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100 Introduction

100.1 With a for-profit business, net income is typically a key indicator of the entity's financial results. Because of the lack of profit motive, however, a nonprofit organization's expenses often provide some of the most meaningful and useful information about the organization's programs, activities, and accomplishments. As a result, properly recognizing and reporting expenses by object and function is important to ensuring the overall usefulness and effectiveness of an organization's financial information.

What Is a Nonprofit Organization?

100.2 Nonprofit organizations range in size from small local entities to large international organizations. They encompass almost every activity imaginable—health and welfare, religion, education, research, social activities, and professional activities. But what exactly *is* a nonprofit organization? The Financial Accounting Standards Board (FASB), in the FASB Accounting Standards Codification™ (the Codification), defines nonprofit organizations by contrasting them to for-profit entities. Specifically, FASB ASC 958-10-20 defines nonprofit organizations as entities that possess the following characteristics not typically found in business enterprises:

a. They receive contributions of significant resources from resource providers who do not expect a commensurate or proportionate monetary return.

b. They operate for purposes other than to make a profit.

c. There is an absence of ownership interests like those of business enterprises.

100.3 In some cases, it may be difficult to determine whether an entity is a nonprofit organization since nonprofit organizations may have the preceding characteristics in varying degrees. (For example, an organization may receive significant revenue from exchange transactions rather than contributions but still meet the nonprofit definition.) In other cases, it is fairly obvious that an entity does not have the characteristics of a nonprofit organization. The glossary definition of “not-for-profit entity” in FASB ASC 958-10-20 notes that nonprofit organizations do not include “investor-owned entities and entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance entities, credit unions, farm and rural electric cooperatives, and employee benefit plans.”

100.4 To help clarify what a nonprofit organization is for purposes of generally accepted accounting principles (GAAP), FASB ASC 958-10-15-3 notes that nonprofit entities include the types of entities listed in Exhibit 1-1.

Exhibit 1-1

Types of Nonprofit Entities

Cemetery organizations

Civic and community organizations

Colleges and universities

Elementary and secondary schools

Federated fund-raising organizations

Fraternal organizations

Health care entities

Labor unions

Libraries

Museums

Other cultural organizations

Performing arts organizations

Political parties

Political action committees

Private and community foundations

Professional associations

Public broadcasting stations

Religious organizations

Research and scientific organizations

Social and country clubs

Trade associations

Voluntary health and welfare organizations

Zoological and botanical societies

Which Nonprofit Organizations Should Use This *Guide*?

100.5 The accounting principles discussed in *PPC's Guide to Nonprofit Expenses* apply to all *nongovernmental* nonprofit organizations except providers of health care services covered by the AICPA Audit and Accounting Guide, *Health Care Organizations*. Thus, this *Guide* does not apply to entities that are required to issue financial reports in accordance with guidance promulgated by the Governmental Accounting Standards Board or the Federal Accounting Standards Advisory Board. Governmental organizations include public corporations and organizations that have one or more of the following characteristics:

a. Popular election of officers or appointment (or approval) of a controlling majority of the members of the organization's governing board by officials of one or more state or local governments.

b. The potential for unilateral dissolution of the organization by a government with the net assets reverting to a government.

c. The power to enact and enforce a tax levy.

Organizations that can issue tax-exempt debt directly are also presumed to be governmental organizations.

Resources for Accounting Guidance

100.6 There is a wide variety of accounting literature related to nonprofit organizations. The FASB Accounting Standards Codification (**http://asc.fasb.org**) is the sole authoritative source of U.S. GAAP for all nongovernmental entities, including nonprofit organizations. All guidance contained in the Codification carries an equal level of authority. The Codification was created by including all standards previously classified as level A-D GAAP that were issued by a standard setter (that is, FASB, AICPA, or their predecessors) in a topically organized searchable database. FASB ASC 958, *Not-for-Profit Entities*, provides

the incremental standards for nonprofit organizations, and the general Topics of the Codification (FASB ASC 100 through but not including 900) apply to nonprofit organizations unless the scope sections explicitly exclude those organizations.

100.7 Accounting and financial reporting practices not included in the Codification are nonauthoritative. Sources of nonauthoritative accounting guidance and literature include the following (FASB ASC 105-10-05-3):

- AICPA Audit and Accounting Guide, *Not-for-Profit Entities*. [1]
- Practices that are widely recognized and prevalent either generally or in the industry.
- FASB Concepts Statements.
- AICPA Issues Papers.
- International Financial Reporting Standards of the International Accounting Standards Board (IASB).
- Pronouncements of professional associations or regulatory agencies.
- Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids.
- Accounting textbooks, handbooks, and articles.

100.8 As mentioned in the preceding paragraph, various industry groups also provide guidance geared more toward their specific industries. For example, voluntary health and welfare organizations should be aware of a publication entitled *Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations*. Known as the Black Book, the objective of that guide is to attain uniform accounting and external financial reporting in compliance with generally accepted accounting principles by all voluntary health and welfare organizations. The Black Book, page 3, is explicit that it does not establish GAAP but rather provides additional explanations of existing authoritative literature and illustrations particularly relevant to voluntary health and welfare organizations. Appendix 1A presents a list of selected publications that address nonprofit accounting.

100.9 The appropriateness of other sources of accounting guidance depends on its relevance to particular circumstances, the specificity of the guidance, the general recognition of the issuer or author as an authority, and the extent of its use in practice.

100.10 This *Guide* uses the referencing structure suggested in the Codification's *Notice to Constituents* (**http://asc.fasb.org/imageRoot/63/6537863.pdf**). Thus, this *Guide* will use the format FASB ASC XXX-YY-ZZ-PP(a), in which:

- XXX indicates the Topic; for example, FASB ASC Topic 958 is Not-for-Profit Entities.
- YY indicates the Subtopic; for example, FASB ASC 958-720 is Not-for-Profit Entities: Other Expenses.
- ZZ indicates the section; for example, FASB ASC 958-720-25.
- PP indicates the paragraph; for example, FASB ASC 958-720-25-4.
- (a) indicates the Subparagraph; for example, FASB ASC 958-720-25-8(b).

100.11 To help accountants with the transition to the new Codification, the authors have continued to include citations to the prior standards that accountants were familiar with and that served as the basis for the Codification.

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[1] The Financial Reporting Executive Committee, the Not-for-Profit Entities Expert Panel, and the Not-for-Profit Guide Task Force released for review by the public a comprehensive revision of the AICPA Audit and Accounting Guide, *Not-for-Profit Entities*, in August 2012. Extensive changes are being proposed to the guide to improve user understanding and minimize diversity in practice. Nonprofit organizations and their accountants should be alert for further developments related to the issuance of this updated guidance.

END OF DOCUMENT -

101 General Considerations for Recognizing and Reporting Expenses

101.1 Expenses are recognized when an organization's assets are used up (or liabilities incurred) to deliver or produce goods, render services, or perform other activities that constitute the entity's major or central operations. If a transaction represents an expense, it should generally be reported at its *gross* amount rather than as a net amount (except for investment expenses; see section 205). FASB ASC 958-225-45-7 requires all expenses to be reported as decreases in *unrestricted* net assets, regardless of the origin of the resources used to pay the expenses.

101.2 Statement of Financial Accounting Concepts (SFAC) No. 6 describes the following broad expense recognition principles:

a. Costs and revenues from exchange transactions that result directly and jointly from the same transaction or event are recognized in the same accounting period (such as sales revenue and cost of sales). [2]

b. Costs that cannot be directly related to particular revenues and are incurred to obtain benefits that are exhausted in the period in which the costs are incurred are recognized in that period (such as salaries and utilities). [2]

c. Costs that provide benefits over several periods are allocated to those periods (for example, prepaid insurance and depreciation). Costs are generally allocated to accounting periods when no direct relationship between revenues and costs exists, and the costs cannot be identified with a particular accounting period.

Example 1-1: Recognizing and reporting expenses—same transaction or event.

In 20X7, a community theater prepares to perform a new play that will open in 20X8. At the theater's year-end of December 31, 20X7, $15,400 of costs have been incurred for scripts, costumes, and scenery relating to the new play. In accordance with recognition principle (a), directly associated costs and revenues should be recognized in the same period. Therefore, the $15,400 in costs should be deferred at December 31, 20X7. The deferred costs would be released and recognized as expenses when the play opens in 20X8.

Example 1-2: Recognizing and reporting expenses—benefits exhausted in period costs incurred.

The community theater incurs telephone, mailing, and other fund-raising costs in its efforts to locate a sponsor to help fund the costs of the new play. As of December 31, 20X7, $750 of costs have been incurred relating to locating a sponsor. In accordance with recognition principle (b), the $750 in costs should be expensed in 20X7.

Example 1-3: Recognizing and reporting expenses—benefits over several periods.

The community theater arranges to rent the stage at the Performing Arts Center. Its current production runs for four weekends in 20X7 and the new play will run for eight weekends in 20X8. The cost of $1,200 is for a total of twelve weekends, four in 20X7 and eight in 20X8. In accordance with recognition principle (c), the $1,200 in costs should be allocated to the periods in which the benefits occur. Thus, $400 should be expensed in 20X7 and the remainder ($800) should be expensed in 20X8.

101.3 In most cases, expense transactions are measured at the amount of cash paid to acquire the goods or services received. However, if the item exchanged is not cash, the transaction is measured at the fair value of the asset exchanged. In certain cases, the cash amount paid at initial recognition might not represent the fair value of the good or service received. For example, if the transaction is in part a contribution, is between related parties, or occurs

under financial duress, the cash exchanged may not be indicative of the value of the item received. Fair value, rather than transaction price, is used to measure an expense transaction in certain of these cases. This *Guide* discusses the following uses of fair value to measure expenses:

- Noncash contributions, as discussed in paragraph 205.27.
- Unconditional promises to give (contributions made) to other organizations, as discussed beginning at paragraph 205.28.
- Guarantees of indebtedness of others, as discussed beginning at paragraph 205.43.
- Measurement of donated materials and supplies, as discussed beginning at paragraph 205.110.

101.4 FASB ASC 820 sets standards for measuring assets and liabilities at fair value. FASB ASC 820-10-20 defines fair value as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” FASB ASC 820 provides additional information about many of the key phrases in that definition. In addition, FASB ASC 820 establishes a framework for measuring fair value that describes how to use inputs and valuation techniques to develop fair value measures. A comprehensive description of that framework is beyond the scope of this *Guide* because fair value measures are not widely used for measuring and recording expenses. [Section 105 of *PPC's Guide to Nonprofit Contributions* contains a description of the framework. That *Guide* can be ordered by calling (800) 431-9025 or visiting **ppc.thomsonreuters.com**.]

101.5 Appendix 1B, “Expenses Checklist—General Considerations,” presents considerations for recognizing and reporting expenses. The checklist is provided to assist accountants in addressing some of the general requirements regarding expenses.

Distinguishing Expenses from Losses

101.6 Losses are decreases in net assets resulting from peripheral or incidental transactions of an entity. In contrast to expenses, losses may be netted against gains for reporting purposes. Although losses may occur as a result of transactions that are outside of an organization's control (such as a change in foreign exchange rates or a loss resulting from flood or fire), the determining factor in distinguishing between a loss and an expense is whether the related transaction is *peripheral or incidental* to the organization's activities. [3] As a result, costs associated with certain transactions (such as those related to a revenue-generating activity) may be reported as either an expense or a loss, depending on the organization's specific circumstances.

Example 1-4: Distinguishing expenses from losses—peripheral or incidental transaction.

A church produces and sells a cookbook to raise funds for a mission trip. The mission trip is part of the church's 25th anniversary celebration. Proceeds from the sale of the cookbook are $10,000, and direct costs to produce the cookbook are $10,500.

The church produces the cookbook as part of its 25th anniversary festivities. It has never produced a cookbook in the past, nor does it intend to do so in the near future. The direct costs of producing the cookbook are not material to the church's total expenses. Therefore, the $10,000 sales proceeds may be netted against the direct costs of $10,500 and reported as a $500 net loss on the sale of cookbooks.

Example 1-5: Distinguishing expenses from losses—significant and ongoing activity.

Each year, a church produces and sells a cookbook to raise funds for its annual mission trip. Proceeds from the sale of the cookbook are $10,000, and direct costs to produce the cookbook are $10,500.

The church produces and sells a cookbook annually as part of its ongoing fund-raising efforts, and the costs to produce the cookbook are material to the church's total expenses. The cookbook sale is considered a central or major activity of the church. Thus, the direct costs of $10,500 should be reported as an expense, and the $10,000 proceeds should be reported as revenue.

Distinguishing Expenses from Agency Transactions

101.7 Distributions to other organizations (or individuals) made by a nonprofit organization in furtherance of its charitable purpose are generally expenses of the organization. However, in some cases, rather than acting on its own behalf, the nonprofit organization is acting as an agent, trustee, or intermediary in a transfer between a donor and a beneficiary specified by the donor (that is, an agency transaction). If a transaction is an agency transaction, the receipt of assets by the organization from the donor should be recorded as a liability, *not* as a revenue. The subsequent distribution to the beneficiary specified by the donor is recorded as a reduction in the liability, *not* as an expense.

101.8 The Transfers of Assets to a Not-for-Profit Entity or Charitable Trust That Raises or Holds Contributions for Others Subsections of FASB ASC 958-605 provides guidance on determining whether a nonprofit organization should report a reduction in a liability or report an expense when it distributes assets to

other organizations or individuals. In general, a nonprofit organization reports a liability rather than contribution revenue if it accepts assets from a donor and agrees to use those assets on behalf of or transfer those assets to another organization or individual specified by the donor. When it subsequently spends the assets on behalf of the beneficiary or transfers the assets, their investment return, or both to the beneficiary, the nonprofit organization reduces the liability it recorded earlier instead of recording an expense.

101.9 The representations made to the donor during the solicitation of a gift are important when determining whether a transaction is an agency transaction. If the nonprofit organization creates a donor's reasonable expectation that the gift will be transferred to a beneficiary specified by the donor, the nonprofit organization cannot recognize contribution revenue (or subsequently recognize contribution expense). The nonprofit organization does not control the economic benefit of the assets it received because its discretion in determining how the assets will be used is severely limited by the donor's specification of a beneficiary. Instead, the donor has made a contribution to the specified beneficiary. The nonprofit organization, which accepted the assets subject to the direction of the donor, has a liability to the specified beneficiary. (If the nonprofit organization receives nonfinancial assets in an agency transaction, such as inventory or supplies, the nonprofit can choose not to recognize the liability, provided that it does so consistently from period to period and discloses its policy in the notes to its financial statements.)

101.10 In contrast, if neither the language used by the donor nor the representations of the nonprofit organization cause the donor to believe that he or she is directing the gift to a specified organization or individual, then the nonprofit organization recognizes contribution revenue (and upon distribution, contribution expense). For example, if a donor directs the gift to one or more fields of interest from a list of community needs prepared by the nonprofit organization, the nonprofit organization recognizes a temporarily restricted contribution. That treatment is appropriate because the contribution is restricted to the designated field of interest, but the organization has the ability to choose which organization or organizations within the field of interest will receive the contribution. Similarly, if fund-raising materials ask donors to *suggest* beneficiaries for consideration by a nonprofit organization's allocation committee, the nonprofit recognizes an unrestricted contribution because its allocation committee retains the right to select the final beneficiaries in accordance with the donors' suggestions or not.

Example 1-6: Distinguishing expenses from agency transactions—agency transaction.

An organization has an annual Christmas toy drive, in which toys are received by the Organization from the public. The Organization distributes the toys to low-income children.

Prior to beginning the toy drive, the county Child Protective Services agency identifies specific children who need assistance. Those children prepare Christmas lists indicating the toys they would like to get. The Organization then provides the public with each child's name and his or her Christmas list. Donors buy toys for individual children and deliver the toys to the Organization. The Organization distributes the donated toys to the identified children.

That is an agency transaction since the Organization has no discretion over which children are to receive what toys. As a result, when the toys are received, the receipt of assets represents a liability of the Organization. When the toys are distributed to the children, they are simply reductions of the liability, *not* expenses.

Child Protective Services would recognize the liability if it has a policy to recognize agency transactions involving nonfinancial assets.

Example 1-7: Distinguishing expenses from agency transactions—expense.

An organization has an annual Christmas toy drive, in which toys are received by the Organization from the public. The Organization distributes the toys to low-income children.

The Organization has no predetermined list of recipient children. Instead, the Organization publishes a *wish list* describing the kinds of toys the Organization hopes to collect. Once toy donations are received, Organization case managers match donated toys with deserving children and distribute the toys to the selected children.

In that case, the toy donations represent contributions to the Organization rather than agency transactions. The Organization has the discretion to determine which children will receive the toys. Thus, the distribution of toys to the children represents an expense to the Organization.

101.11 Some nonprofit organizations participate in activities in which the donor determines eligibility requirements for the ultimate beneficiaries, and the organization must disburse the assets transferred to the organization by the donor to any who meet those eligibility requirements. In some cases, the organization receives a fee for disbursing the assets. Examples of the assets received and distributed are food, food vouchers, public transportation vouchers, and cash. The AICPA discusses those types of nondiscretionary assistance programs in a nonauthoritative Technical Practice Aid (TIS 6140.12).

101.12 TIS 6140.12 states that an organization that receives financial assets (cash or vouchers that can be exchanged for cash) should recognize its liability to the beneficiaries when it recognizes the financial assets received from the donor. An organization that receives nonfinancial assets (such as vouchers that can only be exchanged for a defined quantity of goods or services) should recognize a liability and those assets only if it has a policy of recognizing liabilities for nonfinancial assets received in agency transactions, discloses that policy, and reports consistently from period to period.

Example 1-8: Nondiscretionary assistance programs—nonfinancial assets.

Greenacres County Senior Services receives bus tokens from the Greenville City Bus Company that are to be distributed upon request to any resident of Greenville City who is over the age of 65. No more than 30 tokens may be distributed to any individual in a single month. Upon request from a potential beneficiary of this program, Greenacres County Senior Services is required to (1) verify that the individual is 65 years of age or older, (2) verify that the individual is a resident of Greenville City, and (3) verify that the individual has not received 30 tokens that month.

Greenacres County Senior Services is acting as an agent for Greenville City Bus Company as it is required to distribute the tokens to any eligible individual who requests them. If Greenacres County Senior Services has a policy of recognizing a liability when it receives and distributes nonfinancial assets as an agent, it would recognize an asset (bus tokens inventory) and a liability (bus tokens to be distributed) when it receives the tokens from the bus company. The asset and the liability are reported at the fair value of the tokens received (the number of tokens times the cost of a ride at the senior citizen rate). As the tokens are distributed, the asset and the liability would be reduced. If Greenacres County Senior Services does not have a policy of recognizing a liability when it receives and distributes nonfinancial assets as an agent, the receipt and disbursement of the tokens is not recognized in the financial statements.

Example 1-9: Nondiscretionary assistance programs—financial assets.

Loba Linda College participates in the federal Pell Grant program. It determines a student's eligibility for an award, computes the amount of the award using the Department of Education program guidelines, disburses the award to the student, and submits the forms necessary to obtain reimbursement from the federal government. Loba Linda College is acting as an agent for the federal government in providing financial aid to college students. Because the assets transferred are financial assets, Loba Linda College would increase its cash and report a liability if it received funds from the federal government prior to disbursement to the student. If it disbursed the assets to the student and then applied for reimbursement, Loba Linda would decrease its cash (or the student's tuition receivable account) and recognize a receivable from the federal government.

101.13 **Exceptions to Agency Transaction Treatment**

There are two exceptions in which a nonprofit organization recognizes contribution revenue (and upon distribution, contribution expense) even though the donor specified a beneficiary:

- The nonprofit organization and the beneficiary organization are financially interrelated organizations.

- The donor explicitly grants the nonprofit organization variance power.

101.14 If the relationship between the nonprofit organization and the beneficiary organization meets the criteria specified in FASB ASC 958-20-15-2 for financially interrelated organizations, the nonprofit organization reports contribution revenue and contribution expense when it distributes assets to the beneficiary. FASB ASC 958-20-15-2 provides that organizations are financially interrelated if the relationship between them has both of the following characteristics:

- One of the entities has the ability to influence the operating and financial decisions of the other.

- One of the entities has an ongoing economic interest in the net assets of the other.

