

Converge 2023

Tracking, Reporting, and Understanding Functional Expenses

Presented by:

Mig Murphy Siström, CPA

mig@nonprofitcpa.net

Functional Expenses

All nonprofits have to track expenses by “function” for external reporting. As an internal accountant for your nonprofit, you might wonder:

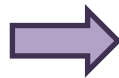
- Why is “functional expenses” such a hot topic?
- What do I need to know in order to ask good questions about functional expense statements?
- What are the rules around presenting various items of cost?
- Is there any useful guidance on cost allocation?

The Big Picture

Expense classifications

Natural category - *WHAT* was purchased

Ex: Salaries, Rent, Supplies



Functional category – *WHY* purchase was

made

Program services

Supporting activities

Functions

- Programs - activities that fulfill the nonprofit’s mission and tax-exempt purpose
- Management and general - activities related to managing the business of a nonprofit, unrelated to the mission or to fundraising
- Fundraising - activities undertaken to raise contributions
- Membership development - includes activities to solicit for prospective members and membership dues, membership relations, and similar activities. If there are no significant benefits to membership, the substance of membership development activities is fundraising.

An organization might have additional supporting functions, such as a thrift store or cafeteria.

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Management & General

FASB definition:

Management and General Activities

Glossary Term Usage

See Topic(s): 958

Supporting activities that are not directly identifiable with one or more program, fundraising, or membership-development activities.

(defined by what it is not)

Matrix of Functional Expenses

	Overnight Shelter	Soup Kitchen	Management & General	Fundraising	Total
Salaries & wages	981,000	577,500	166,500	325,500	2,050,500
Payroll taxes & benefits	226,500	130,500	42,000	73,500	472,500
Contracted services	61,500	19,500	94,500	13,500	189,000
Cost of goods sold	-	2,100	-	14,300	16,400
Payments to national and state affiliates	-	8,600	12,000	4,800	25,400

Depreciation	184,500	264,000	4,500	12,000	465,000
Transaction fees	-	-	9,000	3,000	12,000
Total Expenses	2,965,000	2,247,200	366,000	607,100	6,185,300

Cost Distribution

Why distribute costs?

Because you have to:

- Form 990
- GAAP financial statements

Functional categories:

- Programs

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- Management
- Fundraising

Why distribute costs?

Because you want to (functions vs. activities)

- To demonstrate costs of a program for a grant application
- To maintain funding eligibility
- To determine profit value of a peripheral activity

Designing a System

Designing a system

How the sausage is made

1. Determine final cost classes
2. Determine cost pool classes for shared costs
3. Map initial costs to final cost classes

Step 1: Determine final cost classes

For what purposes will you need cost information?

What cost information will be needed for each purpose?

Examples:

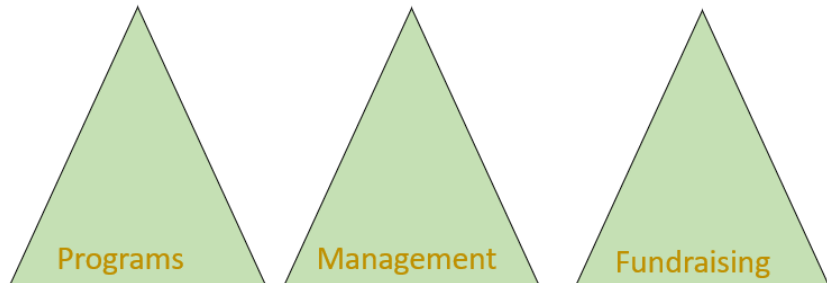
- Form 990
- Annual report
- Grantors
- Internal analysis

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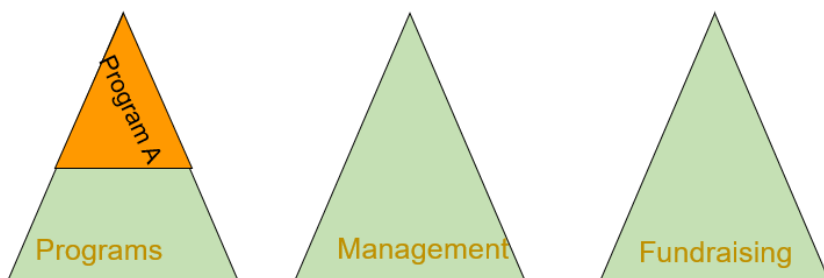
What cost info will be needed?

