Project **Financial Statement Presentation**

Topic **Disaggregation by Function and Nature**

Introduction

1. This paper discusses the boards' preliminary view that income and expense items should be disaggregate by both function and nature on the statement of comprehensive income (SCI). This paper begins by reviewing the responses on that disaggregation approach in the comment letters on the October 2008 discussion paper *Preliminary Views on Financial Statement Presentation*. The paper also summarizes the feedback received on disaggregation by function and nature in various meetings with users and preparers of financial statements.

2. The staff is developing alternatives for disaggregation on the SCI for discussion with the boards in October 2009. The alternatives under consideration are described in the remainder of this paper.

Background

3. The discussion paper indicates that financial information should be presented in the financial statements in two broad sections—**business** and **financing—**and that the business section should be further disaggregated into the **operating** and **investing categories**. The financing section is further disaggregated into the **financing asset** and **financing liability categories**.

4. Within each category, an entity is asked to disaggregate its items of income and expense by **function**. *Function* refers to the primary activities in which an entity is engaged, such as selling goods, providing services, manufacturing, advertising, marketing, business development or administration.

5. Each of those functions is further disaggregated by **nature** to the extent that information enhances the usefulness of the statement of comprehensive income (SCI) in predicting the entity's future cash flows. If that presentation is impractical on the face of the SCI, the entity presents the information in the notes to financial statements. *Nature* refers to the economic characteristics or attributes that distinguish assets, liabilities, and income and expense items that respond differently to similar economic events. Examples of disaggregation by nature include disaggregating total revenues into wholesale revenues and retail revenues or disaggregating total cost of sales into materials, labour, transport and energy costs.

6. If, in the opinion of management, presenting disaggregated information by function would not provide relevant information (because, for example, the entity does not engage in a variety of functions, that is, it provides mainly services), an entity could disaggregate its items of comprehensive income by their nature within the operating, investing and financing categories.

7. Additionally, an entity separately reports any income or expense item where the separate presentation of that item enhances the usefulness of the information in predicting the entity's future cash flows (for example, impairment of goodwill).

Responses on disaggregation by nature and function

8. Respondents were asked whether the level of disaggregation proposed in the discussion paper provides information that is decision-useful to users in their capacity as capital providers. The majority of respondents think that greater disaggregation of income and expense items provides decision-useful information. However, those respondents question whether disaggregation of income and expense items by both nature **and** function on the SCI is the optimal way to provide that information.

9. Respondents explain that the SCI may contain too many line items if disaggregation is required by both nature and function. Consequently, the proposed disaggregation might reduce rather than enhance the relevance and understandability of the information presented in the SCI. To prevent cluttering the face of the financial statements, many respondents recommend including

additional disaggregation of income and expense items in the notes to financial statements.

10. Many IFRS respondents support the approach to disaggregation provided in IAS 1 *Presentation of Financial Statements*. That Standard requires disaggregation of expenses using a "classification based on either their nature or their function within the entity, whichever provides information that is more reliable and more relevant" (paragraph 99). Respondents note that approach:

    (a) is more appropriate than disaggregation by both function and nature as the information disaggregated on the SCI would be that with the greatest predictive power

    (b) provides the appropriate level of decision-useful information

    (c) is consistent with the management approach to classification described in the discussion paper.

11. Some respondents express concern that the costs of presenting disaggregated income and expense items by nature and function would outweigh the benefits. A company that participated in the field test commented that it would be cost prohibitive to change their financial systems to capture information that is currently allocated across business units (such as overhead amounts) at the by-nature level.

12. Respondents are also concerned that the proposed disaggregation of revenue and expense items will result in inconsistent and non-comparable information across entities. That effect may result from the subjectivity inherent in each entity defining its different components by function. Another respondent expressed concern with year-to-year consistency within an entity as well as entity-to-entity consistency.

Financial services entities

13. A number of financial services entity respondents agree with the proposal in the discussion paper that an entity should not have to disaggregate income and expense items by function if that information is not relevant to the analysis of the performance of their business. For example, one respondent suggests that the presentation of information by function should be required "only if it enhances the usefulness of the information". The discussion paper notes that the

types of entity for which by-function information may be irrelevant are those that tend to be service oriented (such as banks, utilities, and healthcare providers) because costs of sales and gross margins are not an important aspect of their financial results.

Field test observations and feedback

14. Preparer participants in the field test completed a survey about how they applied the disaggregation guidance proposed in the discussion paper. Approximately 50 percent of the preparers were of the opinion that application of the disaggregation guidance results in too much disaggregation overall. Additionally, the majority of preparers responded that applying the disaggregation guidance either distracts from or does not improve their ability to communicate their entities' results.

15. When disaggregating information in the SCI, many preparers state that the by-function groupings presented in their recast statements are consistent with management's view of the business and are used to some extent by executive management to manage the business. However, most preparer participants said that the by-nature line items are not useful in that respect or in communicating the entity's results to users of their financial statements. Other preparers indicate that the by-nature information is useful for managing at their segment or business unit levels.

