CAPLAW
Community Action Program Legal Services, Inc.

# Section 3: Creating the Annual Operating Budget


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This section is designed solely to illustrate concepts and practices. Each CAA's mix of funding and requirements imposed on it by specific laws and funding source agreements will be different. A key element in preparing the budget will always be gaining an understanding of all requirements of your funding sources and of how those requirements are interpreted by your local, state and federal funder representatives before making decisions regarding your cost center structure, and particularly treatment of management costs.

The annual operating budget is a comprehensive financial plan that projects all income and all expenses that are expected to be received or incurred within the CAA's fiscal year. It fulfills two key functions: planning and authorization. As a planning tool initiated by management, the budget functions as a comprehensive plan to obtain and use resources to fulfill the CAA's mission and meet all contractual and legal obligations. Board approval of the annual operating budget authorizes management to proceed with implementation of the plan. Board approval of the budget also provides evidence that board members are fulfilling their legal responsibilities to direct the use of resources to fulfill the CAA's mission and ensure compliance with legal obligations. In addition to the key planning and authorization functions, the annual operating budget functions as an important internal control when it is used as a point of comparison with actual financial results achieved, facilitating identification of errors or irregularities and needed corrections.

# Part I: Building the Budget

## Overall Budget Goals

Each board must determine its overall financial goals for the year covered by the annual operating budget. CAAs are encouraged to work toward long-term sustainability, which requires building both cash reserves and net assets (the nonprofit term for equity or net worth). In order to achieve these sustainability goals, the CAA must budget to have overall income exceed overall expenses in the annual budget. Unfortunately, many governmental funding agreements are structured on a "use it or lose it" cost reimbursement basis. Budgeting to generate income that is greater than expenses requires the CAA to develop additional strategies to overcome the limitations of cost reimbursement contracts.

Common strategies include seeking unrestricted contributions, developing fee for service programs, and negotiating performance based contracts that pay service providers for achievement of performance targets rather than reimbursing expenses incurred. Performance based contracts permit CAAs to potentially make and retain a profit on services provided if the payments exceed their costs. Of course, they also involve risks since failure to achieve targets will result the CAA not receiving the maximum contract amount and no additional payment will be made if actual costs exceed the negotiated price for delivery of services.

Tip

**EXERCISE CAUTION WITH DEFICIT BUDGETS**

Under certain circumstances, the board may decide to adopt a deficit budget in which projected expenses exceed projected income. For such a decision to be reasonable, the organization must be in a strong financial position, having sufficient operating reserves to withstand the anticipated loss. Typical reasons for accepting a deficit budget include commitment to invest in development of additional fundraising capacity, development of new programs with potential to generate earned income, or in some cases, the desire to maintain continuity of services while additional funding resources are sought. Whatever the reason, caution is warranted.

## Timeframe

The annual operating budget includes all expenses expected to be incurred in the operation of the CAA during its fiscal year and identifies all sources of income expected to be available to meet those costs. Many CAAs receive funding through multiple governmental grants and contracts, many of which cover periods that do not correspond to the organization's fiscal year. In order to prepare a comprehensive annual operating budget, the CAA must determine which portion of the expenses to be met through each of its funding agreements will be incurred during the fiscal year for which the annual budget is being developed. Similarly, the CAA must determine which portion of the funds awarded in each agreement will be available during the fiscal year to meet the costs associated with the agreement.

Example

Blue CAA (BCA) will receive Award 1 for the award period October 1, 2011 through September 30, 2012. BCA utilizes a July through June fiscal year for its accounting, financial reporting, and annual budget. When preparing the annual budget for the fiscal year beginning July 1, 2011, BCA will include only the portion of Award 1 expenses that will be incurred during the CAA fiscal year (July 1, 2011 through June 30, 2012). BCA will include an amount equal to the project Award 1 expenses for the fiscal year 2011/2012 as Award 1 income for the fiscal year.

| Award #1 | Total Award | FY 11/12 portion | FY 12/13 portion |
|---|---|---|---|
| | 10/1/2011 9/30/2012 | 10/1/2011 6/30/2012 | 7/1/2012 9/30/2012 |
| Personnel | $100,000 | $70,000 | $30,000 |
| Occupancy | $30,000 | $22,500 | $7,500 |
| Supplies | $5,000 | $3,000 | $2,000 |

## Documenting Budget Assumptions

The annual operating budget represents the CAA's best estimate or projection of income and expenses for the upcoming fiscal year. Sound budgeting requires systematic recording of the assumptions that are the basis of the projections. Documenting assumptions is most important for income and expense items of the greatest magnitude. Clear documentation of assumptions will make it much easier to calculate the impact on the overall budget that will occur when assumptions change.

Example

BCA documents its assumptions about the cost of employee health insurance for the fiscal year 2011/2012 by estimating the number of employees that will be covered by the plan for the months July through December, 2011, under the terms of the current contract with the health insurance plan. BCA documents its estimate of the monthly premium charge for the new insurance plan year beginning January, 2012, including estimating the number of employees to be covered in the first six months of 2012.

| Contract period | # of covered employees | Cost per employee per month | Estimated cost for 6 months |
|---|---|---|---|
| 7/1/11 - 12/31/11 | 40 | $450 | $108,000 |
| 1/1/12- 6/30/12 | 38 | $480 | $109,440 |
| Estimated Total Cost | | | $217,440 |

Past experience with both income and expense items is helpful but not definitive. Projections for the most significant income and expense items must be based on detailed schedules of plans for the upcoming budget year. For example, a detailed schedule listing all positions, and all components of compensation for the budget year is essential to accurately project personnel costs. Similarly, projections of income from contributions should be based on specific assumptions regarding the anticipated number of donors, average contribution size, estimated donor retention rate, and the results that are anticipated from each campaign and solicitation strategy.

