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Functional Reporting

Helping Not-for-Profit Organizations Avoid Misreporting Costs

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Not-for-profit organizations are required to present a breakdown of expenses by functional classification in their financial statements. However, because of the level of judgment required when allocating shared costs and identifying joint activities, some not-for-profit organizations fail to comply fully with these financial reporting requirements. The possible consequences of such omissions could include funding reductions from donors or negative publicity in the event these reporting failures come to light.

As a result, not-for-profit organizations must be aware of the accounting requirements related to the functional reporting of expenses, including how to allocate certain expenses that support multiple functions. Using certain methodologies can help not-for-profit organizations to effectively and efficiently identify, assign, and report costs associated with multiple functions.

Problems Arise From Lack of Proper Accounting

Many organizations wrestle with assigning costs because the functional classification of expenses can involve a certain level of judgment. As a result, some not-for-profit organizations are underreporting or misreporting expenses, and, at times, even failing to report any expenses – each of which indicates improper accounting.

On May 21, 2012, the Scripps Howard News Service published a study revealing that 41 percent of all charities and other not-for-profit groups that collected at least $1 million in a one-year time frame reported no fundraising expenses to the IRS – even though the 41 percent raised more than $116 billion.[1] The report, "Money for Nothing: When Nonprofits Mislead," was based on the latest available data reported to the IRS on Form 990, "Return of Organization Exempt From Income Tax," from 2008 to 2010.[2]

"When we shared our findings with experts in tax law and charities, they almost fell out of their chairs laughing," said the study's introduction. "This is not a laughing matter, however, and charities should be making an extra effort to show where our donations go: It's the law, it will help them do a better job in the long run, and it's the right thing to do."[3]

These findings come at a time when many organizations are struggling to raise enough funds to carry out their social welfare and educational programs. According to Giving USA Foundation, charitable contributions grew by just 0.9 percent after inflation in 2011, compared with an inflation-adjusted 4.3 percent in 2010. Until economic conditions improve, some observers believe charitable giving might not return to historic levels until 2016 or later.[4]

Functional Reporting

The Financial Accounting Standards Board's (FASB) Accounting Standards Codification (ASC) Topic 958, "Not-For-Profit Entities," (formerly Financial Accounting Standard (FAS) No. 117, "Financial Statements of Not-for-Profit Organizations") requires not-for-profit organizations to report expenses according to three functional activities:

1. **Program activities.** These relate directly to the organizational mission and result in goods or services being delivered to beneficiaries, customers, or members. For example, a not-for-profit college or university might classify expenses related to their program activities into instruction, research, academic support, and student services. While identifying which programs should be reported separately is a matter of management's judgment, in practice, a program should be reported separately if its revenue or expenses are more than 10 percent of total revenue or expenses.
2. **Management and general activities.** These are informally known as "overhead" or "administrative" activities, which provide support services other than fundraising and program activities to execute the organizational mission. Examples of these expenses include organizational oversight and management, accounting and other recordkeeping, and soliciting revenue from exchange transactions such as government contracts. The development and maintenance of an IT system is a major management and general activity for many not-for-profit organizations today.
3. **Fundraising activities.** These generate revenue to support program and management and general expenses. Advertising, direct mail, and events for donors are common fundraising activities.

Not-for-profit organizations are under growing pressure from donors and industry advisers to minimize fundraising and management/general expenses. Some donors fund only program activities; others allow for an administrative allowance at levels below the realistic administrative needs of an organization. Many granting institutions use ratings from advisers such as Charity Navigator to determine whether and how much to grant to a not-for-profit organization. Recently, Charity Navigator announced that it would count all costs that are allocated between fundraising and other functions under the accounting guidance in ASC 958-720-45 exclusively as fundraising costs when evaluating not-for-profit organizations for its donor-clients.[5]

This pressure can make it more difficult – despite the perceived benefits – for not-for-profit organizations to invest in resources such as computer hardware and software, which can increase efficiencies and reduce fundraising and management/general expenses. The resulting tendency to minimize staffing or drive down salaries in management and general areas such as finance, accounting, or IT, where highly competent and technical individuals are crucial, can significantly increase organizational risk. As a result, the not-for-profit industry must focus on accurately classifying and reporting functional expenses in order to set appropriate expectations for donors and granting institutions while also educating them on the benefits and importance of adequate administrative oversight.