101.15 The ability to influence the operating and financial decisions of the other entity can be demonstrated in several ways:

- The organizations are affiliates as defined in FASB ASC 958-20-20.

- One entity has considerable representation on the governing board of the other entity.

- The charter or bylaws of one entity limit its activities to those that are beneficial to the other entity.

- An agreement between the entities allows one organization to actively participate in the policymaking processes of the other, such as setting organizational priorities, budgets, and management compensation.

An ongoing economic interest in the net assets of another is a residual right to the other organization's net assets that results from an ongoing relationship. The value of those rights increases or decreases as a result of the investment, fund-raising, operating, and other activities of the other organization.

101.16 Most relationships that meet the criteria in paragraph 101.14 are foundations that exist to raise, hold, and invest resources for a specified beneficiary organization. The foundation would recognize contribution revenue when it receives assets from a donor and contribution expense when it subsequently transfers the assets to the beneficiary organization (or organizations) it supports.

Example 1-10: Exception to agency transaction treatment—financially interrelated organizations.

City Architecture Museum Foundation's bylaws state that it is organized for the sole purpose of raising resources to support the activities of City Architecture Museum. When the Foundation distributes resources to the Museum, it recognizes those distributions as an expense. Terms such as “distributions to related parties” or “distributions to City Architecture Museum” may be used to describe the transactions in the financial statements. (The Transfers of Assets to a Not-for-Profit Entity or Charitable Trust That Raises or Holds Contributions for Others Subsections of FASB ASC 958-605 also require that City Architecture Museum record its interest in the assets held by the Foundation using the equity method of accounting. Thus, the Museum recognizes the receipt of the resources from the Foundation as a decrease in its interest in the net assets of the Foundation.)

101.17 If a donor grants variance power, a nonprofit organization recognizes contribution revenue (and upon distribution, contribution expense). The donor must explicitly grant the nonprofit organization the power to redirect the gift to a beneficiary other than the beneficiary specified by the donor—without consulting the donor, the specified beneficiary, or any other interested party. Community foundations usually require a donor to grant that power, called *variance power*, in the gift instrument because the gifts are then entitled to favorable treatment under U.S. Treasury Regulations. Thus, most distributions by community foundations are expenses for contributions made even though the donor specified a beneficiary at the time of the gift.

Example 1-11: Exception to agency transaction treatment—variance power.

A donor gave a large gift to Valley Community Foundation, named Tri-Town Thespians as the beneficiary, and granted Valley Community Foundation variance power. The gift is recorded as contribution revenue by Valley Community Foundation. Future distributions to Tri-Town Thespians will be recorded as contribution expense by Valley Community Foundation.

101.18 Community foundations and other organizations that receive variance power must be diligent when accepting transfers of assets from nonprofit organizations that specify themselves as the beneficiary of the transferred assets. Those transfers usually are not contributions received—even if the organization granted variance power at the time of the transfer—because they are not a *nonreciprocal* transfer. Thus, when the community foundation or other organization receives the assets, it should record a liability rather than contribution revenue. Subsequent distributions to the beneficiary organization are recorded as reductions in the liability, not contribution expense.

Example 1-12: Agency transaction—organization specified itself as beneficiary.

Tri-Town Thespians receives a large gift for its unrestricted use. The governing board decides that the gift should be invested and the investment return used to support the organization's annual expenses. Because it has no investment expertise, Tri-Town Thespians transfers the resources to Valley Community Foundation. It signs an agreement stating that the transfer is irrevocable. Valley Community Foundation agrees that it will distribute annually the investment return earned on the assets to Tri-Town Thespians, subject to the foundation's spending policies and its variance power. The agreement states that the variance power allows Valley Community Foundation to substitute another beneficiary if Tri-Town Thespians ceases to exist or if the governing board of the foundation votes that distributions to Tri-Town Thespians are unnecessary or inconsistent with the needs of the community.

Although Tri-Town Thespians has granted variance power, the transfer to Valley Community Foundation is reciprocal—a liability for future distributions to Tri-Town Thespians is exchanged for Tri-Town Thespians' assets. Accordingly, Tri-Town Thespians should not report an expense for the assets transferred. Instead, it should recognize a decrease in cash (or investments) and an increase in an asset, for example, as “beneficial interest in assets held by Valley Community Foundation.” Valley Community Foundation should initially record a liability rather than contribution revenue when it receives the transferred assets. Subsequently, it should report a reduction in that liability rather than contribution expense when it distributes investment return to Tri-Town Thespians.

101.19 Although the example transaction in paragraph 101.17 and the example transaction in paragraph 101.18 both result in distributions to Tri-Town Thespians, they are accounted for differently because the *donor's* expectation is different. In the first situation, the donor specified Tri-Town Thespians but explicitly granted Valley Community Foundation the ability to use it for other purposes; that is, the donor gave the ultimate determination of the beneficiary to the foundation. Thus, the donor made a gift to Valley Community Foundation, not Tri-Town Thespians. In the second situation, the donor expected the gift to benefit Tri-Town Thespians.

101.20 **Impact of Agency Transactions on Fund-raising Ratios**

Some organizations that raise significant amounts of resources for others are concerned that their organizations may appear less efficient if users of the financial statements compute a fund-raising ratio using a denominator that excludes amounts raised for others in agency transactions. Others are concerned

that the total support they provide to the community will not be apparent if their expenses do not include amounts that they raise and distribute to beneficiaries selected by the donors. For additional information about those concerns and display alternatives that may help mitigate potential misunderstandings, see paragraphs 102.36 and 201.7.

Recording Expenses May Trigger Release of Restrictions

101.21 **Expenses and Purpose Restrictions**

Incurring an expense often triggers a release of restrictions on temporarily restricted net assets. A donor-imposed purpose restriction on a contribution expires when the purpose for which the gift was given is fulfilled, provided that the required time period has passed if the contribution also included a time restriction. Thus, a payroll or purchase transaction of a particular program will lift restrictions on a gift from a donor that required his or her gift be used to support that program. The release of restrictions occurs even if the nonprofit organization has budgeted the expense as part of its unrestricted budget for the program. The donor's purpose has been met regardless of whether separately identified restricted net assets or unrestricted net assets were used to make the payment. (That is often referred to as the *first dollar spent* method of recognizing expirations of restrictions.) Accordingly, in most circumstances the organization cannot avoid recognizing a reduction in temporarily restricted net assets and an increase in unrestricted net assets for the release of the restrictions. The only situation in which the organization can avoid a reclassification is if the expenses are directly attributable to some other specific external source of funding (such as a cost-reimbursement grant) that could be lost if the expenses were attributed to temporarily restricted net assets.

101.22 Many times an organization has multiple resources available when it incurs an expense. In circumstances in which an organization makes an expenditure that could satisfy more than one purpose restriction, accounting standards do not define a hierarchy as to which purpose restrictions are met from among the various sources of temporarily restricted net assets. The following types of resources may be available:

- Temporarily restricted net assets:
  - Purpose-restricted contributions.
  - Unspent income from a purpose-restricted endowment.
  - Unspent net appreciation from a purpose-restricted endowment.
- Other specific external sources of funding:
  - Cost-reimbursement grants that can reimburse the expenditure.
  - Conditional promises to give for which the expenditure satisfies the condition.
  - Exchange contracts for which the expense is directly related.

101.23 To the extent an organization makes an expenditure that meets donor-imposed purpose restrictions on net assets, it should reclassify net assets from temporarily to unrestricted unless (a) the expenditure is for a purpose that is directly attributable to another specific external source of revenue or (b) the temporarily restricted net assets are not available.

101.24 Available means that the temporarily restricted net assets are not subject to time restrictions that have not yet expired. Examples of temporarily restricted net assets that are not available are—

- An unconditional promise to give that is due in a future period (although there is an exception to this rule that is discussed in paragraph 101.27).
- A gift that the donor has explicitly restricted to use in a future period.

• A gift that was received in response to a campaign that indicated it would be spent in a future period.

• The investment earnings of a donor-restricted endowment fund to the extent they have not been appropriated for expenditure by the governing board. (Availability of endowment funds is discussed further beginning at paragraph 101.32.)

101.25 When an organization has multiple sources available for a single expense, it may choose among the available purpose-restricted net assets (contributions, endowment income, or endowment net appreciation) and recognize a release of the restriction, or it may assign the expense to a specific external source of revenue (cost-reimbursement grants, conditional promises to give, or exchange contracts) and recognize the related revenue.

Example 1-13: Expenses and purpose restrictions.

Trinity Research University conducts Alzheimer's disease research. It has the following resources available to conduct that research:

• A cost-reimbursement grant of $80,000.

• Gifts restricted to research of $60,000.

• Gifts restricted to Alzheimer's disease research of $40,000.

• A budget allocation of $120,000.

Trinity Research University incurred $140,000 of expenses for Alzheimer's disease research during the year. All expenses were allowable under the terms of the cost-reimbursement grant. Two of the options that Trinity Research University could use for attributing the expenses are as follows:

Option 1: It can allocate some or all of the expenses to the cost-reimbursement grant, up to the grant amount of $80,000. The University can do that even though there are restricted net assets available for that purpose because a cost-reimbursement grant is a specific external source of revenue that would otherwise not be received by the University. If the University allocates $80,000 to the grant, it must utilize restricted resources for the remaining $60,000 (since temporarily restricted net assets must be used before unrestricted net assets are used). It has a choice of how to allocate that $60,000 among the restricted net assets, however. For example, in order to use the more narrowly restricted net assets first (and thus have more flexibility for future expenditures), Trinity Research University might choose to allocate $40,000 to the gifts restricted to Alzheimer's disease research and the remaining $20,000 to the gifts restricted to research.

Option 2: It could attribute the expenses to donor-restricted net assets to the extent available. Thus, it would allocate $60,000 to the gifts restricted to research and $40,000 to the gifts restricted to Alzheimer's disease research. The remaining $40,000 of expenses could be charged to the cost-reimbursement grant or to the budget allocation because there are no other resources whose restrictions can be met by incurring expenses for Alzheimer's disease research. However, before choosing to use the budget allocation, the University should consider whether it will be able to collect the full amount of the grant in the future if it bypasses the opportunity to allocate allowable expenses now (that is, the University should consider whether it expects to have other expenses that can be allocated to that grant before the end of the grant period).

Trinity Research University cannot choose to allocate the expenses entirely to the cost-reimbursement grant and the budget allocation. Because the University has incurred expenses for a purpose for which restricted net assets were available, the donor-imposed restrictions on those net assets have been fulfilled.

101.26 **Expenses and Time Restrictions**

FASB ASC 958-205-45-11 states that temporarily restricted net assets with time restrictions are not available to support expenses until the time restrictions have expired. The assumption is that, by choosing to restrict the use of a gift until a future period, the donor is implicitly indicating that it is the activities of that future period that the donor wishes to support.

Example 1-14: Expenses and time restrictions—term endowment without purpose restriction.

Jennie Russ gives $50,000 in January 20X0 to Avoiding Armed Violence as a term endowment. Principal and income are to be invested and reinvested for five years, at which time the gift is to be used to support the organization's work. The time restrictions on the $50,000 gift expire in 20X5, and at that time the net assets are reclassified to unrestricted because Ms. Russ did not place purpose restrictions on her gift.

Example 1-15: Expenses and time restrictions—term endowment with purpose restriction.

Ben E. Factor also gives $50,000 in January 20X0 to Avoiding Armed Violence as a term endowment. Principal and income are to be invested and reinvested for five years, at which time the gift is to be used to support the organization's program in preventing gun suicides. Avoiding Armed Violence incurs the following amounts of expenses in that program:

20X0	$ 20,000
20X1	24,000
20X2	25,700
20X3	28,800
20X4	30,000
20X5	32,500

The expenses incurred in years 20X0 through 20X4 do not lift the purpose restrictions on Mr. Factor's gift because the time restriction is still in place. In January 20X5, the time restriction expires, and the $32,500 of expenses incurred that year in the suicide prevention program release purpose restrictions of the same dollar amount. Thus, at the end of 20X5, Avoiding Armed Violence has $17,500 (plus reinvested income) of net assets remaining that are subject to a purpose restriction that they be used to support the organization's work in preventing armed violence. However, those net assets are no longer subject to any time restrictions.

101.27 In most cases, time restrictions on contributions receivable lapse when the receivable is due. FASB ASC 958-605-45-5 states that a time restriction is implied on a promise to give that is due in a future period unless the donor intended the contribution to be used to support activities of the current period. Often, the due date is explicitly stated. Situations in which a contribution receivable is past due or the due date is not explicitly stated are discussed by the AICPA in a nonauthoritative Technical Practice Aid (TIS 6140.03). The implied time restriction on an uncollected contribution receivable expires on its due date, even if that receivable is not yet collected. When a due date is not explicitly stated, circumstances surrounding the receipt of the contribution may make an implicit due date clear. In yet other cases, the organization may need to consider the facts and circumstances surrounding the promise to give to determine the due date, if any. Regardless of the manner in which the due date is determined, the time restriction expires at the due date, not the collection date.

Example 1-16: Expenses and time restrictions—multi-year promise to give.

In December 20X0, Margaret White promises to give $5,000 to Orange County College for scholarships for students from her hometown, payable in five annual payments of $1,000 due on December 15 of each of the next five years. Thus, the gift is available to support $1,000 of scholarships granted after December 20X1, $1,000 of scholarships granted after December 20X2, and so forth, through $1,000 of scholarships granted after December 20X5. Orange County College incurred the following qualifying scholarship expenses, which released restrictions in the following way:

Year	Qualifying Expenses	Restrictions Released
20X0	$ —	$ —
20X1	2,000	1,000
20X2	—	—
20X3	1,800	1,800
20X4	750	750
20X5	2,500	1,450

At December 15, 20X0, there are $5,000 of net assets subject to both time and purpose restrictions. (The requirement to present value the payments receivable has been ignored to simplify this example.) Although $2,000 of qualifying expenses are incurred in year 20X1, the

restrictions released are only $1,000 because the time restrictions must expire before the resources become available to support expenses. Only time restrictions on the payment due in 20X1 have expired.

After recognizing the release of restrictions in 20X1, there are $4,000 of restricted net assets related to the gift. On December 15, 20X2, time restrictions on the $1,000 payment due expire and the net assets are available to support scholarship expenses. The remaining $3,000 is subject to both time and purpose restrictions. Although there was a $1,000 excess of qualifying scholarships in 20X1, those expenses do not release restrictions on December 15, 20X2, because they were incurred before the payment was due. Thus, because no qualifying expenses were incurred in 20X2, no restrictions are released.

When the 20X3 expenses are incurred, there are still $4,000 of net assets remaining related to the gift. Of that amount, $2,000 is subject only to the purpose restriction—$1,000 on which the time restriction expired on December 15, 20X2 and $1,000 on which the time restriction expired on December 15, 20X3. The remaining $2,000 of net assets are subject to both time and purpose restrictions because the payments are not yet due. Thus, the expenses of $1,800 release restrictions on $1,800 of the net assets subject only to the purpose restriction, and $200 of those net assets remain (as well as the $2,000 of net assets on which payments are not yet due).

On December 15, 20X4, time restrictions on the $1,000 payment due expire, and the net assets are available to support scholarship expenses. The $750 of qualifying expenses release restrictions on net assets of the same amount. Afterward, there are $1,450 of net assets related to the gift remaining. Of that amount, $450 of the net assets ($200 + $1,000 − $750) are subject only to the purpose restriction, and $1,000 of the net assets are subject to both the time and purpose restrictions.

On December 15, 20X5, time restrictions on the final $1,000 payment due expire, and the entire $1,450 of net assets are available to support scholarship expenses. All restrictions are released when the qualifying expenses are incurred.

101.28 In some cases in which a donor chooses to pay a promise to give in a future year, no time restriction is implied. If circumstances surrounding the gift indicate that the donor intended to support activities of the current period, there is no time restriction. A common situation in which payments are due in future periods but no time restriction is implied is discussed by the AICPA in a nonauthoritative Technical Practice Aid (TIS 6140.04).

101.29 Often a nonprofit organization will hold a capital campaign to finance the construction of a new building or other major long-lived asset. Gifts raised in a capital campaign may be subject to three (or more) restrictions. First, the gifts are subject to a implied purpose restriction because they are raised in a campaign that represents to donors that their gifts will be used to purchase the long-lived asset. Second, the gifts might be subject to an implied time restriction because the payments are due in a future period. Third, the gifts might be subject to an implied time restriction that expires over the long-lived asset's useful life because it is the organization's policy to imply a time restriction on gifts of long-lived assets and cash (or other assets) that are given to purchase long-lived assets. In addition, a donor may place explicit restrictions on a gift.

101.30 Whether an expenditure for a long-lived asset releases restrictions on a gift to a capital campaign depends on which time restrictions are implied on that gift, and whether a donor placed any explicit restrictions on the gift that have not expired when the expenditure is incurred. A time restriction that expires over the long-lived asset's life would not be implied unless it is the organization's policy to do so, and a time restriction that expires when the payments are due would not be implied if constructing the long-lived asset or placing it in service are considered activities of the current period. The facts and circumstances surrounding promises to a capital campaign should be considered to determine whether those facts and circumstances indicate that time restrictions should be implied. If circumstances indicate that the donors intended to support activities of the current period and it is not the organization's policy to imply time restrictions that expire over the asset's useful life, no time restrictions on the gifts to the campaign are implied.

Example 1-17: Expenses and time restrictions (not expiring over long-lived asset's useful life)—multi-year promise to give received in a capital campaign.

The Plains Festival of the Arts is conducting a capital campaign to add a wing to their building for a second stage. In response to the campaign solicitation, Julie Johnson promises to give $100,000 payable in five equal installments over the next five years. The campaign literature indicates that The Plains Festival for the Arts plans to break ground in the fall and open the new stage for next year's summer concert series. The organization does not imply time restrictions that expire over a long-lived asset's useful life.

Time restrictions on Julie Johnson's gift that expire when the payments are due would not be implied because the facts and circumstances indicate that Ms. Johnson intended to support the construction of the new wing, which is imminent. The Plains Festival of the Arts would recognize a release of restrictions when it incurred expenditures to construct the new wing that would satisfy the purpose restrictions on the gift.

Example 1-18: Expenses and time restrictions (expiring over long-lived asset's useful life)—multi-year promise to give received in a capital campaign.

Assume the same facts as in Example 1-17, but The Plains Festival of the Arts implies time restrictions that expire over a long-lived asset's useful life.

Time restrictions on Julie Johnson's gift that expire when the payments are due would not be implied because the facts and circumstances indicate that Ms. Johnson intended to support the construction of the new wing, which is imminent. However, because it is the organization's

policy to imply a time restriction that expires over the useful life of a long-lived asset, The Plains Festival of the Arts would not recognize a release of restrictions when it incurred expenditures to construct the new wing. Instead, it would recognize a release of restrictions as the depreciation expense for the new wing is recognized.

101.31 Another common case in which a donor chooses to pay a promise to give in a future year, but no time restriction is implied occurs in grant-making organizations. Often a grant-making organization incurs and accrues expenses in the current year that will be paid in the next year, and the organization intends to fund those expenses with the unconditional promises to give that are received in the current year, but will not be collected until the following year. In other words, the revenue and expenses related to the contributions received and contributions made occur in the current year, and the cash flows for them occur in the next year. Although FASB ASC 958-605-45-5 generally requires organizations to report the unconditional promises to give that they receive as restricted net assets if their payments are due in future periods, a time restriction is not implied if the donor explicitly states that the gift is to support current-period activities, or other circumstances surrounding the receipt of the promise make that intent clear.

Example 1-19: Expenses and time restrictions—awards in year of promises to give.

In its solicitation materials, the United Way of Our Town requests that donors give to the 20X0 workplace campaign, and it explains that its allocation committee will award the gifts received to local nonprofit organizations in 20X0. In December 20X0, the allocation committee meets and determines the grant amounts for the local nonprofit organizations. United Way of Our Town informs the grant recipients of their awards prior to December 31, 20X0, which is the United Way's fiscal year-end. Because the United Way has made unconditional promises to give to the local nonprofit organizations, it recognizes grant allocation expenses (decreases in unrestricted net assets) in 20X0 at the time it informs the grant recipients of their awards. Although some of the gifts will be in the form of promises to give with payments due in 20X1, circumstances make it clear that the donor intended the gift to support the 20X0 activities (i.e., grants awarded in 20X0). No time restrictions are implied on those promises to give.

