Introduction to Nonprofit Finance

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Introduction to Nonprofit Finance

This workshop provides a technical foundation for understanding the basic components of a financial management system and serves as an overview of the concepts involved in developing nonprofit financial reports. The course focuses on definitions and provides an introduction to key financial statements. The workshop is designed for all nonprofit staff looking to improve their understanding of the basic concepts of nonprofit finance.

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Objectives

By the end of this workshop, participants will be able to:

- Assess their organization's financial management system and identify areas for improvement.
- Understand the basic terminology of nonprofit finance.
- Read and interpret key nonprofit financial statements

Our Philosophy on Nonprofit Finance

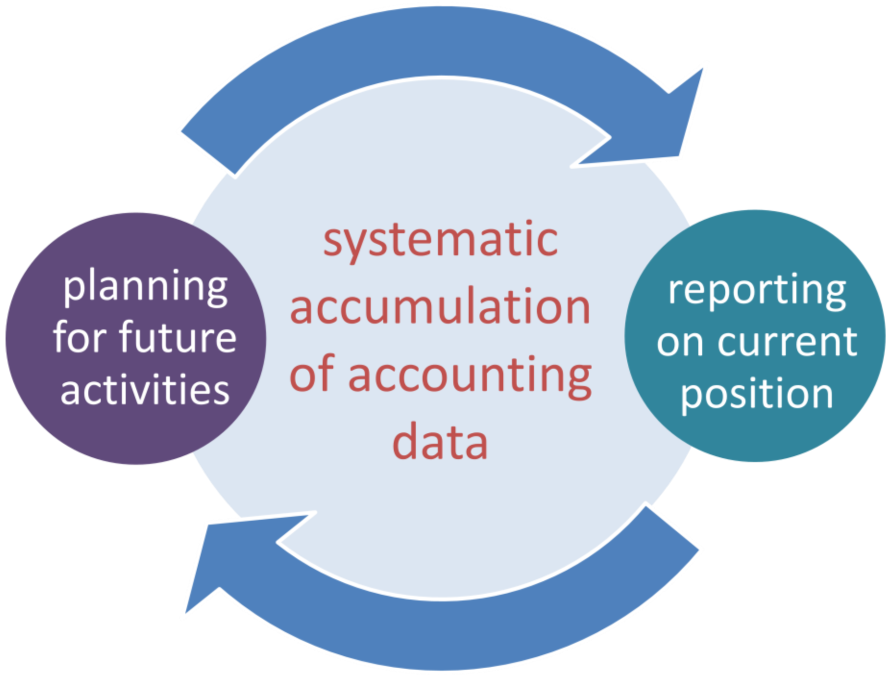
At CompassPoint, our perspective on finance is shaped by our commitment to community-based organizations of all types – as well as our belief in their numerous assets and pivotal role in society. We don't think nonprofits are broken and in need of fixing; instead we recognize the complexity of issues nonprofit leaders have to embrace. We do so with our eyes on the mission prize; that is, we see finance as a way to understand and better plan for programmatic success. Finance is not an end in itself, but a necessary lens through which nonprofit leaders can look at their activities and organizational sustainability.

Having said this, we also believe that nonprofit leaders have to face up to the accountability mandate – not just from the IRS or legislators – but from the people their organizations intend to benefit. In part, this means building individual and organizational capacity to follow the rules of nonprofit accounting and establish a culture of transparency around money. Small and midsized organizations that identify themselves as "grassroots" are not exempt from this mandate. On the contrary, our opinion is that financial transparency is directly in line with the values of being relevant, responsive, and committed to a broad range of social change.

What is Financial Management?

Nonprofit organizations need solid financial management for both internal management and decision-making and external reporting and accountability to stakeholders. To this end, we define financial management as the systematic accumulation of accounting data to enable both:

- Reporting on the organization's current position and past activity;
- Planning/budgeting for future activities



For your organization's financial management system to be fully effective, you must first ensure that you have accurate and reliable accounting data. Two factors that can influence this significantly are having effective finance staffing and a strong accounting system. Though many hear the term "accounting system" and think immediately of software, in fact the heart of an accounting system is what's called the chart of accounts. An accounting system also encompasses internal controls, reporting practices, and fiscal policies and procedures. But at the core of any good accounting system is strong staff.

Staffing the Finance Function

Whether your financial staff is comprised of employees, contract bookkeepers, or consulting CPAs, the most important question you have to answer is, "Do they understand and have experience with *nonprofit* accounting?" For instance, the issue of restricted contributions and how to present them on financial statements is unique to nonprofit businesses. You cannot assume that a board volunteer from the for-profit world—or even a trained bookkeeper—is familiar with this and other nonprofit-specific concepts.

There are many ways to effectively staff the finance function, and in thinking through the various options it can be helpful to consider finance staffing in three categories: strategic, operational, and transactional. The transactional are the clerical tasks that support the accounting function, such as copying, filing, and making bank deposits; they require someone with excellent attention to detail and exposure to basic accounting principles. The operational are the range of accounting functions, such as paying bills and producing monthly financial statements; they require someone with strong nonprofit accounting knowledge, including managing grants and contracts. And the strategic are the systems development, financial analysis, planning, and communication about the organization's financial position; they require CFO-level knowledge and skills.

The key is to determine your optimal staffing approach. Every organization needs all three functions, but organizational size and complexity will determine how much time each requires and the optimal staffing approach. In general, it is income that makes nonprofits more or less complex. A $10,000,000 organization that gets all of its money from individual donors requires a very basic accounting system, while a $2,000,000 organization with government contracts and restricted foundation grants requires a very robust accounting system. You can seriously jeopardize your organization's funding and reputation if you maintain inadequate systems for tracking contract and grant dollars—it's a true nonnegotiable. If you have these funds in your business model, you should assume that you will need to fund a very experienced, senior finance staff role.

So how does an organization with limited resources adequately attend to all three finance functions? Increasingly, we are seeing executives pair contract consultants with staff in the finance function. For instance, a small or midsize nonprofit might invest in an excellent full-time staff accountant who can handle the operational functions expertly and provide oversight to an administrative generalist—such as an office manager, who handles the transactional functions during the 50 percent of her workweek that is directed to the accounting function. Then the executive contracts with a CFO-level consultant who spends fifteen hours per month answering any questions the staff accountant may encounter, doing financial analysis for the management team and board finance committee, developing budgets and projections, and so forth. This way, the executive has a strategic financial partner without creating a fixed staffing cost that she can't afford. Board members, including the treasurer, have a role that is distinct from the staff finance team. The executive needs an uncomplicated relationship to her finance team so that she can direct them in developing the analysis and reporting she needs as the organization's financial leader.

