

Functional Allocation of Expenses For Nonprofits

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Topics

- Why do we have to do this?
- Defining functional expenses
- Allocating expenses and categories
- Direct versus indirect expenses
- Indirect allocation methods and examples
- Substantiating allocations
- Common errors in functional reporting
- What the IRS and donors are evaluating when they use your functional expense statements



Why do we have to do this?



Why Allocate Expenses?

- Manage costs / programs
- Donors may require a specific percentage
- GAAP requires it
- Form 990 requires it
- Benchmarking for the NFP sector



Financial Reporting

Must adhere to accounting principles generally accepted in the United States of America (GAAP versus IRS Code).

ASC 958-205-05 (previously SFAS 117), *Financial Statements of Not-for-Profit Organizations* - Specifies that a statement of activities or notes to the financial statements provide information about expenses **reported by their functional classification** such as major classes of program services and supporting activities.



Financial Reporting (Continued)

ASC 958-720-45 - AICPA Statement of Position (SOP) 98-2, Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising

Provides guidance on the allocation of indirect and joint costs



What is functional allocation?

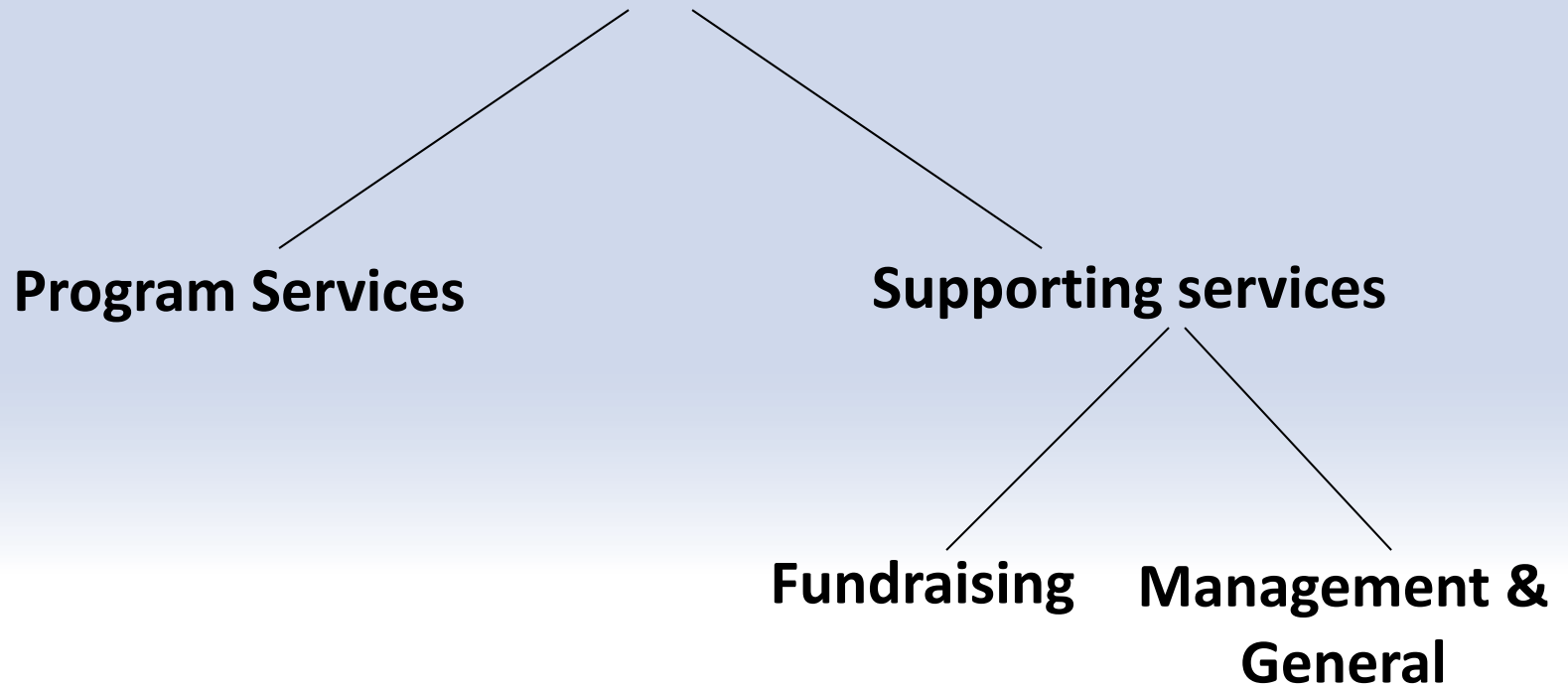


Functional Classification Defined

Method of grouping expenses according to the purpose for which the costs are incurred. The primary functional classifications are program services and supporting activities.



