



# The Basics of Nonprofit Cost Allocations

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# Part I

# Cost allocation for financial statement purposes

# Expense classifications

- **Functional expense classifications** tell *why* an expense was incurred
- **Natural expense classifications** tell *what* was incurred

# Classes of functional expenses

- Per GAAP (Generally Accepted Accounting Principles), there are four classes of functional expenses for NPOs:
  - Program services
  - Management and general
  - Fundraising
  - Membership development
- The last three are called “supporting activities”

# Functional classifications

- Program services:
  - Activities that result in the distribution of goods & services to the NPO's beneficiaries, members, or customers
  - Costs related to providing a nonprofit organization's programs or social services
- Management and general:
  - Overall administration of the NPO
  - Activities include oversight, business, management, record keeping, budgeting, accounting, etc.

# Functional classifications

- Fundraising:
  - Costs involved with soliciting *contributions*
  - The expenses incurred when soliciting funds other than contributions and membership dues should be classified as management and general expenses
- Membership development:
  - Costs involved with soliciting *members*
  - If there are no significant benefits or duties connected with membership, the substance of membership development activities might be fundraising costs

# “Direct costs”

- Are clearly identified with, or directly related to, a single objective or purpose
- Should be directly assigned a functional classification; no actual allocation is involved
- GAAP does not actually use the term “direct cost” – it discusses expenses that can be identified with a specific function

# “Indirect costs”

- **Cannot be** clearly identified with, or directly related to, a single objective or purpose
- Need to be **allocated** to the appropriate functions
- GAAP does not actually use the term “indirect cost” – it indicates expenses that benefit more than one function should be allocated



# Assignment of direct expenses

- If an expense can be specifically identified with a program service or supporting activity, it should be directly assigned to that function
- As much as possible, this should be done during the invoice approval and/or recording process

# Important distinction

## **Indirect Costs**

are NOT the same as

## **Supporting Activities**

- *Rent* is an indirect cost, but it can be allocated to program services
- *Accounting* is a direct cost, directly assigned to management and general (a supporting activity)

# Allocation of indirect costs

- Basic, overriding question: what is the **PURPOSE** of the cost?
- Common specific methods of assigning purposes to indirect costs:
  - Cause and Effect relationships - what activities **CAUSED** the cost to be incurred?
    - Time (the hour is the “cost driver”)
    - Space/area (the square footage is the “cost driver”)
  - Benefits Received
    - Direct costs can be used as a proxy, if indirect costs benefit all functions approximately equally

## There is often not just one “correct” approach

- Any allocation method can work if it's rational, reasonable, consistently applied, and documented
- GAAP requires financial statement disclosures to include an explanation that preparation of financial statements requires the use of management's estimates. Functional expense allocation is often one of the most significant estimates that NPOs encounter.

# Cost allocation: an example

## Preliminary functional assignments

	Program Services	Management & General	Fundraising	Indirect
Program staff	250,000			
Other staff				94,000
Fundraising event			10,000	
Program supplies	40,000			
Office supplies				6,000
Rent				10,000
Utilities				4,000
Accounting		6,000		
Totals	\$ 290,000	\$ 6,000	\$ 10,000	\$ 114,000

# Cost allocation: an example

All indirect costs allocated on the basis of **time** that “Other staff” spends on functional areas

Per a time study:

Other staff’s time spent 69% on program activities, 27% management & general, 4% fundraising

	Program Services	Management & General	Fundraising	Indirect
Program staff	250,000			
Other staff	65,000	25,000	4,000	(94,000) <i>time study</i>
Fundraising event			10,000	
Program supplies	40,000			
Office supplies	4,149	1,596	225	(6,000) <i>time study</i>
Rent	6,915	2,660	426	(10,000) <i>time study</i>
Utilities	2,766	1,064	170	(4,000) <i>time study</i>
Accounting		6,000		
Totals	\$ 368,830	\$ 36,319	\$ 14,851	(\$ 114,000)

# Cost allocation: an example

“Other staff” costs allocated on the basis of staff time (69% 27%, 4%, per prior slide)

Other indirect costs allocated per **area**. The square footage of functional areas:

67.5% for program services; 20% for management & general; 12.5% for fundraising

	Program Services	Management & General	Fundraising	Indirect
Program staff	250,000			
Other staff	65,000	25,000	4,000	(94,000) <i>time study</i>
Fundraising event			10,000	
Program supplies	40,000			
Office supplies	4,050	1,200	750	(6,000) <i>square footage</i>
Rent	6,750	2,000	1,250	(10,000) <i>square footage</i>
Utilities	2,700	800	500	(4,000) <i>square footage</i>
Accounting		6,000		
Totals	\$ 368,500	\$ 35,000	\$ 16,500	(\$ 114,000)

# Joint costs

- Joint costs = costs of activities that have a fundraising component as well as other component(s)
- Tests required for purpose, audience, and content
- Unless all three tests are met, ALL the costs of the joint activity must be considered fundraising
  - Purpose: does the purpose of the joint activity include accomplishing program or management and general functions?
  - Audience: does the audience include prior donors, or was it selected in part based on its ability or likelihood to contribute? (If so, the NPO needs to demonstrate that this was not a significant factor in its selection)
  - Content: does the activity support program or management and general functions?



