CAN
CALIFORNIA ASSOCIATION OF NONPROFITS

ALERT

www.CAnonprofits.org | January-February 2002 • Volume 16 • Number 1 | The Journal for Nonprofit Managers

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

Inside this issue:

PRINTED ON RECYCLED PAPER

CAN ALERT

Kathy Crabb, *Editor*
Daniel Cook, *Art Director*

CAN ALERT is published by the California Association of Nonprofits, 520 S. Grand Ave., Ste. 695, Los Angeles, CA 90071, (213) 347-2070, www.CAnonprofits.org.

CAN *ALERT* encourages participation from CAN members. If you have questions or items of interest, please send them to the address above, or fax: (213) 347-2080, or email: info@CAnonprofits.org.

CAN *ALERT* Deadlines:

ISSUE	DEADLINE
March-April 2002	March 7, 2002

MISSION

The California Association of Nonprofits works to expand and strengthen the influence, professionalism and visibility of nonprofit organizations in a manner that builds their capacity to accomplish their missions and preserves the idealism and value of nonprofit organizations in California.

Printed by **Sundance Press,** a CAN *Preferred Partner.*

on the current state of the organization and its larger context. Did the prior year's budget come close to the actual financial numbers? What are the national and local economies doing? Has the need for your organization grown or diminished in the community it serves? Has the level of programs or projects grown in such a manner as to outstrip the available resources? Has "mission-creep" developed – that is, has the organization gone far beyond its core mission? (While there is nothing inherently wrong with mission-creep, expanding an organization's mission should happen because of conscious choices, not because of panicked pursuit of funds.) These kinds of questions will help focus budget-related decision-making and assumptions down the road.

The mission statement should be referred to constantly throughout the budget process.

The answers to these questions lay in the mission statement. An organization's mission statement lays out exactly why the organization exists and whom or what it will serve. The statement goes a long way to helping develop a coherent budget that follows the mission-set guidelines. The mission statement should be referred to constantly throughout the budget process, if only to provide the much-needed reality check of whether you should be doing *this* as opposed to *that.*

2. Establish Budget Assumptions

Spelling out budget assumptions gives an organization guidelines for working with numbers. It also provides a foundation from which every member of the "budget team" can work, avoiding surprises and disagreements about fundamentals later in the budget process, when it would be harder to change. Assumptions such as percentage of across-the-board staff raises, increased program or membership fees, increased or decreased staffing levels, facilities expansion or contraction – all these are typical assumptions that are developed during the initial budget planning phase.

An example of a revenue assumption would be an increase in the amount of money raised from individuals due to plans for an additional appeals mailing in

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

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.

Chart of Accounts Number and Description	Dec 2000 Plus YTD Nov 2001	Rationale	Budget 2001	Budget 2002
4001-Contributions	523,000	Additional appeals campaign	525,000	550,000
5001-Salaries	275,000	5% across-the-board staff raises	265,000	290,000

For more information, see *Financial Management for Nonprofit Organizations* by Jo Ann Hankin, Alan Seidner and John Zietlow, published in 1998 by John Wiley & Sons, Inc., New York.

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 grantors' funding cycles, when you expect to see the results of your solicitation drives, when you begin to sell tickets to your major fundraising dinners. Capture the ebb and flow of your support and revenue. This method will tell you when to make major new purchases or when you may need to make short-term cutbacks. As discussed above, if you are an organization

Do not take your numbers and simply divide by twelve.

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.

SOURCE: *Dictionary of Accounting* (Second Edition) by Ralph Estes. The MIT Press: Cambridge, MA, 1985.

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.

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:

The Budget Building Book for Nonprofits by Murray Dropkin and Bill LaTouche. Jossey-Bass Publishers: San Francisco, 1998. Available at **www.CAnonprofits.org** (click on "Bookstore" button).

Financial Management for Nonprofit Organizations by Jo Ann Hankin, Alan Seidner and John Zietlow. Wiley Nonprofit Series, John Wiley & Sons, Inc.: New York, 1998. Available at **www.wiley.com**.

The Volunteer Treasurer's Handbook: Financial Management Building Blocks for Not-for-Profit Organizations by Howard B. Levy, CPA. Piercy, Bowler, Taylor & Kern: Las Vegas, Nevada. Available at **www.pbtk.com**.

Streetsmart Financial Basics for Nonprofit Managers by Thomas A. McLaughlin. Wiley Nonprofit Series, John Wiley & Sons, Inc.: New York, 1995. Available at **www.CAnonprofits.org** (click on "Bookstore" button).

