



Why is the City Controller issuing these guidelines?

Per the City Charter, the Controller has the responsibility to protect the financial and functional integrity of City government. City government includes approximately \$400 million of health and human services provided annually by nonprofit contractors. These cost allocation guidelines are meant as best practices, and serve as part of an overall endeavor to ensure the integrity and efficiency of the City's nonprofit expenditures.

What is Cost Allocation?

Cost allocation is a process that seeks, through reasonable and documented means, to allocate costs appropriately to funding sources. Many funding sources, including the City, require that the percentage of costs charged to the funds they are providing be reasonable. In other words, there has to be a clear logic behind the charge and percentage. For example, rent expenses are often charged based on the square footage allocated to a particular program and funding source. Many funding sources also require a written cost allocation plan that describes how shared costs are charged, and the logic behind the percentage allocation.

How do Federal requirements and the City's guidelines relate to each other?

Federal regulations are the primary driver for nonprofit cost allocation requirements. The City's cost allocation guidelines for nonprofit contractors largely follow those described by Generally Accepted Accounting Principles (GAAP) and in Federal OMB Circular A-122.

Specifically, A-122 dictates that costs must be:

- Reasonable
 - Ordinary and necessary
 - Comparable to market prices
- Consistently applied
 - Contractors cannot switch methods to generate more revenue or treat one cost as direct for one contract and indirect for another (see section on direct costs- pg.2).
- Allowable
 - The City follows the guidelines under Federal OMB Circular A-122. Exceptions are any costs prohibited by local law (e.g., costs made ineligible under City prohibitions).
- Allocable
 - Costs must benefit the objective(s) being funded
- Documented
 - The methodology for allocating the cost should be documented. For example, time studies, functional time sheets and percentage of direct salaries.

When is cost allocation required?

Cost allocation is required when a nonprofit agency has:

- multiple activities, one funding source
- one activity, multiple funding sources

- multiple funding sources, multiple activities

In organizations with multiple programs, all costs can be divided into two different types: direct costs and indirect costs.

What is a direct cost?

Direct costs are those which are clearly and easily attributable to a specific program or funding source. Direct costs can generally be identified with a specific final cost objective (i.e., a particular award, project, service, or other direct activity of an organization). However, a cost may not be assigned to an award as a direct cost if any other cost incurred for the same purpose, in like circumstance, has been allocated to an award as an indirect cost. Costs identified specifically with awards are direct costs of those awards and are to be assigned directly to those awards. Costs identified specifically with other final cost objectives of the organization are direct costs of those cost objectives and are not to be assigned to other awards directly or indirectly.

Any direct cost of a minor amount may be treated as an indirect cost for reasons of practicality, where the accounting treatment for such cost is consistently applied to all final cost objectives. The costs of activities performed primarily as a service to members, clients, or the general public, when significant and necessary to the organization's mission, must be treated as direct costs whether or not allowable and be allocated an equitable share of indirect costs. These types of expenses are usually categorized as direct fundraising costs, and may include the following types of activities:

- Maintenance of membership rolls, subscriptions, publications, and related functions.
- Providing services and information to members, legislative or administrative bodies, or the public.
- Promotion, advocacy, and other forms of public relations.
- Meetings and conferences except those held to conduct the general administration of the organization.
- Maintenance, protection, and investment of special funds not used in operation of the organization.
- Administration of group benefits on behalf of members or clients, including life and hospital insurance, annuity or retirement plans, financial aid, etc.
- Salaries and benefits for employees working with clients that are served through a single contract.

What is an indirect cost?

Indirect costs are those which are not easily identifiable with one specific program but which are, nonetheless, necessary to the operation of the program. Indirect costs cannot be easily attributed to one activity or funding source and these costs benefit more than one activity and/or represent one or more funding sources. These costs are shared among programs and, in some cases, among functions (e.g., general fundraising). The Executive Director's salary is a common example of an expense which benefits all programs and functions.

