



# Functional Expense Reporting

*An Executive Summary for Nonprofit Organizations*

White Paper







## INTRODUCTION

This White Paper is a summary of presentations we have hosted for Nonprofits on the topic of Functional Expense Reporting (FER) that is required for all not-for-profit entities. It should be noted that there are a few states where additional considerations impact the process. However, this is a general primer on the nature and goals of Functional Expense Reporting. Our webcast series takes into consideration the particular aspects of state variations (e.g. Massachusetts, California) and we bring in local CPAs to address those aspects.

### GAAP Expense Rules

Looking at GAAP Expense Rules, you should be mindful of three things with regard to your organization's financial reporting:

- 1) Expenses should be recorded as a decrease in unrestricted net assets;
- 2) Expenses should be reported gross, and not netted against revenue (investment expenses would be an exception);
- 3) Expenses should be reported by function.

Keep in mind that expenses paid from temporary restricted contributions would show as "released from restrictions" and the expense would be shown with all expenses in the operating section (or unrestricted).

If you have **incidental** fundraising expenses, you can also net the **direct** expenses associated with the event, but not indirect or allocated costs. It is not unusual for nonprofits to have "special events" that are often ongoing and major events, so the revenues and expenses are reported gross.

The reason expenses are required to be reported by function, is to provide the transparency necessary to help donors, creditors, and others to assess the nonprofit's service. Since the IRS also requires expenses to be reported by functional expense on the Form 990 for 501(c)3 and 501(c)4 organizations – it's important that you have clarity around Functional Expense Reporting.



## FUNCTIONAL EXPENSE REPORTING

It's necessary for all nonprofits in the U.S., per GAAP requirements, to report expenses based on functional classifications. This financial data can be included in the Statement of Activities, Statement of Functional Expenses or Notes to the Financial Statement. You will also need a breakdown of financial expenses on Form 990, part IX.

Functional expenses explain the ***purpose*** of an expense by category. Natural classifications explain ***what*** the money was sent on (e.g. salaries, rent, electricity, interest, depreciation, etc.).

Voluntary health and welfare organizations are required to display expenses in a matrix format, reflecting expenses by function and natural classification.

Here is a sample ***Statement of Functional Expenses*** for the fictional nonprofit, Prairie Dog Rescue:

| Statement of Functional Expenses<br>Prairie Dog Rescue<br>For The Year Ending 6/30/2012 |                   |                  |                  |                   |
|---|-------------------|------------------|------------------|-------------------|
|   | PROGRAMS          | G & A            | FUNDRAISING      | TOTAL             |
| <b>Expenses</b>   |                   |                  |                  |                   |
| <b>Salary</b>   |                   |                  |                  |                   |
| Salary Wages  | 139,297.30        | 29,600.00        | 8,597.16         | 177,494.46        |
| Hourly Wages  | 89,784.79         | 6,100.00         | 8,813.56         | 104,698.35        |
| Overtime  | 8,960.80          | 0.00             | 30.00            | 8,990.80          |
| Insurance   | 2,774.90          | 1,762.00         | 616.68           | 5,153.58          |
| Retirement  | 57,976.54         | 486.00           | 2,256.84         | 60,719.38         |
| FICA Expense  | 34,499.51         | 1,973.70         | 4,111.97         | 40,585.18         |
| SUTA Expense  | 4,195.00          | 20.40            | 890.30           | 5,105.70          |
| <b>Total Salary</b>   | <b>337,488.84</b> | <b>39,942.10</b> | <b>25,316.51</b> | <b>402,747.45</b> |
| <b>Supplies</b>   | <b>16,067.43</b>  | <b>4,613.00</b>  | <b>3,288.40</b>  | <b>23,968.83</b>  |
| Office Supplies   | 8,285.00          | 12.10            | 12.10            | 8,309.20          |
| Computer Supplies   | 14,589.94         | 4,995.00         | 0.00             | 19,584.94         |
| Added by import   | 2,922.00          | 0.00             | 0.00             | 2,922.00          |
| Rent  | 4,592.40          | 2,250.00         | 2,632.08         | 9,474.48          |
| Electricity   | 5,405.40          | 0.00             | 0.00             | 5,405.40          |
| Cleaning services   | 3,357.03          | 0.00             | 0.00             | 3,357.03          |
| Telephone Expense   | 8,596.09          | 0.00             | 1,304.28         | 9,900.37          |
| Depreciation Expense  | 2,037.34          | 1,141.34         | 443.85           | 3,622.53          |
| Operating Supplies  | 10,807.87         | 230.15           | 0.00             | 11,038.02         |
| Occupancy   | 69,348.80         | 0.00             | 0.00             | 69,348.80         |
| Capital Expenditures  | 5,813.90          | 0.00             | 3,539.88         | 9,353.78          |
| Cost of Goods Sold  | 9,644.00          | 7,200.00         | 0.00             | 16,844.00         |
| <b>Total Expenses</b>   | <b>498,956.04</b> | <b>60,383.69</b> | <b>36,537.10</b> | <b>595,876.83</b> |