Example 1-20: Expenses and time restrictions—awards in year of payment.

United Way of Big City conducts its workplace campaign differently than United Way of Our Town. In its 20X0 solicitation materials, the United Way of Big City explains to its donors that its allocation committee will award the gifts received to local nonprofit organizations in 20X1. In December 20X0, the allocation committee meets and determines the grant amounts for the local nonprofit organizations, but it informs the grant recipients of their awards after December 31, 20X0, which is the United Way's fiscal year-end. United Way of Big City has made unconditional promises to give to the local nonprofit organizations and recognizes grant allocation expenses (a decrease in unrestricted net assets) in 20X1 at the time it informs the grant recipients of their awards. All of the gifts received in 20X0 would be purpose restricted until 20X1 (including those received in cash) because the facts and circumstances indicate that the donors intended to fund the grants awarded in 20X1. The purpose restriction is released when the allocation committee informs grant recipients of their awards. Time restrictions on promises to give that expire when the payments are due are not implied because the facts and circumstances make it clear that the donor intended the gift to support the 20X1 activities (i.e., grants awarded in 20X1).

101.32 **Endowment Funds and Time Restrictions**

FASB ASC 958-205-45-30 requires that in a state in which a version of the Uniform Prudent Management of Institutional Funds (UPMIFA) applies, the portion of a donor-restricted endowment fund that is not classified as permanently restricted net assets is time restricted and classified as temporarily restricted net assets until appropriated for expenditure by the nonprofit organization. UPMIFA provides that, unless stated otherwise in the gift instrument, the assets in an endowment fund are donor-restricted assets until appropriated for expenditure by the organization; thus, it is a law that extends a donor restriction on the original gift to the investment earnings (often referred to as net appreciation) of the endowment fund.

Example 1-21: Classification of net assets of a donor-restricted endowment fund.

Joyce Canfield made a contribution of $200,000 to the Mayfield Performing Arts Center to establish a permanent endowment for the purpose of bringing female performers to the Center's stage. Other than specifying the purpose of her gift, Ms. Canfield is silent as to use of the endowment fund. The governing board of the Center, after considering its state's law (which applies a version of UPMIFA) and conferring with its legal counsel, has set a policy of retaining the original endowment gift as permanently restricted net assets. Two years later, the assets of the endowment fund have grown to $225,000. The classification of the net assets of the Canfield Endowment Fund for Women Performers is classified as $200,000 permanently restricted and $25,000 temporarily restricted. The $25,000 is time restricted until appropriated for expenditure and purpose restricted for the purpose of bringing female performers to the Center's stage.

101.33 The time restriction implied on the net assets of a donor-restricted endowment because of UPMIFA expires when the governing board appropriates the net assets for expenditure. Typically, the governing board does that by approving the net assets for expenditure either as part of a formal, annual budget process or during the year as unexpected needs arise. Some organization's use a spending rate policy, in which a defined percentage of a rolling average of the endowment fund's value is appropriated for expenditure. Once the time restriction expires, the assets are available. If the donor did not specify a restricted purpose for the endowment fund (e.g., the donor says the endowment is to support the organization's operations), then when the appropriation is made, the net assets are reclassified from temporarily restricted to unrestricted. If the donor specified a restricted purpose for the endowment fund, then the net assets

are available for that purpose when the appropriation is made. Accordingly, the next occurring expenditure that meets the restriction releases the restriction. (See further discussion of the release of purpose restrictions, including exceptions to this general rule, beginning at paragraph 101.23.)

Example 1-22: Expiration of restrictions of a donor-restricted endowment fund—appropriation based on spending rate.

Continuing Example 1-21, the governing board of Mayfield Performing Arts Center uses a 4.5% spending rate applied to the eight-quarter rolling average of the endowment fund to determine the appropriation for its annual budget. For the Canfield Endowment Fund for Women Performers, that formula results in an appropriation for spending of $10,000 for 20X3 (4.5% of the rolling average value of $222,222). During 20X3, the endowment fund's earnings and appreciation are $12,875 and the Center spends $15,000 bringing women performers to its stage.

At the end of fiscal 20X3, the net assets of the Canfield Endowment Fund for Women Performers is $227,875 ($225,000 - $10,000 + $12,875). The Center reclassifies $10,000 from temporarily restricted net assets to unrestricted net assets, which is the lesser of the amount appropriated ($10,000) or qualifying expenditures ($15,000). The balance of the endowment fund is classified $200,000 permanently restricted and $27,875 of temporarily restricted net assets.

Example 1-23: Expiration of restrictions of a donor-restricted endowment fund—appropriation based on spending rate and additional approved amount.

Continuing Example 1-22, in 20X4, Mayfield Performing Arts Center has applied its spending rate and appropriated $10,200 for expenditure. In mid-season, the Center is presented with the opportunity to host a special Women's Day of Song when the planned venue for the event becomes unavailable. The costs associated with the event are anticipated to be $5,000. The $10,200 appropriated for expenditure is already committed to other performers who will appear during the season. Therefore, the governing board determines that it will appropriate for expenditure an additional $5,000 of the net assets of the Canfield Endowment. During 20X4, the endowment fund's earnings and appreciation are $12,000, and the Center spends $11,000 bringing women performers to its stage, plus an additional $5,000 for the Women's Day of Song.

At the end of fiscal 20X4, the net assets of the Canfield Endowment Fund for Women Performers is $224,675 ($227,875 - $10,200 - $5,000 + $12,000). The Center reclassifies $15,200 from temporarily restricted net assets to unrestricted net assets, which is the lesser of the amount appropriated ($10,200 + $5,000 = $15,200) or qualifying expenditures ($11,000 + $5,000 = $16,000). The balance of the endowment fund is classified $200,000 permanently restricted and $24,675 of temporarily restricted net assets.

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[2] Although fund-raising costs may encourage a contribution that will be received in the future, contributions rarely result directly and jointly from the same transactions as expenses. Most contributions and expenses are more closely related to time periods than to each other. Accordingly, FASB ASC 958-720-25-4 requires all fund-raising costs to be expensed in the period incurred even if the costs are expected to generate contributions in a future period. (See further discussion of fund-raising costs in section 201.)

[3] FASB ASC 958-225-45-16 expands on peripheral and incidental transactions by considering factors such as the significance of gross expenses and how often the activity occurs. FASB ASC 958-225-45-16 does not consider events to be incidental or peripheral that the organization includes as a normal part of its activities or that result in material expenses.

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102 Functional Expense Reporting

102.1 A nonprofit organization's expenses may be grouped (or classified) in the following ways:

a. *Natural (Object) Classification*—This classification indicates the type of expense, such as salaries, employee benefits, occupancy, postage and shipping, etc. Natural classification tells *what* was purchased.

b. *Functional Classification*—This classification involves grouping natural expense classifications by function, such as major classes of program activities and supporting services. Supporting services activities typically include management and general, fund-raising, and membership development, although other supporting services categories may be used. Functional classification tells *why* an expense was incurred.

c. *Mixture of Functional and Natural Classifications*—On the statement of activities, expenses may be presented by a mixture of natural and functional classifications. For example, depreciation might be shown on its own line (which is a natural classification), while other expenses are allocated to major program activities and supporting services (which are functional classifications).

102.2 FASB ASC 958-720-05-4 requires all nonprofit organizations to report information about expenses by their functional classifications, either in the statement of activities or the notes to the financial statements. Thus, to be in conformity with GAAP, organizations that choose to use a mixture of functional and natural classifications in the statement of activities (item c. in paragraph 102.1) must include a note to the financial statements that presents all expenses by functional classification. Voluntary health and welfare organizations must also report expense information by both functional and natural classifications in a separate financial statement using a matrix format (usually referred to as the statement of functional expenses). Other organizations are encouraged, but not required, to also report expense information by natural classifications.

102.3 An example of a statement of functional expenses is provided in Exhibit 1-2. The columns of the statement (community group homes, community-based services, etc.) are the functional categories used by the Blackrock Children's Ranch and Resource Center. The rows of the statement (salaries, payroll taxes, and employee benefits, etc.) are the natural categories used by the organization. The rows and columns form a matrix that allows a user of the financial statements to answer questions such as, “What percentage of total cost of the community group home program is salaries?” (The answer is $3,082,796 ÷ $5,608,146 or 55%.) The matrix format can also help a user of the financial statements understand the composition of fixed and variable costs of a particular program, thus allowing that user to form some conclusions about whether the organization can respond to changes in demand for a program's services.

Exhibit 1-2

Example Statement of Functional Expenses

BLACKROCK CHILDREN'S RANCH
AND RESOURCE CENTER

SCHEDULE OF FUNCTIONAL EXPENSES
YEAR ENDED JUNE 30, 20X2

	Community Group Homes	Community - based Services	Psychiatric Residential Care	Assessment Services	Aftercare Program	Total Program	Management and General	Fund-raising	Total
Salaries	$ 3,082,796	$ 2,527,957	$ 1,332,258	$ 716,129			$ 178,995		

					$ 297,851	$ 7,956,991		$ 43,367	$ 8,179,353
Payroll taxes and employee benefits	648,245	559,772	293,067	154,855	64,674	1,720,613	48,623	9,294	1,778,530
Supplies	399,908	280,144	80,476	177,465	61,177	999,770	32,484	10,505	1,042,759
Tuition	555,277	—	298,996	—	—	854,273	—	—	854,273
Professional fees	285,764	190,344	105,675	54,488	50,148	686,419	95,929	44,192	826,540
Depreciation and amortization	218,391	52,874	218,276	49,222	7,214	545,977	54,200	13,300	613,477
Rental and repairs	37,184	25,544	24,353	15,376	90,502	192,959	1,671	1,255	195,885
Occupancy	87,226	44,058	34,752	16,885	10,143	193,064	—	—	193,064
Telephone	64,810	43,886	19,503	14,582	19,245	162,026	6,108	8,056	176,190
Insurance	66,157	46,310	31,044	14,885	6,997	165,393	417	433	166,243
Travel	12,104	42,233	14,338	12,676	59,497	140,848	4,746	16,544	162,138
Interest	34,122	23,885	15,355	7,677	4,266	85,305	60	20	85,385
Miscellaneous	33,784	22,778	7,698	7,601	12,598	84,459	72	—	84,531
Advertising	23,093	33,193	15,892	7,446	3,109	82,733	—	—	82,733
Client services	30,483	17,792	9,878	4,789	602	63,544	—	—	63,544
Legal fees	14,236	992	13,160	3,288	3,913	35,589	17,515	—	53,104
Printing and publications	6,773	9,288	2,328	3,464	7,747	29,600	4,700	8,200	42,500
Dues and training	3,327	3,321	1,555	670	130	9,003	26,408	1,018	36,429
Postage	1,916	1,331	602	335	606	4,790	13,666	7,165	25,621
Audit	—	—	—	—	—	—	20,034	—	20,034
Provision for bad debts	2,550	—	4,459	—	—	7,009	—	—	7,009
	$ 5,608,146	$ 3,925,702	$ 2,523,665	$ 1,261,833	$ 701,019	$ 14,020,365	$ 505,628	$ 163,349	$ 14,689,342

102.4 Section 103 discusses allocating expenses by function, and section 104 discusses the presentation and disclosure requirements related to functional expense reporting. The following paragraphs discuss natural and functional classifications.

Natural (Object) Classification of Expenses

102.5 Organizations traditionally track expenses by their natural classifications. Because natural (or object) expense classifications relate to the amounts and types of costs incurred by an organization, such as salaries or rent, they are easily understood and monitored by even unsophisticated financial statement users. The board of directors and management of most organizations focus significant attention on natural expense classifications, and organizational budgets are often prepared by natural expense classifications. Depending on the organization, reporting by natural expense classification may be meaningful and appropriate for both internal and external reporting purposes.

102.6 Natural expense classifications may differ from individual expense accounts. Because of the sheer number of expense accounts an organization may track, similar expense accounts are often grouped together into broader natural expense classifications. Each organization should determine what natural classifications are appropriate and what individual expense accounts should be grouped within those classifications. Natural expense classifications may be added or deleted to accommodate changes in an organization's circumstances. However, organizations should report consistently from period to period, including reclassifications.

102.7 An excellent resource for determining natural expense classifications is the book for voluntary health and welfare organizations, titled *Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations* (referred to as the Black Book). The Black Book promotes uniform accounting guidance for all voluntary health and welfare organizations, including those that are members of, or affiliated with, the National Health Council, the National Assembly of Health and Human Services Organizations (formerly the National Assembly of National Voluntary Health and Social Welfare Organizations), and the United Way of America. The Black Book provides suggested natural expense classifications and corresponding expense account groupings that may be meaningful for organizations. The natural categories suggested by the Black Book are presented in Exhibit 1-3. See Appendix 1A for how to obtain the Black Book and other selected publications.

Exhibit 1-3

Common Natural (Object) Expense Classifications

Natural (Object) Classification	Types of Expenses That May Be Included
Salaries	Salaries
	Bonuses and incentive payments
	Vacation and compensated absences
Employee Benefits	Employee insurance
	Contributions to defined benefit pension or contribution plans
	Other employee benefits
Payroll Taxes	Employer portion of FICA
	Unemployment insurance premiums
	Worker's compensation insurance
	Mandatory disability insurance premiums
Professional and Other Contract Service Fees	Accounting and auditing fees
	Legal fees
	Consulting fees
	Actuarial fees
	Outside data processing services
	Investment management fees
	Media production costs
Supplies	Program supplies
	Laundry and housekeeping supplies
	Office supplies
	Copying supplies
Telephone	Telephone
	Long distance
	Fax charges
Postage and Shipping	Postage
	Shipping
	Other delivery expenses
	Shipping materials
Occupancy	Office rent
	Utilities
	Janitorial and maintenance services

Natural (Object) Classification	Types of Expenses That May Be Included
	Building and grounds maintenance supplies
Interest Expense	Interest expense
Rental and Maintenance of Equipment	Equipment rental
	Equipment maintenance
Printing and Publications	Printing
	Advertising
	Commercial art and supplies
	Informational materials
	Technical journals and books
Travel and Transportation	Transportation
	Hotel
	Meals and incidentals
	Auto expense and mileage allowances
Conferences, Conventions, and Meetings	Meeting costs
	Speaker honorariums and expenses
	Participant registration fees
Specific Assistance to Individuals	Medical, dental, and hospital fees and charges
	Client and patient travel
	Food, shelter, clothing
	Children's board
	Homemaker services
	Individual camperships
Membership Dues	Memberships
	Dues
Awards and Grants	Grants to research
	Grants to organizations
Insurance	Property insurance
	General liability insurance
	Professional liability insurance
	Fidelity bonds
	Directors' and officers' liability insurance
	Auto insurance
Depreciation and Amortization	Depreciation—Auto and equipment
	Depreciation—Buildings

Natural (Object) Classification	Types of Expenses That May Be Included
	Amortization—Leasehold improvements
Other Expenses	Other

102.8 When setting up an organization's natural expense classifications, accountants should bear in mind that classifications other than those presented in Exhibit 1-3 may be perfectly suitable and appropriate.

102.9 Although the Black Book is designed for only voluntary health and welfare organizations, much of its guidance may be appropriate for other types of nonprofit organizations as well. The authors believe the Black Book recommendations may be a good starting point for establishing an organization's natural expense classifications.

Functional Classification of Expenses

102.10 FASB ASC 958-720-05-4 requires organizations to report expenses by their functional classifications, such as by their major programs and supporting activities. Functional expense classifications tell *why* an expense was incurred rather than for *what* it was incurred. Most external users of nonprofit organization financial statements are more interested in the functional classification of expenses than in their natural classification. Reporting expenses by functional classification assists donors, creditors, and other users in assessing an organization's service efforts and use of resources. Contributors, funding sources, and regulatory groups are usually more interested in the costs of providing the organization's program services and in the relationship or ratio of program expenses to supporting expenses (particularly fund-raising) than they are in the particular types of expenses incurred. (See section 304 for a discussion of the public scrutiny given nonprofit organizations and some of the expense percentages and ratios that are evaluated by charity watchdog groups and other users of the financial statements.)

102.11 The primary functional classifications are—

- program services, and

- supporting services.

Those primary functional classifications are then further broken down into separate programs and separate supporting services.

102.12 The AICPA discusses the functional classification of certain expenses in nonauthoritative Technical Practice Aids, as follows:

- TIS 6140.06, *Functional Category of Cost of Sales of Contributed Inventory*, is discussed in paragraph 205.63.

- TIS 6140.07, *Functional Category of Costs of Special Events*, is discussed in paragraph 203.2.

- TIS 6140.08, *Functional Category of the Costs of Direct Donor Benefits*, is discussed in paragraph 203.2.

- TIS 6140.11, *Costs of Soliciting Contributed Services and Time That Do Not Meet The Recognition Criteria in FASB ASC 958*, is discussed in paragraph 205.129.

- TIS 6140.21, *Should an NPE Report Amounts Charged to the NPE by a Professional Fund-Raiser Gross, as Fund-Raising Expenses, or Net, as a Reduction of Contributions?*, is discussed beginning at paragraph 201.16.

- TIS 6140.22, *In Circumstances in Which the Reporting NPE Undertakes a Transaction in Which Another NPE (Fund-Raising NPE) Raises Contributions on Behalf of the Reporting NPE, and the Reporting NPE Compensates the Fund-Raising NPE for Raising Those Contributions (Compensation Including, But Not Limited to, an Administrative Fee), Should the Reporting NPE Report the Fund-Raising NPE's Compensation Gross, as Fund-Raising Expenses, or Net, as a Reduction of Contributions?*, is discussed beginning at paragraph 201.16.

102.13 Natural expense classifications often relate to more than one functional classification. To properly report expenses by functional classification, it is necessary to allocate natural expense classifications to the functions to which they relate. For example, a case worker may perform services benefiting more than one program, or an executive director may spend time on both management and general matters and fund-raising.

102.14 Allocation of expenses related to more than one function is discussed in section 103, and allocation of costs related to joint activities is discussed in section 202. The following paragraphs discuss program services expenses and supporting services expenses.

Program Services Expenses

102.15 An organization's program services are activities carried out to fulfill its mission or purpose that result in goods or services being distributed to beneficiaries, customers, or members. Program services are the major purpose for, and output of, an organization. Program services expenses include both direct and indirect costs of providing services.

102.16 Program services may include cost of sales or costs of other revenue-generating activities if the activities are program-related. For example, if a museum has a bookstore that sells merchandise related to its programs, the bookstore's cost of sales may be treated as a program service. An organization's thrift shop may also be a program service if selling good quality used clothing and merchandise (such as those repaired or refurbished as part of a job training program) to the public is consistent with its mission. However, it should be noted that even if an organization's mission is to raise funds for other organizations, it is precluded from reporting its fund-raising expenses as program services expense. Instead, these expenses should be reported under the organization's fund-raising function.

102.17 **Determining an Organization's Programs**

Organizations are required to report expenses by functional classifications (such as by major programs and supporting services). Accordingly, determining which programs represent an organization's *major* programs is important. The number of major programs an organization should report varies according to the nature of its services. Most organizations provide several separate and identifiable program services. If the expenses for these programs are disaggregated and reported by the kind of program, the resulting information is meaningful in understanding the expenses of the organization's mission and its service efforts. For some organizations, a single functional reporting classification may be adequate to report the program service that the organization provides. For example, for private foundations and supporting organizations, a single functional reporting classification may be adequate to report the program service that the organization provides. Younger and smaller organizations may also focus on a single program.

102.18 Accounting guidance about what constitutes a major program is very broad (see discussion beginning at paragraph 102.19), and many organizations experience difficulty determining which program or programs should be separately presented for functional reporting purposes. Given the same programs and dollar amounts, two organizations may arrive at different programs to report since each organization's circumstances are different. Determining what programs to separately report requires judgment and knowledge of the organization's programs, operations, mission, and objectives.

102.19 Current authoritative guidance allows organizations a great deal of flexibility in determining major programs. FASB ASC 958-720-45-3 notes that guidance in FASB ASC 280-10-50-1 through 50-19 may provide helpful information for determining major classes of programs and supporting services. Although FASB ASC 280 is not applicable to nonprofit organizations, its guidance may still be useful.