Because of the diverse characteristics and accounting practices of nonprofit organizations, it is not possible to specify the types of costs, which may be classified as indirect costs in all situations. However, typical examples of indirect costs for many nonprofit organizations may include use allowances on buildings and equipment, the costs of operating and maintaining

facilities, and general administration and general expenses, such as the salaries and expenses of executive officers, personnel administration, and accounting. Further examples of indirect, or shared costs, may include: rent, telephone, postage, printing and other expenses which benefit all programs and functions of an organization. Depreciation costs may also be categorized as an indirect cost, however these are subject to review by the granting agency and / or the Controller's Office.

What are allowable indirect costs?

Usually, these are administrative costs that benefit more than one activity and are not included in an indirect cost rate agreement. These costs may be allocated to all benefiting activities/programs by pooling like costs and allocating them using a reasonable methodology and basis. To be allowable under an award, costs must meet the following general criteria:

- Be reasonable for the performance of the award and be allocable thereto under these principles.
- Conform to any limitations or exclusions set forth in these principles or in the award as to types or amount of cost items.
- Be consistent with policies and procedures that apply uniformly to both federally financed and other activities of the organization.
- Be accorded consistent treatment.
- Be determined in accordance with generally accepted accounting principles (GAAP).
- Not be included as a cost or used to meet cost sharing or matching requirements of any other federally-financed program in either the current or a prior period.
- Be adequately documented.

What is a reasonable cost?

A cost is reasonable if, in its nature or amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the costs. The question of the reasonableness of specific costs must be scrutinized with particular care in connection with organizations, or separate divisions thereof, which receive the preponderance of their support from awards made by Federal agencies. In determining the reasonableness of a given cost, consideration shall be given to:

- Whether the cost is of a type generally recognized as ordinary and necessary for the operation of the organization or the performance of the award.
- The restraints or requirements imposed by such factors as generally accepted sound business practices, arms length bargaining, Federal and State laws and regulations, and terms and conditions of the award.
- Whether the individuals concerned acted with prudence in the circumstances, considering their responsibilities to the organization, its members, employees, and clients, the public at large, and the Federal Government.
- Significant deviations from the established practices of the organization, which may unjustifiably increase the award costs.

What are allocable costs?

A cost is allocable to a particular cost objective, such as a grant, contract, project, service, or other activity, in accordance with the relative benefits received. A cost is allocable to a Federal award if it is treated consistently with other costs incurred for the same purpose in like circumstances and if it:

- Is incurred specifically for the award.
- Benefits both the award and other work and can be distributed in reasonable proportion to the benefits received, or
- Is necessary to the overall operation of the organization, although a direct relationship to any particular cost objective cannot be shown.
- Any cost allocable to a particular award or other cost objective under these principles may not be shifted to other Federal awards to overcome funding deficiencies, or to avoid restrictions imposed by law or by the terms of the award.

What is the City requiring related to cost allocation?

The City requires a written cost allocation plan that is reasonable, based on logic that has a documented and/ or logical basis. “Documented or logical” could be, for example, allocating rent costs by square footage associated with a specific program and funding source, dividing up phone charges by staff and program, and paying for salaries based on the project hours documented on staff timesheets.

As of Fall 2005, the City is streamlining and standardizing its nonprofit monitoring procedures. For fiscal monitoring, a written cost allocation plan is an element that will be asked for and reviewed by fiscal monitors. Because each nonprofit agency is different, and there are differences within City funding sources, there is no “rubber stamp” cost allocation plan.

Illustration of Indirect Cost Allocation

Example 1: Indirect Costs: medium-to-large size organization

The Helping Hands In-Home Support Agency has administrative (Executive Director, Administrative Assistant, Front Office Receptionist, Human Resources Coordinator) and finance (Controller, accounts payable, accounts receivable, and payroll) salaries and benefits costs each month totaling \$30,000. The agency must allocate these indirect costs to all of its cost centers on a reasonable, consistent basis.

Helping Hands also has a Development Director who has an Administrative Assistant. The salaries and benefits of these two staff people must be reported as fundraising staff whose salaries and benefits may not be allocated to programs.