Statement of Functional Expenses



Functional Classifications

Program Services

Activities that result in goods/services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission of the organization. Those services are the major purpose for and the major output of the organization and often relate to several major programs.



Functional Classifications

Management and General

Activities that are not identifiable with a program, fund-raising activity, or membership-development activity but are indispensable to the organization.

May include accounting, general management and oversight, audit, budgeting, financing, communications with the public, human resources, insurance, occupancy, legal and risk management.



Functional Classifications

Fund-Raising

Activities that involve inducing potential donors to contribute money, securities, services, materials, facilities, other assets or time.

Includes publicizing and conducting fund-raising campaigns; maintaining donor lists; conducting special events; preparing and distributing fund-raising materials; etc.

Financial statements should disclose total fundraising expense.



Functional Classifications

Fund-Raising (Continued)

Is there a difference between fundraising and advertising?

Answer: YES! Remember that in order to be considered fundraising it must be an activity that involves inducing potential donors to contribute to your Organization.

Whereas advertising is an activity of attracting public attention to your Organization but does not necessarily need to include solicitations.



Direct Identification Versus Allocation

Direct identification of specific expenses is the preferred method for charging expenses to various functions as it is viewed as the most accurate.

If an expense can be specifically identified with a program or supporting service, it should be assigned to that function.

Let's discuss examples...



What is an indirect cost?



Indirect Cost

Indirect costs are those for activities or services that benefit more than one project or activity.

They're not readily identified with a particular grant, contract, project function or activity, but are necessary for the general operation of the organization.



Indirect Allocation Methods

There is no one right way or required method. We as auditors look to see if the allocation is:

Reasonable

Consistent

Reviewed by management

Methodology is reasonable

Document in an allocation plan.



Indirect Allocation Methods

Examples:

1. Time study.
2. Square footage.
3. Actual usage (telephone allocated based on extensions, supplies/postage based on a study of their use, depreciation or rental of equipment based on asset usage...).
4. % of direct costs.



Indirect Allocation Methods

Illustration 1

Assume a direct mail campaign is used to conduct programs of the entity and to solicit contributions to support the entity and its programs. Further, assume that the appeal meets the criteria for allocation of costs to more than one function.

The letter and reply card include a total of one hundred lines. Forty-five lines pertain to program because they include a call for action by the recipient that will help accomplish the entity's mission, while fifty-five lines pertain to the fund-raising appeal. Accordingly, 45 percent of the costs could be allocated to program and 55 percent to fund-raising.



Indirect Allocation Methods

Illustration 2

Assume that the costs associated with a direct mail campaign including both program and fund-raising components are the costs of stationery, postage, and envelopes at a total of \$100,000.

The costs of stationery, postage, and envelopes to produce and distribute each component separately would have been \$90,000 for the program component and \$70,000 for the fund-raising component.



Indirect Allocation Methods

Illustration 2

Under one cost allocation method, the \$100,000 in indirect costs could be allocated as follows:

$\$90,000/\$160,000 \times \$100,000 = \$56,250$ to program services and

$\$70,000/\$160,000 \times \$100,000 = \$43,750$ to fund raising.



Indirect Allocation Methods

Illustration 3

Assume that an Organization is a school and rents their one building in which all activities of the school take place. The total square footage of the building is 100,000 square feet.

Management has physically determined that the classrooms make up 50,000 square feet of the space, while the development department takes up 25,000 square feet, and administration staff take up the remaining 25,000 square feet.



Indirect Allocation Methods

Illustration 3

The Organization has then determined that certain overhead costs such as rent expense, utilities, and repairs & maintenance could be allocated on a functional basis as:

50% - Program services

50% - Supporting services – broken down further as:

25% - Fundraising

25% - Management and General



Indirect Allocation Methods

Illustration 4

Assume that an Organization has 3 employees, each making \$100,000 in payroll costs. Their roles are as follows:

Sally CEO – As the CEO, Sally is involved in all aspects of the Organization including reviewing solicitations, research and development of the programs, leadership of the staff, approval of the budget, etc. Based on a time study, Sally has determined that her time is spent on a functional basis as follows:

Program services 50%

Fundraising 45%

Administration 5%



Indirect Allocation Methods

Illustration 4

Assume that an Organization has 3 employees, each making \$100,000 in payroll costs. Their roles are as follows:

Carol Communications Director – Carol oversees all communications including managing the website, program and fundraising solicitations, educational materials, and staff handbooks and policies/procedures. Based on a time study, Carol has determined that her time is spent on a functional basis as follows:

Program services 5%

Fundraising 55%

Administration 40%



Indirect Allocation Methods

Illustration 4

Assume that an Organization has 3 employees, each making \$100,000 in payroll costs. Their roles are as follows:

Anna Accountant – Anna prepares the budget and is responsible for all accounting aspects of tracking and reporting the financial operations of the Organization. Based on a time study, Anna has determined that her time is spent on a functional basis as follows:

Program services 0%

Fundraising 5%

Administration 95%



Indirect Allocation Methods

Illustration 4

Employee	Program Services	Fundraising	Administration	Total
Sally	50%	45%	5%	100%
Carol	5%	55%	40%	100%
Anna	0%	5%	95%	100%
Total	55%	105%	140%	300%
Relative Total	18.33%	35.01%	46.66%	100%
Allocation of Payroll	\$54,990	\$105,030	\$139,980	\$300,000

The Organization would then allocate the payroll expenses on a functional basis based on the relative percentages based on the time studies performed.



Substantiating Allocations

Organizations should maintain documentation supporting:

1. Allocation methodology.
2. Calculations used to do the actual allocation and to support disclosures in the financial statements .
3. Basis of calculations (for example: time studies with signed time cards, head count of FTEs by department/function, square footage of a shared facility and each functional area within the facility, etc.)



Substantiating Allocations

Organization should maintain documentation supporting:

4. Reasonableness of the allocations: may include industry information/comparables, trend information for prior years and analysis of this information with respect to current year allocations .
5. Support for the original transactions that make up the expenses that are allocated .
6. Use of consistent methodology during the period and from year to year.
7. Internal controls surrounding expense allocation process.



Common Errors in Functional Reporting on Form 990

- 37% of nonprofits reporting over \$50,000 in contributions report zero fundraising or special event costs to the IRS
 - program-spending ratio
 - fundraising- efficiency ratio
- 13% of nonprofits report zero management and general expenses.
- 7% charged all accounting fees to program and another 20% split them across more than one category.

According to: Nonprofit Overhead Cost Project – by Kennard Wing, Teresa Gordon, Mark Hagar, Thomas Pollak and Patrick Rooney



Common Issues in Functional Reporting in FS (Continued)

The most common errors in allocating costs include the following:

- Not properly allocating management/general expenses.
- Reporting no fundraising expenses when the organization has substantial contribution income.
- Not reporting all of the major programs separately or reporting a grantor as a program.
- Not allocating insurance, occupancy and depreciation.



Common Issues in Functional Reporting in FS (Continued)

- *Difficulty maintaining general ledger on a functional basis, particularly overhead costs*

Establish a means of tracking separately and then allocating management and general costs to various cost centers based on a percentage of staff time charged to a particular cost center or some other reasonable method



Common Issues in Functional Reporting in FS (Continued)

- *Use of a fixed percentage to allocate costs rather than a basis more accurately representing true cost allocations.*

Financial reports that are not truly representative of the related functions.



Tax Reporting

- Only 501(c)(3) & (4) or nonexempt charitable trust must categorize as :

Program Service Expense

Management & General Expense

Fundraising Expense

- Use a reasonable method of allocation

- Do not include the following expenses:

Rental expenses that should be netted with rental income

Cost of inventory sold

Special events or gaming expenses

New line items



What is IRS looking at?

Are allocations “reasonable”?

Are expenses consistent with the organizations exempt purpose?

Are expenses consistent with similar organizations?

May look at grants to foreign organizations & individuals closely.

More important than what the IRS is looking for is what are the other reader’s such as donors looking for?



What Donors are Evaluating

In conjunction with the other information provided by the organization (on Form 990 and/or in the FS if made public), potential donors are looking at efficient use of funds and want to see:

- Minimal administrative expenses
- Amount of fund-raising efforts
- Majority of funds used to further programs and provide services
- Potential donors want their contributions used to provide programs/services



What Donors are Evaluating (Continued)

Potential donors have access to financial information in a variety of ways depending on the organization

Potential donors may utilize public websites that provide functional expense information and analyze these expenses:

www.charitynavigator.org

www2.guidestar.com



What Donors are Evaluating (Continued)

Websites and donors use functional expense information to evaluate organization efficiency and some sites issue scores

Popular ways to evaluate financial information include the following ratios:

Program expenses / Total functional expenses

Administrative expense / Total functional expenses

Fund-raising expense / Total functional expenses

Fund-raising expense / Amounts raised or Contributions; a measure of fundraising efficiency



Questions



Thank you!

