

NONPROFIT AGENDAS MARCH 2009

EXPENSE ALLOCATION

The importance or proper reporting

If a potential funder studied your financial data, would they conclude that your organization is well run? Are the costs you allocate to nonprogram categories — management expenses, for example — believable? The reality is that many funders, watchdog groups, government regulatory agencies and others depend on the ratios gleaned from your cost allocations to make judgments about your organization's efficiency.

Why is cost reporting important?

Most often, third parties use Form 990 to obtain cost information because it's a readily available document. 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.

The reader of the 990 can calculate ratios that indicate your nonprofit's efficiency based upon the functional expense allocation. The two most common ratios obtained by financial information users are:

1. **The program-spending ratio.** Total program expenses divided by total expenses, and
2. **The fundraising-efficiency ratio.** Fundraising expenses divided by total contributions.

The knowledgeable professionals in the Nonprofit and Government Services Group at Marks Paneth & Shron can work with you, if needed, to calculate for yourself your program-spending and fundraising-efficiency ratios.

Where do expenses need to be allocated?

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.

IRS instructions for Form 990 provide a description of the management/general category, which 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. Be careful not to overlook them; see "Where nonprofits fall short" at right.

Not only must you identify the direct costs of each category, but you must classify the less obvious indirect costs. As defined in Form 990 instructions for 2008, 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 cannot be identified specifically with an activity or project. For example, the salary of a physician providing medical services at a free clinic would be a direct cost. The cost of that physician's membership in the state medical society would be an indirect cost.

How do you allocate expenses?

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

Typically, personnel costs are a nonprofit's largest expense, so their proper allocation can have a significant impact on the accuracy of your cost allocations. 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 her time managing the organization, her salary will be allocated to management/general. However, if she spends 10% of her time fundraising, 10% of 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 service portion of total occupancy costs. If 25% of the space occupied by the organization is used for program services, then 25% of rent, utilities and other occupancy expenses would be allocated to the program services cost category.

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 service 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.

These criteria prevent nonprofits 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.

Where can you get information?

Common resources for cost allocation information are Statement of Financial Accounting Standards No. 117 (SFAS 117), "Financial Statements of Not-for-Profit Organizations"; Statement of Position (SOP) 98-2, "Accounting for Costs of Activities of Not-for-Profit Organizations"; and Form 990 instructions. It's also a good idea to review your allocation method with the professionals in the Nonprofit and Government Services Group at MP&S for reasonableness.

Where nonprofits fall short

In a five-year study by the Urban Institute's National Center for Charitable Statistics/Center on Nonprofits and Philanthropy and the Center on Philanthropy at Indiana University, researchers looked at the Forms 990 and financial statements of more than 1,500 nonprofits of various sizes to assess how accurately organizations reported cost allocations. The study found that the information used to form decisions on the efficiency of nonprofits often is seriously inaccurate.

The IRS also suspected that fundraising costs weren't always accurately allocated. By analyzing organizations' 990s as part of the Fundraising Expenses Education Project in 2004, the agency observed that, in some cases, nonprofits with significant contributions were reporting zero in fundraising expenses — an almost impossible scenario.

In this project, the IRS mailed questionnaires to over 2,000 nonprofits inquiring about their fundraising expenses. A significant number of these organizations were found to be underreporting such expenses, which could become a target area in an IRS audit because of the potential fraud and private benefit issues — and ultimately result in accuracy penalties by the IRS.

STEERING CLEAR OF STAFFING EMERGENCIES

Here's a hypothetical example that might ring true for your nonprofit: Your organization is increasingly faced with a shrinking budget while you strive to provide the best in program services. So, how do you address those opposing forces? If you're like most nonprofits, you run lean on staffing.

Besides crunching numbers, your bookkeeper also might answer the phones and work program events, for example. But what would happen if he suddenly resigned or took a leave of absence?

Perfect worlds are hard to find

In a perfect world, your organization would have a complete permanent staff. Among other personnel, you'd have an executive director, a development director, a finance director, an accountant, an IT professional, a receptionist, and a team of people (maybe an army) to focus on program services.

But it's costly to maintain a wide variety of professionals so, instead, nonprofits often count on a smaller workforce to perform multiple duties — a setup that can lead to a staffing emergency when someone unexpectedly leaves.

Solutions are out there

Fortunately, there are a number of options that allow you to avert a staffing crisis:

1. Temps can come to the rescue. Temporary staffing firms can provide administrative and clerical staff, as well as experienced and specialized professionals. Many people out of work look to temporary staffing agencies to carry them over to their next permanent job. So an agency may even be able to provide you with a temp who's qualified to handle a project that requires extensive skills and experience, such as developing a strategic communication plan.