For Form 990, costs must be divided into three categories.



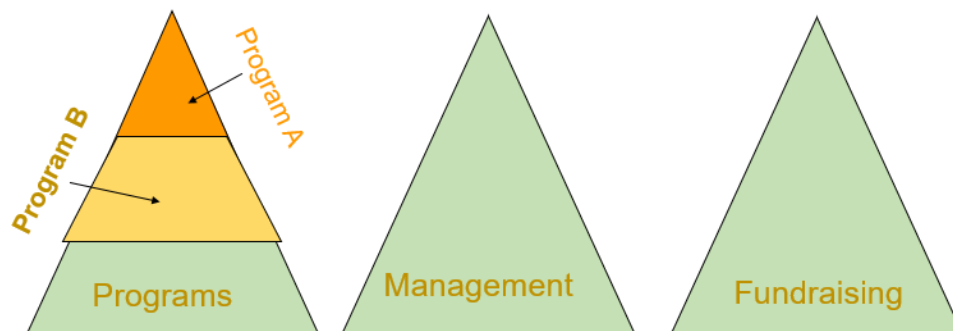
What cost info will be needed?

For Grantor "A," assume Program A costs must be identified separately



What cost info will be needed?

Assume that for internal purposes, Program B costs must be identified separately.



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Final cost classes

Programs

- Program A
- Program B
- Program C

Fundraising

Management

Step 2: Determine indirect cost pools

Segregate costs into 2 broad categories

- Direct costs - costs entirely associated with a particular class
- Indirect costs - costs shared between two or more classes

Determine cost pool classes for indirect costs

Distribution methods for indirect costs

- Assignment - each direct cost is assigned to the specific cost class for which it was incurred
- Allocation - indirect costs are allocated to cost classes based on estimates of the portion of each cost related to each cost class

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Cost drivers examples

<u>Type of Natural Expense</u>	<u>Cost Driver</u>
Copier paper	# copies made
Occupancy (rent, utilities)	# square feet
Staff training & development	# staff members
Office supplies	# FTEs (full-time equivalencies)
Switchboard	# calls
Postage	# pieces mailed

Example: salary costs allocation

Salary = \$120k

Time breakdown:

- Program A - 40%
- Program B - 5%
- Program C - 20%
- Management - 30%
- Fundraising - 5%

Expense breakdown:

- Program A - \$48k
- Program B – 6k
- Program C – 24k
- Management – 36k
- Fundraising – 6k

Typical indirect cost pool classes

Individual staff time for month (ITM)

- Employee benefits
- Payroll taxes
- Salaries & wages

Overall staff time for month (OTM)

- Office supplies

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- Telephone
- Other costs are used in proportion to how the overall staff time is spent during the month the cost is incurred

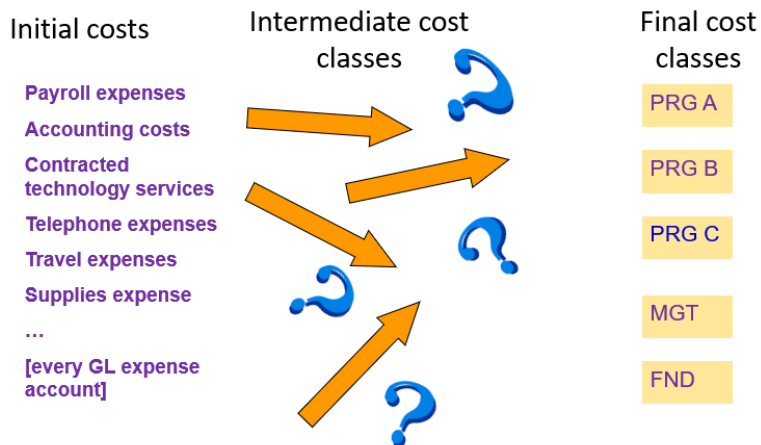
Individual staff time for year (ITY)

