



The Basics of Functional Expense Allocation

A place for everything and everything in its place.

When it comes to your organization's finances, the IRS certainly likes to see everything in its place. To that end, it provides specific guidance on how nonprofits should categorize expenses. Accountants have a technical term for this. They call the division of natural expenses among several functional categories *functional expense allocation*.

IRS Form 990 requires nonprofits to report expenses by their natural classification (i.e., wages, payroll taxes, telephone, occupancy) and then allocate the classifications to one of these functional categories:

- Program Services
- Fundraising
- Management and General

Proper allocation of expenses is important. If you don't build your accounting system around these natural categories and build in a proper allocation plan, you could face serious hurdles when it comes time to prepare your annual Form 990. Just as important, your management and board need accurate information about how much money is being spent on programs, administration and fundraising.

Donors Care, Too

Accurately accounting for fundraising and operational costs is certainly of interest to donors and other supporters, too. Nonprofit watchdog groups have "trained" consumers that organizations with low fundraising and operational expenses are more efficient and make better use of their assets. Consumer advocates suggest that nonprofits strive to apply a high percentage of annual expenses to program services."

Why It's A Challenge

The job of tagging and tallying functional expenses can be complicated. Some expenses span two or all three categories. And the guidelines for allocating expenses are open to wide interpretation — different sources recommend different practices.

For example, time spent by the executive director developing and overseeing programs can legitimately be considered a Program Services expense, yet some nonprofits place the entire director's salary into the Management and General activities function. Similarly, rent, utilities, insurance, supplies and other expenses may be fairly divided among the various functional classifications and should not necessarily be considered exclusively Management and General activities costs.

Clearly, methods of functional expense allocation vary widely from organization to organization.

Some General Guidelines

In general, the instructions for IRS Form 990/990EZ provide guidance on how to allocate expenses by function. In addition, the Financial Accounting Standards Board (FASB) Statement 117 provides additional guidance, establishing these general functional areas:

Program Services — Program expenses are those costs generated in support of activities that *directly* advance your nonprofit mission. In other words, these are activities that result in goods and services being distributed to beneficiaries, customers or members that fulfill the purposes for which your organization exists.

If your mission is to provide clothing for needy families, money spent to buy those clothes is a Program Service expense. On the other hand, money spent to raise donations that will eventually go to buy those clothes does not qualify as Program expenses. The same goes for funds spent to cover rent on your office. These expenses only indirectly support your mission.

Fundraising — Fundraising expenses are the costs you incur in bringing in revenue, typically (but not only) through public donations. Fundraising expenses 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

Management and General — This includes expenses involved in general oversight, business management, record keeping, budgeting, finance and other management and administrative activities.

Finding Your Way

Your organization will need to use these guidelines to decide for itself which expenses are legitimately program expenses and which are support expenses. The key to having any criteria you establish be accepted by auditors and donors alike is to make sure they are reasonable, justifiable and consistently applied.

Once you have established these criteria, you will need to develop a method for allocating costs among the functional areas. Some organizations use different allocation methods for different line items. For example, salaries may be allocated based on time and effort distribution summarized from periodic time sheets.

Copier, postage and telephone activity can often be allocated directly to their specific uses as well (although doing so is often time consuming). Management may also need to allocate some costs based on estimated levels of service where no other reasonable means is available. In other cases, organizations develop an indirect cost rate and allocate a percentage of expenses to each functional area.

Accurate accounting of expenses is important. Let our professionals help you develop guidelines and procedures that work for your nonprofit.

Joint Cost Allocation: When It Doesn't Fit Neatly

So, what about costs that don't fit neatly into a functional category — or that span several? Nonprofits often conduct activities that simultaneously serve more than one organizational objective, especially in the area of fundraising.

For example, say your organization's mission is to create awareness of skin cancer. With summer coming, you send out a mailer that contains a handy card featuring the warning signs of melanoma. In the same piece is an appeal for donations. The warning signs, as educational material, could certainly be considered a program expense. But what about the appeal — is it Program or Fundraising?

In accordance with American Institute of Certified Public Accountants (AICPA) Statement of Position 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*, unless three criteria are met, all costs associated with the joint activity are charged to fundraising — even if some of those costs are bona fide program

costs. The accounting challenge is to determine whether you meet the tests and can allocate part of the joint costs to the other, non-fundraising components.

If an activity meets three specific criteria — Purpose, Audience and Content, in this order — then you should record the costs of the joint activities in the following manner:

- Costs that can be identified with a particular function should be charged to that function.
- Joint costs should be divided between Fundraising and either the appropriate Program activities, or Management and General activities.

If *any* of the three criteria are not met, then all of the costs of the joint activity should be charged to Fundraising. This includes costs that would be considered Program or Management and General costs had they been incurred in a different activity. The exception to this rule is that costs of goods or services provided in exchange transactions that are part of joint activities should not be reported as Fundraising costs.