A number of temporary staffing agencies cater solely to the nonprofit sector while most others have nonprofits in their client base. Advice to the nonprofit? Look for agencies that make the effort to understand your organization's purpose, values and workplace environment.

2. Independents can do the trick. Independent contractors can help you avert a staffing crisis by helping out on a project-by-project basis. Organizations often use contractors for grant writing, program management, marketing and communications, and human resources. Using a contractor is less expensive than hiring a full-time professional — your organization doesn't have to pay employment taxes or provide benefits. And you usually don't need to provide workspace or equipment (such as a computer) either.

It's critical that you differentiate between an "independent contractor" and an "employee" properly, as you're not required to withhold or pay any payroll taxes for independent contractors. The IRS notes on its Web site (irs.gov) that the key to this differentiation is knowing the "business relationship that exists between you and the person performing the services." Generally speaking, the IRS says that an individual is an independent contractor if you have the "right to control or direct only the result of the work and not the means and methods of accomplishing the result."

For example, you may agree to pay an independent contractor \$450 to revamp your organization's Web site because that person estimates it will take 25 hours at \$18 per hour to complete the job. The contractor's payment is not considered payment by the hour because, even if they work more or less to complete the project, they'll still receive \$450.

3. Volunteers can lend a hand. Determine in advance which volunteers — with particular skills your operation uses — might be willing to help out when needed. This might be accomplished on an intake form or application or through personal contact. Then prepare a list of individuals, by skill set, who have volunteered to pitch in.

4. Permanent candidates can take over. Keep detailed job descriptions in place for every position, including education and experience requirements. Advertise the job online and in print immediately. This may take longer, and cost more, than using either a temporary staffing agency or an independent contractor. But the benefit of preparing an employee for a permanent role within the organization may outweigh the expense.

Deciding whether to use temporary help or independent contractors vs. recruiting a permanent candidate will likely be governed by timing. Do you need the job done now or do you have the time to spend recruiting a permanent candidate? You also need to consider the type of work involved. Do you have a one-time project to complete? If so, using a temporary employee may be the answer.

Also, consider that temporary staffing agencies almost always put provisions in their contracts for hiring the “temp.” If the employee works out and is a good fit for your organization, you may want to consider paying the “finder’s fee” to the agency and hiring that person full-time.

Put an action plan in place

It’s important to consider how your organization will handle staffing emergencies *before* they occur. Otherwise, your programs and mission could be compromised while you work through the issues. Form an action plan for your organization now.

Start by taking a look at each employee in your organization and his or her functions. Next, discuss the best way to handle that person’s sudden resignation or leave. Finally, research — and have available — resources should an emergency situation arise. Form relationships now with staffing agencies, independent contractors, career boards and newspapers, even if you don’t need to use them immediately. This will save you valuable time and energy in the long run.

SPENDING LIMITS

Initiatives zero in on endowment management

That mouthful of words — the Uniform Prudent Management of Institutional Funds Act (also known as UPMIFA) — is likely in your vocabulary by now. As of year end, one-half of U.S. states had enacted UPMIFA and the legislation had been introduced in several more states. UPMIFA updates and standardizes investment and expenditure policies for nonprofits. In a nutshell, the law requires organizations to prudently manage investments and control expenditures — in the hope that you’ll have more money for program use.

Understanding UPMIFA

When a donor’s intent is not so clearly expressed in a written gift instrument, UPMIFA provides guide-lines for spending endowment funds, focusing on the original gift amount and its net appreciation. UPMIFA’s predecessor, the Uniform Management of Institutional Funds Act, prescribed the historic-dollar-value method. With that approach, an organization couldn’t use endowment funds below a set sum, such as the amount of the fund at the time it was created. UPMIFA axes this method and, instead, focuses on what constitutes prudent spending while preserving the fund’s level.

Following FASB Staff Position No. FAS 117-1

Because of UPMIFA’s widespread adoption, the Financial Accounting Standards Board (FASB) released guidance in August 2008 on implementing the law in Staff Position No. FAS 117-1, “Endowments of Not-for-Profit Organizations.” FAS 117-1, effective for fiscal years ending after Dec. 15, 2008, provides that:

1. An organization subject to UPMIFA “shall classify a portion of a donor-restricted endowment fund of perpetual duration as permanently restricted net assets,”
2. “[T]he portion of the fund that is not classified as permanently restricted net assets [shall be classified] as temporarily restricted net assets (time-restricted) until appropriated for expenditure by the organization,” and
3. The footnote disclosures for all not-for-profit organizations will be expanded.

FASB was clear that this guidance was intended to “improve the quality and consistency of financial reporting of endowments held by not-for-profit organizations.”

