

# Demystifying Allocations

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## Today's Agenda

- I. Overview of allocation
- II. Activity & source budgets
- III. Types of expenses:
  - a. Program vs. supporting
  - b. Common vs. specific
- IV. Allocating common costs
  - a. Line-by-line allocation
  - b. Bottom line allocation
- V. Allocating administrative expenses
- VI. Categorizing direct & indirect costs
- VII. Calculating your indirect rate

## Learning Objectives

By the end of this workshop you should:

- Understand the nature of nonprofit expenses between program, supporting and shared expenses.
- Learn acceptable allocation methods and the advantages and disadvantages of each method.
- Be able to carry allocations through from programs to funding sources.

## City Guidelines

The City's guidelines on cost allocation can be found at:

[www.sfgov.org/site/controller\\_index.asp?id=32001](http://www.sfgov.org/site/controller_index.asp?id=32001)

## What is allocation?

Allocation is the process of splitting certain expenses between activity centers (cost centers). Nonprofit organizations typically use allocation for common costs on financial statements. They may also use allocation as a method of recovering administrative costs in grants or contracts.

## Why allocate expenses?

There are three primary reasons for wanting to allocate expenses:

- **Business Analysis:** In order to understand the true financial performance of each of your core activities, you need to know the true cost of that activity. In addition to direct programmatic costs for each activity, such as the program director's salary, there are other legitimate costs associated with each activity such as rent, utilities, technology, paying bills, etc. Allocation is a method of assigning these other expenses to the activity, which then provides a more complete picture of all the expenses or the true cost of that activity.
- **Cost Recovery:** Just as we mentioned the importance of knowing the true cost of an activity to be able to analyze your business, you'll also want to be able to fundraise for the entire cost. This is true whether you're raising money from individuals, foundations, or through government contracts. By allocating expenses you can maximize your cost recovery from grants and contracts. If you plan on recovering the full costs of your services for a contract with the City and County of San Francisco, then you must allocate costs.
- **It's Easier!:** Generally Accepted Accounting Principles allow you to allocate certain costs to make it easier for the organization! When an organization buys office supplies it might be difficult and tedious to track which part of the organization is using the most pens. Allocation provides a method to assign these costs to the activity center without driving yourself and your staff crazy with paperwork and bureaucracy.

## The Regulatory Environment

Cost allocation in financial statements is governed by Generally Accepted Accounting Principles (GAAP) as suggested above. In federal contracts,

allocation and cost recovery is most often guided by OMB Circular A-122. This circular requires all costs to be:

- Reasonable: Ordinary and necessary to accomplish the purpose of the contract and comparable to market prices.
- Allowable: As per the circular. Those costs for fundraising activities are not allowed by the government.
- Allocable: They must benefit the cost objective.
- Consistently applied: You cannot switch methods to generate more revenue or treat one cost as direct for one contract and indirect for another government contract.
- Documented: The methodology for allocating costs should be documented. This includes time studies and functional time sheets.

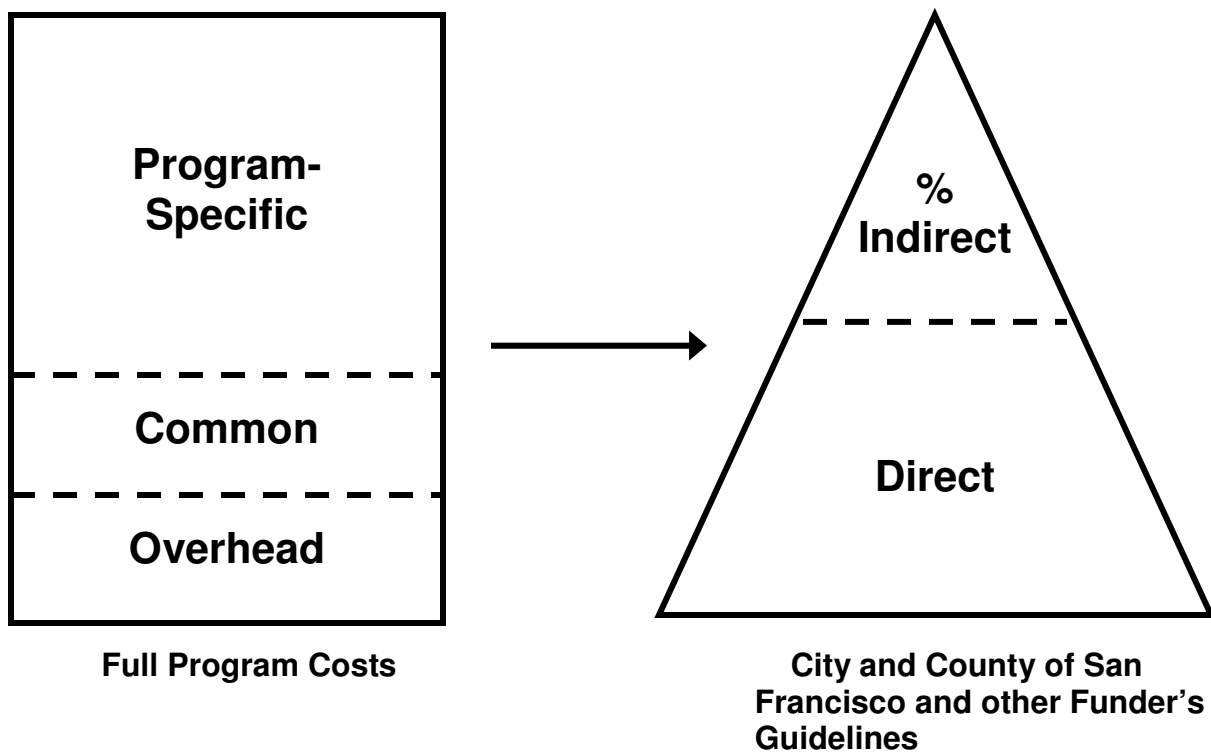
A complete copy of Circular A-122 can be found online at [www.whitehouse.gov/omb/circulars/a122/a122.html](http://www.whitehouse.gov/omb/circulars/a122/a122.html)

The City and County of San Francisco's guidelines largely follow those described by both GAAP and Circular A-122.

