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Functional Expense Classification

Not-for-profit entities (NFPs) are under constant pressure to devote an increasing portion of their expenditures to accomplish their mission. Although this goal is noble, NFPs also need competent management and staff to carry out their mission activities, administer their operations, and maintain sustainable fundraising efforts to provide funding for the organization.

Agencies that rate the effectiveness of NFPs factor in the percentage of expenses devoted to programs as a key component in the formulas they use to monitor, rate, and compare NFPs. Donors and the press, therefore, also track these percentages carefully.

A well-designed, rational expense allocation process is an absolute necessity for every NFP, as constituents want to know, and have a right to know, how the organization uses its resources to accomplish its mission.

This article provides an overview of the financial reporting requirements under generally accepted accounting principles (GAAP) and offers some tips for designing and optimizing your NFP's expense allocation process.

About Functional Expense Classification and Reporting Requirements

Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) Topic 958, *Not-for-Profit Entities*, requires all not-for-profit entities to present the relationship between functional expenses (such as major classes of program services and supporting activities) and natural expenses (such as salaries, rent, electricity, supplies, interest, and depreciation). For financial statement users, this analysis provides an in-depth look at how nonprofits spend toward their missions. For auditors and preparers, it necessitates consideration of the approach to the allocation and reporting of functional expenses.

All NFPs shall report information about all expenses in one location—on the face of the statement of activities, as a schedule in the notes to financial statements, or in a separate financial statement—as discussed in FASB ASC paragraph 958-205-45-6. The relationship between functional classification and natural classification for all expenses shall be presented in an analysis that disaggregates functional expense classifications by their natural expense classifications. To the extent that expenses are reported by other than their natural classification (such as salaries included in cost of goods sold or facility rental costs of special events reported as direct benefits to donors), they shall be reported by their natural classification in the functional expense analysis. For example, salaries, wages, and fringe benefits that are included as part of the cost of goods sold on the statement of activities shall be included with other salaries, wages, and fringe benefits in the functional expense analysis. External and direct internal investment expenses that have been netted against investment return shall not be included in the functional expense analysis. Certain items that are typically reported in other comprehensive income of for-profit entities, such as those items listed in FASB ASC paragraph 220-10-45-10A, are considered gains or losses and, like other gains and losses, shall not be included in the functional expense analysis.

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Expense Classification Considerations

When determining the best approach to classifying transactions, it is important to have a clear understanding of the meaning of *program services* and *supporting activities* under the standards, keeping in mind that the goal is to report meaningful information about the cost of the efforts to accomplish the NFP's mission. To assist NFPs in fulfilling this reporting requirement, the FASB ASC provides the following definitions:

- *Functional expense classification*—"a method of grouping expenses according to the purpose for which costs are incurred. The primary functional classifications of a not-for-profit entity are program services and supporting activities."
- *Program services*—"The activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the not-for-profit entity (NFP) exists. Those services are the major purpose for and the major output of the NFP and often relate to several major programs."
- *Supporting activities*—". . . all activities of a not-for-profit entity (NFP) other than program services. Generally, they include the following:
    a. Management and general activities
    b. Fundraising activities
    c. Membership development activities"

Program Services

Most NFPs incur costs to provide services for more than just one separate and identifiable program and, to tell their story, will report several program service categories.

NFPs have latitude in defining their major programs so that the information provided is meaningful in understanding the expenses of the NFP's service efforts. Factors to consider in determining the programs to present include the following (some factors may be more or less significant than others, depending on the facts and circumstances, and therefore, will be more or less heavily weighted in identifying major programs):

- Program objectives
- Nature of services
- Constituents served, including by geographic or other demographic criteria
- Magnitude of the program to the NFP's overall activities
- Budgetary categories
- Oversight, regulatory, grant, or other compliance requirements that separate the program from others
- Other factors that may be relevant to financial statement users

As discussed in FASB ASC 958-720-45-5, "The components of total program expenses shall be evident from the details provided on the face of the statement of activities, unless the notes to financial statements provide the information in Paragraph 958-720-50-1(b) [for example, information about total program expenses when certain components of total program expenses are not evident from the details provided on the face of the statement of activities, for example, when cost of sales is not identified as either program or supporting services]."

