

FUNCTIONAL EXPENSE ALLOCATION FOR NONPROFITS AFTER FASB ASU 2016-14





The Importance of Functional Expense Reporting

Many nonprofit organizations have a reason to report expenses by **functional expense classification**. Most commonly, the expenses are presented in generally accepted accounting principle (GAAP) financial statements as a statement of functional expense or footnote analysis of expenses by their nature and function, and/or on the face of the statement of activities. Expenses may be similarly reported for cash or income tax bases of accounting. If the nonprofit is a 501(c)(3) or 501(c)(4), presenting by functional expense classification is also necessary for IRS Form 990 purposes.

Beyond meeting compliance requirements, there are very good reasons to care about the functional expense classification. Financial statement readers want to see that the money provided to an organization is being effectively used to meet the organization's purpose. Grantors will look at these expenses and percentages to determine whether to make grants; volunteers may look at these percentages to determine whether it is a worthy cause to which to devote their time; contributors may look at these amounts to gauge how much of their dollars will go to their purpose.

*Do not fall into the trap of trying to get **program services** to be as close to 100 percent as possible.* A variety of potential undesirable consequences may result from misreporting the organization's functional expense classification. First, the IRS may use extreme imbalances in percentages to select organizations for audit to ensure they are truly providing an exempt function. Second, financial statement users may be skeptical of unrealistically high amounts of program, management or **fundraising expenses**, which could prevent the organization from receiving funding. Third, misidentifying an expense's functional expense classification can lead management to make poor or miscalculated decisions regarding the organization's future.

Some organizations try to only pay for programmatic service expenses; that may work in the short term for a small, volunteer-driven organization, but it will ultimately limit the organization's ability to grow. A growing organization will have increasing revenues, and with more revenue will come more expense. The additional expense could come in the way of fundraising expertise for entities that are contribution driven or **membership development** expertise for those that are membership driven. A growing organization will require the underlying business systems and personnel to sufficiently grow with it.



For example, if you double revenues, and therefore likely expenses, one would expect more paperwork to follow. Under this scenario, do you really anticipate the exact same number of accountants can be used to keep the books and records? If so, what shortcuts must they make in order to keep up with the paperwork? Do they now skip certain **internal controls**, for the sake of time, which could provide opportunity for fraud?

A struggle will always exist between those who understand nonprofits and the need to devote a reasonable amount of resources to non-programmatic expenses, and those who do not understand nonprofits and believe that every dollar should be programmatic. Those who are uneducated about the complexities of operating a nonprofit will need some education as to the value of management and general and fundraising expenses. If your organization devotes a reasonable amount to these functional categories, you will have a legitimate business case to present to others.



Functional Expense Classifications

The first consideration for preparing functional expenses is what line items make up **natural expenses**. In most cases this will be a straightforward exercise, but under FASB ASU 2016-14 Not-for-Profit Financial Reporting and Disclosures (ASU 2016-14) there are a few nuances. First, all **external** and **direct internal investment expenses** (that are not for **programmatic investing**) must be netted against investment return and shall not be included in the analysis of expenses by nature and function. This means under GAAP, you are no longer permitted to have investment expenses, other than for programmatic investing, in the statement of functional expenses. Second, all other expenses shall be reported by their natural classification. For example, if cost of goods sold appears on the statement of activities, this must be broken down into its natural classification of salaries, fringe benefits, and purchased goods for the analysis of expenses by nature and function. If special event costs are netted with revenues on the statement of activities, those special event costs must also be included in the natural classification, such as rent or food, in the analysis of expenses by nature and function.

The second consideration in determining how to do a functional allocation is understanding the differences between the types of functional expense classifications. Every natural expense has to be allocated into one or more functional categories. If your organization is required to do GAAP financials, this allocation must be done in grid format with each natural expense listed as a separate row and each functional category as a separate column. Every natural expense must be broken out into the individual functional categories on an analysis of expenses by their nature and function; you cannot simply have a single line to do an “indirect cost” allocation.

The third major consideration is understanding that an indirect cost for government grant purposes has no bearing on the functional expense category for financial statement or Form 990 purposes. These two terms are not synonymous. The cost allocation plan used for financial statement purposes may not match what is needed for indirect cost allocations under the federal grants, or any other grants.



What is a program service expense?

Why is the organization tax exempt? What good does the organization do that merits tax exempt status? What things are done that directly result in that good occurring? What are the expenses needed to do those things that directly result in the good occurring?

Examples include:

- Salaries of direct program workers.
- Salaries of those who are direct supervisors of the direct program workers.
- Salaries of those who are in charge of tracking eligibility for program services.
- Benefits related to those individuals.
- Costs related to those individuals having a place to work, for example rent, telephone, utilities.
- Costs that directly benefit the program. For example, if the program is an educational program, the cost of materials that are handed out to the participants.



