STAFF PAPER

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IASB® meeting

Project	**Primary Financial Statements**
Paper topic	Analysis of operating expenses—presentation in the statement of profit or loss
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This Agenda Paper was initially prepared for the Board's September 2021 meeting as Agenda Paper 21E. However, it was not discussed at that meeting. This Agenda Paper is identical to Agenda Paper 21E for the September 2021 Board meeting.

Objective

1. This paper initiates the Board's redeliberations on the proposals set out in the Exposure Draft *General Presentation and Disclosures* relating to the analysis of expenses classified in the operating category in the statement of profit or loss. As discussed in the January 2021 Agenda Paper 21A *Plan for redeliberations*, the staff plan on a staged approach to the Board's redeliberations on this topic. This initial paper discusses key aspects of the proposals on the presentation of operating expenses in the statement of profit or loss and asks the Board to decide on the general direction of its redeliberations on this topic.

2. Future papers will discuss:

    (a) the issues discussed in this paper relating to the presentation of operating expenses in the statement of profit or loss in more detail, following further development of the agreed approach to those issues (including potentially undertaking targeted outreach); and

(b) the related proposal to require an entity that presents an analysis of operating expenses by function in the statement of profit or loss to also disclose, in a single note, an analysis of its total operating expenses by nature.

Summary of staff recommendations

3. The staff recommends that the Board:

   (a) provides application guidance that builds on the description of the function of expense method set out in paragraph 70 of the Exposure Draft to set out:

      (i) the relationship with expenses of the same nature, that is, typically expenses of the same nature would be allocated to more than one function;

      (ii) the attributes of functions, that is, they represent activities that are on-going and distinguishable from other activities of the entity; and

      (iii) the interaction with the role of the primary financial statements and the principles of aggregation and disaggregation, which can result in aggregating functions but only to the extent such aggregation provides an understandable overview of the entity's operating expenses;

   (b) does not develop a definition of 'cost of sales' as part of this project; and

   (c) provides application guidance to explain that, as a minimum, cost of sales would include inventory expense (if applicable), calculated in accordance with IAS 2 *Inventories*; and

4. The staff also recommends that the Board *explores* an approach to analysing and presenting operating expenses in the statement of profit or loss that would:

   (a) retain the proposal to require operating expenses to be analysed and presented based on their nature or function;

   (b) not retain the proposed prohibition on a mixed presentation in the statement of profit or loss and instead provide application guidance and disclosure requirements to improve comparability; and

(c) retain the proposal to provide application guidance on how to determine which presentation method should be used to provide the most useful information to users of the financial statements, with some modifications to the proposed application guidance as a consequence of not retaining the proposed prohibition on a mixed presentation.

Structure of the paper

5. This paper is structured as follows:

   (a) proposals in the Exposure Draft (paragraphs 8–9);

   (b) summary of feedback received (paragraphs 10–22); and

   (c) staff analysis and questions for the Board (paragraphs 23–56).

6. This paper contains a condensed summary of feedback received on the Board's proposals relating to the analysis of operating expenses. The December 2020 Agenda Paper 21F *Feedback summary—Disaggregation—Analysis of Operating Expenses* contains more information about feedback from comment letters and outreach on this topic, including the fieldwork findings. The December 2020 Agenda Paper 21L *Feedback summary—Literature Review* includes a review of academic literature relating to this topic.

7. This paper should be read in conjunction with April 2021 Agenda Paper 21A *Principles of aggregation and disaggregation and roles of the primary financial statements and the notes.*

Proposals in the Exposure Draft

8. The Board proposed:

   (a) requiring entities to present in the statement of profit or loss an analysis of operating expenses using either the nature of expense method or the function of expense method;

(b) requiring entities to use the method that provides the most useful information to users of financial statements, based upon application guidance on how to determine which method should be used; and

(c) prohibiting entities from presenting line items mixing the two methods, with the exception of line items that are required line items.

9. In the Basis for Conclusions, the Board explains its proposals would strengthen the existing requirements of IAS 1 *Presentation of Financial Statements*, to address concerns from users that useful information can be lost because entities choose which method to use and, in practice, many entities use a mixture of both methods (paragraphs BC109–BC110).