## The World of Rectangles and Triangles

One of the challenges for nonprofit organizations in recovering their expenses is that generally accepted accounting principles and the IRS refer to nonprofit expenses differently than the City and County of San Francisco and other funders.

Understanding how to determine the full program costs prepares us to present those costs in our proposals to the City and County as well as other funders. However, the terms that we are working with—program specific costs, common costs, and overhead—are *your* terms for expenses. Your cost language is not the same as that of the City and County of San Francisco and other funders.



Many nonprofits provide services that philanthropy or government want to fund. Yet we often do not consider the full costs of producing our services when we price them. Businesses routinely analyze their costs and set a selling price, which may or may not equal the cost of production.

The nonprofit experience is not as different as many people assume. A strong, financially viable nonprofit will recover as many of its programs' identified costs as possible within City and County of San Francisco guidelines and those of other funders.

To accomplish this, you will need to look at your business and your budget from at least two perspectives:

INTERNAL view – Activity Budget

EXTERNAL view – Source Budget

## Sample Activity Budget

Food.org					
	Program Activities		Supporting Activities		Total
	Meal Delivery	Nutrition Education	Admin	Fund-raising	
Contributions	-	-	-	31,875	31,875
Foundation grants	480,000	135,000	-	35,000	650,000
Government contracts	-	115,000	-	-	115,000
Interest and dividends	-	-	5,750	-	5,750
<b>Total income</b>	<b>480,000</b>	<b>250,000</b>	<b>5,750</b>	<b>66,875</b>	<b>802,625</b>
Salaries	217,500	126,250	39,250	39,500	422,500
Benefits	54,375	31,563	9,813	9,875	105,626
<b>Personnel expense</b>	<b>271,875</b>	<b>157,813</b>	<b>49,063</b>	<b>49,375</b>	<b>528,126</b>
Supplies	30,775	18,300	990	3,435	53,500
Equipment	61,300	3,600	1,080	1,020	67,000
Printing	10,000	10,000	-	2,500	22,500
Travel	3,750	1,500	500	1,500	7,250
Telephone	11,025	6,300	1,890	1,785	21,000
Postage	9,450	5,400	1,620	1,530	18,000
Occupancy	40,950	23,400	7,020	6,630	78,000
Training	2,500	1,500	500	1,500	6,000
<b>Non-personnel expense</b>	<b>169,750</b>	<b>70,000</b>	<b>13,600</b>	<b>19,900</b>	<b>273,250</b>
<b>Total expenses</b>	<b>441,625</b>	<b>227,813</b>	<b>62,663</b>	<b>69,275</b>	<b>801,376</b>
<b>Income - expenses</b>	<b>38,375</b>	<b>22,187</b>	<b>(56,913)</b>	<b>(2,400)</b>	<b>1,249</b>

An **activity budget** is a projection of income and expenditures for a particular activity or program of your organization. It is based on the actual structure of your organization and its mission-related activities. Activity budgets should:

- Reflect actual program costs or your best projection of what the true costs will be
- Reflect real program services and organizational structures
- Match program costs with program income to give a realistic bottom line
- Enable management to plan, monitor, and adjust program execution

A **source budget** is a plan or projection of how the organization will spend the funds of a particular funding source. It should be based upon the full program costs, but, at best, it will only represent a part of that program. The purpose of the source budget is to communicate to the City and County of San Francisco or other funders how a proposed scope of work translates into income and expenses. Source budgets should:

- Reflect the program reality (be based on the most realistic program plan and budget)
- Adhere to all proposal or grant agreement guidelines
- Support the proposal narrative by explaining the costs of the proposed project

### ***Source ≠ Activity***

For various reasons, source budgets almost never reflect the full costs of an activity. For example:

- The City and County of San Francisco and other funders may not allow all costs such as fundraising expenses or capital purchases. Some funders also will not pay for printing or conferences.
- Program execution may depart from the original proposal (the true costs of a program will inevitably differ from original projections)
- A source budget may be reduced to ask for less than the full costs of the program in order to make the request more competitive
- The person who created the proposal and source budget may not have known the full program cost

As such, organizations need tools to bring together their activity and source budgeting.



