

True Program Costs: Program Budgets and Allocations



While the long-term goal for nonprofits is not to return profits to shareholders, we all know that nonprofits are business entities that need to maintain financial health and stability in order to achieve their mission. Understanding the true, full cost of delivering various programs and services in the community is a critical piece of the management puzzle.

WHY DOES THIS MATTER?

Equipped with accurate information about the cost of each program area, nonprofit leaders are better able to plan and manage budgets and make the case for support and for contract terms that cover the full cost of services. One of the most valuable results of understanding the true cost of programs is the ability to make wise choices about how to support mission critical work. For most nonprofits, some programs may be financially self-sustaining or even generate a surplus. Other activities may require periodic or ongoing subsidy from fundraising or other program areas. Deciding whether and how to support these services is a central strategic decision for nonprofits. Knowing the real costs of each program allows us to make informed decisions and choices that will lead to mission and financial success.

NONPROFITS ASSISTANCE FUND PROGRAM BUDGET AND ALLOCATION TEMPLATE AND RESOURCE

Nonprofits Assistance Fund developed this guide and spreadsheet template to help nonprofits implement program-based budgeting and financial reporting. This resource is an overview of the concepts and management decisions needed to calculate the true costs of activities for a nonprofit and also a how-to guide for the accompanying spreadsheet template. On page 5 you'll find a glossary of terms and a list of articles and resources for more in-depth discussion or technical guidance on this topic. The accompanying spreadsheet template may be used for a one-time analysis project or to implement ongoing program-based budgeting and financial management practices. While a calculation

can be completed for a single program or activity, we highly recommend that these concepts and practices be used throughout a nonprofit. Program-based financial information will be most useful for planning, management, and communications if it is comprehensive, accurate, and used consistently.

GETTING STARTED

Before diving into the numbers and spreadsheets, it's important to begin with a discussion about why the organization is undertaking this process, any specific goals you have, how the financial information will be used, and who will be involved in developing and using the information. If the organization has never allocated costs or overhead before, spend some time discussing the concepts and practices described in this guide. Having a shared understanding and buy-in from senior leaders, financial staff, and program managers is critical to both creating the budget and to using the information for planning and strategic decisions.

GATHER THE DATA

Developing accurate program budgets and allocation formulas requires a number of data sources. Assemble as much as you can in advance, though it's likely that more questions will come up once the process is underway. Some of the information will be specific to your organization, but as a first step you'll need: a list of income and expense categories, detailed budgets, a list of staff, their compensation, and records or estimates of their activities, and information about major expense items, such as facility and program expenses.

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OVERVIEW OF THE PROCESS

1. Define your programs
2. Establish format and structure for accounting
3. Identify direct and indirect costs
4. Select allocation approach and methods
5. Allocate staff salaries, benefits, and taxes
6. Assign direct expenses
7. Allocate direct costs by an appropriate method
8. Identify program specific and general income categories
9. Allocate indirect (administrative) costs
10. Allocate fundraising costs
11. Bring it all together for review

1. Define your programs.

The process begins with the decision of which activities at your organization comprise a program for the purpose of budgets and financial reports. Often, the definition of programs is evident in how your organization delivers services and functions internally. You may already have clearly defined programs, departments, or projects. Some nonprofits identify every activity or grant as a separate program while others combine many activities under the umbrella term. For budgeting and allocations we suggest that you separate your activities into distinct programs that will provide meaningful insight into the financial model. At the same time, avoid making it overly detailed or complicated. As an example, an afterschool program may operate in two locations or be funded by three grants. If the program operates with similar goals, measures, costs, and staff, we'd suggest that these be grouped as a single program.

2. Establish format and structure for accounting

Calculating and analyzing the true cost of programs and activities can be completed as a one-time project or implemented as an ongoing management practice, as we recommend. If that is the goal, it's worthwhile to make sure that the program and cost definitions match the set-up of your accounting system. Any accounting software can be used to maintain program-based financials, but they each have their own structure and terminology. One benefit of structuring accounting this way is that you can control your chart of accounts – the list of income and expense categories. Nonprofits that create new line items in their accounting system every time they start a new program or get a new grant will find that they can simplify their accounting by using program “cost centers.” Whichever system you use, make use of “cost centers”

for the programs you defined and for management & general (administration) and for fundraising. These two cost centers are important components of understanding true costs and are created in parallel with the programs. By organizing your budget and allocations this way, you're also setting up the accounting system to track and report the three functional expense categories required on audits and the IRS Form 990.