Example

BCA plans to send out a year-end appeal to donors who have contributed over the past three years and new prospects identified by board members. The development director documents her assumptions regarding the total contributions that are expected to be received from the year-end appeal. This estimate is added to her other detailed projections of contributions to be received from the board's person-to-person campaign with major donors to estimate the total gifts from individuals to be included in the fiscal year budget.

| Year End Appeal | # Donors | Average Gift Size | Est. % Response | Est. 11/12 Gifts |
|---|---|---|---|---|
| FY 10/11 | 300 | $50 | 80% | $12,000 |
| FY 09/10 | 250 | $45 | 70% | $7,875 |
| FY 08/09 | 275 | $60 | 60% | $9,900 |
| New Prospects | 100 | $25 | 25% | $625 |
| Total | | | | $30,400 |

# Part II: Identifying the Costs

## Cost Center Structure

CAAs frequently operate multiple programs and in many instances, each program is supported through the use of resources from multiple sources. The use of a cost center budget structure facilitates describing how various programs will be supported and how various funding sources will be utilized in accord with the requirements of specific funders

Clear identification of cost centers is the first step in preparing the comprehensive annual budget on a cost center basis. Once cost centers are determined, the CAA projects the income and expenses that are logically related to each cost center. Budgets for all cost centers must be integrated into the comprehensive annual budget document. For example, a CAA with a Head Start, weatherization, and energy assistance programs should develop budgets for each program. It should also develop cost centers for general administration and fundraising.

The cost center budget is best visualized as a matrix (like a spreadsheet) in which the rows are used to list income and expense categories (line items) such as contributions, program fees, salaries , telephone, and the columns are used to identify the distinct program, management, and fundraising purposes that the CAA will undertake. The matrix is completed by determining the portion of each income or expense line item that will be associated with each cost center.

| | Total | Admin | Fund Raising | Program A | Program B | Program C |
|---|---|---|---|---|---|---|
| **Income** | | | | | | |
| Grants | | | | | | |
| Contracts | | | | | | |
| Prog Fees | | | | | | |
| Contributions | | | | | | |
| Total Income | | | | | | |
| | | | | | | |
| **Expenses** | | | | | | |
| Personnel | | | | | | |
| Occupancy | | | | | | |
| **Total Expenses** | | | | | | |

Treating each program, together with the management and fundraising functions, as separate cost centers, mirrors the distinctions that are required for CAA financial reporting on the Statement of Functional Expenses and on IRS Form 990. While IRS and GAAP accounting requirements focus on distinguishing the functional purpose of expense line items, the annual operating budget will be most useful if the cost center structure is also used to classify income line items by cost center as well. The cost center-based budget should reflect the purposes for which contributions and grants are received and/or relationship between the earned income and the programmatic efforts which result in its generation. Unrestricted gifts are attributed to the fund raising cost center, facilitating calculating the net unrestricted income (after subtraction of the fund raising expenses) that is available to underwrite program and management costs or flow into reserves.

Using cost centers is also an important internal control, ensuring compliance with federal funds management requirements. Virtually all governmental funding agreements distinguish management costs from program costs. Many governmental agreements treat fundraising expenses as unallowable. The cost center based budget allows the CAA to demonstrate its plans for compliance with restrictions on the use of funds for administration and/or fundraising. It also allows the CAA to describe its plan to use resources for the specific purposes for which they are provided.

## Management Costs

CAAs should use the same definition of "management" costs to prepare the annual operating budget as they use in their accounting systems, and usually, reporting systems. In general, management costs include costs associated with executive management and financial management, audits, high level IT and HR management, general legal services, public relations, and the board of directors.

One important note here: while both GAAP and the IRS Form 990 instructions include public relations costs in the management function, OMB Circular A-122 deems public relations costs unallowable (while allowing costs for communicating information about programs to potential participants). In federal indirect cost rate proposals, unallowable costs are presented in a separate cost center. Many CAAs use this approach in their budgeting and accounting systems and then analyze the unallowable costs at year-end to put them in the appropriate cost centers for the 990 and GAAP presentation.

In addition to the salaries, taxes, and benefits of individual staff performing those functions, management costs include the supplies, facilities, and other expense line items that are required for satisfactory performance of management functions.

## Fundraising Costs

In general, CAAs use the same definitions to identify the costs that should be attributed to the fundraising cost center in the annual budget as they will use in their audited financial statements and on the IRS Form 990. Both standard accounting and the IRS define fundraising costs as including expenses incurred to prepare, make, and process unsolicited requests for contributions from the general public, as well as expenses incurred to prepare proposals for foundation grants and for government grants that provide services to the general public. Costs in the fundraising cost center include the cost of the portion of staff positions which are devoted to fundraising activities, the facilities and other operating expenses necessary for them to perform the fundraising functions, as well as the direct cost of fundraising events or fund raising materials.

GAAP and the IRS generally treat the cost of soliciting and negotiating exchange transaction agreements as management rather than fund raising costs. Some federal grant programs, such as CSBG, instruct grantees and subgrantees that the definition of management costs for CSBG reporting purposes may be different than for financial accounting purposes.[1] In addition, unlike costs incurred for general fundraising from the public, capital campaigns, and the like, federal grant management requirements and cost principles generally do not prohibit the use of grant funds to prepare proposals for government or private foundation grants.[2]

While the distinctions between management and fundraising costs can be complex, the guiding principle for budget preparation should be making certain that your budget format will be consistent with the structure used in your accounting system which should also be consistent with the structure used in your financial reporting.