# FUNCTIONAL EXPENSE REPORTING

There are three Functional Expense Categories:

- 1) Program Services
- 2) Management and General
- 3) Fundraising

Program services may include a single service or several separate, identifiable services; for example, a university could have programs for instruction as well as research, and patient care. Management and General and Fundraising are also considered supporting services. There is typically only a single column of reporting expenses for each of these categories whereas program services can be one or more columns.

Here is another example using our fictional nonprofit Prairie Dog Rescue. This Program Expenses report shows how several separate, identifiable programs would be reported with their own column, along with a column for Management and General (G&A) and a column for Fundraising:

| Run: 12/16/2013 at 5:30 PM            |                   | <b>Program Expenses</b><br><b>Prairie Dog Rescue</b><br><b>For The Year Ending 6/30/2012</b> |                   |                   |                    |                  | Page: 1           |
|---------------------------------------|-------------------|--|-------------------|-------------------|--------------------|------------------|-------------------|
|                                       | PROGRAM A         | PROGRAM B  | PROGRAM C         | TOTAL             | G & A              | FUNDRAISING      | TOTAL             |
| <b>Revenues</b>                       |                   |  |                   |                   |                    |                  |                   |
| Federal Grant Income                  | 13,750.00         | 150,000.00   | 180,000.00        | 343,750.00        | 0.00               | 0.00             | 343,750.00        |
| State Grant Income                    | 65,460.00         | 0.00   | 0.00              | 65,460.00         | 0.00               | 0.00             | 65,460.00         |
| Local Grant Income                    | 10,814.00         | 0.00   | 0.00              | 10,814.00         | 0.00               | 0.00             | 10,814.00         |
| Youth Service Fees                    | 43,650.00         | 0.00   | 0.00              | 43,650.00         | 0.00               | 0.00             | 43,650.00         |
| Adult Service Fees                    | 0.00              | 0.00   | 0.00              | 0.00              | 0.00               | 0.00             | 0.00              |
| Merchandise Sales                     | 0.00              | 0.00   | 0.00              | 0.00              | 0.00               | 0.00             | 0.00              |
| Miscellaneous Income                  | 68,897.11         | 0.00   | 0.00              | 68,897.11         | 0.00               | 58,040.00        | 126,937.11        |
| <b>Total Revenues</b>                 | <b>202,571.11</b> | <b>150,000.00</b>  | <b>180,000.00</b> | <b>532,571.11</b> | <b>0.00</b>        | <b>58,040.00</b> | <b>590,611.11</b> |
| <b>Expenses</b>                       |                   |  |                   |                   |                    |                  |                   |
| Insurance                             | 2,774.90          | 0.00   | 0.00              | 2,774.90          | 1,762.00           | 616.68           | 5,153.58          |
| Retirement                            | 4,619.70          | 30,167.77  | 23,189.07         | 57,976.54         | 486.00             | 2,256.84         | 60,719.38         |
| FICA Expense                          | 9,988.70          | 13,858.30  | 10,652.51         | 34,499.51         | 1,973.70           | 4,111.97         | 40,585.18         |
| SUTA Expense                          | 4,195.00          | 0.00   | 0.00              | 4,195.00          | 20.40              | 890.30           | 5,105.70          |
| Telephone Expense                     | 0.00              | 0.00   | 0.00              | 0.00              | 0.00               | 0.00             | 0.00              |
| Supplies                              | 15,409.30         | 366.08   | 292.05            | 16,067.43         | 4,613.00           | 3,288.40         | 23,968.83         |
| Office Supplies                       | 4,231.42          | 2,240.00   | 1,813.58          | 8,285.00          | 12.10              | 12.10            | 8,309.20          |
| Computer Supplies                     | 10,597.00         | 2,204.89   | 1,788.05          | 14,589.94         | 4,995.00           | 0.00             | 19,584.94         |
| Added by import                       | 0.00              | 1,609.50   | 1,312.50          | 2,922.00          | 0.00               | 0.00             | 2,922.00          |
| Rent                                  | 4,592.40          | 0.00   | 0.00              | 4,592.40          | 2,250.00           | 2,632.08         | 9,474.48          |
| Electricity                           | 4,190.40          | 675.84   | 539.16            | 5,405.40          | 0.00               | 0.00             | 5,405.40          |
| Cleaning services                     | 2,901.40          | 253.44   | 202.19            | 3,357.03          | 0.00               | 0.00             | 3,357.03          |
| Telephone Expense                     | 6,158.70          | 1,348.03   | 1,089.36          | 8,596.09          | 0.00               | 1,304.28         | 9,900.37          |
| Bank fees                             | 0.00              | 0.00   | 0.00              | 0.00              | 0.00               | 0.00             | 0.00              |
| Depreciation Expense                  | 2,037.34          | 0.00   | 0.00              | 2,037.34          | 1,141.34           | 443.85           | 3,622.53          |
| Loss or (Gain) on sale of asset       | 0.00              | 0.00   | 0.00              | 0.00              | 0.00               | 0.00             | 0.00              |
| Operating Supplies                    | 230.15            | 5,848.79   | 4,728.93          | 10,807.87         | 230.15             | 0.00             | 11,038.02         |
| Occupancy                             | 0.00              | 38,198.80  | 31,150.00         | 69,348.80         | 0.00               | 0.00             | 69,348.80         |
| Capital Expenditures                  | 5,813.90          | 0.00   | 0.00              | 5,813.90          | 0.00               | 3,539.88         | 9,353.78          |
| Cost of Goods Sold                    | 9,644.00          | 0.00   | 0.00              | 9,644.00          | 7,200.00           | 0.00             | 16,844.00         |
| <b>Total Expenses</b>                 | <b>87,384.31</b>  | <b>96,771.44</b>   | <b>76,757.40</b>  | <b>260,913.15</b> | <b>24,683.69</b>   | <b>19,096.38</b> | <b>304,693.22</b> |
| <b>Revenues Over (Under) Expenses</b> | <b>115,186.80</b> | <b>53,228.56</b>   | <b>103,242.60</b> | <b>271,657.96</b> | <b>(24,683.69)</b> | <b>38,943.62</b> | <b>285,917.89</b> |



