Fundamentals of a First-Rate Budget

by Jerry Soto, CPA

Budgets are more than a bunch of numbers on a page. A well-crafted budget tells its reader your organization's story in dollar terms. It describes where your money comes from and where it will be spent. It shows those programs and projects that are your organization's core, as well as services that are more tangential to your mission. In short, a budget is a series of educated guesses about the money your organization will bring in and spend in the coming year.

The budget process is complex. It involves a lot of people, many assumptions, accurate data and, most importantly, a total understanding of the organization. While the number of factors that go into the budget process sometimes appears endless, I have distilled what I believe are the ten “essentials” to creating a good budget. Get these ten essentials right and you’ve given yourself the very real chance of having a budget that can truly help guide your organization.

1. Review the Mission
Before setting numbers to paper, the budget process involves plenty of discussion...
The mission statement should be referred to constantly throughout the budget process.

**Budget Types and Terms**

In this article I will, for the most part, limit my remarks to the “operating budget” because it is the most common form of budget. It is also the most essential budget type because it becomes the basis for the “cash budget” and the “capital budget.”

The operating budget is closely aligned with an organization’s statement of activities (more commonly referred to as the “income statement”), especially for those nonprofits using the accrual basis of accounting. The cash budget, on the other hand, is a predictor of the cash inflows and outflows of the organization, regardless of such financial activities as receivable billings and payable expenses. If your organization is on the cash basis of accounting (as is most commonly found in smaller nonprofits), then treat the operating and cash budgets as essentially the same. However, if you operate using the accrual method of accounting, then you must contemplate developing the cash budget in order to more fully control your cash activity through the fiscal year.

The capital budget is usually developed alongside either capital campaigns or during those times when an organization knows it will be needing to make massive asset outlays for such things as leasehold improvements and building and equipment purchases. This type of budget is, of course, dependent upon the cash and financing resources available to the organization. Unfortunately, both cash budgets and capital budgets are topics too large to include in this article.

Please see the sidebar on page 5 for further explanation of terms.
the upcoming year. You can base realistic (that is, not too optimistic) revenue projections on the history of previous appeals’ results. Concurrently, in this example, fundraising expenses for the extra appeals campaign would also increase. This increase must be factored into that expense line item’s budgeted cost.

It is vital that your general ledger system be maintained properly during the year.

3. Have Adequate Revenue and Cost Information from the Prior Year
Remember past is prologue. The budget numbers are not created in a vacuum. The numbers you set down as hoped-for predictions are based, in large measure, on the numbers that have happened already. This obvious point is made only to highlight the great need for accurate and detailed financial information. The adage “Garbage in, garbage out” is especially true here. Management cannot make educated guesses (remember that is all any budget really is) without good numbers from the past.

If your organization has an inadequate accounting system – if during the year you have trouble accessing good, accurate interim financial reports that provide the level of detail needed to make good management decisions – then formulating a sound budget will be near impossible. It is vital that your general ledger system be maintained properly during the year so you can use its information in trying to predict the future.

4. Review and Update Overhead Cost per Program
Properly allocating overhead costs is critical to understanding and measuring the costs of providing services. Often based on time sheets or square footage, overhead cost allocations are used by organizations to “spread out” the costs of those items that are shared between the nonprofit’s three major functional expense areas of program services, administration, and fundraising.

For example, property and liability insurance is necessary for the operation of an entire organization. However, it is a cost that could be spread by percentage to each program or project within their major functional expense area. The same is true for such costs as rent, telephone, office supplies and administrative support personnel. It is important that the organization spread

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### The Budget: A Tabular Presentation

A sample operating budget for the fiscal year ending December 31, 2002 is shown in tabular format (best done in a spreadsheet). We can assume that the budget development work is being done in December 2001, just prior to the new fiscal year beginning in January. It shows the prior year (year-to-date actual plus prior December’s actual amount), the current budget and the projected budget. The “rationale” column can give descriptive information about the line item, name the person responsible for developing the figure, and/or name factors included when figuring each amount.

<table>
<thead>
<tr>
<th>Chart of Accounts Number and Description</th>
<th>Dec 2000 Plus YTD Nov 2001</th>
<th>Rationale</th>
<th>Budget 2001</th>
<th>Budget 2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>4001-Contribution</td>
<td>523,000</td>
<td>Additional appeals campaign</td>
<td>525,000</td>
<td>550,000</td>
</tr>
<tr>
<td>5001-Salaries</td>
<td>275,000</td>
<td>5% across-the-board staff raises</td>
<td>265,000</td>
<td>290,000</td>
</tr>
</tbody>
</table>


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out these types of costs so as to understand the nature and extent of a program or project’s total costs.

5. Tie Budget Line Items to the Chart of Accounts

One of the most common mistakes I see in the budget process is not tying the budget line items to those line items on your organization's chart of accounts. If the two are not aligned, the usability of interim budget-to-actual variance reports is diminished. This negates the most important reason for the budget – its existence as the point of reference for the actuals throughout the year. Your budget is the canary in the coal mine. When financial numbers are starting to get out of whack, the budget is there to tell you so, but it can only do so if you can compare the budgeted numbers to the actual financial activity on a line-by-line basis.

The best way to tie your budget to the chart of accounts is to use the chart of accounts listing as your guide from the very beginning of the budget process. For example, if your organization tracks salary expense by three different account line items called “salaries-administration,” “salaries-fundraising” and “salaries-program services,” be sure to budget for each line individually. Do not simply put in your budget a single line item projected cost called “salaries.” You must consider each chart of account line item cost separately. That way, when you see interim financial reports during the year, you will see a direct link between actual line item costs and your projections (go to to CAN’s website – www.CAnonprofits.org – and click on “UCOA” if you need a solid example of a chart of accounts).

When financial numbers are starting to get out of whack, the budget is there to tell you so.

