



Technical Advisory Group Issue Paper

AGENDA ITEM: TAGED12-06
18 May 2023 – Online

Section 24 Part II *Classification of Expenses* - Analysis of the Consultation Responses

Summary	The paper analyses the consultation responses on classification of expenses and proposes the way forward for providing guidance on this issue in INPAG.
Purpose/Objective of the paper	The paper identifies the key issues highlighted through the consultation responses. It seeks advice on the proposed approach to developing guidance for INPAG based on the proposals in the Consultation Paper and the responses received.
Other supporting items	N/A
Prepared by	Philip Trotter
Actions for this meeting	Advise on the way forward for drafting the Exposure Draft and associated Guidance.

Technical Advisory Group

Section 24 Part II *Classification of expenses* – Analysis of Consultation Paper responses

1. Introduction

- 1.1 This paper provides:
- an overview of the Consultation Paper
 - a summary of the consultation responses
 - a proposed approach to drafting the Exposure Draft

2. Consultation Paper

- 2.1 The Consultation Paper noted that to maintain trust, information about an NPO's expenses is particularly important as it supports stewardship, transparency and accountability for its activities. Stakeholders may not, however, all be interested in the same information, and accounting requirements within individual jurisdictions may differ to the needs of resource providers and/or regulators.
- 2.2 Providing multiple analyses of expenses information creates a burden for NPOs, and may not support comparability between similar NPOs which could be useful to the users of NPO financial statements. It can though benefit users who have, for example, a specific interest in functional analysis of expenses and ratios which are developed from it, or those who are interested in the significance of support costs in comparison to the total expenses of an NPO.
- 2.3 From a financial reporting perspective, a number of challenges were highlighted in the Consultation Paper. These included:
- it may be challenging to determine the most appropriate disclosures for inclusion in a single set of guidance for NPOs – by function or nature;
 - analysis of expenses by function may not aid comparability – due to differing business models, programmes and activities;
 - allocating costs to function may involve considerable judgement;
 - analysis of expenses by nature might be more useful to support reporting for regulatory purposes; and
 - analysis by both nature and function may not be readily produced from an NPO's accounting system and result in additional costs.

- 2.4 The Consultation Paper noted that IFRS Accounting Standards, the *IFRS for SMEs* Accounting Standard and IPSAS all include specific provisions on the classification of expenses, with IAS 1 Presentation of Financial Statements and IPSAS 1 Presentation of Financial Statements requiring a similar classification to the IFRS for SMEs Standard. The international frameworks currently 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.
- 2.5 The standards are intended to provide users with information on performance, and the IPSAS Standard particularly notes that the disclosures allow users to identify resources allocated to support the major activities of the entity. This enhances transparency and enables an entity to discharge its accountability obligations.
- 2.6 At a jurisdictional-level the differences both within and between jurisdictions was highlighted in the Consultation Paper. Many jurisdictions that have standards or guidance that are consistent with international accounting standards allow entities to choose between classification based on either the function of expense or nature of expense methods. Others, however, have taken alternative approaches. This includes different requirements depending on the type of NPO to reflect their specific reporting needs, requirements to provide functional expenses grouped by program or support as well as a nature of expense categorisation, and hybrid approaches that mix the nature of expenses and the function of expenses analyses.
- 2.7 Four main alternatives for financial reporting guidance were included in the consultation paper. These were:
- **Alternative 1 (international frameworks)** - follows IFRS Accounting Standards, the *IFRS for SMEs* Accounting Standard and IPSAS, allowing each entity to decide how best to present its expenses on the Statement of Income and Expenses based on either their nature or their function within an NPO.
 - **Alternative 2 (remove choice)** - require either a by nature or functional analysis of expenses on the face of the Statement of Income and Expenses.
 - **Alternative 3 (both methods)** - require both methods of analysis to be produced, but a choice as to which method is used for the primary statement.
 - **Alternative 4 (hybrid approach)** - combine elements of the nature and function analyses to produce a single analysis.

- 2.8 The alternatives assumed that whichever classification of expenses is used each class would be disaggregated into material classes of expenses that are useful to the users of the financial statements. This would include the potential for a prescribed minimum classification level, information on the allocation of support services, and information needed about how programme/activity information has been aggregated.

