An Introduction to Functional Accounting, Accounting for Activities that Include a Fund Raising Appeal and Financial Reporting by Not-for-Profit Organizations

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Public Accountability and Financial Reporting by Not-for-Profit Organizations
Publicly supported not-for-profit organizations are accountable to those donors who provide financial support. Many State regulators and federal lawmakers argue that the benefits afforded public charities, primarily exemption from corporate taxation and deductibility of contributions to charities by individual donors, make charitable organizations accountable to the entire public.
Public charities are also held to Standards of Accountability and Precepts of Stewardship issued by advisory groups such as:

- The Better Business Bureau’s Philanthropic Advisory Service
- The National Catholic Development Conference.
Some of the more common accountability standards include:

• Providing annual reports or accountability statements upon request.

• When size warrants having the annual financial statements audited by a Certified Public Accounting firm.

• Having a reasonable percentage of income and public contributions applied to the program and activities for which the organization exists.

• Having Fund Raising costs that are reasonable in relationship to fund raising income and expenditures as a whole.
What is a reasonable allocation of expenditures between Program and Supporting Services?

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- Program Services
- Fund Raising
- Mgmt. and General

- Program Services
- Supporting Services
Rightly or wrongly the contributing public, regulators, and watchdog groups measure the efficiency of a not-for-profit organization on their ratio of Program Services to Supporting Services. The better the ratio of good dollars spent to bad dollars spent, the more efficient the organization will be considered in relationship to other not-for-profit organizations.
The Statement of Functional Expenditures

An integral part of the organization’s financial reporting package
The Statement of Functional Expenditures provides users with the ratio of program to supporting expenses and ...

is a required basic financial statement for voluntary health and welfare organizations.

- Voluntary health and welfare organizations are formed for the purpose of performing voluntary services for various segments of society. They are tax exempt and supported by the voluntary contributions of the general public. They focus on expending their resources in an attempt to solve health and welfare issues throughout the world.
Example of a Non-Profit Organization
“ABC” Missionaries Group, Inc.

• FACTS:
  – “ABC” Missionaries Group, Inc. is a Roman Catholic religious association of Priests and Brothers serving to evangelize the Gospel in Asia
  – “ABC” Missionaries Group, Inc. missionaries work in areas of human development, health, education, agriculture and trade schools.
  – “ABC” Missionaries Group, Inc. is supported primarily from contributions received from the public.

• Based upon the facts, “ABC” Missionaries Group, Inc. is a voluntary health and welfare organization. Therefore the functional expenditure statement is a required financial statement.
What is a Statement of Functional Expenditures?

The Statement of Functional Expenditures shows how the *natural* expense classifications of a not-for-profit organization are allocated to significant program and supporting services.
Natural Expenses

Natural expenses are a type of expense, such as:

- Salaries and benefits,
- Occupancy,
- Postage,
- Printing,
- Telephone and so forth.

The level of detail provided should be sufficient enough for a reader to gain a general understanding of the nature of the expenses incurred in carrying out the programs and activities of the entity.
Functional Classifications provide details according to the purpose for which they incurred.

The two primary functions are:

- Program Services &
- Supporting Services

Generally Accepted Accounting Principles give not-for-profit organizations latitude in defining the types and numbers of major programs and in determining how to aggregate major programs.
“Program Services are the activities that result in goods and services being distributed to beneficiaries, customers or members that fulfill the purposes or the mission for which the organization exists.”

- SFAS #117
“ABC” Missionaries Group, Inc. Program Services could be defined as follows:

- Mission work overseas
- Mission education and information
- Mission training
- Missioners’ medical care
- Missioners’ retirement care
Supporting Services

“Supporting Services are all activities of a not-for-profit organization other than program services. Generally, they include management and general, fund raising and membership-development activities.”

- SFAS #117
- **Management and General Activities** -
  - Include oversight, business management, general record keeping, budgeting, financing, administration and related administrative activities that are not directly related to programmatic or fund raising efforts.

- **Fund Raising Activities** -
  - Include publicizing and conducting fund raising campaigns; maintenance of donor lists; special fund raising events; soliciting contributions from individuals, foundations or governmental agencies.

- **Donor or Membership Development Activities** -
  - Include soliciting for prospective members and membership dues, membership relations and similar activities.
Allocation of Expenditures

Salaries and expenditures, which benefit more than one activity, are required to be allocated to separate functions on a reasonable and accurate basis. **Direct costs** must be traced to the actual program or supporting service benefited and **indirect costs** must be allocated to the program or supporting services benefited.
Common Allocation Methods

• Time and expense reports kept by employees that work in more than one area.
• An evaluation of the organizations activities at the beginning of the year based upon last year’s experience or the current years budget.
• Usage or consumption – for example telephone expenses would be allocated based upon the amount billed by extension.
• Occupancy could be allocated based upon square footage used in relation to the program benefited.
• Stationary and supplies could be allocated based upon a study of usage over a period of time or salaries.
Remember … things aren’t always what they seem to be.

