

**2013  
Nonprofit and  
Association  
Roundtable  
Series**

**October 9**

**Cost Allocation  
& Functional  
Reporting**



**Presented by:**

**Matt Krehe,  
CPA**



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# Cost Allocation & Functional Reporting

October 9, 2013

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# Course Objectives

- Overview
  - What is Functional Reporting?
  - Why is Cost Allocation and Functional Reporting important?
- Functional Categories and Treatment
- Allocating Costs
- Tips and Style
- Other Expense Recognition Issues



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# What is Functional Reporting?

- “Functional” refers to organization’s major classes of program services and supporting services
  - Program services are activities that fulfill purpose(s) of the NPO
  - Supporting services are all other activities
    - Administrative and governance activities
    - Fund development
    - Member development



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# Expense Examples

## ➤ “Natural” (Traditional) Expense Examples:

- Personnel
- Travel
- Occupancy
- Professional services
- Repair and maintenance
- Materials and supplies
- Telecommunications
- Depreciation
- Interest

## ➤ Functional Expense Examples:

- Member services
- Education
- Outreach
- Advocacy
- Government relations
- Governance
- Administration
- Fund development
- Member development



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# Example

## ➤ Statement of Activities with Functional Expense Presentation

<b>HUMAN SERVICES, INC.</b>	
<b>STATEMENTS OF ACTIVITIES</b>	
<b>YEAR ENDED JUNE 30, 2013</b>	
<b>UNRESTRICTED NET ASSETS:</b>	
<b>PUBLIC SUPPORT AND REVENUES:</b>	
Grants and contributions	\$ 115,553
Annual banquet, net of direct expenses of \$4,350	7,150
Other income	<u>1,139</u>
Total public support and revenues	<u>123,842</u>
<b>EXPENSES:</b>	
Children's services	52,400
Senior services	<u>50,900</u>
Total program services	103,300
Management and general	12,034
Fund development	<u>4,287</u>
Total expenses	<u>119,621</u>
<b>INCREASE IN UNRESTRICTED</b>	
<b>NET ASSETS</b>	<u>4,221</u>
<b>NET ASSETS, Beginning of year</b>	<u>242,874</u>
<b>NET ASSETS, End of year</b>	<u>\$ 247,095</u>

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# Example

## ➤ Statement of Functional Expenses

<b>HUMAN SERVICES, INC.</b>					
<b>STATEMENT OF FUNCTIONAL EXPENSES</b>					
<b>YEAR ENDED JUNE 30, 2013</b>					
	<b>Program Services</b>		<b>Supporting Services</b>		
	<b>Children's Services</b>	<b>Senior Services</b>	<b>Mgmt &amp; General</b>	<b>Fund Devel</b>	<b>Total</b>
Personnel	\$ 37,204	\$ 39,033	\$ 3,529	\$ 2,768	\$ 82,534
Occupancy	7,530	7,530	2,221	1,211	18,492
Travel	3,532				3,532
Professional services			5,892		5,892
Other expenses	<u>4,134</u>	<u>4,337</u>	<u>392</u>	<u>308</u>	<u>9,171</u>
<b>Total</b>	<b><u>\$ 52,400</u></b>	<b><u>\$ 50,900</u></b>	<b><u>\$ 12,034</u></b>	<b><u>\$ 4,287</u></b>	<b><u>\$ 119,621</u></b>

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# Why Is This Important?

➤ Financial statements with accurate cost allocation allows the Board of Directors and management to evaluate:

- How efficiently resources were used?
- How effectively resources were used?
- Which programs are successful?
- Which programs require more focus or should be eliminated?



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# Why Is This Important?

➤ Make sure your organization is getting reimbursed and not wasting unrestricted net assets:

- Billing timely and accurately on cost reimbursement grants
- Monitoring spending levels on donor restricted funds
- Bill affiliates for their portion of shared resources



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# Why Is This Important?