- Costs of paid time off

Overall staff time for year (OTY)

- Costs used in proportion to how the overall staff time is spent during the year, such as annual insurance bill, or the costs of a quarterly newsletter

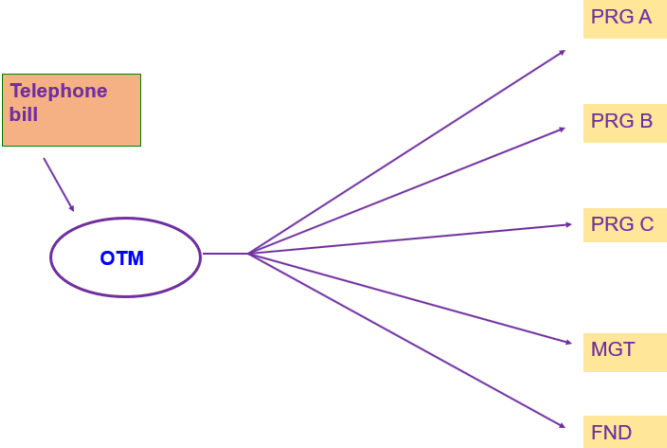
Step 3: Map initial costs to final cost classes



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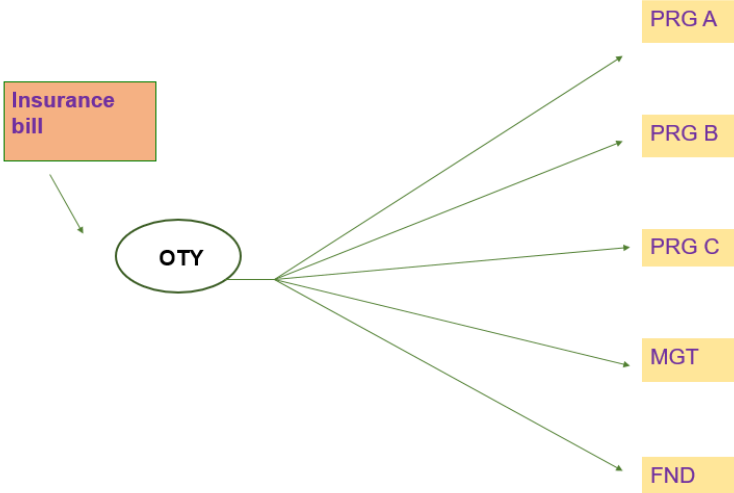
Costs flow map - telephone expenses



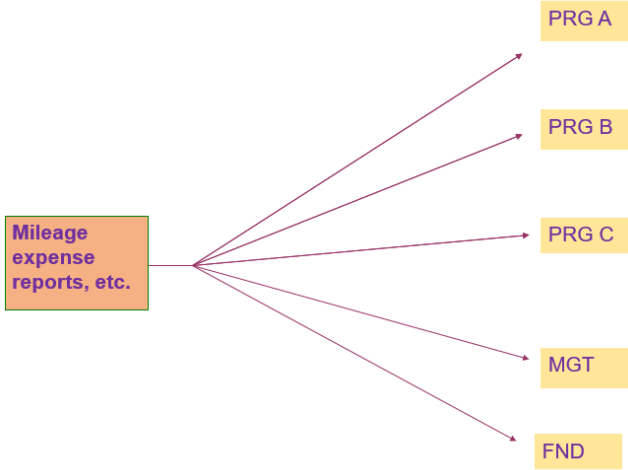
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Costs flow map - workers comp insurance



