# How To Ensure Your Functional Expense Analysis Accurately Depicts Your Activities

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The financial statement presentation for not-for-profit entities (NFP) experienced an overhaul with Accounting Standards Update (ASU) 2016-14, "Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities." Prior to the ASU, only voluntary health and welfare organizations had a requirement to include the statement of functional expenses as part of a complete set of basic financial statements. ASU 2016-14, effective for fiscal years beginning after Dec. 15, 2017, required all NFPs to provide an analysis of expenses by their natural classification as well as their functional classification in one location in its financial statements.

Entities should periodically ensure their presentation of functional expenses they have chosen is still appropriate and accurately portrays the entity's activities. Discussed below are some best practices to keep in mind to ensure your functional expense analysis accurately portrays your entity.

### Choose the Presentation Format

Entities first need to decide which presentation format is most advantageous to their financial statements. ASU 2016-14 permits the analysis of expenses to be presented on the face of the financial statements or in the footnotes. If the expenses are reported on the face of the financial statements, this can be done either on the statement of activities or a separate statement of functional expenses. For a simple entity, a description on the face of the statement of activities or a footnote disclosure might be sufficient. Entities with multiple programs may prefer to use a separate statement of functional expenses to give appropriate detail for how the natural classification of expenses is allocated across functions.

Whether your entity chooses to present the expenses by nature and function on the face of the statement of activities, as a separate statement of functional expenses, or as a schedule within the notes, keep the presentation simple.

### Keep the Presentation Simple

Regardless of the presentation option chosen it is important to keep the presentation simple. Consider the following two questions:

- Who are the end users of your financial statements?
- What information is most beneficial to them?

When disaggregating your programs think about the mission and activities of your entity. What makes the most sense for your entity in terms of the number of programs to present? This will vary depending on the entity's mission and size. The users of your financials will look to the programs outlined to paint a picture of why the entity is in operation.

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The presentation should show the natural expenses of the entity by program and supporting activities, but that doesn't mean every expense account within your general ledger needs its own line item. Focus on the information which will be useful to the reader and use that to drive the natural classifications that are presented. Having a functional expense analysis that fills a page with natural expense classifications can cause readers of the financial statements to lose sight of what is important.

**Develop a Policy**

There will likely be many facets to the entity's expense allocation method. Documentation to support the methodology is necessary. The first step is determining whether an expense follows a direct allocation or an indirect allocation. A direct allocation should occur when an expense is specifically identified with a particular program or funding source.

For indirect allocation, what is your allocation method and how does it apply to each natural classification? For the allocation of salaries and wages, you should understand and document the responsibilities of each position at the entity. At a smaller entity, the chief financial officer may have some program function, but focus primarily on finance. The finance portion must remain in management and general. Someone in the position of a program manager would likely have a larger portion of salaries and wages expense allocated to program category rather than supporting services.

An entity has to look at what allocation methodology makes sense to its operations for each expense category. For example, for some entities it may make sense to allocate rent expense based on personnel headcount and for others it may make sense to allocate rent expense based on actual square footage. Each entity has to make these types of decisions based on the nature of their operations.

Maintaining documentation to support the allocation methodologies ensures the appropriate allocation methods are reasonable and consistently applied. Individuals with suitable knowledge, skill and expertise on the operations of the entity are critical in establishing the policy. If the entity is required to have an audit, this documentation will be requested as part of the audit process.

A best practice is to review your entity's expense allocation policy on an annual basis.

**Review the Policy Regularly for Needed Updates**

Establishing the allocation policy is a start, but not the finish. NFPs are not static. Like other policies, a best practice is to review your entity's expense allocation policy on an annual basis. A new program could start up one year or a new source of funding may come into the NFP, and these may necessitate revisions to the allocation policy. The new program or funding source could change the role of a particular employee or how the space within a facility is used. Keep in mind, your allocation methodology is described in the footnotes of your financial statements. Will the user of your financials find the methodology appropriate?

An NFP's management has the responsibility to review the allocation policy, assess allocated activities, and ensure the allocation method for a particular activity is consistently applied in accordance with the documented policy.

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