Summary of feedback received

Requirement to use the most useful method

10. Respondents expressed mixed views on the proposal to use the method that provides the most useful information. Many respondents (mainly accountancy bodies and standard-setters, but also some users) agreed with the proposal. However, some respondents (mainly preparers and their representative bodies, but also some users) disagreed. Of those respondents who disagreed, their concerns include:

(a) some (mainly users) said that it effectively gives an entity a free choice because the criteria for selecting a method are not sufficiently robust, with a resulting loss of comparability. Most users who raised these concerns, particularly those from Europe, suggested requiring an analysis of expenses by nature in the statement of profit or loss.

(b) some (mainly preparers) said that entities already consider which method is most useful and the proposals would require entities to incur additional costs for no reason.

(c) a few respondents said that the proposal would conflict with local corporate law, which requires minimum line items by function to be presented in the statement of profit or loss. They asked the Board to permit entities to present their analysis of expenses using the method required by their regulator, even if that is not the most useful method for an entity.

11. Some respondents disagreed with the proposed application guidance to help entities decide which method provides the most useful information (paragraph B45 of the Exposure Draft). For example, some thought that considering the key drivers of profitability (paragraph B45(a)) and the way business is managed (paragraph B45(b) would not help to determine which method should be used because internal reports and communication to investors focus on income and profit rather than expenses. That might lead to industry practice (paragraph B45(d)) being the predominant factor. However, some said that there is currently mixed practice in some industries, which could provide support for either method, effectively allowing free choice. A few preparers said that allocation to functions is arbitrary because IFRS Standards do not provide sufficient guidance and therefore application of paragraph B45(d) could always result in presentation of expenses by nature. Some also said that the proposals do not provide guidance for situations where one or more indicators support the nature of expense method, but other indicators support the function of expense method.

Prohibition on mixing the methods

12. Respondents also expressed mixed views on the proposed prohibition on a mixed method of presentation. Many respondents, mainly users, accountancy bodies and standard-setters, agreed with the proposed requirement that an entity should not provide an analysis of expenses classified in the operating category using a mixture of the nature of expense method and the function of expense method. Their reasons included that the proposed requirements would enhance comparability, both from period to period for a reporting entity and in a single period across entities, and that the prohibition on mixing the methods may help users make forecasts.

13. Many respondents, mainly preparers and their representative bodies along with a few users, disagreed with the Board's proposed requirement that an entity should not provide an analysis of operating expenses using a mixture of both methods. Their comments include:

(a) the mixed method provides the most useful information to users and should be allowed. For example, entities may have multiple business activities, and the method most useful for one may not be the method most useful for the other.

(b) the mixed method is common for entities operating in the real estate, mining, hospitality, and oil and gas industries. They have not heard questions or concerns from users of their financial statements regarding their mixed presentation of operating expenses.

(c) the proposed requirements will not enhance comparability, especially with companies applying US GAAP.

(d) not mixing the two methods would result in high costs, because it would require a change in systems.

14. Some respondents also made comments about the interaction between the prohibition of a mixed presentation and the proposed requirement to disclose minimum line items (paragraph 65 of the Exposure Draft), regardless of the method of analysis of expenses used, including:

(a) some of the line items are expenses by nature (for example, impairment losses determined in accordance with IFRS 9 *Financial Instruments*), and some of them are expenses by function (for example, insurance service expenses from contracts in the scope of IFRS 17 *Insurance Contracts*). Therefore, some entities will inevitably use a mixed presentation.

(b) paragraph 65(a)(vii) could be read as requiring presentation of cost of sales even when a by-nature analysis of expenses is presented.

(c) paragraph 65 is an ad hoc collection of line items that have accumulated over the years through new and revised IFRS Standards, not necessarily prepared on the same basis. For example, respondents questioned why impairment losses related to financial assets (a required line item) deserve more prominence than impairment losses related to non-financial assets (not a required line item).

15. Some respondents commented that it was unclear how the proposed paragraph B15, which lists circumstances that would give rise to the separate presentation of other

income and expense items in the statement of profit or loss or in the notes, linked with the proposed prohibition on a mixed presentation.