Function	Specific Tasks
Strategic	• Conduct general financial planning and provide oversight to finance team. • Develop cost allocation framework. • Analyze financial reports on a monthly basis and submit financial and narrative reports to the board and executive director. • Lead the annual budgeting process and develop tools for rolling projections. • Serve as the main point of contact with the auditor.
Operational	• Prepare A/P and A/R; ensuring proper coding of income and expense. • Complete contract invoicing (including the preparation of reports to funders). • Report hours by program to the payroll-processing agency. • Perform journal entries. • Assist with budget and financial statement preparation. • Monitor cash flow. • Allocate all expenses based on the established cost allocation methodology.
Transactional	• Write checks once they are coded. • Distribute financial statements to program managers. • Photocopy checks, invoices and other documents as required for funders. • Make bank deposits. • Maintain personnel files, grant files, invoice files, and vendor files. • Collect time sheets.

Internal Controls

> ***Internal controls** are a set of policies and procedures to prevent deliberate or misguided use of funds for unauthorized purposes.*

One additional consideration related to staffing the finance team is whether you have the right *number* of people. Having sufficient staffing—or a combination of staff and outside expertise—is also important for maintaining internal controls, which are critical for an effective financial management system. If just one person in your organization receives funds, deposits funds, enters bills, issues checks, and does the monthly bank account reconciliation, you can see how that opens the door to possible undetected fraud. In small organizations with few staff, maintaining internal controls can be especially challenging. You will have to involve board members and other staff as appropriate to adequately segregate key financial duties and insert opportunities for checks and balances.

Why do we need internal controls?

- They help to provide *reliable data* by ensuring that information is recorded in a consistent way that allows for useful financial reports.
- They help *prevent fraud and loss* by safeguarding assets and essential records.
- They create a system for *compliance* with organizational policies and funding source requirements.
- They *provide an audit trail*, which means that transactions can be followed all the way through the accounting system, from the original document (such as a check) to the financial statements or vice versa. An auditor uses this trail to evaluate the reliability of the accounting records.

Key Internal Controls

The following is a list of minimal internal controls that all organizations should have in place. Use this checklist to assess your organization's current controls and to prioritize improvements you may want to make.

Does your organization…	Yes	No	Notes
Have an up-to-date accounting procedures manual that includes policies and says who does what in the organization.			
Segregate the duties associated with cash receipts (receipt of cash, depositing of funds, and entry of income into the accounting system).			
Require more than one check signer and/or prohibit payees from signing checks for their own expense reports.			
Require someone other than the person who prepares and signs checks to review the bank statements (preferably received unopened) and canceled checks upon receipt from the bank.			
Have effective board oversight, including approving the budget, reviewing financial statements, and approving all leases, loans, and other major commitments.			
Use a payroll service.			
Have a clear set of personnel policies that are distributed to all employees.			

Chart of Accounts

The heart of an accounting system is what's called the chart of accounts. It is critical that the financial leaders of the organization understand the chart of accounts and influence it so as to ensure meaningful financial reporting. Non-finance staff, including the executive director, interact with the chart of accounts in two ways. First, they use the numerical labels to code the expenses they authorize. Second, all of the reports that an accounting system can produce are based on the chart of accounts. If a consumer of financial information wants a particular activity to be presented in a financial report, it requires the activity being assigned a number in the chart of accounts.

The ***chart of accounts*** *is the set of numerical labels that your organization uses to describe its:*

Assets
Liabilities
Net assets
Income
Expenses

Many nonprofit charts of accounts have three types of labels or segments: account, activity, and funding source. For instance, the bookkeeper at Food.org would enter a bill for supplies for the nutrition class by entering the numerical labels for: the supplies account, the nutrition education activity, and the government contract that funds the program.

Accounting Software

Bookkeepers can often feel limited by the accounting software they are using and may point to it as the reason they cannot produce meaningful financial statements. It is possible to use inexpensive business products like Intuit's *QuickBooks Pro* in a nonprofit context. There are also nonprofit-specific packages that are relatively inexpensive and more than adequate for most community-based nonprofits. As organizations grow they can consider the more expensive and robust accounting software products designed to be responsive to nonprofit issues such as grant tracking and functional expense allocation.

If your organization is large enough to have paid finance staff, the senior finance staff person should be the project manager on an accounting software purchase. She or he can convene a meeting(s) of key consumers to learn what reporting needs are currently unmet; restructure the chart of accounts accordingly; investigate appropriate products in your price range; and work on set-up and implementation.

The important thing about software is this: if a bookkeeper or finance manager understands the key accounting concepts covered in this manual, he or she can create reports in basic spreadsheet software such as Microsoft Excel using data from *any* accounting software. In other words, new accounting software may make report production more efficient, but it will never make up for the fact that someone does not have the proper training in nonprofit accounting.

Should we buy new software?

- Do we actually need new software or are we inadequately trained to maximize our current system?
- Are we buying a product that is consistent with our needs and staff capacity or are we over/under buying?
- Are we using the purchase process as a platform for updating and streamlining our financial tracking procedures (chart of accounts)?
- Is the staff person coordinating the purchase involving the key consumers of the system's reports: program managers, development managers, board treasurer, and executive director?