Supporting Activities

Supporting activities include management and general activities, fundraising activities and membership development activities. Each has a specific definition.

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Management and General Activities

Per the FASB ASC glossary, *management and general activities* are supporting activities that are not directly identifiable with one or more program, fundraising, or membership-development activities.

Paragraph 7 of FASB ASC 958-720-45 presents a listing of management and general activities:

- Oversight
- Business management
- General record keeping and payroll
- Budgeting
- Financing, including unallocated interest costs pursuant to ASC 958-720-45-24, which requires allocation to specific programs or supporting services to the extent possible; interest costs that cannot be allocated are reported as management and general activities
- Soliciting funds other than contributions and membership dues, for example, the costs associated with
    1. Promoting the sale of goods or services to customers, including advertising costs
    2. Responding to government, foundation, and other requests for proposals for customer-sponsored contracts for goods and services
- Administering government, foundation, and similar customer-sponsored contracts, including billing and collecting fees and grant and contract financial reporting
- Disseminating information to inform the public of the NFP's stewardship of contributed funds
- Making announcements concerning appointments
- Producing and disseminating the annual report
- Employee benefits management and oversight (human resources)
- All other management and administration except for direct conduct of program services, fundraising activities, or membership development activities.

Some organizations erroneously allocate departmental expenses for payroll and benefits administration across program and other supporting services, thinking that human resource activities support all functions. However, FASB ASC 958 clarifies that human resource activities support an entity as a whole and, therefore, should remain in management and general activities.

Budgeting, finance, and general oversight or business management also are management and general activities that would not be allocated to other functions. On the other hand, the FASB ASC describes specific cases in which costs of activities that constitute direct conduct or supervision of program or support functions would be allocated to the program or support functions that receive a benefit. Paragraph 8 of FASB ASC 958-720-45 clarifies that when those who usually are responsible for providing oversight and management spend a portion of their time directly conducting or supervising program services or categories of other supporting services, their salaries and expenses should be allocated among those functions.

NFPs need to be careful when assessing costs that appear to be program-related, but instead should be classified as supporting activities. For example, when an NFP symphony advertises the sale of tickets for its upcoming concert season, the advertising expense is considered under the standards to be management and general even though the concert performances are programmatic. Advertising the concerts in an effort to generate ticket sales is neither a program activity (because encouraging the public to avail themselves of concert performances is not the same as performing a concert, for example, promoting ticket sales does not directly accomplish the Symphony's mission) nor fundraising (because revenues from ticket sales are not contributions).

Fundraising Activities

As defined in the FASB ASC glossary, *fundraising activities* are activities undertaken to induce potential donors to contribute money, securities, services, materials, facilities, other assets, or time. A solicitation activity is considered fundraising regardless of the outcome. In other words, whether the intended donor responded favorably to the solicitation or not, the activity was nevertheless undertaken to induce a potential donor to contribute and is considered fundraising in nature.

Paragraphs 9—10 of FASB ASC 958-720-45 provide additional descriptions of fundraising activities. They include

- Publicizing and conducting fundraising campaigns;
- Maintaining donor mailing lists;
- Conducting special fundraising events;
- Preparing and distributing fundraising manuals, instructions, and other materials;
- Conducting other activities involved with soliciting contributions from individuals, foundations, government agencies, and others.

Fundraising activities include soliciting contributions of services from individuals (for example, time), regardless of whether those services meet the recognition criteria for contributions in the "Contributions Received" subsection of FASB ASC 958-605-25. Q&A section 6140.11, "Costs of Soliciting Contributed Services and Time That Do Not Meet the Recognition Criteria in FASB ASC 958" (AICPA, *Technical Questions and Answers*), as amended, states, as an example, that "costs of soliciting contributed services to be used in program functions should be reported as fundraising, even if the services do not meet the recognition criteria. Similarly, costs of soliciting management and general services should be reported as fundraising, even if the management and general services do not meet the recognition criteria."