Each of Helping Hands’ three programs use direct program staff in positions that have similar salary ranges. This makes allocation of indirect salaries and benefits based upon percentages of direct salaries a reasonable method. Total direct costs could also be a basis as long as one program didn’t have disproportionately larger operating costs for some reason. The objective is to find an allocation basis that somehow shares out indirect costs in a manner that approximates the benefits received by each cost center. So, monthly indirect salaries and benefits could be allocated across its programs in the following manner:

Program A: Direct salaries = \$20,000
 Program B: Direct salaries = \$50,000
 Program C: Direct salaries = \$15,000
 Development : Direct salaries = \$5,000

Total Direct salaries = \$90,000

Program A: receives indirect costs of \$ 6,667 ($\$20,000/\$90,000 \times \$30,000$)

Program B: receives indirect costs of \$16,667 ($\$50,000/\$90,000 \times \$30,000$)

Program C: receives indirect costs of \$ 5,000 ($\$15,000/\$90,000 \times \$30,000$)

Development receives indirect costs of 1,666 ($\$ 5,000/\$90,000 \times \$30,000$)

This allocates all of the \$30,000 of indirect salaries and benefits.

Example 2: Indirect Costs: smaller organization

The Helping Hearts Counseling Center has administrative (Executive Director, Administrative Assistant/Receptionist) and finance (Controller, accounts payable, and payroll) salaries and benefits cost each month totaling \$15,000. The agency must allocate these indirect costs to all of its cost centers on a reasonable, consistent basis.

The Executive Director is a Licensed Marriage, Family, and Child Counselor who also serves as the program director for the smaller of Helping Hearts' two programs. She keeps a functional time sheet that shows how much time each week she works in this capacity. The program operates out of a different facility than the administrative offices, so she dedicates one day on site at the program facility and records any program-specific meeting time on her timesheet during the rest of the week. For our sample one month, her time as Executive Director amounts to 75% and her Program Director time amounts to 25% of her total time during the month. 25% of her monthly salaries and benefits are \$1,300. This reduces the indirect salaries and benefits to \$13,700.

Each of Helping Hearts' two programs has total direct costs that are similar (no highly paid professional staff in just one program, no large payments to contractors in only one program, no more than one work shift per day for direct staff in just one program, etc.) So, monthly indirect salaries and benefits could be allocated across its programs in the following manner:

Program A: Total direct costs = \$45,000

Program B: Total direct costs = \$25,000. (includes 25% of the E.D.'s salary and benefits)

Total Direct salaries = \$70,000

Program A: receives indirect costs of \$8,807 ($\$45,000/\$70,000 \times \$13,700$)

Program B: receives indirect costs of \$4,893 ($\$25,000/\$70,000 \times \$13,700$)

This allocates all of the \$13,700 of indirect salaries and benefits.

Example 3: Allocable Direct Costs

The Helping Hand Agency is housed in a 3500 sq. foot facility. Approximately, 1400 sq. feet consists of kitchen areas, which are used to produce meals for Helping Hand's Brown Bag Lunch Program. Consequently, forty percent of Helping Hand's square footage is allocated to this particular program. Helping hand pays \$4000 per month in rent. This means that forty percent of Helping Hands total monthly rent (\$1600 per month or \$19,200 annually) can be

directly allocated to the funding source which finances their Brown Bag Lunch Program. Other Helping Hand Agency programs can be charged with direct rent expense based upon each program's relative percentage of actual square footage used. If administrative and finance offices reside in the same facility, the percentage of square footage used for those offices would be charged to programs as indirect costs.

Additional Resources

- OMB Circular A-122: Cost Principles for Nonprofit Organizations
<http://www.whitehouse.gov/omb/circulars/a122/a122.html>
- American Institute of Certified Public Accountants (AICPA)
<http://www.aicpa.org/index.htm>
<http://www.aicpa.org/Audcommctr/toolkitsnpo/homepage.htm>
- Alliance for Nonprofit Management
http://www.allianceonline.org/FAQ/financial_management
- Compasspoint Nonprofit Services
http://www4.compasspoint.org/p.asp?WebPage_ID=707&Profile_ID=128167
- Independent Sector
<http://www.independentsector.org/issues/sarbanesoxley.html>