Project **Financial Statement Presentation**

Topic **Disaggregation by Function and Nature**

Introduction

1. This paper discusses the FASB and IASB's (collectively, the boards) proposal from the October 2008 discussion paper, *Preliminary Views on Financial Statement Presentation*, that income and expense items should be disaggregated by both function and nature on the statement of comprehensive income (SCI).

2. The staff developed alternatives for disaggregation on the SCI for discussion purposes based on the comment letter responses on the proposed disaggregation approach and preliminary data from the field test and the Financial Accounting Standards Research Initiative (FASRI) experiment. Those alternatives were discussed at the July 27, 2009 meeting of the Joint International Group (JIG) and the Financial Institution Advisory Group (FIAG) and during small group meetings with members of both boards in August 2009.

3. In light of the final results from the FASRI experiment, the analyst survey responses from the field test and other feedback from various groups, the staff refined its thoughts on:

    (a) the level of disaggregation an entity should present in its financial statements (Issue 1)

    (b) where disaggregated information should be presented to be most decision useful in predicting future cash flows (Issue 2).

Summary of staff recommendation

4. In Issue 1, the staff recommend that the boards replace the discussion paper proposal that specifically requires disaggregation by function and nature on the SCI with a disaggregation principle that requires an entity to consider disaggregation by function, nature, and measurement bases in the financial statements as a whole using the principle set forth below. This would mean the boards would not specifically require an entity to disaggregate SCI information by function and nature.

   An entity should disaggregate information and provide line item descriptions in its financial statements in a manner that provides transparency to that entity's business model(s). An entity should consider and apply the disaggregation attributes of function, nature, and measurement basis both individually and in concert with each other to provide the best representation of how the entity uses its resources to generate income and cash flows. An entity should present the disaggregated information so that:

   (a) the activities the entity performs to conduct its business and generate income are clear

   (b) the relationship between significant or material assets, liabilities, income, expenses, gains, losses and cash are faithfully represented,

   (c) the significant or material cash flows of the entity from its business and financing activities are apparent.

5. In Issue 2, the staff recommend that an entity that has only one reportable segment present its disaggregated information on the face of its primary statements and that an entity that has more than one reportable segment should present its disaggregated information in its segment note..

Background—discussion paper proposals

6. The discussion paper proposes that within each category on the SCI (operating, investing, and financing), an entity 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.

7. The discussion paper proposes that each of those functions be further disaggregated by **nature** to the extent that information enhances the usefulness of the SCI in predicting an entity's future cash flows. If that by-nature

presentation is impractical on the face of the SCI, an entity should present 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, labor, transport and energy costs.

8. The discussion paper also proposes that 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.

Issue 1: Level of disaggregation

Comment letter responses

9. Comment letter 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 comment letter respondents think that greater disaggregation of income and expense items **does** provide decision-useful information. However, some of those respondents question whether disaggregation of income and expense items by both function **and** nature on the SCI is the optimal way to provide that information.

10. Comment letter respondents explain that the SCI may contain too many line items if disaggregation is required by both function and nature. Consequently, the proposed disaggregation might **reduce** rather than enhance the relevance and understandability of the information presented in the SCI. To prevent too many line items on the face of the financial statements, many respondents recommend including additional disaggregation of income and expense items in the notes to financial statements.

11. Many IFRS comment letter 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.

12. Comment letter respondents are also concerned that the proposed disaggregation of income and expense items will result in inconsistent and non-comparable information across entities. That concern may result from the subjectivity inherent in giving an entity flexibility to decide both the functions to present on the SCI and the by-nature components that comprise those functions. Other comment letter respondents express 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 information by function may be irrelevant are those that tend to be service-oriented (such as banks, utilities, and healthcare providers) because, for example, costs of sales and gross margins are not an important aspect of their financial results.

Feedback from the field test

14. Feedback from both preparer and analyst field test participants suggests that mandating disaggregation by function and nature is problematic because:

(a) preparers have no independent means of assessing the "most useful" level of disaggregation

(b) disaggregation by function and nature for complex entities results in "too many" line items that are not necessarily organized in a way that portrays the relationship between line items that is necessary to predict future cash flows.

15. The staff observe the following from their review of the recast financial statements provided by preparer field test participants:

(a) some line items contained aggregated expenses that the staff would have expected to be shown on separate lines because of different predictive values (ie net interest aggregated with movements in derivatives or energy/fuel expenses aggregated with other production overheads)

(b) some line item descriptions were too generic to follow the alignment of related items across the primary statements.

16. Those observations indicate to the staff that the **disaggregation guidance proposed in the discussion paper may not be robust or comprehensive enough to result in the most decision-useful level of disaggregation**.