As discussed in Q&A section 6140.20, "NFPs Reporting No Fundraising Expenses" (AICPA, *Technical Questions and Answers*), it would be unusual for an NFP to have contributions but have minimal or no fundraising expenses. However, some NFPs do not engage in fundraising activities, such as faith-based organizations that are sustained by member tithing. Also, some volunteer-led NFPs could have minimal or no fundraising expense.

Membership Development Activities

As defined in the FASB ASC glossary, *membership-development activities* include soliciting for prospective members and membership dues, membership relations, and similar activities.

Some NFPs engage in membership-development activities, for example, when they solicit prospective members and raise money from membership dues, membership relations and similar activities. If no significant benefits are provided to members in exchange for their payment, the substance of the membership-development activities is considered fundraising for the purpose of functional expense reporting. Paragraphs 11—14 of FASB ASC 958-720-45 provide additional information on membership-development activities.

Other Supporting Activities

Although less common than management and general, fundraising, and membership development, NFPs may have one or more of the following additional supporting activities:

- Costs of sales activities that are not program activities. For example, a thrift shop may be operated purely to generate funding. The costs of such a thrift shop could be reported as a separate supporting activity.
- An NFP may own an investment property that is rented to generate income. The expenses of owning and maintaining the property, and the costs of conducting the rental activities could be reported as a separate supporting activity.
- Payments to local and national NFPs that cannot be allocated to other functional categories could be reported as a separate supporting service.

Accounting for Expenses by Function

Direct Identification

Direct identification of specific expenses, which is also referred to as assigning expenses, is the preferable method of charging expenses to various functions. If an expense can be specifically identified with a program or supporting service, it should be assigned to that function. For example, travel costs incurred in connection with a program activity would be assigned to that program.

Cost Allocation

Many expenses relate to more than one program or supporting activity, or to a combination of programs and supporting services. When direct identification is impossible or impracticable, an allocation is appropriate. GAAP does not specify the methods that may be used to allocate expenses, leaving the selection of allocation methods to the judgment of management. The cost allocation methodologies used should be rational and systematic, result in an allocation of costs that is reasonable, and should be applied consistently over reporting periods given similar facts and circumstances.

Reasonable allocations of expenses among an NFP's functions may be made on a variety of bases. There is no “one-size-fits-all” model. Objective methods of allocating expenses are preferable to subjective methods. Allocations may be based on related financial or nonfinancial data. The guidance found in Title 2 U.S. Code of Federal Regulations (CFR) Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance), provides useful information on allocating costs.

Specific guidance to consider when allocating costs includes:

- FASB ASC 958-720-55 provides general guidance to be used in the classification and allocation of costs incurred in activities that include fundraising
- Per FASB ASC 958-720-45-25, occupying and maintaining a building is not a separate supporting service. The expenses associated with occupying and maintaining a building, such as depreciation, utilities, maintenance, and insurance, may be allocated among the NFP's functions based on the square footage of space occupied by each program and supporting service. If floor plans are not available and the measurement of the occupied space is impractical, an estimate of the relative portion of the building occupied by each function may be made.

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- Q&A section 6960.12, "Allocation of Overhead" (AICPA, Technical Questions and Answers), states that allocation of overhead is an interprogram transaction that should not be reported as revenue of the program providing the services, but rather as a reduction of expense of such program.
- Per FASB ASC 958-720-45-24, interest costs, including interest on a building's mortgage, should be allocated to specific programs or supporting services to the extent possible. Interest costs that cannot be allocated should be reported as part of the management and general function. (FASB ASC 835-20-50-1 requires disclosure of total interest costs incurred and the amount thereof that has been capitalized, if any.)

Auditors need to understand how management chooses to allocate expenses and evaluate the methodologies for reasonableness. Using a reasonable allocation method consistently over multiple reporting periods is extremely important to the fair presentation of expense information.

The Overhead Myth

One welcome trend in the philanthropic world is the move away from forming opinions about charities based solely on financial ratios. The *overhead myth* is the false conception that financial ratios could serve as the sole indicator of an NFP's performance or that spending on anything other than direct program services is wasteful. In 2013, the three largest charity ratings agencies, GuideStar, BBB Wise Giving Alliance, and Charity Navigator, wrote a letter recommending that donors look at other performance factors beyond the administrative and fundraising expense ratios. These three watchdog groups then released a second letter to NFP organizations, inviting NFPs to take an active role in helping donors understand other measures.