16. Many of the preparers in the field test indicate that the boards' preference for line-item cohesiveness and the broad disaggregation guidance provided made it difficult to determine how much disaggregation was adequate to satisfy the objectives of the proposed presentation model. For example, once by-nature line items are presented in one functional grouping, some preparers are compelled to consistently disaggregate the same by-nature information in all other functional groupings, even though that information may not be decision-useful for understanding the results of the entity or necessary for use in predicting future cash flows.

Possible alternatives

17. Based on the responses to the proposed disaggregation of income and expenses in the SCI, the staff think the boards may need to include more robust criteria to help determine an adequate level of disaggregation. Further, additional guidance is required to help constituents determine the most useful place in the financial statements to present disaggregated information so as to:

    (a) not impair the communication of the entity's results

    (b) provide information in a manner that is useful in assessing and predicting future cash flows.

18. The staff developed the following four alternatives for discussion at the Working Group meeting.

    Alternative 1: Add explanatory language/guidance to the discussion paper proposal

    Alternative 2: Disclose "by-nature" information in the notes to financial statements

    Alternative 3: Present income and expense items either by nature or function, similar to IAS 1

    Alternative 4: Disclose "by-nature" information as part of the segment note

***Alternative 1*: Add additional explanatory language/guidance to the existing principle**

19. Alternative 1 maintains the concept of disaggregation by function and nature in the SCI (see Appendix A for the illustrative SCI included in the discussion paper) and clarifies the following points:

    (a) **only decision-useful** by-function and by-nature information should be presented

    (b) by-nature information should be in the notes if it distracts from other information on the SCI

    (c) by-nature line items do not need to be the same in each by-function category

    (d) if 'by-function' or 'by-nature information within a function' does not enhance the ability of a user of the financial statements to predict future cash flows of an entity, the entity should not present that information

    (e) the function and nature information on the SCI does not need to carry over to other statements if it does not provide useful information on that statement (for example, the statement of cash flows). The staff is of the opinion that line-item cohesiveness should not result in the presentation of irrelevant information.

Discussion questions – Alternative 1
Question 1: The guidance in the paragraph above includes terminology and decision points that are vague and requires management to decide what information is useful to the users of its financial statements without any benchmarks or bright lines. Should the boards leave this judgment solely to management? Would this alternative result in any more disaggregation on the SCI than there is today?
Question 2: Every line item has the potential to assist in the prediction of future cash flows. Which cash flows are users of financial statements most interested in?

***Alternative 2**: Disclose "by-nature" information in the notes to financial statements*

20. Alternative 2 requires an entity to disaggregate its income and expense items by both function and nature (as clarified in Alternative 1). Alternative 2 gives primacy to disaggregation by function on the SCI and relegates by-nature disaggregation to note disclosures. An entity that does not present by-function information because that information is irrelevant would present by-nature information in the SCI, not in the notes to the financial statements.

21. If Alternative 2 is applied, the resulting SCI may be less cluttered and more useful than if it had been prepared in accordance with the discussion paper proposals. Additionally, the by-nature information that is useful in predicting future cash flows is available to users of financial statements in the notes to those financial statements.

Discussion questions – Alternative 2
Question 3: Do we want to give a presumed primacy to by-function presentation?
Question 4: What happens when a reporting entity has one business model that is best communicated by function and another that is best communicated by nature?

***Alternative 3:** Present income and expense items either by nature or function (similar to IAS 1)*

22. Alternative 3 is similar to Alterative 1 because it gives an entity the option to present income and expense items either by nature **or** by function. IAS 1

requires an entity to present an analysis of expenses recognized in profit or loss either by-nature or by-function, whichever provides information that is reliable and more relevant to the facts and circumstances of the entity. If an entity classifies expenses by function, it is required to disclose additional information on the nature of expenses, including depreciation and amortization expense and employee benefits expense.

23. IAS 1 "encourages" that analysis to be presented in the statement of comprehensive income or separate income statement. The proposed model would make that presentation a requirement.

24. Like Alternative 2, Alternative 3 could result in a less "cluttered" SCI while still providing decision-useful information. Additionally, Alternative 3 retains the provision that entities (e.g., financial services entities) may select the presentation method that is most relevant to their business.

Discussion questions – Alternative 3
Question 5: What do we really mean by "cluttered" and "too much information"? Could these be code words that mean the information for complex reporting entities is not displayed in the proper or most useful manner (e.g., it is not associated with the business model or other elements it pertains to in the company)? **Question 6**: How likely is it that an entity will report by-nature information beyond the minimum information IAS 1 requires? Is all relevant by-nature information being presented or should there be more specific by-nature information required? If so, provide examples.

***Alternative 4*: Disclose "by-nature" information as part of the segment note**

25. Alternative 4 requires by-nature information to be presented by segment in an entity's segment disclosure about particular elements (ie assets, liabilities, gains and losses), patterns of income and expense, and resulting availability of cash flows.

