Functional expense allocation: what to include

As many of you may know, the Financial Accounting Standards Board (FASB) issued a new standard ASU 2016-14, Presentation of Financial Statements. One effect of this standard is it creates consistency on how expenses are presented in the financial statements for all nonprofit organizations, and consistency when preparing the Form 990 Statement of Functional Expenses. Your accounting system should track both nature and function, although the functional breakout can be accomplished by allocations made outside of your accounting system. For example, allocating 50% of rent to M&G does not have to be done in your accounting system, but you must use a systematic, logical approach to functional allocations.

CompanyXYZ
Statement of Functional Expenses
For the Year 201X

	Program Services		*Supporting Services*		
	Program A	Program B	Management & General	Fundraising	Total
Salaries	$ 42,100	$ 29,800	$ 92,000	$ 10,500	$ 174,400
Rent	11,700	7,500	24,900	5,700	$ 49,800
Supplies	6,600	4,200	8,200	5,800	$ 24,800
Depreciation	7,100	5,200	5,700	3,200	$ 21,200
Total	$ 67,500	$ 46,700	$ 130,800	$ 25,200	$ 270,200

As a nonprofit, you are required to report expenses by functional classification, and the Statement of Functional Expenses is where to show expenses by nature (the green rows) and function (the pink columns). This example shows expenses split between Program Services and Supporting Services. The new accounting standard requires both detail as to which types of expenses are allocated and detail on what methodology was used to allocate them. Here we focus on the types of expenses allocated.

What do I need to look out for?

When allocating expenses to the functional categories, it can be tricky figuring out which expenses to put where. Below is a general guide of what should be included in each expense function.

Program Services – These are expenses that are carried out to fulfill the mission of the organization and they can include both direct and indirect expenses. "*Program Services* are mainly those activities that further the organization's exempt purposes. Fundraising expenses should not be report as program-service expenses even though one of the organization's purposes is to solicit contributions."- IRS Form 990 instructions for Part IX. Statement of Functional Expense.

Supporting Services – These expenses are broken down further into two basic types of expenses (as shown above): Management & General (M&G) and Fundraising expenses. If you have contribution revenue, you should have Fundraising expenses.

M&G expenses relate to the overall direction of the organization. These are not identifiable with a specific program and include oversight, business management, record keeping, budgeting and financing. Here are some examples:

Expenses relating to board and committee meetings

Planning and direction provided by the executive director (direct supervision of programs can be allocated OUT of M&G, into Program Services)

Fees for accounting, auditing, budgeting and financial reporting

Preparation of the annual report

Cost of advertising for admissions or ticket sales (i.e. performing arts organizations, zoo, museum tickets, etc.)

Fundraising expenses are costs incurred for the sole-purpose of obtaining contributions whether it be cash, noncash items, services or time. Here are some examples:

Conducting special events, fundraising campaigns or solicitations

Recruiting volunteers (even when no revenue is recognized)

Preparing/distributing fundraising materials

Maintaining donor lists

Allocating your expenses is this first step but you shouldn't stop there. It is also important to be aware that your organization's activities and situations can change from year to year and it is recommended that you check these changes and reallocate your expenses accordingly. If you forget to make these changes, your programs may not be presented properly, your fundraising expenses could be misallocated or certain new expenses may not be allocated at all!

Organizations often want to limit their supporting services expenses but accurately allocating your expenses on your financial statements/ Form 990 is beneficial beyond just meeting compliance requirements. Readers of the financial statements/Form 990, such as grantors and donors, want to see that the money they are giving your organization is effectively meeting the purpose of your organization. Allocating your expenses correctly will also help management make informed and better decisions and can help the long-term growth of your organization.

