

Nonprofit Functional Expense Allocation 101: Is Your Charity Classifying Its Expense Accurately?

By: Greg Rogers, CPA



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.

What are the differences between each of the functional expense categories for nonprofit organizations?

Program expenses are expenses related to activities that result in the distribution of goods and services to beneficiaries that ultimately fulfill the nonprofit's mission. The most common example of programmatic expense are the salaries and related costs of staff that either directly conduct programmatic activities or directly supervise employees who conduct programmatic activities. Time spent by many employees is directly allocated to programmatic expenses if the employees are expected to focus their efforts on conducting programmatic activities based on their job descriptions. However, other employees, including the executive director, often spend a portion of their time supervising employees who conduct programmatic activities or conduct programmatic activities themselves in addition to time devoted to fundraising and management & general functions. For such employees, their salaries and related costs will need to be allocated to each of the functional categories proportionate to the time spent performing each function.

Program expenses also include costs paid directly to further the mission of the nonprofit, including grants paid to a program beneficiary, service delivery expenses incurred to carry out the nonprofit's programs, and program sponsorships paid to further the nonprofit's charitable cause. Program expenses can also include overhead costs, such as depreciation, insurance, rent and utility expenses.

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Membership development expenses are expenses incurred in soliciting new members and managing membership relations, including salaries and related costs as well as the cost of benefits provided to members in exchange for their dues payments. If membership with the nonprofit results in no significant benefits accruing to members, the membership development costs incurred may, in essence, be fundraising costs. That is because membership payments, in this instance, are not reciprocal in value to the benefits received and are, therefore, not entirely considered exchange transactions. Membership development activities may also need to be allocated to both membership development expenses and fundraising expenses based on the extent to which benefits are received in exchange for membership dues payments.

Fundraising expenses are expenses incurred to raise contributions and other support for the nonprofit organization. Fundraising expenses can include costs incurred for grant-writing, conducting capital campaigns, maintaining donor databases, orchestrating special events, mailing out donor solicitations, and soliciting in-kind support. Fundraising expenses can include salaries and related costs of staff devoted to development activities, direct costs associated with the aforementioned activities, and indirect costs allocated to fundraising based on time and effort reporting or some other allocation basis.

If a nonprofit's fundraising activities involve a combination of fundraising and program expenses or fundraising and management and general expenses, it should consider the requirements for joint cost allocation under Financial Accounting Standards Board (FASB) Accounting Standards Codification 958-720. Under this guidance, nonprofit organizations who conduct fundraising activities with joint purposes may be able to allocate a portion of the costs to program or management and general (in addition to fundraising) based on whether the purpose, content, and audience criterion are satisfied. The purpose criterion requires there to be an intention to call the audience to some type of action; the audience criterion requires the audience to be selected based on the likelihood it can benefit from the nonprofit's programs; and the content criterion requires there to be a clear call to action made by the nonprofit to the audience. If all three criteria are satisfied, the expenses can be allocated to both fundraising and program or management and general, depending on the nature of the call to action.

Management and general expenses include expenses related to all other activities of the nonprofit organization that are not encapsulated into the other three functional categories. These include managing the nonprofit organization and its employees, board meetings, bookkeeping, efforts related to submission of required compliance filings (including tax returns and audited financial statements), administering government grants/contracts, disseminating the nonprofit's annual report, and soliciting funds in exchange transactions other than membership dues.

MEASURING FUNCTIONAL EXPENSE ALLOCATION

As the first step in properly measuring functional expense allocation, nonprofits should ensure they have adopted a formal cost allocation plan that clearly articulates the methodology by which expenses are allocated to functional categories. The cost allocation plan does not have to be extensive in length; it merely must provide a reasonable basis by which the nonprofit allocates expenses according to the functional categories. A few examples of expenses and corresponding allocation methodologies that may apply to a nonprofit are: allocating salaries and related costs (payroll taxes and benefits) based on time and effort reporting; allocating rent and utilities based on the building/leased office space square footage devoted to each functional area; and allocating office supplies based on the time and effort reporting of office employees.

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The best practice for measuring usage of resources for ultimate functional expense allocation is to measure it in real time throughout the year. For salaries and related costs, this means that time should be tracked through routine time and effort reporting. This involves requiring all employees to document how they spent their time by functional category on a weekly or bi-weekly basis (as applicable). If time and effort reporting is not possible or practical for a nonprofit to implement, it is imperative that routine time studies be conducted throughout the year to develop a general estimation of how resources are utilized by functional category so expenses can be allocated accordingly. For non-salary related expenses that are allocated across functional categories such as occupancy costs, a nonprofit should routinely take inventory of the percentage of office or building space utilized by employees in each of the functional categories to better estimate the allocation of resources by square footage throughout the year.

