



Technical Advisory Group

AGENDA ITEM: TAGCP03-01

December 2, 2019 – Virtual Meeting

Categorisation of expenses – function or nature

Summary	Categorisation of expenditure has been identified as a specific issue for the not-for-profit sector. This paper brings together material gathered from national and international standard setters.
Purpose/Objective of the paper	To allow TAG members to consider the nature of the issue, potential ways forward and text for inclusion in the Consultation Paper.
Other supporting items	None
Prepared by	Sarah Sheen

Actions for this meeting	<p>Advise on:</p> <ul style="list-style-type: none">• The description of the issue• The list of alternatives to address the issue• Links to other international standard development, national standards or other guidance• The need for any further input
---------------------------------	---



Technical Advisory Group

Categorisation of expenditure

1. Consultation paper draft

- 1.1 At the TAG meeting on November 4, the TAG advised that the categorisation of expenditure should be included in the short list of issues to be included in the Consultation Paper.
- 1.2 Part 2 of this paper has been drafted for discussion, with the aim that the text is capable of being inserted directly into the Consultation Paper, subject to any drafting comments.

Question 1: What comments does the TAG have on Sections 1 and 2?

Question 2: Does the summary of current international guidance in Section 3, together with Annex A, accurately reflect the current international standards/guidance?

Question 3: Does the summary of national-level guidance in Section 4, together with Annex A, accurately reflect the current national standards/guidance? Is the TAG aware of any other guidance on accounting for categorisation of expenditure issued by national standard setters or other regulatory bodies that should be included in the Consultation Paper?

Question 4: Does the TAG agree with the descriptions of the alternatives, their respective pros and cons, and that they should be included in the Consultation Paper?

Question 5: What comments does the TAG have on the initial draft SMCs included in the paper?

2. Next steps

- 2.1 The text drafted below will be included in the Consultation Paper subject to any further comments from the TAG.
- 2.2 The PAG will be consulted on any specific issues raised by the TAG further to this discussion. For example the PAG could be asked about its knowledge of expenditure reporting requirements from NPO's and the extent to which the alternatives will address these needs.

Question 6: Is there specific input to be sought from the PAG?



Part 2 - Draft Consultation Paper Text

Categorisation of expenses – function or nature?

1. Description of the issue

- 1.1 NPOs have numerous potential users of their financial statements including donors and other funders, resource providers and members of the public that have made donations to an NPO. Users may be interested in the resources used for particular programmes or activities while others may be more interested in the different expenses required to fund an activity.
- 1.2 Analyses of expenses are therefore important in providing transparency and accountability for an NPO's activities. This is particularly so for understanding those expenses that form part of an NPO's overheads/ running costs and those that are used to directly fund the delivery of the NPO's objectives.
- 1.3 NPOs may also face a range of requirements for the categorisation of expenses depending on the jurisdiction in which they report and the sources of their income. These requirements may come from a variety of sources, predominantly accounting standards/ guidance, regulators, tax authorities and donors. Providing multiple analyses of expenditure information creates a burden for NPOs.
- 1.4 Accounting requirements within individual jurisdictions may already set parameters around how information must be presented which may either conflict with or not address the needs of donors or resource providers and regulators.
- 1.5 Categorisation of expenses broadly falls into two main forms i.e. analysis by function or nature; function referring to the purpose or activity on which funds have been spent and nature being the description of the type of expenditure incurred e.g. employee costs/benefits, premises costs etc.
- 1.6 An inconsistent approach will impact the comparability of the use of resources between organisations. Comparability on the use of resources between similar NPOs could be useful to the users of NPO financial statements, particularly for donors, other funders and regulators, to assess the comparative impact achieved from resources given.



International Financial Reporting for Non Profit Organizations

2. Financial Reporting challenges

- 2.1 NPOs need to reflect their expenditure in a way that provides a reliable and faithful representation of the expenses but also in a way that takes account of the cost/benefit of alternative presentations. These challenges pose questions on the most appropriate format or formats for inclusion in a single set of Guidance.
- 2.2 A functional analysis of spend that supports the identification of an NPO's overhead/running costs may be difficult to define in a way which is meaningful and gives confidence to users that appropriate costs have been identified. This may flow into consequential narrative reporting including the calculation of ratios.
- 2.3 A functional analysis, might be most useful for donors, but this might not be sufficient to provide the granularity needed to understand spend on individual programs. A nature of spend analysis might be more useful to support reporting for tax purposes to identify accounting transactions such as depreciation.