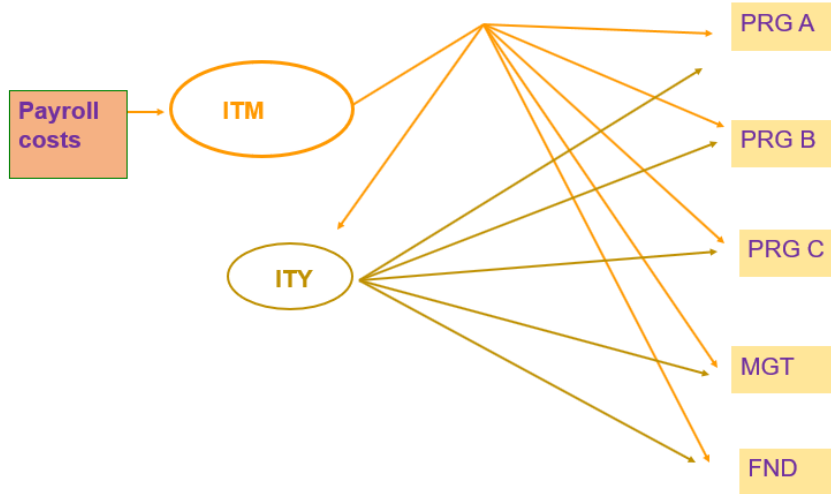
Costs flow map - travel expenses



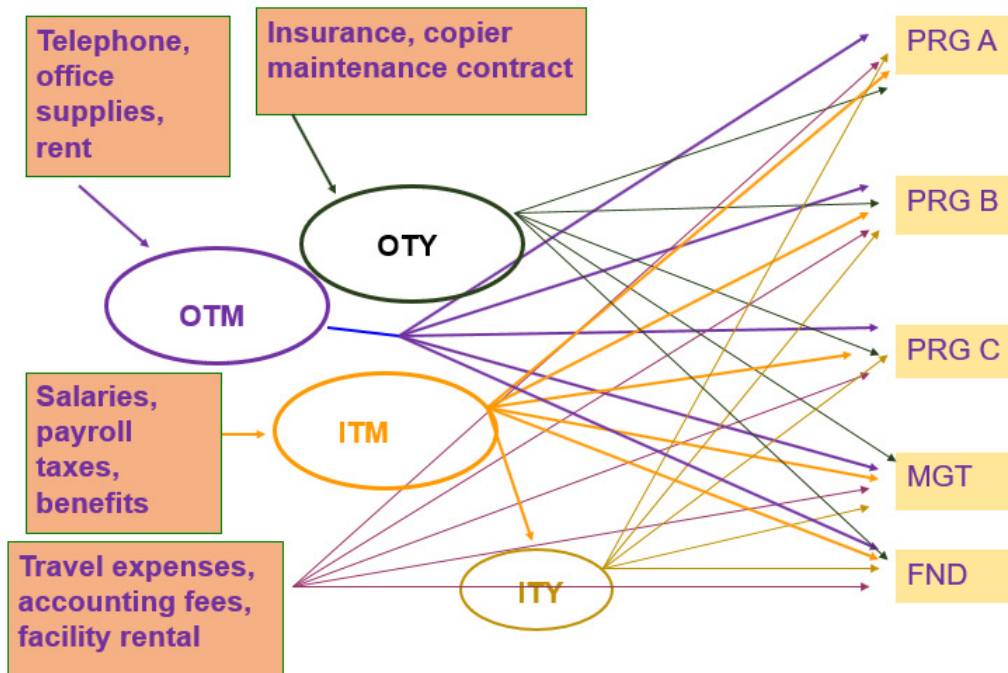
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Costs Flow Map - payroll



