

# **Kerkering, Barberio & Co.**

**What's the Cost?  
Understanding Your Program, Admin  
and Fundraising Expenses**

**June 21, 2012**



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# Introductions

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# Topics

- Importance of functional classifications
- Financial reporting of expenses
- Functional classifications
- Direct and indirect expenses
- Joint costs
- Allocation methods
- The effects of functional reporting

# Importance of Functional Allocations

- How much of my \$1.00 goes to the mission of the entity?

# Importance of Functional Allocations (Continued)

- Websites and donors use functional expense information to evaluate organization efficiency and some sites issue scores
- Potential donors are looking for efficient use of funds

# Financial Versus Tax Reporting

Differences include:

- Sources of authoritative guidance
  - IRS Code versus U.S. Generally Accepted Accounting Principles (GAAP)
- GAAP specifics for voluntary health and welfare entities
- Format and level of detail required
- Users and their agendas/purposes

# Financial Reporting of Expenses

- The Financial Accounting Standards Board (FASB) provides guidance in the Not-for-Profit Entities Topic
  - Information about expenses reported by their functional classification are disclosed in the statement of activities or notes to the financial statements
  - Voluntary health and welfare organizations are 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
  - Other not-for-profits are encouraged but not required to provide information about expenses by their natural classification



# Financial Reporting of Expenses (Continued)

- A Voluntary Health and Welfare Entity is an entity formed for the purpose of performing voluntary services for various segments of society and that is tax exempt (organized for the benefit of the public), supported by the public, and operated on a not-for-profit basis

# Functional Classifications

- What is it?
  - It is a method of grouping expenses according to the purpose for which the costs are incurred
  - The primary functional classifications are program services and supporting activities

# Functional Classifications (Continued)

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

# Functional Classifications (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

# Functional Classifications (Continued)

- *Management and general activities* are not identifiable with a program, fund-raising activity, or membership-development activity but are indispensable to the organization

# Functional Classifications (Continued)

- *Fund-raising activities* involve inducing potential donors to contribute money, securities, services, materials, facilities, other assets or time
- Financial statements should disclose total fundraising expense

# Functional Classifications (Continued)

## Statement of Functional Expenses

# Direct Costs

- Expenses that are directly related to and can be assigned to a single major program or service or a single supporting activity
- Direct identification of specific expenses is the preferred method for charging expenses to various functions



# Indirect Costs

- Expenses that relate to a combination of programs or supporting activities

# Joint Costs

- 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

# Joint Costs (Continued)

- An example of a joint activity is an annual dinner that promotes the entity's programs in addition to raising funds.
- The following can be typical examples of joint costs:
  - Salaries
  - Contract Labor
  - Consultants
  - Professional fees
  - Paper
  - Printing
  - Postage
  - Event advertising
  - Telephones
  - Airtime
  - Facility rentals

# Allocation of Joint Costs

- Three criteria need to be met to allocate joint costs:
  - 1) Purpose
  - 2) Audience
  - 3) Content
- The exception- Costs of goods/services in exchange transactions

# Allocation of Joint Costs

- If any of the criteria are not met, all costs of the joint activity is reported as fundraising

# Allocation of Joint Costs (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

# Allocation of Joint Costs (Continued)

- 2) AUDIENCE criterion is met if the 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

# Allocation of Joint Costs (Continued)

- 3) CONTENT criterion is met if the joint activity supports program or management and general functions



# Allocation of Joint Costs (Continued)

- Can these joint costs be allocated?
  - Donor renewal mailings that fulfill an entity's mission
  - Donor letters required by IRS

# Allocation of Joint Costs (Continued)

- SOP 98-2, Appendix E includes 17 illustrations of applying the criteria to determine whether a program or management and general activity has been conducted allowing costs to be allocated

# Allocation Methods

- There is no specific guidance on methods of cost allocation, however, there are three commonly used cost allocation methods for not-for-profit entities:
  - 1) Physical units method
  - 2) Relative direct cost method
  - 3) Stand-alone joint-cost allocation method

