

All About Expenses for Nonprofits

Functional Expenses and Beyond!



All About Expenses



- 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?
- Is this going to be boring?

Functional Expenses

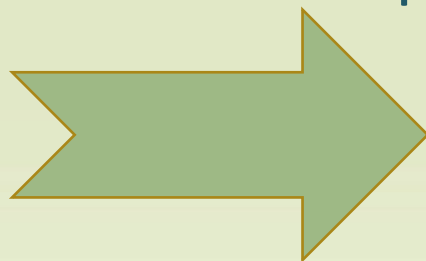
The Big Picture



Expense Dimensions

Natural category - *WHAT*
was purchased

*Ex: Salaries, Rent,
Supplies*



Function – *WHY*
purchase was made

- *Program services*
- *Supporting activities*



Statement of Activities

Expenses and Losses

Programs:

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

Management & General	366,000
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Fundraising	607,100
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Total supporting functions expenses	973,100
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Unallocated payments to affiliates	4,100
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Loss on disposal of assets	19,000
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Total expenses and losses	6,208,400
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Matrix of Functional Expenses

	Overnight Shelter	Soup Kitchen	Total Programs	Management & General	Fundraising	Total
Salaries & wages	981,000	577,500	1,558,500	166,500	325,500	2,050,500
Payroll taxes & benefits	226,500	130,500	357,000	42,000	73,500	472,500
Contracted services	61,500	19,500	81,000	94,500	13,500	189,000
Cost of goods sold	-	2,100	2,100	-	14,300	16,400
Payments to national and state affiliates	-	8,600	8,600	12,000	4,800	25,400
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Total Expenses	2,965,000	2,247,200	5,212,200	366,000	607,100	6,185,300

Functions

- Programs – activities that fulfill mission and tax-exempt purpose
- Supporting Functions – activities ancillary to mission, but essential for operation of organization
 - Management & General – purpose is to manage the business of the organization (ex: accounting, human resources, board of directors)
 - Fundraising – purpose is to raise contributions
 - Membership Development – purpose is to solicit members, manage member relations, etc.
 - [other supporting functions are permissible]

“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.



Functional Expenses

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



Functional Expenses

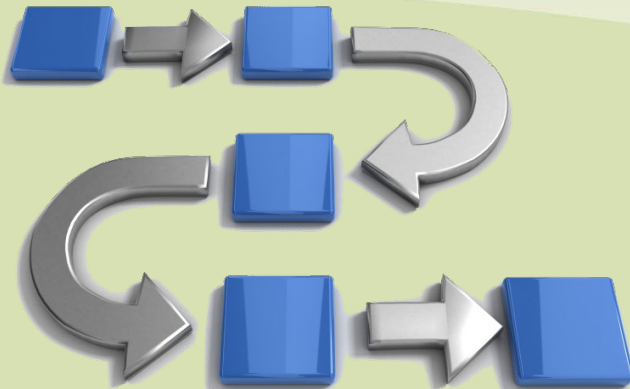
Designing a system



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?



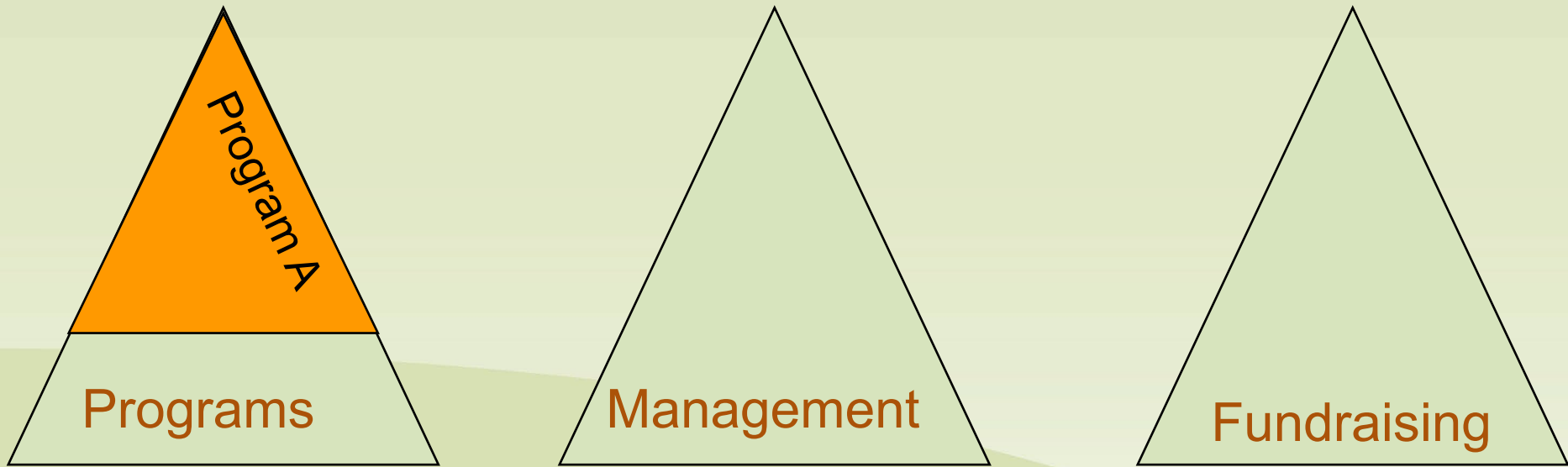
Programs

Management

Fundraising

For Form 990, costs must be divided into 3 categories.

What cost info will be needed?



For Grantor “A,” Program A costs must be identified separately

What cost info will be needed?



