

NCACPA Not-for-Profit Accounting Conference 2025

All About Expenses: Functional Expenses and Beyond!

Presented by:

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All About Expenses

You might wonder:

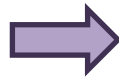
- Why is “functional expenses” such a hot topic?
- What do I need to know in order to ask good questions about functional expense statements?
- What are the rules around presenting various items of cost?
- Is there any useful guidance on cost allocation?

The Big Picture

Expense dimensions

Natural category - *WHAT* was purchased

Ex: Salaries, Rent, Supplies



Functional category – *WHY* purchase was

made

Program services

Supporting activities

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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

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
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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

Functions

- Programs - activities that fulfill the nonprofit's mission and tax-exempt purpose
- Supporting Activities (overhead):
 - 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

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- 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.

Management & General

FASB definition:

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

(defined by what it is not)

Cost Distribution

Why distribute costs?

Because you have to:

- Form 990
- GAAP financial statements

Functional categories:

- Programs
- 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

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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?

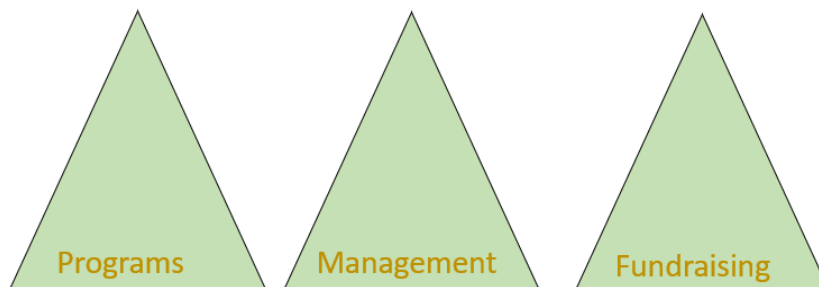
What cost information will be needed for each purpose?

Examples:

- Form 990
- Annual report
- Grantors
- Internal analysis

What cost info will be needed?

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

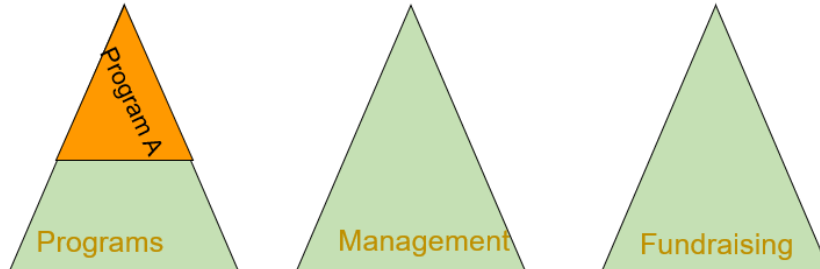


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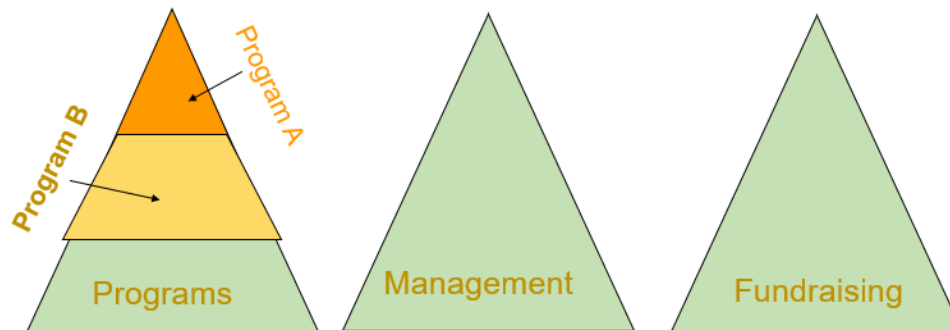
What cost info will be needed?

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.



Final cost classes

Programs

- Program A
- Program B
- Program C

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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 initial 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

Cost drivers examples (not all recommended!)

