

Compliance Matters

Expense Reporting Takes on New Significance

IRS Form 990 requires nonprofits to report expenses by their natural classification and then allocate the expenses according to the purpose for which they are incurred. The technical term for this is “functional expense allocation.”

Properly allocating costs has taken on added significance in light of the new accounting standards for nonprofit financial reporting. In particular, the accounting standards update issued by the Financial Accounting Standards Board (FASB) requires nonprofits to report expenses by both their nature and function in year-end financial statements. Previously, only voluntary health and welfare organizations were required to allocate expenses this way.

Moving forward, all nonprofits will be required to present expenses by functional allocation either on their Statement of Activities, as a separate statement or within notes to the financial statements.

Understanding the Basics

From a big-picture perspective, functional expense allocation lumps expenditures into two broad categories:

1. Delivering actual program services, like paint brushes for an after-school arts program.
2. The activities used to support these services, like the salaries of the staff who deliver the services.

For reporting purposes, the three primary functional classifications are:

1. Program Services – If your mission is to provide meals for needy families, money spent to buy those meals is a Program Service expense. On the other hand, money spent to raise donations that will eventually go to buy those meals does not qualify as a program expense.

2. Fundraising – Fundraising expenses include everything from maintaining donor mailing lists and sending out solicitations to paying for professional fundraisers and grant writers.

3. Management and General – These are the costs involved in business management, record keeping, budgeting, finance and other management and administrative activities of providing program services. These expenses only indirectly support your mission.

Getting Specific

With these three categories in mind, it's easy to see how a \$1,000 bill for “office supplies” might require a deeper dive. For example, you might find that \$500 was for items used for a specific program activity, \$350 was for special supplies used at a fundraising event, and only \$150 relates to office supplies used in your day-to-day operations.

At year-end, the functional expense allocation would look like this:

Program Service Expense = \$500
Fundraising = \$350
Management and General = \$150

Why It's Important

Proper allocation of expenses isn't important just to the IRS. Donors and funders also want to see how expenses are accounted for – particularly for fundraising and operational

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Choosing the Right Board Portal

Increasingly, nonprofits are utilizing a dedicated portal to centralize board-related information and get everyone on the same page. From a single, secure location, board members can access minutes, download meeting materials and check on the status of task assignments and committee actions.

Supplement Your Weaknesses

The right portal software can supplement weaknesses in your current board processes. For example, an online calendaring function can help with that committee chair who is constantly missing meetings because of a scheduling conflict. With a quality board portal, your nonprofit will enjoy the ability to do the following:

- Schedule meetings and create agendas
- Centralize document storage
- Track RSVPs and attendance
- Share meeting minutes
- Create ballots and polls
- Automate email communication

Determine Wants and Needs

Start your portal selection process by critically assessing any shortcomings, redundancies and inefficiencies in your procedures. Use a designated task force to agree on priorities and desired features. Here, it's best to include input from both the least and most tech-savvy board members.

At the same time, identify the databases, systems and technologies that will need to interact with your new portal. For example, consider if and how your donor management software will need to integrate with it.

Just like with any other major software purchase, you'll need to make the case for the expenditure. Start with what you're currently spending on board activities — from the hard costs of printing meeting materials to the administrative time and labor involved. Factor in the savings you anticipate on fixed costs as well as

the intangibles, such as more effective board meetings and a more efficient board.

Run Vendors Through Their Paces

The next step is to begin evaluating potential software solutions and then contact vendors for demos. Leading portal providers include Directorpoint, BoardMax, BoardSpot and BoardEffect.

As you compare features and user experience, be sure to note these key areas:

Platform flexibility — Look for a robust yet flexible app that can adapt as you expand your governance practices.



Adoptability — Can the transition to a board portal be done quickly and without disrupting operations?

Ease of use — This can be a bit of a balancing act, as the portal must satisfy tech-savvy board members as well as less-sophisticated users. If it's too basic, the more experienced users will be frustrated by the lack of functionality. But if there's too much complexity, the tech newbies may be intimidated.

Pricing — Portal software is typically available for a set fee or an ongoing subscription with annual or monthly fees based on the number of users. One-time licensing fees may range from \$9,000 to \$15,000 on the low end to \$26,000 and up for more robust offerings.

Add-ons — Beyond the initial cost, determine any charges for

optional services, such as additional fees for downloading software onto board members' home computers for offline use.

Implementation support — In the best case, your vendor will act as an implementation partner. In addition to providing initial training, look for a vendor who will provide some hand-holding as you prepare for your first post-portal board meeting. Likewise, ask about help with scanning/uploading archival documents, as well as additional training as new features are added to your portal.

Security — The good news is that many nonprofit portals have their origins in the for-profit world, where security is subject to rigorous regulation. At the very least, you'll want to ensure that full-strength encryption and multi-factor authentication are utilized. Data should be hosted at a highly secure site and the associated data center should provide appropriate certifications and reports on internal controls.