3. Identify direct and indirect costs

The terms direct and indirect costs are used with widely varying definitions in the accounting world. For our purposes, we define indirect costs as those expenses that support the overall management of the organization – often called administrative costs or management and general costs. Indirect expenses include the costs of accounting, board meetings, general liability insurance, and other costs associated with running the organization as a whole. This distinction has been problematic for many nonprofits because of the simplistic idea that common costs such as rent, utilities, and technology are all indirect costs, or overhead. The accurate definition for direct costs is those costs that are required to carry out a program or function. Direct costs may be devoted to one program but more often are shared by more than one program. Rent, for example, is a direct cost for all programs that make use of the facility to plan, manage, and deliver the program services based on how much of the space they use. The portion of rent that is for space used for general administration is categorized as indirect. Fundraising may also have direct costs or receive an allocated portion of a direct cost, as will be explained later. Sometimes direct costs will be allocated to all program areas and cost centers, including fundraising and administration. We will discuss the allocation of both direct and indirect costs later in the process. This step asks you to take a fresh look at the list of expenses and identify all of the direct and indirect costs.

4. Select allocation approach and methods

Once you've defined which expense items are direct program costs that are shared by more than one program, you also need to decide how to allocate the cost appropriately. The best allocation methods are reasonable and justifiable while also being simple enough to calculate and maintain over time. An example would be the cost of office supplies that are used by all of our programs and by fundraising and administration. Rather than counting every pen we look for a reasonable basis on which to share the expense proportionally. For our office supplies

example, we'll allocate the expense based on the number of staff members who work in each program, calculated based on FTE. This is a practical method for expenses that "follow the people." The most common allocation methods are: FTE or staff time, square footage, number of clients, "units" of services, and percentage of total direct costs. Other methods may also be appropriate and useful if there is a reasonable connection between the method and the actual use of the resources or expense. The basis of the calculation is sometimes called a "cost driver." In order to keep the allocation system manageable we recommend that you create and maintain just a few allocation choices. The chart on the next page can help you select allocation methods.

5. Allocate staff salaries, benefits, and taxes

Given the significance of personnel expenses to our finances, allocating these costs is essential to understanding true costs. How does each member of the staff spend their time? Job title doesn't necessarily provide the answer. If the Program Director spends 50% of his or her time managing Program A, 30% supervising the managers of Program B, and 20% acting as the organization's HR director, then 80% of the cost of salary and related benefits will be allocated between the programs and 20% will be included in administrative, or indirect costs. Many Executive Directors spend a substantial amount of time working directly in programs. Ideally, salary allocations will be based on regular, reliable tracking of time. The data is already available for nonprofits that track time for grants and contracts. If that has not been your practice we urge you to gather some accurate information by completing a timekeeping report or adding time reporting to payroll or database records. We know from experience that allocating time based on general estimates or gut feeling is often inaccurate. The goal of program-based budgets and allocations is to gain a solid understanding of the true costs, and staff cost is too important to leave to guesswork.

6. Assign direct expenses

When an expense is clearly and exclusively incurred for a specific program area or cost center, we simply assign the expense to that program area or cost center. Examples might include materials purchased specifically for a tutoring program or the cost of an evaluation consultant to document the results of a preschool program. Administration and fundraising may have direct expenses assigned to them as well. The cost of an annual audit would be assigned to administration. The cost of return

envelopes to be included in a fundraising mailing would be assigned directly to fundraising.

7. Allocate direct costs by an appropriate method

In this step you apply the allocation methods described above to the various direct costs that are shared between programs, which may include administration and fundraising cost centers. For the earlier office supply example, you would add up how many FTEs work in each program area and calculate a formula as a percent of the total number of staff. These calculations may be automated through the accounting system or completed manually. The formulas should be revisited if there are major changes in the way expenses are used, such as staff reassignments or growth of a program. For many organizations the formulas don't change more than annually. At this point you will have a subtotal of the direct costs of each program, administration, and fundraising. The process doesn't end there, though.