## Program Costs

Typically CAAs utilize multiple program cost centers and in many cases establish structures involving sub-and sub-sub-cost centers to further distinguish elements of major programs. For example, a CAA may have a major cost center for Head Start and utilize sub-cost centers for costs associated with Head Start activities at a specific location.

Many programs are supported by multiple funding sources. The sub-cost center structure is used by some CAAs to distinguish the portion of costs of a program that are met through specific funding agreements. Other CAAs structure their cost center budget to place the costs associated with each funding agreement into a distinct cost center.

Example

Green CAA uses a separate cost center for each of its major programs. Green uses sub-cost centers for each of the major funding sources for each program.

| Homeless Services Cost Center | City Contract Sub-Cost Center | State Contract Sub-Cost | CSBG (portion for homeless services) Cost Center |
|---|---|---|---|
| Personnel | | | |
| Occupancy | | | |

Orange CAA uses a separate cost center for each funding agreement. When a single funding agreement provides funding for more than one program function, Orange uses sub-cost centers for each distinct program function.

| CSBG Award Cost Center | CSBG Homeless Sub-Cost Center | CSBG Nutrition Sub-Cost Center | CSBG Youth Sub-Cost Center |
|---|---|---|---|
| Personnel | | | |
| Occupancy | | | |

## Direct Costs

Preparation of a cost center-based budget requires analyzing each expense line item to determine which elements of the total cost anticipated in the line item should be attributed to each cost center. The term “direct cost” is used to describe the situation in which it is easy to make a direct association between a specific cost and the cost center (which can also be referred to as the program or grant) that benefits most from the expenditure.

For example, in the budget of a CAA operating a homeless shelter, the cost of the night staff person who runs the shelter obviously should be attributed to the homeless shelter cost center

## Shared Costs

Some line items will include costs that are incurred to provide benefit to multiple cost centers. For example, the line item for rent expense in a CAA which leases one facility to conduct all of its program, management, and fund raising activities provides benefit to all of the cost centers. When expense line items include costs that provide benefit to multiple cost centers, it is often very difficult to determine exactly which portion of the cost should be attributed to each of the benefitting cost centers. Such costs are described as "indirect costs" or "shared costs" because the benefit they provide cannot be directly determined.

There are several distinct approaches to handling shared costs in the annual operating budget. Some CAAs assign the portion of each expense line item that benefits multiple cost centers to one or more indirect cost centers. Other CAAs use specific methods to estimate the benefit that items such as rent will provide to each cost center. These methods are referred to as cost allocation methods. A detailed discussion of the issues raised by cost allocation is beyond the scope of this toolkit.

Example

**Example 1:**

Some CAAs allocate each cost item that benefits multiple functions by applying a formula that estimates the benefit that each distinct cost item provides to each function. In this example, for costs such as rent and telephone, Blue CAA (BCA) decided to create a formula based on the percentage of full-time equivalent positions (FTEs) whose work effort is attributed to each cost center. Fifteen percent of all BCA FTEs are devoted to Management, five percent of FTEs are devoted to Fund Raising, and 40 percent, 30 percent and 10 percent of FTEs are devoted to Programs A, B, and C respectively. BCA uses this formula to allocate the total cost of the rent and telephone line items to each cost center.

| Shared Cost Line Item | Total Cost | Management | Fund Raising | Program A | Program B | Program C |
|---|---|---|---|---|---|---|
| Rent | $1000 | $150 | $50 | $400 | $300 | $100 |
| Telephone | $200 | $30 | $10 | $80 | $60 | $20 |
| Total | $1200 | $180 | $60 | $480 | $360 | $120 |

**Example 2:**

Other CAAs place all costs that provide benefits to multiple functions into a shared or indirect cost pool. They then allocate the total costs in the shared/indirect pool to each of the various functions with a single allocating line, on the basis of the percentage that total indirect costs bear to total direct costs. In this example, BCA has created a cost pool for shared costs that will be allocated based on the percentage of FTE positions devoted to each cost center. Rather than apply the allocation formula to each line item separately as shown in Example 1, BCA collects all of these costs in the shared cost pool, and applies the allocation formula to the total costs in the pool. But, as these examples illustrate, the total costs assigned to each cost center in both methods remain the same.

| Shared Cost Line Item | Shared of Cost Pool | Management | Fund Raising | Program A | Program B | Program C |
|---|---|---|---|---|---|---|
| Rent | $1000 | | | | | |
| Telephone | $200 | | | | | |
| Total | $1200 | | | | | |
| Allocated Shared Costs | -$1200 | $180 | $60 | $480 | $360 | $120 |

The challenge of allocating indirect costs is compounded by the fact that funding sources vary in their views on how grantees should allocate indirect costs – especially management costs. Therefore, CAAs, particularly those without federally negotiated indirect cost rates, should check whether their cost allocation methodology – especially as it relates to management costs – is acceptable to their funding sources.

Of course, the costs that are assigned to the management cost center also benefit all of the other cost centers and meet the definition of indirect costs. Most CAAs find that it works best to use a separate cost center for management costs rather than combining them with other indirect cost centers. This approach facilitates developing an annual budget plan that will meet all funding source requirements related to management costs.

One of the most confusing aspects of the "terms direct" and "indirect" or shared is that while some cost items can be directly attributed to the management function, the management cost center provides indirect benefit to all other cost centers. For example, the cost of an accounting clerk position is readily attributed to the management cost center because there is a direct relationship between the work performed by that position and the management function. But the costs collected in the management cost center function are indirect costs, providing indirect benefit to all of the program and fundraising cost centers.

## Terms with Multiple Definitions

One common challenge in developing a cost center-based annual operating budget is variations in how different CAAs and funders define terms, income and expense items, and cost centers.