Financial Management System Assessment

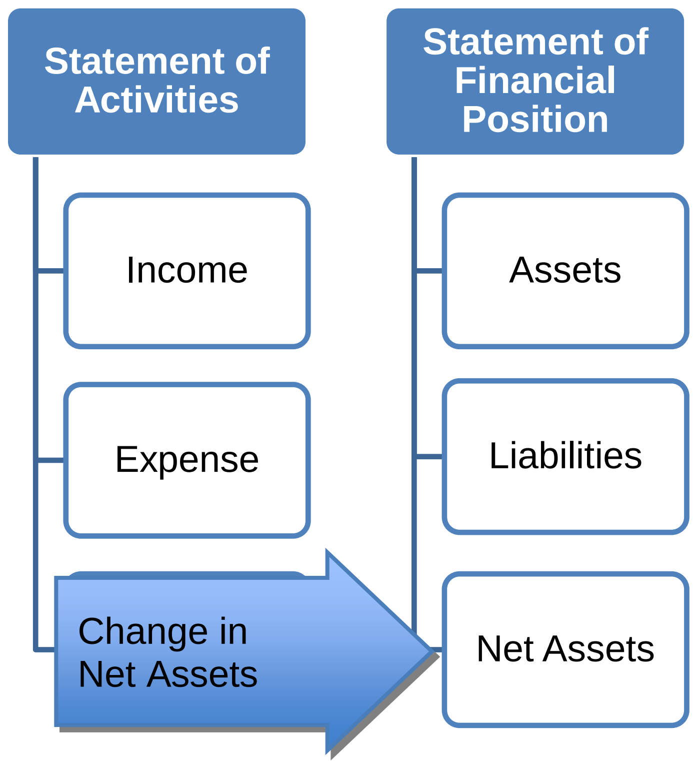
Adapted from Chapter 2 of *Financial Leadership for Nonprofit Executives* by Jeanne Bell and Liz Schaffer.

Category	**Red**	**Yellow**	**Green**
Staffing	The providers of financial reports to management and board are not trained in the specifics of nonprofit accounting.	The providers of financial reports to management and board are in the process of being trained in the specifics of nonprofit accounting.	The providers of financial reports to management and board are well trained in the specifics of nonprofit accounting.
Chart of Accounts	The chart of accounts is managed solely by the bookkeeper and does not reflect the current activities of the organization.	The chart of accounts is fairly reflective of current activities, but needs updating.	The chart of accounts is reviewed and understood by key staff and board. It reflects current activities.
Accounting Software	The accounting software is inadequate for the organization's tracking and reporting needs.	The accounting software is adequate for the organization's tracking and reporting needs, but not well implemented.	The accounting software is adequate for the organization's tracking and reporting needs and has been implemented to support optimal financial reporting.
Internal Controls	Internal controls are not in place.	Some controls are in place but leadership has not prioritized optimal internal controls.	Because of leadership's emphasis on accountability and transparency, internal controls are prioritized and ensured.
Priorities and Next Steps:			

Key Nonprofit Financial Statements

Financial reports are the primary tool for communicating financial progress and assessing an organization's financial health. There are two core financial statements that, when reviewed together, tell the full story of an organization's financial position – these are the Statement of Financial Position (balance sheet) and Statement of Activities (income statement, or profit & loss). We will review each of these financial reports in detail.

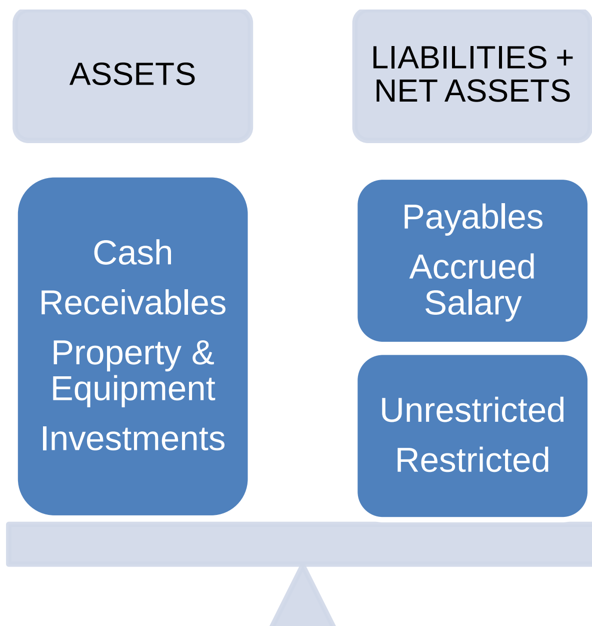
Connections between key financial statements



Statement of Financial Position

The Statement of Financial Position, often called a balance sheet, captures the cumulative net worth of an organization since its inception. It tells the reader what the organization owns, what it owes, and the difference, or net asset position, as of the date on the top of the statement. Notice that total net assets are always equal to total assets minus total liabilities.

The "Balance Sheet"



Net assets are what a nonprofit organization has left when it subtracts what it owes from what it owns or has title to. In the for-profit world, this is called "equity," but because nonprofits do not have shareholders or owners per se, they use the term net assets. To help understand this concept, examine your personal net assets (commonly known as "net worth"). On the asset side, you have things you own or have title to such as cash in the bank, a home, a car, and so forth. On the liability side are things you owe, such as mortgage payments, car payments, credit card payments, and so forth. To arrive at your personal net worth, you would add up the assets, add up the liabilities, and then subtract total liabilities from total assets.

What makes a nonprofit balance sheet uniquely different from for-profit entities is that the total net assets are broken down by restriction so that the reader can distinguish among funds that can be used in any way the organization desires and funds that represent promises to perform according to donor-approved budgets. Without this information, your assessment of funds available to meet organizational goals will be incorrect. Because net assets are where readers of financial statements look to determine the reserve of the organization—funds it could use to start a new program or buy a building, for instance—it is critical that they not blend unrestricted and restricted amounts in the presentation. Depending on how they were generated, net assets are classified as unrestricted, temporarily restricted, or permanently restricted funds.

Sample Statement of Financial Position

Statement of Financial Position
Food.org

As of December 31, 2012

Assets	
Cash	73,800
Accounts receivable	25,000
Grants receivable	100,000
Prepaid expenses	1,000
Total current assets	199,800
Capital purchases	44,900
Less accumulated depreciation	(33,700)
Total fixed assets	11,200
Investments	35,000
Total assets	246,000
Liabilities and net assets	
Accounts payable	20,000
Accrued vacation	5,000
Line of credit	15,000
Total current liabilities	40,000
Long-term net payable	50,000
Total liabilities	90,000
Unrestricted net assets	71,000
Temporarily restricted net assets	50,000
Permanently restricted net assets	35,000
Total net assets	156,000
Total liabilities and net assets	246,000

Statement of Activities

The Statement of Activities describes an organization's income and expenses over a particular period of time (usually a month, quarter, or fiscal year). This is the nonprofit version of a Profit and Loss Statement or 'P&L.' On it, you'll find a column dedicated to temporarily restricted funds—those contributions with a time and/or programmatic restriction. You also see a column dedicated to permanently restricted funds—those funds for which the principal must be held in perpetuity. This columnar format allows the reader to discern the total value of restricted contributions raised during the period as well as the total value of funds released from restriction. In monitoring the release from restriction, readers of financial statements are monitoring the organization's fulfillment of its promises to spend funds in proscribed ways or timeframes.

