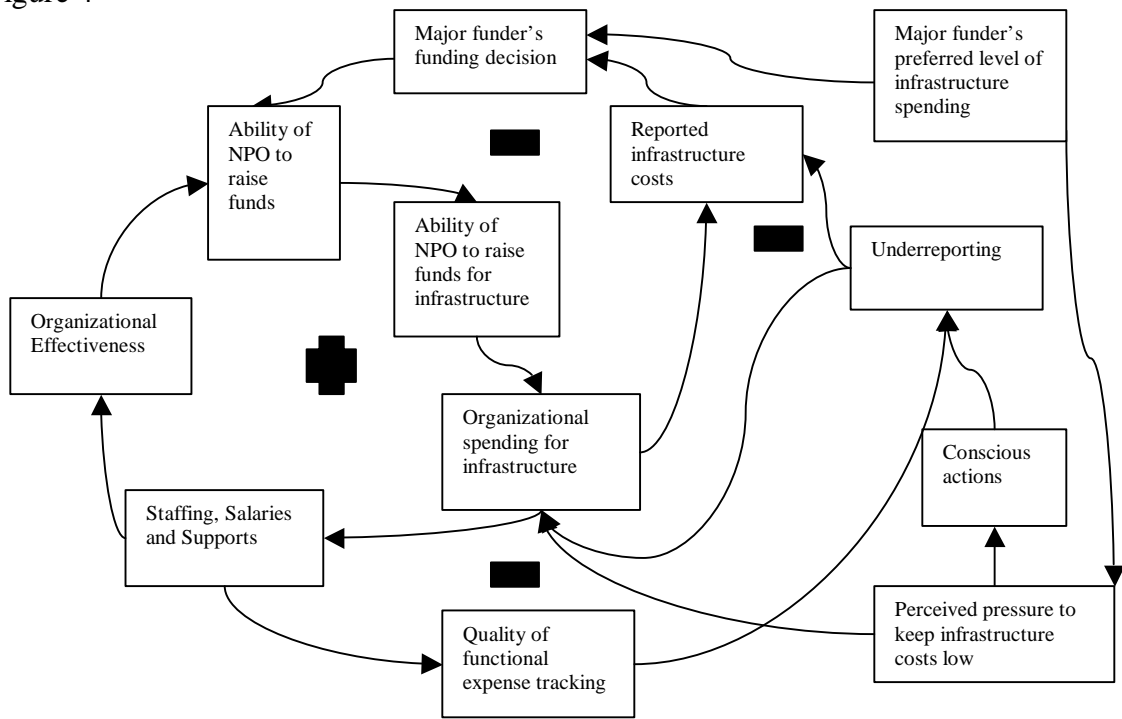


Figure 5

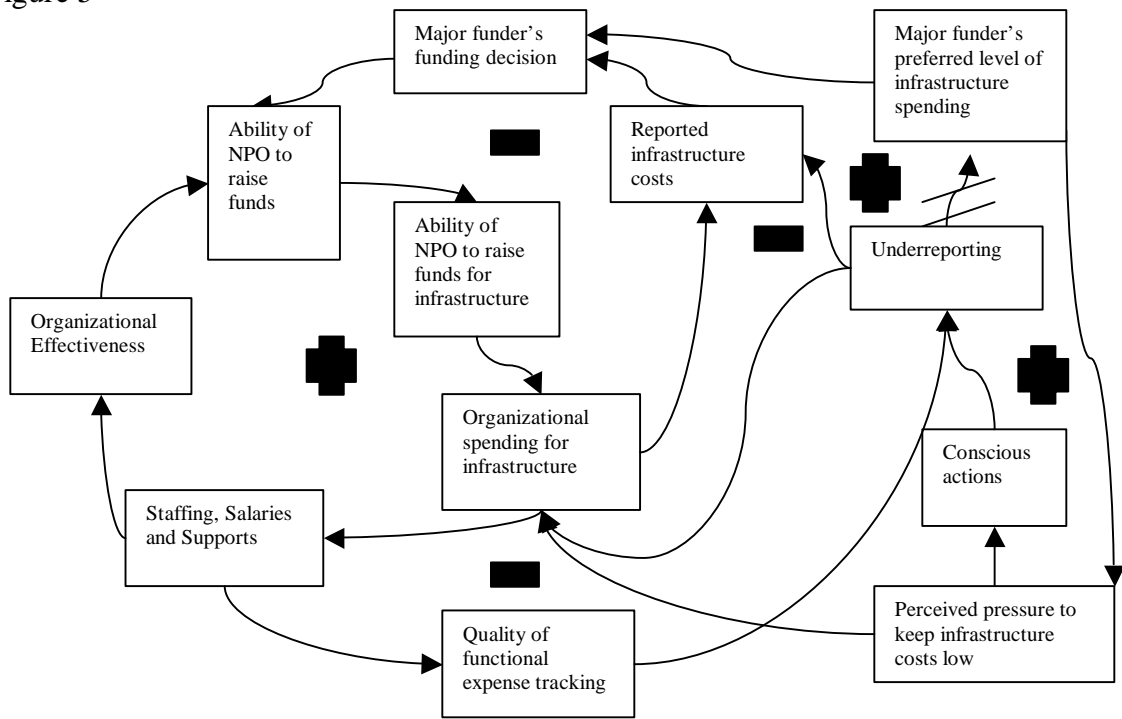


Figure 6

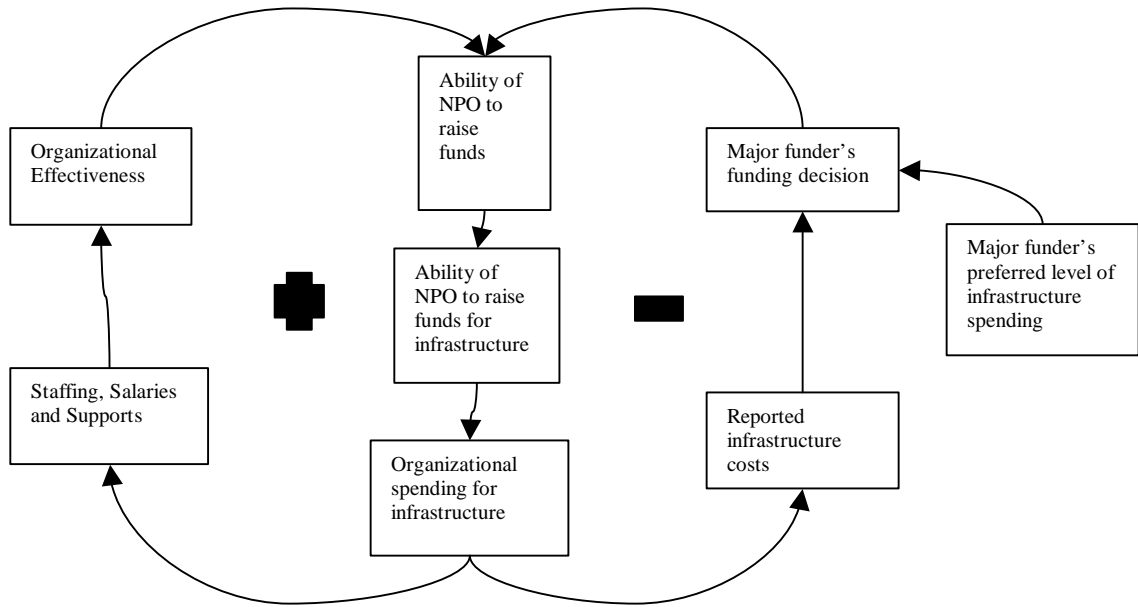


Figure 7