**Sample Activity by Source Budget**

Meal Delivery Program

	Program Total	Funder A	Funder B	Funder C	Funder D	Funding Total	(Over) Under Funded
Salaries	217,500	100,000	85,000	-	16,000	201,000	16,500
Benefits	54,375	25,000	21,250	-	4,000	50,250	4,125
Personnel expense	271,875	125,000	106,250	-	20,000	251,250	20,625
Supplies	30,775	13,250	7,750	-	8,500	29,500	1,275
Equipment	61,300	2,500	1,500	50,000	7,000	61,000	300
Printing	10,000	4,000	-	-	6,000	10,000	-
Travel	3,750	1,250	1,250	-	1,250	3,750	-
Telephone	11,025	2,500	1,000	-	4,250	7,750	3,275
Postage	9,450	4,500	1,000	-	3,500	9,000	450
Occupancy	40,950	20,000	10,000	-	14,000	44,000	(3,050)
Training	2,500	750	1,250	-	500	2,500	-
Non-personnel expense	169,750	48,750	23,750	50,000	45,000	167,500	2,250
Indirect costs	41,338	26,250	20,000	-	15,000	61,250	(19,912)
<b>Total expenses</b>	<b>482,963</b>	<b>200,000</b>	<b>150,000</b>	<b>50,000</b>	<b>80,000</b>	<b>480,000</b>	<b>2,963</b>

## Steps of Allocation

Determining your indirect cost percentage for a grant is the final step in the process of allocating expenses. The process begins with understanding your costs:

Categorize Expenses:	Determine specific and common expenses.
Choose an allocation basis:	The most commonly used one is based on Full Time Employees (called FTE's). To utilize this basis you'll need a staffing plan.
Allocate common costs:	Using your basis, allocate them out to each activity.
Allocate administration costs:	Typically done as a percentage of total costs.
Determine your indirect percentage.	<b>This can vary by funding source.</b>

## Categories of Expenses

There are three different methods of categorizing expenses. Each one has a different use depending on the audience. The three different methods of categorizing are:

Expense Categorization	Possible Audience
Program vs. Supporting	IRS / Audited Financials Watchdog Agencies Donors
Specific vs. Common	Internal management Auditors
Direct vs. Indirect	Funders: Foundations and Government contracts

These expenses are not mutually exclusive. Every organization will have each and all of these.

## Program vs. supporting

The **activities** of your organization, and the costs and income associated with each, can be grouped into two categories, **program activities** and **supporting activities**, based on the **purpose** of an activity and its relation to your **mission**. This is an essential way that nonprofit organizations categorize expenses for IRS Form 990 and to present financial statements in accordance with GAAP (generally accepted accounting principles).

## ***Program activities***

Program activities are those services or expenses that carry out the mission and purpose of the organization. An organization can have their mission-related activities in one or more than one program activity centers.

- An example of program activities for a food bank might be meal delivery and nutrition education. For a health center the program activities might be patient services, community health and health education.

## ***Supporting activities***

Supporting services are all activities of a nonprofit organization other than program services. Generally, they include management and general (or administration), fundraising, and membership-development activities. Management and general activities include those administrative, financial, and management tasks essential to the operation of the organization.

Administration and fundraising are the two supporting activities of the organization.

<b>Administrative activities</b>	<b>Fundraising activities</b>
Board expenses and other costs associated with oversight and general management	Fundraising campaigns
Legal, accounting/finance, budgeting, general record keeping	Developing/maintaining donor mailing lists
Salary of ED/CEO except what's allocatable to programs or fundraising	Maintaining relationships with current and potential donors

## Program vs. supporting (Continued)

### Is it Program or Supporting?

Categorize the following expenses based upon the purpose of the activity for which it was spent:

<u>Expense</u>	<u>Program</u>	<u>Supporting</u>
1) Refreshments for a nutrition education workshop	<u>  X  </u>	<u>          </u>
2) Food for a board meeting	<u>          </u>	<u>  X  </u>
3) Salaries for nutrition educators	<u>  X  </u>	<u>          </u>
4) Consultant fee for a grantwriter	<u>          </u>	<u>  X  </u>
5) Stipend for nutrition workshop leaders	<u>  X  </u>	<u>          </u>
6) Mileage and parking for client home visits	<u>  X  </u>	<u>          </u>
7) Airfare and travel expense for program director to attend national nutrition conference	<u>  X  </u>	<u>          </u>
8) Fees for meal delivery warehouse staff to attend database and computer skills trainings	<u>  X  </u>	<u>          </u>



## Specific vs. common

Program and supporting is one way of categorizing activities and associated costs based on the purpose of the activity or expense. Costs within the organization may also be grouped, based on the **behavior** of the expense, into two categories: **Specific costs** and **common costs**.

### *Specific costs*

**Specific costs are those that are easily identifiable with and benefit a single activity.** If you can take the receipt or invoice for an expense and easily identify the activity to which it belongs, it is an activity-specific cost.

Typical examples of specific costs include:

- Salaries for staff that spend time on the activity
- Stipends and fees for consultants that work on the activity
- Materials and supplies for activity projects
- Rent for activity-specific space
- Travel for activity staff
- Equipment used for a single activity

### *Common costs*

**Common costs are those that benefit more than one activity and are NOT easily identifiable with a single activity.** If you have an invoice or receipt for an expense and cannot easily determine the specific activity to which it belongs and instead think that its benefits will be shared by more than one activity, it is a common cost.

Examples of common costs include:

- Salaries for staff that work on or benefit more than one activity (e.g. information technology manager, office manager, receptionist)
- Rent, maintenance, and utilities for shared office space
- Office supplies, postage, and telephone expense for shared office facilities
- Lease expense for shared office equipment
- General liability and property insurance for shared locations
- Depreciation of the facility or equipment used by more than one department

## Specific vs. common (continued)

### Is it specific or common?

<u>Expense</u>	<u>Specific Program</u>	<u>Specific Supporting</u>	<u>Common</u>
1) Salary for a Meal Delivery Driver	<u>    X    </u>	<u>          </u>	<u>          </u>
2) Salary for the Bookkeeper	<u>          </u>	<u>    X    </u>	<u>          </u>
3) Salary for the Office Manager who maintains facilities, computers, and office equipment and provides reception	<u>          </u>	<u>          </u>	<u>    X    </u>
4) Office supplies for the main office supply cabinet	<u>          </u>	<u>          </u>	<u>    X    </u>
5) Office supplies for Nutrition Education presentations	<u>    X    </u>	<u>          </u>	<u>          </u>
6) Annual auditing expense	<u>          </u>	<u>    X    </u>	<u>          </u>
7) Site liability insurance	<u>          </u>	<u>          </u>	<u>    X    </u>
8) Directors and officers liability insurance	<u>          </u>	<u>    X    </u>	<u>          </u>
9) Annual staff retreat	<u>          </u>	<u>          </u>	<u>    X    </u>

