FUNCTIONAL EXPENSE REPORTING FOR NON-PROFIT ORGANIZATIONS

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ABSTRACT

Non-profit financial reporting has a potential for accounting fraud and scandal as there is a lack of accounting standard. Many nonprofits unable to provide good information about their relative effectiveness in fulfilling their mission. As a result, donors, funders, and charity watchdog organizations have placed undue reliance on financial indicators, many of which are based on reported functional expenses. This study aims to explain the concept of functional expense reporting in non-profit organizations. This study also aims to identify the extent of functional expense reporting by NPOs in Malaysia. Finally, this study discusses various empirical evidences on the need for financial reporting in enhancing accountability and transparency. The presentation of expenses based on a "functional" classification reflects the expenses according to the purpose for which the expenses are incurred. A functional expense presentation helps readers of financial statements including donors, foundations, regulators, and financial institutions in understanding how a nonprofit organization spends its resources. Qualitative research approach is employed to meet the objectives outlined. Content analysis on financial reporting are conducted on ten foundations which provide financial data by functional classification online. The findings of this study are expected to state the current practices of functional expense reporting by NPOs. The review on previous literatures on NPOs' financial reporting are critically discussed. The presentation of expenses as both natural and functional is meaningful to users and is encouraged for all organizations in promoting the accountability among NPOs.

Keywords: *Functional expense reporting, non-profit organizations*

1. INTRODUCTION

Non-profit organizations (NPOs) have gained popular as a main channel for societies to perform charity work. As the number of NPOs is increasing from years to years, it provides a wide range of platforms for donors or volunteers to participate in supporting the NPOs' mission and vision. NPOs are at the same time creating and encouraging caring and loving societies. NPOs basically are referred to legal entities or organizations which are primarily engage in raising or disbursing funds for various purposes. NPOs function for different purposes, whether be charitable, religious, cultural, educational, literary, social or fraternal purposes, scientific, or humanitarian. How the resources disbursed is the main concern of donors.

NPOs receive variety of resources such as membership fees, donations or funds from fundraising activities. Thus, the management and reporting activities of NPO emphasize stewardship for the resources donated to them (DeWitt, 2010). Due to the importance of donated resources, financial managers of NPO organizations not only determine the fund raising targets but also identify the best instruments that meet donors' requirements (Keating and Frumkin, 2001). The funds obtained through ongoing fund raising generally cannot be used for activities that are outside the strategic plan without threatening the mission and long-term sustainability of the organization (Bryce and Bryce, 1999).

This study aims to explain the concept of functional expense reporting (FER) within the NPOs' setting. The nature and goals of FER are discussed which are mainly referred to the latest accounting standard issued by Financial Accounting Standard Board (FASB) on presentation of financial statement of not-for profit entities. This study also aims to identify the extent of functional expense reporting by NPOs in Malaysia. Only financial reporting of NPOs which are available online selected for content analysis purposes. Finally, this study discusses various empirical evidences on the need for high-quality and comprehensive financial reporting in enhancing accountability and transparency of NPOs' reporting.

The extent of reporting requirements is demanding by donors and stakeholders nowadays. This is due to various financial scandals of frauds and misrepresentation in NPOs' annual report (Normah, 2012). Unfortunately, NPOs in Malaysia are not able to demonstrate high-quality financial information for the stakeholders, as standard and minimum regulatory requirements are absent (Zainon et al, 2013). Lam (2009) asserted with high-quality financial information, it support organizations to fulfill their needs to be accountable for good stewardship, and generally accepted accounting standards.

Financial reporting is an important aspect of NPOs' accountability and transparency. It assists stakeholders in making decisions as to whether donate with specific NPOs. How NPOs disseminating financial information to stakeholders reflect the organization's accountability and transparency (Zainon et al., 2014). However, NPOs in Malaysia are not subjected to any statutory requirements to refer accounting standards in preparing annual reports. The absence of regulatory requirements implies that there is insufficient information available about the effectiveness of individual NPOs and their stewardship of community resources collected and used (Zainon et al., 2014).

