# Cost allocation

Presented by

Danosky & Associates, LLC

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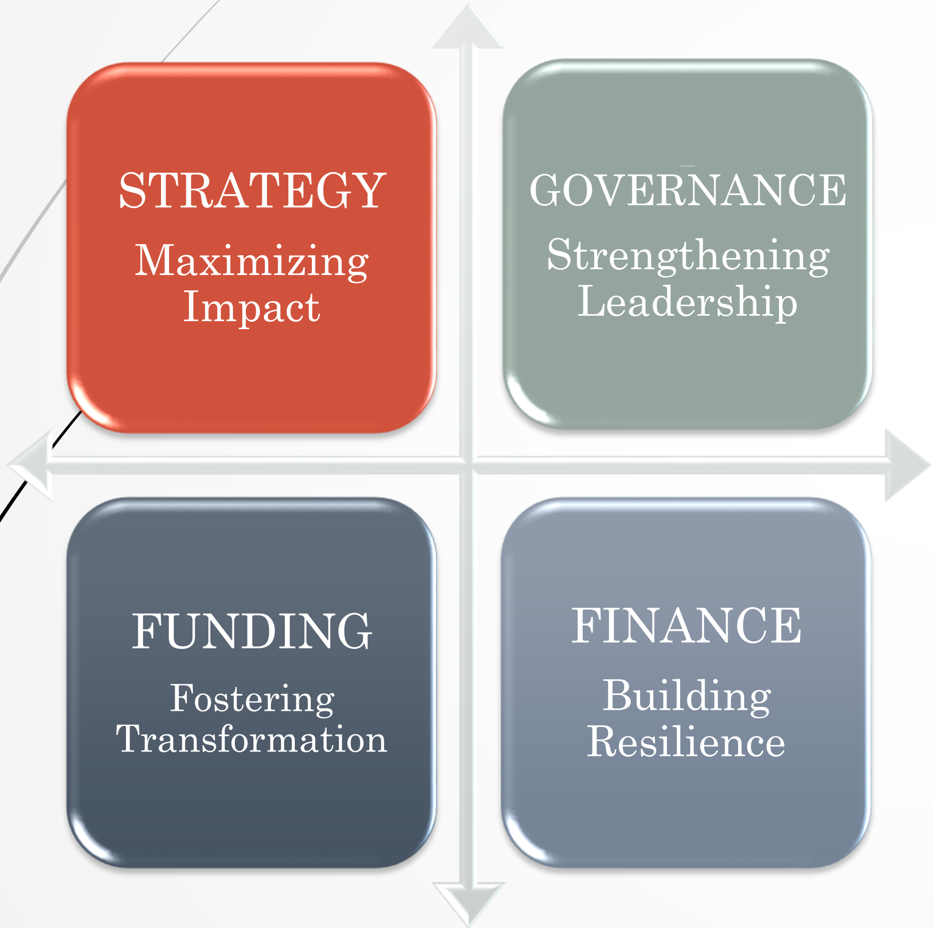
*Consulting for Nonprofits*

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**Our Vision:**
**Every nonprofit will have the capacity to make the world a better place.**

**Our Mission:**
**We provide nonprofits the guidance, support and tools necessary to build a better world.**

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# Introduction

## Sharon Danosky

Sharon Danosky is a BoardSource Certified Governance Trainer, and has conducted rousing seminars and workshops through her affiliations with national, regional and local associations and foundations. With 40 years in the nonprofit sector, 16 years as a consultant, Sharon knows how to drive change and achieve results.

## Susan Rosati

Susan Rosati is a business professional with twenty years' accounting experience. Her expertise includes working in the public, private and non-profit sector.  She is adept at working with small start-up organizations and large established companies. Her goal is to provide the information needed to help management make smart decisions in running their organization.

# Why Allocate?

- To comply with contract or grant requirements associated with a particular funding agreement. Most non-profit funders articulate the terms of applying indirect costs in the agreement, even if only to put a percentage cap. At the far end of compliance regulations tend to be government agencies – local, State & Federal
- To determine the total costs and profitability of a business unit, department, location, activity, award, etc.
- Many non-profit organizations may not be required to allocate costs for compliance purposes but may still want to allocate indirect costs to assess performance.

# What is Cost allocation?

- Cost allocation is the process of spreading shared expenses across significant program services and supporting activities, which are the functional classifications. This should include direct and indirect costs.
  - Direct costs:  costs that are directly identifiable to a specific program or activity.
  - Indirect costs:  costs incurred that benefit more than one objective and cannot be tied to one individual program or activity.