3. SMC 8.a Description of the Issue – Classification of Expenses

- 3.1 For each of the issues in the Consultation Paper stakeholders were invited to comment on whether the paper had appropriately captured the issue. For SMC 9.a, 96% of respondents agreed with the description of the issue.
- 3.2 Only one respondent disagreed. They noted that in their jurisdiction, the items and values required by different regulatory bodies can vary and the concept of function may not be very familiar to non-profit organisations. In their opinion the description of the issues needed to take this into consideration.
- 3.3 The Secretariat notes that individual jurisdictions and regulatory bodies may have their own requirements but the aim of the IFR4NPO project is to put forward internationally applicable proposals. The Secretariat does accept that concept of function may be unfamiliar for some NPOs, particularly smaller and less complex organisations. As other respondents to issue 8 noted, however, this form of classification and reporting of expenses will be familiar to those NPOs that engage in programme and project reporting to donors and other stakeholders or who undertake this for internal management accounting purposes.

4. SMC8.b Are the List of Alternative Treatments Exhaustive?

- 4.1 For each Issue stakeholders were asked to comment on whether the alternative treatments for that issue were exhaustive. 86% of respondents agreed that the list of alternatives was exhaustive Those disagreeing put forward a range of considerations.
- 4.2 One respondent noted that there is too much diversity in the NPO sector to have a single standard fit all organisations so they would prefer a segmented approach with thresholds determining the approach to be taken.
- 4.3 Another proposed that classification by nature should be required for everyone, but that those who choose to also report by function should have the choice of which method to include on the face of the primary statement and which would

be disclosed in the notes. They noted that requiring organisations to classify by function introduces the possibility of complex and costly allocations that are not warranted from a cost/benefit perspective and that this should not be compelled by accounting standards.

- 4.4 Finally, another respondent proposed an alternative hybrid system in which expenses are recorded in a matrix system with both nature and function identified. This would have a clear and transparent allocation to enable management to prevent expenses being allocated to donors projects where these were not permissible.
- 4.5 The Secretariat notes that a segmented approach is undertaken in some jurisdictions with thresholds determining the approach to the classification of expenses. It is, however, difficult to determine thresholds that would be internationally applicable as is evidenced by the debate around which NPOs INPAG is primarily aimed at. The Secretariat does agree that is an issue that will need to be examined further as proposals are developed, taking into consideration the costs and benefits of reporting on one or more classification bases.

5. SMC 8.c Articulation of the Advantages and Disadvantages of the Alternatives

- 5.1 Respondents were asked if they agreed with the advantages and disadvantages articulated for each alternative accounting treatment. Only response did not provide positive agreement, although no detail was provided by the respondent.

6. SMC 8.d Preferred Alternative – Alternative 1 (international frameworks), Alternative 2 (remove choice), Alternative 3 (both methods), Alternative 4 (hybrid approach)

- 6.1 Respondents were split between their favoured alternatives. The most popular was alternative 3 (both methods) (9 in favour, 45%), followed by alternative 1 (international standards) (5 in favour, 25%). There was very limited support for removing choice or a hybrid approach, with three respondents also putting forward support for the alternative they had identified in SMC8b.

Alternative 1: International standards

- 6.2 Respondents preferring alternative 1 highlighted that NPOs should be given the choice to decide how best to present their expenses. This would allow flexibility depending on the activities and resources of the NPO, and ensure that smaller less complex organisations were not required to report in a manner (by function) that would provide limited information.

- 6.3 Where reporting by function would provide useful information to users, which these respondents noted would mainly be for larger more complex NPOs, alternative 1 would permit this reporting.

Alternative 3: Both methods

- 6.4 Respondents preferring alternative 3 noted that this would best ensure that the diverse needs of users were met and assist in ensuring consistency and comparability of reporting by NPOs. It was noted by these respondents that larger organisations in particular would already be undertaking both functional and natural expense reporting either internally or when reporting to donors on a project level. As such it would not be a significant additional burden to provide this information in the general purpose financial statements.
- 6.5 A number of respondents supporting alternative 3 did indicate, however, that a threshold may be appropriate under which NPOs would be permitted to report only on the nature of expenses.

Other alternatives

- 6.6 Although support for the other alternatives was limited, respondents did provide useful comments in support of their preferences. For alternative 2 one respondent noted that classification of expenses by nature is more consistent with the classification required by key international donors. For alternative 4, the respondent who argued in favour noted that combining elements of nature and function analysis to produce a single analysis is most likely to meet the needs of a broad range of stakeholders. They also indicated that this is a similar approach adopted in New Zealand for its Tier 3 simplified accrual-based standard for non-profits and that in a recent post-implementation review this had received overall positive feedback.
- 6.7 The Secretariat notes that requiring NPOs to report using both methods was the most popular alternative, although respondents did note that this could be burdensome for those NPOs that do not currently report by function. Alternative 1 would reduce this burden by giving choice to NPOs, but this would limit comparability. The hybrid alternative received limited support, with a recognition that it may be difficult to combine elements of nature and function that would be internationally applicable for a diverse range of NPOs.