Unified Financial Reporting System for Not-for-Profit Organizations by Russy D. Sumariwalla and Wilson C. Levis, Jossey Bass Publishers: San Francisco, 2000. Available at **www.CAnonprofits.org** (click on "Bookstore" button).

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. ▲

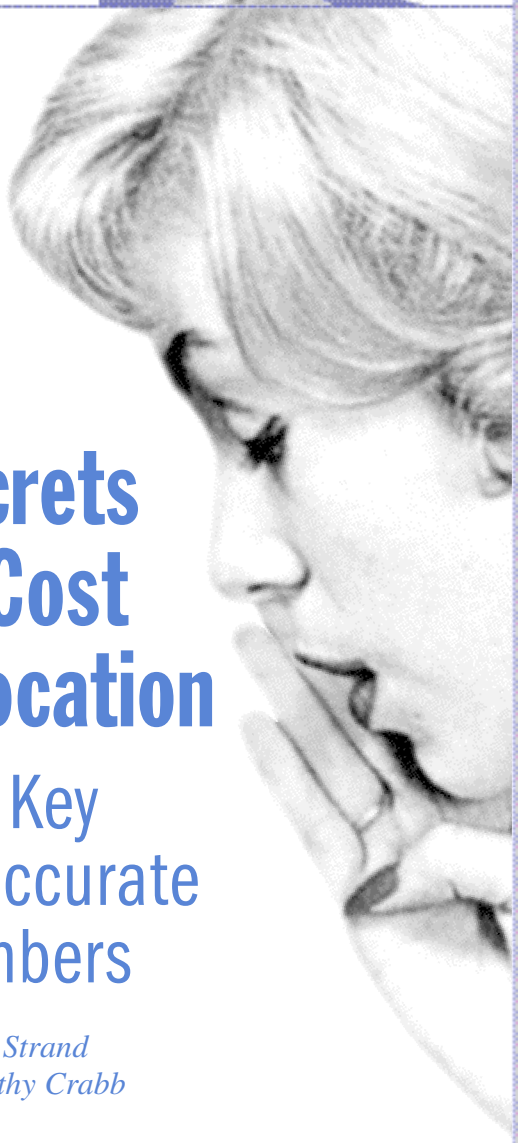
Jerry Soto, CPA is an auditor at Quigley & Miron, a Los Angeles-based public accounting firm specializing in the nonprofit sector. He can be reached at **jsoto@quigleyandmiron.com** *or (213) 639-3556.*

CAN Alert
The Journal for Nonprofit Managers

California Association of Nonprofits

Inside:

Vol. 19 No. 2
Fall 2006



Secrets of Cost Allocation

The Key to Accurate Numbers

by Alan Strand
with Kathy Crabb

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).

	Dollars coming in (income)	Dollars going out (expense)
Who	Who is providing the dollar (i.e., the specific funder)	Who is paying for an expense (i.e., the specific funder)
What	What type of income it is (e.g., grant, contract, earned, etc.)	What the dollar will be spent on (e.g., payroll, supplies, etc.)
Why	Why they are providing the dollar (i.e., for which program or purpose)	Why the dollar is being spent (i.e., for which program or purpose including administration and fundraising)

This article deals

CAN Alert

Kathy Crabb, Editor
Corky Retson, Designer

The CAN ALERT is published by the California Association of Nonprofits (CAN).

CAN ALERT Deadlines: Summer 2006 deadline is 7/15/06.

Printed by **Sundance Press,** a CAN Partner.

primarily with the expense side of the *whats* and the *whys* that appear on a statement of functional expenses, which is a financial report that cross-cuts what an organization's money was spent on (personnel, non-personnel, etc.) with *why* the expenditures occurred (program, general and fundraising). The *whos* — 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.

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

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

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.

For example:

	Functional Area	Type
100	Food Pantry	Program
200	Child Care	Program
300	Case Management	Program
400	Outreach	Program
600	Administration	Management/general
700	Governance	Management/general
800	Fundraising	Fundraising
900	Cost Centers	
910	Occupancy Cost Center	
920	Personnel Cost Center	

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

Mark Florez
Account Representative

Coryn Gardiner
Account Executive Assistant

Kirk Grundman
Employee Benefits Broker

Beth Huntington
Accounts Receivable

Nanci Judd
Dental/Vision Supervisor

Debbie Klug
Compliance Administrator

Sara Mattson
Employee Benefits Broker

Stephanie Moody
Customer Service Assistant

Chanine Neff
Receptionist

Gabriel Padia
Operations Associate

Monique Padia
Marketing Administrator

Alison Parker
Delta Dental/VSP Administrator

John Proko
Account Representative

Nicole Ritter
Account Representative

Pat Rodriquez
Account Representative

Charity Scott
Customer Service Supervisor

Vicky Steen
Office Manager

Herb Walker
Web Administrator

Jennifer Wells
Account Executive

Gary Wills
Employee Benefits Broker

Sibu
Top Dog & Treat Receiver

Welcome, New & Returning Members!