<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

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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
- 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

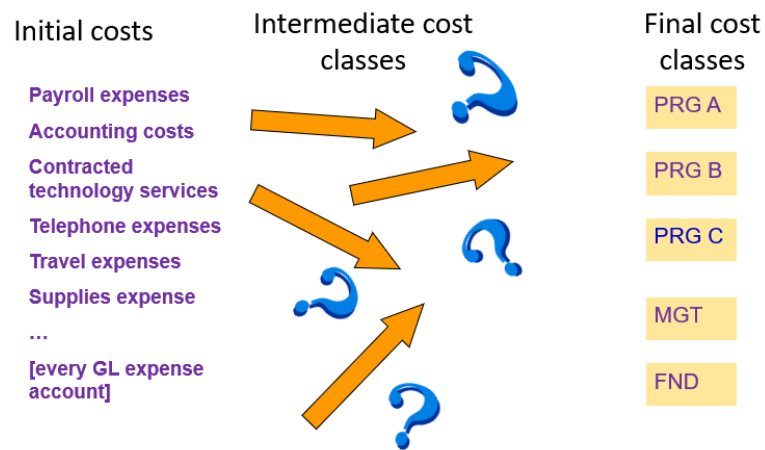
Overall staff time for year (OTY)

- 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

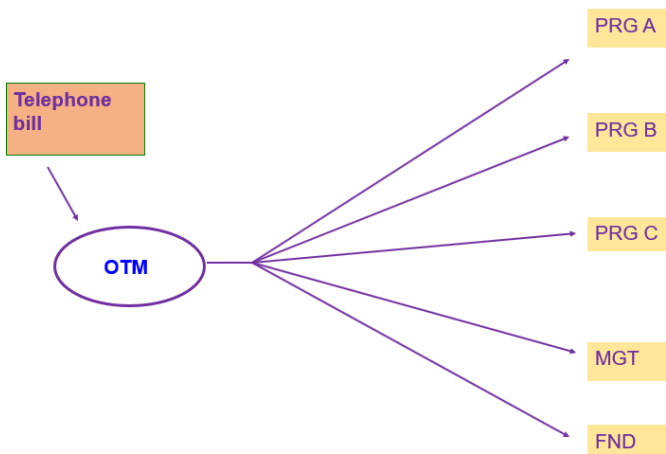
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Step 3: Map initial costs to final cost classes



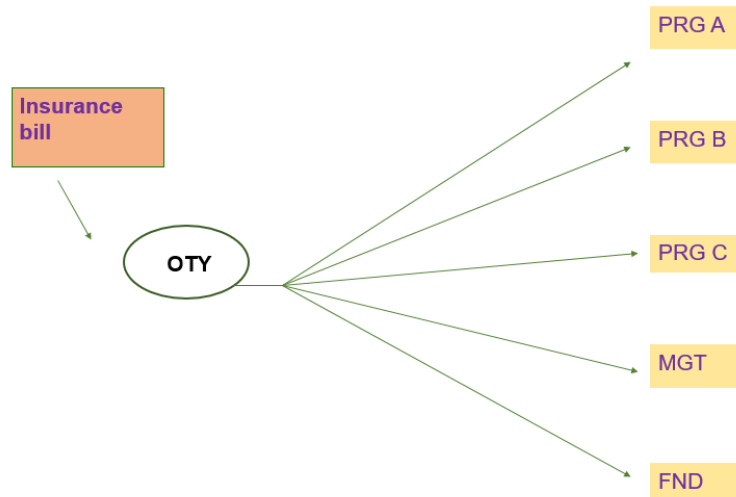
Costs flow map – telephone expenses



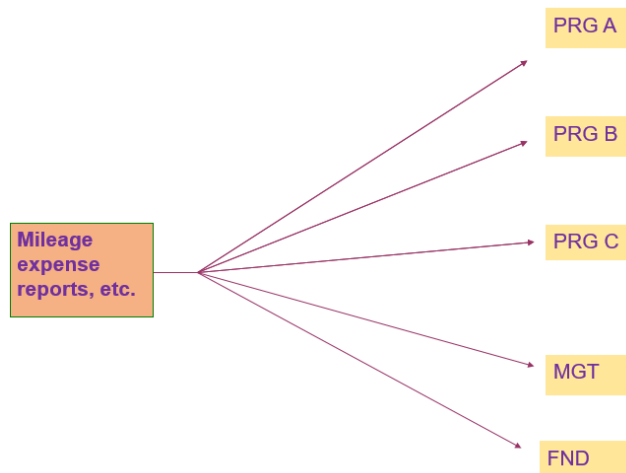
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Costs flow map – workers comp insurance