Some CAAs use the term “indirect” cost to describe all of the costs that benefit multiple cost centers, including management costs and other shared costs such as facility costs. Other CAAs use the term “indirect” to mean only management costs. Within the world of federally negotiated indirect cost rates, nonprofit organizations are free to choose whether they want to define indirect costs as only management costs or whether they want to use the term indirect costs or shared costs to include management and other shared costs.

Whatever definition of indirect costs a CAA chooses, the CAA should still distinguish management costs from other indirect costs that benefit multiple cost centers. This distinction will allow the CAA’s budget to identify the management costs that must be reported on the IRS Form 990 and presented in audited financial statements.[3]

# Part III: Allocating the Costs

## Federally Negotiated Indirect Cost Rates

CAAs that have direct funding relationship with a federal agency (for example, Head Start grantees) may be required to or may choose to obtain a federally negotiated indirect cost rate. CAAs that have no direct federal awards are not able to obtain a federally negotiated indirect cost rate.

Preparing annual budget information in the cost center based format described earlier is essential for negotiating a federally indirect cost rate. Appendix C part II provides guidelines and samples of the formats which are used by nonprofit organizations to submit proposals for indirect cost rates to their federal cognizant agency.[4] As described in the Appendix, there are multiple permissible approaches to negotiating the indirect rate and there are also multiple time periods during which different types of rates remain effective.

CAAs with federally negotiated indirect cost rates should continue to use the cost center-based format to prepare each annual budget in order to check whether their approved indirect cost rate is accurate. The addition or elimination of programs or substantial expansion or contraction of program costs, fundraising costs, or management costs could make it hard to support the approved indirect cost rate.  Close attention is required.

The basic format for submitting an indirect cost rate proposal involves presenting all direct costs in appropriate cost centers, including each program, and fundraising. Management costs are placed in a management cost center. Other indirect costs (such as the cost of shared facilities) may be placed in one or more indirect cost centers. Any costs that are considered unallowable for the use of federal funds, for example lobbying costs, must be excluded from both the direct and indirect cost centers and placed into a separate cost center for unallowable costs.

Once all costs have been categorized as direct, indirect or unallowable, the indirect cost rate is calculated through division of the indirect costs by the direct costs. It is helpful to visualize this calculation as a fraction:

$$\frac{\textbf{Allowable indirect costs}}{\textbf{Allowable direct costs}}$$

As described in the Appendix, indirect cost rates can be based on use of either total direct costs or total direct personnel costs in the denominator. The Appendix also includes discussion of major choices CAAs must resolve in developing indirect cost rate proposals.[5]

## Cost Allocation Plans

CAAs that do not have direct federal funding awards, as well as those that do, but that choose not to obtain a federal indirect cost rate, must develop and implement a written cost allocation plan. These plans must include the organization’s definitions of direct and indirect or shared costs and describe the methods that will be used to estimate the benefit of each type of shared or indirect cost to each cost center.

The methods for estimating the share of the benefit received by each cost center are described as cost allocation methods. Some CAAs will utilize cost allocation methods identical to those used in the negotiation of federal indirect cost rates. Others will use methods that base allocations on the percentages of full time equivalent (FTE) positions assigned to each cost center, the percentage of personnel dollars attributed to each cost center, the percentage of square feet of shared facilities used for the functions of each cost center, and a variety of other methods. The cost allocation plan serves as the basis for allocating indirect costs to the various cost centers in the annual operating budget.

Tip

**SEEK PRIOR APPROVAL OF COST ALLOCATION METHOD**

To avoid questions from funders later on, it is advisable to seek prior approval of your organization's cost allocation methods.

## Fully Loaded Program Costs

Once management and indirect costs have been identified and placed in appropriate cost centers, the total for each cost center is allocated to the direct cost centers, including all the program cost centers and the fundraising cost center. Expenses in each cost center should include all direct costs by line item and line items for allocated shares of management and other indirect costs. The fully loaded cost of each program and the fundraising function is computed by adding the allocated share of indirect costs to the direct costs assigned to the cost center. Calculation of the fully loaded cost for each program allows the organization to justify understand the true cost of operating the program and to the use of funds for the program; it also provides important information that should be considered in contract negotiations.

Example

In this example, if the direct costs of Program A are $2,000, the fully loaded costs for Program A (after the addition of allocated costs) would be $2,480.

| Shared Cost Line Item | Shared Cost Pool | Management | Fund Raising | Program A | Program B | Program C |
|---|---|---|---|---|---|---|
| Rent | $1000 | | | | | |
| Telephone | $200 | | | | | |
| SubTotal | $1200 | | | | | |
| Allocated Shared Costs | -$1200 | $180 | $60 | $480 | $360 | $120 |

## Cost Centers and Income Line Items

The cost center-based annual operating budget presents all the income line items, as well as the expense line items on a cost center basis. When funding agreements limit the use of funds to costs associated with specific programs, it is easy to assign those funds to the appropriate program cost centers. Similarly, when activities within specific programs result in the generation of fees or other earned income, it is logical to attribute that income to the cost center with which they are associated.

Some funding agreements contain specific provisions regarding the use of the funds for a share of the CAA's management costs or to cover the federally approved indirect cost rate. The full amount of such awards should be attributed to the appropriate program cost center so that the allocation of management and other shared costs will result in the grant or contract income being correctly matched to the full cost of running the program.

Some funding agreements impose limitations on the percentage of total award/contract dollars that may be used for management purposes. These limits reflect the maximum management costs the funding source will cover. However, the existence of such a limitation does not define the fair share of management or indirect costs that should be allocated to the program cost center. The fair share according to the organization's allocation plan should be assigned to the cost center. The income section for that cost center should reflect both the primary grant (the one imposing limitations) and the other sources of funds that will be used to cover the portion of the management or indirect costs legitimately allocated to the cost center that exceed the limitations of the primary funding source.