## Part II

# Cost allocation for IRS 990 purposes

# IRS Form 990 expense allocations

- 501(c)(3) and (c)(4) NPOs must allocate expenses to functions in Part IX of the 990
- Per IRS instructions:
  - Use the organization's normal accounting method to complete the schedule
  - If the organization's accounting system doesn't allocate expenses, the organization can use any reasonable method of allocation

# Functional categories

- Only three categories of expenses on the IRS form 990: Program, Management and General, and Fundraising
  - Membership development expenses per GAAP need to be reallocated (commonly to management and general)

# IRS expense categories

- Primary natural expense categories have been pre-set by the IRS
- Some expenses are removed, and placed on different parts of the 990:
  - Rental expenses (that are associated with rental income activities)
  - Costs of inventory sold
  - Direct expenses of fundraising events
  - Gaming expenses

# 990 program services CAN include:

- Lobbying (if that's a purpose)
- Costs to obtain awards used for program purposes
- Unrelated business activities
  - Unrelated business activities costs must be directly connected with the revenue source, have proximate & primary relationship to it, be reasonable and consistently followed, and must be allowable (ordinary & necessary)

# Joint costs disclosed on the 990

- Joint costs are disclosed at the bottom of Part IX of the 990 (if such costs were incurred from a combined educational campaign and fundraising solicitation)
- Also, must disclose *how* the total joint costs of all such combined activities were allocated

## Part III

# Cost allocation for Government award purposes

# Cost allocations to government awards

Authoritative guidance: OMB Circular A-122 (Cost Principles for Non-Profit Organizations), which is now subsumed into the Uniform Guidance (Subpart E of 2 CFR 200)



# General rules

- The OMB Circular A-122 rules were established for federal awards, but many other government entities follow the same principles
- **May NOT** allocate costs based on how much unused funding remains with an award
- Written cost allocation plans are **REQUIRED** for NPOs that receive federal awards

# Determine whether a cost is allowable

Among other things, a cost must be

- Reasonable (ordinary & necessary)
- Adequately documented

# Federal allocation methods

Allowable cost allocation methods per the Uniform Guidance:

- Starting with allocations of direct costs to “cost objectives”:
  - Simplified allocation method
  - Multiple allocation base method
  - Use of specific indirect cost rates
- Starting with allocations of all costs to functions:
  - Direct method
  - Use of specific indirect cost rates

# Determining the direct costs

Direct costs in this context have a somewhat different meaning here than for financial statement allocations. For federal award purposes, direct costs are identified specifically with a *cost objective*

- A cost objective is a specific award, or a “direct activity” of the NPO.
  - Expenses that **can be** allocated to an award **should be** directly allocated to that award
  - Expenses not directly allocable to an award must still be considered “**direct**” if directly identified with serving the NPO’s members, clients, or the general public
  - Fundraising costs are also **direct**

# Simplified allocation method

Allocate the **indirect costs** to all the **direct cost categories** proportionally, by some logical rate

- Can be used if all its major functions benefit from indirect costs by approximately the same degree
- Divide indirect costs by "rate base" (total direct costs or other base)
  - "Other base" can be direct salaries/wages, or some other base that results in an equitable distribution
- To each award or other cost object, multiply the calculated indirect rate by the direct cost base
- **Important:** need to allocate to ALL the direct cost categories, not just the awards

# Multiple allocation base method

- Set up "indirect cost pools" of different categories - depreciation, interest, operation and maintenance, general administration
- Each of those indirect cost pools is allocated to each award or other cost object based on its *own* base (method), as prescribed by the Uniform Guidance

## Can also use a specific indirect cost rate

- A nonprofit organization can propose and negotiate a rate with its “cognizant agency” (federal agency with the largest dollar value of awards)
- Can also utilize a de Minimis 10% indirect cost rate for federal awards
- Simply add the fixed percentage of indirect costs to the direct costs assigned to the award

# Direct method

- A different starting point than the other methods: costs have been allocated similarly to what is done for financial statement purposes (with expenses allocated directly to awards when possible)
- Per the Uniform Guidance instructions:
  - Consider ALL costs to be direct costs (except general administration and general expenses)
  - Direct allocation of costs to general administration and general expenses; fundraising; and other direct functions
  - Costs that need to be allocated – “joint costs” – are prorated DIRECTLY to each award and functional category based on a pre-determined rate
  - Then, the indirect “general” costs are allocated to the direct bases, under the same rules as the simplified allocation method
- This is allowable, PROVIDED each cost:
  - is prorated using a base which accurately measures the benefits provided to each award/activity,
  - the bases are established with reasonable criteria, and
  - the bases can be supported with current data



