



Thank you for joining us!

The presentation will begin shortly.



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2023 **Regional Leaders**

Mastering Your Statement of Functional Expenses

Wednesday, February 21, 2024



CPAs & ADVISORS

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Presenters

Meet the instructors



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Lisa Heller
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Housekeeping

Additional Information

Learning Objective To provide attendees with an overview of functional expense statements.	Instructional Delivery Methods Group Internet-based
Recommended CPE 1 CPE Credit	Recommended Fields of Study Auditing
Prerequisites None required	Advance Preparation None
Program Level Basic	Course Registration Requirements None
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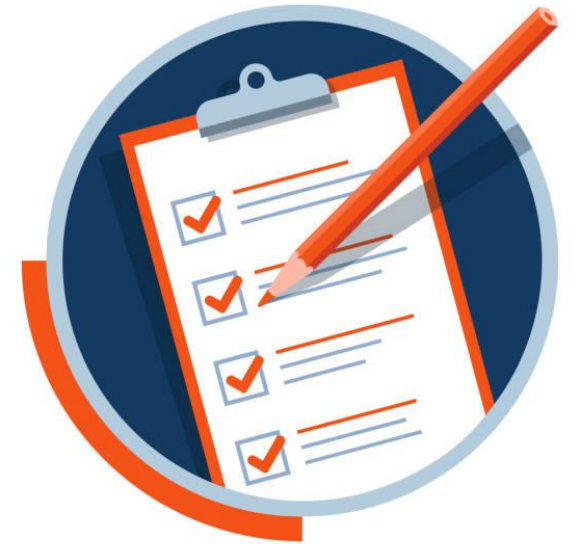
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Agenda

1. Overview of functional expenses
2. Best practices for expense management
3. Methods for cost allocation
4. Common pitfalls and potential solutions
5. Significance of the functional to the preparation of the 990



Polling Question #1

Are you still listening?

A. *Yes*

B. *No*

Functional Expenses

Overview and Recap

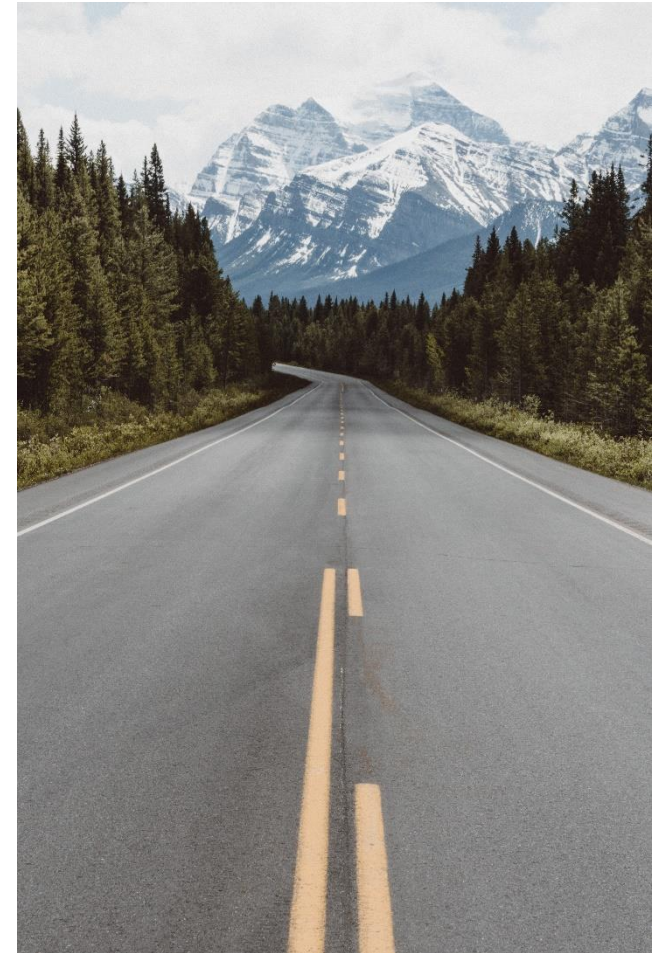


Functional Expenses - Background

- Unique to tax-exempt organizations
- Presents costs on a programmatic and natural expense basis
- 958-720-45-2 “To help donors, creditors, and others in assessing a NFP’s service efforts, including the costs of its services and how it uses resources, a statement of activities or notes to financial statements shall provide information about expenses reported by their functional expense classification, such as major classes of program services and supporting activities ...”

