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Learning Objectives:

During this session we will learn about and understand the new reporting and disclosure requirements under ASU 2016-14, Presentation of Financial Statements of Not-For-Profit Entities. Topics to be covered include:

Understanding how to identify allocable cost and overhead expenses and various allocation methodologies.

Gain and understanding the new reporting requirement for reporting expenses in a NFPs financial statements.

Recognize the new disclosure requirements related to allocation of expenses.
What is a Cost?

An amount that has to be paid or given up in order to receive a good or service of perceived equal value.

In business, cost is usually a monetary valuation of (1) effort, (2) material, (3) resources, (4) time and utilities consumed, (5) risks incurred, and (6) opportunity forgone in production and delivery of a good or service. All expenses are costs, but not all costs (such as those incurred in acquisition of an income-generating asset) are expenses.
Some Typical Language That You Might Hear Regarding Types of Costs

Activity (program, administration, fundraising)
Overhead (administration, fundraising)
Activity-specific (associated with one program)
Common (shared by two or more activities)
The Purpose of Cost Allocation

Cost allocation is the process of identifying, aggregating, and assigning costs to cost objects. A cost object is any activity or item for which you want to separately measure costs. For example:

- Products, services, activities, departments, other organizational units, contracts, subcontracts, contract line items, orders, task orders, grants, sub-grants, etc.

Cost allocation is used to equitably assign costs to identified cost objectives and for financial reporting purposes.
Cost Allocation Methods

The very term "allocation" implies that there is no overly precise method available for charging a cost to a cost object, so the allocating entity is using an approximate method for doing so.

Therefore, an organization may continue to refine the basis upon which it allocate costs, using such allocation bases as square footage, headcount, cost of assets employed, or (as in the example) electricity usage.

The goal of whichever cost allocation method an organization uses is to either allocate costs in the fairest way possible (i.e. equitable), or to do so in a way that reflects the beneficial or causal relationship of the pooled costs to the cost objects. Thus, an allocation method based on headcount might drive program managers to reduce their headcount or to outsource functions to third parties.
Is There a Good Reason for Not to Allocate Costs?

An organization may have justifiable reason for not allocating costs. Sometimes the reason is that no cost should be charged that the recipient has no control over. Thus, in the Africa for Free Democracy decides to not allocate the cost of its rent, on the grounds that none of the six operating departments have any control over the rent expense. In such a situation, the organization simply includes the unallocated cost in the nonprofit's entire cost of doing business. In some situations this might be okay in other it would not be.

The basis for allocating cost should be to show what it cost the organization to deliver a good or service to a participant or beneficiary. Whether the program manager has control over the cost or not.
Various Allocation Methodologies

- Direct Method of Allocating Costs
- Stepdown Method of Allocating Costs
- Reciprocal Method of Allocating Costs
Direct Method of Allocating Costs

The direct method, allocates costs of each of the service department costs to each program and operating department based on its share of the allocation base (i.e. how a cost object used the service department).

Ignores services provided among service departments.

Equitable and fair basis of allocation measures (examples next slide):

- A Resource consumption measure
- An Output measure
- Surrogate that is representative of resources consumed
Examples of Direct Allocation Methods

Resource Consumption:
- Computer Service are allocated based on head count
- Benefits are allocated on direct labor dollars or direct labor percentage
- Maintenance Costs are allocated based on square footage assigned to the unit

Output
- Food Service Costs are allocated based on number of meals served to the unit
- Central processing unit operation costs allocated based on processing time
- Purchasing unit costs allocated based on number of PO’s processed

Surrogate:
- Centralized warehousing costs allocated based on material value
Step Method of Allocation

The second method of allocating service department costs is the step method. Under this method, organizations allocate service costs to operating departments and other service departments in a sequential process. The sequence of allocation generally starts with the service department that has incurred the greatest costs. After this department’s costs have been allocated, the service department with the next highest costs has its costs allocated, and so forth until the service department with the lowest costs has had its costs allocated. Costs are not allocated back to a department that has already had all of its costs allocated.
Reciprocal Method of Allocating Costs

The final method, is the reciprocal method. Although it is the most accurate, it is also the most complicated. In the reciprocal method, the relationship between the service departments is recognized. This means service department costs are allocated to and from the other service departments.
Financial Statements of Not-for-Profit Entities ASU 2016-14
NFP Issues with Expense Reporting

Donors, creditors and other users may not be seeing the full picture when a NFP does not disclose relevant information regarding its expenses for a period. With the issuance of this update, all NFPs will be required to report all expenses per period by Nature and Function.