IASB developments

- 6.8 Since the publication of the Consultation Paper, the IASB has continued to develop the proposals included in the Exposure Draft *General Presentation and*

Disclosures that was published as part of its Primary Financial Statements project. Of significant importance to the classification of expenses are two developments that have occurred as a result of redeliberation.

- 6.9 The first development is a withdrawal of a proposed prohibition on a mixed presentation of operating expenses. Instead the IASB is now looking to allow a mixed presentation of operating expenses. It has tentatively decided to:
- require an entity when considering which method to use to consider the role of the primary financial statements,
 - provide examples of when a mixed presentation might provide the most useful information, and
 - provide application guidance to clarify how to label nature line items when a mixed presentation is used.
- 6.10 The second development relates to a proposal that an entity that presents operating expenses using the function of expense method discloses an analysis of total operating expenses by nature in the notes to the financial statements. Redeliberation following feedback has seen the IASB tentatively decide to revise this to instead require that an entity disclose the amount of depreciation, amortisation, employee benefits, impairments and write-downs of inventory included in each function line item in the statement of profit or loss and that this information would be described in a single note.
- 6.11 The preferences expressed by respondents and the developments from the IASB's Primary Financial Statements project have been taken into consideration by the Secretariat for the proposed way ahead.

7. SMC 8.e Balance between information presented on face of primary statement and notes

- 7.1 Respondents were asked whether they thought that the alternatives provided the right balance between information presented on the face of the income and expenses statement or in the notes.
- 7.2 There were no respondents who disagreed, although one indicated that there should be more consideration as to what is a proportionate level of disclosure in the notes. For them, while some interest from external users on activity and function expenditure is valid (such as around management pay) they noted that there is a tendency for an overly narrow focus on emotive areas such as administrative support and overhead costs that has questionable validity.

8. SMC 8.f Allocation of expenses to functions

- 8.1 Respondents were asked whether the allocation of expenses to functions outlined in issue 8 would be so arbitrary that it would not provide a sufficiently faithful representation of the composition of an entity's functions.
- 8.2 Responses to this question were diverse. The majority of respondents disagreed (12, 57%) and thus support the position that it would provide a sufficiently faithful representation. Responses indicated that functional analysis is already required in some jurisdictions and that provided the guidance includes sufficient direction on how to distinguish between the main categories of expenses, the information should be relevant and comparable. It was also noted that for many NPOs this would be consistent with departmental or project analysis that would typically be already needed for internal financial management and approaches such as activity based costing or full cost recovery.
- 8.3 Other respondents were less clear in terms of their support. One noted that a degree of subjectivity is likely to arise regardless of which approach is adopted under the various alternatives proposed and that flexibility in presenting expense information was needed to meet the information needs of a wide range of stakeholders. This was supported by another respondent who indicated that as different stakeholders need different information it would be difficult to standardise the format.
- 8.4 The Secretariat is mindful that where classification of expenses to functions is undertaken, there is a difficult balance to be struck between ensuring comparability between NPOs and permitting flexibility to enable each NPO to meet the information needs of its users. This has been taken into consideration as part of the proposed way ahead.

9. SMC 8.g Practical issues related to implementation

- 9.1 Finally, respondents were asked whether there were any practical questions that would arise in implementing their preferred option for issue 8 *Classification of expenses*. Those responding to this SMC focused primarily on whether NPOs would have the capacity and capability to undertake functional analysis. Defining functions, putting in place appropriate allocation methods, and then ensuring this was undertaken on a consistent basis were deemed significant practical barriers. This was one reason why many respondents who did support alternatives that included functional analysis felt it may only be appropriate for larger more complex NPOs.



- 9.2 Linked to this was the difficulty that would arise for jurisdictions in deciding what if any thresholds should apply that would require NPOs to undertake functional analysis or a hybrid approach.
- 9.3 As noted the Secretariat is mindful of cost/benefit considerations related to the classification of expenses, particularly with respect to requiring classification by function. Proposals will need to ensure that the costs to NPOs of providing information on expenses are warranted by the benefits obtained by users. This has been taken into consideration for the draft approach.

