

Practitioner Advisory Group

AGENDA ITEM: PAGED11

11 September 2023 – Online

Classification of Expenses

Summary	The paper provides an overview of the proposed guidance being developed for the Classification of Expenses for Exposure Draft 3.
Purpose/Objective of the paper	<p>Proposed guidance is being drafted that would require an NPO to provide an analysis of expenses in the Statement of Income and Expenses based on either the nature of expenses, the function of expenses, or a mixed presentation, whichever provides information that is reliable and more relevant to users. The paper provides an overview of the approach, the guidance that will be provided on factors that should be considered in deciding which method provides the most useful information, and the general principles for allocating and aggregating costs to activities.</p> <p>It also provides an overview of minimum required disclosures in the notes and the potential inclusion of others based on the latest IASB proposals.</p>
Other supporting items	N/A
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Actions for this meeting	<p>Advise on the:</p> <ul style="list-style-type: none"> (i) practical implications of permitting different classification approaches (ii) sufficiency of authoritative guidance on factors to consider and approaches to allocation and aggregation (iii) the appropriateness and practical challenges of providing the proposed mandatory information



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Classification of expenses

1. Introduction

- 1.1 At the June 2023 PAG meeting, members were provided with an overview of the proposed approach to developing the Exposure Draft 3 content related to the classification of expenses, and requested to provide views on what expense information NPOs should be required to present.
- 1.2 The Secretariat has begun to develop guidance based on the proposed approach, taking into consideration PAG feedback, recent IASB developments, further work related to the Supplementary Statement and the results of a focus group held in August. This draft guidance will be taken to the TAG meeting at the end of September for technical advice before being finalised for publication as part of Exposure Draft 3 in early 2024.
- 1.3 This paper provides:
 - an overview of the proposed guidance; and
 - seeks PAG views on:
 - (i) the practical implications of permitting different classification approaches;
 - (ii) sufficiency of authoritative guidance on factors to consider and approaches to allocation and aggregation; and
 - (iii) the appropriateness and practical challenges of providing additional mandatory information.

2. Classification methods

- 2.1 The proposed guidance is based on requirements that an NPO shall provide an analysis of expenses using a classification based on either the **nature** of expenses, the **function** of expenses within the NPO, or a **mixed** presentation, whichever provides information that is reliable and more relevant to the users of the financial statements. This analysis shall be presented in the Statement of Income and Expenses.



- 2.2 Analysis by nature of expense would provide information about expenses arising from the inputs that are consumed to accomplish an NPO's activities. Under this method of classification, expenses are aggregated in the Statement of Income and Expenses according to their nature (for example, depreciation, purchases of materials, transport costs, and employee benefits) without reference to how expenses are allocated to functions within the NPO.
- 2.3 Analysis by function of expense would allocate and combine expenses according to the activity to which the item relates. For example costs of fundraising could be a functional line item that combines expenses related to the NPOs revenue generating activities such as employee benefit costs or advertising costs. Other functional line items could include major operational programmes or administrative support activities. Where an NPO presents functional line items it is proposed that it shall also disclose a narrative description of what types of expenses based on their nature are included in each functional line item.
- 2.4 Analysis by mixed presentation would allow both analysis by nature and analysis by function to be used in a single presentation format. Using this method of classification, expenses are aggregated in the statement of income and expenses partly according to their nature and partly according to their function. It is important to note that this is not a matrix approach where all expenses would be shown from both a natural and functional perspective. Again where an NPO presents functional line items as part of a mixed presentation it is proposed that it shall also disclose a narrative description of what types of expenses based on their nature are included in each functional line item.

Question 1: What practical implications do PAG members consider may arise from permitting NPOs to provide an analysis of expenses based on different classification approaches?

3. Factors to consider in deciding method and the allocation and aggregation of expenses

- 3.1 To assist NPOs in determining which method of expenses analysis will provide the most useful information, the proposed guidance also includes a number of factors that should be considered.
- 3.2 These factors include:
- (a) which method provides the most useful information to users of financial statements about key components of the NPO's surplus or deficit;
 - (b) which method most closely represents the way the NPO is managed and how management reports internally;
 - (c) sector practice - the use of similar methods for an analysis of expenses would enable users to more easily compare expenses across entities in the same sector; and
 - (d) whether the allocation of expenses to functions would be arbitrary and therefore would not provide a sufficiently faithful representation of the line items presented. In such cases, the nature of expense method shall be used.
- 3.3 There may be occasions where a mixed presentation can provide the most useful information to users. For example an NPO with two or more distinct types of activities may present some of its expenses by function and others by nature, to provide information about the key components of surplus or deficit.
- 3.4 A mixed presentation is also the expected format for [the Supplementary Statement](#), which combines natural expense items such as salaries and travel, with functional items such as support costs. Options for the Supplementary Statement will be considered further by the TAG at their September meeting, but NPOs that may be required to, or choose to, present a Supplementary Statement could consider the use of the Supplementary Statement format for their expenses analysis in the Statement of Income and Expenses. It is important to note, however, that the Supplementary Statement format goes beyond a mixed presentation of expenses, as it also include capital costs funded grants and donations.

Question 2: Do PAG members consider that the proposed guidance on factors to consider when determining the method of expenses analysis to be sufficient?

- 3.5 As analysis by function of expense and analysis by mixed presentation involves allocating and aggregating some or all expenses to the activity to which the consumed resource relates, the proposed guidance also provides principles on attributing costs to activities.