16. Some respondents also provided suggestions about a mixed presentation method, including that the Board should:

    (a) undertake further research to establish the prevalence of the mixed method and why entities consider that such a method provides the most useful information.

    (b) permit limited mixing of method, to enable those entities using a functional analysis to present separately specific items analysed by nature, for example, amortisation, depreciation and impairment.

    (c) require separate presentation of particular line items, when an entity presents its operating expenses by function, for example:

        (i) impairment of goodwill, because it is difficult to allocate to functions; and

        (ii) restructuring, because it includes an allocation of items of a different nature (such as employee benefits, impairment of assets, gains or losses on disposal of assets) and is sufficiently different from other functions to warrant separate presentation.

17. Some respondents suggested that the Board should define nature of expense and function of expense. In particular, the respondents asked for:

    (a) a definition of a function;

    (b) guidance for allocation of expenses to functions; and

    (c) a specific definition of cost of sales.

18. A few respondents, including a few users, said that an entity using the by-function method should disclose the definition of its functions and the nature of expenses that contribute to these functions.

Fieldwork findings

19. An analysis of the financial statements of the 49 participants in the fieldwork found that they present expenses as follows:

(a) twenty-five presented expenses by function;

(b) seventeen presented expenses by nature; and

(c) seven presented expenses using a mixed method, with line items presented by functions but also presenting other separate line items, including those for:

  (i) impairment of property, plant and equipment (three participants);

  (ii) impairment of goodwill (one participant);

  (iii) disposal gains and losses (four participants);

  (iv) changes in fair value of investment properties (three participants);

  (v) foreign exchange differences (two participants); and

  (vi) amortisation of intangible assets (one participant).

20. Some participants that presented an analysis of expenses by function raised concerns that some information about expenses that would be useful, such as gains or losses on disposals, would have to be included in the notes instead of in the statement of profit or loss. Some participants said presenting an analysis of expenses that does not mix the nature of expense and function of expense methods and requires the presentation that is most useful may conflict with local regulation.

21. Some participants that originally presented the analysis of expenses using a mixture of the nature of expense method and the function of expense method said it was challenging, or they were unclear on how, to allocate some expenses to functional line items, such as foreign exchange differences, goodwill impairment, restructuring and donations. Some of these participants presented line items labelled 'restructuring' or 'other' to present these expenses but were unclear whether these line items would be consistent with the description of the function of expense method. More generally, some participants said that it was not clear how to apply the function of expense method because:

(a) in their view, there is no clear definition of the method or underlying principle;

(b) there is no guidance on when and how to allocate expenses to functional line items;

(c) there is no guidance on what expenses may or may not be aggregated to form functional line items; and

(d) there are no minimum line items by function other than cost of sales and the contents of cost of sales is not defined.

22. Other aspects of the proposals that participants found unclear included:

(a) which method to use for presenting expenses in the statement of profit or loss when there were multiple main business activities for which the most useful method of presentation would be different;

(b) whether aggregating line items using the nature of expense method and using a label for that line item such as 'general and administrative expenses' constituted a function and would therefore be prohibited as a mixed presentation;

(c) whether line items described as benefiting from disaggregation (paragraph B15 of the Exposure Draft) can be presented separately regardless of the method of analysis of expenses used or should be allocated by functions;

(d) whether minimum line items are always required, even if presenting expenses using the function of expense method; and

(e) whether cost of sales is only a minimum line item when presenting expenses using the function of expense method.

Staff analysis

Objective of the proposals in the Exposure Draft

23. IAS 1 requires entities to 'present an analysis of expenses recognised in profit or loss using a classification based on either their nature or function within the entity, whichever method provides information that is reliable and more relevant' (paragraph 99 of IAS 1). IAS 1 encourages, but does not require, that analysis to be presented in the statement of profit or loss (paragraph 100 of IAS 1). When developing the Exposure Draft, the Board noted that both the nature of expense and the function of expense methods of analysis can provide useful information. Information about the

nature of expenses allows users of financial statements to analyse the detailed components of an entity's operating expenses, helping them to forecast future operating expenses. Information that aggregates operating expenses by function facilitates the calculation of some performance metrics and margins (paragraph BC110 of the Basis for Conclusions). As noted in paragraph 9 of this paper, the proposals in the Exposure Draft were intended to *strengthen* the existing requirements of IAS 1, not fundamentally *change* those requirements. The proposals would strengthen existing requirements by:

(a) requiring the analysis of operating expenses by nature or function to be presented in the statement of profit or loss, as IAS 1 encourages, but does not require, that analysis to be presented in the statement of profit or loss;

(b) providing application guidance on how to determine which method should be used, as IAS 1 contains little guidance on this matter; and

(c) stating that entities must not use a mixed presentation, except when required to do so to present minimum line items that are expenses by nature, to enhance comparability and resolve diversity in practice about how IAS 1 is interpreted and applied.

24. As noted in paragraph 10(a), some respondents (including some users) suggested requiring entities to analyse and present operating expenses by nature in the statement of profit or loss, to enhance comparability, and thereby prohibit use of the by-function method. However, that suggestion goes beyond (and is inconsistent with) the objective of strengthening the existing requirements of IAS 1. Instead, it would represent a more fundamental change to those requirements.

25. It also would have a significant impact in practice because many entities currently use the by-function method. For example, the majority of fieldwork participants use the by-function method or a mixture of by-function and by-nature, with around one-third of participants using the by-nature method. Academic evidence (summarised in the December 2020 Agenda Paper 21L *Feedback summary—Literature Review*) also indicates that the by-function method is commonly used in practice. For example, Cole, Branson, and Breesch (2013) analysed the accounting choices of 197 industrial, financial and technology entities from Belgium, Denmark, Finland, France, Germany,

the Netherlands and the UK in 2009. The authors documented that, on average, 41% of the entities reported expenses by function and 52% reported expenses by nature.

26. Moreover, requiring use of the by-nature method would result in a loss of useful information for those entities for which analysing and presenting operating expenses by function provides the most useful information. Therefore, this paper does not consider further the suggestion to require use of the by-nature method in the statement of profit or loss.

27. The remainder of this paper discusses:

    (a) the meaning of 'function' and 'cost of sales' (paragraphs 28–42); and

    (b) the presentation of operating expenses in the statement of profit or loss, in particular:

        (i) whether to proceed with the proposed prohibition on a mixed presentation method (paragraphs 43–48); and

        (ii) potential modifications and additions to the proposed application guidance in the Exposure Draft if a mixed presentation is permitted (paragraphs 49–56).

The meaning of 'function' and 'cost of sales'

28. As noted in paragraph 17, some respondents have asked for a definition of a 'function' and, more specifically, a definition of 'cost of sales'. Similar comments were received from some fieldwork participants.

What is a 'function'?

29. Paragraphs 68–70 of the Exposure Draft state:

> 68 **An entity shall present in the operating category of the statement of profit or loss an analysis of expenses using a classification based on either their nature—the nature of expense method—or their function within the entity—the function of expense method**…
>
> 69 The nature of expense method provides information about operating expenses arising from the inputs that are consumed to accomplish an entity's activities—such as information about expenses related to materials (raw materials, employees (employee benefits), equipment

> (depreciation) or intangible assets (amortisation))—without reference to how expenses are allocated to functions within the business.
>
> 70 The function of expense method allocates and combines operating expenses according to the activity to which the item relates. For example, cost of sales is a functional line item that combines expenses that relate to an entity's production or other revenue generating activities such as: raw materials, employee benefit expense, depreciation or amortisation.

30. In general, operating expenses arise from the entity's use of economic resources during the period to accomplish its activities. The two methods of analysing operating expenses are based on two different characteristics of operating expenses—the nature of the economic resources used or the function (or purpose) for which those economic resources were used.

31. Although some respondents have asked for a definition of a 'function' for the purposes of analysing and presenting operating expenses, the staff note that the term 'function' is used in the Exposure Draft not only in this context, but also elsewhere, including as part of the broader aggregation and disaggregation principles. For example, to determine the line items presented in the primary financial statements, the Exposure Draft proposes requiring an entity to apply the aggregation principles, including requiring an entity to:

> …classify assets, liabilities, equity, income and expenses into groups based on their characteristics (for example, their nature, their *function*, their measurement basis or another characteristic) resulting in the presentation in the primary financial statements of line items that share at least one characteristic… [paragraph B6(b) of the Exposure Draft, emphasis added]

32. Therefore, developing a definition of the characteristic of 'function' for the specific purpose of analysing and presenting operating expenses could create inconsistencies with how that term is used more broadly. Also, it seems inconsistent to provide more specificity about the meaning of one specific characteristic in one specific context.

33. Rather than develop a definition of a 'function' for the purpose of analysing and presenting operating expenses by function, the staff recommends that the Board

provides application guidance that builds on the description of the function of expense method set out in paragraph 70 of the Exposure Draft.

34. This guidance would address three different aspects of the function of expense method:

    (a) the relationship with expenses of the same nature (paragraph 35);

    (b) the attributes of functions (paragraph 36); and

    (c) the interaction with the role of the primary financial statements and the principles of aggregation and disaggregation (paragraph 37).

35. Firstly, the application guidance could explain that the function of expense method is a method that typically involves allocating operating expenses of the same nature between different types of activities of the entity. For example, employee services are consumed in a range of different types of activities (such as production, sales or research and development) and, therefore, applying the function of expense method entails allocating the costs of those employee services to the different types of activities in which those services were consumed.

36. Secondly, the application guidance could explain that when analysing and presenting operating expenses by function, those operating expenses should relate to activities of the entity that are:

    (a) distinguishable from other activities of the entity, to enable operating expenses to be allocated to those activities in a non-arbitrary way. This point is intended to help ensure functional line items are faithfully represented. If the entity cannot distinguish a particular activity from other activities, it seems unlikely that it could allocate costs to that activity in a non-arbitrary way. This point also links in with the application guidance on determining when to present operating expenses by function or nature (see paragraph 49(d)).

    (b) on-going activities of the entity, which were undertaken in the preceding period and/or are expected to be undertaken in the following period. This point is intended to enhance the comparability of functional line items over time.

37. Finally, application guidance could be provided about how to apply the aggregation principles when analysing and presenting operating expenses relating to particular

activities, to avoid too much or too little aggregation, so as to present an understandable overview of the entity's operating expenses. For example, an entity might have a large number of administrative activities (such as human resources, information technology, accounting, legal, etc) that could be aggregated and presented as administration expenses. In contrast, in practice, some entities present a line item labelled as 'selling, general and administration expenses', which is typically a residual line item that includes all operating expenses other than those included in cost of sales. However, the aggregation principles require aggregated items to share at least one characteristic and it seems unlikely that a single line item for 'selling, general and administration expenses' would comprise expenses with a shared characteristic (other than not being related to cost of sales). It is also unlikely that such a highly-aggregated item would be sufficient for understanding the financial performance of the entity, thus applying the requirements in paragraphs 42 of the Exposure Draft would lead to disaggregation.

38. It should be noted that any application guidance on analysing and presenting operating expenses by function would have some limitations:

(a) the characteristic of 'function' and distinguishing it from 'nature' becomes less clear when applied to expenses that do not relate to a specific activity of the entity. For example, 'general' expenses typically relate to the entity as a whole rather than to any specific activity.

(b) some operating expenses might be difficult to allocate to functions in a non-arbitrary way, such as goodwill impairment—and requiring the entity to instead use the by-nature method for *all* its operating expenses in this situation (which some interpret the Exposure Draft as requiring) could result in a loss of useful information.

(c) some minimum line items are expenses by nature.

39. Those limitations suggest that if any operating expenses are presented by function, a mixed presentation may be inevitable and/or desirable. This point is considered further in the discussion of whether to proceed with the prohibition on a mixed presentation (paragraphs 43–48).

What is 'cost of sales'?

40. The Exposure Draft refers to 'cost of sales' in various places, including in the description of the function of expense method, the requirement for an entity that presents its operating expenses by function to present its cost of sales separately from other expenses and in the application guidance on determining which method of analysis provides the most useful information (paragraphs 70, 71 and B45(a) of the Exposure Draft respectively). IAS 1 also refers to 'cost of sales' in similar ways (for example, paragraph 103 of IAS 1). The Exposure Draft and IAS 1 do not define 'cost of sales' or specify what that line item should comprise.