RECORDKEEPING AND ACCOUNTING FOR FUNCTIONAL EXPENSE ALLOCATION

Measuring and tracking usage of resources is a great first step towards quantifying a nonprofit's functional expense allocation each year but the more critical step involves the contemporaneous recordkeeping and reporting of functional expense allocation in a systematic way in a nonprofit organization's books and records. What does this look like for a nonprofit? For starters, it involves taking the functional allocation data that the organization is meticulously tracking and entering it into the nonprofit's accounting system in real time. For payroll expenses, that means each payroll entry recorded will reflect the allocation of employees by functional category. This approach allows for consistent and accurate reporting of functional expenses from period to period without a need to retroactively classify expenses by functional category at the end of the year, which lends itself to inaccuracy and bookkeeping errors. For overhead expenses that the nonprofit records each month, these costs should be allocated with each entry in the general ledger by functional category depending on the basis of allocation, whether it is square footage or time and effort reporting. All other expenses should be charged to the appropriate functional category or allocated across all categories contemporaneously. For a nonprofit who uses QuickBooks as its accounting system, it is very simple to allocate costs by functional category using the 'Class' system inherent to QuickBooks. Most other accounting applications have similar classification features that provide a mechanism for routine functional expense recordkeeping throughout the year.

FINANCIAL AND TAX REPORTING OF FUNCTIONAL EXPENSE ALLOCATION

If your nonprofit organization is measuring and recording expenses by functional category throughout the year, the year-end financial reporting and tax reporting process for functional expense allocation is typically very straightforward.

Under FASB Accounting Standards Update (ASU) 2016-14, nonprofit organizations are required to present their natural expenses on a functional basis in one of three ways: on the face of the statement of activities, in a statement of functional expenses, or in a separate footnote disclosure. In addition, nonprofit organizations are also required under U.S. Generally Accepted Accounting Principles (GAAP) to disclose the methodology that they use to allocate natural expenses by functional category. This should be a seamless process for nonprofits with a cost allocation plan in place, as the details within the cost allocation plan simply need to be summarized in the footnote disclosure in either narrative or tabular form. IRS Form 990, Part IX Statement of Functional Expenses also requires nonprofit organizations to report their natural expenses by functional category. Care should be taken by nonprofit organizations to ensure their functional expense allocation is reported consistently between the financial statements and tax returns unless there are items that are presented differently between the two reporting frameworks.

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Under FASB ASU 2016-14, nonprofit organizations must take measures to ensure their functional expenses are reported properly on the Statement of Functional Expenses in accordance with U.S. GAAP. All expenses, except for investment fees, must be reported on the Statement of Functional Expenses. However, certain expenses that are presented net of revenue, including cost of goods sold and costs of direct donor benefits from special events, must be backed out of the Statement of Functional Expenses so the reconciled total ties back to the Statement of Activities.

IMPLICATIONS FOR FUNCTIONAL EXPENSE REPORTING

Functional expense reporting is not only important because it is required under U.S. GAAP and IRS tax code regulations, it is also one of the primary metrics that charity watchdog groups, such as Charity Navigator and Guidestar, use to rate nonprofits' financial health. Charity watchdog groups derive the financial data for their rating system from public charity tax return filings that are available to the public and measure the ability of nonprofits to use their resources efficiently and demonstrate both accountability and transparency to the public with respect to their reporting and disclosure requirements. Because of these important implications, it behooves nonprofit organizations to place a heavy emphasis on ensuring that their functional expense allocation is reported accurately and on a timely basis.

EXECUTIVE SUMMARY

Nonprofit organizations are required to undergo an additional level of due diligence in expense classification compared to for-profit entities with the functional expense allocation reporting requirement. Charity watchdog groups evaluate nonprofit organizations on the efficiency by which they utilize their resources on programs/supporting services and provide transparent reporting of how their funding is spent. Nonprofits should fulfill their fiduciary duty to the public by: developing a cost allocation plan, measuring usage of nonprofit resources appropriately, contemporaneously recording functional expense allocation in their accounting systems, and ensuring the financial and tax requirements for functional expense reporting are met. Taking these steps will go a long way towards the achievement of regulatory compliance and the establishment of a strong reputation within the nonprofit sector.



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With over fifteen years of experience serving the needs of tax-exempt organizations, Greg has earned a strong reputation within the nonprofit sector. Greg has a proven track record of guiding public charities and private foundations to help them comply with audit requirements and tax regulations, while simultaneously assisting them with the establishment of best practices for financial reporting and internal control design and implementation. Greg has served as treasurer of multiple public charities over the past ten years. This experience has given Greg a well-rounded perspective that enables him to advise clients on strategies for raising funds, cutting costs, developing their programs, and establishing financial sustainability. Throughout his career, Greg has authored numerous white papers and facilitated an extensive array of webinars and trainings designed to educate clients and staff on nonprofit accounting, auditing, financial reporting, and tax return compliance best practices for tax-exempt organizations.