



Functional Expenses

A concept unique to nonprofit accounting is that of functional expenses: reporting expenses by function, or type of activity for which the expense was incurred. The common functions are program expenses (often various programs are listed) and support services such as management and general expenses and fundraising expenses. The traditional way of listing expenses in categories such as salaries, rent, supplies, is called *natural expense* classification. Nonprofit organizations go a step further and allocate the natural expenses to their *function*. Reporting natural expenses by their function can help management in decision-making and budgeting by allowing them to see total costs by program, progress toward the budget and if programs are sustainable. Donors, funding sources and regulators often use functional expense reports to determine the relationship between program and support services. Detail of expenses by function can help these users of financial data answer the “why” as well as the “what” related to cost reporting.



Types of functions

The program function can include one total for all programs or separate totals for different programs of the organization. A **program** is any activity that fulfills the purpose or mission of the organization. Some organizations have one main program; others have many. Each organization has to look at their program work and determine the best way to present program expenses. **Management and general expenses** are not identifiable by a single program or activity, but necessary to the conduct of business. They include investments in the organization’s infrastructure and operations. Examples of these expenses are salaries for staff that are responsible for accounting, human resources, information technology and Board of Directors expenses. **Fundraising** expenses are those incurred for activities undertaken to induce contributions. Costs associated with fundraising campaigns, special events and solicitations are examples of this function.

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Management and general expenses and fundraising expenses are considered support services.

GAAP Requirements

New accounting standards for fiscal years beginning on or after December 15, 2017 will require all nonprofit entities to present expenses on a functional and natural classification basis either on a separate statement, on the statement of activities or in the footnotes. There will also be new disclosures required about the method used for allocating expenses.

Allocation methods

There is no prescribed allocation method when determining functional expenses. An organization’s methodology should be rational and systematic, the method should be consistently applied and the process should result in an allocation that is reasonable. The direct allocation method is appropriate when specifically identifiable costs can be assigned 100% to a function. For example, you may buy food for your organization’s food bank which can be directly allocated to that program. If you cannot make a

direct identification, indirect allocation is appropriate. Multiple techniques can be used to allocate indirect costs. One technique is to use staff time to allocate salaries and other related expenses. This can be done using time sheets, if data is entered by function and readily available to analyze. If this data is not available, you can perform a periodic time study of how employees spend their time and apply the percentage of time spent for each function to the expenses to be allocated. Another method is the square footage method in which the percentage space used by each function is applied to allocate rent, utilities, depreciation and other common expenses. For smaller organizations, the head count method can be used in which the number of staff dedicated to different functions are used to allocate costs.

IRS Form 990 and functional expenses

For the most part, the functional expense allocation for IRS Form 990 purposes is exactly like those under financial reporting GAAP guidance.

On the IRS Form 990, all 501(c)(3) and 501(c)(4) organizations are required to fill out the full statement of functional expenses form part of the tax return. Other organizations are only required to report expenses by natural category. The IRS states that you can use any reasonable method of allocation. You are to report amounts accurately and document the method of allocation in your organization's records. The IRS gives fairly specific guidance on types of expenses that are considered management and general. Examples include costs of Board of Directors meetings, committee meetings and staff meetings that don't involve program or fundraising elements; general legal services; advertising, accounting services (including billing of program services); general liability insurance; office management; auditing, human resources and other centralized services; annual report expenses; and investment management fees.

The Overhead Myth

Many nonprofit organizations fear that they will be judged by their overhead ratio and try to cut costs in the management and general and fundraising functions to improve that ratio. The overhead ratio is the percentage of support services expenses in relation to total expenses, usually

derived from the IRS Form 990 since this is a public document. While it is true that there are donors and watchdog groups that calculate this ratio and look at it in assessing an organization's financial health, there is a large push in the industry to move away from this thinking. In 2013, the Overhead Myth campaign was started by three of the large watchdog groups: GuideStar, BBB Wise Giving Alliance and Charity Navigator. Their goal is to correct the assumption that low support service costs are inherently desirable. They believe that, in fact, under investing in these costs is linked with poor performance and sustainability in the long run. The campaign encourages donors and other stakeholders to pay attention to a broader set of factors about nonprofit performance: transparency, governance, leadership, and results, as well as finances.

Best practices

- Document your allocation methodology in writing.
- Be sure to outline direct allocation items vs. those allocated indirectly.
- If you use QuickBooks, set up classes to allocate expenses as they are entered into the accounting software. Make it part of your expense approval process to assign a class, or combination of classes, for each expense and have your bookkeeper enter it into QuickBooks using the approved class allocation. This will provide for a much more accurate functional expense breakdown. For example, if supplies were purchased for a specific program, they can be directly recorded as program expense immediately in the accounting software. If this does not occur, supplies expense may be allocated based on an indirect allocation method at year end and may be grossly under or over stated in certain functions.
- Review and update allocations periodically – at least annually.
- Give thought to all expense lines when doing your allocation. There may be some expenses that you assume are “overhead” and automatically assign to the management and general function, when in fact there are program costs in there as well that should be reflected properly.