The final costs flow map



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Making the cost allocations

- Gather data needed to calculate allocation rates (staff time, square footage, # calls, etc)
- Calculate allocation rates for allocating costs from each cost pool to each final cost class
- Gather costs to be allocated from each GL account in each cost pool
- Calculate the amount of costs to allocate from each GL account in each cost pool to the same GL accounts in the final cost classes
- Make journal entries to drain the cost pools

Presentation of Expenses in Financial Statements

Presentation of Expenses

Old standard:

- All nonprofits were required to report expenses by functional classification; encouraged to also report by natural classification
- Voluntary Health & Welfare Entities required to present statement of functional expenses – matrix showing expenses by natural and functional classification

Current standard

- All nonprofits required to present expenses in a matrix format, showing expenses by both natural and functional classification.

Always

- 501(c)(3)s and 501(c)(4)s required to present statement of functional expenses in Form 990

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Matrix of Functional Expenses

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Statement of Activities

Expenses and Losses

Programs:

Overnight Shelter	2,965,000
Soup Kitchen	2,247,200
Total program expenses	5,212,200

Supporting functions:

Management & General	366,000
Fundraising	607,100
Total supporting functions expenses	973,100

Unallocated payments to affiliates	4,100
Loss on disposal of assets	19,000

Total expenses and losses	6,208,400
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Treatment of Specific Items of Expense

Losses

- Not reported by function
- Losses - costs generated by peripheral or incidental activities or by the environment; largely out of control of the organization

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Start-up costs

- Expensed as incurred
- Organizational costs assigned to the Management and General function
- Other start-up costs sometimes allocable to programs

Advertising costs

- Generally included as a dedicated line in statement of functional expenses
- When expensed, always report as Management & General expense
- Certain advertising costs capitalized rather than expensed - direct-response advertising expected to result in probable future economic benefits
 - “Direct-response advertising” - advertising designed to sell to customers who can be shown to have responded specifically to the advertisement
- Advertising costs never capitalized if the advertisement promotes goods or services provided without charge

Payments to affiliates

- Allocate to the various functions to the extent possible.
- To the extent the costs cannot be reasonably allocated, report as a separate supporting activity.

Volunteer management

- Always Fundraising, regardless of the work the volunteers perform
- Exception: expenses related to the governing board are always Management & General

Interest expense

- Allocate to functions to the extent possible
- Interest expense that can't be associated with a particular function is reported as management & general expense

Investment expenses

- Must be netted against investment income on the statement of activities

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- Excluded from the statement of functional expenses

Cost of goods sold

Several options, depending on whether sales activity is a “major or central activity” or a “peripheral or incidental activity”

- As a line in the statement of functional expenses - might relate to any or all functions
- As a line in the income section of statement of activities
- Netted against related income and presented as a single line

Occupancy costs

- Occupancy costs are not a function unto themselves, but are distributed to the various functions.

Cost of giveaways

- Premiums to prospective donors - fundraising expense
- Premiums in exchange for contributions
 - Fundraising expense if cost is nominal
 - Cost of goods sold if cost is more than nominal

Reductions in amounts charged for goods and services

- If provided in exchange for services, report the price reductions as expenses
- If not in exchange for services, report as expenses only to the extent of incremental cost

Special events

- If the event is a peripheral or incidental activity, may net against event revenue
- If major or ongoing activities, report in the statement of functional expenses; costs of direct benefits to donors may be netted against gross revenues from the event

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Cost Allocation Rules

Cost allocation - Background

Ad hoc => IRS scrutiny => SOP 98-2 => ASU 2016-14

FASB guidance

- ASC 958-720-45-17 – 45-27 - specific items of expense (above)
- ASC 958-720-45 through 55 - allocation methods for joint fundraising costs. Examples of methods:
 - Physical units method
 - Relative direct costs
 - Standalone joint costs

AICPA guidance

AICPA Audit & Accounting Guide, “Not-for-Profit Entities”

- Variety of bases may be used
- Objective methods preferable to subjective methods
- May be based on financial or non-financial data
- Evaluate methods periodically and update rates as appropriate

Federal guidance

Title 2 CFR, Part 230 (f/k/a OMB Circular A-122): Cost Principles for Nonprofit Organizations

principles for determining costs of grants, contracts, and other agreements between federal agencies and nonprofit organizations

- Costs must be allocated based on relative benefits received.
- All costs must be allocated based on consistent methods.
- Personnel costs must be allocated based on reports maintained by each employee that reflect an after-the-fact determination of the actual activity of each employee. Budget estimates do not qualify.