Example

| | Management | Fund Raising | Program A | Program B | Program C | Total |
|---|---|---|---|---|---|---|
| Direct Expenses | $100,000 | $25,000 | $400,000 | $200,000 | $75,000 | $800,000 |
| Allocated Admin Expenses | -$100,000 | $3,571 | $57,143 | $28,571 | $10,714 | $0 |
| Total Expenses | | $28,571 | $457,143 | $228,571 | $85,714 | $800,000 |
| | | | | | | |
| Grant Y 5% Management limit | | | $21,000 | | | |
| | | | | | | |
| Charges to Grant Y | | | $420,000 | | | |
| | | | | | | |
| Paid by Other Sources | | | $36,143 | | | |

In this example, the Management expenses allocated to Program A total $57,143. The total funding for Program A from Grant Y is $420,000 and Grant Y has a cap on Management expenses of five percent of the total grant. Therefore, Grant Y will only cover $21,000 of Program A's Management expenses; the remainder must be covered by other sources of funds. The income section of the sample budget below shows that $21,000 of Program A's Management expenses will be paid by Grant Y and that $36,143 will be paid by other sources.

Some sources of income are not so easily attributed to specific cost centers. CAAs actively seek unrestricted contributions to the organization as a whole through fundraising events, mail solicitations, and personal appeals. Unrestricted contributions should be assigned to the fundraising cost center. Unrestricted contributions will be used to meet the cost of fundraising (usually an unallowable cost for governmental funding). The net fundraising income, after covering fundraising expenses, will then become available to subsidize any program cost centers that would otherwise have insufficient income to cover the full cost of the program, including allocated costs for management and other indirect costs.

Some CAAs' budgets will display the allocation of the net fundraising income to subsidize specific cost centers that have expenses in excess of cost center income. Other CAAs will display the net fundraising income in the fundraising cost center to facilitate comparison to actual results from fundraising activities.

# Part IV: Complying with Government Grant Requirements

## Government Awards and Contracts

Budgeting for income from government awards and contracts and for the expenses associated with fulfilling the requirements of multiple layers of government poses particular challenges in the context of the annual operating budget. While in the past, many CAAs approached budgeting for governmental funding on an award-by-award or contract by contract basis, it is now clear that developing an integrated organization-wide annual operating budget is an essential element in meeting the requirements for managing government funds, especially federal funds.

OMB Circular A-122 (2 C.F.R. Part 230) requires an organization-wide approach to cost allocation and/or indirect cost rate determination. Even after successfully negotiating a federal indirect cost rate, CAAs must continue to prepare their annual operating budgets on a comprehensive, all sources and all uses basis in order to ensure that the cost allocation approaches incorporated into the approved indirect rate will not be distorted by rapid growth or contraction of programs or in funding levels. The Head Start Act also requires the board to approve an organization-wide budget. See 42 U.S.C. 9837(c)(1)(E)(iv)(VII)(aa).

In order to build a useful annual operating budget, the CAA should analyze each government award or contract budget to determine what portion of the expenses covered by the agreement will have already been incurred at the beginning of the CAA's new fiscal year. For awards or contracts that will continue beyond the new fiscal year, the analysis should focus on the portion of the total budget that must remain available for expenditure after the close of the organization's fiscal year.

Beyond the challenge of the timing of expenditures, the CAA must examine the basis for payment incorporated into each governmental funding agreement. In agreements that are structured entirely as expense reimbursement, the projected income to be included in the annual budget will be equal to the expenses included in the budget. Agreements that require achievement of service targets or percentage of completion of projects, as well as contracts that are structured as purchase of units of service, will require analysis to determine the appropriate amount of income to include in the annual operating budget. For example, in some unit of service agreements, the unit price is based on the cost over the life of the contract but the start-up period is considerably more costly and may result in delivery of fewer units of service than subsequent months.

The CAA should document its assumptions regarding the number of units of service projected to be delivered within the fiscal year and compare the projections to the actual units of service delivered as part of its analysis of financial performance.

Governmental agreements frequently include caps on management or other specific cost items that may be inconsistent with either a negotiated indirect cost rate or the results of fair application of a cost allocation plan. In such situations, the annual budget must display the other sources of funds that will be available to cover the portion of the capped costs that cannot be covered through the governmental agreement.

Management and board members must determine the extent to which their CAA is willing and able to raise private dollars to cover the fair share of management and other indirect costs in programs which are supported by funding sources utilizing arbitrary limits on covering such costs.

Governmental agreements may also have match requirements and provisions for in-kind contributions (discussed below) that will require attention in the annual operating budget.

## Matching Funds

Many governmental funding agreements require CAAs to obtain matching support from other sources. In some instances, the matching funds can be represented by in-kind contributions. (discussed below). Federal funding regulations (2 C.F.R. Part 230, Appendix A, paragraph A.2.f.) generally prohibit a CAA from satisfying the matching requirement with other federal funds (including CSBG) or with in-kind contributions from entities that are covering the cost of the in-kind contributions with federal dollars. Almost all matching funds agreements require that the recipient not count the same funding source twice.

The annual operating budget provides a great opportunity to test the CAA's plans to meet matching requirements and comply with the myriad requirements on matching. The cost center structure should be designed to facilitate identification of the program in which each source of match will be utilized. Distribution of all the sources of match into the various cost centers will demonstrate that no match is being double-counted.

## In-Kind Contributions and Expenses

The term "in-kind" describes contributed goods or services used by the CAA to carry out its work. Volunteer labor is one example. The contribution of supplies, use of space, transportation or any number of other items of value is also characterized as in kind.