## **Allocating common costs**

Allocation is the process of splitting up costs and distributing or sharing them among two or more programs or activities. Two acceptable methods of allocating common costs are:

- Line by line allocation. Also called case by case allocation.
- Bottom line allocation

### ***Line by line allocation***

This method of allocating common costs relies on an actual rate of usage for each common cost. For example, you may decide to apportion the organization's rent expense among programs and supporting activities based on the square footage used by each. And telephone expense may be divided among the activities of the organization based on the number of phones used by each.

In some cases, records of actual usage will be kept to preclude allocations at all. For example, the maintenance of the photocopier may be based on the number of copies logged for each activity. In a line by line allocation, a different method is adopted for each line item, or "case."

The line-by-line method sometimes feels "comfortable" or "reassuring" because you can see how much each activity is charged for each common cost. A major drawback of this method is that it requires a great deal of time-consuming record keeping.



## Allocating common costs (continued)

<b>Sample Line by Line Allocation of Common Costs</b>					
	<b>A</b>	<b>B</b>	<b>C</b>	<b>D = B X C</b>	<b>E = A + D</b>
	Meal Delivery Specific	Total Common	Allocation Basis	Meal Delivery's Portion of Common	Meal Delivery Specific Plus Common
Salaries	195,000	45,000	52.78% of FTEs	23,750	218,750
Benefits	48,750	11,250	52.78% of FTEs	5,938	54,688
Personnel expense	243,750	56,250		29,688	273,438
Supplies	25,000	11,000	52.78% of FTEs	5,806	30,806
Equipment	55,000	12,000	48.00% of copier usage	5,760	60,760
Printing	10,000	-		-	10,000
Travel	3,750	-		-	3,750
Telephone	-	21,000	33.33% of phones	7,000	7,000
Postage	-	18,000	18.50% of meter usage	3,330	3,330
Occupancy	-	78,000	65.00% of square footage	50,700	50,700
Training	2,500	-		-	2,500
Non-personnel expense	96,250	140,000		72,596	168,846
<b>Total expenses</b>	<b>340,000</b>	<b>196,250</b>		<b>102,283</b>	<b>442,283</b>

## Allocating common costs (continued)

### *Bottom line allocation*

Another method of allocation is to decide on a rate by which all common costs are proportionately distributed to the various programs and supporting activities. Some methods for determining the allocation rate or basis might be:

- A percentage determined by dividing the **number of FTEs** of each activity by the total number of FTEs from all the activities (excluding any whose salaries are treated as common costs).
- A percentage determined by dividing the amount of the **payroll expenses** of each activity by the payroll expenses of all the activities (excluding common).
- A percentage determined by dividing the **square footage** used by each activity by the total agency square footage.
- A percentage determined by dividing the amount of the **specific expenses** of each activity by the total specific expenses of the organization.

**Note that using the percentage of income of each activity is NOT an acceptable method of allocating expenses because income does not necessarily tie in any direct way to the actual consumption of resources.**

### *Advantages*

- Less time-consuming than the line by line method
- Since allocated common costs are presented on a separate line, allows program managers to focus on line items over which they have control and responsibility

### *Disadvantages*

- Program managers may feel that expenses are being allocated to their programs inaccurately
- When preparing budgets and reports to some funders, each common expense line item will need to be multiplied by the allocation basis because for most funders it is unacceptable to show a single line for common costs.

## Bottom Line Allocation example

The example on the following page uses the number of FTEs of each activity to determine the allocation rate and produce the Bottom Line Allocation. To perform this allocation you will need to first prepare a Staffing Plan then determine your allocation percentages and lastly conduct the allocation.

## Staffing Plan

Food.org												
Name	Position	Salary (FTE)	Total FTE	Salary (adj)	FTE	Meals	FTE	Nutrition	FTE	Admin	FTE	F/R
Elena	Exec Dir	50,000	1.00	50,000	0.25	12,500	0.25	12,500	0.25	12,500	0.25	12,500
Paula	Prg Mgr	45,000	1.00	45,000	0.50	22,500	0.50	22,500	0.00	0	0.00	0
Ollie	Off Mgr	45,000	1.00	45,000	0.50	22,500	0.25	11,250	0.15	6,750	0.10	4,500
Gary	Grants	45,000	0.50	22,500	0.00	0	0.00	0	0.00	0	0.50	22,500
Betty	Bookkeeper	40,000	0.50	20,000	0.00	0	0.00	0	0.50	20,000	0.00	0
Wally	Warehouse	40,000	1.00	40,000	1.00	40,000	0.00	0	0.00	0	0.00	0
Delia	Driver	40,000	1.00	40,000	1.00	40,000	0.00	0	0.00	0	0.00	0
Dan	Driver	40,000	1.00	40,000	1.00	40,000	0.00	0	0.00	0	0.00	0
Ina	Intake	40,000	1.00	40,000	1.00	40,000	0.00	0	0.00	0	0.00	0
Trinity	Trainer	40,000	1.00	40,000	0.00	0	1.00	40,000	0.00	0	0.00	0
Tabitha	Trainer	40,000	1.00	40,000	0.00	0	1.00	40,000	0.00	0	0.00	0
			10.00	422,500	5.25	217,500	3.00	126,250	0.90	39,250	0.85	39,500
FTE's without common			10.00									
% of FTE's for allocation of common			100%			52.50%	30.00%		9.00%		8.50%	