For internal purposes, Program B costs must be identified separately

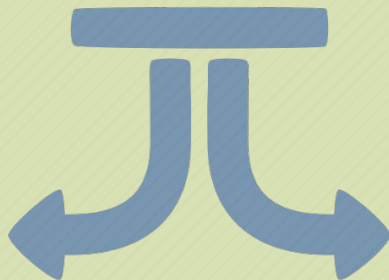
Final cost classes

- Programs
 - Program A
 - Program B
 - Program C
- FND - Fundraising
- MGT - Management



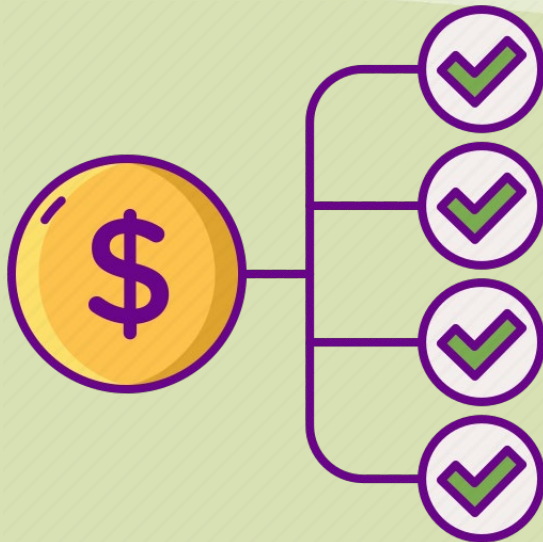
Step 2: Determine indirect cost pools

- 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 (not all ideal)

Type of Natural Expense

Cost Driver

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

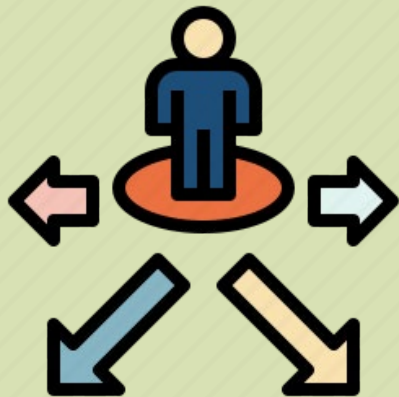
Executive Director salary \$120k

- Time breakdown:

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

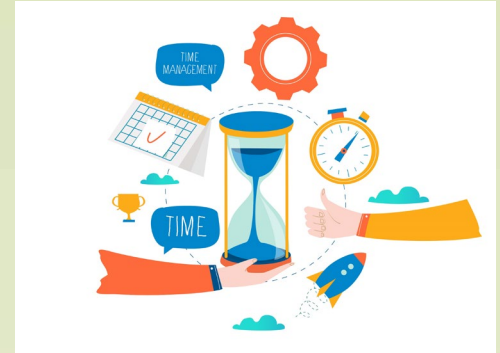
- Expense breakdown:

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

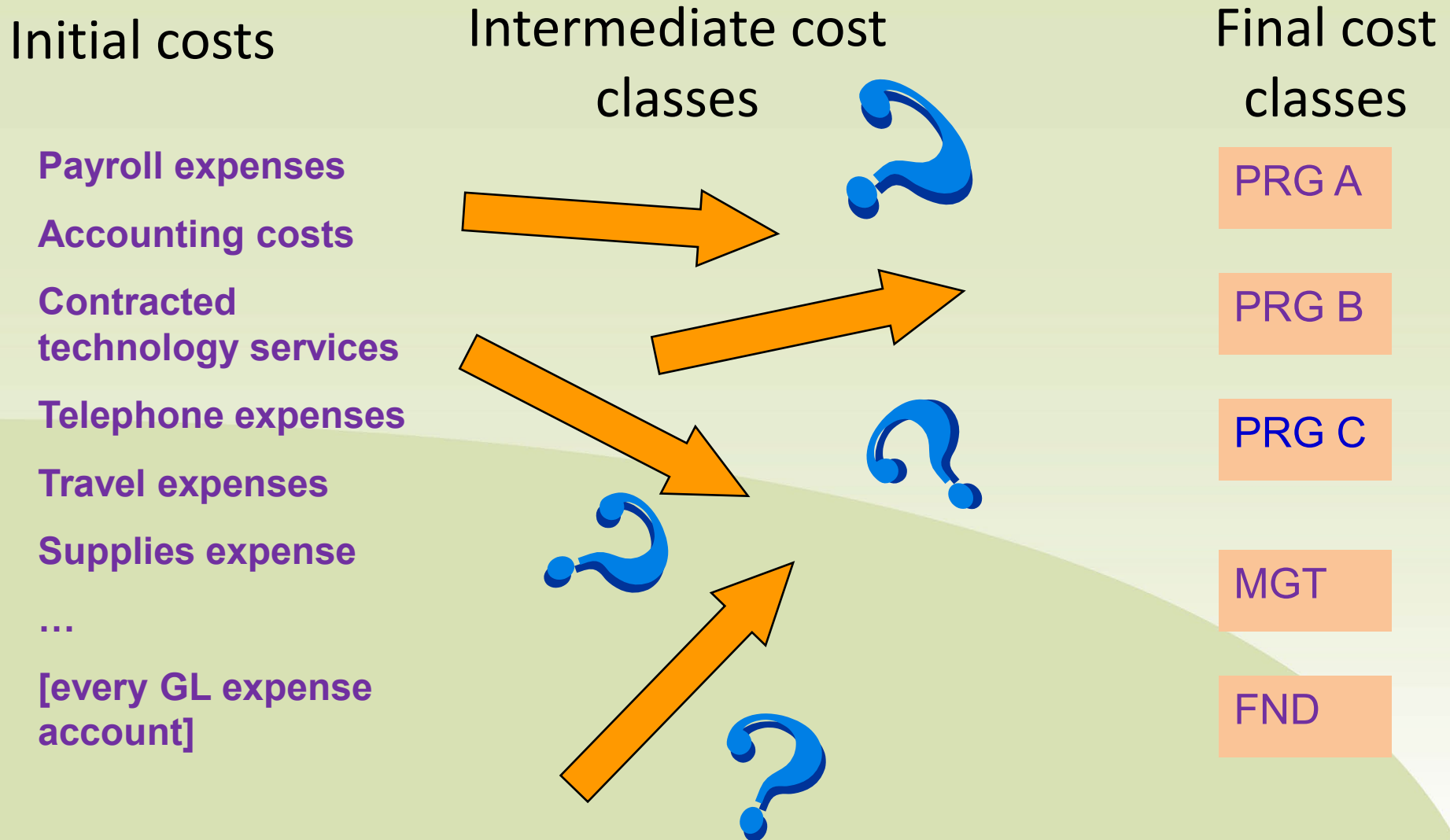


Typical indirect cost pool classes

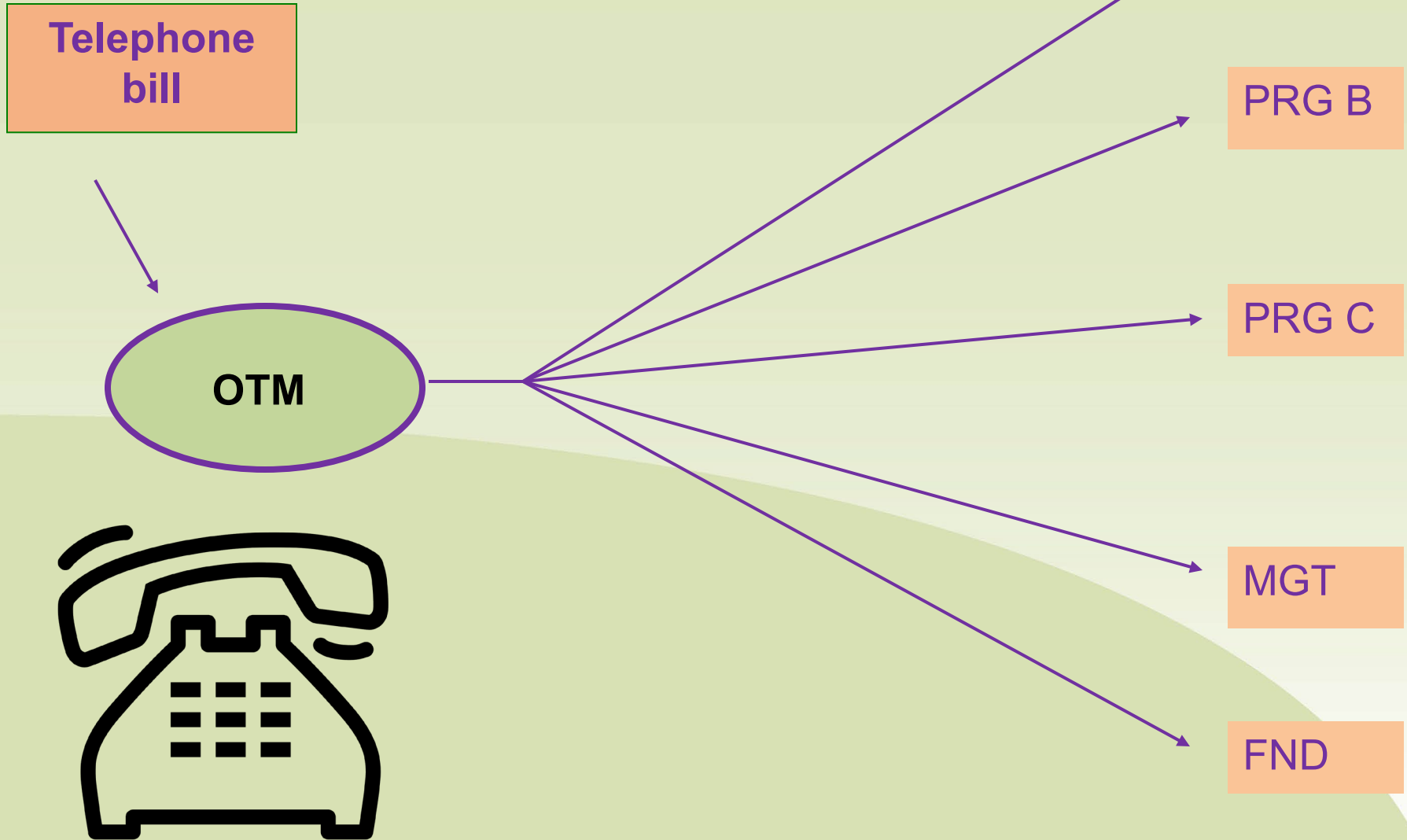
- Individual staff time for month (ITM)
 - Employee benefits
 - Payroll taxes
 - Salaries & wages
- Overall staff time for month (OTM)
 - Office supplies
 - Telephone
 - Other costs are used in proportion to how the overall staff time is spent during the month the cost is incurred
- Individual staff 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



