

Functional expense allocation can be challenging for nonprofits when expenses must be divided among various operations. Below is a brief summary of issues to consider in allocating expenses for your organization.

FUNCTIONAL EXPENSE ALLOCATION-A SUMMARY

U.S. nonprofits are required by GAAP to report expenses based on functional classifications. For the majority of nonprofits, the information can be included either in the Statement of Activities, Statement of Functional Expenses or Notes to the Financial Statements. In addition, a breakdown of functional expenses is required on Form 990, Part IX.

As opposed to natural classifications, which explains *what* the money was spent on (salaries, insurance, etc.), functional classifications group expenses according to the purpose for which the costs are incurred. The functional categories used for nonprofits are:

- Management and general – Costs necessary for the operations of an organization that are not identifiable with a specific program, fundraising or membership activity
- Program – Costs that result in the organization fulfilling its mission
- Fundraising – Costs that involve seeking, soliciting or securing contributions

Third parties, such as donors, creditors and watchdog groups, are common users of nonprofits' functional expense information. The information helps them determine how effectively a nonprofit is fulfilling its mission and using its resources. In addition, the information is used by nonprofit organizations for benchmarking to help manage costs, programs and enhance organizational transparency.

ALLOCATION METHODOLOGY While some expenses can be allocated in their entirety to a single function through specific identification, most expenses relate to more than one function and need to be allocated among the functions benefitted. The allocation methodology utilized should be reasonable, consistent and periodically reviewed and challenged. Common allocation metrics include time, square footage, actual usage, percentage of direct costs and number of employees.

For example, a private high school rents a 100,000 sq. ft. building, which is devoted 100% to school activities. Classrooms, gym facilities and a theater take up 75,000 sq. ft; administrative offices take up 20,000 sq. ft.; and development activities comprise the remaining 5,000-sq.-ft. space. Therefore, management allocates rental and other building related expenses as follows: 75% to program, 20% to administrative and 5% to fund-raising.

Despite existing guidelines, allocating expenses can be a challenge for an organization. Common errors found in functional expense reporting include:

- Reporting all expenses as program expenses

- No allocation of personnel costs among categories
- Reporting contribution revenue but no fundraising costs
- Not allocating insurance, occupancy and depreciation
- Charging all accounting fees to programs
- Incorrectly reporting in-kind donations
- Form 990 functional expense reporting inconsistent with audited financial statements
- Waiting until the end of the year to allocate costs in preparation for the annual audit, instead of evaluating allocation methodology throughout the year
- Use of a fixed percentage to allocate costs rather than on a systematic and rational basis

As is apparent from the list above, there are challenges to functional expense reporting. Nonprofits are often dealing with limited information and time entry systems. Maintaining the general ledger on a functional basis can be difficult. Limited resources may exacerbate the challenges, as well as the interpretive nature of expense allocation methodology.

CREATING A FUNCTIONAL EXPENSE PROCESS Putting appropriate procedures in place and providing strong policies to assure they are followed are critical steps in creating a functional expense process. Furthermore, procedures cannot be static. Nonprofits should review their procedures and policies on a regular basis to assure that they are yielding accurate information.

ABOUT SUSAN JONES Please contact Susan R. Jones, Principal, and leader of Miller Cooper's Nonprofit Services Group at 847-527-1149 or SJones@MillerCooper.com

Susan Jones joined Miller Cooper from a national accounting firm in which she had more than 20 years experience serving a broad range of nonprofit, private and public audit clients. In addition to handling the accounting and audit needs of her nonprofit clients, she consults with them regarding planning and various organizational matters, and shares best practices from working with a variety of organizations.

Ms. Jones received a Bachelor of Science in Accounting from the University of Illinois-Champaign/Urbana. She also received a Master of Business Administration from DePaul University: Kellstadt Graduate School of Business. Ms. Jones is a member of the Illinois CPA Society and its Not For Profit Committee and the Association Forum.