- Reviewed by potential donors/members and watchdog groups
  - Donors and members want to see efficient use of resources
  - Efficiency and effectiveness has been historically associated with low overhead
    - Watchdog groups are changing their focus (see “The Overhead Myth” handout), but don’t expect the overhead focus to go away

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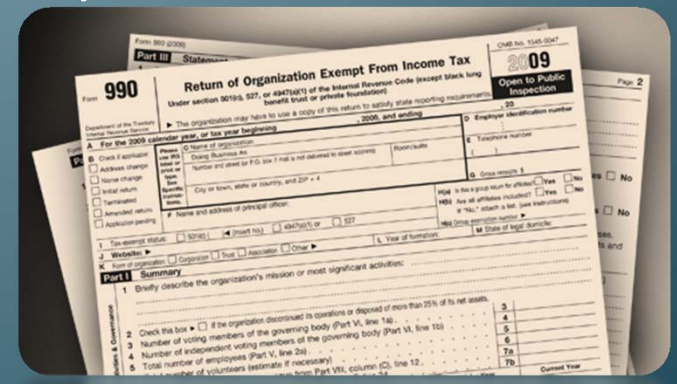
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# Why Is This Important?

## ➤ Tax and GAAP reporting requirements:

### Tax Reporting

- 501(c)(3) and 501(c)(4) nonprofits are required to fill out a statement of functional expenses on the Form 990
  - Separate column for program service expenses, management and general expenses, and fundraising expenses



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# Why Is This Important?

➤ Tax and GAAP reporting requirements:

## GAAP Reporting

- All nonprofit organizations are required to report their expenses by functional classification
  - Can be achieved through the statement of activities, or footnote disclosures
  - At a minimum, total program expenses need to be disclosed

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# Why Is This Important?

## GAAP Reporting cont'd.

Statement of functional expenses is required for “voluntary health and welfare organizations” (VHWs)

- VHW is any organization formed for the purpose of performing voluntary services for benefit of various segments of society.
- Derives most revenue from “**voluntary**” contributions (excluding government entities) from the general public, to be used for general or specific purposes connected with **health, welfare, or community services**
  - Presumed to be publicly supported if contributions are 20 – 30% or more of total revenue and support, including both cash and in-kind contributions, but excluding government support



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# Why Is This Important?

## ➤ Office of Management and Budget (OMB) Requirements

- Nonprofits that receive awards from the federal government are required to follow OMB cost principles



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# Functional Categories and Treatment

## ➤ Program Expense

- Cost of the activities that fulfill purpose(s) of nonprofit
- Program staff salaries, program supplies, program travel, cost of goods sold

## ➤ Management and General

- Expenses not identifiable with a single program, fund-raising activity, or membership-development activity but are indispensable to conduct of those activities and to entity's existence
- Oversight, business management, advertising (other than for contributions or membership dues), accounting, budgeting, and governance



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# Functional Categories and Treatment

## ➤ Fundraising

- Activities undertaken to induce potential donors to contribute money, securities, services, materials, facilities, other assets, or time
- Publicizing and conducting fundraising campaigns, maintaining donor list, conducting fundraising events, distributing fundraising materials

## ➤ Membership Development

- Soliciting for prospective members, membership dues and membership activities
- Similar to fundraising except that purpose is to increase/solicit membership rather than contributions
  - Note: if membership has no significant benefits or duties, then these costs would be considered fundraising



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# Functional Categories and Treatment Considerations

- *All nonprofits have supporting services*
  - Even a single-program nonprofit has governance, administrative, and development activities
- *Most nonprofits have development expenses (fundraising or membership)*
  - If organization has members or receives contributions, would be expected to have development expense to solicit members or contributions
- *Governance is generally considered an administrative expense*
  - Unless a committee is specifically dedicated to a program service or development



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# Functional Categories and Treatment Considerations

- Strictly administrative functions (such as accounting and human resources) generally may *not* be allocated to program services
- Executive activities, including the personnel cost of the executive director, generally should *not* be considered strictly administrative
  - Often weighted somewhat towards administrative and governance functions, but still usually include a sizeable program service component
- Expenses associated with an NPO's headquarters generally should not be considered strictly administrative



