Best Practices for Creating a Statement of Functional Expenses

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Under ASU 2016-14, Presentation of Financial Statements of Not-for-Profit Entities, all nonprofit organizations are required to present an analysis of expenses by their function and natural expense classifications in one location. This information can be presented within the statement of activities, as a schedule in the notes to the financial statements or in a statement of functional expenses (SFE).

Functional expense classification refers to the purpose for which the expenses were incurred, such as program activities and support services. The SFE reports expenses by their function (programs, management and general, fundraising) and by the nature or type of expense (salaries, rent). Natural expense classification is grouping expenses according to economic benefits received, such as salaries and wages, rents, space cost, and professional services.

RECOMMENDED USES

501(c)3s and 501(c)4s should prepare an SFE. The information is required for Form 990 and is readily available. The SFE will help improve stakeholder communications and show donors that the organization is operating efficiently.

Other nonprofit entities may present the information within the statement of activities or the notes to the financial statements. Even so, they should prepare an SFE for the reasons stated above.

Keep the SFE as simple as possible. Too much information can be overwhelming and dilute the message. Limit the number of expense line items and group smaller categories together. Consider using expense line items similar to those on Form 990.

FUNCTIONAL EXPENSE CATEGORIES

Nonprofits are required to group expenses according to a purpose. Functional expense categories include program expenses and supporting services such as management and general, fundraising, and membership development.

Program expenses are the direct and indirect costs incurred to accomplish the organization's mission. Management and general expenses are necessary to operate an effective organization. They include expenses for such things as management, recordkeeping, finance, activities of the governing board and soliciting funds other than contributions and membership dues, such as government grants.

A common misconception about program expenses is that they include all costs related to the operation of a program. Administration of contracts with a government or foundation, including billing and collecting fees, should be classified as management and general expenses.

Fundraising expenses are all costs incurred to raise contributions. They can include personnel costs, professional fees, promotional materials and related indirect costs such as office expenses and rent. Membership development is the expense of a supporting service for attracting and retaining members.

ALLOCATING EXPENSES

Direct costs must be classified to the functional expense category benefitted. Certain costs can be identified to a specific function, such as the salary of an employee who works exclusively on a particular program.

Many costs must be allocated because they cannot be directly attributed to a particular function. For example, the executive director is responsible for the overall management and direction of the organization but may also be involved in program services. Overhead costs, such as rent, must also be allocated.

Acceptable methods to allocate expenses are actual-time records, square footage devoted exclusively to each category and usage studies. Reasonable estimates are acceptable.

Cost allocations made by funding source specifications may not be appropriate for GAAP. For example, funding sources may allow audit fees and internal accounting and recordkeeping costs to be allocated to programs. However, under GAAP, such expenses are identified as management and general.

ASU 2016-14 has enhanced disclosure requirements relating to the methods used to allocate expenses. Statements must adequately identify the types of expenses allocated and the methodology used.

In concept, the SFE may seem like a relatively simple statement. Even so, there can be complications and misconceptions about the SFE. The allocation methodology must be analyzed annually to ensure it remains appropriate, especially if there are changes to the organization.

Donors place a lot of significance on the percentage of expenses allocated to each function, so be sure the allocations are reasonable and consistent with GAAP. Donors want to see most of their donations going towards programs, which is why the SFE is important to show that the nonprofit is operating efficiently.

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