# Allocation Methods (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, lines, physical counts - vehicles, FTEs

# Relative Direct Cost Method

- Joint costs are allocated to components of the activities based on their respective direct costs

# 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
  - Calculations used
  - Basis of calculations
  - Reasonableness of the allocations
  - Expense transactions that are allocated
  - Consistency
  - Internal controls

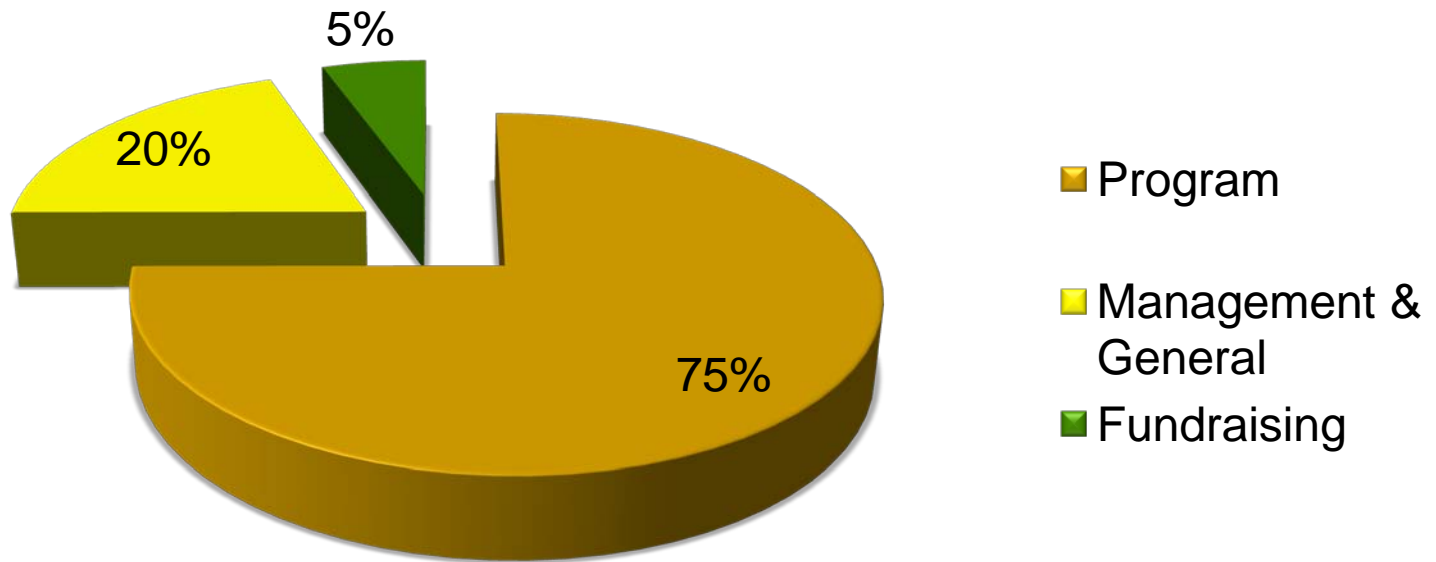


# Common Issues in Functional Reporting

- Difficulty maintaining general ledger on a functional basis, particularly overhead costs
- Use of a fixed percentage to allocate costs rather than a basis more accurately representing true cost allocations
- Annual budget not prepared using a functional basis
- Lack of support for allocations