6. Focus First on Income, then on Personnel Costs

Whenever I observe an organization going through the budget process, most of the discussion seems to revolve around the expenses. This tendency probably happens because expenses are the one area an organization can get its arms around. Costs are, for the most part, easily predictable. The same is not true about income. The hardest thing for any nonprofit to predict is how much money it will raise during the year, especially if it is an organization that depends heavily upon large foundation grants. So understand your funding sources. Work long and hard to establish realistic support and revenue budget numbers. Use most of your time and energy on this and less time and energy on your costs. It is also useful to the budget process if you know and remember the hierarchy of fundraising efforts:

- The most stable, efficient, and
responsive of all funding are smaller, individual donations.

- Much less stable and efficient is funding from foundations and government agencies.
- Least stable and most costly of all is revenue earned from special events.

When you do look at expenses, spend the bulk of your time on personnel-related costs. Why focus on personnel costs? Well, take a look at your own payroll-related costs – I’ll wager that they make up between 65 and 75 percent of your overall costs. How do I know this? Most nonprofit work is notoriously labor-intensive. It is work for and by people.

Also, make sure you pay enough to attract and retain good people. Constantly hiring and losing and hiring again can be an unexpected drain on your income. Monitor your fringe benefits costs regularly to make sure you are doing your best to reward your staff. “For love of the work” typically will only go so far when an employee has received minimal cost of living raises for the last few years. Be sure to factor all the benefits costs into your equations. Additionally, include fringe benefits costs into most, if not all, grant proposals. Most grantors realize the importance of benefits to the overall program costs. Take care of your personnel cost and you will have solved most of your expense-related concerns. Just as with your work on the support and revenues side, know and understand all the costs related to employing someone.

7. Seasonality
In order for a budget to be truly useful, it must predict the future by the economic seasons of the organization as well as by the program or project. In other words, your annual budget must try to reflect the activity as it might really occur, broken out by the twelve months of the fiscal year and within the appropriate program or project heading.

This is especially true of your support and revenues. Do not take your numbers and simply divide by twelve – that would be cheating! Take the time and effort to figure out when you expect the money to come in and get spent. Know your

**Glossary of Budget Terms**

**Budget:** A financial plan showing estimated or planned revenues and expenses.

**Budget variance:** The difference between actual results and amount budgeted.

**Operating budget:** The budget or financial plan for revenue and expenses, that is, for operations. In essence, an operating budget is a projected income statement (for nonprofits, also known as statement of activities).

**Cash budget:** A plan or projection of cash receipts and expenditures for a given period of time.

**Capital budget:** A plan for the acquisition of long-term assets (such as plant and equipment), showing planned expenditures by object and date.

**Capital budgeting:** The analysis and planning of investments in long-term assets.

**Master budget:** The overall budget or financial plan for an organization that integrates detailed budgets, such as program budget, project budget, operations budget, capital budget, and cash budget. The master budget is the end product of constructing and combining these subordinate budgets.

**Income statement:** A report of a company’s revenues, associated expenses and losses, and resulting net income for a period of time, also called profit and loss statement or statement of operations. Additionally called statement of activities in the nonprofit world, showing as an end result the increase or decrease in an organization’s net assets for a period of time.

**Cash flows statement:** A listing of cash receipts and expenditures for a past or future period along with beginning and ending balances.

**Cash basis accounting:** A method of accounting in which changes in the condition of an organization are recognized only in response to tangible, external transactions and events, generally involving either cash payments or receipts.

**Accrual accounting:** A method of accounting in which revenue is recorded when earned, expenses are recorded when incurred, and other changes in the condition of an organization are recognized as they occur, without regard to the timing of related cash receipts and expenditures.

**Zero-base budgeting:** A budgeting approach in which each program or activity is evaluated anew each budget cycle, as opposed to the incremental approach, in which critical evaluation is focused on additions to the prior period’s budget. Zero-base budgeting, advocated primarily for government and nonprofit organizations, calls for each program or activity to be identified as a “decision package.” These are ranked and then funded in order of ranked importance, to the extent allowed by projected revenue. While much has been said about zero-base budgeting, actual (and successful) applications are difficult to find. It appears that the concept is more useful as a way of thinking about programs than as a procedure to be followed rigorously during the budgeting process.

that receives the bulk of your support from individual small donors, you will probably have a more even flow of support than those nonprofits that depend more heavily upon major grants and government contracts. Factor all this information into your calendarized budget.

It is amazing how much more helpful the budget is when you look at it with twelve months of variable predicted activity spread across monthly columns, especially when looking at the support and revenue numbers. Except for special events and various solicitation campaign-related expenses and major program start-up or shut-down costs, most expenses tend to be regular throughout the year. Putting the budget into this format will make your budget-to-actual variance reports more useful and relevant to your decision-making needs.

8. Communicate Variance Reports

Just as the budget is not created in a vacuum, it should not reside only in the hands of the board and management. The proper use of the budget demands that it be communicated on a regular basis to as many staff as possible. It is not enough to ask for input from program and supporting services personnel while the budget is being created and then not to include them in the interim reporting during your fiscal year. They need to know where they stand relative to what was predicted for them.

Of course, instituting this practice means your organization must have an accounting system that allows the general ledger to track allocated costs by program or project. Program staffers need to see these numbers and discuss the variances with management. This process makes the overall efforts of the organization that much more meaningful for everyone and will go a long way toward preventing political maneuvering and suspicion between resource-strapped programs and projects.

9. Minimize Budget Modifications

It is recommended that an organization make all budget modifications only once, at mid-year, except if a major event occurs that requires sudden, unexpected expansion or contraction. Roughly five to six months into the new fiscal year, the organization should hold a mini-summit on the status of the budget as written compared to the actual results of the year. Any new information regarding funding or costs should be discussed. Changes to the budget should be infrequent. The importance of the variances cannot be stressed enough when comparing the budget to the actual financial numbers. These variances provide valuable information about board and management’s understanding and knowledge of the organization. Erasing these variances wipes out this information.

