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International
Accounting Standards
Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**25 January 2007, London**
Project:	**Financial Statement Presentation (Phase B)**
Subject:	**Disaggregation on the Statement of Comprehensive Income (Agenda paper 13B)**

INTRODUCTION

1. In September, the Boards expressed a leaning toward presenting information in the statement of comprehensive income by function (for example, sales; cost of sales; selling, general and administrative), with certain information further broken down by nature (for example, labor, materials, rent, depreciation, and royalties) either on the face or in the notes. In addition, the Boards indicated that the initial discussion document should include general guidance (rather than a bright line, numerical rule) for when items should be presented as a separate line and not aggregated on the financial statements. In December, the Boards expressed the view that future discussions of function-then-nature disaggregation should take into consideration financial institutions and other entities that are service oriented. This memorandum addresses how the Boards' views on disaggregation might be made operational.

2. As most of the items that will be disaggregated on the statement of comprehensive income relate to operating activities, the alternatives addressed in this memo focus only on disaggregation within the operating category. For purposes of discussing disaggregation,

a. *Function* refers to the primary activities in which an entity is engaged, such as selling a product or providing a service, cost of sales, research and development, marketing, and administrative.

b. *Nature* refers to the inputs (costs) required to accomplish those functional activities, such as costs related to people (labor and benefits), materials, energy, equipment (depreciation), and occupancy (rent).

It is possible that an entity could have some expenses, gains, or losses that do not relate to a primary activity (such as goodwill impairment) and thus would not be reported either as a function or as a cost associated with a function. The alternatives address presentation of those items.

3. In addressing this issue, the staff found itself questioning the interaction of disaggregation on the statement of comprehensive with segment disclosures (which includes information disaggregated based on lines of business or geographical areas—reportable operating segments). The staff found the following explanation helpful in thinking about disaggregation by function and nature.

> Disaggregating information on the statement of comprehensive income by functions and then by nature is different than disaggregating information by segments because that functional information represents the **overall** primary activities of an entity. For example, selling products is a function that would be reported on the statement of comprehensive income. While it also would be reported in the segment disclosure for each of an entity's operating segments that engage in that function, it is the **total** product sales that would be reported on the statement of comprehensive income—the details (sales for each line of business) would be in the segment reporting note.

The staff plans to review the relationship of the Boards' decisions and current segment reporting requirements (whether there are any inconsistencies or duplications) and discuss its findings with the Board at a future meeting.

BACKGROUND

4. The disaggregation working principle states that information should be presented in a manner that "disaggregates line items if that disaggregation enhances the usefulness of that information in predicting future cash flows." Thus, the goal of providing disaggregated information is to provide information useful in estimating or predicting future income which, in turn, is used to forecast future cash flows. Furthermore, the goal is to develop principles-based disaggregation guidance that will result in two entities that manage their business in a similar way reporting similar activities in a similar manner.

5. The Boards expressed a preference for presenting information on the statement of comprehensive income initially by function because that information is generally more descriptive of an entity's overall operations. However, because the economic drivers of certain line items are different than the economic drivers of other line items (for example, labor and maintenance), the Boards were interested in disaggregating some of that functional information by nature. Board members also observed that presentation first by function is more consistent with the higher-level functional categories in the working format (that is, operating, investing, and financing).

6. In discussions with users (primarily those who analyze U.S. GAAP financial statements) over the past few months, many expressed dissatisfaction with the current level of disaggregation in the statement of comprehensive income. Because the level at which information is disaggregated is largely up to management's discretion, most entities only present a relatively few line items on the face of the income statement (sales; cost of sales; and selling, general, and administrative expenses). In addition, users are requesting disaggregation of line items by both function and nature citing that while functional disaggregation assists in the study of overall business trends (such as gross and operating margins), it groups items with different economic drivers and thus reduces the predictive value of the reported information. For example, marketing, pension, and rent expense might be grouped together in the SG&A line. Disaggregating expenses based on their nature would isolate expenses that have similar predictability, which would increase the predictive power and analytical value of financial modeling.

POSSIBLE ALTERNATIVES

7. Each of the alternatives discussed below is rooted in a management approach, which is consistent with the classification criteria developed to date and reflective of the fact that businesses and industries are different. Alternatives A and B are consistent with the Boards' September leanings that information be presented first by function and then be broken down by nature. Alternative C is in response to the Board discussion in December related to financial institutions. Each of the three alternatives are described below and illustrated side-by-side on the page following paragraph 14.