41. The staff acknowledges that cost of sales is a key line item when operating expenses are presented by function, which facilitates the calculation of some performance metrics, such as margins. Also, feedback from respondents indicates that there is diversity in practice about which costs are included in 'cost of sales'. However, in the staff view, developing a definition of the term 'cost of sales' would be difficult to do within a reasonable timeframe. Hence, undertaking such work would delay the completion of the project, and the Board has set out timely completion of the project as one of its priorities when discussing project plan in January 2021. Furthermore, in paragraphs B27–B30 of the Board's *Request for Information: Third Agenda Consultation* (RFI), the Board has noted that some stakeholders have suggested the Board consider developing requirements on cost of sales (including cost of goods sold and the cost of providing services), as part of a project on inventory and cost of sales. It seems reasonable to wait for feedback on that RFI before considering whether to develop a definition of cost of sales, particularly given concerns about the feasibility of such a project (as noted in paragraph B29 of the RFI).

42. Nevertheless, the staff think that it would be possible and helpful to provide some application guidance on this matter to explain that, as a minimum, cost of sales would include inventory expense (if applicable), calculated in accordance with IAS 2 *Inventories*. Although that explanation might seem to be stating the obvious in that any measure of cost of sales would be incomplete without the whole of inventory expense, the staff notes that, in practice, some entities exclude components of inventory expense when presenting a 'cost of sales' line item. Therefore, this application guidance would help enhance comparability between entities when cost of

sales is presented. (Paragraph 49(c) discusses the notion of completeness of functional line items more broadly.)

Questions for the Board

Q1 Does the Board agree that it should provide application guidance that builds on the description of the function of expense method set out in paragraph 70 of the Exposure Draft?

If so, does the Board agree with proposed application guidance in paragraphs 35–37, which would set out:

(a) the relationship with expenses of the same nature, that is, typically expenses of the same nature would be allocated to more than one function;

(b) the attributes of functions, that is, they represent activities that are on-going and distinguishable from other activities of the entity; and

(c) the interaction with the role of the primary financial statements and the principles of aggregation and disaggregation, which can result in aggregating functions but only to the extent such aggregation provides an understandable overview of the entity's operating expenses.

Q2 Does the Board agree that it should:

(a) not develop a definition of the term 'cost of sales' as part of this project; and

(b) provide application guidance to explain that, as a minimum, cost of sales would include inventory expense (if applicable), calculated in accordance with IAS 2 *Inventories*?

Presentation of operating expenses

Should the Board proceed with the proposed prohibition on a mixed presentation?

43. The staff considered how the Board should proceed in relation to the proposed prohibition on a mixed presentation, including considering:

    (a) the feedback from respondents and fieldwork participants, as summarised in paragraphs 10–22; and

    (b) the discussion in paragraphs 28–39 on providing application guidance on the function of expense method, including the limitations of that guidance, as noted in paragraph 38.

44. The staff first considered whether the Board should proceed with the proposal in the Exposure Draft, possibly with some refinements, such as clarifying aspects of the proposal that respondents found unclear. That would achieve the Board's objective of strengthening the requirements of IAS 1 (see paragraph 23). However, it would not resolve the concerns raised by many respondents about the proposals, such as the concern that the proposal would prevent entities from presenting relevant information in the statement of profit or loss and is inconsistent. For example, a manufacturing entity that recognised a substantial impairment of its fixed assets could not present separately that impairment in the statement of profit or loss if it uses the by-function method, but it would be required to present separately impairment of its financial assets (unless immaterial).

45. Also, the prohibition on a mixed presentation might not necessarily result in more comparable information. For example, two fieldwork participants with a mixed presentation recast their income statements by removing line items for particular operating expenses presented separately by nature and aggregating those expenses into an 'other operating income and expense' line item. That outcome seems inconsistent with the Board's intention when developing the aggregation and disaggregation principles and might not enhance comparability.

