

## Effective Ways to Assess and Allocate Functional Expenses

Most donors, creditors, and other funding sources are interested in the costs it takes for a Non-Profit Organization (NPO) to fulfill its mission through use of resources and the costs to provide those services. To review these costs, they pay close attention to the Statement of Functional Expenses that presents the functional classifications (i.e., Programs or Management and General) as well as the natural classifications (e.g., Payroll or Rent), of the NPO's expenses.

Program services and supporting activities are considered major functional classes and are required to be included in audited financial statements either in the Statement of Activities or the notes.

- **Program:** Activities that result in fulfilling the purpose or mission for which the NPO exists.
- **Supporting activities:** All other activities, such as management and general, fundraising, and membership-development.

Here is a short list of questions for your organization to review and improve cost allocation reporting:

- **Where are you including a Statement of Functional Expenses?** – You can voluntarily include it in your basic financial statements or as a supplemental schedule (the Statement is required for voluntary health and welfare organizations). Large donors typically request similar information.
- **How much detail should be included in the Statement of Functional Expenses (or supplemental schedule)?** – While it varies by NPO as it is dependent on the complexity of the NPO's activities, locations, etc., it is recommended to include as much detail as possible to accurately describe the

nature of the expenses incurred to perform your programs and activities. Expenses may be presented in any order and may include subtotals.

- **What allocation method are you currently using?** – A significant area that donors, creditors, and other funding sources are interested in is the ratio of program expenses to total expenses. Some costs can be easily identified as relevant to a specific program such as an individual's salary who works exclusively on a specific program, while other costs may be for both program and supporting services. Allocation methods should be reasonable and relevant; some examples include the use of timesheets or square footage.
- **How often is management reviewing the methodology?** – In order to accurately reflect the nature and level of an NPO, management should review, and update as needed, expense allocations periodically (e.g., costs of fundraising: prospective donor list compilation, membership-development salaries), especially if there are significant internal changes. Detailed records are not required as reasonable estimates are acceptable.

There are ongoing deliberations within the Financial Accounting Standards Board that may affect the requirements of this Statement. We plan to update you as new changes emerge.



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If you have any questions or would like an assessment on your organization's current allocation method/strategy, please contact: **Sandra Martinez**, Audit Manager at [smartinez@lvhj.com](mailto:smartinez@lvhj.com) or 415-905-5437.

*Click here to read more about Sandra Martinez.*

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