

## STAFF PAPER

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<b>Project</b>	<b>Primary Financial Statements</b>		
<b>Paper topic</b>	Analysis of expenses by function and by nature		
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This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (the Board) and does not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS<sup>®</sup> Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in IASB<sup>®</sup> *Update*.

### Purpose of paper

1. In this paper, the staff:
  - (a) describe the main problems identified with the current requirements in IAS 1 *Presentation of Financial Statements* for the presentation of an analysis of expenses using the ‘function of expense’ method or the ‘nature of expense’ method and discuss if those requirements are fit for purpose;
  - (b) summarise the results of the staff research on the use of a ‘function of expense’ method and of a ‘nature of expense’ method; and
  - (c) provide some recommendations to the Board to improve the requirements in IAS 1 for presenting an analysis of expenses.
2. We seek the Board’s views on the proposals included in this paper.

### Staff recommendations

3. We recommend that the Board:
  - (a) (Issue 1) describes the ‘nature of expense’ method and the ‘function of expense’ method for the analysis of expenses required by paragraph 99 of IAS 1. The staff proposes the following descriptions:

The nature of expense method provides information about expenses arising from the main inputs that are consumed in order to accomplish an entity's business activities—such as expenses related to materials (raw material purchases), employees (labour and other employee benefits), equipment (depreciation) or intangibles (amortisation)—without reference to how these are allocated to functions within the business.

and

The function of expense method allocates and combines expense items according to the activity from which the item arises.

For example, cost of sales is a functional line item that may combine the following natural line items: raw material costs, labour and other employee benefit costs, depreciation or amortisation. These expenses all arise from the entity's production activities.

- (b) (Issue 2) retains the choice of classification for the analysis of expenses in IAS 1 (either the by-nature or by-function method) but adds more discipline to how an entity makes its choice of classification and how that choice is applied. In this respect, we think that the Board should:
- (i) require an entity to disclose the reasons why the entity has chosen a particular method for providing an analysis of expenses, including why the chosen method provides the most useful information for that entity; and
  - (ii) require entities to use a single method for the analysis of expenses to avoid a mixed approach in the statement(s) of financial performance. This requirement would apply unless specific natural or functional line items are mandated by IAS 1 or by other IFRS Standards.
- (c) (Issue 3) requires:
- (i) the use of the 'nature of expense' method for providing an analysis of expenses when an entity is unable to allocate natural components to the functions identified by the entity on a consistent and non-arbitrary basis; and
  - (ii) an entity that uses the 'nature of expense' method to provide additional information on the function of expenses if this information is used internally by management.
- (d) (Issue 4) requires an entity to present:

- (i) its ‘primary’ analysis of expenses in the statement(s) of financial performance; and
- (ii) additional information (ie by nature or by function –refer to Issue 3) with its primary analysis of expenses, or alternatively, disclosed in a single note.

## Background information

4. At the March 2017 Board meeting, the staff discussed with the Board some basic principles that could guide the aggregation and disaggregation of information in the primary financial statements. IAS 1 requires the aggregation of items into different classes on the basis of their ‘nature’ or ‘function’. At the March meeting the Board expressed the view that it would be helpful to provide more guidance on those bases.
5. We think the results of our research and outreach activities (as summarised in **Appendix A** of this paper) support the fact that aggregation of income and expenses on the basis of their nature or function provides useful<sup>1</sup> information to users (refer to our discussion in paragraphs A10–A12). Hence, we continue supporting the use of those bases in the statement(s) of financial performance.
6. However, as our analysis in this paper shows, preparers and users have different preferences for the presentation of an analysis of expenses. Furthermore, in this paper the staff identify issues both with IAS 1 itself and its application in practice.
7. In this paper, we consider potential improvements to the current requirements in IAS 1 regarding by-nature or by-function presentation and we ask the Board for its views.

## Structure of paper

8. This paper is structured as follows:
  - (a) Identifying the problem (paragraphs 9–34);
  - (b) Staff analysis and staff recommendations (paragraphs 35–61);

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<sup>1</sup> ‘Useful information’ means information that is both relevant and that faithfully represents what it purports to represent (refer to paragraph QC4 in the *Conceptual Framework for Financial Reporting*).

- (c) Other issues to consider to promote more disaggregation of functional or natural line items (paragraphs 62–63); and
- (d) **Appendix A:** Detailed summary of our research and of the feedback received during our outreach activities (paragraphs A1–A25).

## Identifying the problem

9. This section:
  - (a) identifies the main problems with the current requirements in IAS 1 regarding by-nature or by-function presentation; and
  - (b) summarises our research/findings in relation to the main problems identified. This information is based on our research and on the feedback received during our outreach activities (refer to **Appendix A** of this paper for more detail).
  
10. The factors that the staff identified as main contributors to the lack of comparability between entities in the presentation of an analysis of expenses and the lack of consistency in the application of the requirements in paragraph 99–105 of IAS 1 are as follows:
  - (a) lack of descriptions of ‘function’ and of ‘nature’ (paragraphs 11–13);
  - (b) allowing a free choice between two methods for an analysis of expenses and flexibility on the level of detail of this analysis (paragraphs 14–25);
  - (c) limited guidance on the level of detail required for the additional information by nature required by IAS 1 when using a ‘function of expense’ method (paragraphs 26–31); and
  - (d) allowing full flexibility on the location of the analysis of expenses (paragraphs 32–34).