# The Effect of Functional Classifications (Continued)

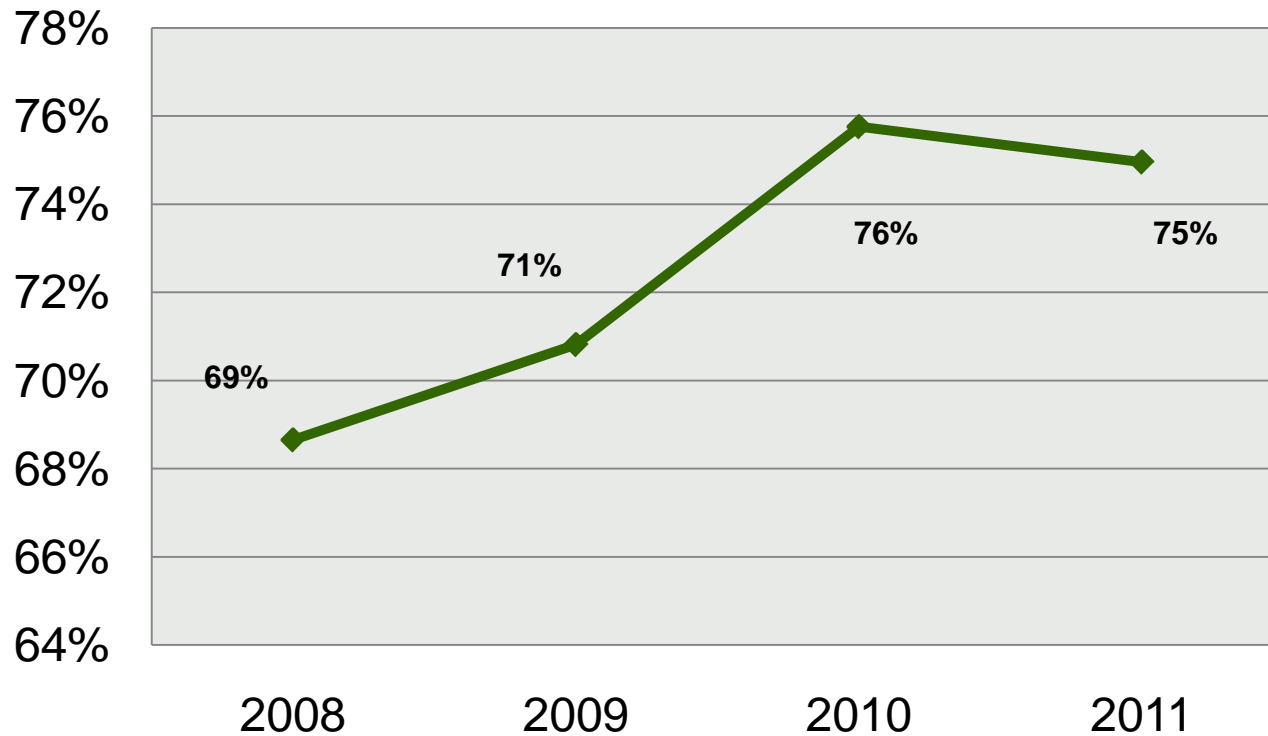
## Expense



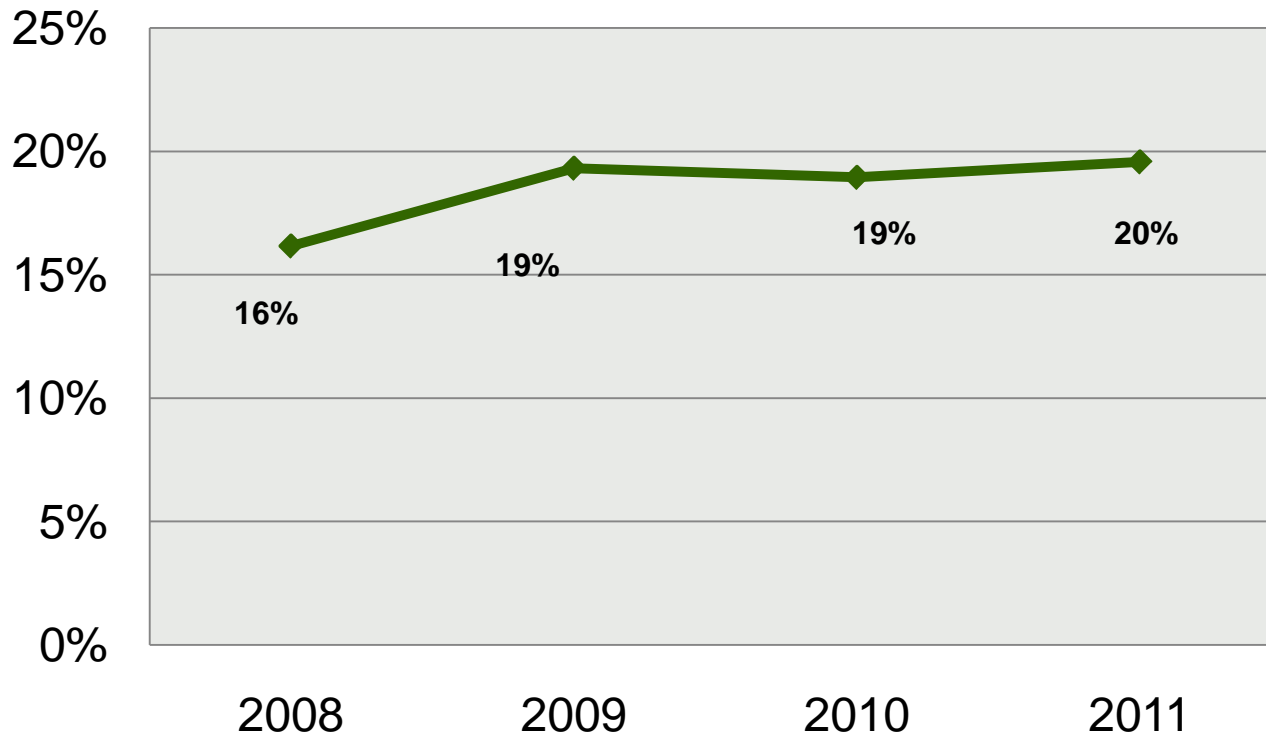
# The Effect of Functional