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- Personnel time reports must be prepared at least monthly and must coincide with one or more pay periods.
- <http://federal.elaws.us/cfr/title2.part230>

Black Book

- Legacy guidance
- Useful plain-English guidance for non-accountants
- Can download free or read online at <http://udpertzl.duckdns.org/0787254223-standards-of-accounting-and-financial-reporting-for-voluntary-health-and-welfare-organizations-the-black-book.html>

IRS guidance

Form 990 instructions

- Any reasonable method of allocation is acceptable
- Must report amounts accurately and document method of allocation
- One-line method may be used for 990, but not for GAAP

Impact on the Audit

- Disclosures required by ASU 2016-14 created new exposure for auditors.
- Develop a reasonable allocation method for each expense account that includes shared costs. Document the methods and the rationale for each.
- Document cost allocation calculations and supporting data thoroughly, so auditors can review the source of the functional expense numbers. Examples:
 - Time records
 - Program participation logs (headcount and hours)
 - Scale diagrams of buildings

Functional Expense Reports as a Management Tool

Management Analysis

- More info is better
 - Functional categories
 - Natural categories

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- Functional expenses matrix
- Functional expenses matrix + revenues by function + balance sheet + non-financial data
- Helpful to have the functional expense matrix + revenues by function + balance sheet + non-financial data
- Compare performance against previous periods and against other organizations.

Sample metrics

Indicator	Formula	Meaning	Benchmark
Outcomes cost	$\text{program expense} / \# \text{ units program outcome}$	measures cost of each unit of outcome (ex. cost per animal rescued; cost per worker trained)	lower is better
Fundraising efficiency	$\text{contributions income} / \text{fundraising expense}$	measures income generated from each dollar spent on fundraising	higher is better; less than 1.0 is bad
Event performance ratio	$\text{event contributions} + \text{event income} / \text{event expense}$	measures effectiveness of event costs	at least 3 to 1
Support ratio	$\text{revenue for a given program} / \text{expense for same program}$	measures extent to which a given program is funded by other sources	1 to 1 = self-sufficient program; higher => program is profitable
Program percentage	$\text{total program expenses} / \text{total expenses}$	measures extent to which organization's funds are used for its charitable purpose	more than 70%; higher is better

Hot Topic: "True Cost" Accounting

"True Cost" accounting

- Allocation of overhead costs to programs for purposes of internal analysis:
 - Helps support appeals to funders
 - Helps with decisions about pricing of services, discontinuation of programs, etc,
- This is an additional layer of allocation beyond what is used for GAAP and 990 purposes
- Some cost drivers to associate overhead costs with programs:

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- Amount of fundraising effort (including volunteer management) dedicated to particular programs
- Amount of unrestricted contributions from fundraising efforts consumed by each program
- Portion of human resources effort dedicated to each program
- Portion of accounting costs associated with particular programs
- Problem: not all overhead costs can be associated with programs at all:
 - Fundraising effort that results in unrestricted gifts carried forward to future years
 - Human resources effort devoted to the organization as a whole (ex. selecting and administering benefits plans)
 - Portion of building used for management & general purposes
 - Accounting costs related to the organization as a whole
- Definitive guidance developed by non-accountants
 - <https://www.bridgespan.org/bridgespan/Images/articles/nonprofit-cost-analysis-toolkit/NonprofitCostsAnalysisToolkit.pdf>

Wrap-Up

Questions?

Feel free to contact me:

