INTERNATIONAL FINANCIAL REPORTING
FOR NON PROFIT ORGANISATIONS

Practitioners Advisory Group

Issue Paper

AGENDA ITEM: PAGFG05-02
16 January 2025 – Online

Expenses Classification – Response to ED3

Summary	This paper provides PAG members with: • a summary of the responses to the specific matters to comment (SMCs) for issues relating to Section 24 Part II *Expenses Classification* and Part III *Fundraising Costs;* and • the Secretariat's proposals on the specific issues identified.
Purpose/Objective of the paper	The purpose of this paper is to seek the views of PAG members on practical issues relating to the final guidance based on respondents' views and feedback on specific proposals. It provides context through a summary of the responses to Section 24 Part II and Part III.
Other supporting items	N/A
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Actions for this meeting	**<u>Comment on</u>**: • the issues raised by including a rebuttable presumption; • the three categories of fundraising costs; • the approach to the exemption on splitting fundraising costs from other costs.

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Expenses Classification and Fundraising Costs – Response to ED3

1. Introduction

1.1 This paper provides:

- a summary of the responses to the specific matters to comment (SMCs) for issues relating to section 24 Part II *Expenses Classification* and Part III *Fundraising Costs* – see Appendix A;
- the Secretariat's views on some of the specific issues identified, and
- suggested approaches for the final guidance.

2. Background

2.1 Section 24 Part II is a new section in INPAG. It specifies the requirements for an analysis of expenses. Section 24 Part II requires an NPO to 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 more relevant and reliable to the users of the financial statements.

2.2 Section 24 Part II includes a rebuttable presumption that a nature of expenses classification provides most relevant and reliable information to users.

2.3 Part II also provides principles-based guidance on the allocation of expenses to activities under a by function or a mixed presentation analysis, including the treatment of shared or support costs.

2.4 Whichever expense analysis permissible under Part II of Section 24 is adopted by an NPO, Part III of Section 24 requires that fundraising costs are separately calculated and disclosed either in the Statement of Income and Expenses or the notes to the financial statements.

2.5 INPAG describes three distinct categories of fundraising activities:

- donations, gifts, grants and similar transfers;
- commercial and trading; and
- investment management.

2.6 For expenses that are incurred for more than one purpose, for example fundraising, while also raising awareness of the activities of the NPO, INPAG requires that these are split. Where splitting the costs would result in undue cost or effort, NPOs may consider all such costs as either relating to fundraising or to another activity depending on what is the primary purpose of the activity.

2.7 A survey was carried out that considered some of the reporting issues that related to both Parts II and III of Section 24. These have been incorporated into the analysis of responses where relevant.

3. Rebuttable Presumption

3.1 For SMC2(a) 78% percent of respondents agreed that a rebuttable presumption by nature is used to classify expenses unless this doesn't provide the most relevant and reliable information to the users of the financial statements. 10% disagreed, and 12% neither agreed nor disagreed. Thirteen respondents did not answer this SMC.

3.2 In addition, 94% of 126 respondents to the survey were of the view that the rebuttable presumption on expenses classification was either important or somewhat important.

3.3 Responses to this SMC focussed both on whether a rebuttable presumption should be used, and which form of expenses classification provides more relevant and reliable information for the users of NPO financial statements.

3.4 The respondents that supported the approach in INPAG Section 24 Part II that a by nature expense classification was a more relevant and reliable presentation commented that it:

- provides a clearer, more straightforward and accessible view for the users of NPO financial statements which reduces complexity and improves accountability;
- presents the information in a consistent and comparable way;
- reduces the risk of arbitrary allocations used in functional classifications, which they considered would not provide a faithful representation; and
- is easier for smaller NPOs to implement.

A respondent also commented that it was a pragmatic approach.