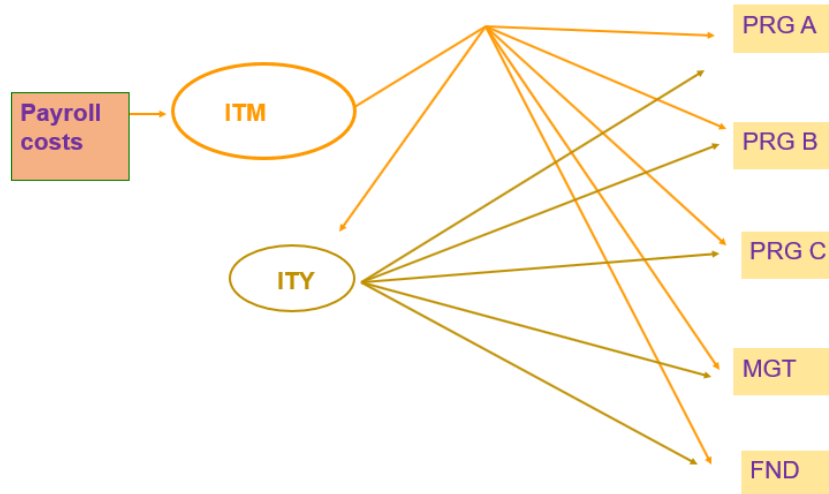
Costs flow map – travel expenses



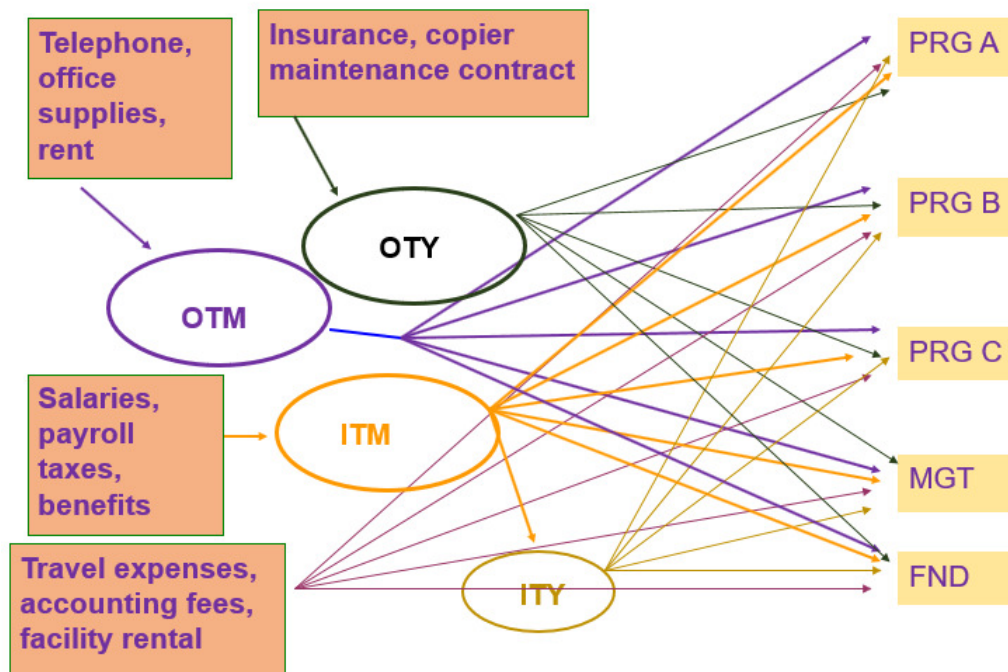
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Costs Flow Map – payroll



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

Gather staff time data needed to calculate allocation rates

- Staff time by class by employee for the month (ITM) – from time logs
- Staff time by class for all employees combined for the month (OTM) – create spreadsheet to combine data from all time logs
- Estimated staff time by class by employee for the year (ITY) – from budget
- Estimated staff time by class for all employees combined for the year (OTY) – from budget