100 BMOC
123EZCORP
826 Valencia
A New Way of Life
A Reason To Survive
Abigail Grafton, M.A.
Able Project
About Productions
AcroSports
Action Alliance for Children
Adoption Horizons
Adventures in Caring Foundation
Advocates for Independent Living
AIG VALIC
Algalita Marine Research Foundation
Alisa Ann Ruch Burn Foundation
Alliance for African Assistance
Alliance for the Arts
Almanor Basin Community Resource Center
Alternative Family Services
Ambulatory Surgery Access
American Humane Association Film and TV Unit
American Red Cross California-Government Relations
American Youth Hostels-Los Angeles Council
Arcata Children's Center
Ark of Refuge, Inc.
Arthritis National Research Foundation
Arts Council of Kern
As You Sow
Asian American Economic Development Enterprises, Inc.
Asian Pacific Islander Wellness Center
Autism Society of America-Los Angeles
Bay Area Outreach and Recreation Program
Bay Area Youth Fund for Education
Bay Planning Coalition
Bayview Hunters Point Foundation
Becoming Independent
Beginnings, Inc.
Behavioral Intervention Association
Berger / Lewis Accountancy Corporation
Berkeley-East Bay Humane Society
Bethel Church
Blind Children's Learning Center
Blood Centers of California, Inc.
Blue Tide Foundation
Bon Air Cottage Foundation
Boys and Girls Club of San Gorgonio Pass
Boys and Girls Club of Santa Maria
Breathe California Golden Gate Public Health Partnership
Building A Generation
California Association of Independent Schools
California Communications Access Foundation
California Community Foundation
California Creativity Association
California Grand Jurors Association
California Health Collaborative
California Housing Consortium Institute
California Staff Assault Task Force

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

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.

	Program	General	Fundraising	Total
Personnel Costs				
7000 – Salaries	$200,000	$50,000	$10,000	$260,000
7100 – Fringe benefits	40,000	10,000	2,000	52,000
Total Personnel Costs	$240,000	$60,000	$12,000	$312,000
Non-personnel Costs				
8010 – Insurance	$1,000	$5,000	$1,000	$7,000
8020 – Postage	15,000	1,000	200	16,200
8030 – Printing	15,000	1,000	50	16,050
8040 – Rent	55,000	20,000	1,500	76,500
8100 – Travel	5,000	5,000	–	10,000
8200 – Utilities	1,500	500	75	2,075
Total Non-personnel Costs	$92,500	$32,500	$2,825	$127,825
Total Expenses	$332,500	$92,500	$14,825	$439,825

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).

continued on page 6

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 allocable 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).

California-Nevada AWWA
Camp Del Corazon, Inc.
Camptonville Community Partnership
Canal Community Alliance
Cancer Federation, Inc.
Capital Research and Management Company Endowments
Capitol Resource Institute
CARE Foundation
Cars 4 Causes
Casa De Esperanza
Casa del Pueblo Housing Cooperative
Center for Cognitive Liberty and Ethics-Alchemind Society
Center for Environmental Health
Center for Human Services
Center for Nonviolent Education and Parenting
Center for the Study of Political Graphics
Central Coast Center for Independent Living
Champions of Caring Connections, Inc.
Charter Schools Development
Cheri Huber
Child Abuse Prevention Agency
Child and Family Institute
Child Quest International
Children Now
Children's Book Press
Christian Encounter Ministries, Inc.
Christian Meditation Center of California
Cindy Navaroli
City of Santa Monica
Civic Ventures
CLARE Foundation
Coalition of Mental Health Professionals, Inc.
Coalition on Homelessness
College Bound
Comerica Bank
Commonweal
Communities Against Substance Abuse
Community Action Partnership of Kern
Community Action Partnership of Santa Barbara County
Community Clinic Consortium
Community Collaborative for Youth
Community Foundation for Monterey County
Community Land Trust Association of West Marin
Community Overcoming Relationship Abuse
Community Resources for Independence
Community Senior Services
Community Services / Catalyst
CompuMentor
Congregation Beth Israel-Judea
Conservation Strategy Fund
Consultative Group on Biological Diversity
Consumer Attorneys of San Diego
Contra Costa Alternative School
Coordinated Youth Services Council
Correct Help
Craft and Folk Art Museum
Crystal Stairs, Inc.
Cure Autism Now
D.E.A.F. Media, Inc.
Deaf West Theatre
Decro Corporation
Demian Quesnel
Desi Geestman Foundation, Inc.
Destiny Arts Center