# Allocations align with the 990

- A nonprofit must classify those expenses into three functional areas – management and general and fund raising which are called support services and program which is how much money is actually spent on their mission.

- This breakdown is required for financial statement presentation to the general public and on the nonprofit's annual IRS Form 990 report. Functional expense reporting is another important financial measurement for the nonprofit. It provides information on how much of their resources are dedicated to their mission.

# Direct or Program Costs?

- Functional accounting calls for you to identify your organizations’ programs.
- Each program has its own functional expense classification – the costs associated with running that program.  These are called direct costs.
  - Salaries
  - Per-diem employees
  - Supplies
  - Training
  - Transportation

# Supporting Activities

- Each program is sustained by supporting activities.  These are indirect costs.
  - Management and general
  - Fundraising
  - Constituent development activities
- These costs must be allocated based on the proportion they support the activity.

# Cost Allocation Matters to Funders

- A formal cost allocation process can:
  - Identify the actual cost of services being provided.
  - Equitably share the costs of shared facilities and support services between departments, programs, and funds throughout the organization.
  - Ensure accuracy of cost-based user fees where the user pays a fee for service.
  - Relieve pressure on the general fund by allocating certain general fund costs to funds that receive a benefit from support services.
  - Comply with state law and minimize audit issues. State and federal funders require that all service rendered shall be paid at its true and full value and that no other program area shall benefit in any financial manner whatever by an appropriation or fund made for the support of another.
  - Receive reimbursement for allowable overhead costs from federal, state or private grants, to the extent that this is allowed by the grant. This usually requires a formal cost allocation plan with internal controls to assure accuracy. Federal monies require strict adherence to.

In other words, there are payor who are very precise that the funding they are providing shall only go to what they have agreed to pay. And you need to document that is so.

# Basic steps of cost allocation

- Identify shared facilities or support services.
- Identify the costs to be allocated.
- Determine the allocation factors/methodology to distribute the costs equitably.
- Allocate the costs.
- Update and monitor the data and methodology to ensure the allocation remains fair and equitable over time.

# Identify Shared Facilities or Support Services: <u>Indirect or Overhead Costs</u>

- **Which staff members or departments support multiple funds or programs?** Common examples include finance directors, payroll clerks, and facility maintenance staff, human resources, and IT.
- **What contracted services support multiple funds or departments?** Examples include a technology firm to provide IT services; phone services, or a company to maintain facilities or grounds.
- **What facilities and equipment are used by multiple departments or programs?** Are all of your departments and programs located in one central services? Did you purchase a piece of equipment (such as a vehicle or a copier) that will be used by multiple departments?

# Identify Costs

- Compile shared overhead functions and designate using either of the following methodologies:
  - Budget projections, which would have to include a monitoring component to make sure the projection is within a reasonable range (1%-5%).
    - 10% of human resources' staff allocate their time to a certain program.
  - Actual – using timesheet data or other accounting methodology.
    - Employees allocate their time as they go – using a spreadsheet or timesheet or some other means.
  - Hybrid – Do one year of a time study, use that percentage for future years.

# Determine Allocation Factors –

- How are you going to spread costs among various departments, funds or programs that benefit from shared services?
- Be sure to remove costs that should not be allocated.

- What allocation method makes the most sense? Allocation methods may vary depending on the type of cost. For instance, below are some common cost allocation methods:
  - Payroll and personnel: Number of full-time equivalents (FTEs) or number of hours worked within each department or fund.
  - Accounts payable/purchasing: Number of transactions for each department or fund.
  - Financial reporting and budgeting: Budget appropriation levels or year-end fiscal totals.
  - Facility operations and maintenance: Square footage or number of employees in the building for each department or fund.
  - Information technology: Number of computers, servers, databases, etc. for each department or fund.
- How will you document the cost estimates? For instance, when allocating wages, salaries, and benefit costs for services such as payroll, budget development, or financial reporting, conduct a periodic timesheet analysis.

# Cost allocation basis

An allocation base is the basis on which Cost accounting allocates overhead costs. An allocation base can be a quantity, such as square footage that is occupied., hours spent.

| Directly Allocated Cost | Basis |
|---|---|
| Facilities (Rent, Utilities) | Square feet of personnel, Expenses, FTE |
| Printing costs | # of prints/copies |
| Vehicle costs | Mileage records |
| IT payroll costs | Service tickets, # of program staff, # of computers |
| Insurance | Cost of property, FTE, Sq. Ft. |
| Human Resource | FTE by program |
| Administrative salaries | Salaries of program staff, FTE, T&E |

# Allocate Costs

- Allocate costs by applying the allocation factors to each department, program, or fund based on their proportionate share (a "one-step" methodology). Be sure to thoroughly and consistently document your calculations.
- Larger or more complex organizations would typically use either a "two-step" methodology.
  - Allocating overhead costs to direct users and to those departments that use the services of the direct users) or,
  - Reciprocal allocation methodology (allowing for overhead to be allocated back and forth between departments).
- Example:
  - Finance and Payroll Department cannot allocate all of the payroll costs to other departments and must retain some of those costs internally, because some of the time is spent on payroll for employees within the department.
  - The facility maintenance costs for an organization are being allocated on the basis of square footage per department.

# Update and Monitor the Data and Methodology

- Periodically review your cost allocation formulas and data to make sure they continue to accurately reflect costs. Incorporating an annual review as a pre-budget development step will help enhance your budget forecasting numbers and update your cost methodology.
- Key Questions to Consider:
  - What are your internal controls to ensure data accuracy and reviews? Incorporating internal control measures into the cost allocation plan demonstrates a commitment to accurate and reliable data.
  - Did you use estimates or budget projections (as opposed to actual costs) in your allocation process? If so, you should include a monitoring component at the end of the year to make sure that the estimated and actual costs are within the acceptable range as defined by your cost allocation plan. Any variances outside of the acceptable range will require adjustment.
  - How often will you update your calculations? You should review and update your data at least once a year, and perhaps more frequently for some figures such as public works timesheet information.

# Some Ways to Allocate

# Allocation by Time

- Employees can wear many hats.
- Estimate your time over on each department during each pay period. Allocation done with each timesheet.
- Some nonprofits will put in reasonable estimates.
- How to calculate: Employee spends 8 hours of a 40 hour work week on fundraising. They would charge 20% to fundraising.

# Square Footage Allocation

- Square footage method to allocate:
- 1. Rent
- 2. Cleaning
- 3. Utilities
- 4. Depreciation
- Example: Development office is 400 square feet.
- Total building space is 1800 square feet.
- Allocation would be (400/1800) or 22%.
- The accountant would allocate 22% of utility costs to Development department.

# Allocation by Head Count

| Ins Package | Annual Premium | Monthly Premium | Annual Unit Cost | Monthly Unit Cost |
|---|---|---|---|---|
| Liability | 14,000.00 | 1,166.67 | 777.78 | 64.81 |
| Umbrella | 1,500.00 | 125.00 | 83.33 | 6.94 |
| Terrorism | 70.00 | 5.83 | 3.89 | 0.32 |
| | | Total | 865.00 | |

| Program | Employee Count | Monthly Terrorism Premium | Annual Terrorism | Monthly Umbrella Premium | Annual Umbrella | Monthly Liabiltiy Premium | Annual Liability Premium |
|---|---|---|---|---|---|---|---|
| A&G | 2 | 0.65 | 7.78 | 13.89 | 166.67 | 129.63 | 1,555.56 |
| Program 1 | 1 | 0.32 | 3.89 | 6.94 | 83.33 | 64.81 | 777.78 |
| Program 2 | 7 | 2.27 | 27.22 | 48.61 | 583.33 | 453.70 | 5,444.44 |
| Program 3 | 2 | 0.65 | 7.78 | 13.89 | 166.67 | 129.63 | 1,555.56 |
| Program 4 | 6 | 1.94 | 23.33 | 41.67 | 500.00 | 388.89 | 4,666.67 |
| Total | 18 | 5.83 | 70.00 | 125.00 | 1,500.00 | 1,166.67 | 14,000.00 |