The essential accounting practice behind this concept is the tracking of expenses by activity so that the fulfillment of promises to spend can be tracked and reported on a monthly or quarterly basis. For instance, in order for Food.org to release funds that were restricted by the donor to the nutrition education program, the organization must know how much it spent on the nutrition education program that month. In spending money the way they promised to in the original grant request, Food.org is releasing funds from restriction.

Sample Statement of Activities

Food.org
Statement of Activities

For the Year Ended December 31, 2012

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Contributions	11,875	-	-	11,875
Foundation grants	15,000	700,000	-	715,000
Total support	26,875	700,000	-	726,875
Government contracts	115,000	-	-	115,000
Interest and dividends	5,750	-	-	5,750
Total revenue	120,750	-	-	120,750
Net assets released from restriction	655,000	(655,000)	-	-
Total income	802,625	45,000	-	847,625
Meal Delivery	443,576	-	-	443,576
Nutrition Education	231,715	-	-	231,715
Administration	57,979	-	-	57,979
Fundraising	68,104	-	-	68,104
Total expenses	801,375	-	-	801,375
Change in net assets	1,250	45,000	-	46,250
Beginning net assets	69,750	5,000	35,000	109,750
Ending net assets	71,000	50,000	35,000	156,000

Key Accounting Practices

Though you may not be an accountant, being aware of and understanding several key accounting practices will give you a good basis for interpreting financial data and using it to inform your organizational and programmatic decision-making. To this end, we have identified six key accounting practices that are critical for all nonprofit leaders to understand and will explore each of these concepts in detail. These concepts include:

1. Accrual basis accounting
2. Treatment of restricted contributions
3. Functional expense classification
4. Allocation of common costs
5. Employee time tracking
6. Capitalization and depreciation

Nonprofit Lifecycles and Financial Practices

Organizations have natural lifecycles – from the start-up phase through maturity and renewal. The sophistication of financial practices evolves as an organization grows – usually because key staff and board eventually become dissatisfied with the very limited financial information they are getting and decide that they need more in order to make good decisions. The reporting demands of foundation and government funders can also spur the development of stronger systems.

It is natural for start-up organizations to be almost myopically focused on mission and survival. Developing systems often comes a bit later, unless it happens to be the strength or passion of the founding leaders. If you are currently working to build or develop systems in your organization, remember that you may not be able to implement them all at once or even in one year. Use the assessment tools in this manual to help prioritize your next steps.

Cash vs. Accrual

Cash basis and accrual basis accounting are two different methods of recording income and expenses. They differ in the determination of when to recognize and record transactions in your financial records.

Cash basis accounting

In a cash basis system, income is recognized and recorded only when the cash is actually received. Expenses are recognized and recorded only when they are actually paid. In other words, in a cash basis system, *the only time a transaction is recorded is when cash has been received or disbursed*. Many people are more comfortable with cash basis accounting because it's how they treat their own finances.

Accrual basis accounting

In accrual basis accounting, income is realized in the accounting period in which it is earned, regardless of when the cash is received. Similarly, expenses are recorded as they are owed (such as when services are performed or goods are delivered) instead of when they are paid.

Modified cash basis

Some organizations keep their books on a cash basis during the year and then re-state their financials on an accrual basis for the purposes of year-end financial statements and the audit. Under this method, the internal financial statements produced throughout the year will differ from the statements produced at the fiscal year end.

Exercise: Cash vs. Accrual

Record the following transactions in January 2012 using both accrual and cash methods of accounting. Compare the results.

	Cash	Accrual
Income:		
Invoiced the city for 2,000 units of service at $5.00 each.	____________	____________
Received $1,000 in new donations.	____________	____________
Received $3,000 in pledges for donations that will be paid in March.	____________	____________
Received $25,000 for units of service invoiced during November and December.	____________	____________
Total income	____________	____________
Expenses:		
Paid $5,000 in December salaries on January 1.	____________	____________
Incurred $7,000 in salary and payroll tax expense that will be paid on February 1.	____________	____________
Received telephone bill for $500 on February 10 (all calls were made in Jan).	____________	____________
Paid $2,000 to the auditors for services rendered during December.	____________	____________
Total expenses	____________	____________
Net income (income – expenses)		

Comparison of Cash vs. Accrual

	ADVANTAGES	DISADVANTAGES
CASH	• Easy to understand • Fewer transactions to process • May work well for small organizations	• Not compliant with GAAP (Generally Accepted Accounting Principles) • Incomplete picture of the organization's financial position and activities • Usually does not work well for mid-sized or large organizations
ACCRUAL	• Compliant with GAAP • More meaningful record of transactions; more accurate view of organization's financial status • Works better for mid-sized or large organizations	• Can be harder for non-accountants to understand • More transactions need to be entered (for example, recording a bill when received and separately when paid) • May be harder for small organizations to implement
MODIFIED	• Allows organizations to use the easier basis for internal interim reporting	• Audit may look very different from internal statements, so the organization may be surprised by financial statements • Tends to de-value the audit because the Executive Director and Board are used to seeing statements on a cash basis

Which is right for your organization?

If you have few unpaid bills or outstanding grants or fees throughout the year, cash basis accounting will give essentially the same financial picture of your organization as accrual basis, and it will be easier to maintain. Many small or new nonprofits do not have many payables or receivables, nor do they have the ability to keep track of accruals on an ongoing basis. Factors to consider when deciding whether your organization should use the cash or accrual basis method include:

- The payables and receivables your organization has on an ongoing basis.
- The expertise and time constraints of your bookkeeping staff.
- The size of your organization's budget.

Why is accrual basis the preferred practice?

Except in the very smallest of organizations, accrual is the best practice because it gives a far more complete picture of the organization's financial condition. For instance, if you were reviewing statements that did not include thousands of dollars in unpaid bills (payables) due in two weeks, you would assume that you had more money to spend than you actually had—a very dangerous situation. Conversely, if you were unaware that a foundation had awarded you a $50,000 grant, you might make overly conservative spending decisions.