FASRI experiment

17. In September 2009, the boards discussed the results of an experiment conducted by FASRI on the discussion paper proposals. That experiment used experienced credit analysts to test whether disaggregation was useful and whether the location of information made a difference in their judgements and forecasts . The FASRI team concluded that, overall, financial statements were more useful to experienced credit analysts when primary financial statements are both classified (ie operating, investing, financing) **and** disaggregated by function and nature. The experiment results also indicate that there is a benefit to a user of financial statements in an entity presenting related information together, in either the primary financial statements or in the notes, rather than spreading that information across the primary financial statements and the notes. That aspect

of FASRI's findings is discussed further in determining where disaggregated information should be presented in Issue 2 of this paper.)

18. Specific findings from the FASRI experiment include:

    (a) classified and disaggregated financial statements aided credit analysts in discerning the fixed and variable costs in their test financial statements

    (b) classified financial statements without disaggregation hindered analysts' assessment of fixed and variable costs

    (c) classified and disaggregated primary financial statements were rated as more transparent than other versions of the financial statements provided to the participants

    (d) analysts were more likely to identify key differences when those analysts used financial statements that were either **both** classified and disaggregated, or **neither** classified nor disaggregated.

Cost considerations

19. Some comment letter respondents express concern that the costs required to change information systems to capture and report disaggregated income and expense items by function and nature would outweigh the benefits. Several preparer field test participants explained that their costing and allocation methodologies "pool" many different types of overhead items together and then allocate portions to each of their business units or functions. In the allocation process, the identity (nature) of the overhead items is no longer determinable.

20. Those field test participants think that modifying their information systems to keep track of the nature of the individual overhead accounts allocated to the business units or functions for consolidated reporting purposes would be very costly. A few of the preparer participants state that this level of disaggregation is better suited for the segment note because that is the level in the entity where the information is most readily available. The staff observe that if the disaggregated information is presented in the segment note, that information

would be grouped with other related information and presented in a context that could make it more useful in predicting future cash flows.

Staff analysis

Is disaggregation by function and nature decision useful?

21. Analyst participants in the field test cited increased disaggregation of line items as the single most useful aspect of the proposed presentation model. When comparing the non-recast and recast financial statements, analyst participants indicate that application of the disaggregation principle enhanced their understanding of the SCI, the statement of cash flows (SCF), the statement of financial position (SFP) and the proposed reconciliation schedule. Over half of the field test analysts indicate that the non-recast statements would have been more useful with more disaggregation. All of the user feedback received by the staff indicates that increased disaggregation is decision useful in predicting future cash flows.

22. However, **how** information is disaggregated and **where** that disaggregated information is presented are important factors in determining the overall usefulness of disaggregation. The discussion paper addresses disaggregation mainly in terms of the SCI and prescribes disaggregation by function and nature for items on that primary statement. Findings and observations from both the field test and the FASRI experiment suggest that:

    (a) the manner of presentation needs to go beyond the discussion of function and nature

    (b) the application principle should be presented more holistically than it was in the discussion paper.

23. Application of the cohesiveness principle creates an interdependency between disaggregation by function and nature that makes it difficult to consider disaggregation in terms of any single primary financial statement. Specifically, the level and effect of disaggregation on any one financial statement must be considered in concert with the effects and possible requirements for disaggregation on the accompanying financial statements.

24. That effect is most clearly demonstrated in the field test results. In the recast financial statements used by the analyst participants, the disaggregated by-function and by-nature information on the SCI carried over to the SCF. The analyst participants' responses indicate that the link in presentation between those two statements is a factor that enhanced the decision usefulness of the recast financial information they reviewed. Comments from the Analyst Representative Group (see paragraphs 34–36 in October joint meeting paper 7A/70A) also indicate that increased disaggregation on the SCF and the would improve the usefulness of that statement.

25. Disaggregation by measurement bases was proposed in the discussion paper in terms of the SFP. However, the staff think that disaggregation by measurement bases is also relevant to the SCI for those entities that use percentage of completion accounting and because some line items on the SCI originate from remeasurements. Therefore, the staff's analysis on this issue considers disaggregation by measurement bases as well as disaggregation by function and nature. Application of the disaggregation principle proposed in this paper to the SFP will be presented to the boards in November.

IAS 1: disaggregation by function* or *nature

26. IAS 1 gives an entity the option to present income and expense items either by function **or** by nature on the face of the primary financial statements. It also requires an entity to present an analysis of expenses recognized in profit or loss either by function or by nature, whichever provides information that is reliable and more relevant to the facts and circumstances of an 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.

27. IAS 1 gives management a lot of flexibility in how they present an entity's disaggregated information. It also prescribes specific minimal by-nature information that must be presented if an entity disaggregates by function on the SCI.

28. The staff considered whether the disaggregation approach proposed in the discussion paper should be replaced with an approach similar to that in IAS 1.

