



# ADVISER

## Helping Not-for-Profits

*As pioneers in this rapidly-growing financial service area, our comprehensive approach to the Not-For-Profit sector is virtually unmatched. In addition to the traditional CPA services, we provide management consulting and strategic planning.*

## Ratio Revelations

### What Expense Data Says About Your Spending Habits

Today, citizens have the tools needed to be more knowledgeable than ever about how a not-for-profit spends its money — and sometimes they don't like what they see. Most everyone has witnessed some form of outrage when a not-for-profit spends more of its funding on administering itself than on the programs it offers.

But how do funders, government agencies and watchdog groups get this information? And what financial information will present your organization accurately and in the best light?

#### Popular ratios

Most often, third parties use Form 990, *Return of Organization Exempt from Income Tax*, to obtain cost information because it's a readily available document. Your financial statements also can provide valuable information for functional expense reporting — mainly, the allocation of costs between the categories of program, management and fundraising expenses.

Readers of the 990 can calculate ratios that indicate your not-for-profit's efficiency based upon the functional expense allocation. There are two common ratios obtained by financial information users. The *program-spending ratio* captures total program expenses divided by total

expenses. The *fundraising-efficiency ratio* represents fundraising expenses divided by total contributions.

#### Expense categories

There are two broad categories of expenses: program service and supporting service expenses. Generally Accepted Accounting Principles (GAAP) define *program services* as "the activities that result in goods and services being distributed to beneficiaries, customers, or members who fulfill the purposes or mission for which the organization exists." *Supporting services* are all activities other than program services, including management/general, fundraising and membership development.

According to IRS instructions for Form 990, the management/general category includes expenses for overall function and management rather than the direct expenses incurred in fundraising or program services. Fundraising expenses are the total expenses incurred in soliciting contributions, gifts, grants and so on. (See the sidebar on the following page, "Keeping Your Expenses Accurate.")

Not only must you identify the direct costs of each category, but you also must classify the less obvious indirect costs. As defined in Form 990 instructions for 2009, direct costs are expenses that can be identified specifically with an organization's activity or project and assigned to an activity or project with a high degree of accuracy. Indirect costs are expenses that can't be identified specifically with an activity or project.

For example, a computer bought by a university specifically for a research project is a direct cost. In contrast, the costs of software licensing for programs that run on all of the university's computers are indirect costs.

#### Time and expense allocations

The first step in accurately allocating expenses is to identify the direct costs. Some of these expenses could be common to more than one function. For example, you could have the cost of producing a brochure that provides educational material (program service) as well as a solicitation for donations (fundraising). GAAP provides specific guidance on *when* allocations must be made, but little direction on *how* to make such allocations. Form 990



(continued)

instructions tell the organization to use a “reasonable method” of allocation.

Typically, personnel costs are a not-for-profit’s largest expense, so properly allocating those expenses can have a significant impact on cost allocation accuracy. The primary method is to track staff time and make the allocation based on each employee.

Time should be tracked through a time-tracking system (TimeClick, Timeslips or GetMyTime, for example). Another option would be to perform a periodic time study of all employees to assess the proper percentage allocation of their time, and thus their compensation.

For example, if the executive director likely spends most of his or her time managing the organization, the salary will be allocated to management/general. However, if he or she spends 10% of the time fundraising, 10% of his or her salary will be allocated to fundraising expense. When allocating personnel costs, all related costs — such as benefits and payroll taxes — should be allocated in a similar manner.

Other costs must be analyzed to determine the most effective way to allocate them. For example, occupancy costs (rent, utilities and insurance) often are most accurately allocated by square footage. That is, the percentage of the area used in program services is applied to occupancy costs (rent, utilities, insurance) to determine the program services portion of total occupancy costs. If 25% of the space occupied by the organization is used for program services, 25% of rent, utilities and other occupancy expenses would be allocated to the program services cost category.

#### Allocation method

The physical-units method can be an accurate allocation method in some cases. For example, if a direct mailing includes program content (100 lines) as well as fundraising content (50 lines), the cost could be allocated based on the proportion of lines for each purpose — for example, two-thirds of the cost for program services and one-third for fundraising. GAAP only allows this type of fundraising activity to be allocated jointly if certain criteria related to purpose, audience and content are met in the communication.

### Keeping Your Expenses Accurate

When you tally your management/general costs and fundraising expenses, make sure you include the following categories:

#### Management/general expenses (*not all-inclusive*):

- Salaries/expenses of the chief officer and staff,
- Board of directors meetings,
- Committee/staff meetings,
- General legal services,
- Accounting,
- General liability insurance,
- Distribution of the annual report,
- Office management and personnel administration, and
- Investment expenses.

#### Fundraising expenses (*not all-inclusive*):

- Conducting fundraising campaigns,
- Soliciting bequests/grants,
- Soliciting government grants,
- Participating in federated campaigns,
- Distributing fundraising manuals and materials,
- Fees paid to professionals, and
- Kickoff events.

These criteria prevent not-for-profits from allocating a portion of fundraising costs to program, management or general expenses when the underlying reason for the communication is really to solicit contributions. For instance, if a mailing, containing legitimate program-related information and soliciting contributions, were sent only to previous or potential donors, the audience criteria wouldn’t be met. All mailing costs would be considered a fundraising expense.

#### Resources

For further information on cost allocation, see Form 990 instructions. It’s also a good idea to review your allocation method with your HRR representative for reasonableness and to help you calculate your program-spending and fundraising-efficiency ratios. **h**

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