Allocating Costs

In many cases, the expenses associated with activities span two or more categories. For example, office space often is used by program staff, management and general staff, and fundraising staff. As a result, financial statements and IRS Form 990 should reflect the allocation of rent expenses among all three categories.

While not an exhaustive list, following are some of the most common costs for not-for-profit organizations that benefit multiple functions.

- **Employment costs** – salaries, health insurance, retirement, retirement insurance, employer portion of *Federal Insurance Contributions Act* (FICA) tax, other benefits, and employment taxes.
- **Occupancy costs** – rent, utilities, janitorial, maintenance, and depreciation.
- **Other costs** – telephone, office supplies, and postage.

Directly identifying expenses to a function is the preferable method for functional reporting, but this might not be practical in all situations.

There are several methods that can be used to allocate costs that benefit multiple functions. The most commonly used methods include:

- **Directly identifying costs to a function.** Commonly used for employees' salaries, this method requires employees to maintain detailed time records that allow their time to be recognized by functional activity. Directly identifying expenses to a function is the preferable method for functional reporting, but this might not be practical in all situations.
- **Allocating costs in proportion to salary expense.** Not-for-profit companies often allocate employment benefits, employment taxes, telephone costs, and office supplies by function proportionately with employees' salaries based on the time records maintained by the employees. For example, a college or university might assume that office supplies are consumed by employees in proportion to the manner in which they spend their time. Therefore, the institution would allocate office supply expense proportionately with the costs of salary expense. To avoid being subjective in its allocation, the institution should perform a study of the prior year's time records by function as maintained by employees. Management would need to periodically update the analysis to make sure it remains consistent over time.
- **Allocating costs in proportion to square foot usage.** This method is commonly used for occupancy costs. It requires an organization to estimate the percentage of square feet associated with each functional expense category. All occupancy costs are then allocated according to those percentages. Even depreciation, which is often thought of as a management and general expense, typically benefits multiple functions and should be allocated. For instance, depreciation on a building can be allocated based on the percentage of the building occupied by various departments. In other words, if a building is occupied 25 percent by accounting, 40 percent by instruction staff, and 35 percent by institutional advancement, depreciation expense may be allocated 25 percent to management and general, 40 percent to program, and 35 percent to fundraising. These space usage measures may also serve as an appropriate base for allocating other costs that might closely follow this usage pattern. Again, management should periodically evaluate the occupancy of the building to make sure that the ratios remain appropriate.

Fundraising: Joint Activities

Adding further complexity, fundraising activities that also include elements of either program or management and general activities (commonly referred to as joint activities), have unique accounting requirements. Not-for-profit organizations must allocate the costs of joint activities according to guidance published by the FASB in ASC 958-720-45. The most common situation where not-for-profit organizations engage in activities that meet the definition of joint activities are mailings with program and fundraising components and special events.

Under the guidance, an activity needs to meet three criteria – purpose, audience, and content – in order to be considered a joint activity:

1. **Purpose.** This criterion is met if the aim of the joint activity includes accomplishing program or management and general functions and requires a call to action by the audience to help achieve the organization's mission. Consider a direct-mail brochure. Half of the brochure addresses an issue of concern to the organization and asks people to write to their elected officials about the issue; the other half of the brochure asks people to consider making a donation to the cause. Because the brochure encourages people to write to their elected officials, it would meet the criterion of purpose.
2. **Audience.** To meet this criterion, the joint activity would need to reach out to a new audience, not just people who have supported the organization in the past. Thus, a brochure with a call to action must be mailed to people who have not donated to the cause in the past – in addition to past donors – in order to meet the criterion of audience. The FASB guidance states that the audience must have a "need to use or reasonable potential for use of the specific [call to] action."
3. **Content.** The content criterion is met if the joint activity supports program or management and general functions and is not strictly a fundraising appeal. Again, a specific call to action that will help accomplish an organization's mission must be evident – a step that many not-for-profit organizations fail to take. However, if an organization's mission includes educating the public, its content does not have to include a call to action.