Disabled Sports Eastern Sierra
Disney Goals
Dominican Sisters of Mission San Jose
Dorothy Day House
DrawBridge
Dubnoff Center
Dunham Academy
Earth Island Institute
Earth Share of California
East Bay Consortium of Educational Institution
East Bay Institute for Research and Education, Inc.
Eastmont Community Center
Ed Source
EdBoost Education Corporation
El Centro de Accion Social
El Rio Mobile Home Park Cooperative, Inc.
El Teatro Campesino
Elder Help of San Diego
Electronic Frontier Foundation
Emmanuel Unique Outreach Partners
Enfinite Possibilities, Inc.
Enterprise for High School Students
Environment in the Public Interest
Environmental Law Foundation
Environmental Volunteers
Epilepsy Foundation
Equal Rights Advocates
Evelyn and Walter Haas, Jr. Fund
Every Child Can Learn Foundation
Excel Youth Zone
Executive Service Corps of Southern California
Fair Housing Council-San Fernando Valley
Family Resource and Referral Center
Family Service Association-Riverside
Family Support Services of the Bay Area
First Impressions
Florence Crittenton Services
Forests Forever
Foster A Dream, Inc.
Foundation for the Preservation of the American Family
Franklin McKinley Educational Foundation
Freedom from Hunger
Friends and Foundation of the San Francisco Public Library
Friends Committee on Legislation of California
Friends of Lincoln Theatre
Friends of the Los Angeles River
Friends of the Observatory
Friends of the River Foundation
Friends Outside In Contra Costa County
Friends Outside National Organization
Fromm Institute For Lifelong Learning
Full Circle Program
Garfield Park Christian Church
Geohazards International
GLBT National Help Center
Glendale Youth Alliance
Global Fund for Women
Greater Riverside Hispanic Chamber of Commerce
Green Hasson & Janks, LLP
GreenInfo Network
Greenway Arts Alliance
Guide Dogs of the Desert
Guidelines, Inc.
Habitat for Humanity Resource Center

- **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

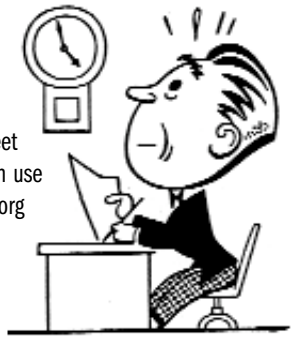
Time Sheet Best Practices

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").

Middle East Children's Alliance
Mollison Enterprises, Inc.
Montessori School of Los Altos
Monteverde School
Morongo Basin Counseling and Recovery Center
Morongo Basin Unity Home
Mountain and Sea Educational Adventure
Mountain Circle Foster Family Agency, Inc.
Mountain Community Resources
Move A Child Higher (MACH 1)
Napa Emergency Women's Services
Napa Valley Coalition of Non Profit Agencies
National Asian Pacific American Families Against Substance Abuse
National Center for Science Education
National Employment Lawyers Association
National Parenting Institute
Neighborhood Youth Association
New Image Emergency Shelter for the Homeless
Nonprofit Finance Fund
Nonprofit Management Solutions
Nonprofit Navigators
North Central Counties, Inc.
North Coast Small Business Development Center
North Lake Tahoe Historical Society
Northbay Family Homes
Northern California Adaptive Living Center, Inc.
Northern Valley Catholic Social Service, Inc.
Novato Chamber of Commerce
NSBN, LLP
Oakland Berkeley Initiative for Healthy Relationships
Ojai Valley Land Conservancy
ONEgeneration
Optelec
Options: A Benefits Training Foundation
Options-A Child Care and Human Services Agency
P.S. Arts
Pacific Coast Youth Homes, Inc
Pacifica Resource Center
Pajaro Valley Shelter Services
Papermill Creek Children's Corner
Paratransit, Inc.
Parent Education Network
Park Avenue Home Owners Association
Pasadena Senior Center
Pasadena Society of Artists
Pathway Society, Inc.
Pegasus Riding Academy for the Handicapped
Peninsula School, Ltd.
People's Self-Help Housing Corporation
Plumas Rural Services, Inc.
Positive Resource Center
Professional Association of Specialty Contractors
Project Independence
Project Restore
Project Sanctuary
Provident Credit Union
Pro-Youth
Psychological Trauma Center
Ramona Animal Shelter
Reach Out 29
Reasons To Believe
Resource Media

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 fund-raising, 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 everything 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

continued on page 10

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 include 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.