# Example: preliminary assignments to cost objectives

	<u>Direct costs:</u>				<u>:</u>	
	<u>Award A</u>	<u>Award B</u>	<u>Unassigned</u>	<u>Fundraising</u>		<u>Indirect</u>
Program staff	175,000	55,000	20,000			
Other staff						94,000
Fundraising event				10,000		
Program supplies	9,000	25,000	6,000			
Office supplies						6,000
Rent						10,000
Utilities						4,000
Accounting						6,000
Totals	\$ 184,000	\$ 80,000	\$ 26,000	\$ 10,000		\$ 120,000

**Not** a functional allocation per GAAP

# Simplified allocation method: direct costs as the rate base

Indirect costs: 120,000    Direct costs: 300,000

40% Indirect cost rate

	<u>Award A</u>	<u>Award B</u>	<u>Unassigned</u>	<u>Fundraising</u>	<u>Indirect</u>
Program staff	175,000	55,000	20,000		
Other staff					94,000
Fundraising event				10,000	
Program supplies	9,000	25,000	6,000		
Office supplies					6,000
Rent					10,000
Utilities					4,000
Accounting					6,000
Preliminary totals	184,000	80,000	26,000	10,000	120,000
Indirect allocations	73,000	32,000	10,400	4,000	(120,000)
Totals	\$ 257,600	\$ 112,000	\$ 36,400	\$ 14,000	\$ 0

# Simplified allocation method: direct wages as the rate base

Indirect costs: 120,000    Direct wages: 250,000

48% Indirect cost rate

	<u>Award A</u>	<u>Award B</u>	<u>Unassigned</u>	<u>Fundraising</u>	<u>Indirect</u>
Program staff	175,000	55,000	20,000		
Other staff					94,000
Fundraising event				10,000	
Program supplies	9,000	25,000	6,000		
Office supplies					6,000
Rent					10,000
Utilities					4,000
Accounting					6,000
Preliminary totals	184,000	80,000	26,000	10,000	120,000
Indirect allocations	84,000	26,400	9,600		(120,000)
Totals	\$ 268,000	\$ 106,400	\$ 35,600	\$ 10,000	\$ 0

# Use of indirect cost rate

Using the 10% de Minimis indirect cost rate

	<u>Award A</u>	<u>Award B</u>	<u>Unassigned</u>	<u>Fundraising</u>	<u>Indirect</u>
Program staff	175,000	55,000	20,000		
Other staff					94,000
Fundraising event				10,000	
Program supplies	9,000	25,000	6,000		
Office supplies					6,000
Rent					10,000
Utilities					4,000
Accounting					6,000
Preliminary totals	184,000	80,000	26,000	10,000	120,000
Indirect allocations (10%)	18,400	8,000	2,600	1,000	(30,000)
Totals	\$ 202,400	\$ 88,000	\$ 28,600	\$ 11,000	\$ 90,000

# Direct method example

Preliminary assignment of costs

(A different starting point than the other methods)

	<u>Award A</u>	<u>Award B</u>	<u>Unassigned</u>	<u>General Expenses</u>	<u>Fundraising</u>
Program staff	175,000	55,000	20,000		
Other staff			65,000	25,000	4,000
Fundraising event					10,000
Program supplies	9,000	25,000	6,000		
Office supplies			2,500	1,200	750
Rent			8,000	2,000	1,250
Utilities			3,000	800	500
Accounting				6,000	
Totals	\$ 184,000	\$ 80,000	\$ 104,500	\$ 35,000	\$ 16,500

# Direct method: direct costs as the rate base

General Expenses: 35,000 Direct costs: 385,000

9% General Expenses allocation rate

	<u>Award A</u>	<u>Award B</u>	<u>Unassigned</u>	<u>General Expenses</u>	<u>Fundraising</u>
Program staff	175,000	55,000	20,000		
Other staff			65,000	25,000	4,000
Fundraising event					10,000
Program supplies	9,000	25,000	6,000		
Office supplies			2,500	1,200	750
Rent			8,000	2,000	1,250
Utilities			3,000	800	500
Accounting				6,000	
Preliminary totals	184,000	80,000	104,500	35,000	16,500
General expense allocations	<u>16,727</u>	<u>7,273</u>	<u>9,500</u>	<u>(35,000)</u>	<u>1,500</u>
Totals	\$ 200,727	\$ 87,273	\$ 114,000	\$ 0	\$ 18,000

# Thank You!!

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