Weighing the impact of FAS 117-1

Your permanently restricted endowment funds may change, though you may not have any additional contributions or releases from restrictions during the year. This depends on how you classified endowment gifts in the past. If donor stipulations were explicit, you would have

classified the funds as *permanently restricted*. If not, the governing board, under UPMIFA and FAS 117-1, must determine the amount that should be preserved or retained, in accordance with current law.

If you have an UPMIFA-governed donor-restricted endowment fund that stipulates its *earnings* are unrestricted, you would classify those earnings as temporarily restricted in your financial statements until their expenditure is appropriated and approved.

The most significant change impacts disclosures in your audited financial statements. In addition to previously required disclosures, you'll need to release information on:

- The reasoning behind your governing board's net-asset classification of donor-restricted endowment funds,
- Your organization's policies for expending endowment assets,
- Your organization's endowment investment policies,
- What makes up your organization's endowment by net asset class at the end of the period, separating donor-restricted from board-directed endowment funds, and
- Reconciliation from the beginning endowment amount to the ending balance of your organization's endowment, including investment return, net appreciation/depreciation, contributions and reclassifications.

All in all, you'll need to be more transparent about how you manage endowments.

Following through

Your organization may face some accounting and reporting challenges as a result of UPMIFA and FAS 117-1. Still, it's important to recognize that both have been designed to help organizations, by modernizing rules and regulations for endowment accounting and reporting. If your state isn't one that has enacted UPMIFA already, that move still may be on the horizon. Contact your accountants now to see how you and your organization may be affected.

NEWS FOR NONPROFITS

New Form 990 requires "Tell All" on compensation

Compensation continues to pique the interest of the IRS. For that reason, one of the major additions to the new Form 990 is the reporting of substantial information about compensation. Starting with tax year 2008, Part VII of the core form requires the reporting of compensation directly from W-2 forms for employees and from Form 1099 for independent contractors. And you need to disclose more compensation details in Schedule J, including information on base pay, bonuses, severance, deferred compensation and nontaxable benefits.

Compensation information is required for officers, directors, trustees, key employees and your five highest compensated employees other than the aforementioned. Key employees are defined as employees other than officers, directors and trustees who:

- Had reportable compensation above \$150,000,
- Had organization wide authority or control, and
- Were among your nonprofit's top 20 highest-paid employees who satisfied the above two tests.

The new form also defines who is an officer, which will require including the CEO at a minimum. Ronald Schultz, senior technical advisor in the IRS's Tax Exempt and Government Entities division, warned at an Oct. 1 American Bar Association continuing legal education program that claiming to have *no* officers is a "bad position" to take.

Mint idea for "going green"

Everywhere you turn these days, you're urged to "go green," but this isn't just a social movement — it can save your nonprofit money as well.

A major initiative would be to design your office space using "green design," such as sensors to monitor overhead lighting, installation of high-efficiency heating, ventilating and air conditioning, and use of recycled content furniture. This can save money in the long term, and you can often

find funders to help fund the initiative. A simpler alternative could be to allow more employees to telecommute, which would cut down on the office square footage you need.

You also can help your employees reduce the impact of their commute by allowing a compressed work week, locating close to major routes for public transportation and providing bike racks and showers.

Higher Ed questionnaire signals new compliance areas

As part of a new compliance initiative, the IRS has sent questionnaires to approximately 400 colleges and universities. The questionnaire gives an indication of areas the IRS will likely address with other nonprofits in the near future. Areas covered include how colleges and universities:

- Report revenue and expenses from taxable activities,
- Determine whether activities are exempt or taxable,
- Calculate and report income and losses on Form 990-T,
- Allocate revenue and expenses between exempt and taxable activities,
- Invest and use endowment funds, and
- Determine compensation of certain highly paid individuals, including how the organization forms compensation policy and determines which factors are used in setting compensation.

The IRS expects to issue a report on this compliance project sometime this year.

SPOTLIGHT ON MP&S

Many recent events related to our economy have placed considerable attention on the area of accounting principles - one being International Financial Reporting Standards (IFRS). Last month, Steven Henning, partner-in-charge of the MP&S Litigation and Corporate Financial Advisory Services Group was profiled in *Financier Worldwide* magazine in an article that discusses the U.S. adoption of IFRS and its movement to replace U.S. Generally Accepted Accounting Principles. (GAAP.) In the article, Steve talks about the different set of IFRS principles and how those principles differ from the approach taken by GAAP. The article entitled "The Future of Accounting Principles" provides a broad overview which demonstrates how this shift to principles-based accounting demands that everyone responsible for financial reporting, including the audit committee, adopt a new mindset.

MP&S FAST FACTS

- Nationally, among the top 30 largest accounting firms and a leader in accounting and auditing (*Accounting Today*)
- The New York Area's 15th largest accounting firm and one of the five fastest growing firms in our market (*Crain's New York Business*)

FOR FURTHER INFORMATION

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