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# Allocating Costs



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# Types of Costs

## ➤ Direct Cost

- Can be clearly identified to a program or supporting service

## ➤ Indirect Cost

- Cannot be identified with or directly related to a single program or supporting service

## ➤ Common Cost

- Related to two or more programs or supporting services that could be achieved separately, but are achieved together

## ➤ Joint Cost

- Related to two or more programs or supporting services that cannot be achieved separately and are therefore achieved together

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# Direct Costs



- To the extent feasible, direct costs should be tracked at the level of detail that allows those costs to be directly charged to a specific program or supporting service
- Examples would include the following:
  - Employee that works solely on one program
  - Supplies used by one program only
  - Consultant services related to one program
  - Rent for facilities or offices used solely by one program

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# Direct Costs

## ➤ Tracking

- To efficiently track direct expenditures, general ledger account structure should be set up so each program or supporting service has own unique identifier
- For example, salary expense for program #3 would be as follows: 4500-03
  - The first group of numbers (4500) would be used for all salary expense
  - The second group of numbers “03” would be added to all general ledger accounts associated with program #3
- This general ledger structure allows for financial reports to be generated at the program level

## ➤ Recording

- Direct costs should be recorded on ongoing basis as expenses are incurred (as rent is paid, payroll recorded, goods or services received)



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# Common, Joint\* & Indirect Costs

➤ There are many ways to allocate indirect or common costs

➤ Organization may choose different methods to allocate costs for different classes of expenditures

➤ Common methods used to allocate costs:

- **Time spent allocation** - used for personnel costs
- **Square footage** - used for occupancy costs (rent, electricity, telecommunications), central support, supplies
- **Head count** – used for occupancy, central support, supplies
- **Direct labor** – used for occupancy, central support, supplies
- **Relative revenue** - used for occupancy, central support, supplies
- **Stand alone costs** (cost for each program alone divided by the combined costs of all programs incurring the costs) – used for occupancy, central support, supplies

*\*That do not include fundraising*



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# Common, Joint\* & Indirect Costs

## ➤ Recording

- Some indirect costs should be allocated as incurred, such as payroll costs for program staff, as these can be recorded based on time sheets submitted by the employees
- Other indirect costs, such as occupancy and executive payroll costs, may be allocated less frequently, such as monthly or quarterly, as financial statements are prepared for management or the board of directors

*\*That do not include fundraising*

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# Tools To Allocate Costs

- Invest the time in setting up your general ledger account structure with separate accounts for each program and supporting activity
  - Allows recording direct expenses to the proper program as they are incurred
  - Reduces amount of allocations needed during the financial close process, saving time and money
  - Provides quicker access to usable financial data
  - Reports can be generated to produce data at the natural or program level
  - Consider your reporting needs when purchasing accounting software





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# Tools To Allocate Costs

## ➤ Create internal forms to facilitate cost allocation:

- Create time cards that require applicable employees to allocate time among programs and supporting services they worked on
- Incorporate form or stamp for program and support personnel to indicate general ledger accounting coding on invoices/check requests to ensure expenses are recorded appropriately
- For indirect and other costs allocated each closing period, develop standard templates that can calculate the allocations and journal entries once monthly data is loaded in. This will allow for less experience personnel to perform the calculations

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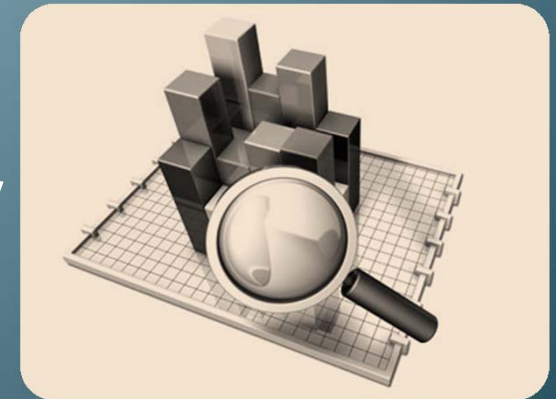
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# Tools To Allocate Costs