**a) Lack of descriptions of ‘function’ and of ‘nature’**

*Current requirements in IAS 1*

11. Paragraph 30 of IAS 1 refers to an aggregation process where items are aggregated together to form a class of information if they have a similar *function* or *nature*. Paragraph 99 of IAS 1 allows a choice in the presentation of an analysis of expenses in the statement(s) of financial performance either by using a ‘function of expense’ method or a ‘nature of expense’ method.
12. Neither paragraph 30 nor paragraph 99 of IAS 1 describe the meaning of ‘function’ or ‘nature’, or describe any natural or functional categories or explain why aggregation on those bases is useful.

*Summary of our research/findings*

13. Our research and results of our outreach activities indicated a lack of consistency between companies in the analysis of expenses presented by preparers and poor disaggregation. We think that this may be attributed to preparers having a lack of understanding of what ‘function’ or ‘nature’ mean, leading to their different interpretations of the terms. If these notions are not clarified, users may continue to find it difficult to understand the criteria used by preparers for aggregating or for disaggregating information by function and/or by nature.

**b) Allowing a free choice between two methods for an analysis of expenses and flexibility on the level of detail of this analysis**

*Current requirements in IAS 1*

14. Paragraph 99 of IAS 1 allows a choice in the presentation of an analysis of expenses depending on which method (ie ‘function of expense’ method or a ‘nature of expense’ method) provides information that is reliable and more relevant.
15. IAS 1 allows entities to use judgement on the level of detail for the by-nature and by-function expense analysis and only some illustrative examples are provided below paragraphs 102–103 of IAS 1 and in the Implementation Guidance to IAS 1.
16. If an entity chooses an analysis of expenses using a:

- (a) ‘function of expense’ method, the only functional line item that is specifically required to be presented (or disclosed) is ‘cost of sales’ (paragraph 103 of IAS 1). This paragraph also mentions (but does not require) the presentation of two other functional lines: costs of distribution and costs of administrative activities.
- (b) ‘nature of expense’ method, paragraph 102 of IAS 1 provides examples of a few line items by nature that could be included (ie depreciation, purchases of materials, transport costs, employee benefits and advertising costs).

17. Paragraphs 102–103 of IAS 1 show the following examples of each methodology:

<u><b>Presentation by Function</b></u>		<u><b>Presentation by Nature</b></u>	
Revenue	X	Revenue	X
Cost of sales	(X)	Other income	X
<i>Gross profit</i>	<u>X</u>	Changes in inventories of finished goods and work in progress	(X)
Other income	X	Raw materials and consumables used	(X)
Distribution costs	(X)	Employee benefits expense	(X)
Administrative expenses	(X)	Depreciation and amortisation expense	(X)
Other expenses	(X)	Other expenses	(X)
<b>Profit before tax</b>	<u><u>X</u></u>	<i>Total expenses</i>	<u>(X)</u>
		<b>Profit before tax</b>	<u><u>X</u></u>

- 18. Paragraph 101 of IAS 1 also states that the notions of ‘frequency, potential for gain or loss and predictability’ can be used to distinguish between expenses. However, the Standard does not describe those notions or clarifies how those notions interact with the analysis of expenses (by function or by nature) required in paragraph 99 of IAS 1.
- 19. Paragraph 82 of IAS 1 requires, in addition, the presentation of a list of thirteen ‘minimum line items’<sup>2</sup>. This paragraph does not label these line items specifically as functional or natural line items. In fact, they are a mixture of both.

*Summary of our research/findings*

- 20. Our research and results of our outreach activities shows that entities tend to report only the minimum information required by paragraphs 82 and 102–104 of IAS 1

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<sup>2</sup> Includes the items added by IFRS 9 *Financial Instruments* (July 2014) and by IFRS 17 *Insurance Contracts* (May 2017).

rather than providing a more robust disaggregation of the entity’s activities. We think that this may be because of the presentation choices provided by IAS 1 and insufficient guidance on how to exercise the judgements about presentation required by IAS 1.

21. The level of detail provided when an entity uses a by-function or a by-nature analysis tends to be influenced either by their local laws and regulations or local GAAP requirements without necessarily considering what provides the best information for users.
22. Some preparers interpret the choice of methodology allowed in paragraph 99 of IAS 1 as allowing them complete freedom to decide which natural lines or functional lines to include in their expense analysis. Other preparers regard it as giving them freedom to present a mixture of by function and by nature line items, thereby making it unclear which method has been used for the analysis of expenses presented by an entity<sup>3</sup>.
23. Users think that allowing preparers a choice of method has led to considerable variation in practice and to a lack of comparability across entities, although there is some evidence of more consistent practices within certain industries<sup>4</sup>.
24. In terms of preference for either methodology, our research indicates that:
  - (a) preparers welcome the choice in IAS 1 for presenting an analysis of expenses because this choice allows them to ‘tell their story’;<sup>5</sup> whereas,
  - (b) users generally favour an analysis of expenses using a ‘nature of expense’ method because it provides them with granular information that they can more easily use to develop forecasts in their analysis, but also find the ‘function of expense’ method useful because it facilitates the calculation of their metrics and margins<sup>6</sup>.
25. Our research on the use of function-of or nature-of expense methods also confirmed that entities choose different methods depending on their industry<sup>7</sup>. Some industries

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<sup>3</sup> Refer for example to our review of research in paragraph A6.

<sup>4</sup> Refer to paragraphs A18–A19.

<sup>5</sup> Refer to paragraph A15.

<sup>6</sup> Refer to paragraph A10.

<sup>7</sup> We analyse the preferences by industry in paragraph A18.

(eg manufacturing entities) find a ‘function of expense’ method more useful because this method is generally more descriptive of the entity’s overall operations and provides useful information about the allocation of resources to the various activities (functions) of an entity. Other entities (eg banks) have only one main function (eg a financing activity) and, hence, preparers find it more obvious to have a more detailed analysis of expenses using a ‘nature of expense’ method because this reflects better the nature of their business.

***c) Limited guidance on the level of detail required for the additional information by nature required by IAS 1 when using a ‘function of expense’ method***

*Current requirements in IAS 1*

26. Paragraph 104 of IAS 1 requires an entity choosing a ‘function of expense’ method to provide additional information on the nature of the expenses. Paragraph 105 of IAS 1 further states that information on the nature of the expenses is useful in predicting future cash flows and as a consequence, additional disclosure is required when the ‘function of expense’ method is used. Only a few natural items are specifically required in paragraph 104 of IAS 1 (ie depreciation, amortisation and employee benefits expense).
27. Paragraph 103 of IAS 1 adds that ‘allocating costs to functions may require arbitrary allocations and involve considerable judgement’.
28. An entity choosing a ‘nature of expense’ method is not required to provide additional information by function. IAS 1 does not explain why this additional information is not required. IAS 1 does, however, explain why additional by nature information is required if an entity presents expenses by function (IAS 1 states that information on the nature of expenses is useful for users in predicting future cash flows<sup>8</sup>). We think that the reason that an entity choosing a ‘nature of expense’ method is not required to provide additional information by function might be because many entities that present expenses by nature do not allocate expenses on a by-function basis even for internal management reporting purposes.

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<sup>8</sup> Refer to paragraph 105 of IAS 1.

*Summary of our research/findings*

29. Our research showed that many entities using a ‘function of expense’ method fail to disclose additional information on the nature of expenses as required by IAS 1<sup>9</sup> and if such information is presented it may be scattered across several notes.
  
30. Our research also indicated that some preparers disagree with the requirement to disclose additional information on the nature of expenses when classifying expenses by function. This is because they say that they are unable to provide this information with their current accounting systems; or may only be able to allocate natural components to the entity’s functions in an arbitrary or inconsistent way<sup>10</sup>.
  
31. Users have raised concerns about the situation described above because they think that inconsistent or arbitrary information reduces comparability between entities, as well as reducing the information content of the functional line items reported. Users favour having break-downs of particular ‘functional’ items (ie cost of sales) into their different ‘natural’ components, as those break-downs allow them to apply their assumptions to different components and enable them to make better predictions of net future cash flows.

**d) Allowing full flexibility on the location of the analysis of expenses**

*Current requirements in IAS 1*

32. Paragraph 99 of IAS 1 allows entities to present the analysis of expenses either in the statement(s) of financial performance or in the notes. Paragraph 100 of IAS 1 encourages entities to present it in the statement(s) of financial performance.

*Outcome of our research/findings*

33. Our research and results of our outreach activities show that there is a wide range of practice in presentation, ie sometimes the analysis of expenses is presented in the statement(s) of financial performance and sometimes in the notes. Some preparers present very little or no analysis in the statement(s) of financial performance.

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<sup>9</sup> Refer to paragraph A2 and A7.

<sup>10</sup> Refer to paragraph A17 and our illustration below this paragraph.

34. Some users that we spoke to during our outreach activities think that the flexibility in presentation granted by IAS 1 reduces the usefulness of the statement(s) of financial performance. Users are concerned that they cannot always find a coherent and full analysis of expenses easily and would rather have that analysis in a single place (preferably in the statement(s) of financial performance rather than in the notes) for easy access to this information and to enable easy comparisons between entities.

### **Staff analysis**

35. We have split our analysis in this paper as follows:
- (a) Issue 1: Should the Board describe the meaning of ‘function’ and of ‘nature’? (paragraphs 36–48)
  - (b) Issue 2: Should the Board eliminate the choice between methods for presenting an analysis of expenses? (paragraphs 49–52)
  - (c) Issue 3: Should the Board retain the requirement to provide additional information on the nature of expenses when choosing a ‘function of expense’ method? (paragraphs 53–57); and
  - (d) Issue 4: Should the Board require the analysis of expenses in the statement(s) of financial performance or in the notes? (paragraphs 58–61).

### ***Issue 1: Should the Board describe the meaning of ‘function’ and of ‘nature’?***

36. IAS 1 does not describe the meaning of ‘function’ or of ‘nature’ which our analysis suggests may lead to confusion and different interpretations of the meaning of those notions. We think IAS 1 should describe the meaning of ‘function’ and of ‘nature’ in the context of the analysis of expenses required by paragraph 99 of IAS 1. We think that describing those terms could:
- (a) serve as a guide for preparers in the aggregation and disaggregation of line items in the statement(s) of financial performance which may lead to greater consistency in how these terms are interpreted and applied by entities, leading to greater comparability;

- (b) allow entities to take a more structured approach to allocating the natural components they have identified to the entity’s functional activities; and
- (c) help users to have a better understanding as to the reasons why some items have been grouped/separated.

37. In subsequent paragraphs the staff provide some initial views about the meaning of ‘nature’ and ‘function’ and provide some recommendations on how a ‘nature of expense’ method and a ‘function of expense’ method could be described.

*What is ‘nature’?*

38. The Oxford Dictionary defines ‘nature’ as follows<sup>11</sup>

The basic or inherent features, character, or qualities of something

39. The staff observe that attempting to identify the ‘basic or inherent features’ of expenses has the risk of over-conceptualising what the ‘nature’ of expenses really means in the context of the statement(s) of financial performance. This is because it would require us to identify features that might distinguish the nature of one item from another and defining these additional features might be challenging. For example, a potential feature may be whether or not an item occurs frequently. However, describing this feature may be subjective as stakeholders may have different views on the meaning of frequency.

40. We are of the view that the Board could take, instead, a more pragmatic and simpler approach to clarify the meaning of ‘nature’. In this respect, we think that the notion of ‘nature’ could be linked to the ‘inputs’ that an entity uses to operate its business. We think that ‘inputs’ is a notion that preparers can easily understand.

41. The Oxford Dictionary defines ‘inputs’ as follows<sup>12</sup>:

What is put in, taken in, or operated on by any process or system.

42. For the statement(s) of financial performance, the definition of ‘inputs’ (above) could be translated as the main categories of resources (ie employees, raw materials) that are

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<sup>11</sup> We consulted the online definition of ‘nature’ in the Oxford Dictionary.

<sup>12</sup> We consulted the online definition of ‘inputs’ in the Oxford Dictionary.

used within an entity's operations (such as a manufacturing process) to obtain a desired output in terms of profits and cash flows. Consequently, we are of the view that 'nature' could be described as the 'major categories of inputs, consumed as expenses, required to accomplish an entity's business activities'.

*What is 'function'?*

43. The Oxford Dictionary defines 'function' as<sup>13</sup>:

An activity that is natural to or the purpose of a person or thing.

44. On the basis of the definition of 'function' above the staff think that an entity's functions would result from the aggregation of different natural items of income and expense *on the basis of a common activity* (eg selling function or research function). Other activities could include discontinued operations, which IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* requires to be reported separately; or a restructuring event (this information is required by paragraph 98 of IAS 1).

*Should the Board develop a list of 'natural' items and a list of 'functional' activities that an entity may be involved in?*

45. We do not think that the Board should prescribe a list of 'natural' items because we think the appropriate natural items will depend on an entity's business activities. Likewise, we do not think that the Board should prescribe a list of activities that an entity could be involved in because these activities would vary depending on the type of industry and the way management runs its business. The staff is of the view that management should be given flexibility to identify its primary activities or functions as well as its natural line items.
46. Nevertheless, the definitions of a 'nature of expense' method and of a 'function of expense' method could mention some of the natural or functional line items mandated by IAS 1 (items such as depreciation and amortisation expense and employee benefits expense, as required by paragraph 104 of IAS 1; or cost of sales, as required by paragraph 103 of IAS 1). We further observe that illustrative examples of natural or

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<sup>13</sup> We consulted the online definition of 'function' in the Oxford Dictionary

functional line items could be developed when the staff focuses on the development of templates for specific industries<sup>14</sup>.

*Staff proposal for defining the ‘nature of expense’ method and the ‘function of expense’ method*

47. On the basis of our discussion above the staff proposes that the ‘nature of expense’ method be described as follows:

The nature of expense method provides information about expenses arising from the main inputs that are consumed in order to accomplish an entity’s business activities—such as expenses related to materials (raw material purchases), employees (labour and other employee benefits), equipment (depreciation) or intangibles (amortisation)—without reference to how these are allocated to functions within the business.

48. On the basis of our discussion above the staff proposes that the ‘function of expense’ method could be described as follows:

The function of expense method allocates and combines expense items according to the activity from which the item arises.

For example, cost of sales is a functional line item that may combine the following natural line items: raw material costs, labour and other employee benefit costs, depreciation or amortisation. These expenses all arise from the entity’s production activities.

**Issue 1—Question to the Board**

1. Does the Board agree with our proposed descriptions in paragraphs 47 and 48 of this paper of a ‘nature of expense’ method and of a ‘function of expense’ method?

***Issue 2: Should the Board eliminate the choice between methods?***

49. IAS 1 allows entities to choose whether to present information on the basis of ‘function’ or ‘nature’. Paragraph 105 of IAS 1 states that each method of presentation has merit for different types of entities. The choice of presentation might depend on the nature of the entity and might be influenced by different historical and industry

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<sup>14</sup> We are planning to bring a paper analysing this topic at a future meeting.

factors. Our research revealed that the choice in the presentation of an analysis of expenses has been in IAS 1 for many years. There is not much in IAS 1 about the history of why we have the by function/by nature choice but we think it was likely ‘inspired’ by the requirements in other local GAAP. For example, in some informal conversations with some stakeholders we became aware that by-nature information was required in Germany before the 4th Directive was implemented there (1985 Act) whereas the UK company law allowed a choice of formats. We also think that a by-nature analysis may have arisen from cost accounting and financial management drivers.

50. In spite of its historical origins, our research indicates that both methods are still considered useful: preparers want flexibility to ‘tell their story’; whereas users find information both by function and by nature useful for their analysis. We are of the view that the Board should therefore retain the choice for presenting an analysis of expenses because preparers and users find both methodologies useful.
51. However, we are of the view that the Board should add more discipline to how an entity makes its choice of methodology and how that choice is applied. In this respect, we think that the Board should:
- (a) require an entity to disclose the reasons why the entity has chosen a particular method for providing an analysis of expenses, including why the chosen method provides the most useful information for that entity. We think that adding such a disclosure would add more discipline to how an entity makes the choice between the two methods and avoid it being a decision based on other factors – such as systems configurations and historical practice – rather than providing the best information for users of the financial statements. The staff is of the view that such a disclosure would make preparers think about the choice made and would give users more confidence in the resulting figures as well as a better understanding of an entity’s business activities.
  - (b) require entities to use a single method for the analysis of expenses to avoid a mixed approach in the statement(s) of financial performance. This requirement would apply except where specific natural or functional line items are mandated by IAS 1 or by other IFRS Standards (or where the

entity supplements its analysis of expenses by function with additional information about the nature of expenses in the statement(s) of financial performance— see Issue 3).

52. The staff could perhaps explore at a later stage whether it would be necessary to develop criteria that entities could follow to determine whether by-function or by-nature presentation provides the most useful information about their business.

**Issue 2—Question to the Board**

1. Does the Board agree with our recommendation in paragraph 50 of this paper that the Board should retain the choice of classification for the analysis of expenses in IAS 1 (either the by-nature or by-function method)?
  
2. Does the Board agree with our recommendations in paragraph 51 of this paper to add more discipline to how an entity makes its choice of classification and how that choice is applied?

***Issue 3: Should the Board retain the requirement to provide additional information on the nature of expenses when choosing a ‘function of expense’ method?***

53. Our research revealed that some entities using the ‘function of expense’ method fail to disclose additional information on the nature of expenses or only provide information about the natural components allocated to the entity’s functions in an arbitrary or inconsistent way.
54. Our research showed that additional information on the nature of expenses is useful for users (refer to paragraph 31). However, we are aware that this may require some preparers who currently only gather information by function, to reconfigure their systems.
55. We think that the project’s first due process document (ie Discussion Paper or Exposure Draft) could gather information about this to find out how feasible and potentially costly it would be for some preparers to change their systems to provide information by nature.
56. We think that it is unlikely that a by function analysis will provide the most useful information to users of financial statements if that analysis cannot be done on a consistent and non-arbitrary basis. Consequently, we think that the Board should

require the use of the ‘nature of expense’ method for providing an analysis of expenses when an entity is unable to allocate natural components to the functions identified by the entity on a consistent and non-arbitrary basis. We think that users would welcome this proposal as in their view the ‘nature of expense’ method is generally considered more useful than a ‘function of expense’ method.

57. The staff observe that if an entity’s ‘primary’ analysis is an analysis by nature, IAS 1 currently does not require a further analysis by function. The staff is of the view that the Board should require by function information if this is used internally by management (our research and results of our outreach activities did not reflect much appetite for forcing a by-function allocation if it is not actually used by the entity).

**Issue 3—Questions to the Board**

1. Does the Board agree with our recommendations in paragraphs 56–57 of this paper that the Board requires:

- (a) the use of the ‘nature of expense’ method for providing an analysis of expenses when an entity is unable to allocate natural components to the functions identified by the entity on a consistent and non-arbitrary basis; and
- (b) an entity that uses the ‘nature of expense’ method to provide additional information on the function of expenses if this information is used internally by management?

***Issue 4: Should the Board require the analysis of expenses in the statement(s) of financial performance or in the notes?***

58. IAS 1 allows entities to choose whether to present the analysis of expenses in the statement(s) of financial performance or in the notes. Furthermore, IAS 1 does not specifically require additional information on the nature of expenses to be presented in a single location (eg it can be presented on the face of the statement(s) of financial performance or across separate individual notes), which leads to diversity in practice.
59. Some users have commented that IAS 1 provides management with more flexibility than they are comfortable with – as demonstrated by the request made by some users for more comparable information between entities, but also for more disaggregation in the statement(s) of financial performance itself. The staff is of the view that the Board should prescribe the location of the primary analysis of expenses to add more

discipline to the presentation of this analysis and address the concerns expressed by users.

60. The Board discusses the role of the primary financial statements and the role and content of the notes in Section 3 of the [Discussion Paper Disclosure Initiative—Principles of Disclosure](#), in particular, paragraphs 3.24(a) and (e) and paragraph 3.28. We think that the feedback we get on this discussion could help us to develop guidance on the location of by-function or by-nature information.
61. However, the staff’s initial views are that:
- (a) an entity should be required (and not just encouraged) to present its ‘primary’ analysis in the statement(s) of financial performance so that users can more easily access this information and make comparisons between entities.
  - (b) if an entity’s ‘primary’ analysis is an analysis by function, that entity should have flexibility to provide the additional information on the nature of expenses either in the statement(s) of financial performance, along with its primary analysis of expenses; or in a single note so that users can find and access this information more easily. The staff think that this proposed presentation would enhance comparability between entities, and enable users to find the relevant information more easily.
  - (c) if an entity’s ‘primary’ analysis is an analysis by nature, and the Board agrees that an entity should further provide information by function if this information is used internally by management, we think that such additional information should be included either in the statement(s) of financial performance or in the notes.

**Issue 4—Questions to the Board**

1. Does the Board agree with our recommendation in paragraph 59 to prescribe the location of the primary analysis of expenses?
2. If the Board agrees with Question 1 above, does the Board agree with our recommendations in paragraph 61 to present an entity’s:
  - (a) ‘primary’ analysis of expenses in the statement(s) of financial performance; and

(b) additional information (ie by nature or by function –refer to Issue 3) with its primary analysis of expenses, or alternatively, disclosed in a single note?

### Other issues to consider to promote more disaggregation of functional or natural line items

62. If the Board wishes to promote more disaggregation of functional or natural line items in the statement(s) of financial performance we think that the following areas could be potentially explored:
- (a) adding more minimum line items to the statement(s) of financial performance (besides the ones already required by paragraph 82 of IAS 1). We think that the identification of these additional minimum line items could be based on line items that are commonly currently reported by industry. We observe that a good starting point could be the line items included in the IFRS Taxonomy. The staff could also look at the requirements for minimum line items from other regulators or standard-setters.
  - (b) incorporating thresholds to prevent the over-aggregation of line items (ie the presentation of large ‘other expense’ or ‘other income’ line items). The staff is aware that Regulation S-X issued by the U.S. Securities and Exchange Commission includes some thresholds that we could consider as a reference. For example, we understand that article 5 of this Regulation, (Rule 5-03 -Income Statements) includes a requirement to separately present revenue categories (ie operating revenues, income from rentals, revenues from services or other revenues) that exceed 10 percent of total revenues. Any revenue categories that are individually 10 percent or less of total revenues may be combined into one line<sup>15</sup>.
  - (c) developing some high-level illustrative primary financial statements (ie templates) for a small number of industries (for example, banks, non-financial institutions, insurance companies and investment property

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<sup>15</sup> <https://www.sec.gov/divisions/corpfin/ecfrlinks.shtml>. Refer to Article 5, Rule 5-03 – Income Statements.

companies)<sup>16</sup>. It might help to look at minimum line items alongside templates to ensure the balance is right.

63. If the Board is of the view that the areas mentioned above should be explored, the staff could bring a further analysis on those matters at a future meeting.

**Issue 5—Questions to the Board**

Does the Board think that the staff should explore:

(a) identifying additional minimum line items for the statement(s) of financial performance by considering line items that are commonly-reported by entities?

Does the Board have any more suggestions about how we could identify additional minimum line items?

(b) developing thresholds to prevent the over aggregation of line items? Does the Board have any more suggestions about how we could develop those thresholds?

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<sup>16</sup> The Board agreed to explore the development of these templates at its December 2016 meeting. Refer to the [IASB Update](#).

## Appendix A

- A1. This Appendix presents the results of the staff research on the use of the ‘function of expense’ method and of the ‘nature of expense’ method. This research includes:
- (a) our review of a sample of financial statements (paragraphs A2–A4);
  - (b) our review of other academic and non-academic studies (paragraphs A5–A8)
  - (c) the feedback received from users and preparers during our outreach activities (paragraphs A9–A17);
  - (d) research on the method preferences by industry (paragraphs A18–A19); and
  - (e) a brief description of the proposals made by the previous Financial Statement Presentation project for disaggregating information by function and by nature and a summary of some of the feedback on those proposals (paragraphs A20–A25).

### ***Sample review of financial statements***

- A2. In our review of a sample of 25 financial statements<sup>17</sup> we observed that most entities favoured an analysis of expenses ‘by function’ (60%) over an analysis ‘by nature’ (20%)<sup>18</sup>. About half of the entities using the ‘function of expense’ method did not provide additional information on the nature of expenses when presenting an analysis of expenses by function despite the requirement in paragraph 104 of IAS 1 ‘to disclose additional information on the nature of expenses, including depreciation and amortisation expense and employee benefits expense’<sup>19</sup>.
- A3. Our review of a sample of financial statements revealed that permitting flexibility in the presentation of an analysis of expenses results in a wide range of presentation

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<sup>17</sup> This analysis was presented in [Agenda Paper 21A](#) of November 2016.

<sup>18</sup> Refer to the table below paragraph 21 in [Agenda Paper 21A](#) from November 2016. The remaining 20% are entities that did not present expenses by nature or by function (eg an entity presented operating expenses as a single line item). Some entities presented an analysis of expenses in the statement(s) of financial performance and some others in the notes.

<sup>19</sup> Refer to the table below paragraph 23 of [Agenda Paper 21A](#) of November 2016.

formats which some users that we spoke to during our outreach activities think reduces comparability across entities<sup>20</sup>.

- A4. We also observed that every entity in the pharmaceutical industry in our sample presented expenses by function. However, we did not find that same level of consistency in other industries.

***Evidence in academic and non-academic studies***

- A5. The academic and non-academic research revealed how entities apply IAS 1 in practice and that some entities apply the requirements in IAS 1 poorly as we explain below.
- A6. The EFRAG Secretariat<sup>21</sup> conducted a research study in 2016 of 34 listed companies included in the S&P Europe 350 Index, to understand current practice on presentation of a limited number of European entities. This study revealed that entities tend to prefer an analysis of expenses using the ‘function of expense’ method more than the ‘nature of expense’ method. The study also revealed that some entities interpret the requirements in IAS 1 as allowing a mixture of by-function and by-nature information<sup>22</sup>. The study further noted that in some cases the number of line items presented was limited and the level of disaggregation was low.
- A7. The Staff of the Securities and Exchange Commission<sup>23</sup> conducted a study in 2011 about the use of IFRS Standards by 183 companies domiciled in 22 countries (the sample analysed included SEC and non-SEC registrants). This study showed that approximately half of the companies included in the study reported expenses by nature and the other half reported them by function. It also showed that about one-third of companies that presented expenses by function did not disclose additional information on the nature of the amounts classified by function, as required by paragraph 104 of IAS 1.

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<sup>20</sup> Refer to paragraph 7 of [Agenda Paper 21A](#) of November 2016

<sup>21</sup> Refer to paragraphs 16-20 in [Paper 10-03](#) by the EFRAG Secretariat discussed at the EFRAG TEG meeting in January 26, 2017.

<sup>22</sup> In 2004 the IFRIC acknowledged that there were different and conflicting interpretations regarding whether IAS 1 allowed an analysis of expenses using a ‘mixed basis’. The IFRIC did not reach any conclusion in this respect (refer to Agenda Paper 3 of October 2004).

<sup>23</sup> Securities and Exchange Commission (SEC). 2011. [Work plan for the consideration of incorporating IFRS into the financial reporting system for US issuers: An Analysis of IFRS in Practice, page 13](#). Washington D.C.

- A8. An academic study by Libby et al (2013)<sup>24</sup> analysed the presentation of the functional line of *selling, general and administrative expenses* and found that entities do not always provide a break-down of the natural expenses allocated to that functional line.

### ***Views from users and preparers***

- A9. At our meetings with the Capital Markets Advisory Committee (CMAC) and the Global Preparers Forum (GPF)<sup>25</sup> users and preparers told us that ‘function’ and ‘nature’ are still considered appropriate attributes to be used for the aggregation and disaggregation of items of income and expense in the statement(s) of financial performance. However, users and preparers have different preferences for providing an analysis of expenses. We explain these preferences below.

#### *Which method is preferred by users?*

- A10. Our outreach activities show that in general users favour an analysis of expenses using the ‘nature of expense’ method because it provides them with more granular information that they could use in their analysis. However, some users also like the ‘function of expense’ method because this information facilitates the calculation of some relevant performance metrics and margins.
- A11. For example, in calculating a ‘core EBITDA’ metric users would normally exclude non-core, financing and tax amounts that may include functional or natural items. Users also need to know other natural components such as depreciation or amortisation to exclude them from the calculation of their ‘core EBITDA’ metric.
- A12. Users also favour having break-downs of particular ‘functional’ items (ie cost of sales) into their different ‘natural’ components, because these break-downs allow them to apply their assumptions to different components and enable them to make better predictions of net future cash flows. For example, in the case of ‘cost of sales’ this functional line item has value for users in determining if the revenue generated from the sale of the items covers the cost. It also helps users make predictions about

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<sup>24</sup> Libby, Robert and Emmett Scott A, [Earnings Presentation Effects on Manager and User Behaviour](#). November 13, 2013. S.C. Johnson Graduate School of Management. Cornell University, page 4.

<sup>25</sup> The minutes from the joint meeting with the GPF-CMAC in June 2016 can be found in: <http://www.ifrs.org/-/media/feature/meetings/2017/june/cmac-gpf/cmac-gpf-meeting-summary-june-2017.pdf>

future margins. However, users are also interested in knowing the composition of ‘cost of sales’ because this functional line item groups natural items (eg raw material costs, labour costs or transportation costs) that may change as the result of different drivers and so it is helpful for users to have separate information about those costs. For instance, labour costs may change as a result of increases in salaries; or distribution costs may change at a different rate as a result of an increase in the cost of fuel.

A13. Some users are of the view that the Board should consider mandating more minimum line items in the statement(s) of financial performance to provide some standardisation to the statement(s) of financial performance, as well as to promote greater disaggregation. Some examples of items that they suggested could be mandated and/or included as part of the list of minimum line items in paragraph 82 of IAS 1 are:

- (a) cost of sales;
- (b) selling, general and administrative expenses;
- (c) research and development costs;
- (d) restructuring costs;
- (e) disposal gains and/losses; and
- (f) share-based compensation expense.

A14. Some users also commented that information disaggregated by the nature of the expense is often considered more useful than information by function. This is because there is a perception that some natural components are allocated in an arbitrary or inconsistent way to an entity’s different functions, which they think reduces comparability between entities as well as reducing the information content of the functional line items reported (we discuss this aspect in paragraphs A16–A17 below).

*Which method is preferred by preparers?*

A15. The preparers that we met during our outreach activities support the choice in paragraph 99 of IAS 1 to present an analysis of expenses using the ‘function of expense’ method or the ‘nature of expense’ method. This is because this choice

allows them to ‘tell their story’. That is, to provide information consistent with their industry type or organisational structure and to be able to show how their business is managed.

- A16. Some preparers disagree that entities classifying expenses by function should be required to disclose additional information on the nature of expenses<sup>26</sup>. This is because they say that they are unable to provide this information with their current accounting systems; or may only be able to allocate natural components to the entity’s functions in an arbitrary or inconsistent way. Those preparers are of the view that they should be given the choice to provide additional information on the nature of expenses rather than being required to provide this information.
- A17. Feedback received from preparers on the 2010 [Financial Statement Presentation Staff Draft](#)<sup>27</sup> highlighted some reasons why some preparers allocate natural components in an arbitrary or inconsistent way to the entity’s functions. Some entities told us that they are unable to track the original nature of the expenses allocated into an entity’s functional activities (ie once the expenses have been allocated into functions) because their systems are not designed for this purpose — leading to information loss and/or an entity providing an arbitrary break-down of the natural components allocated to an entity’s different functions. This is often the case for large multinational companies that may internally allocate a number of items of income and expense to various functions or cost centres. An illustration of this case is provided below:

Illustration

An entity has an information technology (IT) department that serves various functions throughout the organisation. The expenses of the IT department include amongst others, natural expenses such as depreciation and labour expenses.

The IT department passes those expenses on as a single amount called ‘IT cost.’ Once those expenses are allocated to various functions and departments throughout the organisation their original nature (ie depreciation and labour expenses’) is not retained. To further complicate the process, the IT department

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<sup>26</sup> This requirement is in paragraph 104 of IAS 1.

<sup>27</sup> Refer to Agenda Paper 1 (March 2011) Appendix A paragraphs 7-9.

may be allocated costs from another cost centre (ie from the real estate cost centre).

### ***Method preferences by industry***

A18. The staff observe that manufacturing companies more commonly use a classification by function whereas service companies more commonly use a classification by nature. This suggests that the entity's business activities plays an important role in choosing a classification. We found evidence in this respect in the following studies:

- (a) in the SEC survey (2011), a majority of companies in the banking and energy industries presented expenses by nature; while most companies in the chemicals, motor vehicles, and mining and crude-oil production industries presented expenses by function, resulting in comparability on an industry basis, although not a global basis;
- (b) The EFRAG Secretariat study (2016) reflected the following trend for the following industries:
  - (i) preference for presentation by function: Consumer Staples, Healthcare and Information Technology;
  - (ii) 'mixed basis' some information by nature and some by function: Energy; and
  - (iii) preference for presentation by nature: Telecommunication Services and Utilities.
- (c) the [Discussion Paper Preliminary Views on Financial Statement Presentation](#) acknowledged that some service industries, such as banks, tend to disaggregate their expenses by nature only<sup>28</sup> as the majority of their expenses are either compensation or interest related; and

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<sup>28</sup> Refer to paragraph 3.52 of the Preliminary Views Discussion Paper on Financial Statement Presentation.