102.20 Using the guidance in FASB ASC 280-10-50-1 through 50-19, the authors believe a program may be separately reported if, among other things, it meets at least one of the following criteria:

a. Its revenues or expenses are 10% or more of the organization's total revenues or expenses.

b. Its identifiable assets or liabilities are 10% or more of the organization's combined identifiable assets or liabilities.

In addition, if identified major program expenses constitute less than 75% of total program expenses, additional programs may be separately reported until at least 75% of total program expenses are separately reported.

102.21 When determining major programs, the authors believe organizations may also consider the following:

- Whether discrete program financial information is available.
- Whether the organization's management separately evaluates the results of program activities.
- Whether the functional classifications being reported are comparable to those reported in prior periods.

• Whether they represent a substantial portion of the organization's programs or activities.

• The total number of programs. For purposes of preparing Form 990, organizations are required to separately describe their four largest programs as measured by total expenses. Practically, the authors believe the total number should be limited to no more than ten programs since information about more programs than that may become overly detailed.

102.22 Because of the flexibility permitted, an organization may select major programs to *tell the organization's story*. The selection of particular programs as major programs presents an opportunity for the organization to communicate its mission and to emphasize what makes the organization unique or special. In addition, the organization may choose to present as a major program a new program addressing an emerging issue, although significant costs have not yet been incurred. Doing so might highlight the program for financial statements users or improve future comparability. The Financial Reporting Executive Committee of the AICPA believes program information in the financial statements is most meaningful when it correlates with descriptions of the nonprofit organization's mission and programs that are used by the nonprofit organization in its fund-raising materials, its programmatic promotional materials, website descriptions, tax filings, annual reports, and other public information.

102.23 Nonprofit organizations can obtain guidance on determining programs for functional reporting purposes from a variety of industry technical resources. The following paragraphs discuss some of the available industry technical resources related to the following types of nonprofit organizations:

• Voluntary health and welfare organizations.

• Christian ministries.

• Private schools.

• Colleges and universities.

• Federated fund-raising organizations.

102.24 **Voluntary Health and Welfare Organizations**

One of the purposes of the Black Book is to promote uniform reporting among voluntary health and welfare organizations. In doing so, the Black Book encourages voluntary health and welfare organizations to use standardized program service classifications to the extent possible. The major goals of program standardization are to (a) help the public better understand the specific functions of an organization and (b) create as much comparability among organizations as possible. To accomplish those goals, the National Health Council has defined five broad program service classifications for use by its member health organizations. The Black Book recommends that health organizations use the National Health Council functional classifications, which are as follows:

a. Research.

b. Public health education.

c. Professional health education and training.

d. Patient services.

e. Community health services.

Although the Black Book encourages the use of those five classifications, it also permits an organization to use other classification categories if the categories better describe the organization's programs. For example, an organization instead may use classification categories such as disaster relief or health and family services if they are more descriptive.

102.25 **Christian Ministries**

In a desire to strengthen accounting, reporting, and accountability of Christian ministries, the Evangelical Joint Accounting Committee (representing the Christian Management Association, the Evangelical Council for Financial Accountability, the Evangelical Fellowship of Mission Agencies, and the Interdenominational Foreign Mission Association of North America) has published the book, *Accounting and Financial Reporting Guide for Christian Ministries* (Guide for Christian Ministries). To promote uniformity in reporting, the Guide for Christian Ministries recommends major program service categories and subcategories for ministries. The recommended major categories of program services are as follows:

a. Schools, bible schools, and seminaries.

b. Churches, church growth, and evangelism.

c. Education/training ministry (other than bible schools and seminaries).

d. Linguistics ministry.

e. Camps.

f. Media ministry.

g. Medical ministry.

h. Ministry to constituency (excluding fund-raising activities).

i. Relief, rehabilitation, and community development ministry.

j. Services to missions/churches.

k. Rescue mission.

102.26 Within each of the major categories in paragraph 102.25, there are also program subcategories. The Guide for Christian Ministries suggests that large or diverse organizations might reflect multiple major program service categories, while small organizations might report two or more subcategories of one major service category. For example, a church organization might report the following subcategories as its programs:

• Counseling.

• Music.

• Missions.

• Worship.

• Christian education.

Accountants should refer to the Guide for Christian Ministries for a detailed list of subcategories within each major service category. See Appendix 1A for how to obtain the Guide for Christian Ministries and other selected publications. *PPC's Guide to Religious Organizations* contains additional guidance specific to religious organizations. The *Guide* can be ordered by calling (800) 431-9025 or by visiting **ppc.thomsonreuters.com**.

102.27 **Private Schools**

The National Association of Independent Schools has published the book, *Business Management for Independent Schools* (NAIS Book). Part One of the NAIS Book assists independent school officers in fulfilling accounting and financial reporting objectives. Although the NAIS Book does not recommend specific program service categories for private schools, it does present information suggesting that certain program services classifications may be appropriate. For example, the sample chart of accounts in Part One of the NAIS Book illustrates the following program-related departments that may be used to accumulate and track expenses:

a. Instructional.

b. Residential housing.

c. Student activities.

d. Auxiliary services.

In addition to those categories, independent schools may choose to segregate major instructional categories into separate functions, such as kindergarten, lower school, and upper school, or to separate summer programs from other instructional programs. See Appendix 1A for how to obtain the NAIS Book and other selected publications.

102.28 **Colleges and Universities**

The National Association of College and University Business Officers (NACUBO) has established uniform accounting and reporting guidelines for colleges and universities. The *Financial Accounting and Reporting Manual for Higher Education* (FARM Manual), published by NACUBO, recommends functional classifications for use by colleges and universities and describes the types of expenses that should be accumulated for each classification. [4]

102.29 The FARM Manual divides functional classifications for colleges and universities into four main categories—educational and general, auxiliary enterprises, hospitals, and independent operations. Within the education and general main category, the FARM Manual lists seven functional classifications. Within some of those functional classifications, institutions must use judgment in determining whether a particular functional classification represents a program service or a supporting service. (See a discussion of supporting services beginning at paragraph 102.38.)

102.30 The following discussion lists those seven functional classifications identified in the FARM Manual and addresses whether they should be classified as program services:

a. *Instruction*—Represents activities related to an institution's instructional program. Instruction should be classified as a program service.

b. *Research*—Represents activities specifically organized to produce research, whether commissioned externally or internally. Research should be classified as a program service.

c. *Public Services*—Includes activities to provide noninstructional services beneficial to individuals and groups outside the institution. Public services should be classified as a program service.

d. *Scholarships and Fellowships*—Represents student awards under the control of the institution. As discussed beginning at paragraph 205.5, scholarships and fellowships should be classified as program service expenses to the extent they are considered expenses. (Certain scholarships may be agency transactions or allowances that do not represent expenses of the institution.)

e. *Academic Support*—Represents activities necessary to provide support services to the instruction, research, and public services programs (such as libraries, museums, or academic administration). Academic support may be classified as a program service, since it generally includes indirect costs associated with the program service functions.

f. *Student Services*—Includes admissions, the registrar, and activities whose purpose is to contribute to students' emotional and physical well-being and intellectual, cultural, and social development. Student services may be classified as a program service, since it may be considered a part of the costs of delivering programs.

g. *Institutional Support*—Represents the central executive level activities concerned with management and long-range planning for the overall institution. Institutional support should be classified as a supporting service.

102.31 The FARM Manual does not denote a separate functional classification for institutional development (or fund-raising), and in practice many institutions do not present an institutional development supporting service separate from institutional support. That appears to be inconsistent with the guidance at FASB ASC 958-720-45-2, which suggests the presentation of fund-raising activities as a separate supporting service. FASB ASC 958-720-50-1 also requires all organizations, including colleges and universities, to disclose total fund-raising expenses.

102.32 For many colleges and universities, institutional development may not be a significant component of institutional support. If the fund-raising component is material, however, the authors believe that separately reporting institutional development in the statement of activities is preferable to disclosing the amount of fund-raising expenses in the notes to the financial statements.

102.33 FASB ASC 958-720-45-25 prohibits the costs of occupying and maintaining a building from being presented as a separate supporting service. As a result, the FARM Manual no longer presents the operation and maintenance of physical plant as a separate functional classification. See paragraph 102.54 for additional discussion. See Appendix 1A for how to obtain a copy of the FARM Manual and other selected publications.

102.34 **Federated Fund-raising Organizations**

There are many federated fund-raising organizations, of which the United Way of America is the most prominent. Although not all-inclusive, the program services of a federated fund-raising organization such as United Way might include the following:

a. Fund distribution (allocations).

b. Telephone crisis line.

c. Labor relations.

d. Public policy.

e. Information and referral.

f. Volunteer center.

g. Planning for community needs.

h. United Way at work.

i. Day of caring.

j. Retired senior volunteer program.

k. Success by Six.®

l. Americorps.

m. One-to-one mentoring.

102.35 Some local United Way organizations allow a donor to their annual campaign to designate a specific organization to receive his or her gift (other than the local United Way that is soliciting the gift). If a donor elects to do so and does not grant the United Way variance power, United Way cannot include the gift designated by the donor in its revenue or its expenses. The contribution received on behalf of the other organization is a liability of the United Way and the subsequent distribution to the specified organization is a reduction of that liability rather than an expense. (See the discussion of agency transactions beginning at paragraph 101.7.)

102.36 FASB ASC 958-225-55-8 through 55-10 provides examples that illustrate different ways designated contribution amounts (agency transactions) can be presented on the statement of activities. According to that guidance, those presentations are permitted as long as the agency transactions are not shown as *revenues* (that is, they are captioned “total amounts raised,” “campaign results,” etc.). The Codification does not illustrate display alternatives for allocations of designated contributions in the *expense* section of the statement of activities. The authors believe that there is no authoritative guidance that prohibits the presentation of designated allocations as long as the designated amounts are subtracted before an amount is captioned as *expenses* or a term with similar meaning. Because contributions designated to a specific organization are still part of the total support that the local United Way provides to the community, the statement of activities may present gross allocations offset by designated allocations in the expense section of the statement of activities.

Example 1-24: Gross allocations offset by designated allocations.

The local United Way makes allocations of $15,000 to agencies and other United Way organizations. Campaign results that were designated to specific agencies comprised $7,200 of the allocations. The local United Way also provides $2,200 of other program services during the year and incurs $2,400 of support costs. The expense section of the local United Way's statement of activities might be presented as follows:

ALLOCATIONS AND OTHER FUNCTIONAL EXPENSES

Allocations:		
Funds allocated to agencies and other United Ways	$ 15,000	
Less allocations funded through donor designations	(7,200)	
Allocation expenses		$ 7,800
Program services		2,200
Allocation and program services expenses		10,000
Supporting services		2,400
Total expenses		$ 12,400

102.37 **Examples of Determining an Organization's Programs**

Determining an organization's programs requires judgment and knowledge of the organization's operations. Therefore, programs presented for functional reporting purposes may depend on an organization's individual facts and circumstances. To illustrate, each of the following scenarios are based on the same organization's programs and amounts.

Example 1-25: Determining an organization's programs.

An organization separately tracks costs related to the following seven programs:

Alcohol abuse prevention	$ 184,000	12%
Alcohol abuse treatment	386,000	25%
Drug abuse prevention	167,000	11%
Drug abuse treatment	425,000	28%
Group counseling	223,000	14%
Evaluation	69,000	4%
Education	85,000	6%
	$ 1,539,000	100%

Option 1: Applying the quantitative guidance for determining major programs suggested in FASB ASC 280-10-50-1 through 50-19 (see paragraph 102.20), the Organization's program services for functional reporting purposes would be as follows:

Drug abuse treatment	$ 425,000
Alcohol abuse treatment	386,000
Group counseling	223,000
Alcohol abuse prevention	184,000
Drug abuse prevention	167,000
Other	154,000
	$ 1,539,000

Using quantitative factors alone, however, may or may not result in the most meaningful presentation of the Organization's major programs. The remaining examples illustrate how the Organization's choice of programs may differ based on varying circumstances.

Option 2: The Organization's four alcohol and drug abuse programs are separately administered and viewed as separate major services of the Organization. Group counseling and other services are secondary operations. The Organization's program services for functional reporting purposes might be:

Alcohol abuse prevention	$ 184,000
Alcohol abuse treatment	386,000
Drug abuse prevention	167,000
Drug abuse treatment	425,000
Group counseling and other	377,000
	$ 1,539,000

Option 3: The Organization administers the alcohol and drug abuse prevention programs together in the same facilities and evaluates them as one program. The Organization's alcohol and drug abuse treatment programs are separate major activities, as is group counseling. Other services are secondary. The Organization might choose to group its program services for functional reporting purposes as follows:

Alcohol and drug abuse prevention	$ 351,000

Alcohol abuse treatment	386,000
Drug abuse treatment	425,000
Group counseling	223,000
Other	154,000
	$ 1,539,000

Option 4: The Organization considers its three primary services to be alcohol abuse services, drug abuse services, and group counseling. The Organization's program services might be presented as follows:

Alcohol abuse prevention and treatment	$ 570,000
Drug abuse prevention and treatment	592,000
Group counseling	223,000
Other	154,000
	$ 1,539,000

Supporting Services Expenses

102.38 Supporting services expenses relate to an organization's activities other than program services. While organizations may have various kinds of supporting services, they are typically categorized as follows:

- Management and general.
- Fund-raising.
- Membership development.

102.39 Although many organizations report using those categories, authoritative guidance neither encourages nor discourages the use of those or any other functional classifications. Other classifications that describe an organization's supporting services may be used instead. For example, many organizations refer to the management and general classification by a similar descriptive term such as *administrative*. As discussed in paragraph 102.30, colleges and universities typically use the term *institutional support* rather than management and general to describe their overall administrative activities.

102.40 An organization may also choose to present revenue-generating or other functions such as cost of sales or investing activities as separate supporting services if it is meaningful to do so. (Revenue-generating functions may also be classified as program services in some cases. See further discussion at paragraph 102.16.)

102.41 The following paragraphs describe the management and general, fund-raising, and membership development supporting service categories and some of the types of costs typically associated with those categories.

102.42 **Management and General**

Management and general activities relate to the overall direction of the organization. They are not identifiable with a particular program, fund-raising, or membership development activity, but they are indispensable to the conduct of those activities and are essential to the organization. Management and general typically include activities such as organization oversight, business management, record keeping, budgeting, financing, soliciting revenue from exchange transactions (such as government grants or sponsorships that are exchange transactions), and other administrative activities. Exhibit 1-4 lists some of the management and general activities commonly performed by organizations.

102.43 Management and general expenses often include board expenses and the salaries of the executive director and support staff. Costs related to time spent by the executive director or support staff working on programs or other functions should be allocated to those functions, however. (See section 103 for a discussion of allocating costs to more than one function.) In addition, management and general expenses typically include costs of disseminating information to the public about the organization's use of donated funds.

102.44 FASB ASC 958-720-45-7 specifically states that the expenses incurred when soliciting funds other than contributions, *including exchange transactions whether program-related or not*, should be classified as management and general expenses in the organization's financial statements. Two common examples of such costs are:

- The costs of maintaining a grant management or sponsored project administration department, which prepares grant applications or monitors the record -keeping and reporting for those grants and sponsored activities, if those grants and sponsorships are reported as exchange transactions.

- The costs of advertising for ticket sales or admissions of a performing arts organization, museum, arboretum, zoo, or similar organization. (Section 202 provides guidance when advertising for ticket sales or admissions is combined with a request for contributions.)

Example 1-26: Costs of advertising for ticket sales.

The Lakevalley Zoo regularly advertises in the leisure and entertainment section of the local Sunday paper. The advertisement contains pictures and descriptions of the new zoo exhibits, zoo hours, a map showing where the zoo is located, and information about admission prices. The advertisement does not contain a request for contributions. The cost of the advertisement should be charged to management and general expense in accordance with FASB ASC 958-720-45-7.

102.45 The two bullets included in paragraph 102.44 are clear examples of when FASB ASC 958-720-45-7 would require advertising costs to be classified as management and general expenses. FASB ASC 958-720-45-7 does not indicate any exceptions to the requirement to classify expenses as management and general if they are incurred to solicit revenues from exchange transactions. However, there are other circumstances (primarily in voluntary health and welfare organizations) where the authors believe the correct classification of the expenses is not as apparent. For instance, an organization may charge a fee primarily to encourage service recipients to commit to the service and continue receiving it. That is, the organization believes if the service is totally free, the service recipients are more likely to discontinue using the service.

102.46 Thus, in certain situations, the authors believe that the purpose of the advertising and the revenue generated need to be further evaluated when determining whether the advertising expenses should be classified as program expenses or management and general expenses. Some of the factors that might be considered include the following:

- Is the purpose of the advertising primarily to generate revenue from services, admissions, etc. or is it primarily to promote the organization and its services?

- Is the fee charged to the service recipient *de minimis* (that is, a token amount) in comparison to the fair value price of the service?

- If the fee charged is *de minimis*, does it help to increase the effectiveness of the organization's program?

102.47 All of the appropriate factors must be considered when determining the appropriate classification of the advertising expenses. The authors believe that when a ticket price or admission fee is significantly less than the fair value price for the service rendered, the organization is primarily providing free services to the recipient rather than providing those services for the purpose of generating revenue. Accordingly, the authors believe that in those limited circumstances, the requirement at FASB ASC 958-720-45-7 may not apply, and it may be reasonable to charge advertising expenses to program activities. (The authors believe the fact that an organization does not cover its costs by charging a fee is irrelevant. The determining test is whether the fee charged is fair value, that is, the fee that would be received to sell the service in an orderly transaction between market participants at the measurement date.)

Example 1-27: Costs of advertising for a smoking cessation clinic.

The Association to Prevent Lung Cancer places placards at bus stops in a low-income neighborhood advertising a six-week smoking cessation clinic that is available for a fee of $15. Similar classes offered by a for-profit hospital in the area cost $85. The Association used to offer the classes for no charge, but learned by experience that when charged an up-front fee, smokers were more likely to complete the six-week course. Thus, the purpose of the fee is to improve program results rather than to generate revenue from an exchange transaction. Accordingly, the authors believe that the Association to Prevent Lung Cancer could support the position to charge the costs of designing and printing the placards and placing them at the bus stops to program expense.

102.48 **Fund-raising**

Many organizations are sensitive about the types of costs that are reported as fund-raising due to the public scrutiny given organizations that have high fund-raising expenses as a percentage of total expenses. (See section 304 for further discussion of expense percentages and ratios evaluated by charity

watchdog groups and other financial statement users.) Fund-raising expenses are costs related to activities that involve inducing potential donors to contribute assets (including cash and noncash assets), services, or time.[5] Common types of fund-raising activities performed by organizations are presented in Exhibit 1-4.

Exhibit 1-4

Common Types of Supporting Services Activities

Management and General

• Attending general board and committee meetings.
• Providing executive direction and organization planning.
• Attending general staff meetings.
• Accounting, auditing, budgeting, and financial reporting.
• Reporting internally about financial and management areas.
• Managing the office.
• Obtaining legal services.
• Procuring and retaining personnel.
• Purchasing and distributing materials.
• Performing office services, including receptionist, switchboard, mail distribution, and filing duties.
• Performing organizational and procedural studies.
• Soliciting revenue from exchange transactions (such as costs of obtaining certain government grants or sponsorships or advertising costs related to ticket sales, service fees, etc.).
• Disseminating information about the organization's stewardship of contributed funds.
• Announcing appointments.
• Preparing the organization's annual report.
• Performing administrative duties.
• Conducting other activities except for the direct conduct of program services, fund-raising, or membership development.

Fund-raising

• Publicizing and conducting fund-raising campaigns.
• Conducting special fund-raising events.
• Maintaining donor mailing lists.
• Preparing and distributing fund-raising manuals, instructions, and materials.
• Recruiting volunteers.
• Conducting solicitations in person or by mail.
• Participating in federated and federal service fund-raising campaigns.
• Soliciting bequests, foundation grants, and special gifts.
• Conducting training for improving fund-raising techniques.
• Hiring a professional fund-raiser that either charges a fee or retains a portion of contributions raised.
• Receiving contributions from a federated fund-raising organization or other nonprofit organization that withholds a portion of any designated contribution as a fee.
• Conducting other activities involving soliciting contributions.

Membership Development

• Soliciting prospective members.
• Collecting membership dues.
• Performing membership relations activities.
• Maintaining membership data.
• Conducting other membership activities not related to fund-raising.