The effects include:

- Users gain more visibility into the organization’s expenses
- Users will be able to determine how the organization allocates its resources
What Does the ASU Require Related to Expense Reporting?

Report expenses, either on the face of financial statements or in the notes, by:

- Function *
- Natural classification
- Analysis (disaggregate function by nature)

* currently required in GAAP

NFPs are now required to provide qualitative disclosures about methods used to allocate costs among program activities and supporting services.

ASU 2016-14 also provides enhanced guidance on allocations from management and general (M&G) expenses

- Key concept: direct conduct or direct supervision
What Does the ASU Require Related to Expense Reporting?  (Cont’d)

Additional Information

• If expenses are reported in other line items within the statement of activities (e.g., salaries are included in costs of goods sold) they should be included in the functional reporting schedule by their natural classification.

• External and direct internal investment expenses that are netted against investment return should not be included in the functional expense analysis.
Expenses By Both Nature and Function for a College/University

### Analysis of Expense by functional and natural Categories

Total expenses include all operating expenses and the nonoperating expense of other components of net periodic pension cost.

<table>
<thead>
<tr>
<th>Program Activities</th>
<th>Supporting Activities</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Academic and Student Programs</strong></td>
<td><strong>Administrative Support</strong></td>
</tr>
<tr>
<td>Salaries and wages</td>
<td>$10,026,575</td>
</tr>
<tr>
<td>Employee benefits</td>
<td>3,590,259</td>
</tr>
<tr>
<td>Services, supplies, and other</td>
<td>2,667,856</td>
</tr>
<tr>
<td>Occupancy, utilities, and maintenance</td>
<td>83,221</td>
</tr>
<tr>
<td>Grants to others</td>
<td>285,658</td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>808,039</td>
</tr>
<tr>
<td>Interest</td>
<td>-</td>
</tr>
<tr>
<td>Facilities operation and maintenance</td>
<td>1,859,326</td>
</tr>
<tr>
<td><strong>Total operating expense in FY 16</strong></td>
<td><strong>$19,320,935</strong></td>
</tr>
</tbody>
</table>

The financial statements report certain categories of expenses that are attributable to one or more program or supporting functions of the Seminary. These expenses include depreciation and amortization, interest, the president's office, communications, media production, information technology, and facilities operations and maintenance. Depreciation is allocated based on square footage and interest is allocated based on usage of space. Costs of other categories were allocated on estimates of time and effort.

For example: 958-205-55-21 Note F (Page 66 of ASU)
## Cost Methodology Issues - College/University

<table>
<thead>
<tr>
<th>Allocation</th>
<th>Current Cost Allocation Method</th>
<th>Revised Allocation Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Facilities Operation &amp; Maintenance</td>
<td>Sq. Footage basis</td>
<td>Service &amp; effort estimate</td>
</tr>
<tr>
<td>Depreciation &amp; amortization</td>
<td>Sq. Footage basis</td>
<td>No change</td>
</tr>
<tr>
<td>Interest</td>
<td>Usage of Space</td>
<td>No change</td>
</tr>
<tr>
<td>IT related costs</td>
<td>Do not allocate</td>
<td>Service &amp; effort estimate and costs of specific technology utilized</td>
</tr>
<tr>
<td>Media production &amp; Communication</td>
<td>Do not allocate</td>
<td>Service &amp; effort estimate</td>
</tr>
</tbody>
</table>
Example Disclosure for Expense Allocation Disclosure

NOTE X. METHODS USED FOR ALLOCATION OF EXPENSES FROM MANAGEMENT AND GENERAL ACTIVITIES

The financial statements report certain categories of expenses that are attributable to one or more program or supporting functions of the Organization. Those expenses include depreciation and amortization, the president’s office, communications department, and information technology department. Depreciation is allocated based on square footage, the president’s office is allocated based on estimates of time and effort, certain costs of the communications department are allocated based on estimates of time and effort, and the information technology department is allocated based on estimates of time and costs of specific technology utilized.
Impact on Changes to Presentation and Disclosure of Expenses

• Will need to present by function and nature in one location - determine whether you want to include on face of statement of activities, as a separate statement of functional expenses or in the footnotes. (Note: This analysis of expenses cannot be presented as supplemental information.)

• Will need to add disclosures about the methods used to allocate costs. Would recommend this be done in the significant accounting policies note.