8. Identify program specific and general income categories

This process is most valuable when a nonprofit can understand both the full cost of delivering programs and the amount and type of income that relates to those programs. Leaders can use this information to analyze the financial model of programs individually and as part of the whole. In this step you will identify which income items are connected to specific program areas and what income can be directed at the organization's discretion. Examples of income that is assigned directly to a program include contract or fee income for a preschool program or a grant that is received for a tutoring program. For this step we recommend that contributed income that is unrestricted or general operating support be assigned to the fundraising category for the analysis. The final analysis will clearly show what program areas require these sources of support and enable leaders to make the all-important decision about how to best attract and direct flexible funds.

9. Allocate indirect (administrative) costs

The cost of administration, categorized as indirect costs, adds value to every program at a nonprofit. Programs are more effective, better managed, and more responsive to the community when an organization has good accounting and technology, high quality leadership, planning, and governance. In order to have a true picture of what our programs really cost, we must allocate these indirect or administrative costs as well. If we ignore this

step, we will be underrepresenting the expense involved in supporting each program area. As explained above, indirect expenses are generally all of our administrative expenses – those expenses that support the overall management of the organization. Some expenses are assigned to the indirect category specifically, such as the audit. Others are allocated to the indirect category, such as a portion of rent and telephone. For this reason we wait until after all the direct allocations are completed before we turn to allocating the indirect costs. The two most common methods for allocating indirect costs to programs are percentage of total direct costs and percentage of FTE.

10. Allocate fundraising costs

Similarly, the cost of fundraising is valuable to programs and the final step is to allocate fundraising expenses to each. The most common basis for allocating fundraising costs is based on percentage of total support received by each program. This method matches the percentage of fundraising expense charged to a program to the percentage of contributed income that program receives. We leave this step until last because some funders, including many government funders, will not allow fundraising expenses to be charged to their grants or contracts. Regardless of whether a funder will pay for fundraising expense, it remains part of the total cost of running each program and we need this information to be truly informed. The same is true for allocating administrative/indirect costs.

11. Bring it all together for review

After completing the full program-based budget or financial analysis it's worthwhile to take a fresh look for both accuracy and a gut check. Do the formulas, amounts, and financial results match what you expected, or do they surprise you? If there are surprises, first review the data to verify the calculations and choices about allocations and definitions. Sometimes, though, the surprise comes from seeing the true and full costs for the first time. The benefit is that you now have better information for discussions about priorities and how resources are used. With this information your organization is better equipped to review costs, prices, and contract terms; communicate gaps and fundraising priorities; and discuss which programs require financial support and how that relates to accomplishing your mission goals.

CHECKLIST

- Define your programs
- Establish format and structure for accounting
- Identify direct and indirect costs
- Select allocation approach and methods
- Allocate staff salaries, benefits, and taxes
- Assign direct expenses
- Allocate direct costs by an appropriate method
- Identify program-specific and general income categories
- Allocate indirect (administrative) costs
- Allocate fundraising costs
- Bring it all together for review

ALLOCATION METHODS

Common methods	When to use
Direct assignment of expense	Expenses that can be clearly identified and quantified
Formula based on use of staff time	Preferred method for all salaries and benefits
Formula based on use of resources, such as facility or supplies	When resource use is different for program areas and can be measured using a “cost driver” such as square footage or number of clients
Formula based on FTE equivalents	Expenses that “follow the people”
Estimates	Not preferred, but used when resource is difficult to measure or quantify but can be reasonably allocated

GLOSSARY OF TERMS

Allocation: A method of accounting that divides expenses among different program, administrative, and fundraising categories based on a formula that recognizes the use of the resources, such as use of a facility or staff time.

Allocation method: A reasonable and supportable basis for dividing expenses or income between multiple areas.

Cost center: An identifiable activity, department, or function within an organization for which expenses are grouped and managed. May or may not generate revenue.

Cost driver: A measurable unit of activity that causes costs to increase or decrease. Examples are the number of hours for contracted services, or the number of students who receive lunch.

Direct costs: Those expenses which are specifically attributable to a program area or cost center. May be allocated.

Full-time equivalent (FTE): A useful denominator for formulas based on staff composition.

Functional expenses: Term used in accounting and for IRS reporting to identify costs based on how they are used (function) rather than the type of the expense. Standard categories are Program Services, Management & General, and Fundraising.

Indirect costs: The costs that cannot be identified with a program activity but are needed for the general administration of the organization. May be allocated.