102.49 Most organizations perform a variety of fund-raising activities. Some fund-raising activities such as direct mail campaigns may include components that relate to program services or management and general activities. Those types of activities are referred to as *joint activities*. Section 202 discusses the special accounting requirements related to recognizing the costs of joint activities that include fund-raising.

102.50 Fund-raising expenses may include related personnel costs, professional consultants, printing, postage, telephone, direct mail list maintenance, direct contact solicitations, unsolicited merchandise sent to encourage contributions, special fund-raising events, or preparation and distribution of fund-raising manuals and other materials. Section 201 discusses the basic requirements for reporting fund-raising costs.

102.51 **Membership Development**

Membership development expenses are the costs related to an organization's membership activities, such as soliciting members or membership relations. Exhibit 1-4 presents some of the common membership development activities that an organization might perform.

102.52 Membership development activities are not always easy to differentiate from fund-raising activities. To determine whether costs represent membership development or fund-raising activities, the underlying benefits and duties of the membership being offered should be evaluated. If no significant benefits or duties are connected with membership in an organization, membership development activities may actually represent fund-raising activities and the related expenses should be reflected as such.

Example 1-28: Membership development versus fund-raising activities.

A performing arts organization offers $100 memberships to individuals. In return, members receive the following benefits:

- Advance notice of upcoming performances.
- The opportunity to purchase tickets before nonmembers.
- Their names listed as members in organization promotional materials.

In that case, the members receive little tangible benefit. There is little or no exchange element to purchasing a membership—in substance, the *member* is making a contribution rather than receiving membership benefits. Therefore, costs associated with membership development should be reported as fund-raising.

102.53 If membership development activities are conducted in conjunction with other activities, associated costs should be allocated among those activities. Again, the underlying membership received must be evaluated to determine whether other activities such as fund-raising are being conducted.

Example 1-29: Allocating costs between membership development and fund-raising.

The same performing arts organization offers a $100 membership, but it provides members the following tangible benefits in return:

Value of benefits received in return:	
Monthly magazine	$ 25
Discounts on ticket prices	55
	$ 80

For each $100 membership, $20 represents a contribution to the organization and $80 represents membership benefits received in return. Thus, 20% of membership development expenses should be allocated to fund-raising. However, if the membership expenses relate to activities that are joint activities, the organization cannot allocate costs between membership development and fund-raising unless the joint activities' purpose, audience, and content criteria are met. Otherwise, all costs of those joint activities should generally be charged to fund-raising. (See section 103 for a discussion of allocating expenses to more than one function, and section 202 for additional discussion of joint activities and allocation of costs of joint activities.)

Reporting of Certain Expenses

102.54 When discussing the functional reporting of expenses, the Codification provides the following guidance on reporting (and, if necessary, allocating) certain expenses incurred by nonprofit organizations:

• *Payments to Related Local and National Nonprofit Organizations.* Some nonprofit organizations make payments to related local and national nonprofit organizations in return for administrative or fund-raising services or the right to operate in a geographic area. In addition, some nonprofit organizations are required to make payments (such as dues to a national organization) without receiving any identifiable benefits. FASB ASC 958-720-45-26 notes that payments to related local and national nonprofit organizations should be reported by their functional classification to the extent it is practicable and reasonable to do so and the information is available. Any payment amounts that cannot be reasonably allocated to functions should be treated as a separate supporting service and reported on the statement of activities as a separate line item labeled "Unallocated Payments to Local (or National) Organizations." See further discussion of payments to related local and national nonprofit organizations in section 205.

• *Occupying and Maintaining a Building.* FASB ASC 958-720-45-25 specifically prohibits the costs of occupying and maintaining a building from being presented as a separate supporting service. Instead, building occupancy and maintenance expenses (including depreciation) should be reported based on their appropriate functional classifications similar to other costs (typically based on use). That prohibition particularly impacts colleges and universities since, prior to the issuance of specific guidance, they considered plant costs a separate supporting service. See paragraph 102.33 for further discussion.

• *Interest Costs.* Interest costs should be allocated to specific programs or supporting services to the extent possible. FASB ASC 958-720-45-24 requires any unallocated interest costs to be reflected in the management and general supporting service category.

• *Federated Fund-raising Organizations.* Federated fund-raising organizations solicit and receive both designated (received on behalf of others) and undesignated contributions from donors. FASB ASC 958-720-45-27 notes that all costs of fund-raising activities of a federated fund-raising organization, including those related to designated contributions, should be recognized as fund-raising activities. For example, all of the fund-raising costs that the United Way incurs on behalf of the organizations that it funds should be reflected as fund-raising expenses. FASB ASC 958-720-45-27 requires that reporting even if a portion of the campaign results from those activities are designated amounts that are agency transactions rather than contributions.

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[4] In December 2000, NACUBO's Accounting Principles Council issued NACUBO Advisory Report 2000-8, *Suggested Footnote Disclosure for Information Reported on the Statement of Revenues, Expenses, and Changes in Net Assets*. This position paper does not apply to *private* universities. The position paper clarifies that *public* higher education institutions have the choice of reporting expenses by functional or natural classification. The document also suggests the presentation of an expense matrix note disclosure to the public higher education's financial statements that details the expenses presented on the face of the Statement of Revenues, Expenses, and Changes in Net Assets and compares the functional to natural classifications. The position paper also lists the functional classifications that should be included in the note disclosure, if the classifications are applicable.

[5] Some organizations have expressed concern about the classification of costs of soliciting contributed services (time), especially when the services received are prohibited from being recognized as contribution revenue by the Contributions Received Subsections of FASB ASC 958-605. In response, the AICPA staff issued a Technical Practice Aid (TIS 6140.11). The Technical Practice Aid states that organizations should report the costs of soliciting contributed services as fund-raising expenses, regardless of whether those services meet the criteria in FASB ASC 958-605-25-2 through 25-20 for recognition in the financial statements. Other costs incurred in connection with contributed services, such as the costs of training and managing volunteers, should not be reported as fund-raising unless the volunteers being trained and managed perform fund-raising functions. For additional consideration, see paragraph 205.129.

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103 Allocation of Expenses to More Than One Function

103.1 All nonprofit organizations are required to report expenses by their functional classification in the financial statements to help financial statement users assess the organizations' service efforts. As a result, it is necessary to accumulate expense information by function. Some expenses relate directly to a single program or supporting service, while others do not. Expenses that can be directly attributed to a particular program or supporting service should be assigned or charged to that program or supporting service. Expenses that relate to more than one program or supporting service, however, will require allocation among those functions.

103.2 Accordingly, the accumulation of functional expense information will require the following steps:

a. Direct identification of expenses.

b. Allocation of expenses relating to more than one function (including allocations performed for other purposes).

The following paragraphs discuss direct identification and allocation of expenses.

Direct Identification of Expenses

103.3 Direct identification of expenses is the preferred method for charging expenses to a particular function. Whenever an expense can be directly identified with a specific function (such as a program, management and general, fund-raising, or membership development function), it should be directly assigned or charged to that function. Allocating expenses is appropriate only when direct identification is not possible or practical.

103.4 Directly charging or assigning an expense to a particular function means the expense is coded to that function when the expense is entered into the accounting system. [Expenses that are directly connected with more than one function can be charged to the benefited functions. For example, an invoice received with separate amounts for printing (a) a brochure requesting contributions and (b) materials for use in the organization's educational program can be split between fund-raising and the applicable program expense.] Directly assigning as many expense transactions as possible simplifies the functional reporting process since it reduces the amount of expenses and potentially some of the natural expense classifications that require allocation.

103.5 Some expenses typically lend themselves to direct identification, such as program supplies or grant awards. Assigning those expenses to functions is relatively easy, because they can usually be identified and directly coded in the general ledger to their respective expense accounts and departments (or functions). Once that is done, the functional expense tracking is complete for those expenses. Other types of expenses, however, may not be directly identifiable to a particular function, depending on the transaction itself. A good example is consulting expense. Consulting services provided by a fund development consultant may relate only to fund-raising. Alternatively, computer consulting services may be attributable to several functions if the services relate to a centralized area that provides benefit to those functions (for example, the computer consulting services relate to the central computer network that is used for programs, administrative activities, and fund-raising).

103.6 How does an organization track an expense by function when some transactions can be directly identified and some require allocation? Direct assignment of expenses may be accomplished in various ways, depending on how an organization's chart of accounts and accounting system are set up. Some organizations set up their charts of accounts to enable directly assigned expenses to be tracked separately from expenses requiring allocation. That can be accomplished as simply as setting up two separate general ledger accounts for the same expense type, as illustrated in the following:

Account #	Department #	Account Description
5251	20	Consulting—Direct
5252	20	Consulting—Indirect

103.7 Other organizations use more sophisticated methods to segregate expenses related to multiple functions from directly assigned expenses. A common method for segregating costs that indirectly benefit multiple functions is to use indirect cost centers. Indirect cost centers, or pools, are established for those types of expenses or departments that, by their nature, impact more than one function. Indirect cost centers are sometimes established for costs related to areas such as indirect patient services (such as admission, billing, and medical records), labs or pharmacies, building maintenance, grounds maintenance, or vehicle maintenance. Indirect cost centers are usually set up as separate departments similar to programs or management and general. As an expense related to an indirect cost center is incurred, it is directly assigned and coded to that indirect cost center department. The costs directly assigned to the indirect cost pools are then summarized and allocated as part of the functional allocation process. See paragraph 103.34 for an example allocation.

Allocating Expenses for Different Purposes

103.8 Functional allocations may be used by organizations for different purposes. The purpose of the functional allocation often affects the method used to perform the allocation. Organizations commonly allocate expenses for the following purposes:

- Government grant reporting (under OMB Circular A-122, *Cost Principles for Nonprofit Organizations*). [6]

- Evaluation of program viability (using zero-based or full-absorption cost allocation).

- External financial reporting (GAAP).

103.9 A functional allocation performed for grant reporting or program evaluation purposes may or may not be appropriate for external (GAAP) financial reporting. For example, a cost allocation to determine program viability may include all costs as program costs, even though some costs by nature should be classified as supporting services (such as administrative salaries and audit fees). In addition, government grant allocation may allow the organization to pool all indirect costs and charge them to the program based on a computed indirect cost rate. Such methods might not result in a reasonable allocation of indirect costs from a GAAP standpoint.

103.10 Although this chapter focuses primarily on GAAP requirements for external financial reporting, the following paragraphs briefly discuss the allocation requirements for government grant reporting and evaluation of program viability. Paragraph 103.11 discusses government grant reporting, and paragraph 103.12 discusses zero-based program allocation. Functional allocations prepared for GAAP reporting purposes are discussed beginning at paragraph 103.13.

103.11 **Government Grant Reporting**

OMB Circular A-122 sets indirect cost allocation guidelines for costs associated with the receipt of federal awards. OMB Circular A-122 defines indirect costs as those that have been incurred for common or joint objectives and cannot be readily identified with a particular final cost objective. Circular A-122 recognizes that it is not possible to specify the types of costs that may be classified as indirect costs in all cases because of the diverse characteristics and accounting practices of nonprofit organizations. Circular A-122 permits the use of four different allocation methods, depending on the organization's circumstances. The four allocation methods are summarized as follows:

a. *Simplified Allocation Method.* The simplified allocation method is appropriate when an organization's major functions benefit from its indirect costs to approximately the same degree, when the organization has only one major function encompassing a number of individual activities, or when the amount of federal money is relatively small. Indirect costs are identified and separated between allowable and unallowable costs. The indirect cost rate is then computed by dividing total allowable indirect costs by an equitable distribution base. The distribution base may be total direct costs (excluding capital expenditures and other distorting items such as unallowable direct costs), direct salaries and wages, or any other base that results in an equitable allocation. A simple indirect cost rate may be computed as follows:

$$\frac{\text{Total allowable indirect costs}}{\text{Total allowable direct costs}} = \text{Indirect cost rate}$$

The computed indirect cost rate is then applied to allowable direct costs. (See Example 1-30.)

b. *Multiple Allocation Base Method.* If the simplified allocation method cannot be used, indirect costs should be accumulated into separate indirect cost pools and allocated based on the benefits provided to each major function. An indirect cost rate for each pool should be based on a quantitative measure that is common to all the benefiting functions, such as salaries, total direct costs, or square feet used (salaries are often used). Using total direct salaries as an example, the indirect cost rate for a particular major function would be computed as follows (see Example 1-31):

$$\frac{\text{Indirect cost pool amount}}{\text{Total direct salaries of the function}} = \text{Indirect cost rate}$$

c. *Direct Allocation Method.* The direct allocation method is similar to that typically used for external financial reporting purposes, which individually allocates indirect costs based on an appropriate base. That method is acceptable provided that the base accurately measures the benefits provided, it is reasonable, and it is supported by current data. (See the discussion beginning at paragraph 103.13.)

d. *Special Indirect Cost Rates.* In certain circumstances, a single indirect cost rate for a function may not be appropriate because the indirect costs relate to a particular segment of work within the function. In that situation, a separate indirect cost pool should be established for that segment of work.

Example 1-30: Computation of indirect cost rate—simplified allocation method.

An organization's total direct costs of federal grant programs is $200,000, of which $20,000 are not allowable costs. The Organization's total allowable indirect costs are $25,000. The indirect cost rate would be calculated as follows:

$$\frac{\$25{,}000}{(\$200{,}000 - \$20{,}000)} = 13.9\% \text{ indirect cost rate}$$

The 13.9% indirect cost rate should be applied to the $180,000 of allowable direct costs by grant.

Example 1-31: Computation of indirect cost rate—multiple allocation base method.

An organization has an indirect cost pool related to central service activities. The central service indirect costs are $480,000.

The Organization uses direct salaries of grant programs to calculate the indirect cost rate. The direct salaries for grant programs are as follows:

HUD Grant	$ 300,000
HHS Grant	250,000
State Department of Commerce	450,000
Other operating departments	1,400,000
Total	$ 2,400,000

The indirect cost rate would be calculated as follows:

$$\frac{\$480{,}000}{\$2{,}400{,}000} = 20\% \text{ indirect cost rate}$$

The Organization would then apply the indirect cost rate to each of the functions as follows:

	Direct Salaries	Indirect Costs of 20%
HUD Grant	$ 300,000	$ 60,000
HHS Grant	250,000	50,000
State Department of Commerce	450,000	90,000
Other operating departments	1,400,000	280,000
Total	$ 2,400,000	$ 480,000

103.12 **Evaluation of Program Viability**

It is common for organizations to periodically evaluate the viability of their programs. That is sometimes done using a functional allocation method that allocates *all* organization costs to programs, including supporting services. Using a type of zero-based or full-absorption allocation method, an organization can determine whether individual programs generate sufficient revenues to support its activities. In other cases, an organization decides that viability of a program should be determined without expecting the program to cover certain costs. For example, the organization may decide that viability of a program should be determined without allocating expenses such as fund-raising, interest expense, board of director costs, and accounting department costs. While using those types of allocation methods may be meaningful for the limited purpose of evaluating activities, they are *not* acceptable for external financial reporting. FASB ASC 958-720-45-6 clearly states that certain types of activities represent supporting (rather than program) activities, and it would be almost inconceivable for an organization to exist without engaging in any of those defined supporting activities. (See the discussion of supporting services beginning at paragraph 102.38.) As a result, the limited use of financial information derived using zero-based or full-absorption cost allocation methods should be adequately communicated to users of that financial information (such as organization board members).

103.13 **External Financial Reporting (GAAP)**

As discussed in paragraph 103.1, expenses pertaining to more than one program or supporting service must be allocated among the applicable functions for external financial reporting purposes. Costs must be directly identified and charged to a function to the extent possible, and indirect costs must be allocated to the associated programs and supporting functions.

103.14 Although nonauthoritative, the Audit Guide, Paragraphs 13.46-.51, shows that organizations have significant latitude and judgment in choosing allocation methods. Organizations have the opportunity and flexibility to structure their allocations in a manner most meaningful for their specific circumstances. However, that latitude does not extend to financial statement display that reports revenue based on an overhead allocation. An AICPA Technical Practice Aid (TIS 6960.12) explains that the allocation of overhead is an interprogram transaction that should not be reported as revenue of the program providing the services but rather as a reduction of expense of such program.

103.15 The Audit Guide, Paragraph 13.47, provides the following broad observations about choosing a functional allocation method: [7]

- A reasonable allocation may be made using a variety of bases.
- An objective method is preferable to a subjective method.
- The allocation bases used may be either financial or nonfinancial data.

Extensive detailed analyses and overly meticulous computations are not required. Instead, the organization can often prepare meaningful financial statements using reasonable estimates for purposes of allocating expenses.

103.16 The Black Book encourages organizations to consider using an Activity Based Management (ABM) and Activity Based Costing (ABC) approach to performing functional allocation. The Black Book states that some of the advantages of using an ABM/ABC model include the following:

- ABM/ABC enhances management's ability to evaluate the effectiveness of functional areas in terms of end results and costs.
- ABM/ABC decreases accounting complexity by reducing the organization's account structure to accommodate only (a) line item accounts and (b) activity codes. The activity codes classify accounts by cost objectives, such as by functions, projects, or cost centers.
- ABM/ABC facilitates the development of reasonable cost allocation methods.

One disadvantage of using an ABM/ABC approach is that it may not readily lend itself to applying time-keeping sampling for employees who perform multiple functions. Organizations may refer to the Black Book for additional information on using an ABM/ABC approach to functional allocation.

103.17 The key point to remember when developing an allocation method is the ultimate goal of functional allocation. Foremost, functional allocation should result in a *meaningful* allocation of an organization's expenses that relate to more than one function. Each organization should develop a functional allocation method that best reflects its particular activities and circumstances. An allocation method that is meaningful for one organization may be totally unreasonable for another.

Steps to Performing a Functional Allocation Computation

103.18 There is a wide variety of methods that can be used to functionally allocate expenses, ranging from the very simple to the very sophisticated. As long as the allocation method follows the broad guidelines discussed in paragraph 103.15, an organization may use any allocation method it considers meaningful for its specific circumstances.

103.19 Because organizations have such latitude in developing their functional allocation methods, it is difficult to provide guidance about allocation methods and computations that is appropriate for all organizations. Even so, organizations usually go through the following four basic steps when initially performing a functional allocation computation:

1 Identify the natural expense classifications (or indirect cost centers) requiring allocation.

2 Determine the allocation bases to be used for each identified expense.

3 Assemble the required data for each allocation base to be used.

4 Perform the allocation computation.

After performing the initial functional allocation computation, the organization should evaluate the continuing appropriateness of the allocation methodology that it uses at least once a year. (See further discussion beginning at paragraph 103.35.)

103.20 **Identify Natural Expense Classifications to Be Allocated**

Some expenses or natural expense classifications are more likely to require allocation than others. For example, certain job positions require time to be spent working on multiple functions. A program director, for instance, may spend time on both program service delivery and on administrative activities. In that case, the program director's salary should be allocated between functions to reflect the appropriate time spent on each function.

103.21 The first step in performing a functional allocation computation is to determine which natural expense classifications require allocation. As discussed beginning in paragraph 103.6, the organization should have a mechanism in place to separately track directly assigned expenses and expenses requiring allocation. Each expense classification should be separately analyzed to determine whether it can be directly assigned to a function or whether it requires allocation. Indirect cost centers typically require allocation.

103.22 **Determine Allocation Bases**

Organizations have a great deal of flexibility in choosing allocation bases for expenses, so long as the bases chosen produce meaningful results. Allocation bases are usually determined at the beginning of the organization's year because it may be necessary to accumulate data from time or use studies or other base data throughout the year.

103.23 Exhibit 1-5 presents some common bases used for allocating natural expense classifications among the different functions. The allocation bases in Exhibit 1-5 represent only a few of the possible bases an organization might use. As indicated in the exhibit, salaries and square footage are common bases on which to allocate a variety of costs. In fact, some small organizations allocate all expenses using only salaries and square footage as bases. While that may not be meaningful for many organizations, it may be appropriate for some organizations. Applying those two simple allocation bases may be particularly attractive for small organizations with high payroll costs and leased facilities. Paragraph 103.33 provides an example functional allocation computation using only salaries and square footage as allocation bases.