3.5 Several respondents that disagreed favoured classification by function or a mixed presentation commenting:

- classification by function may be more relevant for NPOs as most NPO operations are activity based;
- presentation of expenses 'by nature' does not align well with INPAG's proposals for fund accounting, which appear to be based on the principles of

activity reporting (note that a counter was given to this by a respondent who commented that classification by nature makes more sense when combined with the fund accounting methodology);
- most NPO programmes and/or projects are largely designed using an approach which allows for objectives, activities, inputs, outputs and outcomes. Budgeting for the activities is based on the inputs required which can be analysed with classification of expenses using the mixed approach.

Respondents also commented that the flexibility to use a functional classification should be encouraged if it provides more relevant insights, particularly for larger organisations with varied activities.

3.6 Three respondents suggested that INPAG should include a matrix presentation approach showing expenses analysed by nature and function. Two respondents were of the view that a matrix presentation is not too complex and was informative for users who are interested in either or both. One respondent was of the view that a mixed presentation would be in accordance with a jurisdictional GAAP.

3.7 The Secretariat agrees that a by function or mixed presentation (including in the format of a matrix analysis) can provide more useful information to users of the financial statements. A by function analysis may be more akin to how NPOs operate to support service recipients or to deliver their missions in accordance with funders requirements. For this reason, INPAG permits the use of a functional analysis.

3.8 However, a by function analysis requires substantial judgement by NPOs both to identify the key activities and allocation of costs across those activities. Analysis by function may be resource intensive, require sophisticated judgements and accounting systems and not accord with the needs of governance bodies. In addition, the various operating frameworks, environments and contexts in which NPOs operate will mean that a by function analysis could be diverse which would not allow for comparability and may not be useful for some groups of NPOs.

3.9 A few respondents were concerned about or disagreed with the use of the rebuttable presumption itself. A respondent commented that both IAS 1 *Presentation of Financial Statements* and IFRS 18 *Presentation and Disclosure in Financial Statements* did not contain a rebuttable presumption (noting that the *IFRS for SMEs* Accounting Standard was based on IAS 1). The respondent commented IAS 1 requires that management select the presentation that is more relevant and reliable, without prescribing a default position. Another respondent remarked on the differences between the approach in INPAG and in IAS 1 and IFRS 18.

3.10 One of the respondents that commented on the departure from IFRS 18, and IAS 1 noted that there is a potential risk that some NPOs may apply the default approach of 'by nature' analysis without considering whether the presentation meets the needs of the users of its financial statements.

3.11 A respondent considered that they preferred a softer set of arrangements that meant NPOs could present a mix of expenses without having to address a rebuttable presumption. They raised the concern that comparability may trump the notion of faithful representation. The Secretariat agrees that there is a risk about consistency appearing to "trump" relevant information but considers that if the guidance indicates that users' needs must be effectively considered in rebutting the presumption then this will mitigate against this risk.

3.12 The Basis for Conclusions argues that a single method of expense classification should be promoted. A rebuttable presumption was proposed in ED3 as accounting software generally provides the facility to produce an analysis by nature. It was also to provide a steer, particularly for smaller NPOs. It presumes that the more relevant and reliable information for users is usually provided by nature. This proposal was intended to reduce the burden on preparers.

3.13 The rebuttable presumption may encourage a by nature analysis but NPOs will require an analysis of users' needs to make decisions about whether the presumption should be rebutted. Consequently, there may not be a significant reduction to the effort in determining the most relevant and reliable classification of expenses, but this was not the main driver for the proposal. The presumption also creates a risk that this is perceived by stakeholders to be a default position, with no consideration of users' needs.

3.14 The Secretariat considers that there are arguments (many of which have been put forward by respondents) for allowing NPOs to make their own decisions about which form of classification they should present based on which they consider is most useful to the users of the financial statements.

3.15 The Secretariat proposes to make clear in Section 24 Part II that the NPO may presume that for reporting the classification of expenses that a by nature analysis provides reliable and relevant information unless it has evidence that rebuts the presumption that a by function or mixed presentation classification is reliable and more relevant.