Allocating Costs Related to Joint Activities

If an organization identifies activities that meet the joint activities criteria, the related joint costs should be allocated to appropriate functions. The more common methods of allocation include:

- **Physical units method.** Under this approach, an organization develops a ratio of fundraising costs to other costs and applies the ratio to joint costs based on the number of units of output that can be attributed to each of the materials and activities. For example, if an organization prepares a program-related mailer and decides to include a fundraising-request insert and return envelope within the mailer, the postage of this mailer would be considered a joint cost. The entire mailer weighs 2 ounces. The program-related portion of the mailer alone weighs 1.5 ounces, and the fundraising request and return envelope weigh 0.5 ounces. Management would allocate postage expense 75 percent to program and 25 percent to fundraising.
- **Relative direct cost method.** This method calls for a not-for-profit organization to develop a ratio based on an analysis of the costs associated with fundraising activities and other activities. The ratio is then applied to joint costs. Following the earlier example of the mailer, the program-related portion of the mailer cost $1,000 to make and produce, and the fundraising fliers and return envelopes cost $1,000 to make and produce. The joint cost of postage would be allocated likewise 50 percent to program and 50 percent to fundraising.
- **Stand-alone joint cost method.** Under this method, an organization analyzes the costs of the individual elements that make up a joint activity. It then allocates those costs based on the ratio of costs of each element to the shared costs of the combined project. Again following the earlier example of the mailer, assume that the cost of producing and mailing just the program component of the mailer is estimated to be $1,500, and the cost of producing and mailing just the fundraising portion of the mailer would be $500. In this situation, 75 percent of actual production and mailing costs would be allocated to program and 25 percent would be allocated to fundraising. This would require that management be able to rationally estimate the cost of producing just the programmatic component of the mailer.

Challenges Facing Not-for-Profit Organizations

As a result of pressures to minimize the amount of reported management and general and fundraising expenses, some organizations have instituted aggressive cost-allocation methodologies to shift the costs from management and general and fundraising to program expenses. An unfortunate side effect of this tendency is that granting institutions and donors are left with unrealistic expectations about the level of administrative costs required to effectively and prudently run an organization.

Educating potential donors on their true operating and fundraising costs helps not-for-profit organizations improve their chances of avoiding the not-for-profit starvation cycle.

Accurately reporting such costs at an industry level might highlight not-for-profit organizations' need for administrative resources above and beyond the cost of programming to provide benefits to society. These resources include IT assets to increase productivity, manage critical databases of programming and donor information, and engage the evolving world of social media for communications and outreach.

Organizations that fail to educate donors about their infrastructure needs face a challenging future that authors Ann Goggins Gregory and Don Howard call the "nonprofit starvation cycle."[6] The cycle starts with donors' unrealistic beliefs of how much not-for-profit organizations should spend on nonprogramming resources and becomes a self-fulfilling prophecy when organizations lack the data to justify their needs.

Developing a Realistic Allocation System

Unmi Song, executive director of the Lloyd A. Fry Foundation, said in a speech given at a Donors Forum event in March 2013[7] that what not-for-profit organizations should be asking themselves is how to allocate indirect costs in a meaningful way. She indicated that there is a misconception that granting institutions will not fund indirect costs and said "If the allocated administrative costs are not included in the grant proposal budget, [they] won't get covered. An effective program budget includes costs such as staff training, technology upgrades, monitoring and assessing of program outcomes."

Implementing an accurate system for allocating costs can help organizations comply with accounting and tax regulations and can provide them with the tools they need to show prospective donors how much it actually takes for them to carry out their mission. By educating potential donors on their true operating and fundraising costs, not-for-profit organizations improve their chances of avoiding the not-for-profit starvation cycle.

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[1] "Money for Nothing: When Nonprofits Mislead," Scripps Howard News Service Special Report, May 21, 2012, page 4, http://www.scribd.com/doc/111941936/Money-for-nothing-When-nonprofits-mislead

[2] Ibid, page 9.

[3] Ibid, page 2.

[4] Hall, Holly, "Charitable Donations Barely Grew Last Year, 'Giving USA' Finds," The Chronicle of Higher Education, June 19, 2012, http://chronicle.com/article/Charitable-Donations-Barely/132375/

[5] "Watchdog Barks Louder On Cost Allocation Issues," The NonProfit Times, Oct. 1, 2012, http://www.thenonprofittimes.com/article/detail/watchdog-barks-louder-on-cost-allocation-issues-4893

[6] Gregory, Ann Goggins and Howard, Don, "The Nonprofit Starvation Cycle," Stanford Social Innovation Review, Fall 2009, page 24, http://www.ssireview.org/articles/entry/the_nonprofit_starvation_cycle/

[7] http://www.donorsforum.org/s_donorsforum/doc_event.asp?CID=6232&DID=60502

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