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Page Title: What Nonprofits Should Know About Functional Expense Reporting | [INSERT RELATED SERVICE] | [INSERT FIRM NAME]

Meta Description: [NAME OF FIRM] discusses the importance of functional expense reporting for nonprofits and provides guidance on system implementation.

Headline: What Nonprofits Should Know About Functional Expense Reporting

BODY COPY:

Nonprofit organizations rely on donors and grants to carry out their missions. Transparency and accountability are essential to building trust with current donors, potential donors and grantmaking organizations. Functional expense reporting enables nonprofits to demonstrate that they are using their resources responsibly. In addition to being a best practice and a feature of Generally Accepted Accounting Principles (GAAP) for nonprofits, functional expense reporting is mandatory under federal tax laws. Read on to learn more about functional expense reporting and how nonprofits may implement their own systems.

What Is Functional Expense Reporting?

Businesses typically categorize expenses based on the nature of those expenses. A "natural" expense reporting system might group expenses into categories like rent, utilities, payroll, marketing and depreciation.

A functional expense reporting system categorizes expenses by their purpose or function rather than their nature. This system of categorization enables nonprofit organizations to show how much of their resources goes toward their core mission and how much goes to other uses. Donors, regulators and others can quickly see how a nonprofit is spending its money and how effectively it is pursuing its mission.

Functional expense reporting typically groups expenses into three broad categories:

Program Services

Expenses in this category go directly to a nonprofit's mission-related activities. This represents the majority of expenditures for most organizations. An organization that offers a single service might have one general category for program services, with multiple subcategories, while an organization that provides numerous services might have more program service categories.

An organization that provides animal welfare services, for example, might have multiple programs with separate program service classifications:

- Animal shelter: Rent, utilities and maintenance expenses;
- Rescue and adoption: Transportation costs, pet supplies and marketing; and
- Training: Payroll for trainers.

Overhead

This category includes all expenses that keep the organization running but are not directly related to specific programs. Examples include:

- Payroll for administrative employees;
- Office overhead; and
- Administrative costs, such as accounting and legal services.

Fundraising

Expenses related to soliciting donations and applying for grant funding fall under this category. This might include:

- Payroll expenses for development staff, grant writers and others;
- Marketing and advertising expenses; and
- Administrative costs for payment systems.

How Can Nonprofits Allocate Costs in Functional Expense Reporting?

Nonprofit organizations have several options regarding how they allocate expenses in a functional expense reporting system. They may be able to charge expenses directly to certain categories, or they might need to divide expenses among different categories.

Direct Allocation

Direct allocation works best when an organization can link an expense directly to a function. The cost of a specific social media fundraising campaign, for example, goes into the fundraising category.

Indirect Allocation

This method is more complicated and time-consuming than direct allocation, but it is necessary when an expense could apply to multiple categories. A full-time employee who handles general administrative work and fundraising, while working on a nonprofit's programs, for example, might have their payroll divided based on the amount of time they typically spend on each function:

- They spend, on average, 20 hours per week on general administrative work, so 50% of their salary is categorized under Overhead.
- They spend an average of eight hours per week on fundraising, so 20% of their salary goes into that category.
- The remaining 12 hours – 30% – are split evenly between two of the organization's programs, so 15% of their salary goes into each Program Services category.

Office space may also be subject to indirect allocation. Suppose a small nonprofit rents a 3,000-square-foot space:

- The executive director and their assistant use 600 square feet or 20% of the total space. That percentage of the rent goes into the Overhead category.
- The development director and their assistant also have 600 square feet of space. Their 20% of the rent goes into the Fundraising category.
- The office has a 1,200-square-foot meeting room, which the organization uses to host education programs as part of its services. It also uses the room for staff meetings. Forty percent of the rent would be divided between Program Services and Overhead based on the amount of time used for each function.
- The remaining 600 square feet of the office includes a reception area, a break room and a storage closet. That 20% of the rent goes into Overhead.

Is Functional Expense Reporting Mandatory for Nonprofits?

Nonprofits are obligated to use functional expense reporting, both as a matter of good accounting practice and for federal tax purposes:

- GAAP requires nonprofits to include functional expense reporting in their financial statements. This typically involves a “presentation of expenses by nature as well as function” and “an analysis…showing the relationship between functional and natural classification for all expenses.”
- The IRS requires nonprofits to include a statement of functional expenses in Form 990.

What Are Some Best Practices for Functional Expense Reporting?

- Adopt written policies regarding the classification and allocation of functional expenses.
- Train staff on how to track time and expenses with functional expense reporting in mind.
- Take advantage of software tools that can streamline or automate workflows.
- Conduct annual audits to ensure that cost allocation methods remain accurate.

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