Demystifying Nonprofit Cost Allocations

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When asked what is at the top of their finance department "to-do" list, many nonprofits name the need for an updated cost allocation plan. An effective cost allocation strategy is essential to organizations' understanding of how their resources are being deployed. It is also integral to performing cost analyses, such as evaluating funding requirements and comparing actual versus budgeted costs.

Allocations are an efficient and effective way to distribute costs across activities, including programmatic, administrative and fundraising work. However, many find the practical application of allocation concepts challenging to navigate. While some costs are easily assigned to specific activities and do not need to be allocated at all, there are certain costs that need to be proportionately distributed across activities and the organization, magnifying the potential for complexity and errors.

Allocation Methods

When determining an organization's allocation strategy, limiting the number of different methods utilized can avoid overcomplication, although most organizations use at least two different allocation methods based on the type of cost.

Payroll and related costs are typically a nonprofit's most significant expense. Organizations determine employee time worked and how that information is documented and substantiated in different ways. However, the goal is ultimately the same: to report these costs in a way that reflects where employees spend their time — that is, where resources are actually being deployed.

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For costs other than payroll, or other than personnel service (OTPS) costs, allocation can be accomplished via various methods, including:

- Full-time equivalent (FTE): The FTE method allocates OTPS in the same proportion as employee time worked in different activities.
- Percent of salary dollars: The salary dollars method allocates OTPS in the same proportion as payroll dollars assigned to different activities.
- Square footage (SF): The SF method, typically applied to occupancy costs, allocates costs proportionate to an activity's share of facility space.
- Per participant: The participant-based method, typically applied to OTPS across programs, allocates costs proportionate to the ratio of participants in each activity.

Allocating Grant Costs

Grant agreements add a layer of complexity to nonprofit cost allocation. Commonly, grants require related costs to adhere to funder-approved, line-item budgets and conform to defined terms and conditions. That is true regardless of whether the funding is from another nonprofit, an individual or a government entity. Adopting and implementing both a consistent organizational cost allocation methodology and a consistent grant allocation methodology is critical. Special attention to grant allocations helps organizations:

- Understand progress against each grant's budget
- Avoid the risk of double charging (charging the same cost to two different grants)
- Avoid potential consequences of violating such agreements

To provide an example of how an organizational cost allocation methodology interacts with grant allocations, let's consider the allocation of program supplies expense for a nonprofit with two different grants supporting a certain program:

The nonprofit has chosen to allocate OTPS using the FTE approach. Under this approach:

1. The program's share of personnel time and effort is 20%, so the program also is allocated 20% of shared supply costs.
2. The program's supply expense can be further assigned to the two grants, barring any limitations based on grant budgets and related allowability of those costs per the contracts.

Costs allocated to grants need to be done so with a consistently applied methodology.

From a practical perspective, nonprofit financial systems need to accommodate such multi-dimensional expense tracking. The ability to automate allocation calculations, as opposed to calculating allocations using spreadsheets, is a significant efficiency opportunity. In any case, generating financial reports at different levels of detail, by both activity and grant, directly from the financial system is key.

Once an organization has effectively applied these concepts, the result should be a fair representation of the costs incurred in each program area and in each supportive service. This information is valuable for a variety of reasons. Knowing the cost of programs and the costs covered by grants allows organizations to make more informed choices when evaluating funding opportunities, planning for operational changes and monitoring ongoing activities.

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