3. Relevant international guidance

- 3.1 IFRS for SMEs, IFRS and IPSAS all include specific provisions on the categorisation of expenditure.
- 3.2 IFRS for SMEs requires that an entity analyses expenses on either a nature of expense or nature of function categorisation:
 - **Analysis of nature expense** – IFRS for SMEs provides examples of this categorisation of expense i.e. depreciation, purchases of materials, transport costs, employee benefits and advertising costs. It explains that these costs are not allocated across the functions of the entity.
 - **Analysis by function of expense** – this categorisation requires expenses to be aggregated according to their function as part of cost of sales or, for example, the costs of distribution or administrative activities.
- 3.3 IAS 1 *Presentation of Financial Statements* and IPSAS *Presentation of Financial Statements* require a similar categorisation to IFRS for SMEs. They require that an entity presents, either on the face of the statement of financial performance (or in the notes), an analysis of expenses using a classification based on either the nature of expenses or their function within the entity, whichever provides information that is reliable and more relevant.
- 3.4 Both IAS 1 and IPSAS 1 specify that where an analysis by function is presented that the entity is also required to disclose additional information on the nature of expenses, including depreciation and amortisation expense and employee benefits expense. IAS 1 and IPSAS 1 note that both forms are useful but because information on the nature of expenses is useful in predicting future cash flows, additional disclosure is required when the function of expense classification is used.



International Financial Reporting for Non Profit Organizations

- 3.5 In addition both IFRS and IPSAS have standards on segmental reporting which focus in more detail on the disclosure of operating segments of an entity and on the services and geographical areas in which an entity operates.
- 3.6 The standards are intended to provide users with more information on performance, and the IPSAS particularly notes that the disclosures allows users to identify resources allocated to support the major activities of the entity and enhance transparency to enable an entity to discharge its accountability decisions.
- 3.7 IFRS requires a focus on the revenues of an entity and identification of segments is based internal reports that are regularly reviewed by the entity's chief operating decision maker. The IPSAS is similar but segmental information is more focussed on activities (as opposed to revenues). It provides more guidance on the approach to the identification of segments and includes more discussion on service segments which may have better parallels for NPOs.

4. **National-level guidance**

- 4.1 There are differences both within and between jurisdictions as to how expenses should be analysed. Annex A provides information on a number of jurisdictions from whom information has been gathered or identified.
- 4.2 Most jurisdictions have standards or guidance that are consistent with international accounting standards and allow entities to choose between an analysis of expenses by function of spend or nature spend.
- 4.3 However, there examples of jurisdictions that have taken alternative approaches, but are still reflective the international guidance. For example, in one jurisdiction, separate provisions in the form of Statements of Recommended Practice (SORPs) specify the requirements for different types of NPOs. The SORPs direct the analysis of expenditure to be used, and there are separate analyses for different types of NPO. SORPs reflect the specific reporting needs of the NPOs.
- 4.4 In another jurisdiction NPOs are required to provide functional expenses grouped by program or support as well as by natural expense category (e.g. payroll, rent, etc.) on the face of the statement of activities, in a disclosure, or in a separate financial statement. This approach was adopted to improve the understanding of an organisation's service efforts and to understand inputs, which most organisations were using to track expenditure.

5. **Alternative reporting approaches**

- 5.1 Standard setters both internationally and nationally generally require that entities themselves take the decision on how to categorise and report their expenses in the financial statements to ensure that the information provided is most reliable and relevant to users. Internationally there is



International Financial Reporting for Non Profit Organizations

also a focus on ensuring that if a function analysis is used that a nature of expense analysis is also used.

- 5.2 Segmental reporting provides a further way to look at expense analysis over and above the presentation in the primary statements. This may be of use to provide geographic or other information and could be used in conjunction with the primary statements.



International Financial Reporting for Non Profit Organizations

	Description	Advantages	Disadvantages
<p>Alternative 1</p> <p>Require analysis on both a function and nature of expense analysis.</p>	<p>Require both categorisation by function and nature either on the face of the performance statement or in the notes to the accounts.</p>	<ul style="list-style-type: none"> • Provides the benefits of both categorisations and is more likely to meet the needs of most users. • Not inconsistent with IFRS or IPSAS. • Allow the preparation of information about an NPO's overheads/running costs. • Allow comparability with other NPOs on a nature of expenses basis and the possibility of functional comparisons. • The nature of expense basis would also allow comparison with entities outside of the NPO sector. 	<ul style="list-style-type: none"> • The cost may outweigh the benefits particularly for smaller NPOs. • Difficulty of determining and/or defining a functional analysis.
<p>Alternative 2</p> <p>Require analysis by function</p>	<ul style="list-style-type: none"> • Require NPOs to provide the categorisation of their expenditure on a function basis either on the face of the performance statement or in the notes. 	<ul style="list-style-type: none"> • Likely to be the most useful to donors as it should provide information which is most relevant to their needs i.e. the activities (the functions relating to their donations). • Allow the preparation of information about an NPO's overheads/running costs. 	<ul style="list-style-type: none"> • Resource demanding for NPOs (particularly smaller NPOs). • Lack of comparability if there are different options for a functional analysis. However, it may be difficult to specify functions that are appropriate for all NPOs.