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EXPENSE ALLOCATIONS OF NONPROFIT ORGANIZATIONS – Lyman Hamblin, CPA and Auditor

Nonprofit organizations are subject to a unique accounting and reporting requirement that requires the reporting of expenses according to the purpose for which they are incurred. This process, referred to as functional expense allocation, is one of the more challenging areas of preparing a nonprofit organization's financial statements. Expenses for nonprofit organizations are grouped in functional categories as either program or supporting service expenses. Supporting service expenses are further broken down into the categories of management and general (administrative) and fundraising. Expenses are directly applied to one of these functional categories, or indirectly applied through an allocation process and plan.

Possessing an understanding of the different functional categories is crucial to an accurate functional allocation plan. The functional categories can be summarized as follows:

Program Service Expenses – These are costs related to providing the nonprofit organization's programs or services in accordance with its defined mission. For established nonprofit organizations, program service expenses generally represent the majority of the overall expense of the organization. The public generally prefers to see a nonprofit organization with the largest allocation to this category.

Management and General – These are costs related to administering the day-to-day activities of the nonprofit organization. These expenses do not directly relate to the purpose for which the organization exists and typically includes activities such as bookkeeping, management, and governance. While important to the operation of the nonprofit, organizations generally try to minimize these as much as possible.

Fundraising – These are costs of all activities that relate to an appeal for financial support or for a contribution to an organization. Examples of these expenses are the costs of holding a fundraising event, solicitation of contributions, or salary of individuals involved in the fundraising process.

Before a nonprofit organization can perform a functional allocation, it needs to understand the importance of reporting of expenses on a functional basis. The answer has to do with the users of the financial statements. While management is generally concerned with natural classification of expenses (salary, office expense, travel, etc.), users of the financial statements, such as potential donors, funding sources, regulators, and the governance board, are interested in understanding the relationship between an organization's program expenses and its supporting expenses. This helps the user of the financial statements answer the "why" question regarding an organization's expenses. Consider the following example:

A nonprofit organization receives and pays an invoice for office supplies in the amount of $1,000. This cost is initially recorded as "supplies expense" on the organization's statement of activities (profit and loss statement). Normally, this type of expense would simply be considered a cost of doing business. However, by digging a little deeper into the invoice, what if only $100 relates to general office supplies used in the day-to-day operation of the organization, and $600 relates to supplies used for a specific program activity, and $300 relates to special supplies used at a fundraising event? At year-end, the functional allocation is prepared and this invoice is now reported as follows:

Program Service Expense – $600

Management and General – $100

Fundraising – $300

It is now clearer to the user of the financial statements that the $1,000 spent by the organization was not just a "cost of doing business" but directly supported the mission of the organization and contributed to its fundraising efforts.

Some best practices and critical elements of a functional allocation plan are:

Document the functional allocation plan in writing. It is important that the methodology for allocating expenses can easily be communicated to the organization's governance board, the independent auditors, and the users of the financial statements. By documenting this plan in writing, it makes it easier to understand and update, when needed.

Identify the type of expense transactions that are directly allocated to one of the functional categories, or that need to be allocated amongst several categories. Further, if there are multiple program service offerings, it is important to identify the type of expense transactions that are directly or indirectly allocated to each program. Accurate cost allocation between programs can be important for grant reporting purposes and for determining the overall success of a particular program.

Maintain timesheets for individuals whose responsibilities include tasks that fall into more than one functional category or program. The time sheets should approximate the amount of time in a given week (or month) that the individual spends on program type services, administrative services, and fundraising services. It is important that the individual maintaining the timesheets understand the definitions of the functional categories and the difference in programs.

If an allocation of time is not practicable, which is often the case with rent, utilities, and other space related costs, allocating by square-footage is an acceptable alternative.

Establish a chart of accounts within the accounting system that can help facilitate the allocation process in an efficient manner without providing a burden to management at year-end.

Remain consistent with the functional and cost allocation plan. Special exceptions to the plan should be minimal.

Review the allocation methodology at least quarterly. It is not uncommon for the funding stream of nonprofit organizations to change or for there to be a change in the make-up or responsibility of personnel.