Controller's Office

Cost Allocation Methodologies
for
Nonprofit Organizations

Informational Session

June 7, 2005

Controller’s Office

Nonprofit Training Series:

- Per the City Charter, Controller has responsibility to protect the financial and functional integrity of City government. Controller is providing assistance to departments and their nonprofit contractors to meet this obligation.
- Training is for nonprofits contracting with the City.
- Goal of training series is to increase awareness of financial requirements and to increase the proficiency of nonprofit financial staff.

Agenda

10am Introductions

10:15am Cost Allocation Methodologies
- Hydeh Ghaffari, CPA, *Ghaffari Zaragoza LLP*
- Jeanne Peters, COO and Finance Technical Assistance Specialist, *CompassPoint*

11:30am The City's Perspective
- Monique Zmuda, Deputy Controller

11:45am Questions and Wrap-Up

Regulatory Framework

Financial Accounting Standards Board

- Generally Accepted Accounting Standards (GAAP)

Office of Management & Budget (OMB)

- Cost Principle: Circular A-122*

Non-federal Funding Sources

- CCSF grants and contracts – reasonable and applicable
- Private Sources – if none stated, GAAP

*http://www.whitehouse.gov/omb/circulars/a122/a122.html

Regulatory Framework

Which is applicable?

GAAP

- Where does the cost belong?
- What is the true cost of the organization’s activities?

OMB

- Should the Federal government pay for the cost?

Non-federal Funding Sources

- Should the non-federal source pay for the cost?
- *Note: if reasonable and applicable, City payment would be allowed*

Generally Accepted Accounting Principles (GAAP)

Key Objective of Cost Allocation

Business Analysis

The ability to understand the true financial performance of each core activity.

Consistent *Internal* Language

Activity (program, administration, fundraising)

Overhead (administration, fundraising)

Activity-specific (associated with one program)

Common (shared by two or more activities)

Examples of Overhead

Administration

- General Finance
- Portion of ED
- Board-related
- General Legal

Fundraising

- Grant Writing
- Events
- Postage
- Printing/graphics

Activity vs. Source

- Activities are the core functions of the organization; funding sources come and go.
- Activities are reported on Form 990 and on the Statement of Functional Expenses.
- An activity can and often will have more than one funding source.

Identifying Activities

Example: Agency X

- Point of Entry/Support Services
- Housing Services
- HIV Specialty Services
- Educational and Employment Services
- Administration
- Fundraising

Types of Costs

Example: Agency X

- Program Director, HIV Specialty Services = ACTIVITY SPECIFIC/PROGRAM
- Finance Director = ACTIVITY SPECIFIC/ADMINISTRATION
- Office supplies shared by two or more activities = COMMON

Employee Time Tracking

- Both business analysis and cost recovery *require* good employee time tracking
- Grants/contracts and "chicken or the egg" problem
- Exempt employees still need to document their time across activities

Allocation of Common Costs

<u>Line-by-line</u> based on unique criteria:

- Rent on square footage
- Telephone on system codes

<u>Below-the-line</u> using common cost pool(s) and a rational <u>allocation basis</u>:

- FTE per activity
- Specific costs per activity
- NOT available resources!

Allocation of Overhead Costs

- For cost recovery purposes (not GAAP or Form 990), do you want to allocate to programs the organization's administrative costs? fundraising costs?
- Allocation basis will be percent of total program costs.

Office of Management and Budget (OMB)

Key Objectives of Cost Allocation

Cost Recovery:

- The ability to maximize those costs covered by Federal agencies

- Plan for subsidizing expenses that are not covered by Federal agencies

Cost Principles

- OMB Circular A-21
  (only for nonprofit educational institutions)
- OMB Circular A-87
  (only for governmental agencies)
- **OMB Circular A-122**
  (for all other nonprofits)

OMB Circular A-122

Cost must be:

- <u>Reasonable</u>
  - Ordinary and necessary
  - Comparable to market prices
- <u>Allowable</u>
  - Per the Circular
- <u>Allocable</u>
  - Benefit the cost objective funded