46. The staff also considered whether the Board should not proceed with the proposal in the Exposure Draft and instead retain the existing requirements of IAS 1. Some improvement to the presentation of operating expenses would still be possible, as a

result of other proposals in the Exposure Draft. However, retaining the existing requirements of IAS 1 would not achieve the Board's objective of strengthening those requirements. Also, retaining the existing requirements would not resolve diversity in practice about how those existing requirements are interpreted and applied. For example, in practice, some take the view that IAS 1 does not permit a mixed presentation, while others disagree. Accordingly, if the Board were to retain the requirements of IAS 1, it may be asked to clarify those requirements.

47. As an alternative to either proceeding with the Exposure Draft or retaining IAS 1 requirements, the staff considered whether the Board should explore another approach. The objective of any alternative approach would be to strengthen the requirements of IAS 1, consistent with the overall objective of the proposals in the Exposure Draft on this topic, but in a way that avoids a loss of relevant information.

48. In the staff view, the Board should explore an approach that would:

(a) retain the proposal to require operating expenses to be analysed and presented in the statement of profit or loss based on their nature or function, rather than based on some other characteristic. This point would strengthen IAS 1, which encourages, but does not require, an analysis of operating expenses by nature or function to be presented in the statement of profit or loss.

(b) not retain the proposed prohibition on a mixed presentation method. This point would help to address concerns raised by many respondents, for example, about a loss of relevant information if a mixed presentation is prohibited, and the limitations of any guidance on presenting operating expenses by function (as noted in paragraph 38). Instead, additional application guidance would be provided to help improve comparability (as discussed in paragraph 49).

(c) retain the proposal to provide application guidance on how to determine which presentation method should be used to provide the most useful information to users of the financial statements. This point would strengthen IAS 1, which contains little guidance on determining which presentation method provides the most useful information. However, some modifications to the proposed application guidance would be necessary as a consequence of not retaining the prohibition on a mixed presentation (discussed in paragraphs 50–56).

Additional application guidance to improve comparability

49. Whilst removal of the prohibition on a mixed presentation would enable relevant information to be presented, such removal could lead to less comparable information being presented and potentially misleading labels for line items (when compared with the proposals in the Exposure Draft). In order to improve comparability and help ensure faithful representation, specific application guidance and disclosure requirements on presenting operating expenses could be provided, including:

(a) the presentation method used must be consistent from one reporting period to the next (unless the Standard or another IFRS Standard requires otherwise). This point is based on the general requirement in paragraph 33 of the Exposure Draft (and paragraph 45 of IAS 1) on consistency of presentation. It would serve as a reminder of that requirement, to aid comparability over time.

(b) the entity must disclose narrative accounting policy information to explain the composition of cost of sales and other functional line items, such as what types of expenses are included in cost of sales. This point is based on the general requirement in paragraph 27A of the proposed amendments to IAS 8 in the Exposure Draft (and paragraph 117 of IAS 1) on disclosure of an entity's accounting policies. This disclosure would help users understand what functional line items comprise. For example, it would help users to assess the extent of comparability between entities when cost of sales is presented. It would also establish a 'baseline' for the following point on the completeness of functional line items.

(c) functional line items, including cost of sales, must be complete, meaning that all costs relating to a particular function must be included in the applicable functional line item rather than presenting some of those costs separately by nature. The completeness of a functional line item would be based on the entity's accounting policy for aggregating operating expenses when presenting that functional line item (as discussed in paragraph 49(b) and any specific guidance in the Standard on cost of sales (as discussed in paragraph 42). This point is partly to help faithful representation (completeness is a characteristic of information that is faithfully represented, as discussed in the *Conceptual*

Framework for Financial Reporting). This point is also to help provide some comparability between entities.

(d) when presenting natural line items, the labels used for those line items must faithfully represent what those line items comprise, consistent with the aggregation requirements. For example, an entity must not present a line item described as ‘employee benefits expense’ or ‘depreciation’ if that line item is not complete because a portion of employee benefits or depreciation has been allocated to functional line items. Instead, the entity could use a more accurate label (for example ‘deprecation of office buildings’), or consider whether those expenses could be aggregated with other expenses and presented using a description that faithfully represents the aggregated items.