Two questions must be resolved before including in-kind contributions in the annual operating budget. First, the CAA must decide which in-kind contributions it will include in the annual budget. A starting point will be to include any in-kind that has been included in various funding agreements that will be in force during the fiscal year. Beyond the items that are referenced in funding agreements, most nonprofits structure their budgets to parallel their accounting policies which are in turn structured to comply with GAAP (Generally Accepted Accounting Principles, the standards which guide recording and reporting financial information by professional accountants). GAAP generally requires that the value of in-kind contributions be included in the financial statements if the goods or services being donated are essential to operation of the organization and the value can be estimated with reasonable accuracy.

For example, a CAA operating an emergency shelter services for homeless families through the volunteer efforts of churches that provide volunteer overnight staff, space, and volunteer prepared meals would otherwise have to purchase those items in order to provide shelter for homeless families. Consequently, the value of these contributions would be included in the financial statements. In contrast, the value of the contribution of a volunteer who contributed a beautiful floral arrangement to the homeless shelter every week would probably not be included in the financial statements because the shelter could operate without elaborate floral arrangements. Only services or goods that would be allowable as a reimbursable cost if the CAA had paid for them can be counted towards a match requirement.

Once the nonprofit has determined which in-kind contributions to include in the budget, the next challenge will be determining how to value the contributions. Again, most CAAs turn to the requirements of GAAP accounting, using methods in the budget that are consistent with those that will be used in accounting and financial reporting. Under GAAP, in-kind contributions are recorded at the fair market value of the goods or services received. Far market value is defined as the price at which an item would change hands between a willing buyer and a willing seller. For in-kind labor contributions, the general practice is to identify the compensation level that would be typical for a similarly qualified person to perform similar work. CAAs with substantial in-kind labor contributions should discuss the valuation issue with a CPA so that all nuances are addressed.

In almost all cases in which a CAA decides to include in-kind contributions in the income section of the annual operating budget, an equal amount of in-kind expense must be recorded in the expense section. This approach avoids creating the misleading perception that in-kind contributions would be available to meet non-in-kind expenses.

The only exception to this general rule occurs when the in-kind contribution involves donation of an asset of material value such as a vehicle, land, or a building. In most cases, CAAs record vehicles, land, and buildings as assets on the balance sheet rather than treat them as expenses in the current period. To achieve consistency between the annual budget and the financial reports, the CAA budget will need to include the in-kind contribution of such assets in the income section and note that fair market value of the contribution will be reflected on the balance sheet.

Example

Orange CAA expects to receive an in-kind contribution of a school bus with a fair market value of $30,000 that is expected to have a useful life of at least 3 years. Orange CAA's capitalization policy requires "capitalizing" or recording as an asset, the purchase or acquisition of equipment with a fair market value greater than $5,000 which has a useful life of more than one year. Consequently, Orange plans to treat the donated bus as an asset.

In its budget, Orange will show an in-kind contribution line item of $30,000 to represent the value of the bus it will receive. Orange must decide which method to use to offset the in-kind contribution. It can:

- Show a "placeholder" line item for donated equipment in the expense section of the budget with a footnote explaining that at the end of the year, an accounting adjustment will reduce this expense item to zero and record the value of the in-kind donation of the bus as an asset; or
- Not use a donated equipment line item in the expense section of the budget and allow the inclusion of the $30,000 in-kind contribution in the income section to create the appearance of a surplus (profit) of income greater than expense. In the budget. Orange will attach a note explaining that this "surplus" is not available to meet any costs but a result of the accounting treatment of the in-kind contribution.

# Part V: Accounting for Other Selected Costs and Issues

## Depreciation and Use Allowances

Most CAAs use the same approach on the issue of including depreciation or use allowance expenses in the annual operating budget as they use in their accounting and financial reporting in order to facilitate comparison of the budget to the actual income and expenses reports throughout the year. CAAs that have included depreciation or use allowance expenses in their grant/contract budgets must include them in the annual operating budget in order to integrate grant and contract budgets into the annual budget.

## Budgeting for Purchase of Capital Items

CAAs purchasing or rehabilitating facilities frequently prepare a separate capital budget in addition to the annual operating budget. A capital budget usually treats loans as a source of funds when the loans finance major capital investments (as opposed to working capital needs). Loan proceeds are ignored for purposes of the annual operating budget because they constitute debt rather than revenue. Similarly, funds used to repay the principal of a loan are not typically included in the annual operating budget because they are used to repay debt rather than pay expenses. However, interest paid on a loan would be included as an expense in the budget.

In contrast, it is not unusual to see planned equipment purchases included in the annual operating budget, especially if the purchases are to be made through governmental funding agreements and are included in both the income and expense portion of those agreements. Even when equipment purchases will be made without a specific funding source, many nonprofits will include the purchases in the expense section of the budget to reflect their plan to use current year income to cover the cost of the purchase. Some organizations will actually record equipment purchases as expense line items in the accounting systems during the year, and utilize a year-end accounting adjustment to reclassify the equipment to the balance sheet.

## Temporarily and Permanently Restricted Contributions

CAAs should design their budget format to facilitate comparisons between the budgetary projections and the actual results reported in both interim and audited financial statements. One of the greatest challenges in this effort is developing a budget format takes into account the unrestricted, temporarily restricted, and permanently restricted categories used in GAAP-compliant financial statements.

GAAP requires that nonprofit organizations analyze all contributed income to determine whether the donor has made the gift without restriction or with either a temporary or permanent restriction. Permanent restrictions are typical of endowment gifts in which the donor intends for the organization to invest the gift in order to generate income which will then be available to the organization for either unrestricted or temporarily restricted purposes. Relatively few CAAs deal regularly with endowment gifts.