3.16 Clarification will also be provided that the rebuttable presumption is not the prescribed method and that NPOs will have to assess user needs to decide whether the presumption should be rebutted. The Secretariat considers that this latter point could be set out in the Implementation Guidance and/or the Basis for Conclusions.

3.17 Responses across several of the SMCs raised concerns that the requirement to calculate fundraising costs requires NPOs to present a functional presentation for part of their expenses, which may not be reconcilable to the total.

3.18 The Secretariat agrees that reporting fundraising costs may require a by function presentation of some of the expenses incurred by NPOs. However, although the total for fundraising costs must be able to be evidenced, Section 24 Part III does not require reconciliation of these to the total expenses reported by nature.

3.19 A respondent was of the view that it may be unclear what the Statement of Income and Expenses (SOIE) will look like wondering whether it was possible to present a SOIE does not provide an analysis of expenses. This respondent noted that the reporting of fundraising costs may further reduce clarity.

3.20 The same respondent commented that paragraph G24.43 states that the analysis of expenses must be presented in the SOIE or in the notes to the financial statements and was of the view that this optionality, on top of the optionality over the basis used to analyse the expenses, may significantly reduce comparability between NPOs, which may not be helpful for users.

3.21 The optionality over the location of the classification of expenses is consistent with the IFRS for SMEs Accounting Standard, which permits this to be on the face of the Statement of Income and Expenses or in the notes to the financial statements.

Question 1: Taking account of this feedback what are PAG members' views on the benefits or otherwise of including a rebuttable presumption that NPO should classify expenses by nature?
Question 2: What are PAG members' views on the optionality for an expense classification to be on the face of the Statement of Income and Expenses or in the notes to the financial statements?

4. Fundraising activities – the inclusion of commercial and trading activities and investment management costs that generate returns

4.1 80% of respondents agreed with SMC2(f) that commercial and trading activities that are for the purposes of fundraising and investment management costs associated with a fund whose purpose is to generate future returns are included as fundraising activities. 16% of respondents disagreed and four percent neither agreed nor disagreed. Thirteen respondents did not answer this SMC.

4.2 26% percent of 123 respondents to the survey considered that it will be easy to identify the three categories of fundraising costs (costs of obtaining grants and donations, commercial and trading income and investment management) while 51% percent of respondents considered that it would be manageable. 22% percent were of the view that it would either be difficult or very difficult.

4.3 A respondent that neither agreed nor disagreed commented that while trading or exchange activities may not themselves be a missional activity, they may be considered a type of fundraising activity if the primary objective is to generate funds. However, they considered it is important for the NPO to have the flexibility to determine the primary purpose for each activity.

4.4 Several respondents disagreed with both of these activities being included, commenting:

- Only fundraising activities in the traditional sense should be included with other activities being reported relating to the revenues generated.
- These are not processes to generate voluntary contributions through non-exchange transactions. The risk and nature of those activities are not similar and should not be combined for reporting.
- The revenues are earned by the NPO as dividend or profit. NPOs must follow the [various] regulatory authorities' specifications [note the Secretariat does not believe that this prevents them from being presented as part of fundraising costs].

4.5 The Secretariat has previously noted that these costs may not represent the "traditional" description of fundraising costs. The Secretariat agrees that commercial and trading activities are exchange activities. It also notes that the risk and nature of these activities are different and may be subject to different regulatory requirements. However, the Secretariat is of the view that they are activities that support the generation of funds in pursuit of an NPO's missional objectives and therefore could be reported as fundraising costs.

4.6 A few respondents were of the view that investment management costs should not be considered part of fundraising costs. This is because investment management involves the ongoing administration and oversight of funds, whether managed internally or by a third party. These costs are, however, consistent with the description of fundraising activities outlined in paragraph 4.5.

4.7 Two respondents were of the view that because some investment management costs are "capitalised" (presumably included in the amortised costs calculation) they should not be reported as fundraising costs, with one respondent indicating that would mean that these costs would not be reported transparently if "hidden" in fundraising costs.