Question 1:

Do TAG members have any comments on the feedback provided by respondents to the SMCs in the Consultation Paper and the views expressed by the Secretariat?

10. Approach to Drafting the Exposure Draft for Classification of Expenses

- 10.1 The Secretariat will be developing drafting for the Exposure Draft, based on the proposals in the Consultation Paper and the feedback received from respondents.
- 10.2 There was no clear view from consultation respondents, with advantages and disadvantages outlined and concerns raised about cost/benefit. Since the publication of the Consultation Paper, proposals for a potential Supplementary Statement have also been developed, which while primarily based on classification by nature does provide some functional information, particularly around support costs. If a whole of entity Supplementary Statement were to be produced it would likely cover both natural and functional spend. If separate statements were produced for each significant programme/project/grant this might have implications for considerations on functional analysis.
- 10.3 Taking respondents views, and the potential for a Supplementary Statement, into account, there would be benefit in considering in more detail the recent developments by the IASB on its Primary Financial Statements project. As noted above, following redeliberation this is expected to allow natural analysis, functional analysis or a mix of the two and provide guidance on natural expenses that must be presented when a functional analysis is chosen.
- 10.4 The Secretariat propose to explore the proposals currently being considered by the IASB to consider the implications for NPO financial reporting. In taking forward this work, the Secretariat would examine if a mixed approach would be appropriate for NPOs. It will also consider whether there is a minimum set of natural cost information that would be required for all NPOs and if so, which



natural costs and how should they be presented. Similarly, it will consider if there is a minimum set of function information e.g. support costs that would be required for all NPOs.

- 10.5 If functional analysis is permitted or required as part of INPAG, it is proposed that the guidance would be developed on the identification of functions and the principles for allocating support costs. This would also take into consideration the presentation of fundraising costs.

Question 2: Do TAG support the approach proposed, to explore the work being carried out by the IASB on Primary Statements Project to see whether its approach to the classification of expenses would be suitable for NPOs?

May 2023



Annex A: Detailed Responses to Specific Matters for Comment

Question	Response	Number	%	% Responded
SMC 8(a) Do you agree with the description of issue 8: Classification of expenses? If not, why not?	Agree	22	50%	96%
	Disagree	1	2%	4%
	Neither Agree nor Disagree	0	0%	0%
	<i>Non Response</i>	21	48%	
	TOTAL		44	100%
SMC 8(b) Do you agree that the list of alternative treatments that should be considered for issue 8 is exhaustive? If not, please describe your additional proposed alternatives, and explain why they should be considered.	Agree	18	41%	86%
	Disagree	3	7%	14%
	Neither Agree nor Disagree	0	0%	0%
	<i>Non Response</i>	23	52%	
	TOTAL		44	100%
SMC 8(c) Do you agree with the advantages and disadvantages articulated for each alternative accounting treatment for issue 8? If you do not agree, please set out the changes you propose, and why these should be made.	Agree	20	45%	95%
	Disagree	0	0%	0%
	Neither Agree nor Disagree	1	2%	5%
	<i>Non Response</i>	23	53%	
	TOTAL		44	100%
SMC 8(d) Please identify the alternative treatment that you favour for issue 8, and the reasons for your view.	Alternative 1	5	11%	25%
	Alternative 2	2	4%	10%
	Alternative 3	9	21%	45%
	Alternative 4	1	2%	5%
	Alternative option	3	7%	15%
	<i>Non Response</i>	24	55%	
TOTAL		44	100%	100%
SMC 8(e) Do you think that the alternatives for issue 8 provide the right balance between information presented on the face of the performance statement or in the notes?.	Agree	18	41%	95%
	Disagree	1	2%	5%
	Neither Agree nor Disagree	0	0%	0%
	<i>Non Response</i>	25	57%	



INTERNATIONAL FINANCIAL REPORTING
FOR NON PROFIT ORGANISATIONS

TOTAL		44	100%	100%
SMC 8(f) Would the allocation of expenses to functions outlined in issue 8 be so arbitrary that it would not provide a sufficiently faithful representation of the composition of an entity's functions?	Agree	8	18%	38%
	Disagree	12	27%	57%
	Neither Agree nor Disagree	1	2%	5%
	<i>Non Response</i>	23	53%	
TOTAL		44	100%	100%
SMC 8(g) Are there any practical questions that arise in implementing your preferred option for issue 8?	Agree	11	25%	65%
	Disagree	6	14%	35%
	Neither Agree nor Disagree	0	1%	4%
	<i>Non Response</i>	27	61%	
TOTAL		44	100%	100%