Exhibit 1-5

Common Bases Used to Allocate Natural (Object) Expense Classifications between Functions

Natural (Object) Expense Classification	Common Allocation Bases
Salaries	Time sheets [a]
	Time studies [a]
Employee benefits	Salary dollars
Payroll taxes	Salary dollars
Supplies	Use studies

Natural (Object) Expense Classification	Common Allocation Bases
	Headcount
	Salary dollars
Telephone	Number of extensions
	Use studies
	Salary dollars
Postage and shipping	Use studies
	Salary dollars
Occupancy	Square footage
	Facilities use studies
	Utility meters
Interest expense	Asset use (for debt to acquire property)
	Loan use (for working capital loans)
Rental and maintenance of equipment	Equipment use
Printing and publications	Use studies
	Salary dollars
Travel and transportation	Employee use
	Salary dollars
Insurance	Square footage
	Asset use
	Salary dollars
Depreciation and amortization	Asset use
	Square footage
Other expenses	Salary dollars
	Square footage
	Various other

Notes:

[a] In addition to supporting the use of time sheets or time studies to allocate salary expense, the United Way also supports the use of the full-time equivalent (FTE) method for allocating salary expenses. Under the FTE method, each employee is viewed as having an associated overhead cost. Thus, the number of employees in a functional classification are divided by the number of employees in *all* classifications (excluding the employees whose salaries will be allocated). The resulting percentage is then multiplied by the salary dollars requiring allocation to determine the amount allocated to each function.

103.24 Using simple allocation bases of salaries and square footage may not be appropriate even for some smaller organizations. For example, the occupancy costs related to heating or air conditioning the sanctuary of a church or heating or cleaning the swimming pool at the local YMCA may be significantly higher than the costs of other organizational facilities with similar amounts of square footage. Therefore, it may not be meaningful to allocate those occupancy costs based on square footage. Similarly, other factors such as the inefficient use of space and large amounts of common areas in some organizations also impact the decision on whether the square footage method is acceptable for allocating expenses. In some cases, it may be appropriate to use total direct costs for each activity as an allocation base for allocating expenses.

103.25 As discussed in paragraph 103.15, quantitative objective data is preferable to qualitative subjective data when performing expense allocations. Even so, there may be circumstances where qualitative or subjective criteria may be used if it provides a more meaningful answer.

Example 1-32: Determining allocation bases.

Assume an organization performs an office supply use study as a basis for allocating those supplies. As part of the study, employees are required to log out supplies taken from a central location for use in their departments. The log should then represent office supply use by department during the period of the study. Upon reviewing the use study, it appears the results are not representative, as some departments apparently did not follow instructions to log out supplies when obtained. What should an accountant do in a circumstance like that?

Any number of solutions may be appropriate, some of which may not be quantitative or objective. If the accountant chooses to subjectively adjust the use study results or to qualitatively assign use percentages based on personal judgment or other factors, the authors believe that the allocation method may still be appropriate. Accountants should focus on the two most important factors about the allocation method and bases applied—that they are meaningful and reasonable.

103.26 Accountants sometimes tend to get carried away designing methodologies or computation models. They should consider the following practical suggestions when designing an organization's allocation method:

• *Cost-effectiveness Is Important.* Accountants should remember that the goal of functional allocation is to produce a meaningful allocation of indirect costs. Meaningful does not necessarily have to be exact. If applying an allocation base requires a significant amount of time and effort, does it result in a more meaningful allocation than a base that requires only a short amount of time to prepare? If using two different allocation methods results in materially the same result, it is obviously better to select the method that requires less time or money.

• *Nonfinancial Data May Be More Meaningful Than Financial Data.* Depending on the type of expense, it may be preferable to use quantitative data other than financial data. For instance, it is common to base occupancy-related expense allocations on the square footage used by each function. It is also common for certain types of indirect program-related costs to be allocated based on program service units, such as the number of meals served. In both cases, the nonfinancial data is relevant and quantitative in nature.

• *Complex Allocations Are Not Always Better.* When choosing between a complex and a relatively simple allocation method, the simpler method should usually be chosen if it produces approximately the same result. There is a greater chance for clerical or logic errors to occur in complex computations. Accountants should remember, however, that a simple solution is not useful if the outcome causes distortion or is misleading.

103.27 **Assemble Allocation Data**

Once the allocation bases have been determined, the allocation data must be assembled. The accumulated data provides the foundation for the allocation to be performed. Although it may sound simple, the assembly step can be time-consuming. Any accountant who has burrowed through years of old records in storage searching for a building blueprint would agree that some things can take time. That is not to suggest that an accountant should spend an inordinate amount of time locating data when other types of readily available data may produce a meaningful result. Accountants should remember that estimates may be used if they are reasonable. For example, estimates of the percentages of a building that are used for particular functions may be used if blueprints showing the square footage are not available, and it is not practical to measure the space.

103.28 If time or use studies are to be used as allocation bases, the studies should be representative of the year to be meaningful. As a result, the timing of studies should be carefully considered. For example, if an executive director spends a significant amount of time one month each year assisting with the local United Way campaign, that month may not be representative of his or her time spent on fund-raising throughout the year. In that case, a different month that is more representative of the entire year should probably be selected to perform the employee time study.

103.29 **Perform the Allocation Computation**

Once the allocation bases have been selected and the data assembled, the functional allocation computation can be performed. A functional allocation computation is not typically one calculation, but a series of calculations. Accountants should note that a separate calculation is usually required for each different allocation base chosen. Even in simple allocation computations, there are often two or three separate calculations using different allocation bases that are brought together and summarized. Separate calculations are also necessary for each indirect cost center, which may need to be done in a specific order in the computation process to arrive at a logical result.

103.30 Appendix 1C, “Functional Allocation Computation Worksheets,” represents a series of forms that may be used to perform a functional allocation computation. In addition to providing worksheets for allocating costs and summarizing allocation results, Appendix 1C provides supporting worksheets for computing time spent and square footage by function and documenting the allocation bases applied. To further simplify the computation, accountants may wish to use the worksheets in Appendix 1C as models for developing automated spreadsheets using a spreadsheet program such as Microsoft Excel or Lotus

1-2-3. *PPC's Workpapers for Nonprofit Organization Audits* is an Excel-based product that automates common tasks, including the functional expense allocation. It can be ordered by calling (800) 431-9025.

103.31 It is important for an organization to document and maintain its functional allocation computation. Properly documenting the allocation method and bases applied may streamline the audit procedures required to test the functional allocation and provide support for the allocation of indirect costs, if any, to government grants. In addition, should individuals involved in preparing the computation leave the organization, others can use the documentation as a road map for preparing functional allocations in future years.

103.32 When performing a functional allocation computation, accountants should consider the following recommendations:

• *Establish a Logical Approach and Apply It Consistently throughout the Computation.* Because the allocation computation represents numerous individual calculations, it is essential from the outset to establish a logical approach for each step along the way. Rather than forging ahead, the accountant should plan the approach before beginning the calculations. Once the computation logic is established, the accountant should ensure that it is applied rationally and consistently throughout the computation.

• *Check the Math Carefully.* A functional allocation is essentially a series of mathematical calculations, and mathematical calculations are always subject to error. Even when preparing computations using spreadsheets, errors can easily be made. Formulas can be copied or set up improperly or they can be accidentally erased from individual cells. It is wise to set up additional check totals when using spreadsheets to ensure that formulas are set up correctly.

• *Ensure That Numbers Are Transferred Correctly between Allocation Schedules.* Allocation computations are often based on the results of a few key computations (such as the allocation of salary cost) that are carried forward and applied to other computations. It is critical that all the computed amounts are properly carried forward. Accountants should verify that all numbers or percentages used in other schedules are properly carried forward. If using spreadsheets, it is often helpful to use formulas that automatically link cells on one worksheet with another so that numbers automatically update between worksheets.

103.33 The following example presents a relatively straightforward functional allocation computation. The example assumes that all costs are allocable (that is, there are no expenses that are directly assigned to one function).

Example 1-33: Functional allocation computation—all costs allocable.

The Elkhart Association of CPAs is a trade association for CPAs that provides various services and training to its members. The Association uses the following bases to perform its functional allocation computation:

• Salaries are allocated based on a representative time study.

• All expenses other than occupancy are allocated based on salaries.

• Occupancy expenses are allocated based on square footage.

Using those basic allocation bases, the Association would typically perform the following separate calculations to allocate its expenses to the appropriate function:

1. Determine the time spent by job function based on the time study and the salary for each individual.

2. Allocate salaries by job function and compute salaries by function as a percentage of total salaries.

3. Allocate remaining allocable expenses other than occupancy based on the percentage of salaries by function.

4. Compute square footage by function as a percentage of total square footage.

5. Allocate occupancy expense based on the percentage of square footage by function.

6. Summarize the results of the salary allocation, the occupancy allocation, and the allocation of other expenses.

Exhibit 1-6 presents the resulting functional allocation for the Elkhart Association of CPAs.

Exhibit 1-6

Example Functional Allocation—the Elkhart Association of CPAs

Step 1—Determine the time spent by job position based on the time study and salaries for each job position

Job Position	Member Services	Training	Management & General	Membership Development	Total	Total Salary
Member services coordinator	80%	— %	10%	10%	100%	$ 32,000
Training coordinator	— %	90%	10%	— %	100%	31,000
Member services assistant	100%	— %	— %	— %	100%	18,500
Training assistant	— %	100%	— %	— %	100%	18,000
Executive director	15%	15%	40%	30%	100%	48,000
Administrative assistant	20%	20%	40%	20%	100%	19,000
Total						$ 166,500

Step 2—Allocate salaries and compute them by function as a percentage of total salaries

Job Position	Member Services	Training	Management & General	Membership Development	Total
Member services coordinator	$ 25,600	$ —	$ 3,200	$ 3,200	$ 32,000
Training coordinator	—	27,900	3,100	—	31,000
Member services assistant	18,500	—	—	—	18,500
Training assistant	—	18,000	—	—	18,000
Executive director	7,200	7,200	19,200	14,400	48,000
Administrative assistant	3,800	3,800	7,600	3,800	19,000
Total salaries	$ 55,100	$ 56,900	$ 33,100	$ 21,400	$ 166,500
Allocation % by function	33%	34%	20%	13%	100%

Step 3—Allocate expenses other than occupancy based on salaries

Expense Account/Classification	Total 100%	Member Services 33%	Training 34%	Management & General 20%	Membership Development 13%
Employee benefits	$ 18,700	$ 6,171	$ 6,358	$ 3,740	$ 2,431
Payroll taxes	13,500	4,455	4,590	2,700	1,755
Supplies	9,800	3,234	3,332	1,960	1,274
Telephone	3,200	1,056	1,088	640	416
Printing					

Expense Account/Classification	Total 100%	Member Services 33%	Training 34%	Management & General 20%	Membership Development 13%
	800	264	272	160	104
Insurance	2,400	792	816	480	312
Depreciation on equipment	1,200	396	408	240	156

Step 4—Compute square footage by function

	Square Footage	Percentage
Member services	1,200	26%
Training	2,200	48%
Management & general	800	17%
Membership development	400	9%
Total	4,600	100%

Step 5—Allocate occupancy expenses

Expense Account/Classification	Total 100%	Member Services 26%	Training 48%	Management & General 17%	Membership Development 9%
Rent	$ 24,000	$ 6,240	$ 11,520	$ 4,080	$ 2,160
Utilities	10,800	2,808	5,184	1,836	972
Janitorial	7,200	1,872	3,456	1,224	648
Maintenance	3,200	832	1,536	544	288
Building supplies	850	220	408	145	77
Total occupancy expenses	$ 46,050	$ 11,972	$ 22,104	$ 7,829	$ 4,145

Step 6—Summarize allocation results

	Member Services	Training	Total Program Services	Management & General	Membership Development	Total Supporting Services	Total
Salaries	$ 55,100	$ 56,900	$ 112,000	$ 33,100	$ 21,400	$ 54,500	$ 166,500
Employee benefits	6,171	6,358	12,529	3,740	2,431	6,171	18,700
Payroll taxes	4,455	4,590	9,045	2,700	1,755	4,455	13,500
Supplies	3,234	3,332	6,566	1,960	1,274	3,234	9,800
Telephone	1,056	1,088	2,144	640	416	1,056	3,200
Printing	264	272	536	160	104	264	800
Insurance	792	816	1,608	480	312	792	2,400
Depreciation on equipment	396	408	804	240	156	396	1,200
Occupancy	11,972	22,104	34,076	7,829	4,145	11,974	46,050
Total expenses	$ 83,440	$ 95,868	$ 179,308	$ 50,849	$ 31,993	$ 82,842	$ 262,150

103.34 The following example presents a more complex functional allocation computation that includes the allocation of an indirect cost center.

Example 1-34: Functional allocation computation—allocation of an indirect cost center.

The Whole Child Center (The Center) is a comprehensive evaluation and treatment center for children with developmental disabilities. The Center applies multiple allocation bases and uses an indirect cost center to accumulate costs related to patient admissions, billing, scheduling, and medical records. Because The Center allocates all costs of the indirect cost center to other functions, both directly identified expenses and allocated expenses must be considered in certain computations.

The Center uses the following allocation bases to perform its functional allocation computation:

Expense Account/Classification	Allocation Bases
Employee benefits	Salaries
Payroll taxes	Salaries
Insurance—general liability	Salaries
Office supplies	Use study
Computer supplies	Number of computer terminals
Computer consulting—indirect	Number of computer terminals
Depreciation—computer network	Number of computer terminals
Telephone—base	Number of extensions
Janitorial	Time study
Utilities	Square footage
Building maintenance and repair	Square footage
Insurance—property	Square footage
Depreciation—building	Square footage
Indirect patient services (indirect cost pool)	Unduplicated number of patients served

Using those allocation bases, The Center would perform the following functional allocation computations:

1. Identify expenses that require allocation.

2. Allocate expenses based on the ratio of salaries by function to total salaries. (Salaries have already been directly identified and assigned throughout the year using employee time sheets.)

3. Allocate office supplies to functions based on each function's use.

4. Allocate computer-related costs based on each function's number of terminals to total terminals.

5. Allocate base telephone charges based on the number of extensions used by each function as a percentage of total extensions.

6. Allocate janitorial expense based on the percentage of time spent on each function.

7. Allocate occupancy-related expenses based on the percentage of square footage by function to total square footage.

8. Compute the percentage of the indirect patient services cost pool to be allocated to each program function based on each function's unduplicated number of patients served as a percentage of total patients served.

9. Combine the directly identified and allocated costs related to the indirect patient services cost pool. Allocate the cost pool (both directly identified and allocated costs) to each of the three direct program services (pediatrics, physical and occupational therapy, and psychiatric services) based on each function's percentage of patients served.

10. Combine the directly identified and allocated costs for pediatrics, physical and occupational therapy, and psychiatric services (before the indirect cost pool allocation) and add to them the allocated indirect cost pool expenses.

11. Summarize the results of each of the allocation computations.

Exhibit 1-7 presents each of the functional allocation steps for The Whole Child Center.

Exhibit 1-7

Example Functional Allocation—the Whole Child Center

Step 1—Identify expenses requiring allocation

	Total	Pediatrics	Physical & Occupational Therapy	Psychiatric	Indirect Patient Services	Management & General	Fund-raising
Expenses directly identified:							
Salaries	$ 1,010,000	$ 242,400	$ 151,500	$ 363,800	$ 60,600	$ 143,100	$ 48,600
Program supplies	82,000	42,400	16,000	23,600	—	—	—
Computer consulting—direct	17,200	—	—	—	13,600	1,700	1,900
Professional fees	29,000	—	—	—	—	25,000	4,000
Telephone—long distance	2,600	100	100	300	800	600	700
Postage and shipping	12,800	100	100	200	5,100	3,100	4,200
Printing	13,700	300	200	800	3,800	5,200	3,400
Travel	6,100	200	100	300	100	2,800	2,600
Conferences, conventions, and meetings	8,900	2,300	1,400	2,400	500	1,600	700
Membership dues	4,600	600	400	800	—	2,400	400
Insurance—professional liability	8,700	2,800	1,700	4,200	—	—	—
Depreciation—other equipment	17,600	5,100	3,800	1,900	2,700	2,900	1,200
Total expenses directly identified	1,213,200	$ 296,300	$ 175,300	$ 398,300	$ 87,200	$ 188,400	$ 67,700

Expenses to be allocated:	
Employee benefits	121,200
Payroll taxes	80,800
Office supplies	17,500
Computer supplies	19,600
Computer consulting—indirect	28,800
Telephone—base	9,800

Janitorial	31,000
Utilities	38,400
Building maintenance and repair	26,200
Insurance—property	4,200
Insurance—general liability	5,300
Depreciation—building	37,500
Depreciation—computer network	7,500
Total allocable expenses	427,800
Total expenses	$ 1,641,000

Step 2—Allocate salary-related costs

	Total	Pediatrics	Physical & Occupational Therapy	Psychiatric	Indirect Patient Services	Management & General	Fund-raising
Salaries	$ 1,010,000	$ 242,400	$ 151,500	$ 363,800	$ 60,600	$ 143,100	$ 48,600
Allocation % by function	100.0 %	24.0 %	15.0 %	36.02 %	6.0 %	14.17 %	4.81 %
Expenses to be allocated based on % of salaries by function							
Employee benefits	$ 121,200	$ 29,088	$ 18,180	$ 43,656	$ 7,272	$ 17,174	$ 5,830
Payroll taxes	80,800	19,392	12,120	29,104	4,848	11,449	3,887
Insurance—general liability	5,300	1,272	795	1,909	318	751	255

Step 3—Allocate office supplies

	Total	Pediatrics	Physical & Occupational Therapy	Psychiatric	Indirect Patient Services	Management & General	Fund-raising
Use study	100.0 %	3.0 %	1.0 %	4.0 %	36.0 %	38.0 %	18.0 %
Expense to be allocated based on % of office supplies used							
Office supplies	$ 17,500	$ 525	$ 175	$ 700	$ 6,300	$ 6,650	$ 3,150

Step 4—Allocate computer-related costs

	Total	Pediatrics	Physical & Occupational Therapy	Psychiatric	Indirect Patient Services	Management & General	Fund-raising
Number of computer terminals used by each function	20	3	2	4	4	5	2

	Total	Pediatrics	Physical & Occupational Therapy	Psychiatric	Indirect Patient Services	Management & General	Fund-raising
Allocation % by function	100.0 %	15.0 %	10.0 %	20.0 %	20.0 %	25.0 %	10.0 %
Expenses to be allocated based on % of terminals by function							
Computer supplies	$ 19,600	$ 2,940	$ 1,960	$ 3,920	$ 3,920	$ 4,900	$ 1,960
Computer consulting— indirect	28,800	4,320	2,880	5,760	5,760	7,200	2,880
Depreciation—computer network	7,500	1,125	750	1,500	1,500	1,875	750

Step 5—Allocate base telephone charges

	Total	Pediatrics	Physical & Occupational Therapy	Psychiatric	Indirect Patient Services	Management & General	Fund-raising
Number of extensions used by function	30	6	5	10	3	5	1
Allocation % by function	100.0 %	20.0 %	16.67 %	33.33 %	10.0 %	16.67 %	3.33 %
Expense to be allocated based on % of extensions by function							
Telephone—base	$ 9,800	$ 1,960	$ 1,633	$ 3,267	$ 980	$ 1,633	$ 327

Step 6—Allocate janitorial costs

	Total	Pediatrics	Physical & Occupational Therapy	Psychiatric	Indirect Patient Services	Management & General	Fund-raising
Time study	100.0 %	29.0 %	32.0 %	22.0 %	7.0 %	8.0 %	2.0 %
Expense to be allocated based on % of time spent							
Janitorial	$ 31,000	$ 8,990	$ 9,920	$ 6,820	$ 2,170	$ 2,480	$ 620

Step 7—Allocate occupancy-related expenses

	Total	Pediatrics	Physical & Occupational Therapy	Psychiatric	Indirect Patient Services	Management & General	Fund-raising
Square footage by function	20,700	6,400	4,200	5,200	2,300	1,800	800
	100.0 %	30.92 %	20.29 %	25.12 %	11.11 %	8.7 %	3.86 %

Allocation % by function							
Expenses to be allocated based on % of square footage by function							
Utilities	$ 38,400	$ 11,873	$ 7,791	$ 9,646	$ 4,266	$ 3,341	$ 1,483
Building maintenance and repair	26,200	8,101	5,316	6,582	2,911	2,279	1,011
Insurance—property	4,200	1,299	852	1,055	467	365	162
Depreciation—building	37,500	11,595	7,609	9,420	4,166	3,262	1,448

Step 8—Compute percentage of patients served by program function

	Unduplicated # of Patients Served	Percentage
Pediatrics	2,267	31.6 %
Physical and occupational therapy	1,296	18.1 %
Psychiatric	3,599	50.3 %
Total	7,162	100.0 %

Step 9—Combine and allocate the indirect patient services cost pool

		Indirect Patient Services 100.0%	Pediatrics 31.6%	Physical & Occupational Therapy 18.1%	Psychiatric 50.3%
Salaries	D	$ 60,600	$ 19,150	$ 10,968	$ 30,482
Employee benefits	A	7,272	2,298	1,316	3,658
Payroll taxes	A	4,848	1,532	877	2,439
Program supplies	D	—	—	—	—
Office supplies	A	6,300	1,991	1,140	3,169
Computer supplies	A	3,920	1,238	710	1,972
Computer consulting—direct	D	13,600	4,298	2,461	6,841
Computer consulting—indirect	A	5,760	1,821	1,042	2,897
Professional fees	D	—	—	—	—
Telephone—base	A	980	310	177	493
Telephone—long distance	D	800	253	145	402
Postage and shipping	D	5,100	1,612	923	2,565
Janitorial	A	2,170	685	393	1,092
Utilities	A	4,266	1,348	772	2,146
Building maintenance and repair	A	2,911	920	527	1,464
Printing	D	3,800	1,201	688	1,911
Travel	D	100	32	18	50
Conferences, conventions, and meetings	D	500	157	91	252
Membership dues	D	—	—	—	—

		Indirect Patient Services 100.0%	Pediatrics 31.6%	Physical & Occupational Therapy 18.1%	Psychiatric 50.3%
Insurance—property	A	467	147	85	235
Insurance—professional liability	D	—	—	—	—
Insurance—general liability	A	318	100	58	160
Depreciation—building	A	4,166	1,317	754	2,095
Depreciation—computer network	A	1,500	474	272	754
Depreciation—other equipment	D	2,700	853	489	1,358
		$ 132,078	$ 41,737	$ 23,906	$ 66,435

D = Expenses directly assigned to indirect patient services (from Step 1).