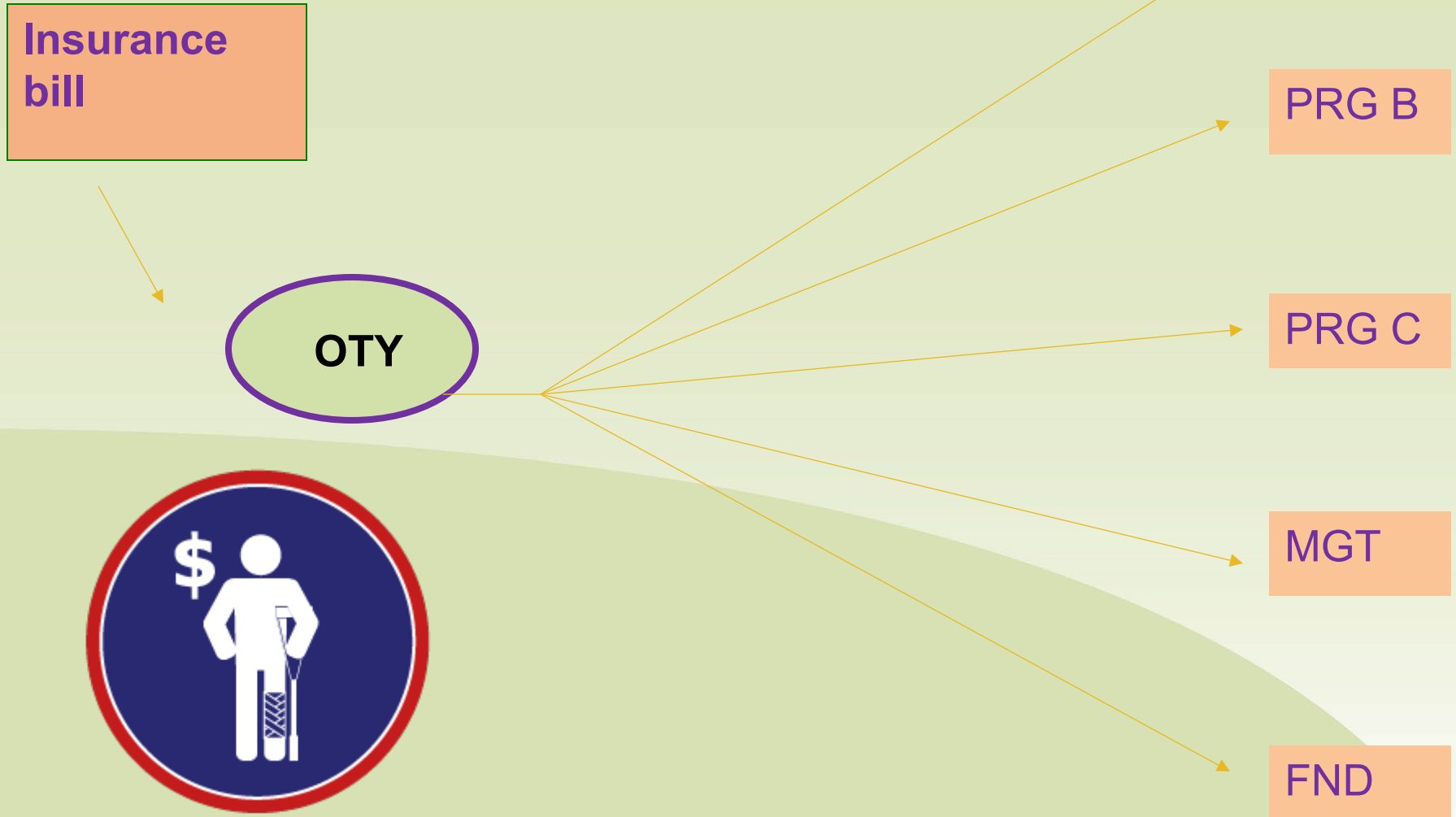
Step 3: Map initial costs to final cost classes