Riekes Center for Human Enhancement
Riverside Public Library Foundation
Safe Alternatives for Everyone, Inc.
San Diego Association of Nonprofits
San Diego Performing Arts League
San Francisco Beautiful
San Francisco Camerawork
San Francisco Women Against Rape
San Luis Obispo County Community Foundation
Sandra G. Holmes
Santa Clarita Valley Commission on Aging, Inc.
Santa Cruz Community Credit Union
Santa Cruz County Parents Association, Inc.
Santa Cruz County Veterans Memorial Building
Santa Cruz Museum Association
Santa Monica Bay Restoration Commission
Save San Francisco Bay Association
Sea Shepherd Conservation Society
See the Sea, Charitable Foundation
Senior Services Coalition of Alameda County
Sensory Access Foundation
Shalom Institute
Sierra Adoption Services
Sierra Nonprofit Support Center
Silicon Valley Community Foundation
Silicon Valley Council of Nonprofits
Sims & Layton, Attorneys at Law
Siskiyou Training and Employment Program, Inc.
Smart Business Resource Center
SOMARTS
South Coast Wildlands Project
South of Market Child Care, Inc.
Southern California Institute for Research and Education
Special Treatment, Education and Prevention Services, Inc.
Speech and Language Development Center
Stanford Flying Club
Stiles Hall
Stony Knoll Youth Services
Sustainable Sciences Institute
Sweet and Hot Music Foundation
Taproot Foundation
Tarzana Treatment Center, Inc.
Tea Suite
The Children's Village of Sonoma County
The Coral Reef Alliance
The COREConnection
The Crime Victims Fund
The Living Room Center
The Museum of Art and History
The SCILS Group
The Staubach Company
Theatre Bay Area
Toolworks
Training and Health Education Center for Youth
Trauma Intervention Program of San Diego County, Inc.
Travelers Aid Society Los Angeles
Travelex
Treasure Island Homeless Development Initiative
Tribal Law and Policy Institute
Tri-Valley Haven
Tulare County Alcoholism Council, Inc.
Tuolumne River Preservation Trust

United Cancer Research Society
Unity Schools
University of Judaism
University of the West
Urban Ecology, Inc.
Urban Resources Systems
Vajrayana Foundation
Vallejo Community Access Television
Vallejo Neighborhood Housing Services, Inc.
VIDA
VSEDC
Watsonville Wetlands Watch
Western Justice Center Foundation
Western Law Center for Disability Rights
Western States Youth Services Network- Sonoma County
WILD for Human Rights
Wildlife Rescue, Inc.
Will Rogers Institute
Women Against Gun Violence
Women Donors Network
Women in Film
Women's Initiative for Self Employment
Workplace Fairness
Yellow Ribbon Suicide Prevention Program of Southern California
Yerba Buena Center for the Arts
Yolo Mutual Housing Association
Yosemite Ridge at Camp Wawona
Youth for Environmental Sanity
Youth Service of California
Youth Treatment and Education Center
YWCA Pasadena Foothill Valley
YWCA-Contra Costa County

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

CAN Alert
The Journal for Nonprofit Managers

California Association of Nonprofits

Inside:

Vol. 18 No. 2
March-April 2005

Preventing Fraud in a Nonprofit Setting

Controlling the Risk of Misappropriation

by Gale L. Case, CPA, CFE

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

CAN Alert

Kathy Crabb, Editor
Corky Retson, Designer

The CAN ALERT is published by the California Association of Nonprofits (CAN).

CAN ALERT Deadlines:
May/June Deadline is 6/1/05.

Printed by Sundance Press, a CAN Partner.

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 antique furniture to an organization. Somehow, some of the nicer pieces mysteriously find their way into the homes of the CEO, other managers, or employees.

- Theft of cash received in direct-contact solicitations: This misappropriation is particularly difficult to control. If 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.*

CAN
CALIFORNIA ASSOCIATION OF NONPROFITS

ALERT

www.CAnonprofits.org | January–February 2001 • Volume 15 • Number 1 | The Newsletter for Nonprofit Managers

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

Inside this issue:

PRINTED ON RECYCLED PAPER