International Financial Reporting for Non Profit Organizations

		<ul style="list-style-type: none"> • Specification by function may allow for comparability for similar types of NPO. 	<ul style="list-style-type: none"> • Specification of functions risks the functional analysis not being useful for some groups of NPOs' and their users. • Lack of information about the nature of expenses, which may hinder transparency and forecasting.
<p>Alternative 3</p> <p>Require analysis by expenditure type</p>	<ul style="list-style-type: none"> • Require NPOs to provide the categorisation of expenditure on a nature of expenses basis on the face of the performance statement or in the notes. 	<ul style="list-style-type: none"> • Likely to be the easier to produce and at lower cost than adopting a functional basis. • Enable comparability with other NPOs and other organisations. • Likely to be easier to audit than functional analysis. 	<ul style="list-style-type: none"> • Will not provide information on the cost of activities or an NPO's running costs, which may be more useful to users such as donors.



International Financial Reporting for Non Profit Organizations

<p>Alternative 4</p> <p>Allow analysis by function or nature of expense</p>	<ul style="list-style-type: none">• Require categorisation of expenditure either on the face of the performance statement or in the notes but allow NPOs the choice between analysing their expenses by means of either a nature of expenses or a function basis.	<ul style="list-style-type: none">• Consistent with IFRS and IPSAS.• Allow the preparation of information about an NPO's overheads/running costs.• Allows NPOs to produce an analysis that is most useful to the users of their financial statements.• Allows smaller NPOs to consider the best presentation for their users and also on the most cost effective basis.	<ul style="list-style-type: none">• Does not enable comparability to assess how well the NPO has utilised the resources donated and given to it.• The most informative is not always the easiest analysis to produce.
---	---	--	--



International Financial Reporting for Non Profit Organizations

Specific Matters for Comment

Do you agree that the list of alternative treatments that should be considered is exhaustive? If not, please describe your additional proposed alternatives, and explain why they should be considered.

Do you agree with the advantages and disadvantages articulated for each alternative accounting treatment? If you do not agree, please set out the changes you propose, and why these should be made.

Please identify the alternative treatment that you favour, and the reasons for your view.

Are there any practical questions that arise in implementing your preferred option?

[Draft generic questions for further discussion]

Annex A – Categorisation of expenditure - analysis to support alternatives

	IFRS and IPSAS	UK	Australia	New Zealand	Canada	USA	Colombia
Alternative 1 Require NPOs to produce an analysis on both a function and nature of expense analysis.						US GAAP requires NFPs to disclose their expenses by both functional and natural classification in one location in the financial statements.	
Alternative 2 Require an analysis by function		UK GAAP for Charities requires an analysis by activity.					
Alternative 3: Nature of expense analysis		Higher and Further Education SORP requires a nature of expenses analysis.					



International Financial Reporting for Non Profit Organizations

	IFRS and IPSAS	UK	Australia	New Zealand	Canada	USA	Colombia
<p>Alternative 4: Allow or provide NPOs choice between nature of expense and nature of function.</p>	<p>IFRS and IFRS for SMEs and IPSAS, require an analysis of expenses using a classification based on either their nature or their function within the entity, whichever provides information that is reliable and more relevant. IAS 1 and IPSAS 1 permit this information to be reported either on the face of the performance statement or in the notes.</p>	<p>Smaller charities are allowed the alternative to provide a nature of expense analysis.</p>	<p>NFPOs are required to present an analysis of expenses recognised in profit or loss using a classification based on either their nature or their function within the entity, whichever provides information that is reliable and more relevant.</p>	<p>An entity is required to present, either on the face of the statement of comprehensive revenue and expense or in the notes, an analysis of expenses using a classification based on either the nature of expenses or their function within the entity, whichever provides information that is faithfully representative and more relevant.</p>	<p>NFPOs may present expenses in the statement of operations by nature, function or program. Expenses should be presented in the manner that results in the most meaningful presentation.</p>		<p>In accordance with IFRS for SMEs.</p>



International Financial Reporting for Non Profit Organizations

Standards References	IAS 1 <i>Presentation of Financial Statements</i> , Paragraph, IFRS for SMEs paragraph 5.11 and IPSAS 1 <i>Presentation of Financial statements</i> paragraph 109.	Charities SORP (FRS 102) (Second Edition Section 4). HEFE SORP	AASB 101, <i>Presentation of Financial Statements</i> paragraph 99.	PBE IPSAS 1 <i>Presentation of Financial Statements</i> , paragraph 109	Reference- CPA Canada Handbook – Accounting: Section 4400, Section 4470, and CPA Canada Public Sector Accounting Handbook: PS 4200, and PS 4270.	FASB ASC 958- 205-45-1 to 6 and definitions ASC 958-205- 20	
---------------------------------	---	--	---	---	--	---	--