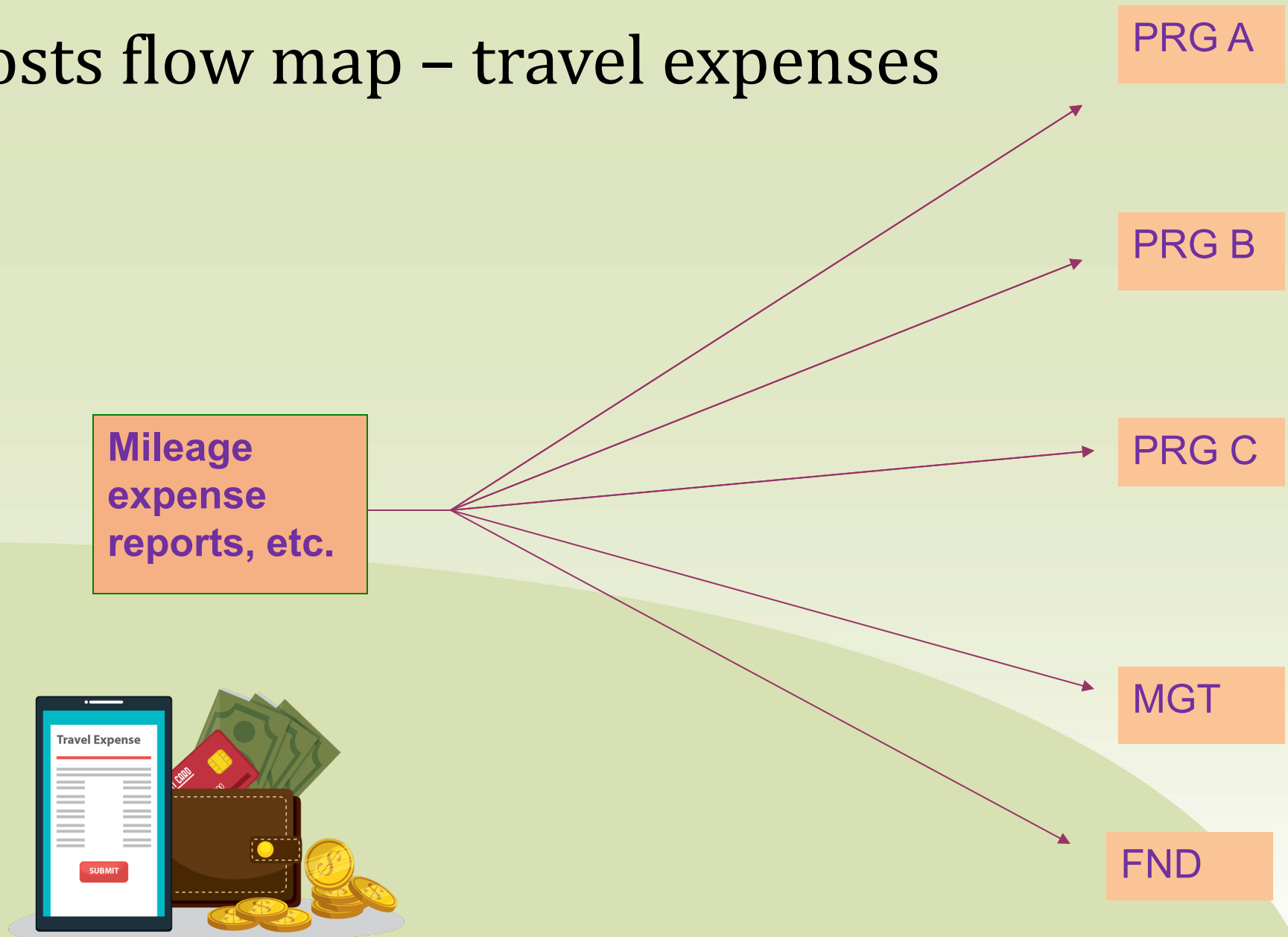
Costs flow map – telephone expenses



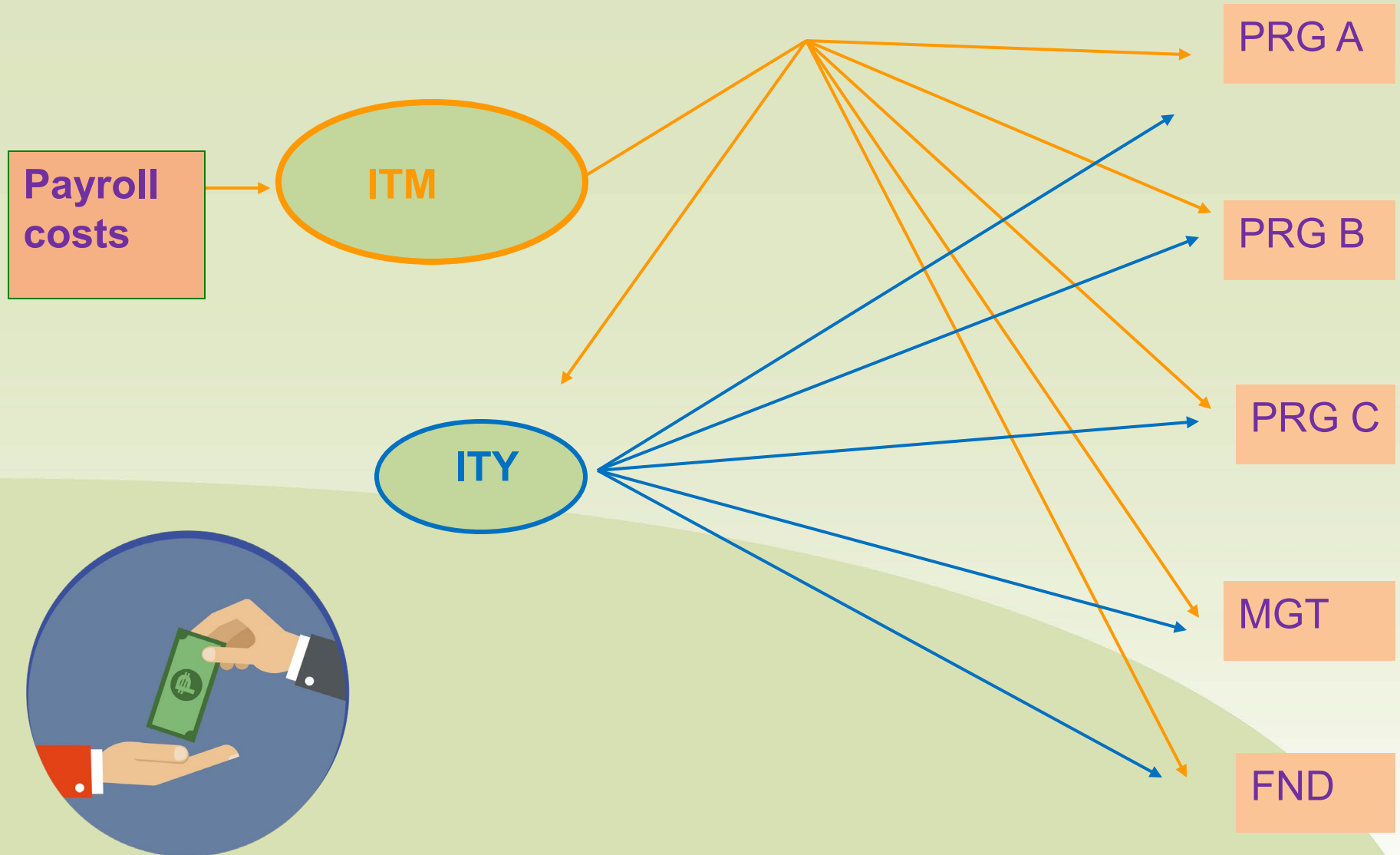
Costs flow map – workers' comp insurance