2. LITERATURE REVIEW

2.1 NPOs in Malaysia

The establishment of NPOs in Malaysia is different from one to another depending on types of NPOs were set up. There are a few forms of NPOs namely:

a. Trust fund for which NPOs are incorporated under Trustee Act 1952. It is an act to provide for the incorporation of trustees of certain bodies or association of persons formed for the purpose of social / charitable, scientific, literary, or religious education as provided for under Section 2, Act 258[1]. This Act shall apply to Peninsular Malaysia only;
b. Organization for which NPOs are registered under Incorporation Act 1966, ;
c. Company Limited by Guarantee for which NPOs are incorporated under Companies Act 1965. NPOs with revenue of more than RM1 million can be registered as companies limited by guarantee and must be registered with the Companies Commission of Malaysia (CCM) ; and
d. Trust Company and Labuan Foundation for which NPOs are registered under Labuan Trust Act 1966 and Labuan Foundation Act 2010 respectively.

NPO refers to legal person or arrangement or organization that primarily engages in raising or disbursing funds for charitable, religious, cultural, educational, social or fraternal purposes, or for the carrying out of other types of 'good works' (FATF, 2012). NPOs play a vital role in the world economy and in many national economies and social systems. Their efforts complement the activity of the governmental and business sectors in providing essential services, comfort and hope to those in need around the world. The FATF recognises the vital importance of NPOs in providing these important charitable services, as well as the difficulty of providing assistance to those in need, often in high risk areas and conflict zones, and applauds the efforts of NPOs to meet such needs.

The number of NPOs registered is increasing in many countries including Malaysia. There are 59,534 active NPOs which have been registered under Registry of Societies Malaysia (ROS) as at September 2016[2]. Since there is no specific accounting standard for NPOs in Malaysia, NPOs are encouraged to comply with international financial reporting standards adopted by the Malaysian Accounting Standard Board or any reporting standards applicable for private entities in the preparation and presentation of their financial statements (Arshad et al, 2013).

The risk of NPOs being misused is due to several reasons. Firstly, NPOs have an easy access to carry out activities. They are easily conduct activities or program locally internationally. Secondly, NPOs gain public trust. Provision of comprehensive information in annual reports of NPOs is an important mechanism in enhancing the credibility of organization and public trust (Arshad et al., 2013). Lastly, NPOs are dealing with cash intensive. NPOs day-to-day activities are exposed to cash. Countries should review the adequacy of laws and regulations that relate to non-profit organisations which the country has identified as being vulnerable to terrorist financing abuse (FATF, 2012).

2.2 Functional Expense Reporting (FER)

FER is not a new type of financial reporting for NPOs. FER is basically useful for both management and giving decisions as non-profit managers and their donor rely on it (The Urban Institute and Indiana University, 2004). FER is functional classifications group expenses according to the purpose for which the costs are incurred comprising program, administration and fund-raising. FER is also a method of grouping expenses according to the

[1] http:www.bhaeu.gov.my
[2] http:www.ros.gov.my

purpose for which the costs are incurred. The primary functional classifications are program services and supporting activities (Lucas, undated).

Functional Classification of Expenses is meant to help donors, creditors, and others in assessing an NPO's service efforts, including the costs of its services and how it uses resources, a statement of activities or notes to financial statements shall provide information about expenses reported by their functional expense classification, such as major classes of program services and supporting activities, for example:

a. Program services
b. Supporting activities, which often include one or more of the following:
   1. Management and general activities
   2. Fundraising activities
   3. Membership development activities

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. For example, information technology generally can be identified as benefiting various functions, such as management and general (for example, accounting and financial reporting and human resources), fundraising, and program delivery. Therefore, information technology costs generally would be allocated among the functions receiving direct benefit (FASB, 2016).

2.2.1 Program Services

Activities that result in goods or services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission of the organization. Those services are the major purpose for and the major output of the organization and often relate to several 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 mission for which the NFP exists. Those services are the major purpose for and the major output of the NFP and often relate to several major programs. For example, a large university may have programs for student instruction, research, and patient care, among others (FASB, 2016).