Overhead: See Indirect costs.

Shared expenses: An expense line item that is incurred to benefit more than one program, cost center, or functional area.

Statement of Functional Expenses: A standard financial report included in the financial audit of many nonprofits to communicate expenses categorized by function as well as by line item.

A comprehensive glossary of nonprofit financial terms can be found on the Nonprofits Assistance Fund website.

ADDITIONAL RESOURCES AND LINKS

This overview and guide to using the Program Budget and Allocation Template is not intended to be a definitive or comprehensive document for such a complex financial management practice. We hope that you will be able to use this resource to understand the concepts and steps and to implement this valuable process at your nonprofit.

Here are a few additional resources for more extensive discussion and application of the concept.

From Nonprofits Assistance Fund:

- Overhead Cost Definitions
- 10 Step Budgeting Checklist
- Transforming Nonprofit Business Models

From other sources:

- Real Talk About Real Costs video, Donors Forum
- Costs are Cool: The Strategic Value of Economic Clarity, The Bridgespan Group
- Nonprofit Cost Analysis: Introduction, The Bridgespan Group
- Book: The Sustainability Mindset by Jeanne Bell and Steve Zimmerman

TRAINING

Nonprofits Assistance Fund periodically schedules training workshops and webinars on this and other topics. Check for upcoming training here or contact us to learn about customized training sessions for your organization or association.

How-to Guide: Budget and Allocation Template

OVERVIEW

The Program Budget and Allocation Excel template was developed as a tool for nonprofits for analysis of the true costs of programs and to implement this financial management practice. The template is based on the information and decisions described in the process outlined in the previous section, such as defining programs, identifying direct and indirect costs, and selecting allocation methods. The Excel template workbook includes 13 tabs that will be completed using detailed financial data. This level of detail works well for small and mid-sized nonprofits. Larger organizations will need to group expenses or salary categories to keep the information manageable.

BEFORE YOU BEGIN

Several decisions will be needed before you begin entering numbers onto the worksheet. These initial choices will automatically trigger input prompts and formulas throughout the workbook.

1. Define your programs. The template accommodates up to nine programs in addition to Management & General (Admin) and Fundraising, which are pre-populated.
2. Select allocation approach and methods. The template accommodates up to three allocation methods, including the formula based on Full-Time Equivalent (FTE).

Formulas are built in and linked between tabs to calculate allocations and subtotals based on data entered. Some selections are made through drop-down menus. This spreadsheet is locked so that formulas and links cannot be changed. If you are an advanced Excel user you can request an unlocked version by sending an email to info@nonprofitsassistancefund.org.

DETAILED INSTRUCTIONS

FIRST: read the instructions on Tab 1 and enter the information requested on Tabs 2 and 3. All of the input prompts and formulas rely on this information.

Tab 1) Introduction

Enter information in green-shaded fields ONLY. The tabs must be completed in order.

Tab 2) Your Programs

- Row 6 – Enter your organization's name.
- Row 9 – Enter the date of your fiscal year end.
- Rows 15 to 23 – Enter up to nine programs. Management & General and Fundraising are pre-entered. Each program name must be unique.

Tab 3) Your Chart of Accounts

- Rows 9 to 13 – Name income accounts or line items that are contributed or donated.
- Rows 17 to 21 – Name income accounts or line items that are earned or contracted.

- Rows 31 to 61 – In column B, choose H for Header or A for Account from the drop down list. Header lines are intended to help you group your expenses. Accounts are intended to represent your line items.

Tab 4) Salary, Taxes, Retirement

- Rows 4 to 6, Columns C to G – Enter information in these rows first. In Column C, enter the number of hours in your work week (Example: 40).
- In Row 5, Column G, choose Yes or No from the dropdown list to indicate whether your state has an unemployment insurance tax. If yes, enter your organization’s state unemployment insurance tax rate in Row 6, Column G.
- Enter the annual taxable wage base for your state in Row 7, Column G. This is the maximum amount of wages that are subject to UI tax for an employee in a single calendar year.
- Rows 4 to 6, Columns I to L – Use these fields if your organization pays any other tax or benefit that is calculated as a percentage of gross salary or wages. Enter the name of the tax or benefit in Row 6, Columns I, K, or L. Then enter the corresponding percentage used to calculate the tax or benefit on Row 7, Columns, I, K, or L.
- Rows 10, 27, 44, 61, 78, 95, 112, 129, 146, 163, Column B – In the green-shaded fields, enter the names of up to 10 employees. For each employee you enter, a green-shaded box will appear in Column C in which to enter the total annual salary. A second box will appear immediately below the salary amount. Enter the total number of hours the employee works in a year. (Example: 40 hours/week = 2080 hours/year).
- Column C – For each employee you entered, a list of the programs you entered in Tab 2) will appear in Column B. Next to each program name, you will see a green-shaded field in Column C. Enter the percentage of each employee’s time that is spent working on each program. The total for each employee should equal 100%. Some employees may only work in one program. Some may work in all.