Functional Expenses

- Importance of Allocations
 - Ability of management to identify all program costs including allocation of administrative costs; presents the full costs of all programs administered by the nonprofit entity
 - Management makes more informed decisions
 - Presentation of ratios for donors and outside readers
 - Recover donor funds for administrative costs
 - Allocate costs equally to all programs



Functional Expenses - Presentation



- Must present expenses by natural expense and by functional classification
- Presentation options
 - Face of the Statement of Activities
 - In a separate statement – Statement of Functional Expenses
 - Disclosed in the footnotes

Functional Expenses - Presentation

- Additional
 - If expenses are reported in other line items within the statement of activities (e.g., salaries are included in costs of goods sold) they should be included in the functional reporting schedule by their natural classification.
 - External and direct internal investment expenses that are netted against investment return should not be included in the functional expense analysis.



Functional Expenses - Typical Example

	Program Activities				Supporting Services			Total Expenses
	A	B	C	Programs Subtotal	Management and General	Fundraising	Supporting Subtotal	
Salaries and benefits	\$ 7,400	\$ 3,900	\$ 1,725	\$ 13,025	\$ 1,130	\$ 960	\$ 2,090	\$ 15,115
Grants to other organizations	2,075	750	1,925	4,750	-	-	-	4,750
Supplies and travel	890	1,013	499	2,402	213	540	753	3,155
Services and professional fees	160	1,490	600	2,250	200	390	590	2,840
Office and occupancy	1,160	600	450	2,210	218	100	318	2,528
Depreciation	1,440	800	570	2,810	250	140	390	3,200
Interest	171	96	68	335	27	20	47	382
Total Expenses	\$ 13,296	\$ 8,649	\$ 5,837	\$ 27,782	\$ 2,038	\$ 2,150	\$ 4,188	\$ 31,970

Functional Expenses - Categories

- Program services
- Supporting activities
 - Management and general
 - Fundraising
 - Membership development
- Direct identification
- Certain costs benefit more than one function and, therefore, shall be allocated



Functional Expenses - Program Services



- Program services are the activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the NFP exists.

Functional Expenses - Supporting Services

- Management and general:
 - Oversight
 - Business management
 - General record keeping and payroll
 - Budgeting
 - Financing
 - Soliciting funds other than contributions and membership dues (government proposals)



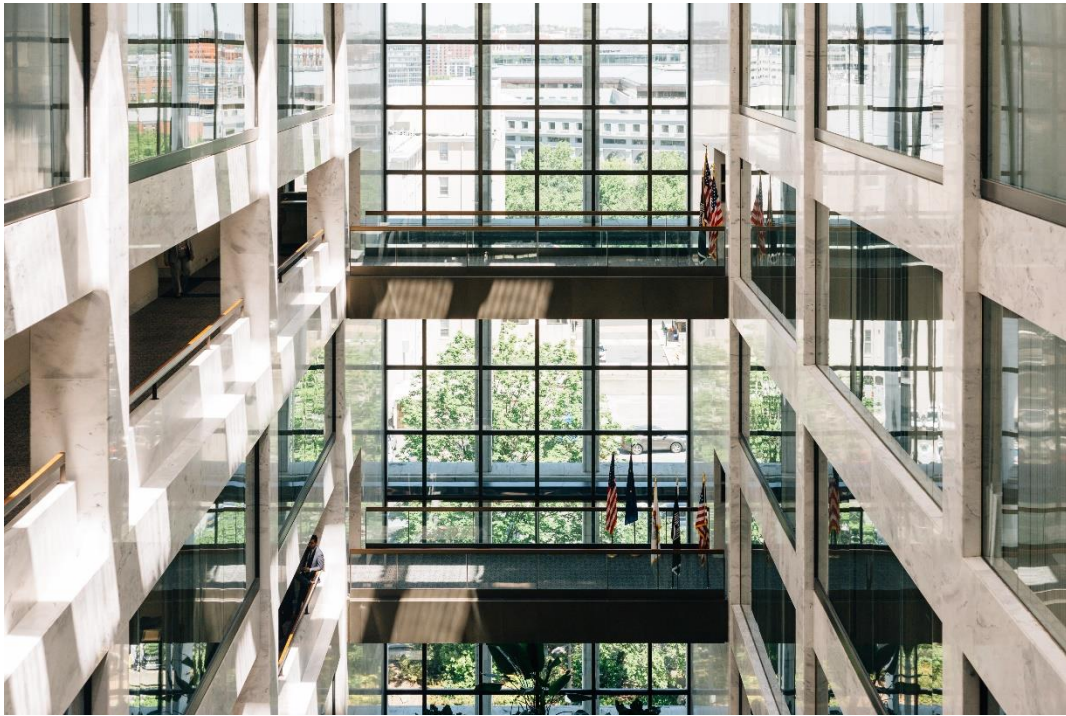
Functional Expenses - Supporting Services

