Understanding Indirect Cost Allocation and How it Directly Affects Your Nonprofit

5 min read

Key Takeaways

- Indirect costs are those which cannot be completely and clearly allocated to a single product, service, project, or program (unlike direct expenses such as cost of goods sold or cost of services). You can find indirect costs, on your income statement, below the gross profit line.
- When managing finances for a nonprofit, your organization's funding sources will most likely dictate how you allocate indirect costs.
- Accurate and transparent cost allocation reporting is not only useful for attracting benefactors, these reports will also go a long way in your board meetings.

In all kinds of businesses, job costing is essential to making the kinds of data-driven decisions that will increase profits and grow the company. In a nonprofit, accurate job costing and cost allocation is so much more.

Indirect cost allocation, in particular, can mean the difference between securing funding for the next year, quarter, or month from government grants, individual benefactors, and corporate donors.

Accurate cost allocation ensures your organization spends the funding it receives as promised while remaining compliant, making the most of your nonprofit's budget and fulfilling your mission.

What Are Indirect Costs?

Indirect costs are those which cannot be completely and clearly allocated to a single product, service, project or program (unlike direct expenses such as cost of goods sold or cost of services). **You can find indirect costs, on your income statement, below the gross profit line.** For this reason, indirect costs are sometimes referred to as "below the line costs." On an income statement, these include line items such as operating expenses, taxes, and interest.

For a nonprofit, the cost of personnel (salaries, benefits, health insurance and taxes) is usually responsible for the largest portion of indirect costs, followed by expenses like rent and utilities (or cost per square foot), insurance, security expenses and office supplies. Since employee costs generally comprise the majority of a nonprofit's indirect costs, this is a good place for a nonprofit, new to indirect cost allocation, to start tracking.

What Is Cost Allocation?

Cost allocation is the process of assigning and dividing expenses among particular categories, classes or items. In a nonprofit, these categories might include programs, projects, events, fundraisers or departments. Allocating direct costs is fairly simple because it is already clear where these expenses have gone. Dividing and allocating indirect, or overhead, costs between categories, however, is less straightforward.

For example, if an organization plans to host a gala fundraising event, the cost of chair rentals (a direct expense) would be completely allocated to that single occasion. But that organization also needs to be able to allocate a percentage of indirect expenses which was dedicated to the event. **The nonprofit's financial manager needs to know and report what percentage of costs associated with staff time and office space was spent on planning and hosting the event.**

Two Ways Nonprofits Tackle Indirect Cost Allocation

When managing finances for a nonprofit, your organization's funding sources will most likely dictate how you allocate indirect costs.

1. Cost Allocation Plan

Most nonprofits that receive no funding from government sources choose to use a method referred to as a "cost allocation plan." A cost allocation plan typically estimates indirect costs and allocates them to separate categories by basing these off of an estimated percentage, which can be used to track indirect costs in proportion to the organization's total costs.

If the nonprofit operates more than one ongoing program or project simultaneously, then its financial manager might choose to break down indirect costs differently. With a standard cost allocation plan, organizations can improve budgeting for each individual project or program and for the organization overall.

2. Indirect Cost Rate (ICR)

Nonprofits that receive funding from government sources must handle indirect cost allocation differently. These entities are required by the government agency providing the funding to base indirect costs off of a predetermined rate, called the indirect cost rate (ICR). The ICR will sometimes be mandated, could be based on your organization's past indirect cost allocations or might be negotiable. **When a nonprofit receives a grant for a specific dollar amount, the government entity will usually reimburse direct expenses and indirect expenses up to a certain percentage on the project.**

In a sense, using an indirect cost rate forces nonprofits to reverse the order of budgeting. Rather than allocating a portion of indirect expenses to each fund source, the organization must collect a rate-based dollar amount from funders to be put toward indirect expenses. In addition, the indirect cost rate must be applied consistently throughout the project.

A pre-determined ICR complicates the process of indirect expense allocation and requires increased strategic planning on the part of financial managers and bookkeepers. **If a nonprofit fails to allocate indirect costs to government-funded programs properly and consistently, they stand to potentially lose money elsewhere.**
Government-funded organizations must have an indirect cost allocation method which complies with the terms of its grants or risk losing funding altogether.

Safeguard Your Funding with an Impeccable Indirect Cost Allocation Method

Whether your organization receives funds from government grants, non-government entities or a combination of the two, a sound management reporting and accounting system and bookkeeping infrastructure will ensure your financial manager has the ability to accurately track and report indirect cost allocation. **When using any government-originated funds, nonprofits are required by law to report and adhere to their predetermined indirect cost rate to ensure continuation of funding and reimbursement for past expenses.**

Tracking indirect cost allocation is important and helpful for organizations that operate solely using non-government donations as well. **Allocating indirect costs gives your board of directors and fundraising teams better fundraising metrics.** Potential benefactors prefer to give to nonprofits which use donations responsibly, stretching each dollar to its greatest potential for good.

When individuals in your organization can show potential future donors and past donors exactly how their dollars were or will be spent, it allows potential benefactors to donate with confidence that their money will go to support your good cause.

Accurate and transparent cost allocation reporting is not only useful for attracting benefactors, these reports will also go a long way in your board meetings. Cost allocation allows your financial committee to look at profit and loss statements for the entire organization or broken down by individual programs. With clear cost allocation reports, accurate profit and loss statements and sound nonprofit management accounting, your organization's financial manager and executive director can work together with the board of directors to reduce overhead costs, improve your operation and devise strategic plans to boost the future growth of your nonprofit organization.