Do not make changes to the budget on the fly just to avoid having to explain the differences at a board or committee meeting. The variances mean something. Being ahead of or behind the actual numbers is meaningful. It is up to management to figure the source and significance of the differences.

Just as the budget is not created in a vacuum, it should not reside only in the hands of the board and management.

10. Treat the Budget Process Seriously

Finally, do not just talk a good game about the budget process – take it seriously. Set a time frame for its development and stick to it. When presenting it to the board, stress its importance. Then, once it is board-approved, sell it to the staff. They helped create it, so assure them that they will be included throughout the year in update meetings where wide variances will be discussed and minimal differences applauded.

A good budget can be a source of quiet confidence, allowing management to play out “what-if” scenarios, gauging different economic and operational factors. It can be used to instill trust between the board and management, and between management and employees. Most of all, a good budget can allow an organization to get the most out of its resources. In today’s volatile economic world, that is no mean feat. ▲

Resources

Many books regarding the financial management of nonprofits either are devoted entirely to or contain chapters on the budget process. Among some of the best are the following:


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www.CAnonprofits.org
As you know, lines 13-17 of IRS Form 990, the federal tax form for exempt organizations, are often scrutinized by supporters and potential supporters as they try to determine what percentage of each dollar they give will go to programs, management and/or fundraising for the organization.

The Internal Revenue Service (IRS) also has an interest in those numbers as IRS personnel decide which organizations to audit. For example, recent studies have found that even some multimillion-dollar nonprofits are reporting zero fundraising costs: a certain red flag for IRS auditors.

You should also be concerned about lines 13-17, and not just because of the threat of fewer donations or likelier audits. You should be concerned because those numbers — and others like them — have the potential to give you important insight into the real costs of your programs. This insight could directly impact the decisions you make about the programs and services you offer.

And the key to getting those numbers correct is a little something called cost allocation.

But before we get into cost allocation, a little brush-up on nonprofit accounting.

**Functional Accounting**

Functional accounting is a method of accounting that is based on the organization’s two major types of activities, primarily (a) program or mission-based services and (b) supporting services such as administration, governance and fund development.

Functional accounting allows you to identify three key characteristics of every dollar coming into and going out of the organization (see chart at right).

This article deals

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**Table:**

<table>
<thead>
<tr>
<th>Dollars coming in (income)</th>
<th>Dollars going out (expense)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Who</td>
<td>Who is paying for an expense (i.e., the specific funder)</td>
</tr>
<tr>
<td>(i.e., the specific funder)</td>
<td></td>
</tr>
<tr>
<td>What</td>
<td>What the dollar will be spent on (e.g., payroll, supplies, etc.)</td>
</tr>
<tr>
<td>(e.g., grant, contract, earned, etc.)</td>
<td></td>
</tr>
<tr>
<td>Why</td>
<td>Why the dollar is being spent (i.e., for which program or purpose including administration and fundraising)</td>
</tr>
<tr>
<td>(i.e., for which program or purpose)</td>
<td></td>
</tr>
</tbody>
</table>
Secrets of Cost Allocation continued

primarily with the expense side of the what and the why that appear on a statement of functional expenses, which is a financial report that crosscuts what an organization’s money was spent on (personnel, non-personnel, etc.) with why the expenditures occurred (program, general and fundraising). The who -- the funders -- are dealt with in a separate report geared to the particular funder reports you need to produce.

Breaking down expenses by what and why reflects the broad outlines of major nonprofit reporting requirements. For example, Section 2 of IRS Form 990 asks nonprofits to divide expenses by program, management/ general and fundraising. A statement of functional expenses is required as part of the audit for voluntary health and welfare organizations. (In California, audits are required of nonprofits with $2 million or more in annual income, and many smaller organizations choose to be audited as well.)

But a statement of functional expenses is also recommended for every organization for three reasons. First, unless your organization is very small (less than $25,000 in revenue annually), you probably have to file a 990 already.

Second, even if you are very small now, you might someday be large enough to need an audit -- so you might as well get in the habit of creating a statement of functional expenses right now.

Third, and perhaps most importantly, a statement of functional expenses is an ideal method for tracking the real costs of program and supporting activities, making it an invaluable tool for decision-making. It allows you to see exactly what Program A is costing, what Program B is costing, whether your fundraising is proportionate to the areas that need it, whether you want to build, maintain or scale back a program and so forth.

The information found in a statement of functional expenses can most easily be organized, streamlined and accessed through the meeting of two basic functional accounting tools: your chart of accounts and your functional areas.

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Here is an example of a portion of a chart of accounts:

<table>
<thead>
<tr>
<th>Account</th>
<th>Type</th>
</tr>
</thead>
<tbody>
<tr>
<td>4</td>
<td>Income</td>
</tr>
<tr>
<td>4010</td>
<td>Individual/business contribution</td>
</tr>
<tr>
<td>4110</td>
<td>Donated professional services -- GAAP</td>
</tr>
<tr>
<td>4140</td>
<td>Gifts in kind</td>
</tr>
<tr>
<td>4210</td>
<td>Corporate/business grants</td>
</tr>
<tr>
<td>4230</td>
<td>Foundation/trust grants</td>
</tr>
<tr>
<td>5</td>
<td>Expense</td>
</tr>
<tr>
<td>5180</td>
<td>Program service fees</td>
</tr>
<tr>
<td>5210</td>
<td>Membership dues</td>
</tr>
<tr>
<td>7000</td>
<td>Grant and contract expense</td>
</tr>
<tr>
<td>7040</td>
<td>Awards/grants -- individuals</td>
</tr>
<tr>
<td>7200</td>
<td>Salaries &amp; related expenses</td>
</tr>
<tr>
<td>7210</td>
<td>Salaries</td>
</tr>
<tr>
<td>7230</td>
<td>403(b) plan match contributions</td>
</tr>
<tr>
<td>7240</td>
<td>Health insurance</td>
</tr>
<tr>
<td>7241</td>
<td>Workers compensation</td>
</tr>
<tr>
<td>7246</td>
<td>Vacation</td>
</tr>
<tr>
<td>7250</td>
<td>Payroll taxes</td>
</tr>
<tr>
<td>7500</td>
<td>Contract services</td>
</tr>
<tr>
<td>8100</td>
<td>Non-personnel expenses</td>
</tr>
<tr>
<td>8110</td>
<td>Supplies</td>
</tr>
<tr>
<td>8130</td>
<td>Telephone, local and longdistance</td>
</tr>
<tr>
<td>8131</td>
<td>Website and e-mail services</td>
</tr>
<tr>
<td>8170</td>
<td>Printing and copying</td>
</tr>
</tbody>
</table>

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Chart of Accounts

A chart of accounts consists of numbered account names that describe the types of income and expenses that your organization experiences over time. It is the list of categories that tracks the what of each dollar coming into and going out of your organization.