What is a fundraising expense?

A fundraising expense is any expense incurred for the purpose of obtaining contributions. A contribution is something of value provided to the organization whereby the donor receives nothing or something of substantially less value in return. Note that if an organization has contribution revenue, there is a presumption that it has fundraising expenses. If your organization has contribution revenue and no fundraising expenses, document how the fundraising was done completely by volunteers with no utilization of any organization resources. Examples of fundraising include:

- Salaries of fundraisers or fund development.
- Salaries of grant writers, if those grants are contributions.
- Benefits to those individuals.
- Costs related to those individuals having a place to work, for example rent, telephone, utilities.
- Postage and printing costs for appeals to the public for contributions.
- Maintaining donor lists.
- Publicizing and conducting fundraising campaigns.

What is a membership development expense?

This is similar to fundraising, but instead of obtaining a contribution, the organization is obtaining an exchange transaction for membership revenue where the purchaser receives something of commensurate value for their payment. Examples include:

- Salaries of those trying to obtain additional members.
- Salaries of those who are responsible for assisting members with membership benefits.
- Benefits to those individuals.
- Costs related to those individuals having a place to work, for example rent, telephone, utilities.
- Costs of membership recruitment materials.



What is a management and general expense?

Everything else is a **management and general expense**. These are expenses that typically are absolutely necessary for the operation of any organization. However, they are necessary based on the organizational structure rather than based on the mission of the organization. Think of things that all entities have to incur as expenses that do not fit into items above.

Examples include:

- Salary of the Executive Director. There is a rebuttable presumption that the Executive Director is management and general. If they are directly conducting or directly supervising programmatic services, not just supervising all employees, or fundraising, a portion may be allocated to another functional category.
- Any type of general recordkeeping such as board minutes, payroll, accounting, budgeting, financial statement preparation, audits or tax returns. This includes accounting, even accounting that is specific to individual grants that are for program services. It does not include things like tracking eligibility for a particular program.
- Legal services.
- Procurement (purchasing) personnel.
- Incorporation fees.
- Annual reports.
- Financing.
- Soliciting non-contribution and non-membership income, such as soliciting customers.
- Administering contracts including government or foundation grants.





Allocation Methods

Prior to ASU 2016-14, some organizations had a generic note that indicated expenses were allocated using percentages, and that management believes this is a reasonable approximation of actual costs. Under ASU 2016-14, the financial statement notes must include more detail as to which types of expenses are allocated, and under what method. Essentially, the functional expense allocation disclosure will need to state which natural classifications were allocated and an explanation of what methodology was used to allocate them.

Direct allocation is the preferred method when it is reasonably efficient. This is assigning each expense (i.e., invoice, line item on an invoice, individual employee) to a functional category based on direct usage.

Indirect allocation is used when the direct method is too burdensome. This is using a rational and objective basis to allocate expenses based on financial or nonfinancial data to the functional expense categories. Note: smaller, less major natural expenses are typically allocated in proportion to some major natural expense.

Salaries/Wages

This is almost always one of the largest expenses for an organization. Following are two ways to allocate salaries and wages.

1. If you have a large number of employees who each work on one functional category, you may be able to allocate directly based on the salary descriptions. For example, if an organization had three employees – a program director, a fundraiser, and an Executive Director – and job descriptions were such that each worked on their own functional category (program for the program director, fundraising for the fundraiser, and management and general for the Executive Director), then you could simply allocate each individual's wages to the appropriate functional category.
2. Most organizations that have a smaller number of employees will find that each employee works on multiple, different functional categories, and cannot simply be allocated based on job description. Instead, some sort of time study will be necessary. Time studies can be as elaborate as having each individual track their time daily to each functional category (including the specific programs); this would be a good option for those entities that have a large portion of government-sponsored grants, as they likely are doing this for grant purposes anyway. That is a direct allocation.

Less elaborate time studies can be as simple as picking a “representative” one week to one month in the year and having each employee track their time daily to each functional category (including specific programs). A “representative” period of time is one that is similar to what is done year-round. For example, if there is a large gala event once a year, choosing the week leading up to the large gala event would likely result in more time being allocated to the gala event (fundraising) than is truly spent over the course of the year on the gala. This less elaborate time study would then be used to allocate salaries and wages, using an indirect allocation, for the year.





Benefits

Benefits relate directly to the employees for whom the salaries and wages relate, so the allocation of benefits should be similar to salaries and wages. This allocation is almost always done on an indirect allocation.