- (d) a European Survey from INEUM Consulting (2008) noted that utilities, travel and leisure companies tend to use a nature classification while the automobile and parts companies tend to use a functional classification<sup>29</sup>.

A19. The staff observe that some studies suggest that the choice of methodology might also be influenced by<sup>30</sup>:

- (a) the laws and regulations issued by securities regulators. For example, the U.S. Securities and Exchange Commission does not allow a choice for the presentation of natural or functional lines. Regulation S-X specifically requires a combination of natural and functional lines (ie a ‘mixed approach’) for commercial and industrial companies. For the other industries (ie banks, insurance entities and investment entities), Regulation S-X requires the display of natural lines<sup>31</sup>.
- (b) local GAAP requirements. For example, in France the *Autorite Des Normes Comptables* (ANC) has issued recommendations for the presentation of the statement(s) of financial performance when using a ‘function of expense’ method and the ‘nature of expense’ method. These are recommendations for non-financial entities and for financial entities<sup>32</sup>.
- (c) a need to provide more comparability with entities in other countries. For example, there is evidence indicating that some European companies switched from a by-nature method to a by-function method to provide more comparability to some U.S. companies. Reporting by function also provides the information necessary to compute some financial ratios<sup>33</sup>.

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<sup>29</sup> INEUM Consulting 2008 Evaluation of the Application of IFRS in the 2006 Financial Statements of EU Companies in [http://ec.europa.eu/internal\\_market/accounting/docs/studies/2009-report\\_en.pdf](http://ec.europa.eu/internal_market/accounting/docs/studies/2009-report_en.pdf), pages 70–71. This survey was cited in Chapter 4 of the ‘Handbook to IFRS Transition and IFRS U.S. GAAP’, Wiley (2012).

<sup>30</sup> Additionally, academic research, such as Kvaal and Nobes (2012) has found that companies’ accounting policies under National GAAP before they adopted IFRS Standards influence their accounting policy choices under IFRS Standards. (Kvaal, E. and Nobes, C.W. 2012, ‘IFRS Policy changes, and the Persistence of National Patterns of IFRS Practice’, *European Accounting Review*, 24 (2): 343–71.)

<sup>31</sup> <https://www.sec.gov/divisions/corpfin/ecfrlinks.shtml>. Refer to Article 5, Rule 5-03 – Income Statements.

<sup>32</sup> We reviewed the recommendations issued by the ANC: [Recommandation n° 2013-03 du 7 novembre 2013](#) (non-financial entities), [Recommandation n°2017-02 du 2 juin 2017](#) (banking sector) and [Recommandation n° 2013-05 du 7 novembre 2013](#).

<sup>33</sup> Minutes from the [Financial Accounting Standards Advisory Council](#) meeting in June 22, 2006, pages 13-14.

### **Previous Financial Statement Presentation Project**

- A20. The previous Financial Statement Presentation project proposed the use of a ‘function of expense’ method for an analysis of expenses (as a *primary sort*), followed by further disaggregation of the functions identified into its natural components (ie a ‘nature of expense’ method) as a *secondary sort*. This approach made sense at the time because this project required the presentation of some functional categories in the statement(s) of financial performance (ie operating, investing<sup>34</sup> and financing categories).
- A21. The Discussion Paper [Preliminary Views on Financial Statement Presentation](#)<sup>35</sup> proposed that within each category that the project had identified (ie operating, investing and financing categories) an entity should disaggregate its items of income and expense by function *and further* by nature (for all the identified functional categories) in the statement(s) of financial performance. Entities were required to apply judgement to discern the appropriate functions within each category and to determine the level of natural information to be disaggregated within those functions. Entities could choose not to provide information by function if they judged that disaggregation was not useful for users, and instead provide information just by nature.
- A22. The staff observe that the reason why the Board favoured at the time a ‘function of expense’ method in the Financial Statement Presentation Project was because it thought that such method was important in understanding how items of income and expense relate to the entity’s activities. However, some feedback on the due process documents published at the time indicated that allocating natural components to functions sometimes leads to arbitrary and inconsistent information (we discuss this aspect in paragraphs A16–A17 above).
- A23. Furthermore, some feedback on the Discussion Paper [Preliminary Views on Financial Statement Presentation](#)<sup>36</sup> indicated that requiring information *both* by function and by nature in the primary financial statements led to too much

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<sup>34</sup> ‘Operating’ and ‘Investing’ formed the ‘Business’ category.

<sup>35</sup> Refer to paragraphs 3.42 and 3.48–3.49.

<sup>36</sup> Refer to Agenda Paper 17C of July 2009 (paragraph 44).

information which some users thought diminished understandability of the information presented in those statements. To prevent too many line items in the primary financial statements, many respondents recommended including additional disaggregation of income and expense items in the notes to financial statements.

- A24. Some feedback also indicated<sup>37</sup> that presenting an analysis of expenses (by function or by nature) in the consolidated statement(s) of financial performance of a diversified entity is not particularly useful for users in predicting future cash flows. This is because the consolidated statement(s) of financial performance of a diversified entity commonly aggregates financial data of subsidiaries and other entities, and these entities may have different financial structures, lines of business or risk attributes.
- A25. Some users suggested that in the case of diversified entities the analysis of expenses (by function or by nature) could be presented, instead, as part of the segment reporting note, where the categories of expenses are most likely to be more homogeneous, and therefore more meaningful for assessing the profitability of individual units. For example, in analysing cost of sales there was a view that users would be able to better predict future cash flows if they are able to relate specific raw material costs to the related labour or overheads corresponding to a particular ('manufacturing') segment.

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<sup>37</sup> Refer to Agenda Paper 5C/7C of October 2009 (paragraphs 39-40).