4.8 Where these "capitalised" transaction costs are included in an amortised cost calculation it is likely that they would not be a part of investment management costs. The Secretariat's view is that the current description of investment management costs is unlikely to include transaction costs and therefore this is unlikely to be a significant issue.

4.9 A respondent that agreed had reservations about the wording of paragraph G24.66 which states:
"*Where an NPO holds an investment that **it relies** on to generate returns to be able to carry out its missional purposes, investment management is considered as a category of fundraising costs" [emphasis added]*
Their view was that this is a narrower scope than suggested by the SMC and that investment costs may arise in circumstances where the NPO is not reliant on the returns for its working capital but is investing in funds for treasury management purposes. Also, treasury management costs appear not be included.

4.10 The Secretariat is of the view that treasury management costs would form a part of fundraising activity costs and would probably be activities either under portfolio management or administration costs and are therefore within the scope. It is of the view that this can be addressed in Implementation Guidance.

4.11 The same respondent referred to a jurisdictional GAAP which provides a practical exemption where entities are not expected to pro-rate investment management fees charged to a collective investment scheme to identify the notional cost attributable to its own holding in the scheme. They suggest that a similar exemption may be used in INPAG on a cost/benefit basis. The Secretariat wishes to investigate, including through the focus groups whether such an exemption would be beneficial in INPAG.

4.12 A respondent that agreed recommended that there is clear guidance on the split of costs where expenses are incurred for more than one purpose (including fundraising costs) and particularly in the light of the clarification that commercial and trading activities do not include those charges that are part of the operating model established to meet an NPO's mission or objectives. The Secretariat will consider whether this might usefully be included in Implementation Guidance.

4.13 It is important to note that there was strong support for the proposals, even though some respondents have raised points in relation to both commercial activities and investment management costs carried out for fundraising purposes. The Secretariat is seeking to explore whether only requiring disclosure of these fundraising costs (even if the cost is material) where these activities contribute a material amount to an NPO's income would provide a pragmatic response. While this would remove the requirement to disclose for many NPOs, it would add complexity and require additional work to evaluate the materiality of the funds generated to the NPO's overall income.

Question 4: Do PAG members consider the feedback raises new issues about whether commercial and trading and investment management costs should be included in fundraising costs? Would exploring reference to materiality in relation to funds raised used be useful?
Question 5: Do PAG members consider that the description of investment management costs should refer specifically to treasury management activities or should NPOs be able to make a judgement based on its significance to funds raised?

5. Pragmatic exception – undue cost or effort

5.1 73% percent of respondents agreed with SMC2(g) and the pragmatic exception that fundraising costs do not need to be split from other costs where the cost of doing so would exceed the information benefit to stakeholders. 15% of respondents disagreed and twelve percent neither agreed nor disagreed. Eleven respondents did not answer this SMC.

5.2 17% of 122 respondents to the survey considered that it would be easy to apply the INPAG requirement to disclose fundraising costs where the purpose of an activity is not entirely for fundraising while 46% were of the view that it would be manageable. 33% were of the view it would be difficult or very difficult.

5.3 Respondents that agreed commented that where expenses cross multiple activities including fundraising, cost allocation should be based on reasonable and practical methods to avoid a disproportionate administrative burden.

5.4 Two respondents suggested other approaches to reducing the reporting burden including materiality or including a set threshold. The Secretariat considers that NPOs are already able to take decisions on materiality and that PAG and TAG have not been keen to take forward proposals on thresholds.

5.5 A respondent that agreed was of the view that where the exemption has been used this must be clearly disclosed in the notes to the financial statements including:

- why resources required to separate costs exceeds the informational benefit
- describing the benefits of not separating costs, such as reduced administrative burden or simplicity of the financial statements.