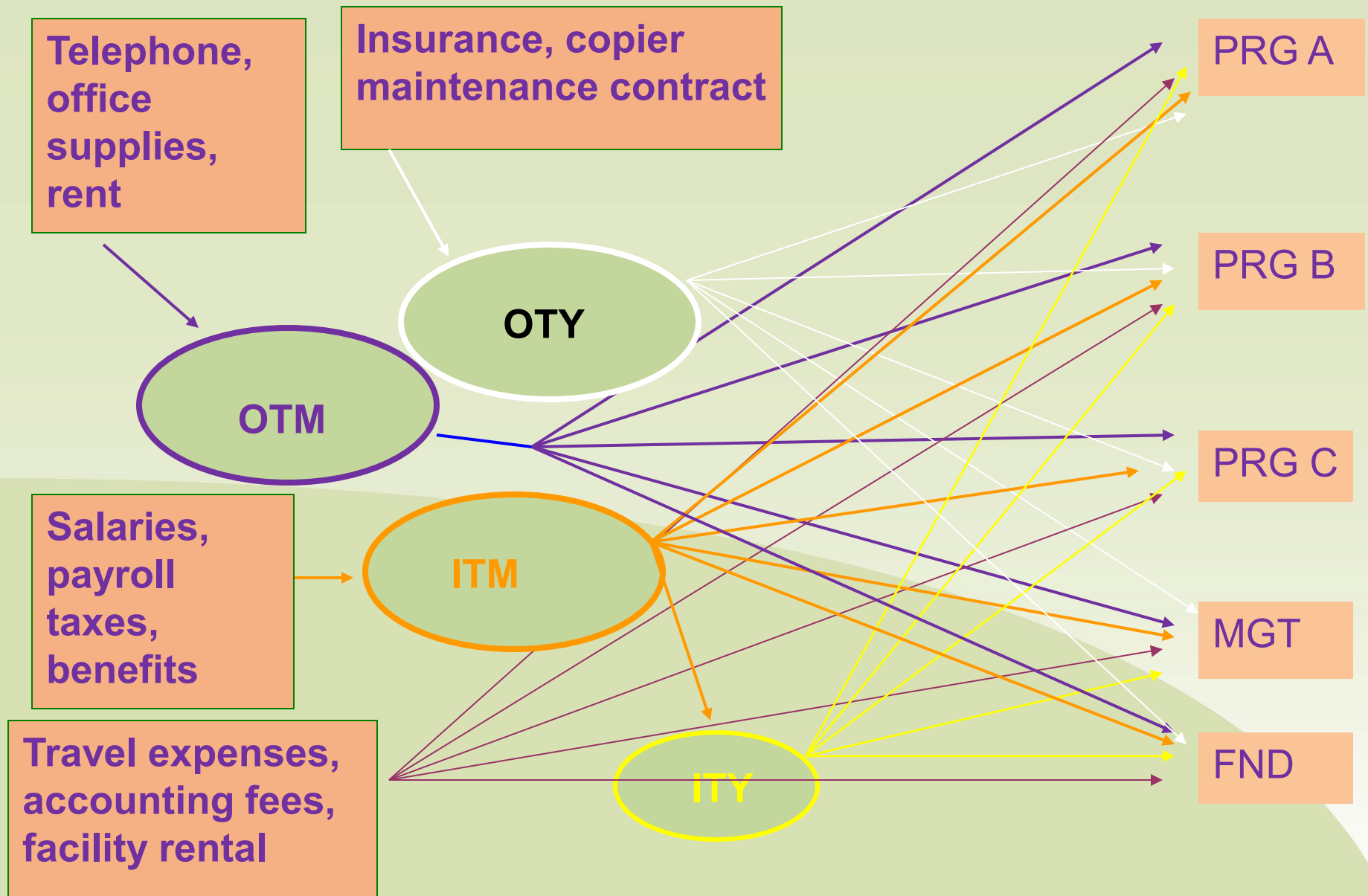
Costs flow map – travel expenses



Costs Flow Map – payroll



The final costs flow map



Making the cost allocations

1. Gather data needed to calculate allocation rates (staff time, square footage, # calls, etc.)
2. Calculate allocation rates for allocating costs from each cost pool to each final cost class
3. Gather costs to be allocated from each GL account in each cost pool
4. 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
5. 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

Staff time data

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

Allocation rates

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%
<i>Total hours worked</i>	97%	77%	100%	91%
Holiday hours	0%	0%	0%	0%
Paid time off	3%	23%	0%	9%
ITY	3%	23%	0%	9%
<i>Total hours paid:</i>	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

***Sample Nonprofit
Payroll Allocation Workbook
Gross Pay to Allocate
September 2016***

	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 \times 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

Gross pay allocation

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	-	-	-	-
	6,847.90	7,673.41	5,583.33	20,104.65
Holiday hours	-	-	-	-
Paid time off	235.43	2,326.59	-	2,562.02
ITY	235.43	2,326.59	-	2,562.02
	7,083.33	10,000.00	5,583.33	22,666.67

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

Journal entries to record

	JE#		
CREDITS:			
	Class to credit:	ITM	ITM
	GL account to credit:	7010	7210
	Amount of credit:	22,666.67	1,677.21
DEBITS:			
	GL account to debit:	7010	7210
	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
 - PTO benefits
 - PTO taxes

Functional Expenses

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 (ASU 2016-14)
 - 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	Total Programs	Management & General	Fundraising	Total
Salaries & wages	981,000	577,500	1,558,500	166,500	325,500	2,050,500
Payroll taxes & benefits	226,500	130,500	357,000	42,000	73,500	472,500
Contracted services	61,500	19,500	81,000	94,500	13,500	189,000
Cost of goods sold	-	2,100	2,100	-	14,300	16,400
Payments to national and state affiliates	-	8,600	8,600	12,000	4,800	25,400
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Total Expenses	2,965,000	2,247,200	5,212,200	366,000	607,100	6,185,300

Statement of Activities

Expenses and Losses

Programs:

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

Management & General	366,000
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Fundraising	607,100
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Total supporting functions expenses	973,100
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Unallocated payments to affiliates	4,100
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Loss on disposal of assets	19,000
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Total expenses and losses	6,208,400
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Beyond Functional Expenses

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

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



Startup Costs

- Expensed as incurred
- Organizational costs assigned to the management and general function
 - Incorporation, tax exemption, etc.
- Other start-up costs sometimes allocable to programs.
 - Examples:
 - New facility
 - New service
 - New class of customer

Advertising Costs

- Generally include as a dedicated line in statement of functional expenses
- When expensed, always report as management & general expense
- Certain costs capitalized rather than expensed – “direct-response advertising” expected to result in probable future economic benefits
- Advertising costs never capitalized if the advertisement promotes goods or services provided without charge



Fundraising Materials

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

	Overnight Shelter	Soup Kitchen	Total Programs	Management & General	Fundraising	Total
Salaries & wages	981,000	577,500	1,558,500	166,500	325,500	2,050,500
Payroll taxes & benefits	226,500	130,500	357,000	42,000	73,500	472,500
Contracted services	61,500	19,500	81,000	94,500	13,500	189,000
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Total Expenses	2,965,000	2,247,200	5,212,200	366,000	607,100	6,185,300

- To the extent not allocable, report as a separate supporting activity on income statement

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

Volunteer Management

- The costs of recruiting and managing volunteers (other than the governing board) are always fundraising expenses.
- All costs related to the governing board are business management (“management & general”) expenses.



Interest Expense

- Allocate to functions to the extent possible
- Report as management & general expense if can't be allocated



Investment Expense

- Must be netted against investment income on the statement of activities
- Excluded from the matrix presentation of functional expenses



Cost of Goods Sold

Treatment depends on nature of sales activity

- Major or central activity – present COGS as a component of expense or displayed immediately after sales income.
- Peripheral or incidental activity – present COGS as a component of expense or may (optionally) net COGS against related income

(Consistent with general principle that revenues and expenses are presented at gross amounts)

Cost of Goods Sold

Option 1: a line in the statement of functional expenses

	Overnight Shelter	Soup Kitchen	Total Programs	Management & General	Fundraising	Total
Salaries & wages	981,000	577,500	1,558,500	166,500	325,500	2,050,500
Payroll taxes & benefits	226,500	130,500	357,000	42,000	73,500	472,500
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Cost of goods sold	-	2,100	2,100	-	14,300	16,400
Payments to national and state affiliates	-	8,600	8,600	12,000	4,800	25,400
<hr/>						
Total Expenses	2,965,000	2,247,200	5,212,200	366,000	607,100	6,185,300

This presentation is always acceptable.