## Sample Allocation of Common Costs

	Food.org					Total
	<i>Program Activities</i>		<i>Supporting Activities</i>			
	Meal Delivery	Nutrition Education	Admin	Fund-raising	Common	
Salaries	218,750	126,250	39,250	39,500	-	422,500
Benefits	54,688	31,563	9,813	9,875	-	105,626
Personnel expense	271,875	157,813	49,063	49,375	-	528,126
Supplies	25,000	15,000	-	2,500	11,000	53,500
Equipment	55,000	-	-	-	12,000	67,000
Printing	10,000	10,000	-	2,500	-	22,500
Travel	3,750	1,500	500	1,500	-	7,250
Telephone	-	-	-	-	21,000	21,000
Postage	-	-	-	-	18,000	18,000
Occupancy	-	-	-	-	78,000	78,000
Training	2,500	1,500	500	1,500	-	6,000
Non-personnel expense	96,250	28,000	1,000	8,000	140,000	273,250
Total specific costs	368,125	185,813	50,063	57,375	140,000	801,376
% of FTE's	52.50%	<u>30%</u>	<u>9%</u>	<u>8.5%</u>	-100%	0%
Allocation of common costs	73,500	<u>42,000</u>	<u>12,600</u>	<u>11,900</u>	(140,000)	-
Total expenses	441,625	227,813	62,663	69,275	-	801,376

## Allocating Administrative Expenses

In addition to allocating common costs, organizations also should allocate their administrative costs or “overhead.” Remember, these expenses are associated with the finance department and board of directors. Just as when you buy a cup of coffee you are paying for the cashier and bookkeeper, when you write grants you need to recover the cost of your administrative expenses.

Fundraising costs are typically not allocated to programs as government contracts and many foundations typically do not cover these expenses. The fundraising activity center should receive an allocation of administrative expenses.

Administrative expenses are typically allocated by percentage of specific and common expenses for each category.

For example, the percentage of overhead costs that can be assigned to the meal delivery program would be calculated as follows:

### Meal Delivery Expenses

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**(Meal Delivery Expenses + Nutrition Education Expenses + Fundraising Expenses)**

Fill in the spaces below to calculate the percentage of costs that should be assigned to the meal delivery program:

$$\frac{[ \quad 441,625 \quad ]}{[ \quad 441,625 \quad ] + [ \quad 227,813 \quad ] + [ \quad 69,275 \quad ]} = [ \quad 60\% \quad ]$$

Food.org

	<i>Program Activities</i>		<i>Supporting Activities</i>		Common	Total
	Meal Delivery	Nutrition Education	Admin	Fund-raising		
Salaries	217,500	126,250	39,250	39,500	-	422,500
Benefits	54,375	31,563	9,813	9,875	-	105,626
Personnel expense	271,875	157,813	49,063	49,375	-	528,126
Supplies	25,000	15,000	-	2,500	11,000	53,500
Equipment	55,000	-	-	-	12,000	67,000
Printing	10,000	10,000	-	2,500	-	22,500
Travel	3,750	1,500	500	1,500	-	7,250
Telephone	-	-	-	-	21,000	21,000
Postage	-	-	-	-	18,000	18,000
Occupancy	-	-	-	-	78,000	78,000
Training	2,500	1,500	500	1,500	-	6,000
Non-personnel expense	96,250	28,000	1,000	8,000	140,000	273,250
Total specific costs	368,125	185,813	50,063	57,375	140,000	801,376
Allocation rate	53%	30%	9%	9%	-100%	0%
Common costs	73,500	42,000	12,600	11,900	(140,000)	-
Expenses before admin	441,625	227,813	62,663	69,275	-	801,376
% of program activity	60%	31%	-100%	9%	-	0%
Admin costs	37,598	19,425	(62,663)	5,640	-	-
Total expenses	479,223	247,238	-	74,915	-	801,376

## **Categorizing Direct and Indirect Costs**

Whereas we categorize costs internally by purpose (program activities vs. supporting activities) and by behavior (specific vs. common), the City and County of San Francisco and other funders often group costs into “**direct**” and “**indirect**” cost categories.

