# NONPROFIT NAVIGATOR

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## Expense Allocations
## Not as Easy as it Seems
### By Colette Kamps, CPA

Program, management and general and fundraising … what's so difficult about that? This sounds simple enough, but in practice, it's not always that easy to determine these allocations, as required by GAAP. Here are some of the problems organizations face.

Many nonprofit organizations allocate expenses within their accounting system for the purpose of tracking expenses charged to specific funding sources. This is especially important when an organization receives a large amount of revenue under cost reimbursement arrangements, but it is also important in other situations with specific grants or contracts. This system of allocating will usually differ from what GAAP requires because the grant or funding source (in many cases) will cover administrative expenses. The definition of "administrative expenses" for these funding source purposes is usually quite different from the definition of "management and general" under GAAP. So if the organization's accounting system is not set up to handle both types of allocations, it may be necessary for accounting staff to develop an allocation methodology and spreadsheet outside of the accounting software for financial statement reporting.

There may be some confusion as to which types of expenses fall into each of the three functional categories. For example, a CEO's salary is most likely 100% M&G, but in small organizations, the CEO may be spending a portion of her time acting as a Program Director, so some of her salary may need to be allocated to program. She may also spend a portion of time developing donor relationships, so some of her salary may need to be allocated to fundraising. Another example is that some organizations are not aware that all expenses relating to board meetings, accounting and audit functions and human resources should be 100% M&G.

Indirect expenses pose problems too. Here are some questions and answers:

- **What types of expenses are considered to be indirect and allocable?** Examples are rent, depreciation, insurance, utilities, supplies and printing. Many expenses may benefit two or all three of the functional categories.

- **What documentation should be maintained to support the basis of the allocation methodology?** To ensure consistency and to support your basis, you should maintain documentation that outlines how the allocation was determined such as square footage for each area, listing of employee positions with allocation percentages or listing of certain expense types with percentages for allocations and notes on how they were determined.

- **What is the best way to allocate indirect expenses among the functional categories?** Develop a methodology that isn't too complicated and is reasonable for your organization. There should be a basis for allocating that is not just a guess. Square footage is a good basis for rent, mortgage interest, depreciation, property insurance and utilities. Since payroll is usually the largest expense, full-time equivalents or salaries may be a good basis for various indirect expenses.

Overall, once a system for allocating is developed and documented, it's important to apply it consistently, but to consider the need for changes if there are significant changes within the organization.

**If you have any questions, Colette can be reached at (480) 839-4900 or ColetteK@hhcpa.com.**

## ABOUT US

*Our not-for-profit niche at Henry & Horne was officially formed 30 years ago, but we have been serving the not-for-profit community since we opened our doors in 1957. We are dedicated to Arizona's nonprofit community, and as a local firm with such a long history, we truly understand what is important to our nonprofit clients. Our team members receive quality continuing education specifically in nonprofit topics and are continually researching various nonprofit issues, which results in a very broad level of nonprofit expertise.*

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*An organization's nonprofit status is at risk when CEOs behave unethically or illegally, yet a CompassPoint nonprofit executive leadership study found only 45% of nonprofit CEOs have reviews.*

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*Twelve percent of all nonprofit giving comes during the last three days of the year (Source: Network for Good).*

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*Arizona nonprofits represent 12% of all paid jobs in the state and contribute nearly 8% of Gross State Product per the results of the Arizona Nonprofit Economic Vitality Study (conducted by the collaboration of ASU, ASU Lodestar, the Alliance of AZ Nonprofits and The Phoenix Philanthropy Group).*

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*The average donation made by text-to-donate fundraising efforts is $107 (Source: AtPay).*

# Why Should You Establish an Audit Committee?

**By Kristian Haralson**

While audit committees are not required in Arizona, establishing one is considered to be a best practice for nonprofit organizations. An audit committee can provide donors and the Board of Directors with confidence that financial statement error, or fraud within the organization, will be addressed. In addition, the committee takes on the responsibility of overseeing the auditors and the audit process and serves as a liaison between the Board of Directors and the auditors.

Audit committees provide oversight by meeting with both the financial officers of the organization as well as the auditors to ensure direct communication with both parties. The committee should make inquiries of both parties about various issues such as the adequacy of internal controls and segregation of duties, what the cause was for any deficiencies reported, the types of revenue streams and their expected continuity, enforcement of the conflict of interest and fraud whistleblower policies, the adequacy of operating reserves, how executive compensation is determined, etc. On an ongoing basis, the audit committee should work in conjunction with the finance committee in reviewing and maintaining effective controls over the accounting transaction systems and financial reporting process. The committee can discuss areas for improvement and create an action plan for the organizational team to implement. This process is essential for an organization because proper internal controls will lead to better efficiencies and reliability of financial data.

In order for an audit committee to be effective, it should be comprised of independent, non-executive directors that individually bring a diversity of experience and knowledge. The Board of Directors should have regard to candidates that are familiar with fundamental concepts of professional auditing standards, experience with compliance systems, an understanding of major accounting and reporting issues and extensive business experience.

As a result of the audit committee's level of expertise, they are able to provide insight to the organization's leadership by creating and reviewing their fraud prevention and detection programs. If the organization becomes aware of fraud, then the committee generally provides guidance to management to ensure an effective investigation takes place. If an ethics and compliance program is not already in place, then the audit committee will work with management to develop one to enhance the corporation's tone of ethical behavior.

They are also responsible for the oversight, appointment and compensation of an external auditor. This means they meet with the external auditors to monitor their services and activities to ensure that they are providing a quality audit and that independence is being maintained. The audit firm will generally discuss their observations with the audit committee on management's ability to maintain strong internal controls and provide recommendations for improvement, if any.

More importantly, a nonprofit's reputation is strengthened by maintaining an audit committee. Public awareness of nonprofit fraud has increased in recent years and as a result, donors want to know that the organization they are supporting has a firm foundation of fiscal accountability and governance. By having an audit committee, it communicates to donors that they can rely, trust and depend on the organization to expend their funds in accordance with the nonprofit's mission.

**If you have questions, Kristian can be reached at (480) 839-4900 or KristianH@hhcpa.com.**

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