Classifications

- 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

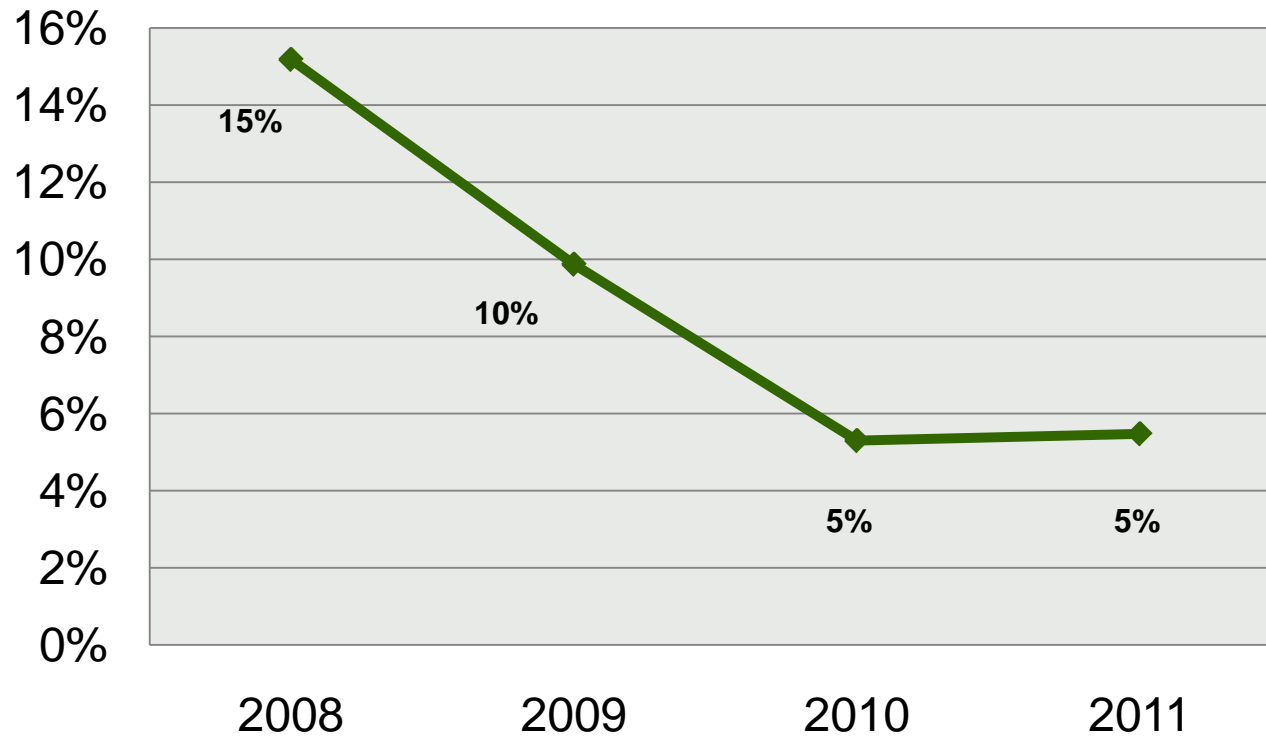
# Program Expenses as a Percentage of Total Functional Expenses