1. If all, or substantially all, employees have the same benefits, you could simply use the percentage of total salaries allocated to each functional category to allocate benefits. This would be an indirect allocation.
2. If instead, different classes of employees have different classes of benefits, you would need to aggregate salaries by class of employees and aggregate benefits by class of employees to do the allocation. This would be an indirect allocation.
3. It would be possible to track benefits per individual employee and allocate them according to that employee's salary; this would be a direct allocation. For example, one employee may not use the organization's health insurance, so none of the health insurance would be allocated based on that employee's salary.

Occupancy costs

These costs include rent, utilities, insurance for the building, repairs and maintenance, depreciation, etc. These also are typically significant expenses, which will use an indirect allocation.

1. If occupancy usage is typically commensurate to salary, you can allocate based on the same percentages as salary. For example, the Executive Director might be paid twice as much as an entry level program staff person; if the Executive Director's office is approximately twice the size of the entry level program staff person's cubicle, this would be an efficient and effective way to allocate.
2. If occupancy usage is not commensurate to salary, you may need to do an occupancy study. Determine the square footage used by each individual, and use the individual's time study results to allocate their square footage's costs of occupancy. For example: occupancy is \$100,000; total square footage is 10,000 square feet; Sally uses 100 square feet; Sally's salary is allocated 50 percent program and 50 percent fundraising. Therefore you would take 100 square feet of Sally's space / 10,000 total square feet times \$100,000 occupancy costs times 50 percent to get \$500 charged to program and an additional \$500 charged to fundraising. Depending on your organization's programs and layout, this method could also be used to allocate by department instead of by person.

Other costs

For other significant costs, you would want to either track directly how much went to a specific functional category (such as having to enter in a code each time you make a copy or a phone call) or run a study similar to the salary study to track usage.

For less significant costs, you can make a determination of how those costs are used in conjunction with other costs. For example, if the larger the office, the more copies are being made for a person, you might allocate copier expenses based on occupancy cost.





Joint Costs

One last consideration in allocation is **joint costs**. These tend to be communications with those outside of the organization, with a request for funding, that also have some type of programmatic or management and general function included in the communication. Traditionally these have been mailings that provide information on programmatic services and also request contributions; they could also include advertisements on radio or television, or even emails. GAAP essentially has set up criteria to ensure that organizations can't take something that is mostly fundraising and allocate it out of fundraising. When these joint costs are incurred, three criteria must be met in order to allocate any of the joint cost somewhere other than fundraising.

Purpose criteria

The purpose of the **joint activity** accomplishes program or management and general functions.

For programmatic functions, this means there is a specific call to action that either benefits the recipient of the communication (such as improving their health and well-being) or benefits society.

For management and general functions, three tests must be met for the purpose criteria to be filled. First, the majority of compensation or fees for any party's performance of any component of the joint activity cannot vary based on the contributions raised by that joint activity. Second, the management and general activity uses the same medium, on a scale similar to (or smaller than) an activity being done outside the joint activity, or the message calls for a specific action that will accomplish the mission. The third test is a qualitative test based on all available evidence that the purpose of the joint activity truly includes a management and general component.

Audience criteria

There is a rebuttable criteria if the audience is selected based on prior donors or likelihood of a contribution to the organization that is for fundraising purposes only. The audience criteria is met when the audience is selected for any of the following reasons: a) the audience's need or potential need to use the specific action called for in the purpose criteria, b) the audience's ability to take the specific action called for in the purpose criteria, or c) for a management and general component, the organization is required to direct the communication to an audience or the audience has reasonable potential for use of the information.

Content criteria

For program expense, there is a specific call to action to the recipient that will help accomplish the organization's mission. For management and general, the joint activity fulfills a management and general responsibility.





Auditors and Your Functional Expense Allocations

If you receive audited financial statements, you can expect your auditors to perform certain steps on the allocation plan during the audit. Those steps may include:

1. Obtain a copy of the cost allocation plan.
2. Obtain an understanding of the internal controls over:
 - The inputs into the cost allocation plan
 - The calculation of the cost allocation plan
3. Review the studies done by the organization for allocating expenses.
4. Compare the methodology used in the current year to methodology used in the prior year; be prepared to justify changes.
5. Compare total percentages of expenses in each functional category between current and prior year; be prepared to justify significant changes.