# Allocation of Health Insurance

| Health Ins | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Age Adjusted Monthly Premium | | | | Projected Annual Premium | | | Projected Monthly Premium | | | Projected Weekly Premium | | |
| Employee | Current Monthly Premium | Projected Increase Percentage | New Monthly Premium | Total Annual Premium | Company Annual 75% Contribution | Employees Annual 25% Contribution | Company Monthly 75% Contribution | Employee Monthly 25% Contribution | Monthly Premium Total | Company Weekly Contribution | Employees Weekly Contribution | Weekly Premium Total |
| **Program A** | | | | | | | | | | | | |
| Employee A | **627.43** | 15% | 722.00 | 8,664.00 | 6,498.00 | 2,166.00 | 541.50 | 180.50 | 722.00 | 124.96 | 41.65 | 166.62 |
| Employee B | **627.43** | 15% | 722.00 | 8,664.00 | 6,498.00 | 2,166.00 | 541.50 | 180.50 | 722.00 | 124.96 | 41.65 | 166.62 |
| Employee C | **627.43** | 15% | 722.00 | 8,664.00 | 6,498.00 | 2,166.00 | 541.50 | 180.50 | 722.00 | 124.96 | 41.65 | 166.62 |
| Employee D | **627.43** | 15% | 722.00 | 8,664.00 | 6,498.00 | 2,166.00 | 541.50 | 180.50 | 722.00 | 124.96 | 41.65 | 166.62 |
| **CSSE Total** | **2,509.72** | | **2,888.00** | **34,656.00** | **25,992.00** | **8,664.00** | **2,166.00** | **722.00** | **2,888.00** | **499.85** | **166.62** | **666.46** |
| **Program B** | | | | | | | | | | | | |
| Employee A | **627.43** | 15% | 722.00 | 8,664.00 | 6,498.00 | 2,166.00 | 541.50 | 180.50 | 722.00 | 124.96 | 41.65 | 166.62 |
| Employee B | **627.43** | 15% | 722.00 | 8,664.00 | 6,498.00 | 2,166.00 | 541.50 | 180.50 | 722.00 | 124.96 | 41.65 | 166.62 |
| Employee C | **627.43** | 15% | 722.00 | 8,664.00 | 6,498.00 | 2,166.00 | 541.50 | 180.50 | 722.00 | 124.96 | 41.65 | 166.62 |
| Employee D | **627.43** | 15% | 722.00 | 8,664.00 | 6,498.00 | 2,166.00 | 541.50 | 180.50 | 722.00 | 124.96 | 41.65 | 166.62 |
| **Housing Total** | **2,509.72** | | **2,888.00** | **34,656.0** | **25,992.0** | **8,664.0** | **2,166.0** | **722.0** | **2,888.0** | **499.8** | **166.6** | **666.5** |
| **Social Total** | **0.00** | | **0.00** | **0.00** | **0.00** | **0.00** | **0.00** | **0.00** | **0.00** | **0.00** | **0.00** | **0.00** |
| **Agency Total** | **5,019.44** | **15%** | **5,776.00** | **69,312.00** | **51,984.00** | **17,328.00** | **4,332.00** | **1,444.00** | **5,776.00** | **999.69** | **333.23** | **1,332.92** |

# Evaluate the most advantageous methodology

- Compliance requirements:
  - When determining whether to charge an expense as direct vs. indirect, the organization's compliance requirement arrangements are first considered.
  - For a grant or contact-dependent organization, funders may place artificial indirect rate caps or apply other prescriptive rules on what may or may not be considered direct. Sometimes funders refer to federal regulations like 2 CFR Part 200, and other times, funders create their own rules.
- Financial advantages:
  - Organizations should consider the best financial outcome of charging an expense as direct vs. indirect.
  - When funders place restrictive caps on the allowable percentage of indirect, it may be beneficial to allocate as many costs as possible directly to the funder, thereby reducing indirect costs and the indirect rate. This could maximize reimbursable costs potential losses.
- Cost-Benefit:
  - Organizations should determine whether analyzing, tracking, and allocating costs are worth it.
  - An organization must consider the right decision for them. For example, printing costs can often be directly charged to a particular award, department, or program by utilizing a key code for each print job. However, the benefit of charging printing directly may outweigh the staff time used to accomplish this.

# Document and Automate

- Document your cost allocation methodology.
  - Ensures consistent application.
  - Easier to explain to auditors, funders and management teams.
- If cost allocations are a necessary and ongoing process, develop a tool so you can effectively and consistently apply your policy.
  - An Excel template.
  - A template within your accounting system.

# Some pitfalls to avoid

- Costs must be expensed as direct or indirect and not applied situationally to both.
  - Once classed as indirect, the same expense should generally not be charged as direct.
  - For example, an Executive Director's wages should generally not be charged as direct on some awards or indirect on others. There may be minor exceptions, but they should be small and justifiable.
- All programs/awards should be allocated their fair share of direct and indirect costs, even if a funder won't pay for it or can not afford the allocation.
  - This shortcut will distort the profitability of both the program/award not applied AND all remaining programs/awards that did receive an allocation.
  - This practice is also not in compliance with federal regulations.