Accrual also ensures that earned income—such as tickets sales, service fees, and many government contracts—is matched with related expenses, regardless of whether the cash has been received. This is often referred to as the "matching principle," and it is necessary to assess the performance of a given activity in a given month or quarter. For instance, if Food.org delivers meals to 1,000 people in January and their state contract pays them $10 for each meal delivered, then Food.org earned $10,000 in January despite the fact that the check from the state won't be received until March. If Food.org did not keep its books on an accrual basis, readers of the financial statements would assume that January was a difficult month when in fact the organization's work earned them $10,000 to cover meal delivery expenses.

Accounting for Income

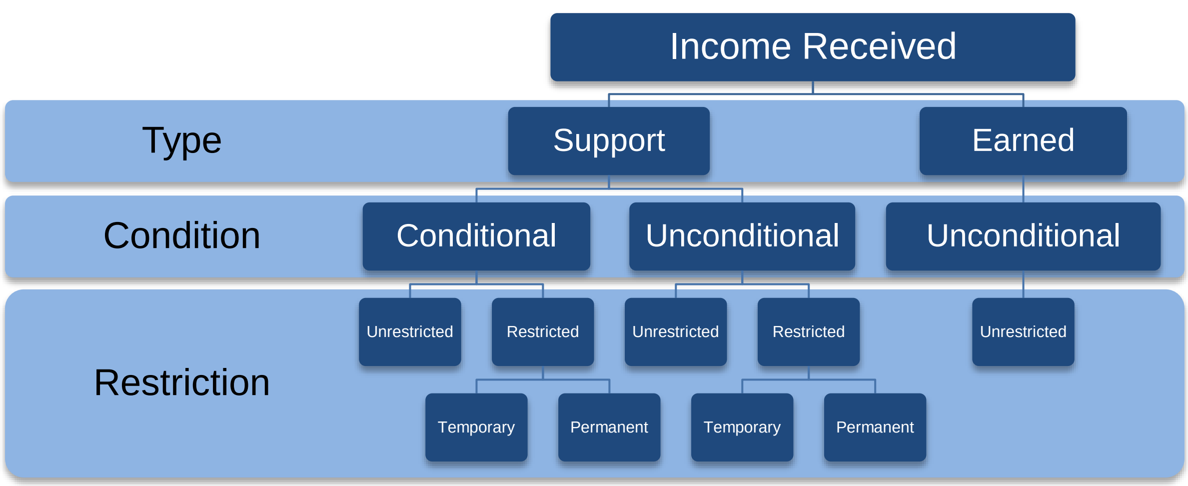
In nonprofit organizations, income is broken into two main categories: earned and support. It is the contributed or support revenue that is more complicated and unique to nonprofits, and needs to be assessed based on both conditionality and restriction.

Earned revenue

Earned revenue is income that the organization obtains through exchange transactions. Examples of earned revenue include fees, ticket sales, and some government contracts. In accrual basis accounting, these transactions should be recorded when the revenue is earned—i.e., in the accounting period during which the service is provided.

Support

Support is made up of grants and contributions. When and how these grants and contributions are recorded is determined by two factors: conditionality and level of restriction.



Types of Contributed Income

Unconditional support

Most donations are unconditional, meaning that they are given without reference to any contingency or qualifying event. According to GAAP for nonprofit organizations, *unconditional grants and contributions should be recorded <u>when the donor makes the commitment</u> to give*.

Conditional support

Conditional grants and contributions are made contingent upon a qualifying event. The most common example of conditional support is a matching gift, whereby the donor says that he or she will make a donation if the organization can raise a certain amount in matching funds. Since the organization may or may not be able to meet the matching condition, *the contribution is <u>not recorded until the condition is met</u>*.

Unrestricted support

Unrestricted grants and contributions have been given by the donor without reference to a specific purpose or use within a specific time period. This form of support requires the least amount of record keeping. These gifts should be recorded as unrestricted support on the statement of activities and increase the unrestricted net assets of the organization. Board designations are not treated as restricted because the restriction must be donor imposed, although the organization may choose to reflect board designations separately as part of the unrestricted net assets on the statement of financial position.

Temporarily restricted support

Temporarily restricted grants and contributions are those gifts that are to be spent for a specific purpose or during a restricted period of time. Temporarily restricted grants and contributions should be recorded as such on the statement of activities. Once the restriction is met, no further record keeping is required by the donor or grantor.

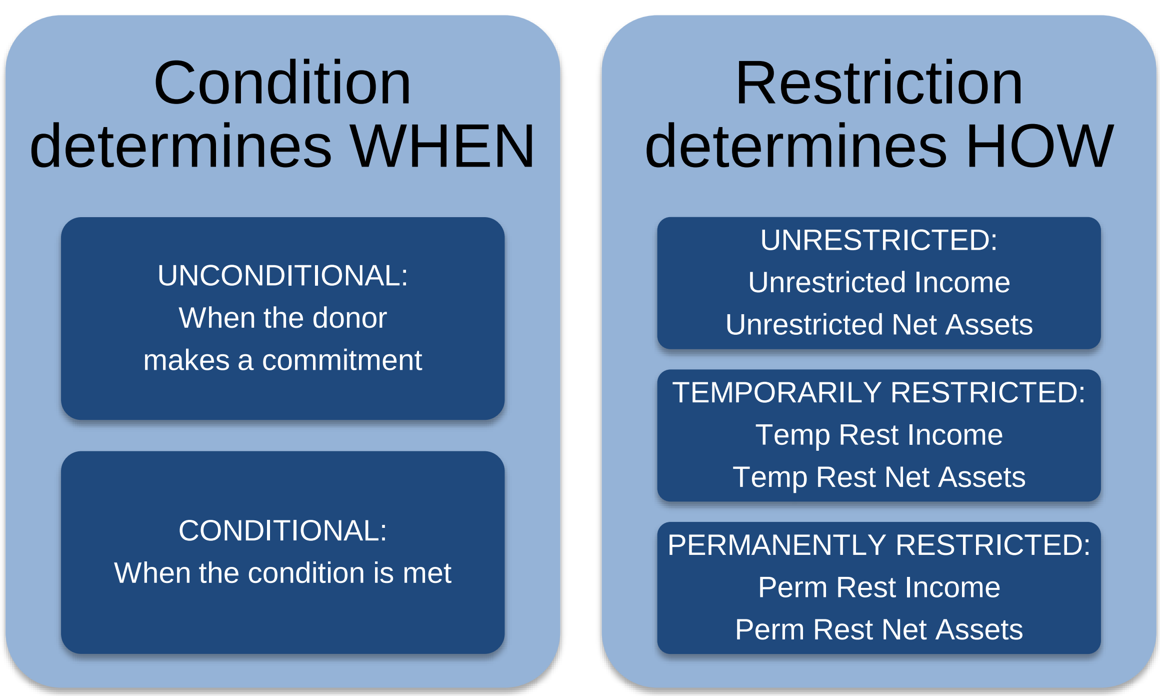
Once a nonprofit organization receives a temporarily restricted contribution, it has to monitor expenses according to the budget approved by the donor. As the nonprofit spends money according to that budget, it is releasing funds from restriction. In other words, it is the act of spending restricted contributions that allows a nonprofit to consider the funds unrestricted and available to cover expenses.