The staff think IAS 1 provides management more flexibility in presentation than most comment letter respondents or analyst field test participants were comfortable with—as demonstrated by numerous requests for consistency and comparability between reporting entities. The staff also think that an IAS 1 approach is not robust enough to support cohesiveness between the disaggregated SCI information and its related functional information or related SFP or SCF information. IAS 1 does not require the additional by-nature information to be presented in a single location (eg it can be presented in separate individual notes). That might result in a disjointed presentation of by-nature information in the notes.

29. In addition, reporting entities tend to gravitate to reporting only the minimum information required. Under IAS 1 an entity might disaggregate and present only the "required" by-nature information rather than provide a more robust presentation of the activities sought in a more principled approach.

Staff recommendation

30. The staff think that function, nature, and measurement bases are appropriate attributes to use for disaggregation in the financial statements. However, the staff think that those disaggregation attributes should be applied more generally to the financial statements as a whole, not just the SCI.

31. The staff developed a disaggregation principle that considers the interplay with the cohesiveness principle and does not link any particular disaggregation attribute to a specific financial statement. That disaggregation principle focuses on communicating a total "picture" of an entity's financial results using disaggregation attributes that are appropriate for that entity. Consequently, application of the disaggregation principle proposed in this paper should result in presentation of more relevant information than the approach in the discussion paper. The staff proposal should also result in greater transparency of an entity's businesses model(s) and the activities the entity performs to execute that business model.

32. The staff recommend that the following disaggregation principle be included in the exposure draft:

An entity should disaggregate information and provide line item descriptions in its financial statements in a manner that provides transparency to that entity's business model(s). An entity should consider and apply the disaggregation attributes of function, nature, and measurement basis both individually and in concert with each other to provide the best representation of how the entity uses its resources to generate income and cash flows. An entity should present the disaggregated information so that:

(a) the activities the entity performs to conduct its business and generate income are clear

(b) the relationship between significant or material assets, liabilities, income, expenses, gains, losses, and cash are faithfully represented

(c) the significant or material cash flows of the entity from its business and financing activities are apparent.

33. The staff uses *business model* to mean the related resources that an entity uses or deploys to generate a revenue stream. *Significant* is used to describe those activities or items that have or are likely to have an influence or effect on management's decision making. *Material* is used in the same context as discussed in the conceptual framework.

34. The staff think that the above disaggregation principle is consistent with the core presentation principles of cohesiveness and disaggregation. The staff view the principle as expanding on the description of the overall intent of disaggregation and explaining how disaggregation interacts with cohesiveness. That principle also addresses the specific criticisms provided by preparers and analysts that participated in the field test because it:

(a) does not leave the interpretation of what is decision useful solely to criteria established by each entity's management

(b) provides benchmarks for preparers of financial statements to use in determining how much disaggregated information needs to be presented

(c) focuses less on the differences between types of entities and more on communicating an individual entity's financial performance

(d) provides a common objective and set of expectations regarding application of the disaggregation principle for all types of entities

(e) provides a principled basis for disaggregation and presentation that can be independently validated or challenged by financial statement users and other stakeholders such as those providing attestation or assurance services.

Questions 1 and 2: Level of disaggregation
Q1. The staff recommend that disaggregation by function and nature should not be limited to the statement of comprehensive income and should be applied broadly across the financial statements as a whole along with disaggregation by measurement bases. **Do the boards agree with that staff recommendation?** **Q2**. The staff recommend that the disaggregation principle in paragraph 32 be included in the exposure draft. **Do the boards agree with that staff recommendation**?

Issue 2: Where to present disaggregated information

Comment letter and field test responses

35. Many respondents are concerned about the potential for the disaggregation principle in the discussion paper to result in so many line items on the SCI that the usefulness of the SCI would be diminished. In an effort to minimize those concerns, the discussion paper allows management to provide by-nature information in the notes if management believes putting the by-nature information on the SCI would make that statement too lengthy or detract from its overall understandability.

36. Several issues arise in allowing management to present by-nature information in the notes as proposed in the discussion paper:

(a) unlimited management subjectivity in determining what is "too lengthy" or when by-nature information "detracts" from the SCI's understandabilty

(b) the resulting effect of management's discretion on consistency and comparability between reporting entities

(c) maintaining cohesiveness between the primary statements and by-nature information in the notes becomes difficult

(d) keeping related resources, income, expenses, gains, and losses together with the related cash flows is not possible when some information is in the notes and some is on the face of the primary statements.

37. Many comment letter respondents and preparer participants in the field test suggest that by-nature information be presented in the notes. The FASRI experiment suggested that it did not matter where the disaggregated information was presented as long as the related information was presented in the same place—either both on the face of the primary statements or both in the notes.