# How to Track Grants?

# Where do Grants come from?

- 1. Government – federal, local or state.
- 2. Public Charities – recipient is in line with their mission.
- 3. Community Foundations – local to area.
- 4. Family Foundations – smaller funding sources.
- 5. Private Foundation.

# Accounting for Government Grants

- Grants are support from the government by either cash or in-kind. They must comply with the conditions and meet the prescribed obligation.
- Organization must adopt an appropriate accounting method to account for government grants – income vs. capital approach (P&L or Balance Sheet).
- Grants are considered revenue and must be received when it is received or pledged.
- Organization must indicate amount of benefit derived from government grant during the reporting period.

# Income Approach – Government Grants

- Government grants are treated as income over one or more periods.
- Grant is considered income and you must match some income with the costs that the grant tends to compensate.
- The benefit can be estimated on a prudent basis. This estimate is credited to the income of the reporting period.
- Deferred Income – when the grant will cover a future time period.

# Types of Grants

- Unconditional Grants – no conditions.  This is more typically a grant from a private foundation.  Some reporting is usually expected.
  - What did you learn?
  - What outcomes to you achieve?
  - Is this what you expected to achieve – why or why not?
- Conditional Grants – designated usage requirements. Organization must comply with the conditions attached to the government grant or private foundation.  You will have to provide documentation that you have done so.
- Reimbursable Grants – Dedicated purpose or project. You provide all the upfront costs using your resources then you're reimbursed by providing documentation.
  - Cost reimbursement process.
  - Allowable / Unallowable.

# Matching Principal

- Record the revenue the moment that it is received or the pledge is made.
- Reasonable Assurance – you will receive the grant…book it.
- Different fiscal year – When you recognize the grant in a different year then receiving it. Book a receivable.
- Mistakes on accounting can provide misleading and inaccurate information.

# Best Practice – Keep it Simple

- Cost Allocation can be extremely complicated to track.
- Federal guidelines (within 2 CFR Part §200:403-405) state that costs must be allowable, reasonable, and allocable.
- No universal rule for classifying costs as indirect or direct.
- Perfection is not required – reasonable.
- Can you defend an allocation using logic and reason.
- Revisit and revise the allocations.

# Pitfalls and Benefits

# What is the impact of poor cost allocation?

- Management may incorrectly assess profitability by business unit, department, location, activity, award, etc. This could result in expanding or closing a particular activity while using inaccurate data.

- Non-profit organizations have one or more grants or contracts that stipulate cost allocation requirements. Failure to follow these rules could result in a breach of contract, repayment to funders, and audit findings.