A = Allocable expenses originally allocated to indirect patient services (from Step 2 through Step 7).

Step 10—Combine indirect patient services allocation with other program service costs

Expense Account/Classification		Pediatrics Before Allocation	Indirect Patient Services Allocation	Total Pediatrics	Physical & Occupa-tional Therapy Before Allocation	Indirect Patient Services Allocation	Total Physical & Occupa-tional Therapy	Psychiatric Before Allocation	Indirect Patient Services Allocation	Total Psychiatric
Salaries	D	$ 242,400	$ 19,150	$ 261,550	$ 151,500	$ 10,968	$ 162,468	$ 363,800	$ 30,482	$ 394,282
Employee benefits	A	29,088	2,298	31,386	18,180	1,316	19,496	43,656	3,658	47,314
Payroll taxes	A	19,392	1,532	20,924	12,120	877	12,997	29,104	2,439	31,543
Program supplies	D	42,400	—	42,400	16,000	—	16,000	23,600	—	23,600
Office supplies	A	525	1,991	2,516	175	1,140	1,315	700	3,169	3,869
Computer supplies	A	2,940	1,238	4,178	1,960	710	2,670	3,920	1,972	5,892
Computer consulting—direct	D	—	4,298	4,298	—	2,461	2,461	—	6,841	6,841
Computer consulting—indirect	A	4,320	1,821	6,141	2,880	1,042	3,922	5,760	2,897	8,657
Professional fees	D	—	—	—	—	—	—	—	—	—
Telephone—base	A	1,960	310	2,270	1,633	177	1,810	3,267	493	3,760
Telephone—long distance	D	100	253	353	100	145	245	300	402	702
Postage and shipping	D	100	1,612	1,712	100	923	1,023	200	2,565	2,765
Janitorial	A	8,990	685	9,675	9,920	393	10,313	6,820	1,092	7,912
Utilities	A	11,873	1,348	13,221	7,791	772	8,563	9,646	2,146	11,792
Building maintenance and repair	A	8,101	920	9,021	5,316	527	5,843	6,582	1,464	8,046
Printing	D	300	1,201	1,501	200	688	888	800	1,911	2,711
Travel	D	200	32	232	100	18	118	300	50	350
Conferences, conventions, and meetings	D	2,300	157	2,457	1,400	91	1,491	2,400	252	2,652
Membership dues	D	600	—	600	400	—	400	800	—	800
Insurance—property	A	1,299	147	1,446	852	85	937	1,055	235	1,290
Insurance—professional liability	D	2,800	—	2,800	1,700	—	1,700	4,200	—	4,200
Insurance—general liability	A	1,272	100	1,372	795	58	853	1,909	160	2,069
Depreciation—building	A	11,595	1,317	12,912	7,609	754	8,363	9,420	2,095	11,515

Expense Account/Classification		Pediatrics Before Allocation	Indirect Patient Services Allocation	Total Pediatrics	Physical & Occupa-tional Therapy Before Allocation	Indirect Patient Services Allocation	Total Physical & Occupa-tional Therapy	Psychiatric Before Allocation	Indirect Patient Services Allocation	Total Psychiatric
Depreciation—computer network	A	1,125	474	1,599	750	272	1,022	1,500	754	2,254
Depreciation—other equipment	D	5,100	853	5,953	3,800	489	4,289	1,900	1,358	3,258
		$ 398,780	$ 41,737	$ 440,517	$ 245,281	$ 23,906	$ 269,187	$ 521,639	$ 66,435	$ 588,074

D = Expenses (other than indirect patient services allocation) directly assigned to program (from Step 1). Indirect patient services allocation is from Step 9.

A = Allocable expenses other than indirect patient services allocation (allocated in Step 2 through Step 7). Indirect patient services allocation is from Step 9.

Step 11—Summarize allocation results

Expense Account/Classification		Pediatrics	Physical & Occupa-tional Therapy	Psychiatric	Total Program Services	Manage-ment & General	Fund-raising	Total Supporting Services	Total
Salaries	D	$ 261,550	$ 162,468	$ 394,282	$ 818,300	$ 143,100	$ 48,600	$ 191,700	$ 1,010,000
Employee benefits	A	31,386	19,496	47,314	98,196	17,174	5,830	23,004	121,200
Payroll taxes	A	20,924	12,997	31,543	65,464	11,449	3,887	15,336	80,800
Program supplies	D	42,400	16,000	23,600	82,000	—	—	—	82,000
Office supplies	A	2,516	1,315	3,869	7,700	6,650	3,150	9,800	17,500
Computer supplies	A	4,178	2,670	5,892	12,740	4,900	1,960	6,860	19,600
Computer consulting—direct	D	4,298	2,461	6,841	13,600	1,700	1,900	3,600	17,200
Computer consulting—indirect	A	6,141	3,922	8,657	18,720	7,200	2,880	10,080	28,800
Professional fees	D	—	—	—	—	25,000	4,000	29,000	29,000
Telephone—base	A	2,270	1,810	3,760	7,840	1,633	327	1,960	9,800
Telephone—long distance	D	353	245	702	1,300	600	700	1,300	2,600
Postage and shipping	D	1,712	1,023	2,765	5,500	3,100	4,200	7,300	12,800
Janitorial	A	9,675	10,313	7,912	27,900	2,480	620	3,100	31,000
Utilities	A	13,221	8,563	11,792	33,576	3,341	1,483	4,824	38,400
Building maintenance and repair	A	9,021	5,843	8,046	22,910	2,279	1,011	3,290	26,200
Printing	D	1,501	888	2,711	5,100	5,200	3,400	8,600	13,700
Travel	D	232	118	350	700	2,800	2,600	5,400	6,100
Conferences, conventions, and meetings	D	2,457	1,491	2,652	6,600	1,600	700	2,300	8,900
Membership dues	D	600	400	800	1,800	2,400	400	2,800	4,600
Insurance—property	A	1,446	937	1,290	3,673	365	162	527	4,200
Insurance—professional liability	D	2,800	1,700	4,200	8,700	—	—	—	8,700
Insurance—general liability	A	1,372	853	2,069	4,294	751	255	1,006	5,300
Depreciation—building	A	12,912	8,363	11,515	32,790	3,262	1,448	4,710	37,500
Depreciation—computer network	A	1,599	1,022	2,254	4,875	1,875	750	2,625	7,500
Depreciation—other equipment	D	5,953	4,289	3,258	13,500	2,900	1,200	4,100	17,600

Expense Account/Classification	Pediatrics	Physical & Occupa- tional Therapy	Psychiatric	Total Program Services	Manage - ment & General	Fund- raising	Total Supporting Services	Total
Total expenses	$ 440,517	$ 269,187	$ 588,074	$ 1,297,778	$ 251,759	$ 91,463	$ 343,222	$ 1,641,000

D = Expenses directly assigned. Pediatrics, physical and occupational therapy, and psychiatric amounts are from Step 10. Management and general and fund -raising amounts are from Step 1.

A = Allocable expenses. Pediatrics, physical and occupational therapy, and psychiatric amounts are from Step 10. Management and general and fund-raising amounts are from Step 2 through Step 7.

103.35 **Periodically Evaluate Expense Allocation Methods**

After a functional allocation method is established, organization management should periodically evaluate and revise it to reflect significant changes in the nature or level of the organization's activities. For example, the organization may review employee time studies, space usage studies, or supplies consumption studies to determine if the revised results differ significantly from the studies currently being used.

103.36 Management should also review the organization's expense allocation for obvious discrepancies. For example, if the organization reports grant income, it most likely should report proposal and grants management expense as a management and general expense (see the discussion beginning at paragraph 102.44) or solicitation of contributions as a fund-raising expense. (See the discussion beginning at paragraph 201.15 for possible exceptions.) If the organization allocates salary expenses to fund-raising, it should probably have other related expenses, such as fringe benefits, payroll taxes, rent, and depreciation allocated to fund-raising as well. The allocation of expenses should include program services, management and general, fund-raising expenses, and membership development (if applicable). If any of these categories are missing, management should review the allocation and correct anything that does not appear reasonable for the organization.

103.37 Accountants should be aware that a change in the allocation method may represent a change in accounting principle, [8] unless the facts and circumstances related to the basis for applying the allocation method have changed. For most organizations, the allocation bases (such as time studies or use studies) will usually remain the same from year to year, while the allocation data assembled to apply the allocation bases will change based on current activities.

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[6] In June 2004, the OMB issued changes to Circulars A-122, A-21, and A-87 (the circulars that address cost principles for nonprofit organizations, educational institutions, and governments). The primary changes are deletion of items, changes in language for consistency, and extension of certain items previously only in one or more—but not all—sets of OMB cost principles to another set or sets of OMB cost principles. Although the changes minimized the number of differences between the OMB cost principles, there remain several cost items that are unique to one type of entity and not to other entities. The *List of Selected Items of Cost Contained in OMB Cost Principles Circulars* is contained in Part 3 of the OMB Circular A-133 Compliance Supplement, accessible at **www.whitehouse.gov/omb/circulars/a133_compliance_supplement_2010**.

[7] Footnote 9 of Paragraph 13.47 of the Audit Guide notes that OMB Circular A-122 includes guidance that may be helpful in allocating expenses to different functions. Paragraph 103.11 discusses that guidance.

[8] FASB ASC 250 contains the requirements for the accounting for and reporting of a change in accounting principle.

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104 Financial Statement Presentation of Expenses

Statement of Activities

104.1 Because of reporting flexibility permitted by FASB ASC 958-225, organizations may present expenses on the statement of activities in a number of different ways. First, organizations have the option of presenting expenses by functional classification or by natural classification. Even if organizations choose to present expenses by natural classification on the statement of activities, however, they are still required by FASB ASC 958-720-45-2 to report functional classifications in the notes to financial statements (see paragraph 104.21). Thus, choosing to report expenses by natural classification in the statement of activities does *not* relieve an organization from its requirement to present information about expenses by function. In addition, expenses that have similar characteristics should be aggregated into reasonably homogeneous groups on the statement of activities.

104.2 The authors recommend that organizations report expenses by their functional classification in the statement of activities rather than in the notes to financial statements unless the organization has only one program. In the case of an organization with only one program, the authors recommend that the organization use the program name as a subheading, then list the program expenses by their natural classification following the subheading. Following a subtotal for the program expenses, the organization would report amounts for fund-raising and management and general. In that manner, readers of the statement of activities receive important information about both functional and natural classification for the organization's mission-related activities.

104.3 Organizations also have other options for presenting expenses on their statement of activities. They may choose to present certain expenses (such as cost of sales) interspersed with related revenues rather than with other types of expenses. In addition, organizations may separately report operating and nonoperating activities. The following paragraphs describe and illustrate some of the statement of activities expense reporting options commonly presented by nonprofit organizations.

104.4 **Reporting by Functional Classification**

When reporting expenses by function, an organization should present separately its major program services and supporting services. Totals are not required to be presented in the statement of activities for “Total program services,” “Total supporting services,” or “Total expenses.” FASB ASC 958-720-05-4 requires the financial statements to describe each of the major classes of programs, either on the face of the statement of activities (through use of descriptive captions or headings) or in the notes to the financial statements. In addition, organizations are required to disclose (a) total program expenses if its components are not evident from the captions used on the face of the statement of activities (see paragraph 104.22) and (b) information about why the amount disclosed either does not agree with the statement of activities or cannot be easily determined from amounts on the statement of activities (if applicable). Accordingly, the organization may choose whether or not to present subtotals for program services and supporting services.

Example 1-35: Reporting by functional classification—subtotals.

The following is an example statement of activities expense section in which an organization presents subtotals for program services and supporting services:

EXPENSES	
Program services	
Exhibitions	$ 562,000
Education	348,000
TOTAL PROGRAM SERVICES	910,000
Supporting services	
Management and general	112,000
Fund-raising	50,000
Membership development	32,000

TOTAL SUPPORTING SERVICES	194,000
TOTAL EXPENSES	$ 1,104,000

Example 1-36: Reporting by functional classification—no subtotals.

The following example presents the same expense section as Example 1-35 without subtotals for program and supporting services:

EXPENSES	
Program services	
Exhibitions	$ 562,000
Education	348,000
Supporting services	
Management and general	112,000
Fund-raising	50,000
Membership development	32,000
TOTAL EXPENSES	$ 1,104,000

104.5 **Reporting by Natural (Object) Classification**

As discussed in paragraph 104.1, organizations may present expenses by their natural classification on the statement of activities. Organizations that choose to follow that presentation, however, are still required to report expense information by function in the notes to financial statements (see paragraph 104.21). An organization that chooses to report expenses by their natural classification on the statement of activities typically lists each of the material natural expense classifications and amounts.

Example 1-37: Reporting by natural (object) classification.

The following example presents the expenses for the same organization illustrated in paragraph 104.4 reported by natural classification rather than by functional classification:

EXPENSES	
Salaries	$ 640,000
Employee benefits	58,000
Payroll taxes	51,000
Artist fees	240,400
Auditorium rental	46,000
Accounting fees	12,000
Legal fees	3,200
Postage	3,300
Printing	4,500
Office supplies	3,800
Telephone	2,100
Transportation	800
Conferences and travel	1,900
Insurance	4,700
Utilities	28,000
Equipment rental	4,300
TOTAL EXPENSES	$ 1,104,000

The disclosure example at paragraph 104.21 illustrates the required footnote disclosure associated with reporting the above expenses by their natural classification.

104.6 **Expenses Interspersed Throughout Revenue Accounts**

Expenses are not required to be reported separately from revenues. Rather, various expense captions may be interspersed throughout the related revenue accounts. Examples of expenses that might logically be presented in the revenue section of the statement of activities are cost of sales, investment expenses (which may be netted against investment income), or the direct benefits received by donors as part of a special event.

104.7 If an organization chooses to intersperse certain expenses within its revenue accounts, and if it also includes expense totals in the expense section on the statement of activities, those expense totals will not agree to the statement of functional expenses (for voluntary health and welfare organizations) or to additional expense information that might be presented in the notes to the financial statements (for other organizations). In those cases, the authors suggest that the statement of functional expenses (or the note disclosure) be reconciled to the statement of activities by including a subtotal for “Total expenses” on the statement of functional expenses. From that subtotal, expenses deducted from revenues on the statement of activities would be subtracted leaving only total expenses reported by function on the statement of activities. The following example illustrates the presentation on the statement of activities when expenses are interspersed throughout revenue accounts.

Example 1-38: Expenses interspersed throughout revenue accounts.

Jobs for All, Inc. is an organization that provides job training and placement for unskilled workers. Exhibit 1-8 presents the unrestricted portion of the organization's statement of activities in which the following expenses have been interspersed within the revenue accounts:

- Cost of sales from the organization's thrift shop.
- Cost of direct benefits received by donors in conjunction with the organization's annual Gala ball.
- Investment expenses that have been netted against investment income.

The interspersed expenses on the statement of activities have been shaded to highlight their placement on the statement.

Paragraph 104.19 discusses the corresponding Jobs for All, Inc. example statement of functional expenses, and Exhibit 1-11 illustrates the statement. The illustrated statement of functional expenses properly reflects the interspersed expenses by their natural classification. In addition, the illustration reconciles total expenses to expenses reported on the statement of activities.

Exhibit 1-8

Example Statement of Activities—
Expenses Interspersed within Revenue Accounts

JOBS FOR ALL, INC.
STATEMENT OF ACTIVITIES
For the Year Ended December 31, 20X7

		Unrestricted
REVENUES, GAINS, AND OTHER SUPPORT		
Contributions		$ 284,000
Federal financial assistance		420,000
Program service fees		360,000
Thrift shop revenues	$ 180,000	
Less: thrift shop cost of sales	(115,000)	65,000
Gala ball	160,000	
Less: costs of direct benefits to donors	(90,000)	70,000
Investment return (net of $1,200 investment expenses)		33,000

Net assets released from restrictions	16,000
Expirations of time restrictions	
REVENUES, GAINS, AND OTHER SUPPORT	1,248,000
EXPENSES	
Program services	
Job training	608,000
Job placement	372,000
Supporting services	
Management and general	184,000
Fund-raising	52,000
EXPENSES	1,216,000
INCREASE IN NET ASSETS	32,000
NET ASSETS AT BEGINNING OF YEAR	648,000
NET ASSETS AT END OF YEAR	$ 680,000

104.8 If the statement of activities does not reflect the components of total program expenses because expenses are interspersed within revenue accounts, certain disclosures are required. See paragraph 104.22 for further discussion.

104.9 **Operating versus Nonoperating Expenses**

Organizations are permitted to present their statements of activities using a variety of options for classifying items within a net asset class, including segregating operating and nonoperating activities. Organizations have the prerogative of determining what are meaningful presentations of operating activities for their individual organizations.[9] Exhibit 1-9 illustrates a sample statement of activities that presents an intermediate measure of operations.

Exhibit 1-9

Example Statement of Activities—Intermediate Measure of Operations

HOPES AND DREAMS, INC.