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Staff time data

Source: summary sheet of respective employee's time log for the month

Class	Employee 1	Employee 2	Employee 3	Total overall
Program A	90.00	10.00		100.00
Program B	41.75	98.50		140.25
Program C			23.00	23.00
Management	35.50	24.25	150.00	209.75
Fundraising				-
Total hours worked:	167.25	132.75	173.00	473.00
Holiday hours				-
Paid time off	5.75	40.25		46.00
ITY	5.75	40.25	-	46.00
Total hours paid:	173.00	173.00	173.00	519.00

Calculate allocation rates

For each pool, staff time for a final cost class / all staff time = allocation rate for that final cost class

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Calculation of ITM and OTM formulas

Source: automatically calculated from staff hours by class

Class	Employee 1	Employee 2	Employee 3	Total overall
Program A	52%	6%	0%	19%
Program B	24%	57%	0%	27%
Program C	0%	0%	13%	4%
Management	21%	14%	87%	40%
Fundraising	0%	0%	0%	0%
Total hours worked:	97%	77%	100%	91%
Holiday hours	0%	0%	0%	0%
Paid time off	3%	23%	0%	9%
ITY	3%	23%	0%	9%
Total hours paid:	100%	100%	100%	100%

Gather cost data to be allocated

Amounts to allocate = expenses in each cost pool from the accounting records

Gross pay to allocate

Source: payroll report from accounting system

	Employee 1	Employee 2	Employee 3	Total overall
gross pay:	7,083.33	10,000.00	5,583.33	22,666.67

Calculate amount of indirect costs to allocate to each final cost class

For each pool, the allocation rate for a final cost class x cost to be allocated for a GL account = cost for that GL account to be allocated from the respective cost pool class to the respective final cost class

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Gross pay allocation

Source: automatically calculated from gross pay to allocate x calculation of ITM and OTM formulas

gross pay:	7,083.33	10,000.00	5,583.33	22,666.67
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Class	Employee 1	Employee 2	Employee 3	Total overall
Program A	3,684.97	578.03	-	4,263.01
Program B	1,709.42	5,693.64	-	7,403.06
Program C	-	-	742.29	742.29
Management	1,453.52	1,401.73	4,841.04	7,696.29
Fundraising	-	-	-	-

Total hours worked:	6,847.90	7,673.41	5,583.33	20,104.65
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Holiday hours	-	-	-	-
Paid time off	235.43	2,326.59	-	2,562.02

ITY	235.43	2,326.59	-	2,562.02
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Total hours paid:	7,083.33	10,000.00	5,583.33	22,666.67
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Make a journal entry to drain each cost pool

- Will have a separate journal entry for each cost pool
- For each GL account that has costs in the cost pool, credit the GL account and the cost pool class; and debit the same GL account in the final cost class

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Journal entries to record

Source: automatically calculated from gross pay allocation and FICA allocation

JE#

CREDITS:

Class to credit:	ITM	ITM
GL account to credit:	7010	7210
Amount of credit:	22,666.67 <input type="text"/>	1,677.21 <input type="text"/>

DEBITS:

GL account to debit:	7010	7210
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Class to debit:	gross pay	FICA
Program A	4,263.01	326.12
Program B	7,403.06	566.33
Management	7,696.29	588.77
Fundraising	-	-
Subtotal	19,362.36	1,481.22
ITY	2,562.02	195.99
Total	22,666.67	1,677.21

Cost allocation journal entries

- ITM allocations
 - Salaries
 - Health insurance
 - Taxes
- OTQ allocations
 - Rent
 - Telephone
 - Office Supplies
 - (all office costs and occupancy costs)
- ITY allocations
 - PTO salaries

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- PTO benefits
- PTO taxes

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

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
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Statement of Activities

Expenses and Losses	
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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

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

Fundraising materials

- No need to include as a dedicated line in statement of functional expenses unless amount is significant

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- When expensed, always report as fundraising expense
- Certain costs capitalized rather than expensed – brochures and promotional items expected to result in probable future economic benefits

Fees to United Way, etc.

- Organizations like United Way, Earth Share, etc. are “federated fundraising organizations.” They and certain other fundraising businesses charge for their services.
- Fees paid to them for fundraising services are fundraising expenses, not reductions to revenue.

