Lessons Learned from Implementing ASU 2016-14 – Functional Expenses

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Nonprofit organizations with calendar year ends are working to implement the provisions of Accounting Standards Update (ASU) 2016-14, Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities.

The ASU is effective for annual financial statements issued for fiscal years beginning after Dec. 15, 2017. Specifics of the requirements of the ASU have been highlighted in prior articles in the Nonprofit Standard and can be accessed in the Fall 2016, Winter 2016 and Spring 2017 issues. The ASU can be found here.

As implementation efforts have been undertaken, we have seen one area that is causing more issues than anticipated. This is the presentation of the statement of functional expenses that shows the analysis of expenses by function and natural classifications. As part of developing this information, entities are looking at their current cost allocation methodology as well as what components, both program and natural expense classifications, that they want to include.

Overall, the entity can decide whether to present this information in the statement of activities, as a separate statement of functional expenses that is part of the main financial statements, or as a footnote. The main issue is to determine the most efficient presentation and the one that will be the most beneficial to the readers of the entity's financial statements.

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A word of advice on the presentation: Keep it simple. Yes, the statement of functional expenses should show the natural expenses of the entity by program and supporting activities, but this doesn't mean that every type of expense should be presented on its own line. A straightforward approach is needed to prevent the presentation from becoming overly complex and unwieldy. Focus on the information that will be useful to the reader of the financial statements in understanding the costs of the activities of the entity. Decide on which natural classification groupings are important and relevant. However, keep in mind that too much detail can overwhelm the reader of the financial statements.

Once the format is determined, entities should look at their allocation methods for their management and general costs (M&G) and determine if the items being allocated are necessary for the direct conduct or direct supervision of programs and supporting activities, such as membership development or fundraising. If not they shouldn't be allocated. The costs that are allocated should be for the direct benefit of the activity they are being allocated to. For example, occupancy costs can be allocated to the programs if the programs utilize space to conduct their activities. The cost of the space is related to the direct conduct of the program and should be allocated to this functional classification to show the direct benefit the program receives from the use of the space.

An example provided in the ASU addresses the consideration of the CEO's costs. An organization may have all of the CEO's salary recorded as M&G. But upon further examination, they may determine that the CEO is directly involved in supervising one or more programs of the entity and that their time should be allocated to these programs. In addition, an entity may find that the CEO is directly involved in contacting donors and personally performing other activities to raise funds for the entity. If this is the case, these costs could be allocated to the fundraising function. The costs for the CEO's time to oversee the general operations of the entity would remain in M&G.

The ASU made a change to the examples of what constitute management and general activities. The following item was added to the list of what is included in M&G: Employee benefits management and oversight (human resources). Entities should look at their internal policies to determine how these costs have been traditionally treated and, if allocated, determine the effect on current and prior year numbers.

It is important to note that all expenses, with the exception of external and direct internal investment expenses, should be reported by their natural classification in the analysis of expenses by nature and function. An example of a scenario that is often excluded but shouldn't be are any salaries or other expenses included in cost of goods sold that are presented net of the related revenue in the statement of activities.

Once these allocations are reviewed by the entity, it should update its policies and develop the new required footnote disclosure that provides a description of the methods used to allocate costs among program and support functions.

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