Non-Profit Notes Newsletter

Functional Expense Reporting Gets a Facelift

By Mark Piszko, CPA, CGMA, Partner

Changes to not-for-profit financial statements and disclosures, as described in Financial Accounting Standards Board's (FASB) Accounting Standards Update (ASU) 2016-14, include new requirements for functional expense reporting and additional related note disclosures. The ASU also contains enhanced definitions of management and general expenses.

This might be a good time to review the presentation of your organization's financial statements to determine if any of the changes outlined in this e-newsletter affect them.

Functional Expense Reporting and Related Notes

Among the amendments contained in the ASU is the requirement to report, in one location in the financial statements or notes, expenses by function and natural class. The ASU also requires enhanced disclosure about the methods used to allocate expenses among functions.

Under the ASU, there is no standard prescribed format of how expenses should be presented, as long as the required information is provided. As a result, organizations have some flexibility as to how they report expense information.

Under current standards, organizations characterized as voluntary health and welfare organizations must report expenses in a statement of functional expenses. The guidance contained in the new ASU removes the definition of a voluntary health and welfare entity, allowing those types of organizations other options to report expenses.

Nevertheless, many organizations, including voluntary health and welfare entities, will choose to present their expense information using a statement of functional expenses rather than in the financial statement notes.

Schedule of Functional Expenses Disallowed

Organizations currently using a *schedule* of functional expenses will have to report instead the same information in a *statement* of functional expenses (or in the financial statement notes).

Use of a *schedule* to report functional expenses will no longer qualify, as this information must be contained in the basic financial statements and accompanying notes.

Change in Definitions of Management and General Expenses

To narrow the current diversity in practice regarding the characterization of management and general expenses, the new ASU updates and clarifies the definition of those types of expenses. The current definition of management and general expenses contained in FASB guidance is as follows:

> Activities that are not identifiable with a single program, fundraising activity, or membership-development activity, but that are indispensable to the conduct of those activities and to an entity's existence.

The new ASU changes the definition of management and general expenses to the following:

> Supporting activities that are not directly identifiable with one or more program, fundraising, or membership-development activities.

The FASB further clarifies the definition in ASC 958-720-45-2A by stating:

> Activities that represent direct conduct or direct supervision of program or other supporting activities require allocation from management and general activities. Additionally, certain costs benefit more than one function and, therefore, shall be allocated.

Allocation of Costs

Under the current definition, management and general expenses that are not clearly identifiable with a single program or activity are in many cases charged to the management and general function. The revised definition removes the "single program" aspect, allowing costs to potentially be allocated among several activities, including programmatic, that benefit from those activities. This could include the allocation of salaries of the CEO, CFO or information technology personnel to programs, depending on their job responsibilities.

If your organization has been allocating costs the same way for years simply because no effort was made to change, or if information to make allocation changes was not readily available, now is the perfect time to review your allocation policies and expense types to ensure that they are properly allocated among functions. You may discover that costs that are currently allocated between programmatic and supporting functions may be more accurately reported to only one function.

Sample Enhanced Disclosure

The new ASU requires enhanced disclosure regarding the method(s) used to allocate indirect expenses, or those costs allocated to more than one activity.

The ASU provides the following illustrative example of the required expense allocation note disclosure:

> The financial statements report certain categories of expenses that are attributable to one or more program or supporting functions of the Organization. Those expenses include depreciation and amortization, the president's office, communications department, and information technology department. Depreciation is allocated based on square footage, the president's office is allocated based on estimates of time and effort, certain costs of the communications department are allocated based on estimates of time and effort, and the information technology department is allocated based on estimates of time and costs of specific technology utilized.

AICPA guidance also provides a similar example:

> The financial statements report certain categories of expenses that are attributed to more than one program or supporting function. Therefore, expenses require allocation on a reasonable basis that is consistently applied. The expenses that are allocated include occupancy, depreciation, and amortization, which are allocated on a square footage basis, as well as salaries and wages, benefits, payroll taxes, professional services, office expenses, information technology, interest insurance, and other, which are allocated on the basis of estimates of time and effort.

Effective Date

The changes contained in ASU 2016-14 will be effective for annual financial statements issued for fiscal years beginning after December 15, 2017, and for interim periods within fiscal years beginning after December 15, 2018. Early application of the amendments in the ASU is permitted.

Contact Us

If you have any questions about functional expense reporting — or not-for-profit accounting and auditing matters in general — please contact Mark Piszko, CPA, CGMA, Partner-in-Charge, Not-for Profit Services, at mpiszko@pkfod.com or 646.449.6316 or the partner in charge of your account.

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