2.2.2 Management and General

Activities that are not identifiable with a program, fund-activity, or membership-development activity but are indispensable to the organization. It may include accounting, general management and oversight, audit, budgeting, financing, communications with the public, human resources, insurance, occupancy, legal, and risk management.

FASB, 2016 listed the management and general activities include the following:

a. Oversight
b. Business management
c. General recordkeeping and payroll
d. Budgeting
e. Financing, including unallocated interest costs
f. Soliciting funds other than contributions and membership dues
g. Disseminating information to inform the public of the NFP's stewardship of contributed funds
h. Making announcements concerning appointments
i. Producing and disseminating the annual report

j. Employee benefits management and oversight (human resources)
k. All other management and administration except for direct conduct of program services, fundraising activities, or membership development activities.

2.2.3 Fundraising

Activities that involve inducing potential donors to contribute money, securities, services, materials, facilities, other assets, or time.– Includes publicizing and conducting fundraising campaigns, maintaining donor lists, conducting special events, and preparing and distributing fund-raising materials. Financial statements should disclose total fundraising expense.

Table 1: Sample of Statement of Functional Expenses

Home4U
Statement of Functional Expenses
For the Year 2015

	Program #1	Program #2	Management & General	Fundraising	Total
Salaries and benefits	$45,000	$93,000	$30,000	$10,000	$178,000
Rent and utilities	12,000	20,000	5,000	5,000	42,000
Printing and supplies	6,000	10,000	3,000	5,000	24,000
Depreciation	5,000	8,000	2,000	1,000	16,000
Total	$68,000	$131,000	$40,000	$21,000	$260,000

= NATURE = FUNCTION

In US, all NPOs are required by Statement of Financial Accounting Standards (SFAS) 117, Financial Statements of Not-for-Profit Organizations to report expenses by functional classification. (The Urban Institute and Indiana University, 2004). The most widespread and serious problems in nonprofits concern expenses by functional classification (program, management and general, and fundraising). Many nonprofits cannot provide good information about their relative effectiveness in fulfilling their mission. As a result, donors, funders, and charity watchdog organizations have placed undue reliance on financial indicators, many of which are based on reported functional expenses.(Wing et al., 2006). Many users of nonprofits' financial statements place primary emphasis on expenses by functional classification, so nonprofits should treat the allocation of expenses as an important audit issue.

2.3 How FER Contributed towards Accountability and Transparency

NPOs are held accountable by various numbers of entities ranging from their boards, their funders, regulators and the general public. Zainon et al. (2014) has suggested that the disclosure practices by NPOs could be improved by disclosing a good quality of information.

One of the ways is by preparing the functional expenses reporting for NPOs' stakeholders. Disclosure statements and reports are among the most widely used tools of accountability and are frequently required by federal or state laws in many countries (Ebrahim, 2010). The lack of regulatory requirements or best practices with regard to accountability increases various risk exposures to NPOs including fraud risk (Abu Bakar et al., 2013).

One of the issues often raised is whether these organizations have been efficiently utilizing the resources that they have been receiving from the government, as a local funder, and from charity donors. Donors suffer from information asymmetry because NPOs delay or limit their release of information. (Zainon et al., 2014).Thus, NPOs would perform better by communicating relevant information to potential donors. Consequently, it enhances the level of transparency in reporting the financial expenses of NPOs to the stakeholders. Such examination is expected to provide some insight into the potential motivations for transparency in annual reports of the NPOs and consequently contributes to the deliberations of enhancing transparency of NPOs by various regulatory authorities. (Abu Bakar et al., 2013). Nevertheless, the increasing calls for transparency in the non-profit sector indicate that donors need some information that can provide assurance regarding the NPOs reputation and legitimacy.