One might assume because the nature of her work the Office Manager Department would be 100% Managerial and General. In reality, this is not the case …

The Office Manager is charged with overseeing Project Distributions therefore part of her salary should be allocated to Program Services.
A Time For Change

It has been approximately 10 years since the current functional expense matrix was created.

An opportunity to change the “ABC” Missionaries Group, Inc. Functional Allocation Methodology presents itself with the application of SOP 98-2 entitled:

“Accounting for Costs of Activities of Not-For-Profit Organizations and State and Local Governmental Entities that include Fund Raising”

The SOP presents guidance for the functional allocation of joint costs incurred in an effort that includes fund raising.
Accounting for Activities that Include a Fund Raising Appeal
Background

- Not-for-Profit entities solicit support through a variety of fund raising activities. These include direct mail, telephone solicitation, door-to-door canvassing, preaching assignments, special events, e-commerce, grant writing and planned giving to name a few.
- Sometimes a fund raising effort includes a programmatic or supporting service function. When this is the case the
  - not-for-profit organization wants the costs associated with the joint activity allocated to both functions in order to lower fund raising costs and increase program costs.
  - external users of the not-for-profit’s financial statements want the assurance that the fund raising costs as well as the programmatic or management and general costs are fairly stated in relation to one another.
- SOP 98-2 establishes rules governing the allocation of costs associated with joint activities as well as disclosure requirements and acceptable allocation methods.
Accounting for Activities that Include Fund Raising

If the criteria of; *purpose, audience and content* are met the costs identified with the particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general function.

If any of the criteria are not met *the entire activity* including those that would otherwise have been program or management and general are to be reported 100% fund raising expense.
Does the activity include soliciting contributions?

- Yes: Apply the provisions of the SOP.
- No: Do not apply the provisions of the SOP.

The following flowchart is commonly used to help determine if joint cost allocation is appropriate...
PURPOSE

Does the activity call for specific action?

No

Does the activity have elements of management and general functions?

No

Yes

Yes

Does a majority of compensation or fees of any party performing a component of the discrete joint activity vary based on contributions raised for that discrete joint activity?

Yes

All costs of the activity should be charged to fund raising [except for the costs of goods or services provided in exchange transactions.]
Is the program (including a call for action) or management & general component conducted on a similar scale using the same medium without the fund-raising appeal?

No

Is the purpose criterion met based on other evidence?

No

All costs of the activity should be charged to fund raising [except for the costs of goods or services provided in exchange transactions.]

Yes

AUDIENCE

To next section
Is the audience prior donors or otherwise selected based on its ability or likelihood to contribute?

Yes

Can the presumption that the audience criterion is not met be overcome because the audience is selected for program or management and general reasons?

Yes

No

Is the audience selected for program or management and general reasons?

No

All costs of the activity should be charged to fund raising [except for the costs of goods or services provided in exchange transactions.]

Yes

To next section
Does the activity motivate the audience to action in support of program goals?

Does the content fulfill management and general responsibilities?

All costs of the activity should be charged to fund raising [except for the costs of goods or services provided in exchange transactions.]

Yes

No

 Costs that are identifiable with a particular function should be charged to that function and joint costs should be allocated.
“Educational” means the instruction or training of an individual for the purpose of improving or developing his or her capabilities. It also includes the instruction of groups of people or the general public on subjects useful to individuals or beneficial to the community. Educational components of a joint activity must contain clear calls to action.

Calls to action should motivate the audience to improve their own situations, that of certain others, or for society as a whole for them to be considered a programmatic component of a joint activity.
Is prayer a call to action?

In the original exposure draft, prayer was not considered to be a call to action. However, this point was omitted from the final SOP. It is our belief that prayer is in fact a call to action. If your appeals are intended to evangelize and motivate the public to participate in prayer and the sacraments - this is a call to action.
Entities that allocate joint costs should disclose the following in the notes to their financial statements:

- The types of activities for which joint costs have been incurred.
- A statement that such costs have been allocated.
- The total amount allocated and the portion allocated to each functional category.
What does this mean to you?

We need your help to develop an activities based costing model from which we will create the new functional expenditure matrix. This matrix will be the foundation of the Functional Expenditure Statement for years to come.
How can you help us in our goal of reformulating “ABC” Missionaries Group, Inc. functional expenditure statement?

1. Consider how you utilize the resources entrusted to you:
   - Cash
   - Staff
   - Facilities
   - Equipment

   a. Ask yourself do these resources benefit more than one function for which “ABC” Missionaries Group, Inc. has been established? More than one supporting service?

   b. If yes, then help us determine an appropriate allocation measure.
2. If you have a dual purpose fund raising effort planned:
   a. Make sure your backup documents prove that the three criteria
      ✓ Purpose
      ✓ Audience
      ✓ Content
      are met.
   b. Make sure you have developed a rational and systematic method for allocating expenses.
   c. Make sure your allocation method is consistently applied.
3. Apply activity based management principles in your daily routine. Keep a journal of how your time and resources are allocated. Help us to develop an appropriate, reasonable & defensible allocation method for your Department if such is warranted.
Thank you!