Your chart of accounts should be flexible enough to change as your organization changes. For example, you want to be able to insert new income and expense categories as they arise. But you want to be able to insert them within the broader categories of the existing chart instead of simply appending them to the end of it, which is why it is numbered by the tens, hundreds and thousands instead of 1, 2, 3 and so on.

If you don’t have a chart of accounts, or if you’re not happy with the one you have, the California Association of Nonprofits (CAN) has developed a prototype for nonprofits called the Unified Chart of Accounts (UCOA®) in
partnership with the California Society of CPAs, the National Center for Charitable Statistics, the IRS and a team of nonprofit accounting experts including UCOA originator Bill Levis.

The UCOA (pronounced yoo-KOH-uh) provides a structure for your accounting system that meets all major nonprofit reporting requirements, including those of the Internal Revenue Service, Generally Accepted Accounting Principles (GAAP), A-133 Single Audits, government contracts, private foundations and United Way. Yet it is also flexible enough that you can tailor it to your own organization’s needs, both now and as your nonprofit evolves in future years. And — best of all for nonprofit finance types — it can save you a lot of time putting together financial reports for all stakeholders.

The UCOA can be integrated into any accounting software, used as a standalone chart or overlaid on the chart of accounts you already use. If you’re already using QuickBooks Premiere, you’re in luck: The UCOA is included as its model nonprofit chart of accounts. You can also download a copy of the UCOA for your own use at www.CAnonprofits.org/financial/990web.html or e-mail astrand@CAnonprofits.org to receive a copy.

It’s important to remember to use your chart of accounts — whether it’s the UCOA or not — from budgeting all the way through reporting. If you do, it will be much easier to do comparatives and other types of reports that depend on your budget numbers.

**Functional Areas**

Functional areas are the *whys* related to each dollar coming into or going out of your organization. They are the areas — such as program, administration or fundraising — into which you distribute each incoming or outgoing dollar. Some organizations that I have worked with tend to track dollars according to the funder or contract rather than by mission-based purpose. But if you use functional accounting, you can use functional areas to cross-cut funder information with programs and services (*why*) and with income or expense line items (*what*) so that you can accurately track any given dollar, in a number of different ways, in its journey through your organization.

If you haven’t already developed functional areas, start with your mission. Read your goals and values statements, and take a look at how your nonprofit is divided programmatically. Identify each larger purpose, within the overall organization, on which you spend time and money.

<table>
<thead>
<tr>
<th>Functional Area</th>
<th>Type</th>
</tr>
</thead>
<tbody>
<tr>
<td>100</td>
<td>Food Pantry</td>
</tr>
<tr>
<td>200</td>
<td>Child Care</td>
</tr>
<tr>
<td>300</td>
<td>Case Management</td>
</tr>
<tr>
<td>400</td>
<td>Outreach</td>
</tr>
<tr>
<td>600</td>
<td>Administration</td>
</tr>
<tr>
<td>700</td>
<td>Governance</td>
</tr>
<tr>
<td>800</td>
<td>Fundraising</td>
</tr>
<tr>
<td>900</td>
<td>Cost Centers</td>
</tr>
<tr>
<td>910</td>
<td>Occupancy Cost Center</td>
</tr>
<tr>
<td>920</td>
<td>Personnel Cost Center</td>
</tr>
</tbody>
</table>

A further explanation of the “cost center” lines above will be provided momentarily.

I know a number of groups that have kept separate books for each grant and then tried to bring those multiple systems together for different programs and reports. It creates a nightmare scenario for tracking and reporting and takes an incredible amount of time and effort for the person generating the financial reports. Instead, each transaction coming into or going out of the organization should be identified with a code corresponding to the who, the what and the why of that transaction. The more you can integrate these three pieces, the higher-quality, more accurate reports you will produce. And you will produce them more quickly.

*continued on page 4*
If your accounting system cannot slice and dice your numbers in these three ways, you might consider an upgrade of your financial software. (Unless you are keeping your books in Excel or another spreadsheet program, which I do not recommend, most accounting software packages should be able to handle these types of reports.) Also, don’t forget to integrate those three questions — who, what and why — into all your relevant processes such as payment requisition forms and record-keeping for bills that come in. It can take some time to set up, but once it is set up, tracking and reporting run very smoothly. And it will make your auditor happy, too.

Cost Allocation
Once you have a system set up in which you can track the who, the what and the why of each dollar coming into and going out of your organization, you can start to think about cost allocation.

Cost allocation is a method for apportioning shared expenses or shared costs (also called common costs, joint costs or directly allocable costs) across functional areas. It generally works well to “dump” all shared costs into cost centers — temporary holding tanks for functional areas — and then allocate them out across those functional areas on a periodic basis, usually monthly or yearly. (If you choose, you may allocate every time you receive an invoice, but doing so generally takes more time — something nonprofit staff are notoriously short of!)

For example, you receive a bill from your office supply store for $500. Using the two charts on pages 2 and 3, you would code it to the expense line “8110 – Supplies” in the chart of accounts and initially to the functional area “910 – Occupancy Cost Center.” Then, at month-end, year-end or whenever you allocate costs, you will remove the lump sum of $500 out of the cost center and divide it out between the specific functional areas that actually used the office supplies. So you might end up with $50 of that bill being allocated to “600 – Administration,” $75 to “800 – Fundraising” and $375 proportionately across various programs. Your allocation method is your way of deciding what percentage of that bill to apportion to each functional area.

