

# **Kerkering, Barberio & Co.**

**FUNCTIONAL EXPENSE REPORTING  
FOR NONPROFITS  
OCTOBER 29, 2009**





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# Introductions

- Facilitators
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- Topics
  - Difference in allocating expenses for financial reporting versus tax reporting
  - Tips for handling joint cost allocations

# Introductions (Continued)

- Topics (Continued)
  - Understanding direct and indirect expenses
  - Definitions of functional classifications
  - What donors are evaluating when they use your functional expense statements / financial indicators
  - Common errors in functional reporting
  - Questions

# 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.

# Financial Versus Tax Reporting

Differences include:

- Sources of authoritative guidance (IRS Code versus GAAP)
- GAAP specifics for voluntary health and welfare organizations
- Format and level of detail required
- Users and their agendas/purposes

# Tax Reporting

- Only 501(c)(3) & (4) or nonexempt charitable trust must categorize as
  - Program Service Expense
  - Management & General Expense
  - Fundraising Expense
- Use the organization's normal accounting method
- 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

# Tax Reporting (Continued)

- Program Service Expenses
  - Further the organization's exempt purposes
  - May include
    - Lobbying expenses
    - Unrelated trade or business expenses
    - Costs to secure a grant
    - Costs to conduct research



# Tax Reporting (Continued)

- Management & General Expenses

- Related to overall operations & management
- Wages of chief executive and his or her staff
- Investment management fees must be reported here
- Lobbying expenses if not directly related to exempt purpose
- Board meeting, committee meetings, staff meetings (not costs of that relate to fundraising or specific program services)
- General legal services
- Accounting & auditing
- General liability insurance
- Office management, human resources, and other centralized services

# Tax Reporting (Continued)

- Fundraising Expenses
  - Incurred in soliciting contributions, gifts, and grants
    - Including allocable overhead costs,
  - Publicizing and conducting fundraising campaigns
  - Soliciting bequests and grants from foundations or other organizations, or government grants
  - Conducting fundraising events that generate contributions

# Financial Reporting

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

- SFAS 117, *Financial Statements of Not-for-Profit Organizations* (Continued)
  - Voluntary health and welfare organizations required to report functional classifications together with expenses by their natural classifications (i.e. salaries, rent, interest, depreciation, grants to others, etc.) in a matrix format in a separate financial statement

# Financial Reporting (Continued)

- Voluntary health and welfare organizations: not-for-profits that derive their revenue primarily from voluntary contributions from the general public for purposes connected with health, welfare or community service
  - Most concentrate their efforts to solve health and welfare problems of society or specific individuals
  - Excludes governmental entities

# Financial Reporting (Continued)

- 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 joint costs

# Financial Reporting (Continued)

- Program, Management and General, and Fund-raising classifications are functional classifications thought to be predominant in practice, however, other functional classifications may be used as appropriate for the organization

# Financial Reporting (Continued)

- *Program services* are the 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.



# Financial Reporting (Continued)

- *Management and general activities* are not identifiable with a program, fund-raising activity, or membership-development activity but are indispensable to the organization
  - May include oversight, business management, general recordkeeping, budgeting, financing, soliciting revenue from exchange transactions such as government contracts and related administrative activities and all management and administration except for direct conduct of programs services and fund-raising activities

# Financial Reporting (Continued)

- *Fund-raising activities* 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

# Financial Reporting (Continued)

- Some expenses are directly related to and can be assigned to a single major program or service or a single supporting activity. Other expenses relate to a combination of programs or supporting activities.
  - Examples: salaries of persons who perform more than one kind of services and the rental of a building used for various purposes.

# Direct Identification Versus Allocation

- Direct identification of specific expenses is the preferred method for charging expenses to various functions
- If an expense can be specifically identified with a program or supporting service, it should be assigned to that function
  - Example: travel incurred in connection with a program activity should be assigned to that program

# Reporting Joint Cost Allocations

- When joint costs are allocated and include fund-raising, the following should be disclosed:
  - Type of activities for which joint costs have been incurred
  - That such costs have been allocated
  - Total amount allocated during the period and the portion allocated to each functional expense category

# Joint Cost Allocations

- Joint activities: activities that are part of the fund-raising function and have elements of other functions such as programs and/or management and general
- Joint costs: costs of joint activities that are not identifiable with a particular component of the activity
  - Examples may include salaries, professional fees, postage, event advertising, telephones, and facility rentals