- Management and general (continued):
 - Administering government, foundation, etc. 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
 - 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 or membership development activities

Functional Expenses - Supporting Services

- Fundraising
 - 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

Functional Expenses - Supporting Services



- Membership Development
 - Soliciting for prospective members and membership dues
 - Membership relations
 - Similar activities



Best Practices

Best Practices

Be Intentional



Natural Expense Categories

Less is more

5-10



Programmatic Expense Categories

Tell the Organizations' Story

Consider who the reader is



Allocation Methodologies

Consistent

Documented

Best Practices

Be Intentional



Employee Time

Take Credit
Consider the Role



Frequency

Be Proactive
Update throughout the year



Membership Development

Don't over-look
Costs of soliciting new members and
communicating with current members

Polling Question #2

Are you still listening?

A. *Yes*

B. *No*

Allocation Methodologies



Allocation Methodologies

Two Overall Methods

Direct Allocation

Definition:

- Cost that can be readily identified as benefiting one specific program.
- This is the preferred method, when possible

Examples:

- Salary of a Fundraising Director – salary would be fully allocated to fundraising
- Purchase of supplies or services to further one specific program
- Lease expense of a building that is only used to serve clients of a specific program

Indirect Allocation

Definition:

- Cost that cannot be readily identified as benefiting one specific program
- Used when direct allocation method is too burdensome

Examples:

- Lease expense of the main office location used by all employees
- Depreciation of computers and equipment used by various employees
- Salary of a staff working and assisting with various programs

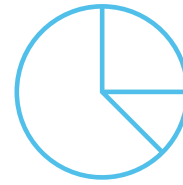
Indirect Cost Allocation Methods



Staff Hours



Staff Salaries



% of Direct Costs



Square Footage

Indirect Allocations

- Staff hours
 - When employees split their time between various programs
 - Track time spent using a time study or timesheet
 - Allocate salaries to programs based on percent of time spent on each
- Staff salaries
 - Can be used to allocate benefits, payroll taxes, bonuses
 - Can be used to allocate occupancy costs (if occupancy use is commensurate to salary)



Indirect Allocations



- Percent of direct costs
 - Allocate various indirect costs
 - Allocate to programs based on that programs % of overall direct costs
- Square footage
 - Allocate occupancy costs (Rent, Utilities, Telephone, Maintenance, Depreciation)
 - Determine square footage use of each individual or each program

Common Pitfalls and Potential Solutions



Common Pitfalls

- Using a fixed percentage to allocate (vs. a systematic/rational basis)
- Reporting all costs charged to a specific grant as programmatic even though administrative in nature
- Confusing federal indirect process with financial statement reporting process
- Ignoring joint cost allocations



Common Pitfalls

- Improperly using categories of expenses that are not natural expense categories, proper examples of which are salaries, payroll taxes, utilities, supplies, rent, insurance, depreciation, etc.
- Too many categories
- Not presenting significant programs separately (lumping into one “program services” category)
- Not showing fundraising expense although the organization solicits donations, no membership development expenses although there are members