# Administrative Expenses as a Percentage of Total Functional Expenses

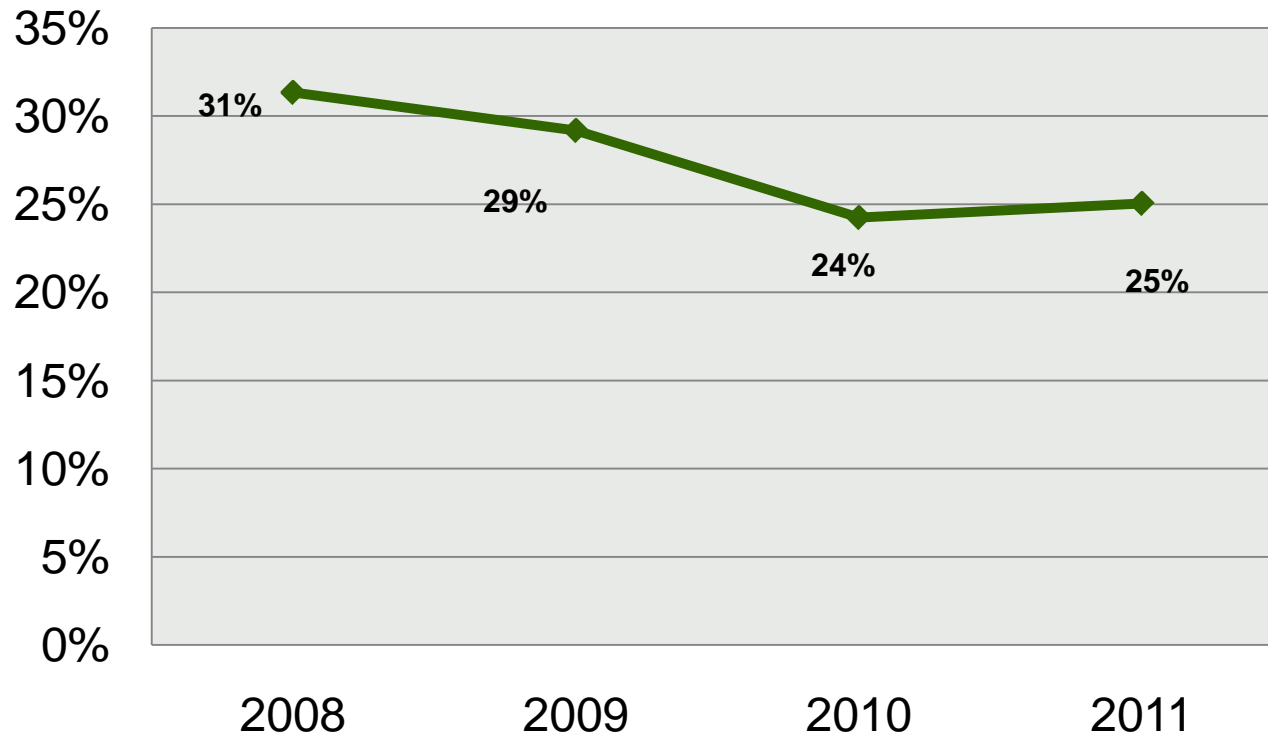


## Fund-raising as a Percentage of Total Functional Expenses

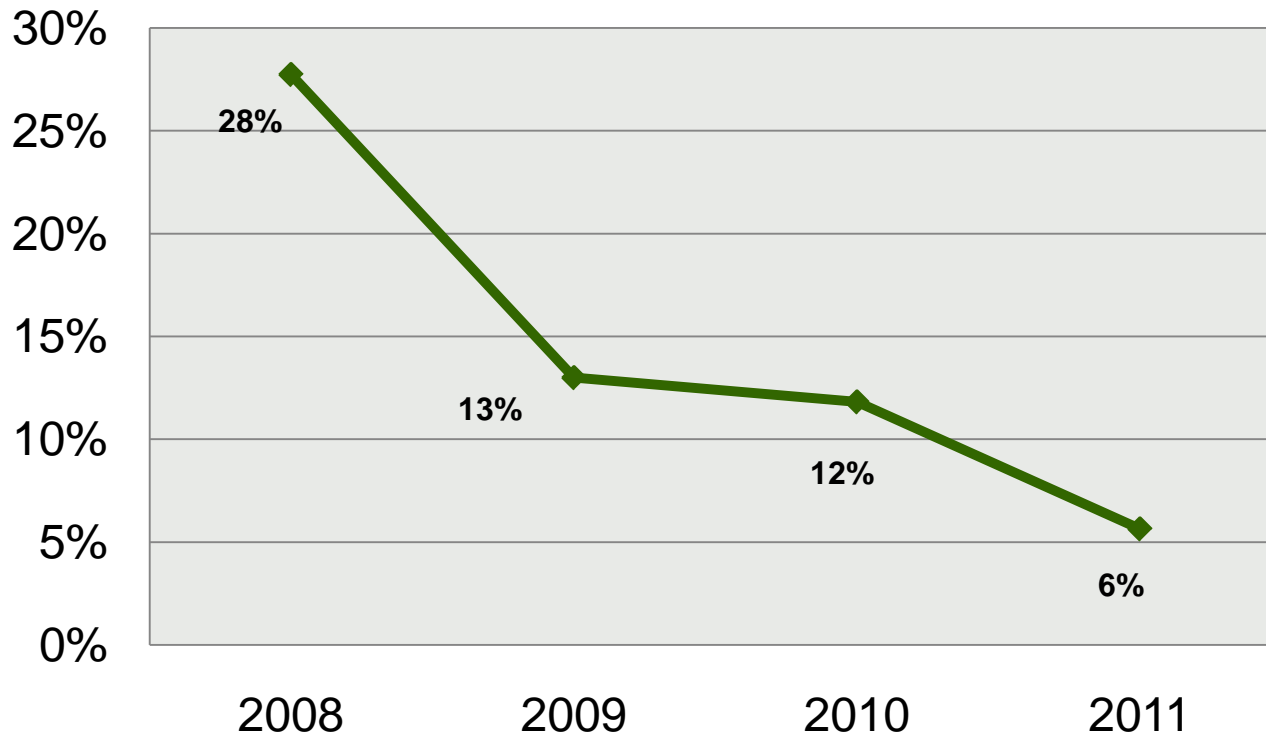


# Overhead Expenses as a Percentage of Total Functional Expenses

(Overhead = General Administration and Fund-raising)



# Fund-raising Expense as a Percentage of Amounts Raised or Contributions





# Questions

Thank You!



*Serving you in two locations*

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