## FUNCTIONAL EXPENSE REPORTING

### Program Services

Any activity of your nonprofit that fulfills the purpose of your organization or mission is defined as Program Services. The number of program services will vary by nonprofit entity – with some nonprofits offering a single service and other nonprofits offering dozens of services.

There may be circumstances where a **program service category** can be created in which to combine several individual programs. To illustrate how this might work, let's say that a nonprofit manages historical property and several buildings on that property are undergoing restoration. That nonprofit could create a program service category called "Restoration" and the restorations on several buildings could be recorded there making it unnecessary to separately identify each building.

You will want to provide some sort of description of the major classes of programs. You can disclose these descriptions through footnotes or by using column headings.

### Management and General Expenses

What are management and general expenses (G&A) column? They are expenses that are not identifiable by a single program or activity. However, they are expenses that are indispensable to the conduct of activities and the entity's existence.

Examples of these types of expenses are business management, general record keeping, annual report, and the salaries of the governing board, CEO, and CFO.

*A note about salaries:* salaries should be allocated if a portion of their time is spent on program activities as well as general and administrative. When salaries are allocated, all related expenses such as Employer FICA and unemployment insurance should follow the salaries. (If you don't have a payroll system that supports allocation of employer costs, the use of a fringe benefit rate is fine, but the basis for it must be clearly documented each fiscal year.)

### Fundraising Expenses

Fundraising expenses are those activities undertaken to induce contributions to your organization. The contributions can come in the form of money, securities, services, materials, etc.

Examples of fundraising expenses are the costs associated with fundraising campaigns, maintaining donor lists, special fundraising events, and other costs incurred to solicit contributions from individuals, foundations, and governments.

The vast majority of fundraising costs are typically not prepaid or deferred and should be expensed when incurred. Even though the solicited funds and contributions may not come in until a later date (maybe even in the subsequent year), the cost of mailing solicitation letters and the salaries of development/fundraising employees should be expensed as the expense is incurred.

There could be exceptions – cost for a fundraising event paid in advance (in the prior fiscal year) which could include rental of a facility, equipment, etc. These could be recorded as **prepaid** because you could get your money back if the event did not take place.