Form 990

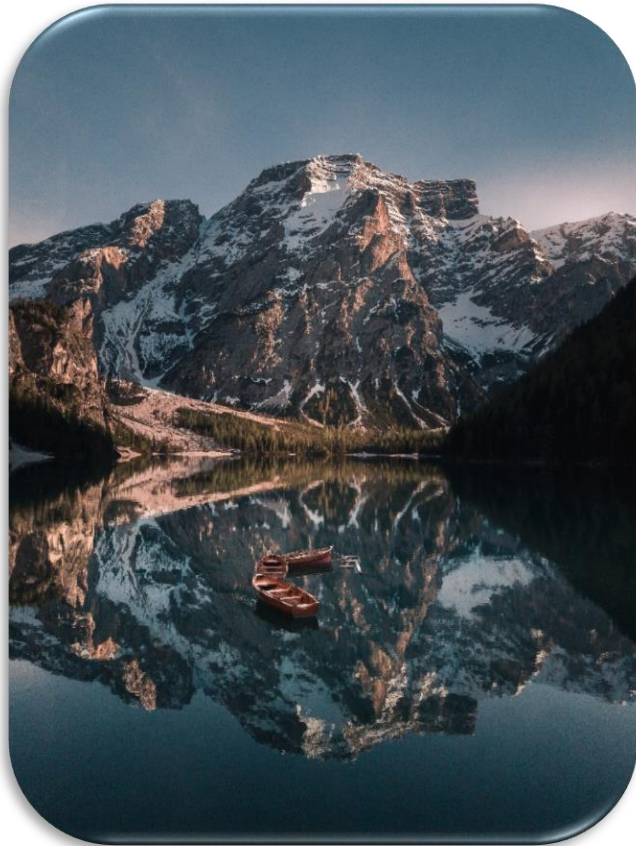


990 Reporting of Functional Expenses

- Part IX of Form 990
 - Required for 501(c)(3) and 501(c)(4) orgs, optional for others
 - Report expenses by natural and functional category
- Use the organization's normal accounting method at Part IX
- Use any reasonable method to allocate expenses
- All PSEs grouped together at Part IX, col. (B)
 - Also reported by program at Part III
- Should agree to or reconcile with audit reporting
- SOP 98-2 joint cost reporting



Direct and Indirect Expenses for Tax Reporting



- Direct Expenses
 - Can be identified specifically with an organization’s activity or project
 - Can be assigned to an activity or project with a high degree of accuracy
- Indirect costs
 - Can’t be identified specifically with an activity or project
 - Options for reporting at Form 990, Part IX:
 - All as M&G on their natural expense lines (consider this option carefully!)
 - Separate line item at #24, called “Allocation of Expenses”

Polling Question #3

Are you still listening?

A. Yes

B. No

Final Thoughts



Charity Navigator Ratings

- Four key indicators (“Beacons”), weighted as follows:
 - Impact & Results – 50%
 - Accountability & Finance – 32.5%
 - Culture & Community – 10%
 - Leadership & Adaptability – 7.5%