Cost allocation is important because, done accurately and consistently, it can provide a realistic picture of what different programs and

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Example of a Statement of Functional Expenses

Below is an abridged version of a statement of functional expenses. Note that the rows (personnel, non-personnel, etc.) represent what the money was spent on, while the columns (program, general and fundraising) are the whys of each dollar spent. Not shown here is the who — the third dimension — which you would code as you enter the transaction into your accounting software but, as a practical matter, would appear in a separate funder report.

<table>
<thead>
<tr>
<th>Personnel Costs</th>
<th>Program</th>
<th>General</th>
<th>Fundraising</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>7000 – Salaries</td>
<td>$200,000</td>
<td>$50,000</td>
<td>$10,000</td>
<td>$260,000</td>
</tr>
<tr>
<td>7100 – Fringe benefits</td>
<td>40,000</td>
<td>10,000</td>
<td>2,000</td>
<td>52,000</td>
</tr>
<tr>
<td>Total Personnel Costs</td>
<td>$240,000</td>
<td>$60,000</td>
<td>$12,000</td>
<td>$312,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Non-personnel Costs</th>
<th>Program</th>
<th>General</th>
<th>Fundraising</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>8010 – Insurance</td>
<td>$1,000</td>
<td>$5,000</td>
<td>$1,000</td>
<td>$7,000</td>
</tr>
<tr>
<td>8020 – Postage</td>
<td>15,000</td>
<td>1,000</td>
<td>200</td>
<td>16,200</td>
</tr>
<tr>
<td>8030 – Printing</td>
<td>15,000</td>
<td>1,000</td>
<td>50</td>
<td>16,050</td>
</tr>
<tr>
<td>8040 – Rent</td>
<td>55,000</td>
<td>20,000</td>
<td>1,500</td>
<td>76,500</td>
</tr>
<tr>
<td>8100 – Travel</td>
<td>5,000</td>
<td>5,000</td>
<td>–</td>
<td>10,000</td>
</tr>
<tr>
<td>8200 – Utilities</td>
<td>1,500</td>
<td>500</td>
<td>75</td>
<td>2,075</td>
</tr>
<tr>
<td>Total Non-personnel Costs</td>
<td>$92,500</td>
<td>$32,500</td>
<td>$2,825</td>
<td>$127,825</td>
</tr>
<tr>
<td>Total Expenses</td>
<td>$332,500</td>
<td>$92,500</td>
<td>$14,825</td>
<td>$439,825</td>
</tr>
</tbody>
</table>
other activities cost. Your allocation method also determines 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. Finally, it is used in cost recovery for reimbursable expenses, directly impacting your bottom line and related fundraising decisions.

There are a number of legitimate cost allocation methods. In order of popularity, the most common methods are:

- **Payroll.** Allocations are based on a percentage of the total actual time worked or the total payroll dollars charged by all employees in each functional area. For example, four employees’ time sheet data shows that they spent 15 percent of their aggregated time during the last payroll period on Program A, 35 percent of their aggregated time on Program B, 25 percent on program C, 15 percent on Administration and 10 percent on Fundraising. This is a popular method not only because it reflects actual time worked but also because it can weigh the percentages based on each employee’s pay scale. (If you’re interested in a step-by-step Web-based demonstration of how one organization uses this method, see the sidebar on page 11.)

- **Cost-to-cost or direct cost.** Allocations are based on the previous year’s percentage breakdowns for each functional area. If you don’t want to base your entire allocation method on cost-to-cost data, you can also use these percentages to quickly allocate out smaller invoices, such as bottled water delivery or overnight delivery charges that generally don’t amount to much.

- **Full-time equivalents (FTEs).** Rather than relying on time sheets, FTE allocations are based on a percentage of the time budgeted for each employee as opposed to the actual time each person worked in various functional areas. While this method is similar to allocating by payroll dollars, in many cases it reflects reality less accurately because actual time worked in each area can be radically different than what was projected at the beginning of the year. In my experience, this method is most useful as a way of estimating percentages throughout the year until you “true them up” at year-end using actual time sheet data (more on that to follow).

### Glossary of Terms

- **A-133 single audit** A type of audit required by the federal Office of Management and Budget (OMB) of nonprofit organizations who expend $500,000 or more in federal monies in a year. It is intended to provide a cost-effective audit for non-federal entities in that one audit is conducted in lieu of multiple audits of individual programs.

- **Chart of accounts** A list of numbered account names that describe the types of income and expenses that your organization experiences over time.

- **Common costs** See “Directly allocable costs.”

- **Cost allocation** A method for apportioning shared expenses or shared costs across functional areas.

- **Cost centers** In a list of functional areas, a temporary holding tank for directly allocatable costs where those costs are recorded until you are ready to allocate them. Also known as cost pools.

- **Direct costs** Costs connected to and directly impacting a specific activity.

- **Directly allocable costs** Costs that are shared between activities such as rent, utilities and telephone. Also known as joint costs, shared costs and common costs.

- **Expenses** Costs you incur in the course of doing your work (payroll, rent, office expenses, etc.). Also known as costs.

- **Functional accounting** A method of accounting based on the organization’s major types of activities, primarily (a) program or mission-based services and (b) supporting services such as administration, governance and fund development.

- **Functional area** Coded, purpose-driven areas (such as administration, fundraising or specific programs) into which you distribute each incoming or outgoing dollar.

- **Generally Accepted Accounting Principles (GAAP)** The common set of accounting principles, standards and procedures that companies use to compile their financial statements. GAAP is a combination of authoritative standards (set by policy boards) and simply the commonly accepted ways of recording and reporting accounting information.