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
- 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
- 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

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- 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

Options for fundraising events that are major/ongoing activities

Assumptions for following examples:

- Nonprofit has a special event that is an ongoing and major activity with ticket revenue of \$100.
- The activity does not meet the audience criterion to permit allocation of a portion of event costs as program or business management, so all costs of the activity, other than the direct donor benefits, should be reported as fundraising.
- The event includes a dinner that costs the organization \$25 and that has a fair value of \$30.
- The organization incurs other direct costs of the event of \$15 in connection with promoting and conducting the event, including incremental direct costs incurred in

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transactions with independent third parties and the personnel costs for the activities of employees who are directly associated with, and devote time to, the event.

- These other direct costs have been included in fundraising expenses. The other direct costs are unrelated to the direct benefits to donors and, accordingly, should not be included as costs of benefits to donors.
- The other direct costs include \$5 that otherwise might be considered management and general costs if they had been incurred in a different activity, and fundraising costs of \$10.
- The organization has the following transactions, which are unrelated to the special event:
 - Contributions without donor restrictions of \$200
 - Program expenses of \$60
 - Management and general expenses of \$20
 - Fundraising expenses of \$20.

Special events - option A:

We may report gross revenues of special events and other fundraising activities with the cost of direct benefits to donors (ex. meals and facilities rental) displayed as a reduction in special event revenues.

Changes in net assets without donor restrictions:

Contributions		\$ 200
Special event revenue	100	
Less: Costs of direct benefits to donors	(25)	
Net revenues from special events		<u>75</u>
Contributions and net revenues from special events		<u>275</u>
Other expenses:		
Program		60
Management and general		20
Fundraising		<u>35</u>
Total other expenses		<u>115</u>
Increase in net assets without donor restrictions		<u><u>\$ 160</u></u>

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Special events – option B:

We may report gross revenues of special events and other fundraising activities with the cost of direct benefits to donors displayed in the same section of the income statement as are other programs or supporting services and allocated, if necessary, among those various functions

Changes in net assets without donor restrictions:

Revenues:

Contributions	\$ 200
Special event revenue	100
Total revenues	<u>300</u>

Expenses:

Program	60
Costs of direct benefits to donors	25
Management and general	20
Fundraising	35
Total other expenses	<u>140</u>

Increase in net assets without donor restrictions	<u>\$ 160</u>
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Special events – option C:

We may report gross revenue from special events and other fundraising activities as part exchange and part contribution.

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Changes in net assets without donor restrictions:

Contributions		\$ 270
Dinner sales	30	
Less: Costs of direct benefits to donors	<u>(25)</u>	
Gross profit on special events		<u>5</u>
Contributions and net revenues from special events		<u>275</u>
Other expenses:		
Program		60
Management and general		20
Fundraising		<u>35</u>
Total other expenses		<u>115</u>
Increase in net assets without donor restrictions		<u><u>\$ 160</u></u>

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

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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.
- 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

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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
 - 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.