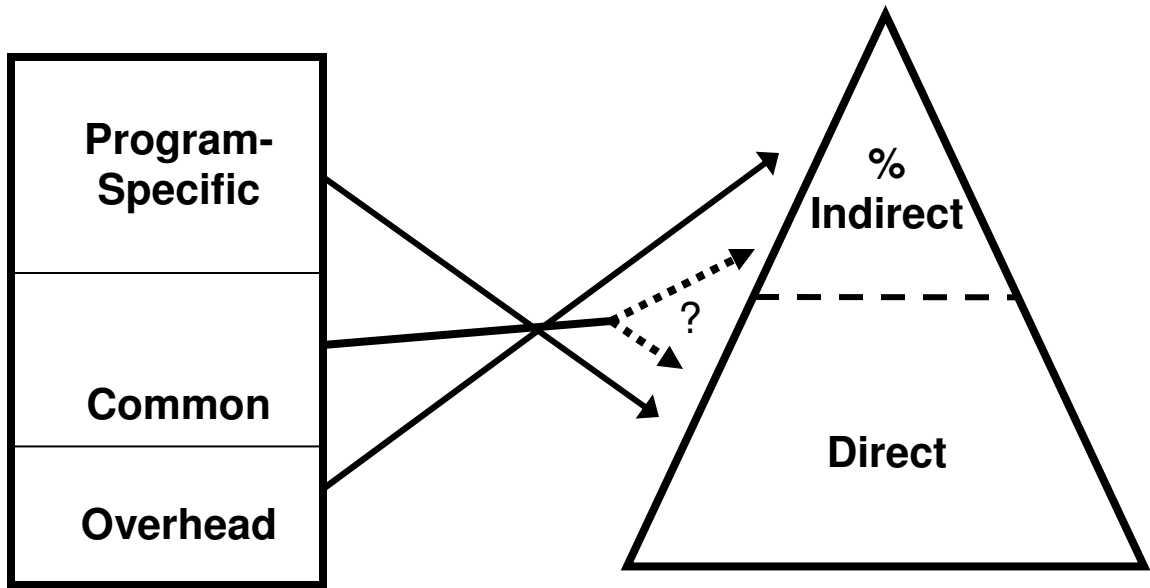
### ***Direct costs***

For the City and County San Francisco and other funders, direct costs are typically those costs you specify, justify, monitor, and document explicitly. These will usually be made up of your program-specific costs and some or all of your common costs.

### ***Indirect costs***

Indirect usually corresponds to what you call overhead. In the language of the City and County of San Francisco and other funders, indirect costs are expressed as a percentage of direct costs, and the sum of direct and indirect costs is the total allowable cost for the project.

**Although overhead is not allocated for the purposes of IRS Form 990 or for financial statements prepared in accordance with GAAP, it is essential to understand these costs as part of the full program costs for the purposes of fundraising and contract negotiation.**



Program specific costs translate to direct costs and overhead (or administrative costs) tends to relate to indirect costs. Common costs, however, can be considered either direct expenses or indirect expenses depending on the funder's guidelines.

The indirect rate can vary significantly depending on which expenses are included as indirect costs. Most contracts with the City and County of San Francisco include common costs as part of your indirect rate. **You should check with your department to see if this is how your contract is set up.**

Large federal contracts may have an agreed upon indirect rate that will include all common costs and may be quite high. However, if your organization does not have such rate, common costs may be included as direct costs.

## Calculating Your Indirect Rate

Using our previous example, let's calculate the indirect rate for the meal delivery program using both methods.

**If common costs are included as indirect costs:**

$$\frac{\text{Allocated Administrative Costs} + \text{Allocated Common Costs}}{\text{Specific Costs}} = \text{Indirect \%}$$



$$\frac{[ 37,598 ] + [ 73,500 ]}{[ 368,125 ]} = 30 \%$$

If common costs are NOT included as indirect costs:

$$\frac{\text{Allocated Administrative Costs}}{\text{Specific Costs + Common Costs}} = \text{Indirect \%}$$

$$\frac{[ 37,598 ]}{[ 368,125 ] + [ 73,500 ]} = 9 \%$$

You can also calculate the indirect percentage without first having allocated the expenses. The following calculation assumes that shared costs have already been allocated:

$$\frac{\text{Administrative Expenses (Supporting Costs)}}{\text{Total Program Expenses (Programmatic Costs)}} = \text{Indirect \%}$$

## Allocating Indirect Costs to Grants

After determining your indirect cost percentage you will need to allocate the appropriate percentage to each of the funding sources for the programs. Allowable indirect rates can vary by department at the City and County of San Francisco and other funders. Foundations typically allow a higher rate than government contracts.

What to do if the allowable rate is less than your actual rate?

This is one of the most common questions we hear from organizations. Indirect costs, as you know, are real costs that organizations face and they must be paid for in some manner. If the City and County of San Francisco's or other funder's allowable rate is lower than your rate, the organization has the following options:

- Fund the overhead with another funder: Perhaps there is another funder that will allow for a higher rate or will pick up more of the overhead costs. This is commonly done with unrestricted funds.

- Lower overhead costs: Look carefully at your overhead rate and determine if there is a way to lower overhead costs.
- Raise the issue in your contract negotiation to see if anything can be done. It is important that you raise the issue with the City and County of San Francisco before you sign the contract.
- Say “no” to the funding: Another option is to say no to the funder. The overhead rate is included in the cost of your service. Just as you don’t barter when you go to a coffee shop, funders should not always be allowed to barter with you. If you have no other source of funding to cover the overhead costs and you cannot lower costs, refusing the funding may be your best option.

## Common Allocation Mistakes

In order to have useful financial information allocation should be done carefully and consistently. Some common classification errors that are made include:

- **Failure to allocate the executive director’s salary into the appropriate activity.** With few exceptions, the executive director of an organization spends significant amounts of time on program planning, implementation, and evaluation, fundraising, and management and general activities. As a result, their time should be allocated to each of these activity centers. Many organizations fail to do this allocation, instead putting the entire salary in administration and overstating the supporting activities expense.
- **Allocating costs based on the organizational chart rather than the purpose for which the cost was incurred.** Frequently information technology personnel or office management personnel will report to the Director of Finance and Information. However, just because the finance side is an administrative expense, these are still common costs benefiting all activities and should be classified as a common cost and allocated out.
- **Failure to allocate depreciation.** Some organizations charge all depreciation to administration or management and general expense. Depreciation should be allocated across activity centers based on usage if possible, or by FTE as a common cost.
- **Requesting an external accounting firm perform your allocation.** Rarely will anyone external to your organization have enough information to properly assign or allocate costs among the functional classifications. The fear is that inaccurate allocations can lead to higher supporting activities cost and misrepresent the accomplishments and efficiency of your organization. While using an outside firm may be easier for organizations, they should still understand how allocations are being performed.
- **Thinking low overhead means more effectiveness.** Some people inexplicably think that an organization’s indirect cost percentage is an

indication of how effective that organization is. This is not true. Some organizations with 0% overhead have had the most fraud. Low overhead MAY be an indication of efficiency but never effectiveness. Also, because of economies of scale, it is often easier for large organizations to have a smaller overhead percentage.