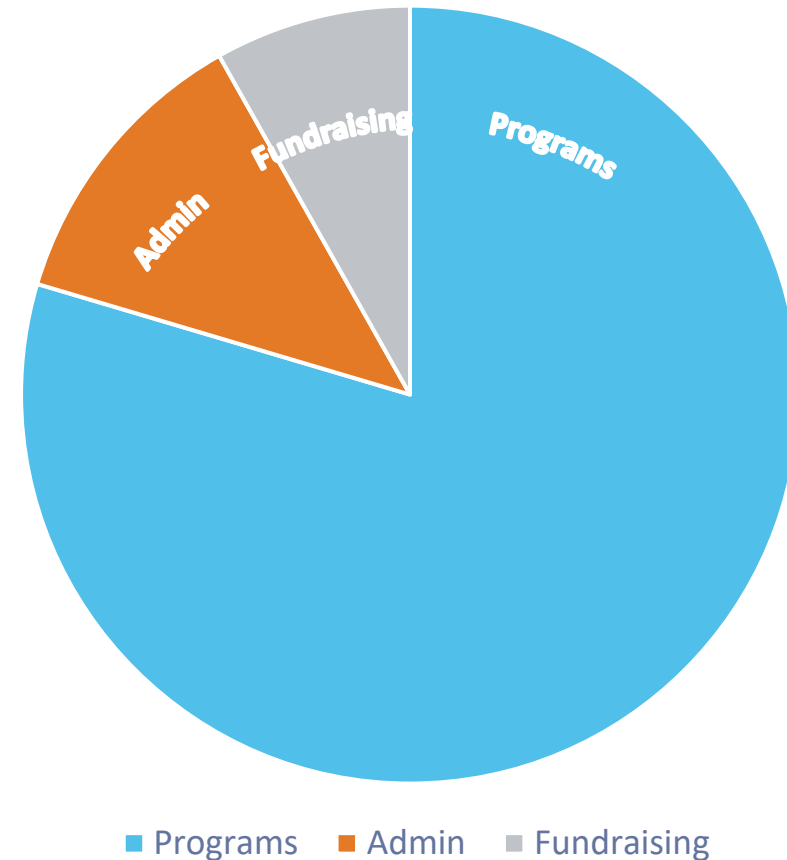
Charity Navigator Ratings



- Encompass Rating System
 - Numerical scoring of 0-100
 - 75 or higher is considered effective and transparent in assessed areas
 - Star Rating System
 - Points and ratings consider an org's size and scope
- Learn more at <https://www.charitynavigator.org/about-us/our-methodology/ratings/>

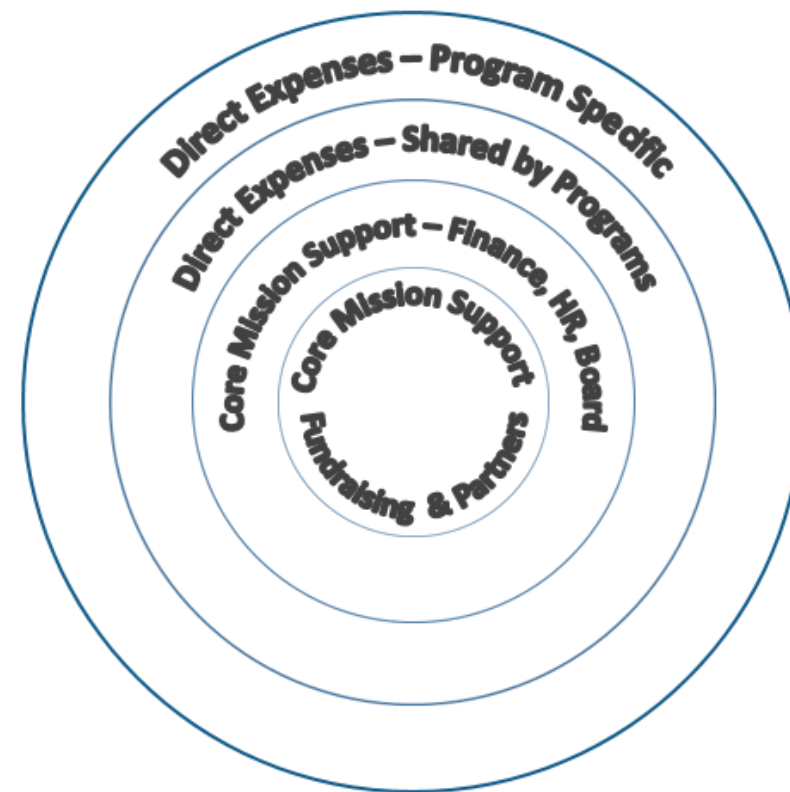
The Functional Expense Debate

- When nonprofits are viewed this way, no matter how hard we try to think differently, we imagine important infrastructure expenses as taking a slice out of the pie – as diminishing the “real” work of the organization’s mission. Strategic financial functions, good governance, and the development of key funding partnerships are vital to strong organizations.



Core Mission Support

- Rather than thinking of investment in key infrastructure as diminishing programs, see it as valuable **Core Mission Support**.
- Core Mission Support functions are necessary, vital, and integral.
- Strong, strategic finance and accounting
- Progressive human resources practices
- Capable, responsive board governance
- Talented and engaged development staff





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Questions?

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