• Will need to reevaluate you methodology for allocating expenses is appropriate and how you are allocating expense and presenting and disclosing are one in the same.

• That you organization has policies and processes that not only support the basis for allocating expenses but also has a requirement for evaluating the methodology and updating it a regular basis.
A Changing Landscape

1. Increasing pressure on fundraising via “normal” means
2. Aging donor base
3. Changing landscape of how organizations raise money
4. Overhead myth
5. Continued challenges between oversight and Organizations
Cost Recovery and Allocation in the Federal and State Environment
Cost Recovery

For NFPs that receive funds from federal and state governments use similar terminology such as cost allocation plans and indirect cost rate proposals (ICRP). Which are both documents used for cost recovery that help entities show their allocated resources. However, this often different from the cost allocation for GAAP purposes. In the case above both documents have distinguishing characteristics, and are equally important in the world of cost allocation for governmental purposes. The characteristics are as follows to help you understand the differences between a cost allocation plan and an ICRP:
Cost Recovery (Cont’d)

Cost Allocation Plan

A cost allocation plan is an accounting report that calculates and spreads agency-wide indirect cost to departments (e.g., Parks and Rec) and funds that receive a service from other departments (e.g., Payroll).

Indirect Cost Rate Proposals

An ICRP is used to calculate a specific percentage rate that can be applied to a program or grant to determine a recovery amount. It is required to substantiate the establishment of an indirect cost rate.

Indirect costs are normally charged across departments within an agency, to an outside organization, or to federal awards, by the use of an indirect cost rate.
Cost Recovery Methods

Most nonprofit organizations have several options to recover costs expended in the process of managing federal awards.

1) Federal award recipients may apply for a federally negotiated indirect cost rate from their cognizant agency.

2) Subrecipients may use a state negotiated indirect cost rate or a rate negotiated between the pass-through entity and the subrecipient (in compliance with 2 C.F.R. Part 200).

3) Eligible non-federal entities may elect to use a flat de minimis rate of 10% of modified total direct costs (MTDC).

4) Non-federal entities may charge costs directly (Direct Charge) as long as the practice is consistently applied across all federal awards.

   - Salaries of administrative and clerical staff are normally treated as indirect (F&A) costs, however may be direct charged if conditions as outlined in 2 C.F.R. §200.413 are met.
5) There is actually a 5th option for some organizations that have programs with statutes or regulations in place, allowing organizations to charge administrative costs as specified.

- For instance, AmeriCorps grantees are allowed 5% of federal funds may be used for administrative costs, and 10% matching may be used for administrative costs.
Not To Be Confused With
Joint Activity Costing
Common Mistakes to Avoid in Joint Cost Activity

1. Not undertaking a preliminary analysis to determine whether the organization can allocate joint costs on a particular activity
2. Failing to apply a systematic and rational allocation methodology
3. Failure to understand call to action
4. Over-allocating educational language as program expense
5. Overlooking various components of joint activities
6. Failing to find creative and meaningful ways to engage the audience
Accounting Guidance
Accounting Guidance for Joint Activity Costing

The Guidance for Joint Cost Allocations was originally promulgated by the American Institute of Certified Public Accountants in Statement of Position 98-2, Accounting for Costs Activities of Not-For-Profits Organizations and State and Local Governmental Entities That Include Fund Raising and now can be found in the Financial Accounting Standards Board Codification 958-720-05 to 958-720-55.

Note: The Accounting for Joint Activities flowchart in ASC Paragraph 958-720-55-2, Not-for-Profit Entities—Other Expenses—Implementation Guidance and Illustrations—Flowchart of Application of the Criteria for Classification of Joint Costs can be extremely helpful.
Joint Cost Activities - Defined

A Joint Cost Activity is an activity that is part of the fund-raising function and has elements of one or more other functions, such as program, management and general, membership development and other functional categories used by a nonprofit organization.

Additionally, joint costs are costs of conducting joint activities that are not identifiable with a particular component activity.
Example of Joint Cost Activities

If you have a mailer that is providing mission related material to your mailing list and on the back of the flyer is a request for donations (those little check-boxes that encourage $75, $100, $150 pledges), that mailer is possibly a joint activity (also referred to as joint cost). Other joint activities might include special fundraising events that also function as member drives or serve educational or awareness purposes.

Joint activities can create some accounting confusion in terms of how to allocate the expenses between program membership development, management and general or fundraising.
QUESTIONS