- **Indirect costs** General and administrative costs not related to or directly impacting a specific activity. Usually includes (but may not be limited to) management, general record-keeping, budgeting, financing costs and fundraising.

- **Joint costs** See “Directly allocable costs.”

- **Overhead** Nondirect program costs. Some may be allocable to a particular program, while others may be strictly indirect costs.

- **Revenue** What you earn through grants, contracts, donations, sales or rental fees. Also known as income.

- **Shared costs** See “Directly allocable costs.”

- **Statement of functional expenses** A financial report presented in spreadsheet format in which the rows represent what the money was spent on (personnel, non-personnel, etc.), while the columns are the whys of each dollar spent (program, general and fundraising).
• **Square footage.** Allocations are based on the proportionate space occupied by each functional area in your office or worksite. For example, Program A occupies 10 percent of your office space, Program B occupies 20 percent, Program C 50 percent, Administration 5 percent and Fundraising 15 percent. This method can be useful for allocating rent, utilities and other occupancy-related costs.

• **Units of service.** Given the fluid and unpredictable nature of much nonprofit work, this is a difficult method to create and apply consistently. One good, clean example is a food bank that collected food in a central warehouse and then distributed it to several satellite offices. They based their allocation on the percentage of pounds of food distributed to each satellite office. It worked beautifully for them because their units of service were discrete and easily measurable.

• **Percentage of revenue.** Some organizations allocate common costs based on the percentage of revenue they receive. If the bulk of your organization’s income is fairly predictable, this method might be a workable one for you. However, if you receive an unexpected grant mid-year, develop a new program or otherwise change your income and/or program structure, your allocations may be thrown off significantly.

Your organization might require more than one method of cost allocation, for example using payroll for personnel-related expenses and square footage for office-related expenses. You might have to pick and choose which method or combination of methods work best for your organization in terms of both your available time and the accuracy of the data produced. That said, if you have many different allocation methods, some consolidation might be in order. Whatever method(s) you decide to use, use it consistently, put it in writing and have it approved by the executive director. It should also be ethical — not a method you would regret being described in a front-page story in your local newspaper.

**Payroll-based Allocation**

A common allocation method is based on percentages of payroll. Used correctly, it is a consistent, clean, regular and reliable method that is easily tracked and takes into consideration the time worked and the cost of that work.

Here’s another example of why payroll can be a good allocation method: A couple years ago, CAN was contracted to review and make

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**Time Sheet Best Practices**

Besides being general best practices, these guidelines are also from the government reporting side, so if you follow these, you should be in compliance with any federal grants you have (check your contract to be sure).

• Employees should generate time activity reports at least monthly, in time spans coinciding with the payroll period. (According to federal and state law, payroll has to be at least monthly.)

• Time sheets or time activity reports should be signed by the employee and by his or her supervisor.

• They should include total hours worked and hours allocated by program. You can choose to have them allocate by the half-hour, by the hour or in whatever time increments you want.

• They should reflect actual, after-the-fact activity — not projections or estimates.

On the following page is an example of a portion of a time sheet created in Excel for a fictional employee. Ideally, each employee fills out this time sheet on a day-to-day basis to get the most accurate reporting possible and turns in a copy, signed by his or her supervisor, at the end of each pay period.

Notice how all the program areas are listed in the left column, with the dates across the top in two rows corresponding to the pay periods. On the far right column, formulas in the spreadsheet automatically calculate the percentage of time spent in each program area for the duration of the pay period, as the employee enters the time spent in each area. A row across the bottom of the main section calculates the number of hours spent working each day so that you can easily look and see if you need to pay overtime to non-exempt employees. At the very bottom is an in/out section for hourly employees to fill in.

You can download a copy of this time sheet to adapt for your own use at www.Canonprofits.org (click on “Financial Support”).
recommendations for a nonprofit organization’s accounting system. They had budgeted the full-time equivalents (FTEs) that the executive director believed should occur (based, in turn, on their income sources), then allocated common costs based on those budgeted FTEs.

For example, they believed the executive director was spending 50 percent of her time on fundraising, 35 percent of her time on management and 15 percent of her time spread out over a couple of programs. They believed the manager of Program A devoted all of her time to that program, and likewise for Program B’s manager.

But the organization wasn’t doing any time tracking either to verify or to challenge those assumptions, so CAN helped them set up a time tracking system based on their functional areas. Once the organization’s employees had tracked their time for a few weeks, they were able to see that what they were actually doing was very different from what was in the budget. The executive director spent a lot more time than she realized pitching in to support a certain program, while the program managers participated in a significant amount of fundraising activities. Some employees were doing more administrative paperwork than they thought they were. Others were working in service areas different from the programs for which they were budgeted.

In short, the organization was not getting a realistic picture of what was happening day-to-day, and the time sheet was how they identified those discrepancies. The exercise caused them to alter their budget and even to change some positions around to better meet the reality of what they were doing.

Payroll-based allocation depends on employees filling out time sheets, or time activity reports. For legal reasons, non-exempt employees should always fill out a time sheet. For allocation purposes, exempt employees should, too. In California, exempt employees do not currently have to deduct sick or vacation time for an absence that is fewer than four hours, nor do they have to report times in and out of the workplace. But their day-to-day activities do bear on allocation and every thing that comes out of it. Time sheets for exempt employees might better be called “time activity reports,” since they do not have to include time in and time out. (For more about time sheets, including best practices and a sample sheet, see pages 6-7.)

However you get the data about how your employees are spending their time, there are three basic ways to allocate payroll:

continued on next page
1. **Allocate as you do payroll.** As part of your process at the end of each pay period, you can immediately allocate the costs for that pay period using percentages from the time sheet data for that same pay period.

2. **Spread out only at month-end.** As part of your month-end financial wrap-up, you can include a step for calculating time sheet data and allocating percentages across functional areas for that month.

3. **Charge based on estimates that you “true up” at the end of the year.** You can use the full-time equivalents (FTEs) method throughout the year and then correct it at year-end based on actuals from the time sheets for the year. If you choose this method, I highly recommend that you do a time study at mid-year to confirm or correct your working estimates. Doing so will help minimize surprises at year-end.