## Joint Cost Allocations (Continued)

- U.S. Office of Management and Budget Circular A-122 may be helpful in allocating costs
- AICPA issued SOP No. 98-2: established accounting and disclosure standards on accounting for costs of joint activities

# Joint Cost Allocations (Continued)

- SOP No. 98-2:
  - Joint activity costs should be reported as fund-raising (except costs of goods/services in exchange transactions), including costs that might otherwise be considered program or management and general costs UNLESS three criteria are met
    - 1) Purpose
    - 2) Audience
    - 3) Content



## Joint Cost Allocations (Continued)

- 1) PURPOSE criterion is met if the purpose of the joint activity includes accomplishing program or management and general functions by calling for specific action by the audience that will assist the entity in accomplishing a specific program, mission or goal

## Joint Cost Allocations (Continued)

- 2) AUDIENCE criterion: audience is not principally composed of prior donors or is not selected based on ability or likelihood to contribute to the entity but is selected for at least one of the following reasons:
- Audience has a specific need or a reasonable potential for use of the specific program action component of the joint activity
  - Audience has the ability to take the proposed action or assist with the specific program action component of the joint activity
  - Entity is either required to direct the management and general component of a joint activity to the particular audience or the audience has use for the management and general component

## Joint Cost Allocations (Continued)

- 3) **CONTENT** criterion is met if the joint activity supports program or management and general functions. Documentation of a call for specific action by recipients or documentation that the activity actually fulfills one or more of the entity's management and general responsibilities through a component of the joint activity is required.

## Joint Cost Allocations (Continued)

- SOP No. 98-2, Appendix E includes 17 illustrations of applying the criteria to determine whether a program or management and general activity has been conducted (and therefore costs can be allocated to these functions)

# Joint Cost & Other Allocations

- SOP No. 98-2 does not provide specific guidance on methods of cost allocation, however, the AICPA provided an appendix to the SOP illustrating three commonly used cost allocation methods:
  - 1) Physical units method
  - 2) Relative direct cost method
  - 3) Stand-alone joint-cost allocation method

# Joint Cost & Other Allocations (Continued)

- Method of allocation should be selected based on what can result in a reasonable allocation of joint costs
- Methodology used should be rational and systematic and consistently applied

# Physical Units Method

- Joint costs are allocated proportionately based on number of units
- Method assumes benefit received from the joint costs incurred are directly proportional to the units of measure attributed to the activity
- Examples: square feet, minutes, physical counts - vehicles, FTEs, etc.

# Relative Direct Cost Method

- Joint costs are allocated to components of the activities based on their respective direct costs
- Direct costs are expenses incurred in connection with multipurpose materials or activities that are specifically identifiable with a program, fund-raising or management and general function



# Stand-Alone Joint-Cost Allocation Method

- Joint costs are allocated to each component of an activity based on a ratio of the cost that would have been incurred had the functions been performed separately
- Based on assumption that efforts for each component in the stand-alone situation are proportionate to the efforts actually undertaken in the joint cost situation
- Formula to allocate cost to a specific function:

Estimated costs for a specific function if independently incurred      X      Actual joint costs

Estimated total costs for all functions if independently incurred

# Substantiating Allocations

- Organization should maintain documentation supporting:
  - Allocation methodology: were one of the three methods described by accounting guidance utilized? How was this applied?
  - 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 (Continued)

- 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 allocation process

# 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](http://www.charitynavigator.org)
  - [www2.guidestar.com](http://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

# 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 percent of nonprofits report zero management and general expenses.
- 7 percent charged all accounting fees to program and another 20 percent split them across more than one category



## Common Errors in Functional Reporting on Form 990 (Continued)

- Donated space and services
- Reporting for nonprofits comprising multiple, affiliated, legal entities
- Staff time-tracking
- Under-reporting overhead expenses

# Common Issues in Functional Reporting in FS

- 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)

- Annual budget not prepared using a functional basis
  - Useful for controlling costs and measuring and attaining financial goals within each cost center
  - Allows management to effectively monitor and analyze financial data the way potential donors and others external to the IRS will view financial information throughout the year, not just retrospectively

# Common Issues in Functional Reporting in FS (Continued)

- Use of more than one method to allocate expenses during a reporting period
  - Lack of consistency affecting ability of management and readers of financial statements to analyze activity of the organization
  - Not in compliance with GAAP

# 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

# Common Issues in Functional Reporting in FS (Continued)

- Lack of support for allocations
  - Good documentation can facilitate future allocations
  - Reputational and other risk (noncompliance with funding requirements, qualified audit opinions, etc.) if support for allocations is not available

# Questions



Thank You!





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