The misconception has been recognized by agencies such as Charity Navigator; and, in 2023, the administrative expense ratio was removed from Charity Navigator's rating system. However, other agencies and donors may still look at the ratio and believe that, as a general rule, this ratio should not exceed 35%. Many leading organizations have recognized the real need to invest in supporting services and have responded by altering the ways they measure performance across NFPs.

Tips to Optimize an NFP's Functional Allocation Process

- For most NFPs, payroll and related costs are a significant part of total expenses. If your NFP's approach involves allocating those expenses based on time records, be sure to train staff on the importance of diligent timekeeping. Certain employees, regardless of job title, will likely have some time allocated across two or more expense categories. For example, a CEO could provide oversight of the organization (management and general), meet with potential donors (fundraising), and provide assistance with program deliverables (program services), or a CFO could assist development staff with structuring or soliciting new gifts (fundraising), and oversee the organizational budget (management and general). FASB ASC 958-720-55-171 through 176 provides examples of allocations of payroll and related costs among program and supporting services. One primary method of allocating costs is through the use of time records. To help ensure accuracy, put controls in place to ensure that time records are reviewed by the employees' supervisors. Optimize the timekeeping system to clearly define and identify key functions so staff are able to understand how to appropriately code their timesheet. Finally, ensure alignment with other efforts for tracking time related to labor laws and federal grants.
- Verify the consistent application of the allocation methodologies and update them regularly for any changes in your cost structure or operating facts and circumstances. Triggering events could include the following:
    - office space added or given up
    - new debt entered into

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  - o significant new program started or discontinued
  - o staff positions added or removed
- Analytically review functional classifications by comparing prior period amounts to the current period. Make sure you can explain significant variances or the lack of expected variances.
- Remember that your financial statements tell a story about your NFP and its use of resources to accomplish its mission. Consider the readers of your financial statements, including your NFP's constituents, which could include donors, charity ratings agencies, granting agencies, program participants, and the community at large. Consider whether the number of programs reported is adequate based on the complexity of your organization and its activities. As the organization evolves and grows, periodically review your approach.
- If your functional expense methodologies are in need of an overhaul, don't hesitate to ask your external auditor for help. Most are familiar with industry practices and can provide recommendations to help you understand the available options.

Expense Reporting Considerations

FASB ASC 958 requires all not-for-profit entities to report information about all expenses in one location—on the face of the statement of activities, in the notes to the financial statements, or in a separate statement. Investment expenses that are netted against investment return may not be included in the analysis. The following are important considerations for nonprofits that are evaluating their choice of location:

- Within the Statement of Activities – If a not-for-profit selects this option, the statement needs to be easy to follow. Only very small, simple entities are likely to use this option.
- Notes to the Financial Statements – When using this format, it is important to include appropriate references, so that the schedule's place in the notes is clear.
- Statement of Functional Expenses – Complex entities may want to consider this option for clarity.
- Note that presentation as supplementary information is not permitted.

Regardless of the format and location chosen, the methods used to allocate costs among program and support services must be clearly described in the notes. Inadequate disclosure is an error, and as usual, risk increases when new disclosure requirements are imposed. Auditors and preparers will need to pay careful attention to how allocation methodologies are described. FASB ASC 958-720-55-176 and Note F in FASB ASC 958-205-55-21 provide useful examples of note disclosures of methods used for cost allocation.

The allocation of functional expenses requires careful consideration and professional judgment. Auditors and preparers need to take a close look at the potential for misstatement due to flaws in the models. Auditors also need to consider the risk of fraudulent reporting, as the pressure on not-for-profit entities to minimize general and administrative and fundraising and development costs is ever present.

Related Resources

Statement of functional expenses: GAAP vs. tax: Learn how the statement of functional expenses differs for audited financial statements versus a Form 990, from both accounting and tax perspectives.

Functional expense schedule best practices for not-for-profits: Read about best practices for nonprofits to keep in mind as they prepare functional expense schedules.