## ➤ *My Organization Doesn't Track Expenses by Function – How Can I Meet Reporting Requirements?*

- Some organizations with only 1 program do not allocate expenses throughout the year – example to follow
- Some organizations utilize a hybrid reporting method – Some costs allocated, but others such as occupancy and personnel are reported separately – example to follow



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# Tools To Allocate Costs

## ➤ No Functional Allocation

<b>HUMAN SERVICES, INC.</b>	
<b>STATEMENTS OF ACTIVITIES</b>	
<b>YEAR ENDED JUNE 30, 2013</b>	
<b>UNRESTRICTED NET ASSETS:</b>	
<b>REVENUES:</b>	
Membership dues	\$ 1,213,553
Annual banquet, net of direct expenses of \$40,350	106,150
Other income	<u>11,039</u>
Total public support and revenues	<u>1,330,742</u>
<b>EXPENSES:</b>	
Salaries	452,400
Occupancy	250,900
Supplies	325,000
Travel	145,000
Depreciation	85,034
Other	<u>35,287</u>
Total expenses	<u>1,293,621</u>
<b>INCREASE IN UNRESTRICTED NET ASSETS</b>	<u>37,121</u>
<b>NET ASSETS, Beginning of year</b>	<u>242,874</u>
<b>NET ASSETS, End of year</b>	<u>\$ 279,995</u>



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# Tools To Allocate Costs

## ➤ Hybrid Reporting Method

<b>XYZ ASSOCIATION</b>	
<b>STATEMENTS OF ACTIVITIES</b>	
<b>YEAR ENDED JUNE 30, 2013</b>	
<b>UNRESTRICTED NET ASSETS:</b>	
<b>REVENUES:</b>	
Membership dues	\$ 1,213,553
Annual banquet, net of direct expenses of \$40,350	106,150
Other income	<u>11,039</u>
Total public support and revenues	<u>1,330,742</u>
<b>EXPENSES:</b>	
Membership training and seminars	452,400
Legislative activity	250,900
Personnel	325,000
Occupancy costs	145,000
Management and general	85,034
Membership development	<u>35,287</u>
Total expenses	<u>1,293,621</u>
<b>INCREASE IN UNRESTRICTED NET ASSETS</b>	<u>37,121</u>
<b>NET ASSETS, Beginning of year</b>	<u>242,874</u>
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# Tools To Allocate Costs

- These organizations will need to allocate these costs *annually* to meet 990 reporting (501(c)(3) and 501(c)(4)) or GAAP reporting (all nonprofits)
- Example allocation procedures:
  - Step 1 - Separate direct vs. indirect costs
  - Step 2 - Estimate indirect salary allocation through interview with personnel
  - Step 3 - Apply program salaries % to indirect cost to estimate total indirect program costs
- Organization can still choose not to allocate for statement of activities presentation, but will need to calculate total program costs for footnote disclosure to meet GAAP reporting requirement



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# Tips and Style

- Take credit for the services you provide
  - *You don't want to under-report program expenses!*
  
- It is common for organizations to overstate general and administrative by overlooking allocable costs:
  - Depreciation, insurance, interest on building mortgage, subscriptions, supplies, printing and postage are common costs that can be missed
  - Don't forget to allocate executive time spent on program activities

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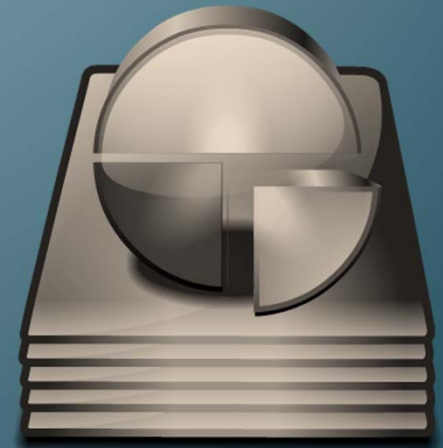
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# Tips and Style