Engage Your Board

Change can come slowly, so it will help if you can find a board member who will champion the move to a portal. Provide training to the group as a whole and then follow this up with individual training for those who aren't quite picking it up.

Then consider transitioning to the new portal by running your current processes in tandem with the board portal for a few meetings. Once everyone is familiar with the new system, set a hard switch-over date.

Your board is your greatest asset. By making it easier for board members to do their job, a board portal can be a wise investment in your nonprofit's governing body.

Contact our office for guidance on board best practices, including the use of a board portal.

Functional Expense Reporting Have a Plan (and Stick to It)

Before you can perform functional expense reporting, you should have a written policy in place addressing cost allocation. The policy should be reviewed at least annually and revisions made as necessary.

Other critical steps for an effective allocation plan include the following:

Be consistent. Use consistent allocation methods over the reporting period and from year to year. Minimize any exceptions to the plan and document them when they do occur.

Establish reasonableness. Make sure you can establish the reasonableness of your expense allocations. For example, analyze overhead expense levels for comparable nonprofits.

Create a chart of accounts. Set up your accounting system to facilitate the allocation process so that you have the necessary data on hand at year-end.

Maintain documentation. Keep supporting documentation that can substantiate your allocations. For example, maintain time studies with signed time cards used to calculate allocation of salary and benefits. Also maintain floor plans of your facilities that show the square footage information you'll need to facilitate occupancy allocations.

Avoid temptation. While it's tempting to tweak your ratios, nothing will raise suspicion faster than reporting substantial contribution income with little or no fundraising expenses.

Don't fall for errors. A common error is failing to appropriately allocate the Executive Director's salary into all of the activities he or she spends time on. Many organizations instead put the entire salary under Management and General.

From a program director's salary to rent and utilities, effective cost methodologies can help your nonprofit better understand the true cost of its core activities. Take steps today to ensure you have a plan in place.



Compliance Matters: Expense Reporting

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costs. Just as important, your management and board need accurate information about how much money is being spent on programs, administration and fundraising.

That said, there are some challenges in tagging and tallying functional expenses. Some expenses span two or all three categories. For example, if the City Mission's Executive Director is spending 15 hours a week developing and overseeing programs, that expense certainly can be allocated to Program Services.

Yet, Kids for the Arts might choose to allocate the Executive Director's entire salary to Management and General.

The Allocation Should Make Sense

The American Institute of Certified Public Accountants (AICPA) is quick to note that there's no one "right" way or required method. The guidelines for allocating expenses are open to wide interpretation and methods vary widely from organization to organization. Rather, auditors look to see if:

1. The allocation method is rational and systematic.
2. The method is applied consistently.

3. The process results in an allocation that is reasonable.

In other words, the allocation should make sense.

Prepare for Change

The new accounting update, *Presentation of Financial Statements of Not-for-Profit Entities*, will also require organizations to provide comparative information on the Statement of Functional Expenses. Specifically, your nonprofit will need to disclose the methods used to allocate costs among program and support functions.

For example, if you decide to allocate rent to programs based on level of effort, you'll need to disclose this methodology in the footnotes.

Now is the time to ensure that your accounting system is built around functional expense categories. You want to have the data in hand when it comes time to prepare your annual financial statements and file your IRS Form 990.

Accurate accounting of expenses is important. Let our professionals help you develop guidelines and procedures that work for your nonprofit.

HOW CAN YOU BUILD YOUR ORGANIZATION FOR TOMORROW?



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Reduce Uncertainty with an Operating Reserve

It's critical for nonprofits of all sizes to build an operating reserve – a financial nest egg that serves as an organizational “savings account.” For example, your board might establish a cash reserve to continue program services should a long-time donor drop off or a grant expire.

It's important to understand that a cash reserve is just that – cash, or a portion of your net assets that is unrestricted by donor-imposed stipulations. Such a reserve is built using unrestricted contributions or investment income, or by intentionally budgeting to create a surplus.

How Much Is Enough?

A generally accepted benchmark is that reserves should cover three to six months of operating expenses. Of

course, the amount your organization can commit to depends on a variety of factors, including how reliable (and diverse) your revenue streams are, the nature of your liabilities and the stability of your expenses.

Whatever the amount, you board will need to draft a policy governing the reserve. Areas to cover include specifying the desired size of the reserve, its intended purpose, and rules and restrictions on the use of the reserve, including guidelines for replenishment.

Get the Pennies in the Bank

With policies in place, the next step is to get the money socked away. Time-tested strategies include:

- Budget a surplus each year to go into your operating reserve.

- Put unexpected gifts and windfalls into the reserve.
- Conduct an annual appeal to your membership to raise reserve funds.



Ultimately, donors, funders and constituents look favorably on organizations that establish sound operating reserves. They see it as a sign of good planning and long-range thinking.

Our nonprofit team can help you set up policies and procedures for building an operating reserve. Please call for an appointment today.



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