

Nonprofits: How to Approach Functional Expense Requirements



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As nonprofits began to implement Accounting Standard Update (ASU) 2016-14, Not-for-Profit Entities (Topic 958): Presentation of Financial Statement of Not-for-Profit Entities, for the first time they were required to present functional analysis of expenses by function and natural classification in one location. Previously this was only required by voluntary health and welfare organization but upon implementation was required by all nonprofit entities.. Although many nonprofits were already presenting this information voluntarily, many organizations were not aware that further guidance regarding functional expenses is provided in Topic 958.

The purpose of reporting expenses on a functional basis is intended to provide management, funders, and others an overview into the Organization's use of resources to complete its mission. The relationship between functional classification and natural classification for all expenses must be presented to allow for analysis that disaggregates expenses by major class of program or service and those items considered supporting activities such as management and general or fundraising. This analysis can be presented in one of three ways: within the statement of activities (must be easy to follow), statement of functional expenses, or within a disclosure to the financial statements. With the standard it is no longer permitted to present this information as supplemental information. Losses are not included in this schedule such as impairment, change in market value of investments, and gain or loss of sale of property and equipment.

The natural classification of expenses refers to the "what" grouping of expenses in accordance with the category of costs incurred such as salaries, occupancy, and professional expenses. These classifications are considered standard across many organizations but can vary between organizations depending on the segment of the public they serve. Functional classification is the "why" method of grouping expenses in accordance with the purpose for which those same costs were incurred. The primary functional classes are program & services or supporting activities: management and general and fundraising. Organization may choose to expand upon each of these categories to provide even more detail such as having program expense broken out by all major programs they provide.

The goal of nonprofit organizations is to be good stewards of the support entrusted to them for the programs and community they serve, and they strive to show a high percent use of funds in programs as compared to supporting activities. However, all organizations have overhead, and these costs are indispensable to the organization to allow programs to function and be supported. There has not always been a consensus on what exactly should be considered supportive services and what should be considered program expenses. ASU 2016-14 helps us to clarify and pinpoint which expenses should be considered supportive services and which should not. An example is the human resource function of an organization. Although human resources support all functions of an organization it is

considered a supporting activity of the Organization as a whole and as such is a supporting activity and should remain fully in the management and general function of the analysis. Additionally budgeting, finance, and general oversight of business management are costs that should not be allocated over all functions but remain as a supporting activity within management and general. Activities that are not identifiable with a direct impact on a program are considered a supporting activity whether they are management or fundraising.

Fundraising or sometimes referred to as development or advancement is a function of the supporting activities that can sometimes be overlooked by organizations and generally only thought to be a component of holding events. Fundraising activities also involve courting or seeking potential donors to contribute to the organization through donation of funds, in-kind support, or time. These activities can be accomplished through public or private fundraisers, capital campaigns, special events, distributions, time spent with potential donors, costs of solicitation, or a myriad of other activities. Examples of these costs are development staff and executive director time including benefits, cost of printing, postage etc. related to invitations or direct mailings and the total costs of events or outreach activities. If determined through appropriate allocation methods, costs can be allocated to this category as well. It has been noted in some review of functional expense reporting, organizations are reporting almost no fundraising costs but have support revenue. Always keep in mind it takes money to make money and this holds true for nonprofits not just for-profit organizations. If you are bringing in support revenue or contributions, it is highly unlikely you will not have some costs that should be considered part of the fundraising function of your organization.

Where possible costs should be identified as a direct impact or relation to a function but not all costs can easily be assigned to one program or one function. These costs are considered joint costs. These costs are costs of conducting joint activities that are not identifiable with a particular component of the activity. For this reason, management must choose allocation methods that are able to be supported and reasonable based on the Organization. Some of these methods could include use of direct time for program work and support activities through time studies or square footage to allocate costs such as rent, and utilities based on use of space by staff. The key is the allocation methods used by management must be internally documented and consistently applied. Allocation methods must also be disclosed in the footnote disclosures and these disclosures are evaluated by auditors. These methods do not necessarily need to be complex, but as mentioned consistent and documented and periodically reviewed for appropriateness.

In looking at the financial statements as a whole and how they have been presented in the past there has been a disconnect on what expenses need to be included in the statement of functional expenses or the analysis when presented by one of the other means. All expenses should be included, and this includes costs that are being netted against revenues on the statement of activities. This can include salaries or rental costs included in the cost of goods sold or special events costs included in special event revenue to show a net revenue. Although these revenue lines can still be presented net of expenses on the statement of activities these costs do also need to be included in the presentation of functional expenses as well, which could require a reconciliation back to the statement of activities.

The presentation of functional expenses has been around for quite some time but there are key requirements that were clarified and brought to the forefront with the new standard. As organizations close out their next reporting period and start to prepare financial statements they should keep in mind the key requirements and how to approach functional expense breakouts. Always noting the true purpose of this report is to provide insight and transparency into the organization. The goal is not to make this schedule look as if the organization is spending all funds on programs. The overall costs by function are not necessarily the best indication of whether an organization was a good steward of the support they received but an analysis only of where those funds are spent. It has been such a focus for so long that a high percentage of all support should go to program expenses, but Organizations and supporters alike underestimate the true amount of overhead and support needed to make those same programs flourish because organizations must make investments in their future through improving relationships, processes and tools that will allow them to continue to provide programming and grow programming.