Application guidance to help entities determine when to use a mixed presentation method

50. The Exposure Draft contains proposed application guidance on the presentation of operating expenses, including guidance on determining which presentation method provides the most useful information (paragraph B45 of the Exposure Draft). That application guidance was intended to result in an entity making a single overall determination on which method to apply to all of its operating expenses—either all by function or all by nature. Hence, if a mixed presentation is not prohibited, the proposed application guidance would need to be modified to allow for the possibility that, for some entities, providing the most useful information may entail presenting some operating expenses by nature and other operating expenses by function.

51. Paragraph B45 of the Exposure Draft sets out matters that the entity must consider when determining how to analyse and present its operating expenses so as to provide the most useful information, which are:

(a) the key drivers of profitability (paragraph B45(a) of the Exposure Draft);

(b) how the entity’s business activities are managed and reported internally (paragraph B45(b) of the Exposure Draft);

(c) industry practice (paragraph B45(c) of the Exposure Draft);

(d) whether the allocation of particular expenses to functions would be arbitrary and therefore would not provide a faithful representation of the line items presented (paragraph B45(d) of the Exposure Draft).

52. A point could be added to the matters included in paragraph B45 of the Exposure Draft, to require entities to consider whether those matters indicate that presenting some operating expenses by function and other operating expenses by nature would provide the most useful information. That additional point would not introduce a new distinct matter for entities to consider, but rather would allow for the possibility that considering the matters included in paragraphs B45 of the Exposure Draft could indicate that a mixed presentation would provide the most useful information.

53. An example of when a mixed presentation could provide the most useful information is when the entity manages and reports internally some of its operating expenses by function and other operating expenses by nature. For example, a service entity might manage and report internally by function those operating expenses that are directly attributable to generating revenue, to monitor its margin on providing those services. However, other operating expenses that are not directly attributable to generating revenue might be managed and reported internally by nature.

54. Another example is when an entity has different types of main business activities, for which the reporting of key components or drivers of the entity's profitability would entail presenting some operating expenses by function and some by nature. For example, an entity with both banking and insurance activities might present a natural line item for interest expense and a functional line item for insurance service expenses.

55. However, for entities with different types of main business activities (such as a group with subsidiaries operating in different industries), using a mixed presentation does not necessarily mean such an entity should, in effect, analyse and present its operating expenses by segment (or by subsidiary) in its statement of profit or loss. The entity must still comply with the broader presentation requirements, such as requirements relating to the role of the primary financial statements, the aggregation and disaggregation principles, and the classification and presentation of income and expenses in the specified categories. For example, a consolidated statement of profit or loss must provide an *understandable overview* of the operating expenses *of the*

group. Hence, a complex or highly disaggregated presentation of operating expenses (for example, disaggregated by segment or by subsidiary) in the consolidated statement of profit or loss might not result in an understandable overview of the group's operating expenses.

56. If the Board agrees with the recommendations to remove the prohibition of a mixed presentation and develop application guidance on when to use a mixed presentation, the staff plan to develop the initial suggestions discussed in paragraph 52–55 further, including considering feedback on the proposed guidance on which method to use (summarised in paragraphs 10–11), and undertaking targeted outreach. We think targeted outreach is needed because the proposed guidance on which method to use, and the feedback received, were prepared under the assumption that a mixed presentation would be prohibited. We would need to test whether a similar approach can work when a mixed presentation is permitted. After that work is completed, the staff will bring to the Board a full set of recommendations relating to the guidance on which method to use.

Questions for the Board

Q3 Does the Board agree to explore the approach outlined in paragraph 48, whereby the Board would:

(a) retain the proposal to require operating expenses to be analysed and presented in the statement of profit or loss based on their nature or function;

(b) not retain the proposed prohibition on a mixed presentation and instead provide application guidance to improve comparability; and

(c) retain the proposal to provide application guidance on how to determine which presentation method should be used to provide the most useful information to users of the financial statements, with some modifications to the proposed application guidance as a consequence of not retaining the proposed prohibition on a mixed presentation?

Q4 If the Board agrees with staff recommendation to explore the approach outlined in paragraph 48, does the Board have any feedback on the staff's initial suggestions for modifications and additions to the proposed application guidance:

(a) additional application guidance and disclosure requirement to improve comparability (see paragraph 49); and

(b) application guidance to help entities determine when to use a mixed method (see paragraphs 52–55)?