Cost of Goods Sold

Option 2: a component of gross revenue in the income statement

Sales	143,000
Cost of goods sold	(16,400)
Gross revenue	<u>126,600</u>

Other support and revenue

Cash contributions	1,641,000
In-kind contributions	135,000

Appropriate if sale of goods is a major or central activity.

Cost of Goods Sold

Option 3: netted against revenue in the income statement

Support and Revenues

Cash contributions	1,641,000
In-kind contributions	135,000
Grants	4,600,000
Sales, net of cost of goods sold of \$16,400	126,600
Registration fees	21,000
Interest and other income	10,500

Total support and revenues	<u>6,534,100</u>
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Acceptable only if the activity is peripheral or incidental

Occupancy Costs

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



Giveaways

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



Reductions in Amounts Charged

- If provided in exchange for services, report the price reductions as expenses

	<u>Debit</u>	<u>Credit</u>
Web design services expense	\$600	
Workshop fees revenue		\$600

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

Special Events



- Peripheral or incidental activity - may net against event revenue
- Major or ongoing activity - 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

Assumptions:

- 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 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

Changes in net assets without donor restrictions:

Contributions		\$ 200
Special event revenue	100	
Less: Costs of direct benefits to donors	<u>(25)</u>	
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>

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

Special Events – Option B

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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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

Special Events – Option C

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>

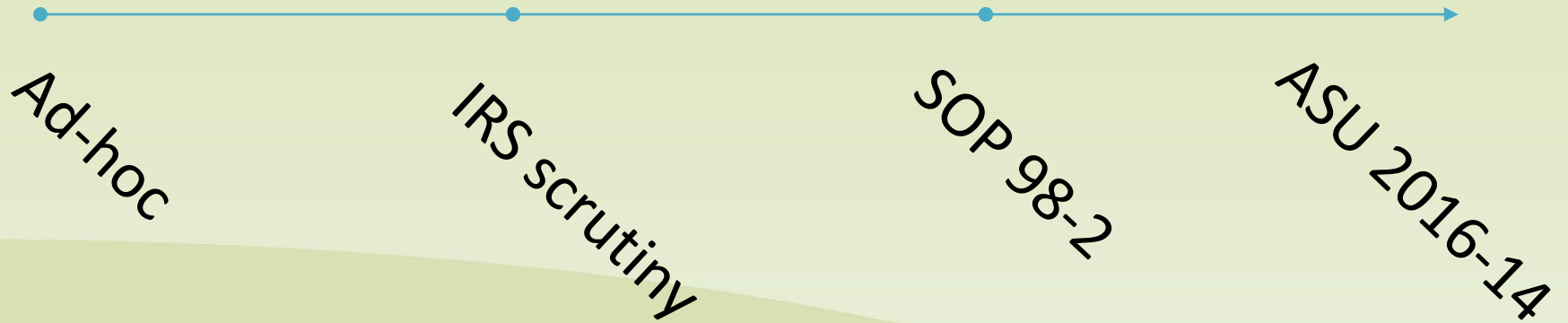
may report gross revenue from special events and other fundraising activities as part exchange and part contribution

Beyond Functional Expenses

Cost Allocation Rules



Cost Allocation - Background



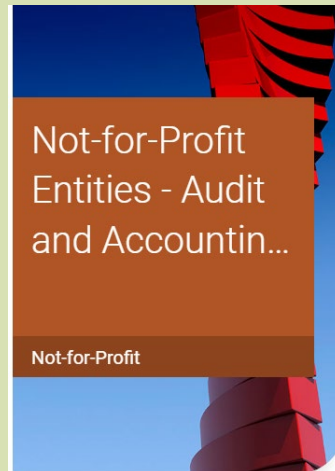
Guidance on Cost Allocation: FASB

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



Guidance on Cost Allocation: AICPA

- 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



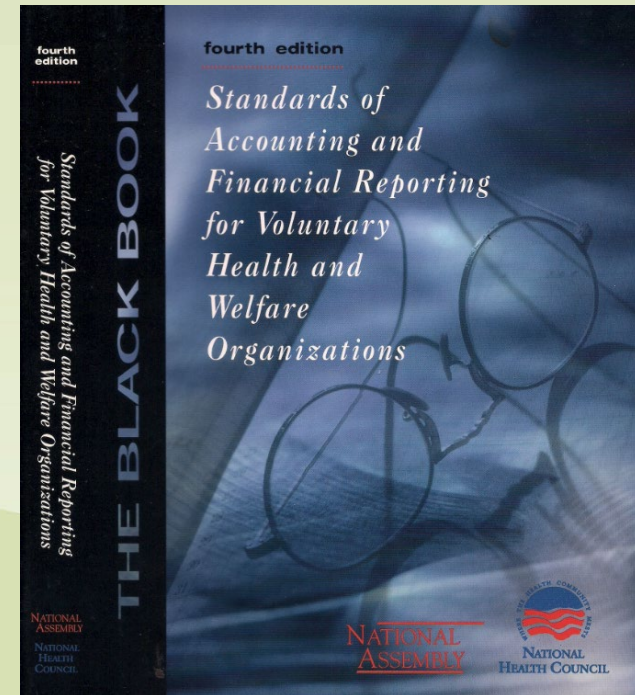
Guidance on Cost Allocation: Federal Cost Principles

Cost Principles for Non-Profit Organizations (f/k/a OMB Circular A-122)

- Allocate costs based on relative benefits to each function (i.e. not ability to bear, etc.)
- Use consistent methods (similar costs allocated same way)
- Use actual time records to allocate personnel costs
 - Not budgeted time
 - Not time for a sample period
- Prepare time reports at least monthly to coincide with one or more pay periods

Guidance on Cost Allocation: Black Book

- Black Book
 - Legacy guidance
 - Plain English
 - Key cost allocation points:
 - Activity-based costing
 - Identifying cost drivers
 - Staff time records



