



Mastering the Statement of Functional Expenses: Overcoming Common Challenges

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Your Speakers



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Agenda

- Understanding the Statement of Functional Expenses
- Importance of the SFE in Nonprofit Accounting
- Common Challenges in Preparing the SFE
- Solutions and Best Practices
- AICPA Top 7 Functional Expense Allocation Errors



Understanding the Statement of Functional Expenses

- The AICPA defines the functional expense classification as "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."
- Natural Classification – type and nature
- Functional Classification – major categories related to the programmatic mission and supporting activities of the NFP



Program and Supporting Services

- **Program Services** – Expenses related to the purpose or mission for which the NFP exists.
- **Supporting Activities** - Activities of a NFP *other than* program services. For example:
 - Management and general activities
 - Fundraising activities
 - Membership development activities



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.
- Examples include:
 - Budgeting
 - General record keeping and payroll
 - HR related activities
 - Annual report production



Fundraising Activities

- Per the FASB Glossary, fundraising activities are activities undertaken to induce potential donors to contribute money, securities, services, materials, facilities, other assets, or time.
- Examples include:
 - Maintaining a donor mailing list
 - Publicizing and conducting fundraising campaigns
 - Activities involved with soliciting contributions.
- Most NFPs with contributions have fundraising expenses as well, however there are exceptions (ex. faith-based organizations sustained by member tithing)



Membership Development Activities

- Per the FASB Master Glossary, membership development activities include soliciting for prospective members and membership dues, membership relations, and similar activities.
 - However, if there are no significant benefits or duties connected with membership, the substance of membership development activities may, in fact, be fundraising.
- In practice not as common to see on NFP financials as the other supporting activities.



Importance of the SFE

- **Transparency and accountability**
 - Consider the user of the financial statements, helps tell the story of the organization and how funds are used.
- **Compliance**
 - Required by GAAP
 - IRS Form 990
- **Decision-making**
 - Budgeting and evaluating the efficiency of various programs and activities.
- **Fundraising**
 - Demonstrates to donors that funds are used effectively, enhancing trust and potentially increasing contributions.



Common Challenges in Preparing the SFE

- **Allocation of Expense** – Difficulty in accurately dividing expenses between functional categories.
- **Consistency** – Maintaining consistency in expense classification over time.
- **Regulatory Requirements** - Keeping up with changes in accounting standards and regulations.
- **Multi-Program NFPs** – Allocating expenses in organizations with multiple, diverse programs.
- **Software Limitations** – May not be tailored for nonprofit needs.
- **Training** – Lack of training or expertise among staff responsible for preparing the SFE.



Solutions and Best Practices

- **Allocation of Expenses**

- Develop clear allocation policies and methodology
 - Common methodologies include direct costs, time and effort, square footage
- Utilize time tracking system processes or surveys
 - Have supervisors approve time spent on various functions during timecard approval process.
 - Conduct time studies or employee surveys to allocate personnel costs accurately.
- Regular review and adjustment
 - Periodically review allocation methods and adjust them as necessary to reflect changes in operations or activities.
 - Compare allocations to the prior year.



Solutions and Best Practices (cont.)

- **Consistency**

- Standardized procedures
- Train staff regularly

- **Understanding regulatory requirements**

- Stay informed
- Engage experts

- **Complexity of Multi-Program Organizations**

- Detail program codes
- Allocate indirect costs
 - Develop a method for allocating indirect costs (e.g., administrative expenses) fairly across programs.



Solutions and Best Practices (cont.)

- **Software and system limitations**

- Invest in nonprofit-specific accounting software
- Integrate systems (donor management & payroll systems)

- **Staff training and expertise**

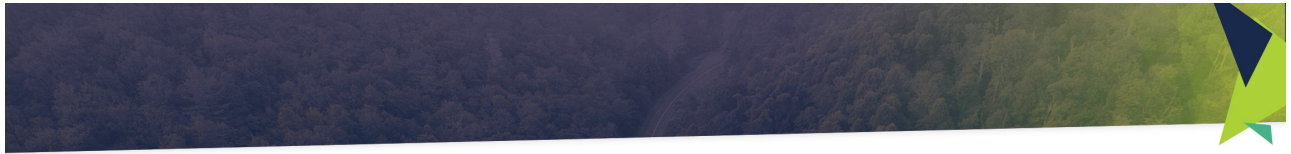
- Ongoing professional development
- Cross-training



AICPA Top 7 Functional Expense Allocation Errors

1. Lack of expense allocation methodology
2. Incorrect classification of management and general
3. Not allocating enough costs to programs
4. Ignoring consideration of joint costs
 - The costs of conducting joint activities that are not identifiable with a particular component of the activity.
5. Not considering the level of detail in natural expense presentation
6. Lack of fundraising salaries expense allocation
7. Misclassification of investment-related activity





Questions?



Thank You!



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