

JO Knows Functional Expense Allocation

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Nonprofit organizations must comply with an additional layer of expense classification that their for-profit counterparts do not have to, and that extra layer of expense reporting is the functional expense allocation. The functional expense allocation requirement is unique to certain tax-exempt organizations, including public charities. This allocation requires nonprofits to classify all costs not only by their natural category (i.e. salaries and related costs, consulting costs, grants paid, etc.) but also by functional categories: program, management & general, fundraising, and membership development. The primary purpose of the functional expense allocation requirement for such nonprofits is to provide transparency to users of nonprofit financial statements and tax returns as to the extent to which charitable funding has been spent on the charity's programs (program expenses) versus supporting services (management & general, fundraising, and membership development). This transparency allows stakeholders to understand how much of every dollar donated to the nonprofit is used to fulfill its mission; this ratio is referred to as the nonprofit's efficiency ratio. The efficiency ratio often serves as a key metric by which philanthropic decisions are made by prospective donors.

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