Guidance on Cost Allocation: IRS

- Form 990 instructions

2024

**Instructions for Form 990
Return of Organization
Exempt From Income Tax**



- 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

Beyond Functional Expenses

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
- Compare performance across time and across organizations

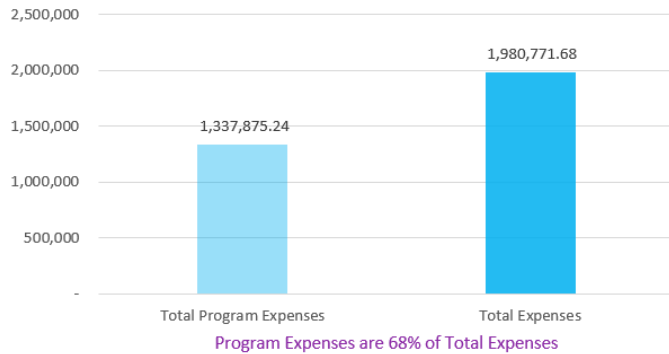


Useful Expense Metrics

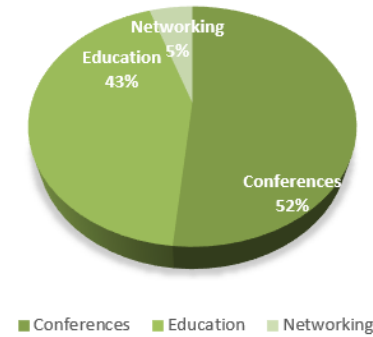
Indicator	Formula	Meaning	Benchmark
Outcomes cost	$\text{program expense} / \# \text{ units program outcome}$	measures cost of each unit of outcome (ex. cost per animal rescued; cost per worker trained)	lower is better
Fundraising efficiency	$\text{contributions income} / \text{fundraising expense}$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

Expenses Dashboard

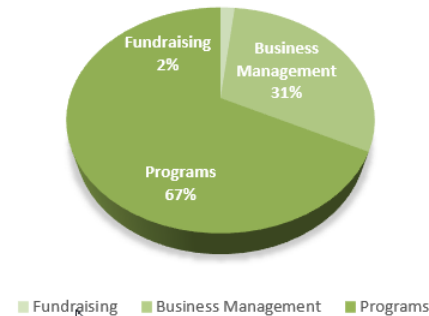
Program Percentage



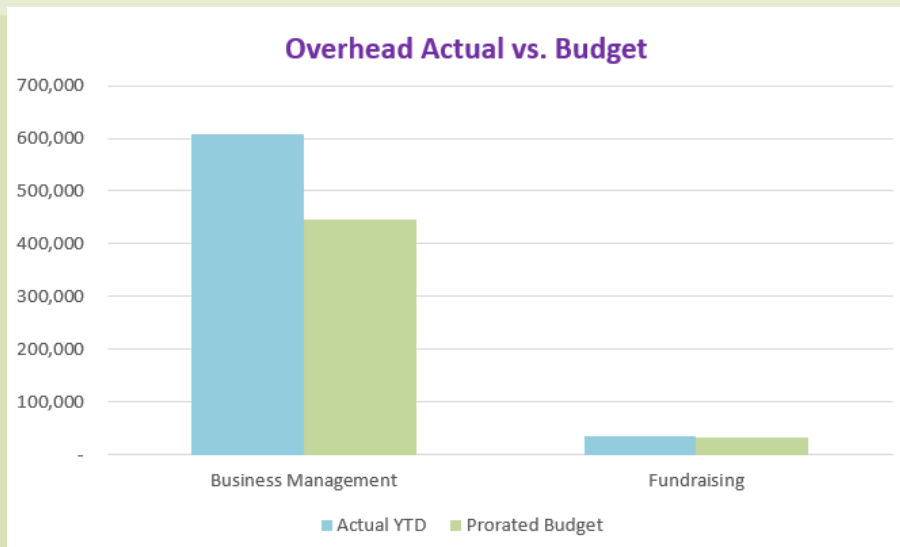
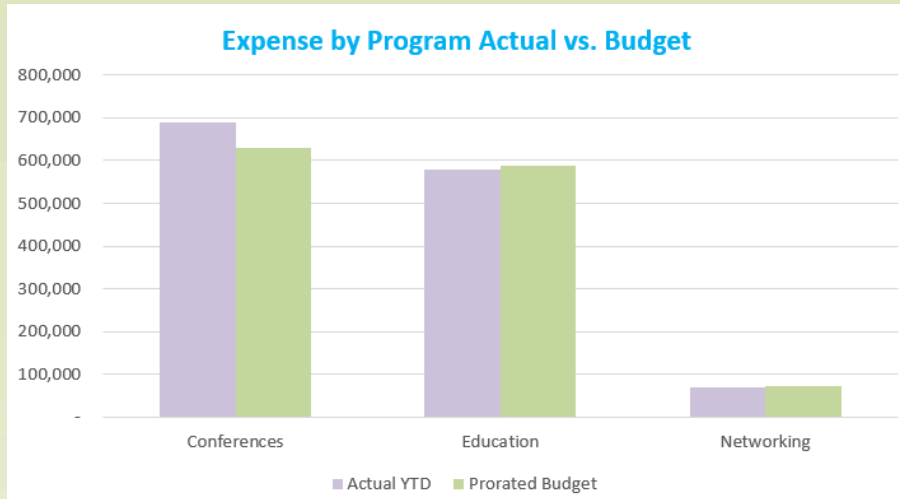
Total Program Expenses by Program



Expense by Activity



Expenses Dashboard



Hot topic: true cost

- Allocate all shared costs out of their temporary cost pools and into the final costs classes, as normal.
- Then allocate the overhead (supporting costs) to programs
- Must be done off the books since the books and the form 990 need to reflect GAAP.
- Helps present a case to funders of the “true cost” of a program to encourage them to support it.

Questions?

- ✓ What does functional expenses mean and why do we do it?
- ✓ Analyzing cost distribution from a design perspective
 - ✓ Financial statements presentation
 - ✓ Treatment of specific items of expense
 - ✓ Cost allocation rules
 - ✓ Management analysis of expenses





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