A Nonprofit Leader's Guide to Using Historical Data

6 min read

Key Takeaways

- **The Challenge of Covering Operating Costs and Capital Expenditures:** How Nonprofits Can Use Data to Inform Decisions.
- **Understanding How to Use Gross Profit in a Nonprofit:** Gross profit allows you to add program budget items for activities like community awareness.
- **Financial Ratios for Nonprofits: Allocating Indirect Expenses to Direct Program Costs:** One mistake that nonprofits make when allocating operating costs is that they do not consider the true portion of expenses that should be considered direct costs that are necessary for running programs.

Nonprofits should be run like successful for-profit businesses. That starts with using financial insights to make data-driven decisions that will maximize your outcomes.

Of course, nonprofit leaders do not set out to make profits; their goal is to serve and further their missions. To maximize the impact of your nonprofit, however, **you have to know your numbers.**

A good starting point? Looking at your Nonprofit Operating Income...

Nonprofit Operating Revenue: The Challenge of Covering Operating Costs and Capital Expenditures

One of the biggest challenges that nonprofit leaders face every day is figuring out how to cover operating costs (also called indirect, overhead, fixed, or below-the-line expenses).

Every nonprofit has operating costs like labor, equipment, delivery vehicles, office rent or a building loan payment, utilities, and office supplies. Although not considered direct costs of services provided, these costs are essential to every nonprofit's mission.

The challenge in covering overhead costs arises because money from foundations, grants, and other restricted funds cannot always easily be used to cover these costs. You can't simply list new vehicles, labor costs, or rent on a grant application – unless you receive a grant specifically dedicated to capital funding [1] like those that can be found on GrantWatch.

Most government or foundation nonprofit revenue sources require that their funding go directly toward your mission, covering only direct costs. So, you need to be able to demonstrate, prove, and justify the use of any portion of these funds on indirect costs and show how those dollars did actually directly contribute to your nonprofit's programs.

As a result, it is necessary to perform program-specific overhead cost allocation that enables you to justify spending a portion of funding on operating costs that are directly associated with specific programs.

Cost allocation enables executive directors to justify financial ratios for nonprofits that make it possible for them to dedicate certain portions of otherwise restricted funds toward the operating costs associated with their programs.

So, how can you do this? It starts with establishing solid, automated bookkeeping and accounting processes that make expense tracking, cost allocation, and the generation of nonprofit financial statements like profit and loss reports by program possible.

Knowing your nonprofit's numbers enables you to make the most of your income (no matter the nonprofit income category) that you can put toward operating expenses in order to efficiently and compliantly cover these costs while generating the greatest ROI or community impact possible.

Nonprofit Income Categories and Calculating Gross Profit

Let’s get into the numbers. Here’s how to advise your financial function to properly calculate your organization's gross profit.

Gross Profit = Earned Income - Cost of Services Provided

They first must divide your income into two categories: earned income and unearned income. Earned income includes any fees or membership dues that the nonprofit receives in exchange for its services. Unearned income includes monetary donations that you receive. To calculate, gross profit, only consider your organization's earned income, not your total revenue.

Some nonprofits don't have any earned income. For example, no one pays a fee to occupy a bed in a shelter. So, most nonprofit shelters do not generate earned income because they do not charge their guests to stay overnight. These types of nonprofits operate solely on donated income. In these cases, gross profit will be negative, you'll have a loss, and that's okay. You'll still have a gross profit margin to calculate; it will simply be a negative margin.

Next, have your financial function determine how much it costs to provide services (i.e. the cost of services provided). In a nonprofit, the cost of services provided is equivalent to the cost of goods sold in a for-profit. It includes all the direct (above-the-line or variable) costs. Above-the-line costs include two expense categories: **direct labor** and **direct materials**.

Direct labor should be calculated as the fully-loaded labor costs (including salaries, taxes, insurance, 403B matching, and other benefits) directly spent on providing your services. So, the cost of the hours that employees have spent directly delivering services is your direct labor.

Direct materials include the cost of everything that those employees needed to deliver services. For example, if you provide training, then your training materials would count as direct materials. If you travel to a classroom or off-site location to deliver services, those travel expenses are direct costs. If you needed a computer to teach classes, then that computer is a direct cost. Basically, anything you purchased that enabled you to provide your services should be considered a direct materials cost.

The reason it's so important to look at your cost of services provided is that these expenses are variable, meaning that the total of these costs increases as your services increase. When you separate above-the-line costs from below-the-line costs, you can actually determine how much it costs you to serve each person which means you also know how much it will cost you to serve another person, and another person, and so on. You can also determine how many more people your nonprofit can actually afford to serve.

Gross profit allows you to see how much it costs each time you deliver your services. If you lose money on each service you provide, then you understand that continuing to provide services or increasing services will strain cash flow.

The Basics: Understanding How to Use Gross Profit in a Nonprofit

- Separating above and below-the-line costs allows you to allocate overhead costs back to specific programs. This is useful when writing case statements for grant or foundation funding.

- Gross profit allows you to add program budget items for activities like community awareness.

- Calculating gross profit allows you to take portions of overhead costs that are actually spent on activities like program awareness and move them to your direct costs for programs.

Financial Ratios for Nonprofits: Allocating Indirect Expenses to Direct Program Costs

One mistake that nonprofits make when allocating operating costs is that they do not consider the true portion of expenses that should be considered direct costs that are necessary for running programs. Each of your programs needs a budget that includes its fair share of the organization's overhead.

Too often organizations raise money without considering the portion of, for example, the cost of the executive director's salary and office space that should be allocated to fundraising efforts or program awareness. So, when executive directors keep track of the amount of time they spend on various tasks, you can allocate that percentage of the executive director's fully loaded labor costs and their office costs to those activities.

For example, if an executive director's time breaks down as follows: 30% spent on fundraising, 20% on administrative duties (board meetings and management), and 50% on program work, then you get to allocate 30%, 20%, and 50% of her labor costs and office costs respectively to each of those categories.

This enables nonprofits to use program-specific funds for covering certain portions of overhead costs associated with not just the executive director's labor and office costs, but every employees' labor and office costs. The final result is that you'll vastly improve your nonprofit's gross profit and cash flow.

Setting Up a Simple, Yet Smart Back Office With QuickBooks

We understand that all of this might seem daunting. However, tracking your data, knowing your numbers, using financial insights to make decisions, and identifying operating income to maximize your outcomes is actually a fairly easy process that can be automated with a few simple bookkeeping and accounting tools like QuickBooks, Bill.com, and TSheets time-tracking software.

Instead of hiring bookkeepers, a controller, and CPAs who specialize in nonprofit accounting, nonprofit organizations can access the expertise and skills of an entire back office team with a strong outsourced accounting partner- at just a fraction of the cost of hiring them full-time. Your nonprofit can leverage the skills of highly experienced nonprofit accountants, and you can gain valuable insights into the financial drivers of your organization.

When you take your nonprofit's back office and accounting processes to the next level, you'll not only be able to improve the coverage of your operating expenses, but you'll also be able to maximize the ROI on every dollar you bring in, furthering your mission and growing your nonprofit's positive impact.

[1] https://www.grantwatch.com/cat/3/capital-funding-grants.html