5.6 The Secretariat agrees and proposes that a cross reference is made to Section 2 *Concepts and pervasive principles* to clarify that when this exception is applied an NPO is required to report that fact and the reasons why applying the requirement would involve undue cost or effort.

5.7 A respondent did not agree with the exception because undue cost or effort exemptions had been removed from jurisdictional GAAP for entities of a comparable size. The Secretariat notes these comments but as the Secretariat is not aware of an NPO-specific reason for moving from the *IFRS for SMEs* Accounting Standard, considers that there is no reason for change.

5.8 A respondent that agreed suggested expanding the requirements to:

- provide a clear definition of what constitutes a "material" cost. The Secretariat is of the view that the enhanced guidance on materiality will mitigate this concern.
- provide a narrative explanation of the rationale behind not splitting costs (addressed in paragraph 5.6 above).
- require periodic reviews of whether applying the pragmatic exemption remains appropriate, especially if the nature or scale of activities changes (addressed in Section 2, but the Secretariat proposes to reinforce this requirement).

Question 6: What are PAG members' views on the proposals to make cross references to other guidance/requirements within INPAG so that the reporting and review requirements are understood?

January 2025

INTERNATIONAL FINANCIAL REPORTING FOR NON PROFIT ORGANISATIONS

Appendix A

Summary of Feedback Responses on Expenses SMCs

SMC 2(a) Do you agree that there is a rebuttable presumption that a by nature classification of expenses is used unless this doesn't provide the most relevant and reliable information to the users of the financial statements? If not, why not?	**Response**	**Number**	**% of those who responded**
	Agree	39	78%
	Disagree	5	10%
	Neither agree nor disagree	6	12%
	No Response	13	-
		63	100%

SMC 2(b) Do you agree that the rationale for using a classification of expenses other than by nature should be disclosed? If not, why not?	**Response**	**Number**	**% of those who responded**
	Agree	45	88%
	Disagree	3	6%
	Neither agree nor disagree	3	6%
	No Response	12	-
		63	100%

SMC 2(c) Do you agree that where a functional or mixed presentation of expenses is used, a narrative description of the types of expenses incurred on each function line item is sufficient and that a requirement for these to be quantified is not necessary? If not, why not?	**Response**	**Number**	**% of those who responded**
	Agree	33	66%
	Disagree	9	18%
	Neither agree nor disagree	8	16%
	No Response	13	-
		63	100%

SMC 2(d) Do you agree with the expense disclosure requirements? If not, what would you change and why?	Response	Number	% of those who responded
	Agree	45	87%
	Disagree	-	-
	Neither agree nor disagree	7	13%
	No Response	11	-
		63	100%

SMC 2(e) Do you agree with the description of direct costs, shared costs and support costs and that these allow the full cost of an activity to be identified? If not, why not?	Response	Number	% of those who responded
	Agree	45	85%
	Disagree	1	2%
	Neither agree nor disagree	7	13%
	No Response	10	-
		63	100%

SMC 2(f) Do you agree that commercial and trading activities that are for the purposes of fundraising and investment management costs associated with a fund whose purpose is to generate future returns are included as fundraising activities? If not, why not?	Response	Number	% of those who responded
	Agree	40	80%
	Disagree	8	16%
	Neither agree nor disagree	2	4%
	No Response	13	-
		63	100%

SMC 2(g) Do you agree with the pragmatic exception that fundraising costs do not need to be split from other costs where the cost of doing so would exceed the information benefit to stakeholders? If not, what would you change and why?	**Response**	**Number**	**% of those who responded**
	Agree	38	73%
	Disagree	8	15%
	Neither agree nor disagree	6	12%
	No Response	11	-
		63	100%

SMC 2(h) Do you agree that the costs for each of the three categories of fundraising activity should be separately disclosed and presented gross? If not, what should be disclosed and why?	**Response**	**Number**	**% of those who responded**
	Agree	49	94%
	Disagree	2	4%
	Neither agree nor disagree	1	2%
	No Response	11	-
		63	100%