Differences with Federal Grant Requirements

- If a program for GAAP purposes is a federal grant, it is likely those expenses allocated using the direct allocation method are considered direct costs for a federal grant.
- Typically, the salaries and fringe benefits of employees working on the federal grant are direct costs for a federal grant. Fringe benefits are typically considered direct costs for federal grants, even if they are allocated using an indirect allocation method, such as applying a percentage to salaries.
- Costs of materials are typically direct costs for a federal grant.
- Administrative and clerical staff should typically be considered indirect costs for federal grants even if they are directly expensed for program services.
- Facilities is an indirect cost for federal grants. This is similar to occupancy costs. The overall allocation of occupancy likely is going to result in different numbers for financial statement versus grant reporting. For grant reporting, it is essentially allocated 100 percent between programs and fundraising (whereas for financial statement reporting a portion remains management and general) and it may be allocated using a different allocation method for grant purposes.
- Administration is defined as general administration and general expenses such as the director's office, accounting, personnel, and all other non-facilities indirect cost. Many of these items are considered management and general for financial reporting, but for grant reporting they are allocated as an expense of the grant.
- Other differences include capitalizing fixed assets for financial reporting and including them as expenses for grant reporting.





Glossary

Direct internal investment expenses – Direct investment expenses involve the direct conduct or direct supervision of the strategic and tactical activities involved in generating investment return. These include, but are not limited to, both of the following: a) salaries, benefits, travel, and other costs associated with the officer and staff responsible for the development and execution of investment strategy and b) allocable costs associated with internal investment management and supervising, selecting, and monitoring of external investment management firms. (FASB ASC 958-225-45-14A) This does not include costs related to programmatic investing.

External investment expenses – Expenses paid directly to third parties for investment management and investment fees. This does not include costs related to programmatic investing.

Functional expense classification – A method of grouping expenses according to the purpose for which costs are incurred. The primary functional classifications of a nonprofit entity are program services and supporting activities (which consists of management and general expenses, membership development expenses, and fundraising expenses). (FASB ASC 958-720-20)

Fundraising expenses – Activities undertaken to induce potential donors to contribute money, securities, services, materials, facilities, other assets, or time. (FASB ASC 958-720-20)

Internal controls – Procedures that are in place for the organization to prevent material misstatements or detect and correct material misstatements in a timely manner. These controls will typically involve segregation of duties, authorization or approvals, reconciliations, and review.

Joint activity – An activity that is part of the fundraising function and has elements of one or more other functions, such as program, management and general, membership development, or any other functional category used by the entity. (FASB ASC 958-720-20)

Joint costs – The costs of conducting joint activities that are not identifiable with a particular component of the activity. For example, the cost of postage for a letter that includes both fundraising and program components is a joint cost. Joint costs may include the following costs: salaries, contract labor, consultants, professional fees, paper, printing, postage, event advertising, telephones, airtime, and facility rentals. (FASB ASC 958-720-20)

Management and general expenses – Supporting activities that are not directly identifiable with one or more programs, fundraising, or membership development activities. (FASB ASC 958-720-20)

Membership development activities – Membership development activities include soliciting for prospective members and membership dues, membership relations, and similar activities; however, if no significant benefits or duties are connected with membership, the substance of membership development activities may, in fact, be fundraising. (FASB ASC 958-720-20)

Natural expense classification – A method of grouping expenses according to the kinds of economic benefits received in incurring those expenses. Examples of natural expense classifications include salaries and wages, employee benefits, professional services, supplies, interest expense, rent, utilities, and depreciation. (FASB ASC 958-720-20) This does not include external or direct internal investment expenses, but does include other expenses reported in the revenue section of the statement of activities

Programmatic investing – The activity of making loans or other investments that are directed at carrying out a nonprofit entity's purpose for existence rather than investing in the general production of income or appreciation of an asset (for example, total return investing). An example of programmatic investing is a loan made to lower-income individuals to promote home ownership. (FASB ASC 958-225-20)

Program services expenses – The activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the nonprofit entity exists. Those services are the major purpose for and the major output of the nonprofit and often relate to several major programs. (FASB ASC 958-720-20)

Supporting activities – Supporting activities are all activities of the nonprofit entity other than program services. Generally, they include the following: management and general activities, fundraising activities, and membership development activities. (FASB ASC 958-720-20)



Authors



Wendy L. Thompson, CPA

Wendy is Yeo & Yeo's Training Manager and a member of Yeo & Yeo's Nonprofit Services Group. She provides training in audit, compilation, review, and tax services for employees throughout all the firm's offices. She is a member of the American Institute of Certified Public Accountants, the Michigan Association of Certified Public Accountants, and the Association for Talent Development. *Contact Wendy at wentho@yeoandyeo.com.*



Timothy P. Crosson, Jr., CPA

Tim is a Manager in Yeo & Yeo's Ann Arbor office, and serves on the firm's Nonprofit Services Group. His areas of expertise include audit services for nonprofit organizations, government agencies and school districts, and single audits. He is a member of the American Institute of Certified Public Accountants and the Michigan Association of Certified Public Accountants. *Contact Tim at timcro@yeoandyeo.com.*

For more information and assistance with navigating functional expense allocations, contact any member of Yeo & Yeo's Nonprofit Services Group.

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