Tab 5) Other Benefits

- Rows 6, 19, 32, 45, 58, 71, 84, 97, Column A – Enter the name of up to eight additional personnel benefits that your organization provides to employees. A list of the employees you entered in Tab 4) will appear in Column A when you have entered the name of the benefit.
- Column B – For each benefit listed, you will see a list of your employees. In Column B, enter the total annual cost of the benefit for each employee separately. For example, if you provide health insurance and the monthly premium for your executive director is \$440, then the total annual cost would be \$440 X 12 months or \$5,280 for your executive director. The cost for each individual employee might vary.

Tab 6) Direct – Assignment

- Based on information you entered on Tab 2) and Tab 3), you will see green-shaded boxes in the rows where you have a line item and the columns where you have a program. If applicable, enter amounts in these green-shaded boxes that represent direct income or direct expenses that are easily assigned to each of these programs. These items are generally attributable to only one or two programs. An example would be textbooks purchased for a tutoring program, where the books are used for only that one program and the expense should be charged to only that program.
- NOTE: Income or expense items that are directly assigned to Management & General or Fundraising should be entered on this tab. Management & General and Fundraising will receive an appropriate share of allocated income and expenses in the following tabs.

Tab 7) Direct Allocation (FTEs)

- Based on the programs you entered on Tab 2) and the line items you entered on Tab 3), you will see green-shaded boxes in Column C. This tab is designed to allocate income and expenses based on the percentage of FTEs (full-time equivalents) working in each program. The calculations are done automatically and are based on information you entered in Tab 4). Enter only income items or expense items in Column C that are meant to be allocated based

on the FTE allocation method. Some examples of common items allocated by FTE are unrestricted individual contributions or office supplies or telephone. You will not necessarily use all the green-shaded fields.

Tab 8) Direct Allocation Method 1

- Based on the programs you entered on Tab 2) and the line items you entered on Tab 3), you will see green-shaded boxes in Column C. You will also see green-shaded fields in Row 5. This tab is designed to allocate income and expenses based on a method chosen by your organization. This could be number of square feet occupied by program, the number of students served by program, or the number of client intakes processed by program. Enter the name of your allocation method in Row 2, Column C.
- This tab can calculate only one allocation method. In Row 5, enter the number of units that each particular program uses of the total number of units in your chosen method. Here is an example. If your organization has three programs and sees 4,300 clients per year, in Row 5 you might enter 1200 in Column D for Program 1, 2000 in Column E for Program 2, and 1100 in Column F for Program 3. The allocation for each program is calculated automatically based on the number of units per program.
- In Column C, enter the total annual dollar amount of any income item or expense item that should be allocated using the chosen method. You may or may not have dollar amounts for every item. The allocated amounts are calculated automatically based on the units you enter.

Tab 9) Direct Allocation Method 2

- Follow Tab 8) instructions. Complete this tab if you have income items or expenses that are allocated using a different method than Tab 7) or Tab 8).

Tab 10) Indirect Allocation

- The only data entry required on this tab is to choose whether you allocate indirect expenses as a percentage of total direct expenses or as a percentage of FTEs. Both are commonly used methods. The spreadsheet will calculate the indirect allocation based on information already provided in previous tabs.

Tab 11) Fundraising Allocation

- No data entry is required on this tab. In this spreadsheet, fundraising expenses are allocated based on the percentage of total contributed support in a given program divided by the total contributed support raised for the entire organization.

Tab 12) Total by Program

- No data entry is required on this tab. This tab displays a detailed report of all line items by program area.

Tab 13) Summary

- No data entry is required on this tab. This tab displays a summary report showing income and expenses rolled up into summary categories by program.