Donors or grantors making gifts with temporary restrictions intend that the gift will be used, but want to limit its use to expenditures on specific purposes or within specific time periods. GAAP-compliant financial statements characterize all contributions as either unrestricted, temporarily restricted or permanently restricted. In contrast, income other than contributions – for example income earned through performance of services or sale of products – is always considered unrestricted for the purposes of the GAAP classification system.

GAAP treatment of foundation grants typically differs from the treatment of government awards. Foundation grants, like gifts from individual donors, are classified as either restricted or unrestricted depending upon the direction provided by the grantor.

The challenges, therefore, are in developing a budget format that addresses restricted gifts and grants from foundations and individuals as well as unrestricted (for GAAP purposes) governmental grants. GAAP requires not only that temporarily restricted contributions be distinguished from unrestricted contributions, but that the entire amount of the temporarily restricted contribution be recorded in the period in which the donor's commitment to contribute is received. This means that the award of a three-year foundation grant must be recorded in its entirety in the month the award letter is received, even if the payment of the award will be spread over three years. Similarly, a pledge from an individual to make a gift of $1000 in each of the following three years must be recorded as a $3000 temporarily restricted contribution in the month in which the pledge is received.

GAAP also requires that when a nonprofit incurs expenses for the purposes for which a temporarily restricted gift has been made, the total of these expenses be recorded as a "release from temporary restriction" which results in increasing the unrestricted income.

Although most government funding agreements contain numerous restrictions regarding the use of the funds, the most common payment mechanisms for government agreements generally result in income being recorded in the unrestricted classification within GAAP accounting systems. Both the cost reimbursement payment mechanism and the federal cash drawdown systems are based on the concept that the CAA will either have incurred expenses already or will incur them shortly after receiving the federal cash. This makes the cumbersome process used for handling multi-year foundation grants and pledges unnecessary.

In these governmental agreements, the nonprofit is required to track and report the exacted use of the funds. In terms of the annual operating budget, this need to identify and track the specific uses of funds provided by governmental awards and contracts is addressed through the cost centers which parallel the use of cost centers in the accounting system. The accounting system should be designed to produce reports on each of these cost centers which document the organization's compliance with the restrictions and limitations incorporated in the award agreement/contract.

A more complete explanation of GAAP requirements for dealing with temporarily restricted contributions is beyond the scope of this toolkit. However, CAAs dealing with either multi-year foundation grants or multi-year donor pledges should adapt their budget format to facilitate comparison of the budget to the GAAP-based financial statements. Specifically, the annual operating budget should distinguish the plans for obtaining and expending temporarily restricted contributions from the plans for obtaining and using unrestricted income, remembering that the term "unrestricted" for this purpose would include all or almost all governmental awards and contracts.

## Part VI: Working with the Budget Through the Grant Period

### Funds in the Annual Budget

Governmental funders may sometimes, upon request, give the CAA permission to expend funds after the official close of either the annual budget period or the multiyear grant term, i.e. to carry over the funds. In some cases, these are funds that have already been disbursed to the CAA but have not yet been expended or obligated by the CAA. In other instances, the original award amount was not fully disbursed, to the CAA.. In most cases, the grantee will not have treated these unused amounts as income in the year in which they were originally intended to be used. Instead, it would only have recorded those expenses actually incurred in that grant year and recorded an equal amount as grant/contract income. In such situations, the budget for the subsequent grant year should include the "unused" funds that the organization will expend in that year with the funder's permission.

**Example**

Orange CAA has received permission to use $50,000 in funds awarded as part of its FY 10/11 State Grant to meet expenses which will be incurred in FY 11/12. In the 11/12 annual budget, Orange will use two distinct income line items to present its income from the State Grant:

- State Grant FY10/11
- State Grant FY 11/12

Orange will use separate cost centers to track the use of each of the State Grant amounts.

The best way to present the organization's plan to use past profits to support activities in the current year is to add a budget item titled "planned use of net assets" which is positioned below the Total Expenses line in the budget. Using this technique permits comparison of what actually happens during the year to what the plan the board has adopted for the year.

For example, if the CAA planned to use $80,000 in funds accumulated in prior years to cover current year costs, they would expect to see a net loss of $80,000 on the financial statements, if all went according to plan. If the financial statements reported a net loss of $50,000 it would be clear that things had gone better than planned and if the financials reported a net loss of $100,000 it would be clear that things were going much worse than planned.

CAAs should avoid the use of the term carryover to depict plans to use profits from prior years to meet current year expenses. Instead, the budget document should present clearly the plan to incur an operating loss (expenses in excess of income). Then the board can determine the extent to which it is prudent to plan to reduce the net worth (net assets) of the CAA to meet expenses which cannot be met through current year income.

Example

BCA reported revenues which exceeded expenses by $100,000 in FY 10/11. In the FY 11/12 budget, BCA represents its plan to use $50,000 of the surplus it generated in FY 10/11 to sustain an essential service for which funding has been reduced. This plan is illustrated below

| FY 11/12 Budget | |
|---|---|
| Income | $4,950,000 |
| Expenses | $5,000,000 |
| Net Loss | ($50,000) |
| Planned Use of Net Assets | $50,000 |

## Using the Budget

Both the board of directors and management should use the annual budget as a reference point for evaluating progress toward agreed upon goals. The budget represents the integration of complex funding and program strategies into a unified plan for operation and for building financial health. Comparing the actual revenues and expenses to the budget plan facilitates identification of potential problem areas.