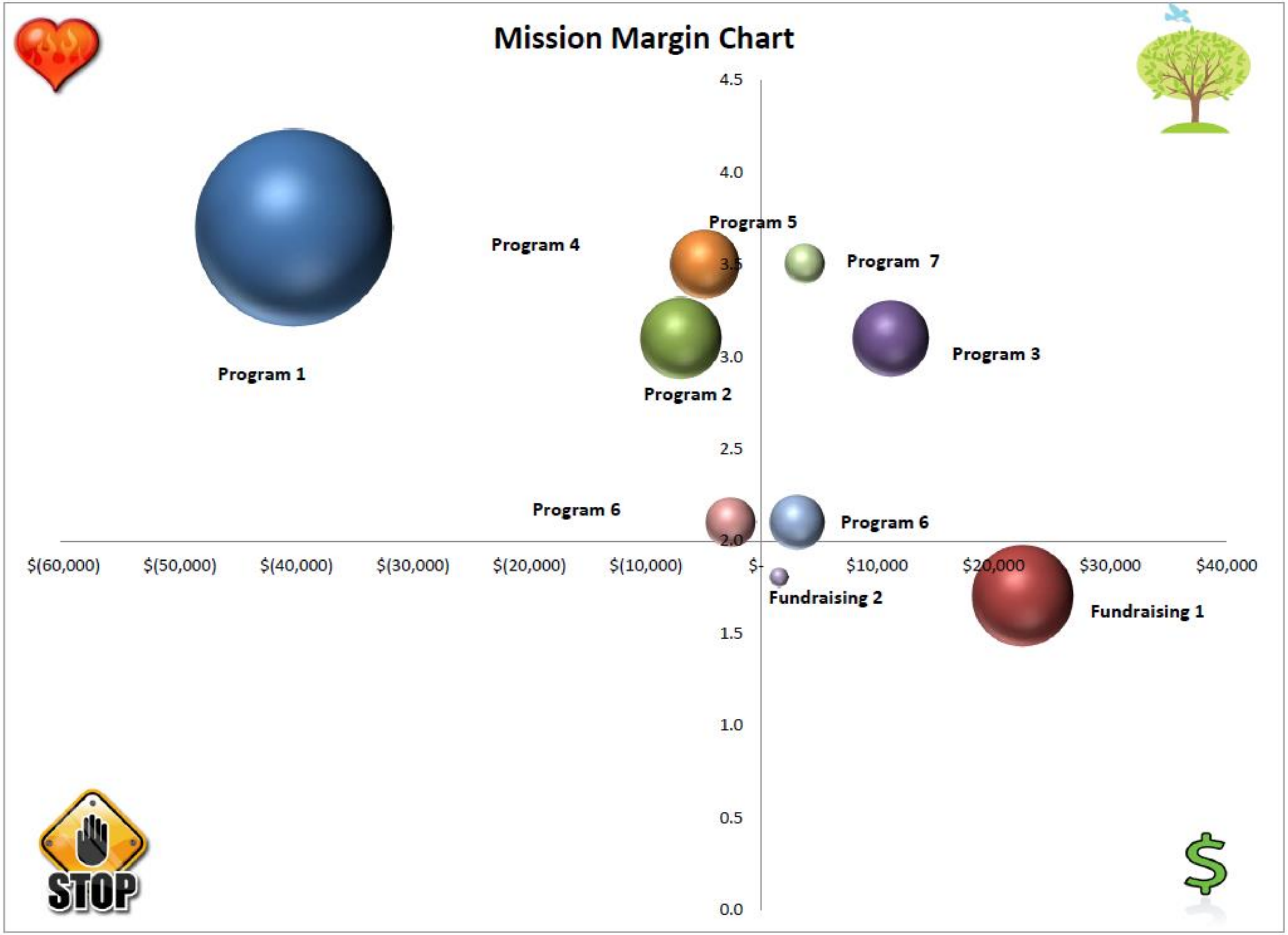
- Poor cost allocation methodology may result in unrecovered costs from funders, which forces an organization to use unrestricted funds to make up the shortfall or result in net losses to the organization.

# Benefits

- Internal:
  - A better understanding of the true costs of specific programs, which allows you to set appropriate funding (and fundraising) goals to help ensure program sustainability.
  - A program with high costs may be worthwhile if the mission impact is also high, but you may need to generate additional revenue to cover it.
  - With proper allocation, you can make better financial decisions and more effectively assess the cost-benefit of individual programs and fundraising efforts.
- External:
  - Meeting the IRS's expectations is only one way allocating your expenses properly can benefit your nonprofit from the outside.
  - Donors, grantors, and other funding sources review financial information when deciding how to contribute (or whether to contribute at all).
  - You'll want to ensure your allocation methods are not inadvertently overstating management and general expense, while ensuring program costs are being fairly presented.

# Using allocation to measure financial viability

- What is the profitability of a particular program?
- What percentage of expenses does the program require?
- What is the mission impact?
  - Mission alignment
  - Excellence in execution
  - Scale
  - Depth
  - Filling an important gap
  - Leverage
  - Community Building



Mission Margin Chart
4.5
4.0
Program 5
Program 4
3.5
Program 7
3.0
Program 3
Program 1
Program 2
2.5
Program 6
Program 6
2.0
$(60,000)
$(50,000)
$(40,000)
$(30,000)
$(20,000)
$(10,000)
$-
$10,000
$20,000
$30,000
$40,000
Fundraising 2
Fundraising 1
1.5
1.0
0.5
STOP
0.0

For most nonprofit organizations, the art of making tradeoffs is a condition of survival as well as a key element of success. Nonprofit leaders constantly make choices about the most effective way to allocate available resources among competing priorities.

The consequences of these tradeoffs are visible daily: in the activities a nonprofit offers, the programs it supports, and the initiatives it pursues. Together, they constitute the engine that either drives the organization’s strategy forward or renders it irrelevant.

Resource-allocation decisions present one of the most powerful levers nonprofit executives can apply to achieve their organization’s goals. *The Bridgespan Group*

**Know how you are spending the resources you are raising to achieve the greatest good**