# FUNCTIONAL EXPENSE REPORTING

## Classification of Expenses to Multiple Functions

It's clear-cut where an expense should be recorded, when it is directly and exclusively related to a single function. But often expenses can relate to more than one function and should be allocated.

## Direct Identification versus Allocation of Costs

Specifically identifiable costs are assigned 100 percent to that function. If it is impossible or impractical to make a direct identification, allocation of funds is appropriate. There are a variety of ways to allocate expenses.

You may use a **financial** method to allocate expenses; perhaps a percentage of program salaries to total salaries could be used to allocate payroll taxes, benefits, or office supplies. An example of a **non-financial** allocation might be units of service, square footage, number of employees, number of students, to name just a few.

## Allocation of Expenses

There is no prescribed allocation method though there are prescribed characteristics of the allocation method used for your financial reporting. Here are three guidelines:

- Allocation methodology should be rational and systematic
- Method used should be consistently applied
- Process should result in an allocation that is reasonable

In other words: Does the allocation make sense?

Let's take a look at some scenarios around allocation methods applied to employee salaries, payroll taxes, and benefits.





## FUNCTIONAL EXPENSE REPORTING

### ***Employee Salary/Tax Scenario:***

Time records or time studies could be methods by which you allocate employee salaries. Using employee time records, specifically identified tasks could then be charged specifically to each appropriate function. A time study records employee activity with each function and then uses the findings of the study to determine the percentage of time spent on each function. Going forward those percentages are used to allocate employee salaries. (It is recommended that time studies be done a couple of times a year to ensure that percentages are accurate and address any changes.) In this day and age of available technology the preferred method is direct entry of hours spent per task per day. Your accounting system should be able to use these for allocation purposes.

Payroll tax allocation methods might be based on a percent of salaries associated with an organization function. Similarly, benefits may be a percent of salaries, or, if practicable, actual costs. Of course, if an employee's job is 100 percent related to a program or fundraising, etc., then charge 100 percent to that function.

### ***Building Expense Scenario:***

Some organizations use physical space to determine occupancy expense allocations. As always, if it is practicable, actual cost should be the method. However, if it is not practicable to use actual cost, a nonprofit organization might allocate by the square footage of each department, calculate a percentage for each department and then allocate building expenses such as depreciation, utilities maintenance, and insurance.

### ***Summary: Allocation of Expenses***

This is not an exhaustive treatment of allocation of expenses and functional expense reporting, however it is meant to be instructive. For a more in-depth discussion, it's helpful to have professional business consultants such as a CPA and technology consultant to help you ensure that you have a proper process and that your accounting software system can provide you with the appropriate reporting.

Nonprofit organizations should evaluate expense allocation methods periodically to ensure they are still reasonable. Changes in personnel or the organization's activities could result in revisions to the allocation method used. These changes might include expansion or downsizing of the entity, or adding a capital campaign or new fundraising event.





# FUNCTIONAL EXPENSE REPORTING

## About AccuFund

**AccuFund Accounting Suite** for nonprofits is very user friendly when it comes to allocating costs. The system allows you to classify expenses by category or allocate by units (e.g. square feet, hours) or a percentage.

The AccuFund Allocations module is integrated with AccuFund Accounting Suite General Ledger, which is requisite for the allocations functionality.

AccuFund Allocations module:

- Supports allocations based on approved rates for indirect and fringe benefits
- For endowment management purposes, it may use a unitized basis similar to mutual funds
- Allocations may be designed to be run multiple times during the month
- Allocations supports both actual and budget distributions, and may be tracked in a separate journal for reporting purposes
- Average daily balance calculations are available
- Multi-step allocations are available

AccuFund is designed specifically for nonprofit organizations and is scalable to meet the needs of all but the very largest nonprofit accounting departments.

AccuFund nonprofit accounting software is available in both cloud (software as a service) and on-premise options with the functionality required to effectively manage the complex FASB reporting requirements of nonprofit organizations.

The AccuFund Accounting Suite includes a core system and a number of modules that may be added to customize the installation to meet your agency's specific requirements including payroll, time entry, purchasing with electronic approvals and more.

For more information please contact us at 877-872-2228 x215 or email us at [sales@accufund.com](mailto:sales@accufund.com). Visit our website [www.accufund.com](http://www.accufund.com) for more product information, a schedule of webcasts for nonprofits, and other information on fund accounting and fundraising.