



## Cost Allocations for Nonprofits – What’s The Fuss All About?

Some state and local agencies have been modifying their audit protocols to focus on the cost allocations reported to them each year.

Why the increased scrutiny? Governments are looking for justification for budget cuts by rationalizing that nonprofit organizations are not running as lean as they should. In addition, there have been some highly publicized examples of nonprofit organizations that have had to endure media criticism of both their executive compensation and their cost allocation methodologies.

Unlike public companies, nonprofit organizations’ expenses are reported by their functional classification on the statement of activities, as required by generally accepted accounting principles (GAAP). Functional reporting involves allocating and reporting expenses by major classes of programs and supporting services. Additionally, a voluntary health and welfare organization is required to report in a separate statement of functional expenses its matrix of expenses by both its functional classification and natural classification (salaries, rent, utilities, supplies, etc.) One of the benefits to functional reporting is donors have more meaningful information about the types of programs and activities and their costs that are carried out to fulfill an organization’s mission.

Cost allocations are also important because when done accurately and consistently, they can provide a realistic picture of the total cost of different programs. This information becomes critically important in the current economic environment as nonprofit organizations work to stretch reduced resources over multiple programs and determine whether they must discontinue certain programs. In addition, many nonprofit organizations are required to report reimbursable expenses annually on cost reports. How you report these expenses by functional program will have a direct impact on your bottom line and potentially impact fundraising decisions.

Allocation methods also impact the percentages of program, management and fundraising that will appear on your Form 990 and other reports – numbers that potential donors use to judge your organization’s worthiness for their contributions.

I am frequently asked how much an organization should spend on program expenses vs. supporting services. My response is always to consider several factors, including but not limited to the following:

### Size of the Organization

There is a minimum infrastructure that is required for any organization. The smaller organizations, those with operating budgets under \$5 million, will generally have a higher percentage of supporting services to maintain proper internal controls, have proper technology for use, and maintain adequate staffing to properly supervise the

program staff of the organization. Conversely, the larger organizations, those with operating budgets in excess of \$100 million generally achieve smaller percentages of supporting services due to the achievement of economies of scale in their cost structure.

### Funding Mix

The types of funding, either public or private will also dictate the percentage of the supporting services that an organization will have. Some federal contracts put caps on supporting services at lower percentages, around 6% to 8%. For nonprofit organizations with operating budgets that are small to midsized, this could require private donor dollars to support a larger infrastructure.

### Complexity

Too much program expense may mean an organization is under-investing in technology, personnel support and development, or financial planning and audit services. Too little program expense may mean an organization is not being as efficient as it should be with donor contributions. When assessing an organization's program expenses vs. supporting service expenses, I recommend you compare it with the ratios of similar organizations instead of expecting there is a "right" percentage which would be expected for all nonprofit organizations.

### Conclusion

The recognition and allocation of supporting service costs is an important piece of a nonprofit organization's cost structure. The ability to fund these costs can make the difference between a successful organization and an unsuccessful one.

Understanding your organization's total costs can also help you increase efficiency and distribute your organization's resources in a way that maximizes program outcomes.

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