Alternative A: Pure Management Approach

8. Under Alternative A, an entity would be required to present the following:

   a. Information based on the primary activities (functions) in which the entity engages
   b. For each of those functions, information about the significant related costs (by their nature) that would provide information useful in predicting future cash flows.

9. As noted above, this disaggregation approach is similar to the approach taken for classifying items into the overall functional categories—that is, it's based on how management runs its business. The standard would include examples of functional activities and related costs that an entity might present separately. Those examples would include:

   a. Functional activities:
      (1) Sales of product
      (2) Sales of services
      (3) Cost of product sales
      (4) Cost of services sales
      (5) Marketing
      (6) General and administrative
      (7) Research and development

   b. Related costs by their nature:
      (1) Salaries and wages
      (2) Pension and other benefits
      (3) Materials
      (4) Depreciation
      (5) Amortization
      (6) Rent
      (7) Energy
      (8) Lease
      (9) Maintenance
      (10) Technology
      (11) Royalty fees
      (12) Licensing fees.

10. In addition, an entity would be required to break out any other cost that is important in understanding its operating results that may not be or relate to a functional line item because it does not relate to what the entity does on a regular basis (not a primary activity). Examples would be a gain or loss on disposal of an asset or impairment of goodwill.

Alternative B: Modified Management Approach

11. Alternative B would be the same as Alternative A except that the first seven costs listed in Alternative A would be **required** to be presented separately unless the cost is deemed to be insignificant. Those costs are:
    a. Salaries and wages
    b. Pension and other benefits
    c. Material
    d. Depreciation
    e. Amortization
    f. Rent
    g. Energy.
12. As with Alternative A, an entity also would be required to break out any other cost that is important in understanding its operating results that may not be or relate to a functional line item because it does not relate to what the entity does on a regular basis (not a primary activity). Examples would be a gain or loss on the disposal of an asset or impairment of goodwill.

Alternative C: Permit Nature Only (as exception to Modified Management Approach)

13. Alternative C would add an exception to Alternative B that would permit an entity to present information only based on the nature of expenses (materials, labor, depreciation, and so forth) if classifying costs (expenses) into functional activities provides information that is not relevant. This alternative is similar to IAS 1 that requires an entity to "…present an analysis of expenses based on either the nature of expense or their function within the entity, whichever provides information that is reliable and more relevant" (paragraph 88). That paragraph goes on to state that "entities classifying expenses by function [should] disclose additional information on the nature of expenses, including depreciation and amortization expense and employee benefits expense."
14. As with the other alternatives, an entity also would be required to break out any other cost that is important in understanding its operating results that may not be or relate to a functional line item because it does not relate to what the entity does on a regular basis (not a primary activity). Examples would be a gain or loss on the disposal of an asset or impairment of goodwill.

The following examples are for illustration only and do not purport to provide definitive guidance from the Boards. These examples assume that the entity has no items that would be classified as OCI items and omit some totals and subtotals.

Alternative A
Statement of Comprehensive Income

(in millions)	2006	2005
BUSINESS		
Operating Income		
Sales	68,222	56,741
Cost of sales:		
Salaries & Wages	(12,990)	(9,928)
Materials	(6,474)	(6,100)
Other cost of sales	(10,261)	(8,712)
Total cost of sales	(29,725)	(24,740)
Selling/Marketing	(8,073)	(6,917)
General & Administrative	(12,949)	(11,544)
Research & Development	(2,075)	(1,940)
Loss on Asset Disposal	(300)	0
Goodwill Impairment	(200)	0
Operating income	14,900	11,600
Investing Income		
Income from minority investment	150	100
Investing income	150	100
FINANCING		
Financing income		
Interest income	250	200
Financing expenses		
Interest expense	(1,119)	(834)
Net financing expense	(869)	(634)
INCOME TAXES		
Provision for income taxes	(3,729)	(3,058)
Comprehensive Income	10,452	8,008