Once the restriction has been met, a grant or contribution should be shown as "net assets released from temporary restriction" on the statement of activities, with a corresponding reduction in the temporarily restricted net assets on the statement of financial position.

Permanently restricted support

Permanently restricted support refers to grants and contributions that are to be held in perpetuity, usually in an endowment that will generate future income for the organization. The income from the investment can be either further restricted or unrestricted. Since the principal of the contribution cannot be used for operations, etc., continuous record keeping is required.

Condition vs. Restriction



Recording Income

Indicate when and how the following grants and contributions would be recorded on an accrual basis:

	CONDITION: When will it be recorded?		**RESTRTICTION: How will it be recorded?**		
	Unconditional	Conditional	Unrestricted	Temporarily Restricted	Permanently Restricted
A foundation promises to give $25,000 for current operations.	________	________	________	________	________
A foundation awards a 3-year grant to support the meal delivery program.	________	________	________	________	________
Individuals pledge to contribute $65,000 to the organization's endowment.	________	________	________	________	________
A foundation awards a 3-year $30,000 grant to support nutrition education programs contingent upon the organization raising another $60,000 in matching funds.	________	________	________	________	________

Functional Classification of Expenses

In the nonprofit world, there are three core functions that have to be tracked: 1) program/mission-related activities; 2) administrative activities; and 3) fundraising activities. (Nonprofits incorporated with the IRS as membership organizations will have a fourth core function: membership development activities.) Auditors of nonprofit financial statements expect to see expense data by core function when they review your year-end statements, and the IRS requires that nonprofits report expenses functionally every year on the Form 990. In addition to these requirements, understanding the true costs of your core activities is good management, so you'll want to be sure that your accounting system is set up to track by function. These core functional areas are defined by the IRS as follows:

Program	Costs resulting in distributing goods and services to clients and fulfilling the mission of the organization. This includes lobbying expenses if it is directly related to the organization's exempt purpose.
Administration	Costs not identifiable with program delivery or fundraising that are indispensable to the organization's existence such as governance, finance and accounting, legal, and executive management.
Fundraising	Costs associated with soliciting contributions from individuals, foundations, and corporations, maintaining donor mailing lists, and conducting fundraising events.

All nonprofits with paid staff have expenses in each of the core functions. For instance, it is important to recognize that even nonprofits that do not have development directors have fundraising expenses. Somebody is raising money; it may be the executive director and program directors, for instance.

For some organizations, one functional reporting classification for program activities may be enough to portray the program service that the organization provides. In most cases, however, there are several different program activities provided, and the expenses associated with these distinct program services should be separated into multiple programmatic functional categories. For example, a large university may have programs for student instruction, research, and public service. A social service agency may have programs for health and family services, public education, disaster relief, etc.

Although external reporting requirements (IRS Form 990 and GAAP financial statements) only require that expenses are classified by function, it is a good idea to also classify the organization's income in these functional categories. This helps management to understand how the organization is doing in its cost-recovery efforts for each activity, and to better understand the overall business model of the organization (i.e. which activities are generating surpluses to help subsidize activities that are not fully covering costs). When you categorize income by its functional purpose, it also helps readers of financial reports to understand how restricted funds are designated to specific programs.

Is it administrative?

The IRS identifies these specific expenses as Management & General, or administrative, for the Form 990:

- Costs of board of directors meetings, committee meetings, and staff meetings (unless they involve specific program services or fundraising activities);
- General legal services;
- Accounting (including patient accounting and billing);
- General liability insurance;
- Office management;
- Auditing, human resources, and other centralized services;
- Preparation, publication, and distribution of an annual report;
- Management of investments;
- Lobbying (not related to exempt purpose).

Sample Statement of Functional Expenses

Food.org
Statement of Functional Expenses
For the Year Ended December 31, 2012

	Program Activities		*Supporting Activities*		
	Meal Delivery	Nutrition Education	Admin	Fund-raising	Total
Salaries	218,750	128,750	36,250	38,750	422,500
Benefits	54,688	32,188	9,063	9,688	105,625
Personnel expense	273,438	160,938	45,313	48,438	528,125
Supplies	30,806	18,361	917	3,417	53,500
Telephone	11,083	6,417	1,750	1,750	21,000
Postage	9,500	5,500	1,500	1,500	18,000
Occupancy	41,167	23,833	6,500	6,500	78,000
Equipment	56,056	611	167	167	57,000
Printing	10,000	10,000	-	2,500	22,500
Travel	3,750	1,500	500	1,500	7,250
Depreciation	5,278	3,056	833	833	10,000
Training	2,500	1,500	500	1,500	6,000
Non-personnel expense	170,139	70,778	12,667	19,667	273,250
Total expenses	443,576	231,715	57,979	68,104	801,375

Allocation of Common Costs

While it is possible to apply some expenses to a specific program or supporting activity, other costs may not be easily identifiable with a single function. These are known as *common* or *shared costs.* There is a tendency in many nonprofits to treat these expenses as part of administration, but, in fact, these are expenses that often benefit all of the activities of the organization.

Typical common costs

Examples of expenses that are often treated as common costs include:

- Office supplies
- Telephone
- Postage
- Occupancy (rent and utilities)
- Insurance
- Depreciation
- Computers
- Salaries of staff who work on more than one activity

In order to accurately describe the true expense of an activity and to properly report expenses functionally, an organization must not only record the specific costs of that activity, but also its fair share of the organization's shared expenses. As a financial leader in your organization, you need to understand whether and how these common costs are charged to each activity. If you are looking at a particular program's financial condition without considering its use of common costs, you will have a distortedly positive view. In fact, common costs can be as much as 50 percent or more of a program's full cost.