26. If a reporting entity does not present segment information in the notes to the financial statements, one of the following options is used:

(a) If a reporting entity consists of a single business model, then either the by-nature **or** the by-function/by-nature disaggregation should be presented on the SCI so that the key elements, the patterns of income and expense and resulting availability of cash flows of the business model are apparent.

(b) If a reporting entity consists of more-than-one business model, but does not meet the requirements to present a segment disclosure, then either the by-nature **or** the by-function/by-nature disaggregation should be presented **by business model in a separate note disclosure** so that the key elements, the patterns of income and expense and resulting availability of cash flows of each business model are apparent.

27. Disaggregating by-nature information can be useful in predicting future cash flows because it provides information about expenses that respond to different economic stimuli. If segmental expenses are separated based on different economic drivers, a user of financial statements can consider the segment's sensitivity to that driver, thereby increasing the predictive value of the information.

28. Application of Alternative 4 results in the presentation of information within the context of a business model or group of similar business models (segments). By presenting disaggregated information in the context of the business model, that information's relevance and predictive value may be enhanced.

Discussion questions – Alternative 4
Question 7: Which sections and categories should by-nature information be presented in if by-nature information is moved to segment reporting?
Question 8: How should centralized activities be presented?
Question 9: Would the costs to present by-nature information at the segment level be substantially less than presenting by-nature information at the entity level? Would the benefit be greater?

Appendix A

ToolCo Financial Statements (proposed format)

STATEMENT OF COMPREHENSIVE INCOME

	For the year ended 31 December 2010	2009
BUSINESS		
Operating		
Sales—wholesale	2,790,080	2,591,400
Sales—retail	697,520	647,850
Total revenue	*3,487,600*	*3,239,250*
Cost of goods sold		
Materials	(1,043,100)	(925,000)
Labour	(405,000)	(450,000)
Overhead—depreciation	(219,300)	(215,000)
Overhead—transport	(128,640)	(108,000)
Overhead—other	(32,160)	(27,000)
Change in inventory	(60,250)	(46,853)
Pension	(51,975)	(47,250)
Loss on obsolete and damaged inventory	(29,000)	(9,500)
Total cost of goods sold	*(1,969,425)*	*(1,828,603)*
Gross profit	*1,518,175*	*1,410,647*
Selling expenses		
Advertising	(60,000)	(50,000)
Wages, salaries and benefits	(56,700)	(52,500)
Bad debt	(23,068)	(15,034)
Other	(13,500)	(12,500)
Total selling expenses	*(153,268)*	*(130,034)*
General and administrative expenses		
Wages, salaries and benefits	(321,300)	(297,500)
Depreciation	(59,820)	(58,500)
Pension	(51,975)	(47,250)
Share-based remuneration	(22,023)	(17,000)
Interest on lease liability	(14,825)	(16,500)
Research and development	(8,478)	(7,850)
Other	(15,768)	(14,600)
Total general and administrative expenses	*(494,189)*	*(459,200)*
Income before other operating items	*870,718*	*821,413*
Other operating income (expense)		
Share of profit of associate A	23,760	22,000
Gain on disposal of property, plant and equipment	22,650	-
Realized gain on cash flow hedge	3,996	3,700
Loss on sale of receivables	(4,987)	(2,025)
Impairment loss on goodwill	-	(35,033)
Total other operating income (expense)	*45,419*	*(11,358)*
Total operating income	**916,137**	**810,055**
Investing		
Dividend income	54,000	50,000
Realized gain on available-for-sale securities	18,250	7,500
Share of profit of associate B	7,500	3,250
Total investing income	**79,750**	**60,750**
TOTAL BUSINESS INCOME	**995,887**	**870,805**
FINANCING		
Interest income on cash	8,619	5,500
Total financing asset income	**8,619**	**5,500**
Interest expense	(111,352)	(110,250)
Total financing liability expense	**(111,352)**	**(110,250)**
TOTAL NET FINANCING EXPENSE	**(102,733)**	**(104,750)**
Profit from continuing operations before taxes and other comprehensive income	*893,154*	*766,055*
INCOME TAXES		
Income tax expense	(333,625)	(295,266)
Net profit from continuing operations	*559,529*	*470,789*
DISCONTINUED OPERATIONS		
Loss on discontinued operations	(32,400)	(35,000)
Tax benefit	11,340	12,250
NET LOSS FROM DISCONTINUED OPERATIONS	**(21,060)**	**(22,750)**
NET PROFIT	**538,469**	**448,039**
OTHER COMPREHENSIVE INCOME (after tax)		
Unrealized gain on available-for-sale securities (investing)	17,193	15,275
Revaluation surplus (operating)	3,653	-
Foreign currency translation adjust—consolidated subsidiary	2,094	(1,492)
Unrealized gain on cash flow hedge (operating)	1,825	1,690
Foreign currency translation adjust—associate A (operating)	(1,404)	(1,300)
TOTAL OTHER COMPREHENSIVE INCOME	**23,361**	**14,173**
TOTAL COMPREHENSIVE INCOME	**561,830**	**462,212**
Basic earnings per share	7.07	6.14
Diluted earnings per share	6.85	5.96