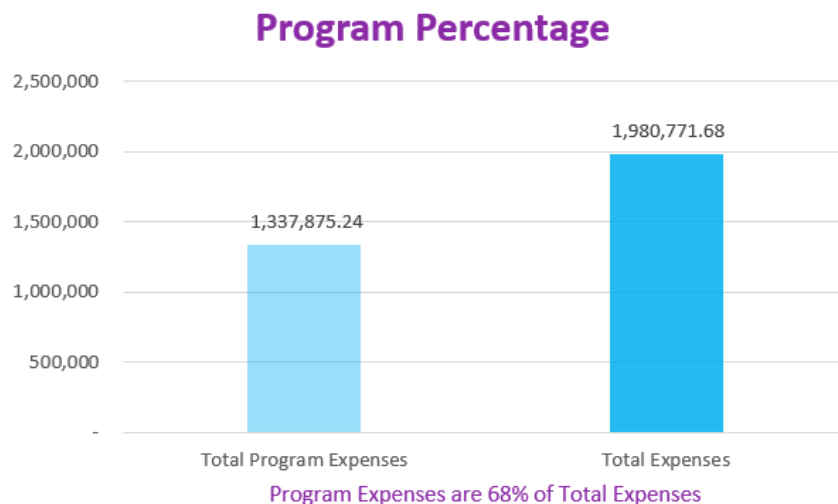
Sample metrics

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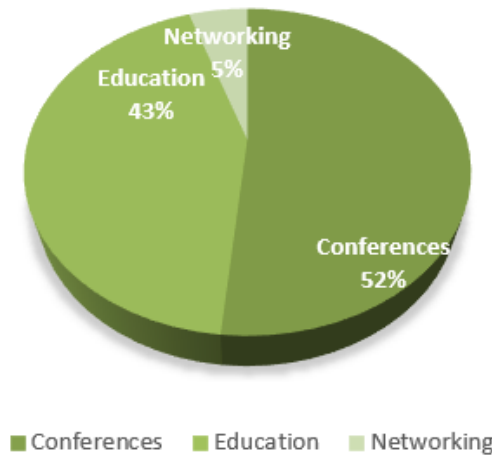
Indicator	Formula	Meaning	Benchmark
Outcomes cost	$\text{program expense} / \# \text{ units program outcome}$	measures cost of each unit of outcome (ex. cost per animal rescued; cost per worker trained)	lower is better
Fundraising efficiency	$\text{contributions income} / \text{fundraising expense}$	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

Sample graphics to include in dashboard

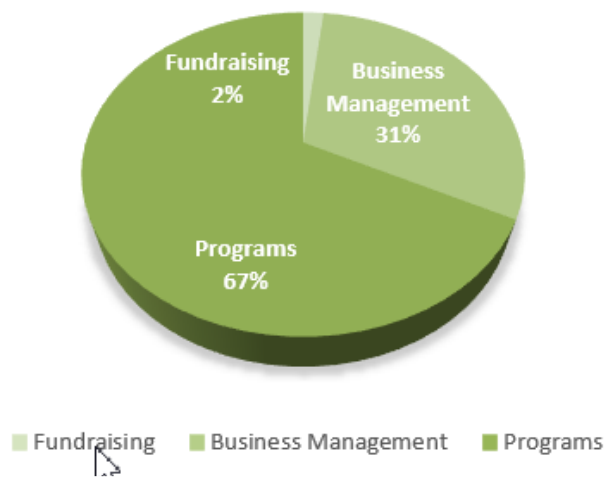


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Total Program Expenses by Program