Allocation simply means to distribute these shared costs across activities. Allocation is accomplished using an allocation basis. The basis is the criteria for determining how much of the common costs each activity is charged. The most widely used allocation basis is the number of full-time equivalents (FTE)—or employees—in each activity. So for instance, if your organization has 10 full-time staff members and five of them work in Program A, Program A will be allocated 50 percent of your organization's

> ***Cost allocation** is the process of assigning to two or more activities the costs of an item shared by those activities. The goal is to ensure that each bears its fair share, and only its fair share, of the total cost of the item.*

common costs. Other possible allocation bases include: percentage of total payroll costs per activity and percentage of activity costs before allocation. While these are three frequently used bases for allocating common costs, the organization may choose a hybrid basis or may find another basis. The key is to choose a basis that most accurately reflects the actual use of resources and to apply it consistently. Note that using the percentage of income of each activity to the total income of the organization is NOT an acceptable basis for allocating common costs because income is not an accurate measure of how resources are used. Allocation decisions are important and specific to individual organizations.

Frequently used cost allocation rates	
FTE	$\frac{\text{FTE for Each Activity}}{\text{Total FTE – Shared Cost FTE}}$
Payroll Expense	$\frac{\text{Payroll Expense for Each Activity}}{\text{Total Payroll – Shared Cost Payroll}}$
Square Footage	$\frac{\text{Square Footage for Each Activity}}{\text{Total Agency Square Footage}}$
Specific Expense	$\frac{\text{Specific Expenses for Each Activity}}{\text{Total Specific Expenses for the Agency}}$

Once an organization determines its basis for cost allocation, it must also select a method with which it will be applied. Two common methods are the line-by-line allocation and the bottom line allocation.

Line-by-Line Allocation

To use this method of allocating common costs, the organization determines a rate of usage for each line item. For example, it may be decided to apportion rent expense based on the square footage used by each activity. And telephone expenses may be divided among each activity based on the number of telephones used by each. In some cases, records of actual usage will be kept to preclude allocations at all. For instance, the cost of maintaining a photocopier may be based on the proportion of copies logged by each activity; or timesheets may be used as the basis for distributing salary expenses. The idea here is that a different basis can be adopted for each line item.

Sample Line-by-Line Allocation

Food.org

Meal Delivery Program Costs

	A	B	C	D = B X C	E = A + D
	Meal Delivery Specific	Total Common	Allocation Basis	Meal Delivery Portion of Common	Meal Delivery Plus Common
Salaries	195,000	45,000	52.78% of FTE's	23,750	218,750
Benefits	48,750	11,250	52.78% of FTE's	5,938	54,688
Personnel	243,750	56,250		29,688	273,438
Supplies	25,000	11,000	52.78% of FTE's	5,806	30,806
Telephone	-	21,000	33.33% of telephones	7,000	7,000
Postage	-	18,000	18.50% of meter usage	3,330	3,330
Occupancy	-	78,000	65.00% of sq. footage	50,700	50,700
Equipment	55,000	2,000	48.00% of copier usage	960	55,960
Printing	10,000	-		-	10,000
Travel	3,750	-		-	3,750
Depreciation	-	10,000	40.00% of computers	4,000	4,000
Training	2,500	-		-	2,500
Non-personnel	96,250	140,000		71,796	168,046
Total expenses	340,000	196,250		101,483	441,483

Bottom Line Allocation

Another method of allocating common costs is to determine a rate by which all shared expenses will be proportionately distributed among the activities of the organization. Using this method, all shared costs are pooled together and distributed across the activities as a lump-sum.

Sample Bottom Line Allocation

Food.org

Overall Expenses by Activity

	Program Activities		*Supporting Activities*			
	Meal Delivery	Nutrition Education	Admin	Fund-raising	Common Costs	Total
Salaries	195,000	115,000	32,500	35,000	45,000	422,500
Benefits	48,750	28,750	8,125	8,750	11,250	105,625
Personnel	243,750	143,750	40,625	43,750	56,250	528,125
Supplies	25,000	15,000	-	2,500	11,000	53,500
Telephone	-	-	-	-	21,000	21,000
Postage	-	-	-	-	18,000	18,000
Occupancy	-	-	-	-	78,000	78,000
Equipment	55,000	-	-	-	2,000	57,000
Printing	10,000	10,000	-	2,500	-	22,500
Travel	3,750	1,500	500	1,500	-	7,250
Depreciation	-	-	-	-	10,000	10,000
Training	2,500	1,500	500	1,500	-	6,000
Non-personnel	96,250	28,000	1,000	8,000	140,000	273,250
Total specific	340,000	171,750	41,625	51,750	196,250	801,375
Allocation rate	52.78%	30.56%	8.33%	8.33%	(100.00%)	-
Allocation of common costs	103,576	59,965	16,354	16,354	(196,250)	-
Total expenses	443,576	231,715	57,979	68,104	-	801,375

Selecting an Allocation Methodology

Remember, although these are two common methods for allocating common costs, they are by no means the only methodologies that could be used in an organization. For example, some organizations choose a hybrid of the two, adopting only one allocation basis but applying it line by line.

	ADVANTAGES	DISADVANTAGES
LINE-BY-LINE	• A different allocation basis can be adopted for each line item. • "Feels" more accurate.	• Requires time-consuming record keeping. • Feeling of accuracy *may* be deceptive. • Rolling allocated expenses into the specific costs may confuse program managers.
BOTTOM LINE	• Less time-consuming than the line by line method. • Since allocated common costs are presented on a separate line, it allows program managers to focus on line items over which they have control and responsibility.	• Program managers may feel that expenses are being allocated to their programs inaccurately. • When preparing budgets and reports to funders, each common expense line item will need to be allocated because it is unacceptable to show a single line for common costs.

Is your cost allocation methodology adequate?

The most important things to remember when choosing a cost allocation methodology is that it is reasonable (reflecting the actual use of resources considering the type of activity and costs), documented (with a written narrative or clear footnotes that explain the methodology) and consistently applied (done regularly in the same manner throughout the organization and over the course of the fiscal year).

Employee Time Tracking

In most nonprofit organizations, staff have multiple job responsibilities. It is also typically the case that employee salaries and benefits are the largest category of expenses in a nonprofit organization. Therefore, having in place some mechanism for tracking how employees use their time across the functional categories described above—as well as across specific program activities—is essential to accurate financial reporting, both for presentation of salary expense and to use as a basis for allocating common costs.