Alternative B
Statement of Comprehensive Income

(in millions)	2006	2005
BUSINESS		
Operating Income		
Sales	68,222	56,741
Cost of sales:		
Salaries & Wages	(12,990)	(9,928)
Materials	(6,474)	(6,100)
Depreciation	(2,750)	(2,300)
Energy and Supply Chain	(2,982)	(2,517)
Technology	(2,677)	(2,260)
Other cost of product sales	(1,852)	(1,635)
Total cost of product sales	(29,725)	(24,740)
Selling/Marketing:		
Salaries & Wages	(3,400)	(2,892)
Advertising fees	(3,000)	(2,700)
Other selling/marketing	(1,673)	(1,325)
Total Selling/Marketing	(8,073)	(6,917)
General & Administrative:		
Pension and other benefits	(3,369)	(3,252)
Salaries & Wages	(3,236)	(2,754)
Depreciation	(1,627)	(1,084)
Amortization	(1,000)	(800)
Rent	(1,000)	(1,000)
Technology	(1,100)	(1,100)
Other operating expense	(1,617)	(1,554)
Total general & administrative	(12,949)	(11,544)
Research & Development:		
Salaries & Wages	(1,000)	(800)
Materials	(825)	(940)
Other research & development	(250)	(200)
Total research & development	(2,075)	(1,940)
Loss on Asset Disposal	(300)	0
Goodwill Impairment	(200)	0
Operating income	14,900	11,600
Investing Income		
Income from minority investment	150	100
Investing income	150	100
FINANCING		
Financing income		
Interest income	250	200
Financing expenses		
Interest expense	(1,119)	(834)
Net financing expense	(869)	(634)
INCOME TAXES		
Provision for income taxes	(3,729)	(3,058)
Comprehensive Income	10,452	8,008

Alternative C
Statement of Comprehensive Income

(in millions)	2006	2005
BUSINESS		
Operating Income		
Sales	68,222	56,741
Costs and expenses:		
Salaries & Wages	(20,626)	(16,374)
Materials	(7,299)	(7,040)
Depreciation	(4,377)	(3,384)
Pension and other benefits	(3,369)	(3,252)
Advertising Fees	(3,000)	(2,700)
Amortization	(1,000)	(800)
Rent	(1,000)	(1,000)
Energy and Supply Chain	(2,982)	(2,517)
Technology	(3,777)	(3,360)
Other operating expense	(5,392)	(4,714)
Total costs and expenses	(52,822)	(45,141)
Loss on Asset Disposal	(300)	0
Goodwill Impairment	(200)	0
Operating income	14,900	11,600
Investing Income		
Income from minority investment	150	100
Investing income	150	100
FINANCING		
Financing income		
Interest income	250	200
Financing expenses		
Interest expense	(1,119)	(834)
Net financing expense	(869)	(634)
INCOME TAXES		
Provision for income taxes	(3,729)	(3,058)
Comprehensive Income	10,452	8,008

ANALYSIS OF ALTERNATIVES

Alternative A –Pure Management Approach

15. Alternative A provides entities with the most flexibility in determining what information should be disaggregated. However, some might consider the pure management approach too subjective to result in the desired level of disaggregation. Because this alternative would provide a suggested but not required list of items to be disaggregated, the staff is doubtful that entities will voluntarily disaggregate many of the items suggested. Therefore this alternative might not address user requests for more disaggregated information to aid them in predicting cash flows.

Alternative B –Modified Management Approach

16. Similar to Alternative A, Alternative B would provide entities with flexibility in determining what information should be disaggregated. However, Alternative B would require that a minimum amount of information be presented on the face of the statement of comprehensive income (unless an item is deemed to be insignificant to an entity's operations). This minimum list will guarantee at least some level of disaggregation and will provide some discipline to the disaggregation process. The required list of items is based on information frequently requested by users and that many entities would, in the staff's opinion, consider key inputs to their businesses. Those items are also consistent with (a) the items that are required to be disclosed by the SEC in the notes to financial statements (if not on the face) and (b) the items required to be presented under IAS 1 if a functional presentation is used.

17. Preparers are likely to argue that the disaggregation of costs associated with various functions might lead to disclosure of proprietary information and, thus, the requirement could be viewed as anticompetitive. In addition, some are likely to comment that the list of required items would not be significant for many entities and therefore might result in an entity reporting meaningless information. However, as noted previously, there would be a provision stating that a required item wouldn't have to be presented if it is insignificant to an entity's operations.

18. The staff acknowledges that presenting the "by nature" information for each functional activity could be a tedious process for entities with a significant number of functions. However, some entities currently provide this type of information in the MD&A section that discusses changes in

gross and operating margins. In addition, not each of those seven types of expenses will relate to each reported function.

Alternative C – Permit Nature Only (as exception to Modified Management Approach)

19. Based upon feedback from the Financial Institutions Advisory Group (FIAG) and a review of current reporting practices, it is clear that some industries report information on their income statement by nature alone. The entities that do so (such as banks, utilities, and healthcare) tend to be service oriented, thus costs of sales or gross margins are not a key aspect of their income statement. Consider the following:

    a. Most banks report interest, fees, commissions, trading and realized gains on security sales each as a separate line item; however, revenues are netted against costs. Personnel expenses are usually presented separately since this is usually a significant line item.

    b. Utility providers, which might disaggregate revenue streams (electric, gas), typically report costs by nature alone.

    Examples of a statement of comprehensive income for a bank and a utility company as currently presented (nature only) and then as it might be presented under a function-then-nature requirement follow on the next page.

20. While certain industries do not currently present information disaggregated by function, the staff asserts that they present information by nature because it is more relevant to their business, not because they are not able to disaggregate their expenses by function. Requiring those entities to begin with a functional presentation before presenting expenses by nature would result in presentation of information that is not currently provided which would result in more consistency in presentation by all entities.

21. As noted above, industries that do not currently present information disaggregated by function likely do so because reporting by nature alone is more relevant to their business. The accompanying example of a bank's reporting based on Alternative B illustrates this point. Reporting the revenue and expense components of commissions and fees for a financial institution under separate functional activities (such as sales and cost of sales) would provide additional information, but the staff asserts that this information would be of little use to an analyst. These items are typically reported net and analyzed on a net basis. Furthermore, interest income and expense are typically disaggregated but reported together on the statement of comprehensive income; to present them under different functions to satisfy a functional

presentation might result in less relevant information. Thus one could argue that requiring those entities to adhere to a function-then-nature approach is inconsistent with one of the primary reasons for presenting disaggregated information—providing users with information that will be useful in predicting future cash flows.

The following examples are for illustration only and do not purport to provide definitive guidance from the Boards. These examples assume that the entity has no items that would be classified as OCI items and omit some totals and subtotals.

Banking - Current reporting by nature
Statement of Comprehensive Income

	2006	2005
	(in millions)	
BUSINESS		
Operating Income		
Interest Income	5,440	3,490
Interest expense	(4,100)	(2,545)
Net interest income	1,340	945
Provision for credit loss	(40)	(25)
Net interest income after credit los	1,300	920
Net Fee and Commission income	3,145	2,800
Net Trading income	455	490
Net Realized gain on AFS securitie	20	10
Salaries & Wages	(2,540)	(1,830)
General & Administrative	(1,805)	(1,105)
Depreciation	(150)	(145)
Amortization	(30)	(105)
Net operating income	**395**	**1,035**
Investing Income		
Income from eq method investment	125	80
Net investing income	**125**	**80**
Net business income	**520**	**1,115**
FINANCING		
Financing income		
Interest income	0	0
Financing expenses		
Interest expense	(480)	(350)
Net financing expense	**(480)**	**(350)**
INCOME TAXES		
Provision for income taxes	**(305)**	**(235)**

Banking - (based on Alternative B)
Statement of Comprehensive Income

	2006	2005
	(in millions)	
BUSINESS		
Operating Income		
Revenue:		
Interest income	5,440	3,490
Fee and Commission income	3,420	3,025
Trading income	1,150	640
Realized gain on AFS securities	30	15
Net Revenue	10,040	7,170
Cost of revenue:		
Interest expense	(4,100)	(2,545)
Fee and Commission expense	(275)	(225)
Trading loss	(695)	(150)
Realized loss on AFS securities	(10)	(5)
Provision for credit loss	(40)	(25)
Salaries & Wages	(2,540)	(1,830)
Other cost of revenue	(900)	(390)
Total cost of revenue	(8,560)	(5,170)
Selling & Marketing	(300)	(200)
General & Administrative:		
Salaries & Wages	(410)	(357)
Depreciation	(150)	(145)
Pension and other benefits	(100)	(80)
Amortization	(30)	(105)
Rent	(45)	(38)
Other general & administrative	(50)	(40)
Total general & administrative expense	(785)	(765)
Net operating income	**395**	**1,035**
Investing Income		
Income from eq method investment	125	80
Net investing income	**125**	**80**
Net business income	**520**	**1,115**
FINANCING		
Financing income		
Interest income	0	0
Financing expenses		
Interest expense	(480)	(350)
Net financing expense	**(480)**	**(350)**
INCOME TAXES		
Provision for income taxes	**(305)**	**(235)**