## Final Thoughts: Key Tips

- **Allocate costs correctly:** Review your costs and categorize them correctly by their behavior – specific vs. common.
- **Understand grant agreements:** Understand what the City and County of San Francisco and your other funders are requiring so that your indirect costs are correct and you are maximizing cost recovery.
- **Consistency:** While allocation may not feel 100% accurate to you, the key is consistently using the same allocation method from year-to-year.
- **For contracts with the City and County of San Francisco, in all cases, speak to your City contract manager if you have questions or concerns.**

## Final Exercise

This exercise uses the activity budget and staffing plan on the next pages. This organization uses the FTE (Full Time Employees) method as a basis for common costs.

- Using the staffing plan, figure out the allocation percentage for common costs for each department.
- Allocate the organization's common costs on the activity budget using these percentages.
- Allocate administrative expenses using the percentage of direct specific costs method.
- Determine the indirect percentage for the organization's shelter program. For purposes of this exercise, the funder includes common costs as part of the indirect rate but does not allow any fundraising expenses as part of the indirect rate.

Indirect % = \_\_\_\_\_39%\_\_\_\_\_

**Domestic Violence Intervention & Prevention Agency**  
**2007-08 Budget: First Draft (summarized)**  
**As for May 29, 2007**

	Program Activities		Supporting Activities			Total 2007-08
	Shelter Services	Support Groups	Admin- istration	Fund- raising	Common	
Contributions	-	-	-	80,000	-	80,000
Fundraising events - net	-	-	-	135,000	-	135,000
Foundation grants	-	-	-	125,000	-	125,000
<b>Total support</b>	-	-	-	<b>340,000</b>	-	<b>340,000</b>
Government contracts	815,009	-	-	-	-	815,009
Interest and dividends	-	-	10,000	-	-	10,000
Unrealized gain (loss) on investments	-	-	-	-	-	-
<b>Total revenue</b>	<b>815,009</b>	-	<b>10,000</b>	-	-	<b>825,009</b>
Net assets released from restriction	-	445,000		5,000	-	450,000
<b>Total income</b>	<b>815,009</b>	<b>445,000</b>	<b>10,000</b>	<b>345,000</b>	-	<b>1,615,009</b>
Personnel expenses	329,852	214,881	117,365	127,339	179,161	968,598
Non-personnel expenses	416,750	129,300	28,100	44,750	224,113	843,013
<b>Total specific costs</b>	<b>746,602</b>	<b>344,181</b>	<b>145,465</b>	<b>172,089</b>	<b>403,274</b>	<b>1,811,611</b>
% of FTE's	45%	31%	11%	13%		
Allocation of common costs	181,473	125,015	44,360	52,426		-
Expenses before overhead	928,075	469,196	189,825	224,514		1,811,611
Change before overhead	(113,066)	(469,196)	(179,825)	(224,514)		(196,602)
% of direct costs	57%	29%		14%		
Allocation of admin costs	108,628	54,918	(189,825)	26,279		
<b>Total expenses</b>	<b>1,036,704</b>	<b>524,114</b>	-	<b>250,793</b>		<b>1,811,611</b>
Change in net assets	(221,695)	(79,114)	10,000	94,207		(196,602)

**Domestic Violence Intervention & Prevention Agency**  
**2007-08 Budget: Staffing Plan (FTE)**  
**As of April 22, 2007**

<b>Name</b>	<b>Position</b>	<b>2007-08 Total</b>	<b>Shelter Services</b>	<b>Support Groups</b>	<b>Admin</b>	<b>Fundraising</b>	<b>Common</b>
Elena	Executive Director	1	0.1	0.25	0.4	0.25	0
Freda	Director of Finance and Admin.	0.75	0	0	0.75	0	0
Albert	Accounting Manager	0.5	0	0	0.5	0	0
Ina	IT Manager	0.5	0	0	0	0	0.5
Ollie	Office Manager	1	0	0	0	0	1
Carla	Custodian	0.5	0	0	0	0	0.5
Paula	Director of Programs	1	0.6	0.4	0	0	0
Sherri	Shelter Manager	1	1	0	0	0	0
Denise	Day Coordinator	1	1	0	0	0	0
Natalie	Night Coordinator	1	1	0	0	0	0
India	Intake Coordinator	1	1	0	0	0	0
Cathy	Case Worker	1	1	0	0	0	0
Connie	Counselor	1	1	0	0	0	0
Alexis	Advocacy Manager	1	0	1	0	0	0
Adriana	Adult Community Organizer	1	0	1	0	0	0
Yani	Youth Community Organizer	1	0	1	0	0	0
Lani	Legislative Advocate	1	0	1	0	0	0
Dana	Director of Development	1	0		0	1	0
Dennis	Development Associate	0.75	0		0	0.75	0
		<b>17</b>	<b>6.7</b>	<b>4.65</b>	<b>1.65</b>	<b>2</b>	<b>2</b>

FTE's without common

% of FTE's for allocation of shared

15	6.7	4.65	1.65	2	
	45%	31%	11%	13%	

## Key words and definitions

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### **A-133**

See OMB A-133

### **Accounts payable**

An organization's unpaid bills.