Time tracking systems vary widely across nonprofits depending on their size and mission type. We advise that small organizations with less defined job descriptions should still make an effort to get a handle on time tracking. For instance, employees may do a 2-week time study each year—where all staff track their time spent on various activities in half-hour intervals for a two-week period—to get a good sense for what kind of human resources (and therefore cost) are being dedicated to the organization's various activities. This data can then be used to establish how each employee's salary will be charged to each activity for that year.

As organizations mature, they should institute a timesheet system that captures people's use of time across core activities year round. For instance, at Food.org, the timesheet's categories would be meal delivery, nutrition education, administration, fundraising, and shared. Each employee would turn in a timesheet for each pay period listing their hours in each category each day. Let's say that Food.org's program director reports 60% of her hours are spent on the meal delivery program, and 40% on the nutrition education program, the bookkeeper would charge those percentages of her salary to each program. Without this information, the bookkeeper cannot confidently report how much the organization is spending on each of its activities.

Among nonprofits that receive temporarily restricted foundation grants and/or government contracts, time tracking often gets complicated by a "chicken or the egg" problem. When a position is budgeted in a grant or contract at 25 percent time for instance, there is an incentive for organizations to “force” that to be true rather than relying on actual time data throughout the year. The only way to get better at budgeting people’s time for grants and contracts purposes is to track the real thing and then use that data to inform the budgeting process in future years. The bottom line is that funders want to pay for actual salary costs not predetermined ones.

Capitalization and Depreciation

The accounting practice of capitalization and depreciation allows organizations to spread the cost of capital acquisitions such as telephone systems and computer networks across their estimated useful life. For instance, if Food.org buys a new van for its meal delivery program for $17,500, it will add that amount to the capital purchases on its Statement of Financial Position to note that it now owns an asset with a value of $17,500. Let's assume that according to Food.org's capitalization policy, they ascribe a useful life of five years to vehicles. For each of the next five years, Food.org will depreciate the value of the vehicle by $3,500 until its full depreciation is captured on their Statement of Financial Position. At the end of five years, the full value of the vehicle will be offset in the accumulated depreciation line on the statement; in accounting terms, the vehicle no longer has material financial value.

> ***Capitalization** means that an item is recorded as an asset when it is purchased rather than as an expense.*

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

The key thing to understand is that at the time of purchase, Food.org did write a check for $17,500, thus lowering their cash total, but in capitalizing the van, they converted one kind of asset (cash) into another kind (vehicles). Fixed assets like furniture and equipment are listed on the Statement of Financial Position with the corresponding depreciation total immediately below. This allows you to recognize when such assets are nearing complete depreciation; this may indicate that you will have to invest in new equipment in the near term.

Look at the asset section of Food.org's Statement of Financial Position (Page 35) to find the total cost of all their capital purchases, which is $44,900. Depreciation of these assets over the years totals ($33,700), which makes the current value of these assets $11,200. See the corresponding depreciation schedule on the following page. All organizations should keep such a schedule to track the acquisition and subsequent depreciation of their capitalized assets.

Sample Depreciation Schedule

Food.org Depreciation Schedule

Item Description	Date Acquired	Cost	Exp. Years	2010 Dep. Exp.	2010 Accum. Dep.	2010 Ending Value	2011 Dep. Exp.	2011 Accum. Dep.	2011 Ending Value	2012 Dep. Exp.	2012 Accum. Dep.	2012 Ending Value	2013 Dep. Exp.	2013 Accum. Dep.	2013 Ending Value
Computer #1	2010	2,400	3	800	800	1,600	800	1,600	800	800	2,400	-	-	2,400	-
Laser Printer	2010	2,100	3	700	700	1,400	700	1,400	700	700	2,100	-	-	2,100	-
Copier (Capital Lease)	2010	3,000	5	600	600	2,400	600	1,200	1,800	600	1,800	1,200	600	2,400	600
Van #1	2010	17,500	5	3,500	3,500	14,000	3,500	7,000	10,500	3,500	10,500	7,000	3,500	14,000	3,500
Office Furniture	2011	5,500	5	-	-	-	1,100	1,100	4,400	1,100	2,200	3,300	1,100	3,300	2,200
Computer #2	2011	1,500	3	-	-	-	500	500	1,000	500	1,000	500	500	1,500	-
Computer #3	2012	1,800	3	-	-	-	-	-	-	600	600	1,200	600	1,200	600
Computer #4	2012	2,100	3	-	-	-	-	-	-	700	700	1,400	700	1,400	700
File Server	2012	7,200	3	-	-	-	-	-	-	2,400	2,400	4,800	2,400	4,800	2,400
Computer #5	2013	1,800	3	-	-	-	-	-	-	-	-	-	600	600	1,200
Total		44,900		5,600	5,600	19,400	7,200	12,800	19,200	10,900	23,700	19,400	10,000	33,700	11,200

Form 990

All nonprofit organizations have an annual requirement to submit a tax return to the IRS. Called the Form 990, the return is essentially a set of much enhanced financial statements. Not only does it include the key numbers from your Statement of Activities and Statement of Financial Position, but it also inquires about your functional expense totals, your key programmatic accomplishments for the year and how much each cost, your lobbying activities, and the compensation of your key employees and consultants, among other issues. Because the form is required of virtually all nonprofits and because it includes such detailed information, it has become a central component of the nonprofit accountability efforts of the last five plus years. This is manifest in the success of the website www.Guidestar.org, which, through a relationship with the IRS, scans hundreds of thousands of Form 990s into a free, searchable database. Because Form 990 is by law a public document, GuideStar does not need an organization's permission to do this. State attorneys general also have an interest in Form 990. They are charged with protecting the interests of state citizens from solicitation fraud among other things and most require an annual filing of Form 990. Finally, as a public document, you are required to make Form 990 available to anyone who asks for it, including your own staff, donors, and the media.

With all of this public access to your Form 990, you should treat it as another communication tool with your key stakeholders. As such, organizational leadership should ensure that the form is completed accurately and on time. We recommend that organizations that have websites create a PDF of their Form 990s and post them on the site. This demonstrates accountability and allows you to direct inquirers to the site rather than hand copying and mailing requested documents.

Action Plan

List three things that you will do differently, practice, try, or share with your co-workers as a result of this workshop:

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2. ______________________________

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3. ______________________________

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