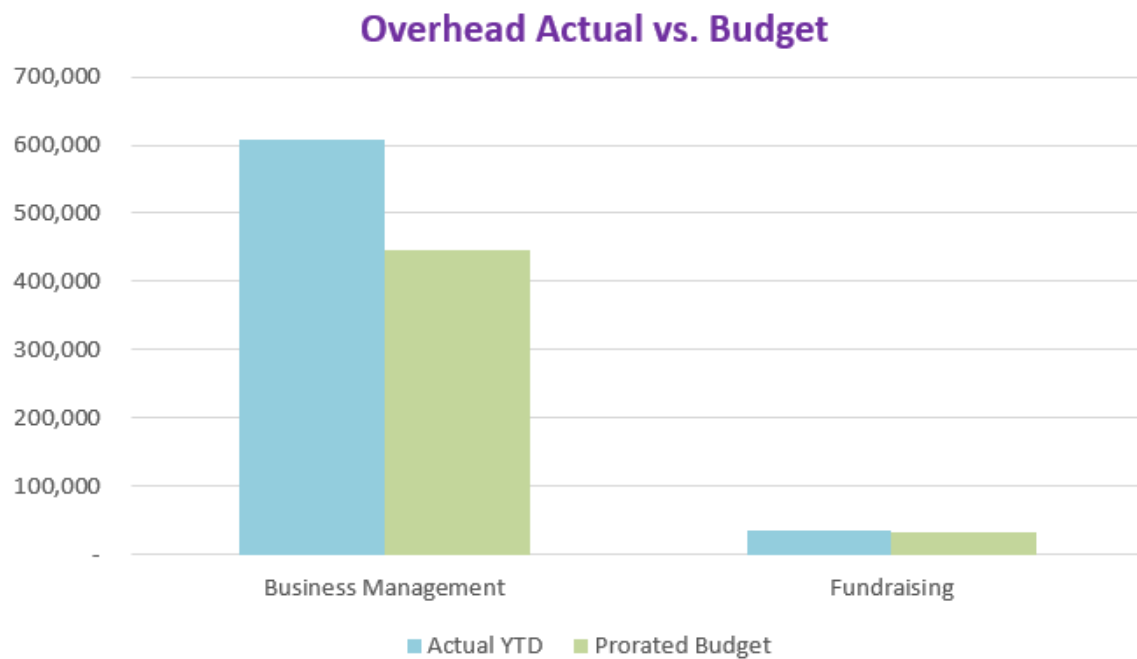
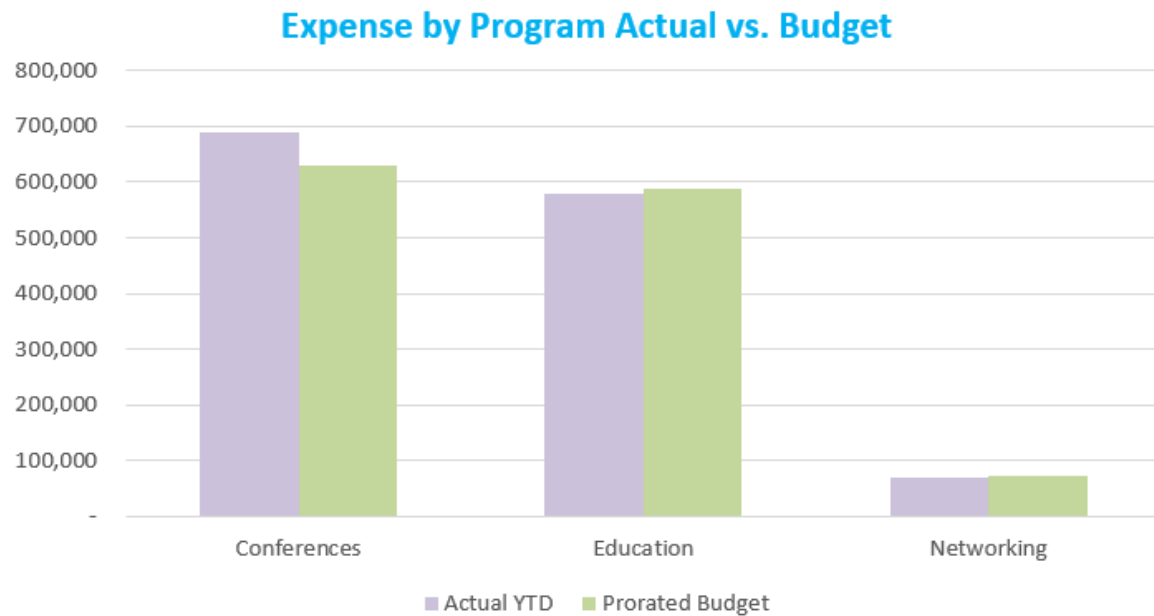


Expense by Activity



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Hot Topic: “True Cost” Accounting

“True Cost” accounting

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- 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:
 - 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 to 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>

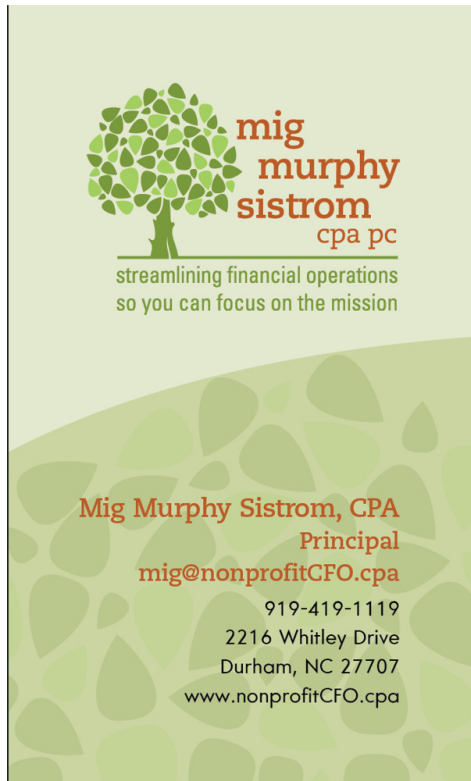
NCACPA Not-for-Profit Accounting Conference 2025

All About Expenses: Functional Expenses and Beyond!

Wrap-Up

Questions?

Feel free to contact me:



Note: phone is not monitored – email is best!