Functional Allocation of Expenses for Not-for-Profits

Lucas LaChance, CPA, CIA
214.461.1475
llachance@lgt-cpa.com
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?
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

Program Services

Supporting Services

Management & General

Fundraising
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 Classification

- Fundraising
  - Activities that involve inducing potential donors to contribute money, securities, services, materials, facilities, other assets, or time.
  - Includes publicizing and conducting fundraising campaigns, maintaining donor lists, conducting special events, and preparing and distributing fund-raising materials.
  - Financial statements should disclose total fundraising expense.
Functional Classifications

• Fundraising (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 viewed as the most accurate.
- If an expense can be specifically identified with a program or a supporting service, it should be assigned to that function.
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

• The associated document is an allocation plan.
Indirect Allocation Methods

• Examples:
  – Time study
  – Square footage
  – 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)
  – Percentage 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 fundraising appeal. Accordingly, 45% of the costs could be allocated to program and 55% to fundraising.
### Indirect Allocation Methods

**Illustration 2**

- Assume that the costs associated with a direct mail campaign including both program and fundraising 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 fundraising 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 x $100,000 = $56,250 to program services
  – $70,000/$160,000 x $100,000 = $43,750 to fundraising
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 function 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, education 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 organizations. 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

<table>
<thead>
<tr>
<th>Employee</th>
<th>Program Services</th>
<th>Fundraising</th>
<th>Administration</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sally</td>
<td>50%</td>
<td>45%</td>
<td>5%</td>
<td>100%</td>
</tr>
<tr>
<td>Carol</td>
<td>5%</td>
<td>55%</td>
<td>40%</td>
<td>100%</td>
</tr>
<tr>
<td>Anna</td>
<td>0%</td>
<td>5%</td>
<td>95%</td>
<td>100%</td>
</tr>
<tr>
<td>Total</td>
<td>55%</td>
<td>105%</td>
<td>140%</td>
<td>300%</td>
</tr>
<tr>
<td>Relative Total</td>
<td>18.33%</td>
<td>35.00%</td>
<td>46.67%</td>
<td>100%</td>
</tr>
<tr>
<td>Allocation of Payroll</td>
<td>$54,990</td>
<td>$105,000</td>
<td>$140,010</td>
<td>$300,000</td>
</tr>
</tbody>
</table>

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:
  – Allocation methodology
  – Calculations used to do the actual allocation and to support disclosures in the financial statements
  – 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:
  – 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
  – Support for the original transactions that make up the expenses that are allocated
  – Use of consistent methodology during the period and from year to year
  – Internal controls surrounding expense allocations
Common Issues in Functional Reporting on Form 990

- 37% of not-for-profits reporting over $50,000 in contributions report zero fundraising or special event costs to the IRS
  - Program-spending ratio
  - Fundraising-efficiency ratio
- 13% of not-for-profits 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 Financial Statements

• The most common errors in allocating costs include the following:
  – Not properly allocating management/general expenses
  – Reporting no fundraising expenses when the organizations 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 Financial Statements

- 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 Financial Statements

- 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) and (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 the IRS looking at?

- Are allocations “reasonable”?
- Are expenses consistent with the organization’s 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 readers (i.e. 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 fundraising 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](http://www.charitynavigator.org)
  - [www.guidestar.org](http://www.guidestar.org)
What Donors are Evaluating

• 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
  – Fundraising expense/Total functional expenses
  – Fundraising expense/Amounts raised or Contributions; a measure of fundraising efficiency
Questions?