Generally, payroll can be charged to activities based on budget, estimates or actuals. However, if any federal money is being received, the allocation method must be based on actual, after-the-fact reporting — which in my estimation is the best way to do it, anyway, because you are acknowledging what people have actually done, not trying to guess what they are going to be doing in the future.

### For Your Consideration

Despite all your best efforts, cost allocation is almost never a clean and simple process — whether you use payroll or any other method. There are a few important things to consider as you put your allocation plan into motion.

1. **Variances between overhead rates** can impact the way you generate reports. Although GAAP requires all nonprofits to present expenses by functional areas, some grants and contracts include overhead rates that are different from the true overhead rate. For example, a funder might allow you to charge 15 percent overhead, but your actual overhead is 20 percent. In that case, you would still keep your books in GAAP fashion and then make adjustments in Excel (or another spreadsheet program) after exporting your reporting data to that program.

2. **Variances between GAAP standards and government contracts** sometimes exist. For example, property and equipment might be expensed for the purpose of the

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**Order of Allocation**

There is a proper order in which to go about allocating common costs:

1. **Assign direct costs.** These are costs connected directly to a specific activity or functional area, such as an employee whose time is devoted completely to Program A, food purchases that are solely for Program B or time spent writing a funding proposal.

2. **Allocate directly allocable costs (also called shared costs, joint costs or common costs).** Directly allocable costs are those that are legitimately shared between a number of different activities throughout the organization, including programs. Examples of common costs include rent, utilities and telephone charges.

3. **Allocate all indirect costs if you’re getting government money.** Indirect costs are not the same as directly allocable costs; they are costs that cannot be apportioned out to various programs—unless you have a government contract that allows you to do so (generally these are federal contracts of $500,000 or more, but check your own contract to make sure). Indirect costs include (but are not limited to) management, human resources, D&O insurance, general record-keeping, budgeting, financing costs and fundraising.

Allocating costs in this order will simplify the process and ensure you do it correctly. If you are unsure about what is directly allocable as opposed to direct, ask yourself whether or not it benefits a program directly. If the answer is yes, it is generally a directly allocable cost. If the answer is no, it is generally an indirect cost.

Take note that fundraising — even though it clearly has a direct benefit to programs — is always counted separately from direct and indirect costs by the IRS.

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*continued on page 10*
contract but capitalized for GAAP. As with variances between overhead rates, you should follow GAAP for your own records and simply modify the data when you need to report to the funder.

3. **Some strictly administrative functions** may not be allocated to program expenses at all except to the extent that they are a direct and integral part of a program’s operation. Some examples of non-allocable expenses include human resources, accounting, audits, and directors and officers (D&O) insurance.

4. On the other hand, **some activities that are often assigned to the administrative side are allocable.** Common ones include activities of the executive director as well as rent for your main office. Since these are often some of the largest expenses in your organization, do not just automatically charge those out to administrative.

Finally, use allocation for cost recovery so you can get reimbursed at your true rate. These reports form the basis for contractor reimbursement rates, so it is important to make sure you have all the real costs in the right places and correctly allocated. Failing to allocate correctly could mean you get paid less than the real cost of your work. That means additional and possibly unnecessary work for the development department and higher fundraising percentages down the road. On the other hand, charging more overhead than is allowed can get you into deep trouble on the other side — leading, in extreme cases, to demands for returned funds and unflattering stories on the front page of your local newspaper.

**Conclusion**

Cost allocation should not be ignored as a cornerstone of your financial management and reporting. It is critically important to all aspects of your organization: How you budget from year to year, how you make management decisions, how you appear to potential supporters and the amount you are reimbursed for services all depend on proper and consistent cost allocation.

Allocation can look tricky at first glance, and initially it can be difficult to set up a reliable, consistent and simple system. But once your system is in place, it should go rather smoothly.

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The Incidence of Fraud

Per the Association of Certified Fraud Examiners’ (ACFE) 2004 Report to the Nation on Occupational Fraud and Abuse, the incidence of reported fraud is as follows:

- Nonpublic companies were hit with 41.8 percent of the losses, with a median of $123,000.
- Public companies sustained 30.3 percent of the losses, with a median of $100,000.
- Government incurred 15.8 percent of the losses, with a median of $37,500.
- Nonprofit organizations suffered 12.2 percent of the losses, with a median of $100,000 (as high as for public companies!).

The ACFE estimates that, on average, six percent of Gross Domestic Product is lost to occupational fraud and abuse each year. While frauds themselves are often large, particularly in the highly publicized cases, public company shareholders typically incur personal losses (in the form of lost stock value) that can be 500 to 1,000 times larger than the underlying fraud itself.

Nonprofit organizations typically suffer losses consisting of damage to reputation, loss of public trust, and alienation of donors. These losses are far more significant and longer lasting than actual monetary losses. Still, bearing in mind that 43 percent of nonprofits operate on less than $100,000 per year, fraud risks running into six figures are intolerable.

While it is certainly understandable that nonprofit management and boards focus their attention primarily on their mission, the risk of losses to fraud cannot be ignored without jeopardizing that mission.

Fraud occurs in different (though related) ways:

- Misappropriation of assets.
- Fraudulent misstatement of financial information.

This article deals primarily with controlling misappropriation risks. (A later article will explore ways to control fraudulent misstatement of nonprofit financial information.) Theft can involve a variety of valuable nonprofit assets. This article focuses on three of the most common assets lost to misappropriation: cash, receivables, and investments.

Cash

According to ACFE studies, 93.4 percent of misappropriations involve cash. Clearly, cash is the asset most at risk of theft. Some common cash-related frauds include:

- Theft of deposits: One way a fraudster can do this is by diverting deposits to a personally controlled bank account with a name similar to the nonprofit organization. A fraudster may form an organization (or forge documents) with a similar name (e.g., an acronym based on the nonprofit’s name) and open a personally-controlled bank account. Because of high transaction volumes, banks cannot be relied upon to detect minor variations between payee names and the name on a deposit account. Once a
Preventing Fraud continued

check is deposited into such an account, spending the money is no problem.