OMB Circular A-122

Cost Objective

- An award (Housing services for residents of City of San Francisco)
- A project/service (One-on-one employment counseling)
- An activity (Housing services, HIV specialty services, educational & employment services)

OMB Circular A-122

Charges to Federal awards may include:

- <u>Allowable Direct</u>

  Support must show the cause-benefit relationship

- <u>Allocable Indirect</u>

  Obtained through indirect cost rate negotiation

Indirect Cost Rate

- **Calculated at organization-wide level**
- **Based on projections for the future**
- **Types include:**
  - Provisional rate
  - Final rate
  - Predetermined rate
  - Fixed rate

Indirect Cost Rate

A ratio:

- Numerator = Allowable indirect
- Denominator = Direct distribution base, less distorting costs

Methods of calculation include:

- Direct
- Simplified
- Multiple-base

Indirect Cost Rate

Indirect cost may be:

- A <u>functional</u> classification (e.g., administration and common)
- A <u>natural</u> classification (e.g., rent, utilities, telephone)

Indirect Cost Rate

Rate varies depending on:

- Selected method of common cost allocation
- Selected base for allocation

Little or no effect on $ recovery

Indirect Costs vs. Direct Costs

(Example Agency Y: Simplified Method)

	Administration	Fundraising	Program	*Common*
Salaries	*2,500*	1,500	15,000	*1,000*
Rent	*0*	0	0	*6,000*
Supplies	*100*	500	1,800	*1,200*
Travel	*500*	300	2,500	0
Total	***3,100***	**2,300**	**19,300**	***8,200***

Allocation base = direct cost

$$\frac{\text{Indirect cost}}{\text{Direct cost}} = \frac{3{,}100 + 8{,}200}{2{,}300 + 19{,}300} = 52\%$$

Allocation base = direct salaries

$$\frac{\text{Indirect cost}}{\text{Direct salaries}} = \frac{3{,}100 + 8{,}200}{1{,}500 + 15{,}000} = 68\%$$

Indirect Costs vs. Direct Costs
(Example Agency Y: Direct Method)

	Administration	Fundraising	Program	*Common*
Salaries	*2,630*	1,570	15,800	*0*
Rent	*780*	420	4,800	*0*
Supplies	*256*	584	2,760	*0*
Travel	*500*	300	2,500	*0*
Total	***4,166***	**2,874**	**25,860**	***0***

Allocation base = direct cost

$$\frac{\text{Indirect cost}}{\text{Direct cost}} = \frac{4{,}166}{2{,}874 + 25{,}860} = 14\%$$

Allocation base = direct salaries

$$\frac{\text{Indirect cost}}{\text{Direct salaries}} = \frac{4{,}166}{1{,}570 + 15{,}800} = 24\%$$

Documentation Requirements for Personnel Costs

Personnel files

Time activity reports/substitute system

- After-the-fact determination
- Budgets are not acceptable
- Signed by employee or immediate supervisor
- Prepared at least monthly

Same rules apply to volunteers

Vacation Pay

- In the form of regular compensation during the absence
- In the form of accrued expenses, in accordance with policy
- Absorbed by all organization activities in proportion to the relative amount of time or effort actually devoted to each

Non-federal Funding Sources (CCSF)

The City's Perspective

- **Clarifying Expectations**
- **"Reasonable and Documented"**

  Reasonable = allocable, legal (not prohibited by City law), based on methodology

  Documented = time studies, actual costs, written plan approved by ED and/or Board
- **Other Issues**

  - Approval of indirect cost methodologies
  - Charging costs not reimbursable by funding source
  - Varying indirect rates imposed by City depts.
  - Charging accrued sick leave/vacation, etc.

Next Steps

Follow-up actions by the City:

- Directive on accrued sick leave/vacation charges
- City guidelines on cost allocation plan methodology
- Clarification of indirect cost limits
- Additional trainings
- Ongoing audits

Wrap-Up and Questions

For future trainings and related resources:

http://www.sfgov.org/site/controller

(Click on ‘Resources for Nonprofits’)