3. METHODOLOGY

The research method employed for this study is using content analysis procedure. Financial data, financial review, financial highlights, Statement of Comprehensive Income, Statement on Income and Expenditure and notes to the accounts of selected NPOs are critical analyzed. This procedure was conducted in order to identify whether expenses are presented according to its functions. The samples selected are among NPOs which have published their annual reports online from the financial year ending 2013 until 2015.

4. FINDINGS AND DISCUSSION

A functional expense presentation helps users of financial statements namely donors, foundations, regulators, and financial institutions in understanding how a NPO spends its resources. Based on content analysis conducted on available financial information, it is found that about 30% of selected NPOs presented their expenses by functional. The allocation of expenses is distributed to program/projects, administration or general expenses, and fund-raising. It shows that the NPOs are voluntarily disclosed their financial information in more detail and transparent. However, 20% of NPOs provided the expenses information only in percentages without showing the exact amount spent for particular expenditure. Thus, it limited the information delivered to users of financial statements. The failure to communicate sufficient information would lead to negative perceptions regarding the organisation's effectiveness in managing their funds (Arshad et al., 2013). Besides that, donors suffer information asymmetry and misallocation of funds because NPOs delay or limit their release of information (Zainon et al., 2014). It is interesting to note that some NPOs (10%) do prepare the FER but it is meant for internal users only. The financial information provided for are specifically for management accounting purposes. The donors are informed regarding on how their money are spent by charity organizations by financial report or letter sent personally to them.

The high-quality of financial information should be provided by NPOs since this third sector is highly exposed to financial fraud and mismanagement. The characteristics of quality financial information need to be identified by the financial reporting regulators and preparers. By doing so, it is not only could promote the accountability and transparency of NPOs' reporting but also retaining the donors relationship with NPOs. The best way to sustain the NPOs-donor relationships is for NPOs to strengthen the relationship with donors through the disclosure of information. (Nathan and Hallam, 2009). FASB (2016) stated that while existing standards for Financial Statements of NPOs are sound, they could be improved by providing quality information to donors and other users of financial statements. FASB added that analysis of expenses by both natural classification and functional classification (the separate presentation of expenses by functional classification and expenses by natural classification is still required) should be prepared. NPOs that previously were required to present a statement of functional expenses do not have the option to omit this analysis; however, they may present the comparative period information in any of the formats permitted consistent with the presentation in the period of adoption.

NPOs as independent entity should have strong governance framework that include accountability and transparency elements to ensure strategic and responsible use of funds. It is subject to sound financial management systems and controls to ensure that all expenditure is fully accounted for and audited on an annual basis. As the NPO sector's high susceptibility to fraud is frequently due to its reliance on volunteeers and community members. With insufficient to no internal control in place, NPOs become tempting target for fraud. The ultimate responsibility for identifying gaps and developing fraud controls rest with management. To meet this responsibility, management should avoid complacency and not assume that if fraud occurs 'the auditors will catch it'.

5. CONCLUSION

There is an urgency to have a proper and sound financial reporting standard for NPOs in Malaysia including the requirement of reporting the expenses by its functional. Recently, FASB (2016) has released new standard for NPOs to provide information about expenses by function. This is vital as to provide more useful information to donors, grantors, and other users of financial statements. In addition, public accountants must begin to bring same standards of practice to auditing the expenses classifications that they currently apply to auditing assets, liabilities, revenues and total expenses because users of nonprofit financials rely so heavily on reported expenses by functional classification (The Urban Institute and Indiana University, 2004).

The emphasis on providing the information needed by the stakeholders should be enforced by the regulators. Taken together, the existence of the expectation gap between the management of NPOs as the annual reports preparers and the stakeholders may be reduced by the regulator's involvement. Regulators should consider imposing new standards and regulations for the implementation of charity annual reports. (Zainon et al., 2014).

The disclosure of FER would increase the quality of information delivered to donors. Thus, it could influence a potential donor's decision to donate year to year. Consequently, it would be also improving accountability and transparency in reporting. The proper financial reporting is crucial in curbing the potential of accounting fraud and scandal globally.

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