### **Accounts receivable**

Income already promised or earned but not yet received by an organization. Can be further specified, for example, grants receivable, contracts receivable, pledges receivable.

### **Accrual basis of accounting**

The recognition and recording of income when earned, regardless of when the cash is received and expenses are recorded as they are incurred (such as when services are performed or goods are delivered), instead of when they are paid.

### **Activity**

A core element of the nonprofit organizations, for example, key programs, administration, and fundraising.

### **Activity-based system**

Is the recording of an organizations finances based primarily on its' activities rather than its' funding sources.

### **Activity by funding source report**

A report that shows how costs for a particular activity are covered by multiple funding sources.

### **Administrative activity**

The finance, legal, board-related, and general oversight activities of a nonprofit organization.

### **Allocation**

The process of spreading costs to two or more activities.

### **Allocation basis**

The rationale for allocation percentages, for example, number of full-time-equivalents (FTE) per activity or total costs before allocation.

**Assets**

The properties or resources the agency owns and uses.

**Audit**

The process completed by an auditor that results in an issued opinion on whether year-end financial statements reflect the actual financial activity and condition of the organization for the time period in question.

**Bottom line allocation**

The process of allocating common costs proportionately among the activities of the organization.

**Budget**

The organization's plan expressed in dollars (income and expenses). Allows the organization to track actual performance against an approved plan.

**Capitalization**

The recording of an item as an asset rather than as an expense when it is purchased.

**Cash basis of accounting**

Is the recognition and recording of income only when the cash is actually received and expenses are recognized and recorded only when they are actually paid.

**Cash flow projection**

A projection that focuses on the timing of cash receipts and disbursements rather than on its functional classification or level of restriction so that an organization may assess its ability to meet its obligations.

**Chart of accounts**

The numerical system for tracking assets, liabilities, net assets, income, and expenses in an accounting system. Drives the reporting capacity of an organization.

**Common Costs**

Those costs that benefit more than one activity and that are not easily identifiable with a single activity. (Also called "shared.")

**Conditional Support**

Revenue such as grants and contributions that are made contingent upon a qualifying event, such as a challenge grant.



**Current ratio**

A comparison of the organization's current assets to its current liabilities; indicates that ability to pay bills and meet financial obligations.

**Deficit**

Expenses in excess of related income.

**Depreciation**

The process whereby the cost of a capitalized item is broken down systematically among the periods in which the organization will receive benefit from its use.

**Donated Goods & Services**

Items and professional services that are donated to an organization

**Earned Revenue**

Earned revenue is income that the organization obtains through exchange transactions such as fees, ticket sales, and certain but not all government contracts.

**Fiscal year**

The organization's business year, for example, January through December or July through June.

**Fixed Assets**

Assets with a prolonged useful life such as equipment, land and buildings.

**Form 990**

The Federal tax return required to be filed annually by most nonprofits.

**Full-time equivalent (FTE)**

The number of full-time positions at an organization, for example, two full-time staff people and two half-time staff people equals a total of four employees but three FTE.

**Functional expense classification**

The presentation of information about expenses by functional classification (or activity): Program, administration and fundraising.

**GAAP**

Generally Accepted Accounting Principles – principles and guidelines developed by FASB (Financial Accounting Standards Board) to provide guidance in the proper recording and reporting of an organizations accounting affairs.

**General ledger**

A recording of all transactions of the organization entered into the accounting system usually ordered by the chart of accounts.

**In-Kind Contributions**

Items and professional services that are donated to an organization

**Internal Controls**

A set of policies and procedures to prevent deliberate or misguided use of funds for unauthorized purposes.

**Liabilities**

The debts of the organization, for example accounts payable, unpaid employee salaries and vacation leave, and loans.

**Line by line allocation**

The process of allocating common costs by a predetermined rate for each expense line item.

**Liquid operating reserve**

Unrestricted money that the organization has accumulated over time beyond what it needs to pay its immediate bills and other commitments.

**Net Assets**

The resources ultimately available to the organization. (Assets – Liabilities = Net Assets)

**OMB A-122**

The federal Office of Management and Budget's circular on cost principles for nonprofit organizations. This pronouncement governs cost allocation for federal contracts.

**OMB A-133**

The principles for complying with auditing for federal contract awards. The A-133 audit is required of all nonprofits that spend more than \$500,000 in federal awards in a year.

**Overhead rate**

The percentage calculated by comparing total overhead expenses (administration plus fundraising) to total expenses.

**Permanently Restricted Support**

Grants and contributions whose principal is to be invested according to the donor's wishes.

**Program Services**

The activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the organization exists.

**Source-based system**

Is the recording of an organization's finances based on its funding source reporting requirements rather than its activities.

**Statement of activities**

Also known as the income statement or profit and loss statement in the for-profit world, this statement reports the financial activity of the organization over a period of time by function.

**Statement of financial position**

Also known as the balance sheet in the for-profit world, this statement summarizes the assets, liabilities, and net assets of the organization as of a specific date.

**Supporting Services**

All activities of a not-for-profit organization other than program services (management, fundraising and membership development).

**Temporarily Restricted Support**

Grants and contributions that are to be spent for a specific purpose or during a restricted period of time.

**Unconditional Support**

Revenues that are given without reference to any contingency or qualifying event.

**Unrestricted Support**

Grants and contributions given by the donor without reference to a specific purpose or use within a specific time period.

**Variance**

Difference between planned and actual financial performance.