Utilities - Current reporting by nature
Statement of Comprehensive Income

	2006	2005
	(in millions)	
BUSINESS		
Operating Income		
Revenue	816	845
Fuel consumed in electric generation	(224)	(211)
Purchased power and transmission	(102)	(124)
Operations and maintenance	(158)	(182)
Impairment charges	0	(30)
Deferred energy costs	0	4
Other income and expenses	(8)	(7)
Taxes other than income taxes	(54)	(53)
Depreciation and Amortization	(68)	(77)
Net operating income	**202**	**165**
Investing Income		
Minority interest	(2)	(2)
Net investing income	**(2)**	**(2)**
Net business income	**200**	**163**
FINANCING		
Financing income		
Interest income	0	0
Financing expenses		
Interest expense	(66)	(112)
Net financing expense	**(66)**	**(112)**
INCOME TAXES		
Provision for income taxes	**(41)**	**(21)**

Utilities - (based on Alternative B)
Statement of Comprehensive Income

	2006	2005
	(in millions)	
BUSINESS		
Operating Income		
Revenue:		
Delivery and services	702	731
Generation and marketing	114	114
Net revenue	816	845
Cost of revenue:		
Fuel consumed in electric generatio	(224)	(211)
Purchased power and transmission	(102)	(124)
Operations and maintenance	(123)	(147)
Deferred energy costs	0	4
Net Cost of revenue	(449)	(478)
Selling/Marketing	(10)	(10)
Research & Development	(7)	(7)
General & Administrative:		
Taxes other than income taxes	(54)	(53)
Depreciation	(34)	(37)
Amortization	(34)	(40)
Other income and expenses	(8)	(7)
Administrative	(8)	(8)
Pension and benefits	(5)	(5)
Rent	(5)	(5)
Total general & administrative	(148)	(155)
Impairment charges	0	(30)
Net operating income	**202**	**165**
Investing Income		
Minority interest	(2)	(2)
Net investing income	**(2)**	**(2)**
Net business income	**200**	**163**
FINANCING		
Financing income		
Interest income	0	0
Financing expenses		
Interest expense	(66)	(112)
Net financing expense	**(66)**	**(112)**
INCOME TAXES		
Provision for income taxes	**(41)**	**(21)**

Staff Recommendation

22. The staff initially preferred Alternative B—besides being consistent with the Boards' leaning toward disaggregation by both function and nature, the approach is easy to understand, relatively straightforward to apply, and should provide for the amount of disaggregated information users are looking for. However, recognizing that there are circumstances in which **not** allocating costs to functions provides more useful information, the staff recommends Alternative C which would permit an entity to present information on the statement of comprehensive income only by nature when that presentation provides more relevant information.

23. The staff also recommends that in all cases the disaggregated cost information be presented on the face of the statement of comprehensive income, not in the notes. The staff is of the view that if "by nature" cost information is important it should be presented on the face. In addition, requiring the disaggregated information to be presented on the face rather than giving entities a choice of disclosing that information in the notes will result in a more consistent presentation by all entities. In other words, analysts will always know where they can find that disaggregated cost information.

24. The staff notes that, consistent with the Boards' expressed interest in having similar line items in the statements of comprehensive income and the statement of cash flows, the goal would be for cash flow information to be disaggregated in a similar way. The staff plans to consider this issue when readdressing presentation of cash flow information for discussion at a future meeting.

Questions for the Boards

- **Which of the three alternatives for disaggregating information do Board members prefer?**
- **Do Board members agree that disaggregated information should be required to be presented on the face of the statement of comprehensive income (rather than permitted to be included in the notes to financial statements)?**