Tip

**SYNCHRONIZE YOUR BUDGET AND FINANCIAL STATEMENTS**

**To facilitate the comparison of actual revenue and expenses with budgeted revenue and expenses by the board and staff, design the budget format to align with the financial reports.**

Board members need to be able to rely upon management to monitor actual results in comparison to the budget on a detailed grant-by-grant, program-by-program, line-item-by-line level. The board's role in reviewing actual results in comparison to the budget should be focused on trend analysis and evaluating management's recommendations for achieving overall financial goals. Management should provide the finance committee and the board with its analysis of the financial performance of the organization including calling attention to areas of great success as well as potential problem areas in which either income targets are not being met or actual expenses are significantly greater than anticipated in the budget. Management's analysis should note the strategies which management has put in place to address problem areas.

The annual budget plays a key role in the CAAs overall system of internal controls. Each manager within the CAA should be clear about the extent to which they have been given authority and responsibility for achieving budget targets in both income and expense line items. Fulfilling responsibilities relating to achieving budget targets should be a key element in the performance reviews of managers assigned financially related responsibilities.

## Budget Revisions

Budgets are projections. The annual budget should reflect agreement between the board and management about priorities for the use of resources and strategies for obtaining the income needed both to meet current expenses and to ensure sustainability.

The role of the budget in a nonprofit organization differs significantly from that of a budget in a governmental entity. Most governmental entities are legally prohibited from expending funds in excess of the authorization level provided by the adopted budget. In nonprofit organizations, there is not a similar legal prohibition. The extent to which management may shift resources among line items or among programs in a nonprofit is generally determined by board policy.

When CAAs experience significant changes in funding, programming, or major cost items during the year, the comparison of the adopted budget to the actual revenues and expenses may become confusing. Some CAAs address this potential problem through a system of preparing a mid-year budget revision proposal for board discussion and approval. The mid-year revised budget incorporates the new information that has become available to the CAA in the first portion of the year and reflects the actual plan for moving forward. Typically, the revised budget is then substituted in comparison of actual revenues and expenses to the budget.

For this approach to work well, the CAA must determine whether the proposed budget revisions will impact the expenditure of grant and contract funds and meet funder requirements for budget amendments when necessary. Revising the annual budget without obtaining funder approval for award budget revisions will create significant confusion and may lead to audit findings.

Another approach to dealing with significant changes during the fiscal year is the use year-end projections as a meaningful point of comparison with both actual revenues and expenses and with the approved budget. To prepare year-end projections, management combines the year-to-date financial information with its understanding of the impact that various changes will have to predict the year-end balances of each account within each cost center.

Year-end projections provide a powerful tool for board oversight. The projections reflect the strategies management has identified to cope with changes in both income and expenses and to ensure the overall financial health of the CAA. Presenting the projections on the financial statements avoids the need for management to continuously review changes that have already been discussed and facilitates board understanding of the overall impact of changes.

## Next Steps

Budgeting for CAAs is challenging and requires the integration of multiple specific grant budgets and development of realistic strategies to allocate shared costs fairly. While the underlying budget work papers are complex, documenting hundreds of assumptions and the interplay among them, the final budget document must be understandable to the board of directors, which will include individuals with widely varying levels of experience with financial information.

Fortunately, time invested in developing effective budget formats and spreadsheets will often pay off over multiple years, allowing the CAA to update assumptions as information becomes available, and add or remove programs as they emerge or conclude. Even with a great budget format and spreadsheet template, developing the annual budget will require tremendous team effort.

Given the complexity of the issues, and constant time pressures, it is easy for the person in charge of developing the budget to become swamped by detailed technical issues and have difficulty presenting the final proposed budget document in a way that facilitates meaningful discussion by the top management team, finance committee, and board of directors. This challenge requires allowing enough time for reflection after the technical budget development work is completed. The final step of preparing the budget for discussion by the CAA's leadership will be highlighting the key financial choices the CAA confronts and expressing concisely the assumptions about those choices that have been included in the proposed budget.

In fact, beginning with the end in mind may be the best guiding principle for undertaking the budget process. What are the key choices that the budget document must address? Funding cutbacks, funding overhead costs during a period of contraction, benefit cost increases, major shifts in program emphasis, compensation expectations? Whatever the major choices and challenges your CAA will confront, early identification will facilitate targeting your budgeting efforts to address the most important challenges, and provide a strong foundation for communicating the key assumptions and underlying choices to staff and board.

**Endnotes:**

1. See Office of Community Services Information Memorandum No. 37. *http://www.acf.hhs.gov/programs/ocs/csbg/guidance/im37.html*.
2. See 2 C.F.R. Part 230, App. B, ___ .17 and 45 C.F.R. § 74.27(b)(1).
3. See Financial Accounting Standards Board (FASB) ASC 958-720-45, which discusses requirements for presentation of expenses by function. The FASB Accounting Standards Codification (ASC) Glossary provides definitions for the Supporting Services and the terms "management and general activities," "fund raising activities," and "membership development activities, which together comprise "Supporting Services." See also 2 C.F.R. Part 230, App. A, § C.3., which addresses management costs, and App. B, § 17(a) and (c). See also 45 C.F.R 74.27 (b)(1) the version of OMB Circular A-110 adopted by the U.S. Department of Health and Human Services, which states that the immediate cost of preparing bids, proposals, and applications for federal and non-federal awards, contracts and other agreements are allowable as indirect costs.
4. The cognizant federal agency is the federal agency that, on behalf of all federal agencies, is responsible for establishing final indirect cost and administering cost accounting standards for a CAA's federal grants and contracts. By assigning one agency to oversee these matters, the federal government ensures that a CAA is not subject to the conflicting or duplicative requirements that could result if two or more agencies imposed separate requirements.
5. See *http://www.dol.gov/oasam/programs/boc/costdeterminationguide/main.htm* for a guide to indirect cost rates published by the U.S. Department of Labor.