STATEMENT OF ACTIVITIES

For the Year Ended June 30, 20X7

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
OPERATING REVENUES, GAINS, AND OTHER SUPPORT				
Federal financial assistance	$ 43,500	$ —	$ —	$ 43,500
Program service fees	22,400	—	—	22,400
Investment return designated for operations	4,100	—	—	4,100
United Way Services	—	156,300	—	156,300
Expiration of time restriction— United Way Services	146,500	(146,500)	—	—
Other	2,800	—	—	2,800
TOTAL OPERATING REVENUES, GAINS, AND OTHER SUPPORT	219,300	9,800	—	229,100
OPERATING EXPENSES				
Program services				
Women and children	134,100	—	—	134,100
Men	94,200	—	—	94,200
Supporting services				

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Management and general	55,600	—	—	55,600
Fund-raising	13,600	—	—	13,600
TOTAL EXPENSES	297,500	—	—	297,500
CHANGE IN NET ASSETS FROM OPERATING ACTIVITIES	(78,200)	9,800	—	(68,400)
NON-OPERATING ACTIVITIES				
Capital contributions				
New men's shelter	—	46,200	—	46,200
Capital campaign	—	4,800	—	4,800
Equipment acquisition	—	30,000	—	30,000
Endowment	—	—	2,700	2,700
Other	89,800	—	—	89,800
Auxiliary revenues	22,400	—	—	22,400
Auxiliary expenses	(19,600)	—	—	(19,600)
Investment return in excess of spending rate	1,600	500	—	2,100
Interest expense	(2,800)	—	—	(2,800)
Change in value of split-interest agreement	—	1,800	—	1,800
Restrictions satisfied by charitable lead trust receipts	25,000	(25,000)	—	—
Restrictions satisfied by payments	11,900	(11,900)	—	—
CHANGE IN NET ASSETS FROM NON-OPERATING ACTIVITIES	128,300	46,400	2,700	177,400
INCREASE IN NET ASSETS	50,100	56,200	2,700	109,000
NET ASSETS AT BEGINNING OF YEAR	612,500	435,900	4,200	1,052,600
NET ASSETS AT END OF YEAR	$ 662,600	$ 492,100	$ 6,900	$ 1,161,600

104.10 Most organization expenses are likely to be classified as operating activities since expenses generally represent activities related to the ongoing operations of an entity. However, if certain revenues are classified as nonoperating (such as a portion of investment income), related expenses might also be classified as nonoperating.

104.11 Examples of expenses that might be treated as nonoperating on the statement of activities include the following:

- The costs of goods or services that are peripheral to the organization's major activities.

- Expenses related to transactions reported as investing or financing activities on the statement of cash flows, such as interest expense.

- The costs of certain auxiliary activities of colleges and universities.

- Expenses related to discontinued operations.

Accountants should note that those expenses must still be functionally reported on the statement of activities or in the notes to financial statements. In addition, voluntary health and welfare organizations would have to functionally report those expenses in the statement of functional expenses. For example, the interest expense presented in Exhibit 1-9 is an object classification that should be functionally reported in the statement of functional expenses.

Statement of Functional Expenses

104.12 FASB ASC 958-205-45-6 requires voluntary health and welfare organizations to present a separate financial statement in a matrix format that reports expenses by both function and natural (object) classification. (See discussion beginning at paragraph 102.1 for a description of functional and natural classifications.) Other types of nonprofit organizations are also encouraged to present information by natural classification, but are not required to do so.

104.13 As discussed in paragraph 102.2, all organizations, including organizations other than voluntary health and welfare organizations, are required to present expense information by functional classification.

104.14 The authors recommend that organizations other than voluntary health and welfare organizations also consider presenting a schedule that reports expenses by both functional and natural classifications. The authors believe the schedule often provides meaningful information for financial statement users and typically requires little additional effort. Since FASB ASC 958-720-05-4 requires all organizations to provide information about expenses reported by their functional classifications, any allocation of expenses, such as salaries or occupancy, to various program and supporting services would already have been done. For organizations other than voluntary health and welfare organizations, information reporting expenses by both functional and natural classifications is typically presented as a supplemental schedule or in the notes rather than as a basic financial statement.

104.15 The statement of functional expenses should reflect the nature of the expenses and costs incurred in each functional category in sufficient detail for a reader to obtain a general understanding of the nature of the organization's costs of carrying out its activities. The statement must present *all* expenses of the organization in a matrix format.

104.16 Typically, a statement of functional expenses lists expenses by their natural classification down the left-hand column. Captions for functional categories of expenses are then listed as column headings from left to right across the top of the statement. Although not required, most functional expense statements present separate totals for program services, supporting services, and total expenses.

104.17 The authors believe an organization's financial statements are more meaningful and easily understood if expense information on the statement of functional expenses can be readily agreed to the statement of activities. Thus, the authors recommend using captions and totals on the statement of functional expenses that correspond with the captions and totals on the statement of activities.

104.18 Exhibit 1-10 illustrates a sample statement of functional expenses for The Family Center. That statement uses a common format followed by many voluntary health and welfare organizations.

Exhibit 1-10

Example Statement of Functional Expenses

THE FAMILY CENTER

STATEMENT OF FUNCTIONAL EXPENSES

For the Year Ended December 31, 20X7

	Program Services			Supporting Services			
	Counseling	Education	Total	Management & General	Fund-raising	Total	Total Expenses
Salaries	$ 51,700	$ 45,300	$ 97,000	$ 16,200	$ 7,600	$ 23,800	$ 120,800
Payroll taxes and employee benefits	6,700	5,300	12,000	1,400	600	2,000	14,000
Total compensation	58,400	50,600	109,000	17,600	8,200	25,800	134,800
Printing	25,500	19,300	44,800	5,600	4,300	9,900	54,700
Postage	4,200	3,600	7,800	2,500	900	3,400	11,200
Rent	12,000	10,000	22,000	5,000	3,500	8,500	30,500
Utilities	8,900	6,900	15,800	2,900	1,600	4,500	20,300
Conferences and training	2,700	3,200	5,900	1,000	—	1,000	6,900
Legal	6,400	2,900	9,300	2,400	—	2,400	11,700
Supplies	4,300	3,600	7,900	800	700	1,500	9,400
Depreciation	4,000	3,000	7,000	1,600	300	1,900	8,900
Other	5,100	4,800	9,900	4,300	2,500	6,800	16,700
Total expenses	$ 131,500	$ 107,900	$ 239,400	$ 43,700	$ 22,000	$ 65,700	$ 305,100

104.19 **Expenses Interspersed with Revenue on the Statement of Activities**

The statement of functional expenses must report *all* expenses by their natural classification, even those expenses that are interspersed with revenue accounts on the statement of activities. The statement of functional expenses may include a reconciliation of total expenses by function to the expenses reported on the statement of activities. If such a reconciliation is not presented, it may be necessary to provide additional disclosure in the notes to the financial statements to explain the difference between expenses presented on the statement of activities and total expenses by function (see paragraph 104.22).

Example 1-39: Statement of functional expenses—reconciliation to expenses reported on the statement of activities.

As discussed in paragraph 104.7, the authors recommend presenting a reconciliation on the statement of functional expenses that reconciles the difference between total expenses by function and functional expenses reported on the statement of activities.

In the Jobs for All, Inc. example illustrated in paragraph 104.7, cost of sales, costs of direct benefits received by donors, and investment expenses were interspersed with revenues in the Organization's statement of activities (see Exhibit 1-8).

The example statement of functional expenses for Jobs for All, Inc. is presented at Exhibit 1-11. The shaded amounts in that statement represent the expenses that were interspersed with revenues in the statement of activities. Exhibit 1-11 includes a reconciliation of total expenses to expenses presented on the statement of activities, enabling the user to readily identify the differences. In addition, if total program expenses were not reconciled between the statement of functional expenses and the statement of activities, the notes to financial statements would be required to provide an explanation of the components of total program expenses (see paragraph 104.22).

Exhibit 1-11

Example Statement of Functional Expenses—
Including Reconciliation of Expenses to Statement of Activities

JOBS FOR ALL, INC.

STATEMENT OF FUNCTIONAL EXPENSES

For the Year Ended December 31, 20X7

	Program Services				Supporting Services				
	Job Training	Job Placement	Thrift Shop	Total	Manage-ment & General	Fund-raising	Direct Benefits to Donors	Total	Total
Salaries	$ 340,000	$ 245,000	$ 19,000	$ 604,000	$ 115,000	$ 32,000	$ —	$ 147,000	$ 751,000
Employee benefits	70,000	29,400	2,200	101,600	13,800	4,000	—	17,800	119,400
Payroll taxes	50,000	19,600	1,500	71,100	1,000	2,500	—	3,500	74,600
Total compensation	460,000	294,000	22,700	776,700	129,800	38,500	—	168,300	945,000
Conferences and travel	5,700	3,800	—	9,500	4,100	—	—	4,100	13,600
Clothing and housewares	—	—	57,300	57,300	—	—	—	—	57,300
Cost of meals	—	—	—	—	—	—	67,000	67,000	67,000
Entertainment	—	—	—	—	—	—	7,000	7,000	7,000
Depreciation	12,800	7,800	—	20,600	3,800	800	—	4,600	25,200
Equipment rental	33,000	10,800	2,800	46,600	4,000	—	—	4,000	50,600
Insurance	6,000	4,600	3,700	14,300	5,900	—	—	5,900	20,200
Investment expenses	—	—	—	—	1,200	—	—	1,200	1,200
Occupancy	24,000	16,400	20,400	60,800	7,200	1,200	16,000	24,400	85,200
Postage	2,200	3,400	1,400	7,000	4,800	2,200	—	7,000	14,000
Printing	3,900	4,700	2,300	10,900	6,200	3,800	—	10,000	20,900
Supplies	52,500	18,600	4,400	75,500	7,600	4,100	—	11,700	87,200
Telephone	4,800	4,300	—	9,100	2,800	1,000	—	3,800	12,900
Transportation	3,100	3,600	—	6,700	2,100	400	—	2,500	9,200

Other	—	—	—	—	5,700	—	—	5,700	5,700
Total expenses	608,000	372,000	115,000	1,095,000	185,200	52,000	90,000	327,200	1,422,200
Less expenses included with revenues on the statement of activities	—	—	(115,000)	(115,000)	(1,200)	—	(90,000)	(91,200)	(206,200)
Total expenses included in expense section on the statement of activities	$ 608,000	$ 372,000	$ -0-	$ 980,000	$ 184,000	$ 52,000	$ -0-	$ 236,000	$ 1,216,000

Disclosures

104.20 An organization may be required to present a number of expense-related disclosures, some of which depend on the type of information presented on the organization's statement of activities. The following paragraphs discuss the required general disclosures related to expenses. See section 205 for additional specialized expense disclosures.

104.21 **Functional Classification of Expenses**

If not presented on the face of the statement of activities, expenses must be reported by functional classification (such as major classes of program services and supporting services) in the notes to financial statements.

Example 1-40: Disclosure—functional classification of expenses.

The following functional classification disclosure would be appropriate for the example statement of activities in paragraph 104.5, which presented information about expenses by their natural classifications:

Note X—Functional Expense Allocation

Expenses by function for the year ended December 31, 20X7 were as follows:

EXPENSES	
Program services	
Exhibitions	$ 562,000
Education	348,000
Supporting services	
Management and general	112,000
Fund-raising	50,000
Membership development	32,000
TOTAL EXPENSES	$ 1,104,000

104.22 **Components of Total Program Expenses**

If the components of total program expenses are not evident from the captions used on the face of the statement of activities (for example, cost of sales is not presented as relating to a particular program or supporting service), FASB ASC 958-720-45-5 requires the notes to financial statements to disclose total program expenses and provide information about why it does not agree to the statement of activities.

Example 1-41: Disclosure—components of total program expenses.

Assume that the Jobs for All, Inc. statement of functional expenses illustrated at Exhibit 1-11 did *not* present a reconciliation between total program expenses and program expenses on the statement of activities. Since FASB ASC 958-720-45-5 requires the notes to financial statements to disclose total program expenses and provide information about why it does not agree to the statement of activities, the Organization could comply with that requirement by providing the following disclosure in the notes to the financial statements:

	Job Training	Job Placement	Thrift Shop	Management & General	Fund-raising	Direct Benefits to Donors	Total
Expenses per statement of activities	$ 608,000	$ 372,000	$ —	$ 184,000	$ 52,000	$ —	$ 1,216,000
Cost of sales in revenue section	—	—	115,000	—	—	—	115,000
Investment expense netted against income	—	—	—	1,200	—	—	1,200
Direct benefits to donors in revenue section:							
Cost of meals	—	—	—	—	—	67,000	67,000
Entertainment	—	—	—	—	—	7,000	7,000
Occupancy	—	—	—	—	—	16,000	16,000
Total expenses	$ 608,000	$ 372,000	$ 115,000	$ 185,200	$ 52,000	$ 90,000	$ 1,422,200

The Organization could also comply with the disclosure requirement by simply disclosing in the notes to the financial statements that total program expenses were $1,095,000 and included cost of sales for the thrift shop.

104.23 **Nature of Activities**

FASB ASC 958-205-50-1 also requires organizations to present a description of the nature of their activities, including a description of each of its major programs, either in the financial statements (by use of column headings) or in the notes to financial statements. In addition, FASB ASC 275-10-50-2 requires organizations to describe their principal markets, the sources of revenue for the organization's activities, and the relative importance of the organization's activities in each business if it operates in more than one business.

Example 1-42: Disclosure—nature of activities.

The following is an example footnote disclosure describing the nature of an organization's activities:

Note A—Nature of Activities

The Safe House (the Shelter) provides temporary housing for the homeless. The Shelter also provides counseling services to assist clients in obtaining permanent housing, locating employment, and combating substance abuse. The Shelter is supported primarily by donor contributions, grants, and the United Way. Approximately 32% of the Shelter's support for the year ended December 31, 20X7, came from United Way allocations.

104.24 **Fund-raising Expenses**

FASB ASC 958-720-50-1 requires organizations to disclose total fund-raising expenses. That is of particular importance for colleges and universities because NACUBO guidelines allow management and general and fund-raising supporting services to be combined into one functional category called *institutional support*. See paragraph 102.31 for further discussion.

104.25 Additional disclosures are also required when organizations perform fund-raising activities in conjunction with program services or other supporting services. See section 202 for further discussion.

104.26 **Investment Expenses**

Organizations are allowed by FASB ASC 958-225-45-14 and 958-320-45-4 to net investment expenses against investment revenues on the statement of activities. If organizations follow that presentation, FASB ASC 958-225-45-14 and 958-320-45-4 require them to disclose the amount of the total investment expenses either on the face of the statement of activities or in the notes to financial statements.

Common Errors in Financial Statement Presentation of Expenses

104.27 This chapter explains and illustrates the application of generally accepted accounting principles as they relate to the expenses of nonprofit organizations. In an effort to identify some common problems, the authors reviewed recent financial statements of numerous nonprofit organizations. A high percentage of the reviewed financial statements (which included both large and small organizations) contained apparent errors. Some of the most common errors related to expenses include the following:

• Expenses, including supporting activities, were not reported by functional classification. (Program services should be presented by major program services. At a minimum, supporting services should include management and general and fund-raising.)

• A mixture of functional and natural categories was used on the face of the statement of activities without providing information about functional classification for all expenses elsewhere (e.g., depreciation and interest or salaries and benefits were shown as line items in an otherwise functional classification).

• Many financial statements reported only one amount for program services. While there might only be one program, some of those financial statements had notes that seemed to indicate there was more than one program.

• The required disclosures regarding major program services were not clearly reflected in the statement of activities, and such disclosures were not included in the notes to the financial statements.

• Total program costs were not identified and its components were not evident from the face of the statement of activities.

• No separate disclosure of total fund-raising expenses was made.

• Financial statements with contribution revenue did not have any related fund-raising expenses. [10] Although there are legitimate reasons for zero fund-raising expenses (as discussed at paragraph 201.15), the notes to the financial statements did not disclose any special circumstances regarding fund-raising efforts. Accordingly, zero fund-raising expenses may be an indication of an inadequate financial reporting system. [11]

• The method used to compute the ratio of fund-raising expenses to funds raised was not disclosed when such a ratio was disclosed in the organization's financial statements.

• Advertising expense was classified as a program expense even though its purpose appeared to be for the solicitation of revenue in an exchange transaction. In that case, the advertising expense should be classified as general and administrative expense.

• Loss on the sale of a fixed asset was reported in the statement of functional expenses. A loss is not an expense and should not be reported on that statement.

• Grantors are listed on the statement of functional expenses as programs (for example, the Department of Justice). The name of the grantor alone is generally insufficient to indicate the nature of the program (that is, the mission-related nature of the activity) conducted.

• Expenses were netted against revenues when the transactions were not incidental or peripheral. (Gross revenues and related costs should be reported separately.)

• Expenses were included in temporarily or permanently restricted net asset classes. (All expenses should be reported as decreases in unrestricted net assets.)

• Contributions of services that appear to meet the recognition criteria of FASB ASC 958-605-25-16 were not recognized as contributions and expenses in the statement of activities. Several of the statements included a note such as “the value of time contributed is not reflected in these financial

statements since it is not susceptible to objective measurement or valuation." Difficulty in measuring contributed services is not a reason for not recognizing them. Services that meet the recognition criteria should be recognized using best estimates of value.

• Volunteer services were recorded in the financial statements that did not appear to meet the recognition criteria of FASB ASC 958-605-25-16. The notes to the financial statements indicated that the services were recorded to meet grantor requirements. Financial statements should be reported in accordance with GAAP, which may differ from the requirements imposed in grant agreements.

• Financial statements do not include all required disclosures relating to joint costs of multipurpose activities or donated services of volunteers.

• Financial statements with disclosures about donated services did not include a description of the programs or activities for which the services were used or the nature and extent of contributed services received for the period.

• Items that were not unusual or infrequently occurring events and, thus, did not warrant separate disclosure on the statement of activities were presented separately on the statement as "Other changes" instead of included in "Total expenses."

• The expense caption "Unbudgeted" was included on the statement of activities. (This is inappropriate, regardless of whether expenses are reported by function or natural classification.)

• Certain expenses were not included in the statement of functional expenses (for example, expenses netted against revenues or nonoperating expenses).

• The allowance for doubtful accounts was not disclosed.

• The amount of interest paid (net of amounts capitalized) was not disclosed.

• The total amount of interest capitalized was not disclosed.

• A general description of the organization's leasing arrangements was not disclosed.

• Future minimum rentals on operating leases were not disclosed.

• Expenses are not allocated correctly. Expenses that relate to more than one function must be allocated among all of the appropriate functions. For example, organizations must allocate depreciation expense to program expense to the extent it relates to assets used to provide program services, to management and general expense to the extent it relates to assets used to provide those functions, etc. Some specific issues related to the allocation may include:

•• Failing to allocate expenses such as occupancy, utilities, insurance, and depreciation.

•• Failing to allocate overhead costs across all functions.

•• Over-allocating costs of executive time to program activities.

•• Failing to use timesheets or other employee time tracking methodology detailed enough to determine appropriate allocations.

•• Not applying a systematic and reasonable allocation method.

•• Failing to maintain a documented methodology for indirect overhead cost allocation.

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[9] If the meaning of the term *operations* within the statement of activities is not apparent, FASB ASC 958-225-50-1 requires organizations to disclose the nature of the reported measure of operations or the items excluded from operations.

[10] As discussed at paragraph 309.38, the IRS expects nonprofit organizations to report fund-raising costs in the Form 990.

[11] If the fund-raising expenses are not disclosed because the amount is determined to be immaterial, the authors believe it would be helpful to the users of the financial statements if the accounting policy footnote includes the reasons the amount is considered to be immaterial and, if applicable, a statement such as “immaterial amounts of fund-raising expenses are included in general and administrative expense.”

END OF DOCUMENT -

Appendix 1A
Selected Resource Publications Addressing Nonprofit Organization Expenses

Publication	Organization	Contact
Not-for-Profit Entities (Audit and Accounting Guide), updated as of March 1, 2012	American Institute of Certified Public Accountants (AICPA)	AICPA (888) 777-7077 **www.cpa2biz.com**
Government Auditing Standards and Circular A-133 Audits (Audit Guide), updated as of February 1, 2012	AICPA	AICPA (888) 777-7077 **www.cpa2biz.com**
Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations, 4th Edition (Black Book), 1998	National Health Council and National Assembly of Health and Human Services Organizations	National Health Council (202) 785-3910 **www.nationalhealthcouncil.org**
Accounting and Financial Reporting Guide for Christian Ministries, 2001	Evangelical Joint Accounting Committee (representing the Christian Management Association, the Evangelical Council for Financial Accountability, the Evangelical Fellowship of Mission Agencies, and the Interdenominational Foreign Mission Association of North America)	Evangelical Council for Financial Accountability (800) 323-9473 **www.ecfa.org**
Business Management for Independent Schools, Fifth Edition, 1997	National Association of Independent Schools (NAIS)	NAIS (800) 793-6701 **www.nais.org**
Financial Accounting and Reporting Manual for Higher Education (FARM Manual)	National Association of College and University Business Officers (NACUBO)	NACUBO (800) 462-4916 **www.nacubo.org**
FASB Accounting Standards Codification	Financial Accounting Standards Board (FASB)	FASB (800) 748-0659 **www.fasb.org** **http://asc.fasb.org**

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