38. However, neither the FASRI experiment nor the field test adequately address how the decision-usefulness of the disaggregated information is affected by either the complexity of an entity or the number of business models that may be in place in the entity. The staff believe it would be a challenge for a complex entity or a diversified entity that has more than one business model to present disaggregated but related information together so that the information is useful for predicting future cash flows.

39. Preparer field test participants questioned the usefulness of the disaggregated information in the consolidated SCI. Those participants point out that when a diversified entity presents disaggregated by-function and by-nature information, the relationship or context of the line items and the way those line items work together to create value or cash flows may not be apparent. In other words, though the financial information is disaggregated, it does not tell a complete story about the entity's financial results.

40. The usefulness of disaggregated information in predicting future cash flows for a complex or diversified entity is highly dependent on whether related line items of information can be analyzed in the context of its related business activities. A preparer participant in the field test explained this best by pointing out that the entity he prepares financial statements for is made up of several segments that

have different responses to the same economic stimuli. While he could provide additional disaggregation of raw materials, labor and overheads in his entity's cost of goods sold, a user would not be able to adequately predict future cash flows without being able to relate the specific raw materials to the related labor or overheads. In other words, the only thing the disaggregated line items for materials have in common is that they are raw materials used somewhere in the business.

Staff analysis

41. Those findings and observations lead the staff to the conclusion that disaggregated information should be presented in the context that makes the most sense of that information. That is, either on the face of the primary financial statements or in the notes depending on the complexity of the entity. The staff is of the view that presentation of disaggregated information should **not** rest on whether management thinks the statements have too many line items or on the level of relevance management attaches to that information.

42. For a simple entity that is comprised of one segment, the staff think that all disaggregated information, whether by function, nature, or measurement bases, should be presented on the face of the primary financial statements. Results from the field test suggest that users do have a capacity to work with primary statements that are longer (have more line items) than the statements generally provided today.

43. The majority (about 80%) of analyst participants in the field test that reviewed the financial statements for Steelworks Company (which had by-function and by-nature information on the face of the SCI) thought the level of disaggregation was adequate and useful. The majority indicate that they prefer to see by-function and by-nature information on the face of the primary statements. (Excluding totals and headings, the non-recast version of Steelworks SCI had 25 line items of information; the recast version had 64 line items.)

44. For a complex entity comprising more than one segment, such as an entity composed of more than one type of business or business model, or multiple product lines, the question becomes how to present that information in the notes

in the most decision-useful way. Recognizing the boards' prior concerns with modifying the accounting requirements for segment note disclosures, the staff considered developing a new matrix-type note that would present the related information together. However, in order for a matrix-type note to present disaggregated information in context, it would need to include (duplicate) some information from the primary financial statements. For example, section and category information from the SFP, SCI and SCF would need to be included in the matrix note.

45. Therefore, the staff think enhancing an entity's segment note to include the additional disaggregated information is the most decision-useful way to present disaggregated information. Presenting the disaggregated information in the segment note results in the presentation of related information within the context of a business model or group of similar business models (reportable segments). Each reportable segment is more likely to respond similarly to any given set of economic drivers. Therefore, by presenting disaggregated information in the context of the reportable segment, that information's relevance and predictive value is likely to be enhanced without disaggregating each individual revenue stream and its related line items.

46. In support of enhancing the segment note disclosure, the staff notes that:

(a) the general information an entity is required to disclose about its segments today (eg, basis of organization, types of products and services), complements the factors underlying the disaggregation principle recommended by the staff

(b) a reconciliation of specific segment totals to amounts on the consolidated financial statements is required by current segment guidance; that reconciliation is consistent with the principle of cohesiveness

(c) using the existing segment note instead of adding a new note reduces complexity and repetitive information in the financial reports

(d) the majority of the preparer field test participants indicated that the management approach to classification did not conflict with the management approach underlying their company's segment note.

47. Comments received from field test participants and feedback from JIG and FIAG members that discussed this topic with the staff also support the staff analysis. It was clear from the comments provided by the analyst participants that a significant number believed the principles in the discussion paper regarding classification, disaggregation and cohesiveness are also supposed to apply to the segment note. It was also clear that some measure of their enthusiasm for the increased disaggregation is based on that belief. That belief persisted even though the discussion paper and the field test financial statements did not include a segment note nor did the survey ask questions about the segment note.

Staff recommendation

48. The staff recommend that an entity consisting of one reportable segment be required to present its disaggregated information on the face of its primary statements and that an entity comprising more than one reportable segment should be required to present its disaggregated information in its segment note.

49. If the boards agree with the staff that the segment note is the most decision-useful place to present the disaggregated information for an entity with more than one segment, the staff will come back to the boards with its recommendation on how the segment note might be modified.

Question 3: Where to present disaggregated information
Q3. The staff recommend that an entity with only one reportable segment present its disaggregated information on the face of the financial statements and that an entity with more than one reportable segment present that information in its segment note. **Do the boards agree with that recommendation?**