- 3.6 It notes that NPOs should ensure that the methods of allocating and aggregating expenses should be reasonable and consistently applied and consistent between reporting periods unless circumstances change.
- 3.7 It also notes that in attributing costs to activities, NPOs shall apply the following general principles:
- **Direct costs** attributable to an activity must be allocated directly to that activity (for example the salary cost of someone solely employed on a particular activity or the cost of running a vehicle used wholly for a particular activity);
 - **Shared costs** which contribute directly to more than one activity must be apportioned between those activities (for example the cost of a staff member whose time is divided between a fundraising activity and working on the delivery of a programme); and
 - **Support costs** which are not attributable to a single activity must be apportioned between the activities being supported (for example the cost of a staff member working in a central finance department).
- 3.8 The proposed guidance indicates that NPOs can balance the benefits of greater accuracy with the costs involved when selecting methods of apportioning costs, and provides examples of bases for apportionment including:
- usage of a resource or activity in terms of time taken, capacity used, or requests made;
 - per capita, based on the number of people employed within an activity;
 - floor area occupied by an activity; or
 - time, where staff duties span more than one activity.

Question 3: Do PAG members consider that the proposed guidance on principles on attributing costs to activities is sufficient?

4. Mandatory disclosures and IASB developments

- 4.1 Regardless of the classification method utilised, it is also proposed that, at a minimum, an NPO will disclose in the notes a number of other expenses if not already presented in the statement of income and expenses.
- 4.2 One of the potential concerns in allowing NPOs to select a classification method, is lack of consistency in NPO financial reporting. To address this point, the minimum disclosure would require certain prescribed information of all NPOs, however they choose to classify their expenses.

These are:

- 4.3 **Expenses related to key management personnel** - Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the NPO, directly or indirectly. In the NPO context this may include trustees, directors and others who are charged with governance. Some key management personnel may receive compensation for carrying out these roles. Any compensation paid to key management personnel shall be disclosed in accordance with Section 33 Related Party Disclosures which requires disclosure of compensation in total.
- 4.4 **Employee remuneration and other related expenses including volunteers** - Employee remuneration shall include all remuneration paid to employees of the NPO and all other costs directly related to their employment. This shall include short-term employee benefits, post-employment benefits, other long-term benefits and terminations benefits as defined in Section 28 Employee Benefits. Where volunteers receive benefits such as free or subsidised services or goods these shall be included in this disclosure. Where compensation is paid to key management personnel, this shall not be included in this disclosure but separately disclosed.
- 4.5 **Expenses on grants and donations** - Expenses on grants and donations shall be calculated and disclosed in accordance with Section 24 Part I *Expenses on grants and donations*. This will require information on the nature, amount, timing and uncertainty of expenses and related assets and liabilities.
- 4.6 **Ex-gratia payments** - An ex-gratia payment is a payment, or the waiver of a right to an asset, which those charged with governance of the NPO have no legal obligation or legal power to make from the NPO's funds but which they believe they have a moral obligation to make.¹ It is proposed that NPO's must disclose details of all ex-gratia payments made including those where the NPO has obtained any authority to make the payments from a court, regulator or similar body. NPOs may aggregate payments of a similar nature where this does not impact on the understanding of the arrangement. For each payment (or in aggregate) the notes to the accounts must:
- provide an explanation of the nature of the payment;
 - state the legal authority or reason for making the payment; and

¹ An example would be where an individual leaves their entire estate as a gift to an NPO in a will, but the NPO is aware the individual wanted to change the amount of the gift and leave some of the estate to another individual or entity but were unable to complete the necessary legal changes prior to death. While legally the NPO may be entitled to the entire amount of the estate, they may feel they have a moral obligation to ensure that some of it is provided to the other individual or entity.

- state the amount of the payment (or value of any waiver of a right to an asset).
- 4.7 **Expenses related to fundraising** - Expenses related to fundraising should be calculated and disclosed in accordance with Section 24 Part III *Fundraising costs*. These proposals are currently being developed but this is expected to include total fundraising costs and the method used to allocate and aggregate these costs.
- 4.8 **Total expenditure on programme activities** - Total expenditure on programme activities will include all direct and shared costs attributable to providing services and goods or otherwise carrying out programme and similar activities, in pursuit of the NPO's stated mission or objectives. This is all called 'programme activities' for brevity. In addition to total expenditure on programme activities, an NPO may present a programme analysis of the main activities that comprise this expenditure. Where an NPO presents information via a programme analysis, the NPO shall describe the basis for preparing and presenting the information.
- 4.9 **Total expenditure on support activities** - Total expenditure on support activities will include all support costs that are not attributable to providing services and goods or otherwise carrying out programme and similar activities in pursuit of the NPO's stated mission or objectives.

Question 4: Do PAG members consider these mandatory disclosures appropriate to ensure the consistency of key information? What practical challenges do PAG members foresee for NPOs in providing this information?

- 4.10 Finally, the Secretariat notes that the IASB, as part of its financial statements project, is considering the potential of requiring additional mandatory natural expense disclosures where an entity utilises a functional or mixed classification approach.
- 4.11 For each line item included in the statement of profit or loss this would require the disclosure of:
- Depreciation
 - amortisation,
 - employee benefits,
 - impairments, and
 - write-down of inventory

An example of how this might look is provided below:



Operating expenses by nature		Tab 1
(in currency units)	20X2	20X1
Depreciation	175	...
Cost of goods sold	100	...
General and administrative expenses	25	...
Research and development expenses	50	...
Amortisation	100	...
Research and development expenses	100	...
Employee benefits	375	...
Cost of goods sold	150	...
Selling expenses	100	...
General and administrative expenses	50	...
Research and development expenses	75	...
Impairments	80	...
Research and development expenses	80	...
Write-downs of inventory	50	...
Cost of goods sold	30	...
Other operating expenses	20	...

Question 5: Do PAG members consider that where an NPO utilises a functional or mixed classification approach, the additional mandatory natural expense disclosures proposed by the IASB are appropriate? What practical challenges, if any, do they foresee for NPOs in providing this information?

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