- In this age of scanners and laser printers, auditors need to be alert to the possibility that a nonprofit’s bank statements may have been scanned by a dishonest client (or employee) and altered to show facts that do not match reality. Care must be taken to ensure that responses to bank confirmations are from legitimate bank sources.

Receivables

Among the common types of receivables fraud are the following:

- Lapping: A pledge payment is stolen and covered up by applying a later payment to the original (stolen) pledge. (Some organizations think such payments can’t be stolen because donors would complain if they don’t receive the pledge gift they’ve been promised. But such nonprofits often fail to control access to gift items, and a fraudster could easily steal a supply to send to the donors whose pledge payments were stolen.)

- False credits and writeoffs: After having stolen a pledge payment, a fraudster normally must write a journal entry or issue a credit memo to get the pledge receivable off the books. Most fraudsters who get caught are not caught in the act of stealing. Rather, their attempts to cover up their theft in the records are noticed by a fellow employee, manager, auditor, etc. (The author has recently encountered a nonprofit whose system automatically deletes unpaid pledges after a few months. This practice omits an important control mechanism: With “unpaid” pledges automatically purged from the records, a fraudster is relieved of the need to cover his or her trail and is that much less likely to be caught.)

- Theft of non-cash items contributed to a nonprofit: For example, an estate may give valuable items, and a fraudster could easily steal a supply to send to the donors whose pledge payments were stolen.)

- Theft of cash received in direct-contact solicitations: This misappropriation is particularly difficult to control. If a cash makes its way into a solicitor’s pocket, there is usually no way for the nonprofit to know what was actually given (and stolen).

Internal controls are needed to guard against contributions fraud in order to:

- Ensure that the existence and nature of donor restrictions are identified at the time promises to give are received—and that such restrictions are properly observed in the safeguarding and expenditure of such funds.

- Identify and keep appropriate records of funding sources, grantors, programs, and types of expenses.

When confirming contributions receivable, auditors need to be alert to the reliability of responders. If, as is usually the case, names and addresses of contributors are supplied to the auditors by a nonprofit’s management or employees, the possibility exists that such information could be bogus and that replies could be from a fraudster or a confederate seeking to cover a theft or misstatement of revenue and receivables.

Investments

Some common types of investment fraud include:

- Stealing investments or diverting income or gains: A fraudster may instruct a broker to transfer a nonprofit’s investments to an account he or she controls or to pay interest or dividend income (or gains on sale of securities) to such an account (or issue a check that is then stolen). If such instructions come from a CEO or CFO, a broker may have little reason or inclination to verify their validity.

- Borrowing securities for personal use: Such a fraud can be accomplished in ways similar to the above, except that the fraudster returns (or, at least, intends to return) the security to the nonprofit. If no one is paying attention, the loss of earnings during the “borrowing” may go unnoticed.

- Recording phony investments to “window dress” the financial statements: If no one is looking closely, such fictitious assets can go undetected for a long time. If anyone asks, the phantom “securities” are said to be in a (perhaps nonexistent) safe-deposit box somewhere.

- Misclassifications and misstatements: Many securities are not actively traded on an organized
exchange. Determining the fair value of such securities is a matter of judgment. A nonprofit’s management may be tempted to over- or understate the value of such securities to portray the organization as stronger than it really is financially—or perhaps as more needy of support from a potential donor or grantee.

Internal control considerations include:

• Controls are needed over the purchase and donation of investments. Controls need to focus on proper recording of ownership, prices, fair values, etc. to ensure that the organization’s investments are safeguarded and recorded accurately.

• Controls are also needed over the recording of income and gains and losses. Such controls will help ensure that no one is diverting such income to their personal benefit and to the detriment of the organization.

• Other important controls are needed to identify the existence and nature of donor restrictions on securities given to the nonprofit. Only by creating accurate and comprehensive records at the time of receipt and maintaining those records in readily accessible form can a nonprofit ensure that it is acting with integrity toward those who support it. (The author has dealt with a situation in which a client did not maintain such records. After a number of years, it became unclear how much money was in the endowment fund and how much was available to support current operations. Finding answers to those questions required poring through years of incomplete and confusing records and proved to be a time-consuming and costly project.)

• Controls are also needed to ensure that boards of directors designations are properly observed. As time passes and the composition of the board changes, a nonprofit needs to know what its board has done in the past and why. Otherwise management may violate poorly understood board instructions or may be hamstrung by board designations the current board may no longer regard as appropriate.

**Summary**

It is always more fun to focus on a nonprofit’s mission and to create innovative ways to achieve its vital goals. However boards and management must give serious time and attention to controlling fraud risks. Otherwise the mission may be compromised by the loss of vital resources.

_Gale Case_ is a shareholder and principal in the Beverly Hills office of Rothstein, Kass & Co., PC. He is both a Certified Public Accountant and a Certified Fraud Examiner. He is a past president of the California Society of CPAs and chairs CAN’s Nonprofit Quality Reporting Task Force.
Everything You Want To Know From Your CPA But Can’t Afford To Ask

By Gale L. Case, CPA, CFE

The often-arcane world of record keeping, financial reporting and auditing — not to mention the complex nature of nonprofit sector accounting — can give rise to anxiety (or worse) among nonprofit non-accounting types. Certified public accountants (CPAs) play a crucial role in supporting nonprofit organizations and helping to maintain and enhance the health of the nonprofit sector.

But what exactly do they do? And how can nonprofits make the most of their relationship with their CPA? First, a primer of tasks and terms:

Services and Reports
CPAs provide a variety of services to charities and other nonprofit organizations, including assistance with the bookkeeping and accounting process, financial reporting, tax reporting and consulting on a wide range of topics.

Accounting assistance — Your CPA can provide assistance in determining how to...