## ➤ *How disaggregated should you report?*

- Standards do not say how much detail to show – consider what is meaningful to financial users
- Although may be useful internally to report programs at detail level, aggregating programs with the basic purpose in common will be more useful to those outside organization
  - Best functional categories are those derived from the nonprofit's mission and goals
- Similarly, a larger number of natural line items may be more useful to internal financial statement users than general public



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# Tips and Style

## ➤ Example with few natural categories

### BBB Wise Giving Alliance

#### Schedule of Expenses by Function

Year ended December 31, 2012 with Comparative Totals for 2011

	Program services		Supporting services		Totals	
	Charity Reporting Activities	Management and General	Fundraising	2012	2011	
Salary and benefits	\$ 845,267	\$ 37,139	\$ 38,423	\$ 920,829	\$ 937,296	
Printing and publications	154,873		23,134	178,007	124,105	
Office expenses	84,531	28,859	3,518	116,908	117,055	
Professional services	81,582	11,027	29	92,638	72,580	
Depreciation	30,713	1,338	1,406	33,457	30,949	
Travel, meetings and conferences	12,822	8,855		21,677	21,318	
	1,209,788	87,218	66,510	1,363,516	1,303,303	
Expense allocation reimbursed to the Council of Better Business Bureaus, Inc.	260,343	106,966	5,623	372,932	480,109	
Total expense	\$ 1,470,131	\$ 194,184	\$ 72,133	\$ 1,736,448	\$ 1,783,412	



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# Tips and Style

➤ Example  
with many  
natural  
categories

XYZ Association					
STATEMENT OF FUNCTIONAL EXPENSES					
YEAR ENDED JUNE 30, 2013					
	Membership	Legislative	Training	General and Administrative	Total
Salaries	305,413	151,727	117,086	240,332	814,558
Retirement	30,541	15,173	11,709	24,033	81,456
Payroll taxes	24,433	12,138	9,367	19,227	65,165
Other benefits	45,812	22,759	17,563	36,050	122,184
Special events	194,345				194,345
Marketing	102,068				102,068
Board functions				62,978	62,978
Rent	24,304	12,368	5,566	24,304	66,542
Telephone	9,179	2,989	1,340	3,915	17,423
Internet	290	100	80	55	525
Utilities	3,786	4,500		18,886	27,172
Professional fees	3,786	4,500		18,886	27,172
Consulting	1,821	2,152	1,500	1,803	7,276
Depreciation	4,768	2,408	2,408	4,768	14,352
Cost of goods sold			16,920		16,920
Equipment rental and leasing	1,989	1,595	3,933	2,223	9,740
Equipment supplies and maintenance	1,775	1,191	1,797	3,817	8,580
Supplies	3,646	1,820	1,107	2,789	9,362
Automobile expense	1,451	170	71	638	2,330
Insurance and bonding	1,151	599	599	1,151	3,500
Dues and subscriptions	1,578	1,380		1,090	4,048
Credit card fees	2,929		523		3,452
Associate relations	968	504	504	968	2,944
Local meals and entertainment	2,396	120	60	382	2,958
Mail expenses	995	472	122	753	2,342
Travel	1,397				1,397
Taxes licenses and fees	233	121	206	233	793
Training and seminars	112	28	115	308	563
Miscellaneous expense	18			385	403
<b>Total expenses</b>	<b>\$ 771,184</b>	<b>\$238,814</b>	<b>\$192,575</b>	<b>\$ 469,974</b>	<b>\$ 1,672,547</b>

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# Tips and Style

➤ Consider combining natural categories

Personnel {  
Occupancy {  
Outside services {  
Equipment expense {  
Misc. expense {

XYZ Association					
STATEMENT OF FUNCTIONAL EXPENSES					
YEAR ENDED JUNE 30, 2013					
	Membership	Legislative	Training	General and Administrative	Total
Salaries	305,413	151,727	117,086	240,332	814,558
Retirement	30,541	15,173	11,709	24,033	81,456
Payroll taxes	24,433	12,138	9,367	19,227	65,165
Other benefits	45,812	22,759	17,563	36,050	122,184
Special events	194,345				194,345
Marketing	102,068				102,068
Board functions				62,978	62,978
Rent	24,304	12,368	5,566	24,304	66,542
Telephone	9,179	2,989	1,340	3,915	17,423
Internet	290	100	80	55	525
Utilities	3,786	4,500		18,886	27,172
Professional fees	3,786	4,500		18,886	27,172
Consulting	1,821	2,152	1,500	1,803	7,276
Depreciation	4,768	2,408	2,408	4,768	14,352
Cost of goods sold			16,920		16,920
Equipment rental and leasing	1,989	1,595	3,933	2,223	9,740
Equipment supplies and maintenance	1,775	1,191	1,797	3,817	8,580
Supplies	3,646	1,820	1,107	2,789	9,362
Automobile expense	1,451	170	71	638	2,330
Insurance and bonding	1,151	599	599	1,151	3,500
Dues and subscriptions	1,578	1,380		1,090	4,048
Credit card fees	2,929		523		3,452
Associate relations	968	504	504	968	2,944
Local meals and entertainment	2,396	120	60	382	2,958
Mail expenses	995	472	122	753	2,342
Travel	1,397				1,397
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Training and seminars	112	28	115	308	563
Miscellaneous expense	18			385	403
<b>Total expenses</b>	<b>\$ 771,184</b>	<b>\$ 238,814</b>	<b>\$ 192,575</b>	<b>\$ 469,974</b>	<b>\$ 1,672,547</b>

October 9

Cost Allocation  
& Functional  
Reporting



Presented by:

Matt Krehe,  
CPA



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# Other Expense Recognition Issues

## ➤ Treatment of Losses:

- Definition - Losses result from peripheral or incidental transactions (fire, flood, loss on sale of building, lawsuit)
- Losses do not need to be reported by their functional classification or in the matrix of functional expenses

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# Other Expense Recognition Issues

- Treatment of Special Event Expenses:
- If activity or event is incidental or peripheral, direct expenses of activity may be presented as contra-revenue on statement of activities.

*Examples: Annual banquet, annual fundraising golf tournament*

- Special event expenses do need to be reported on a statement of functional expenses

<b>HUMAN SERVICES, INC.</b>	
<b>STATEMENTS OF ACTIVITIES</b>	
<b>YEAR ENDED JUNE 30, 2013</b>	
<b>UNRESTRICTED NET ASSETS:</b>	
<b>PUBLIC SUPPORT AND REVENUES:</b>	
Grants and contributions	\$ 115,553
Annual banquet, net of direct expenses of \$4,350	7,150
Other income	<u>1,139</u>
Total public support and revenues	<u>123,842</u>
<b>EXPENSES:</b>	
Children's services	52,400
Senior services	<u>50,900</u>
Total program services	103,300
Management and general	12,034
Fund development	<u>4,287</u>
Total expenses	<u>119,621</u>
<b>INCREASE IN UNRESTRICTED NET ASSETS</b>	<u>4,221</u>
<b>NET ASSETS, Beginning of year</b>	<u>242,874</u>
<b>NET ASSETS, End of year</b>	<u>\$ 247,095</u>

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# Other Expense Recognition Issues

Joint cost that includes fundraising expense:

- If nonprofit has activity that includes fundraising component and program or general & admin. component, special rules apply
  - Example: Mass mailings, TV and radio ads, and free community seminars that both promote the organization's cause and solicit donations
- ASC 958-720-55 (Formerly SOP 98-2) governs the functional classification of joint costs.
  - ASC 958-720-55 *starts* with the presumption that such costs will be charged 100% to *fundraising*
  - Then provides a series of tests to determine whether some of costs can be charged to applicable program service or to general & administrative
- Disclosure of allocation method is required for 990 and financial statement footnotes

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# Questions?

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