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Project	<b>Financial Statement Presentation</b>
Topic	<b>Disaggregation of Income and Expense Items</b>

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## Introduction

1. This paper for discussion at the financial statement presentation (FSP) working group (WG) meeting addresses disaggregation of income and expenses by function, by nature, and by segment.

## Staff Draft proposal

2. The Staff Draft proposes that an entity
  - (a) Disaggregate its income and expenses by function<sup>1</sup> so that the information is useful in understanding the activities of the entity and in assessing the amount, timing, and uncertainty of future cash flows, and
  - (b) Further disaggregate those functional amounts by nature<sup>2</sup> to the extent that the information is useful in assessing the amount, timing, and uncertainty of future cash flows.
3. An entity would present that disaggregated information in the statement of comprehensive income or in the notes to financial statements as described below:
  - (a) In the FASB Staff Draft, entities that are required to provide a segment note would disaggregate in that note income and expenses by their function and further by nature for each reportable segment, with different by-nature disaggregation permitted for each reportable segment.

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<sup>1</sup> *Function* refers to the primary activities in which the entity is engaged, such as selling goods, providing services, manufacturing, advertising, marketing, business development, or administration.

<sup>2</sup> *Nature* refers to the economic attributes or characteristics that distinguish assets, liabilities, and items of income, expense, and cash flow that do not respond similarly to similar economic events.

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- (b) In the IASB Staff Draft, all entities would disaggregate income and expenses by their function and further by nature on an entity basis (not by reportable segment) and present that information in the statement of comprehensive income or disclose that information in a separate note.
4. An entity would **not** disaggregate its income and expenses by function if that disaggregation is not useful in understanding the entity's activities and the amounts, timing, and uncertainty of future cash flows (for example, a services entity that has no cost of sales). An entity that does not present its income and expenses disaggregated by function would disaggregate and present its income and expenses by nature in the statement of comprehensive income. The FASB Staff Draft would require that information be disclosed by segment for a multi-segment entity. (See Appendix A for the paragraphs from the Staff Draft on disaggregating income and expenses.)

## What we heard during outreach activities

### *Field visit input*

5. Field visit companies are opposed to presenting information by function and by nature for the following reasons (which are expanded on in paragraphs 6-14) :
- (a) System costs associated with the compiling the information will be extremely high.
  - (b) Further disaggregation of by function expenses by nature is not relevant to how they manage or how they would describe their business.
  - (c) The proposed disaggregation in the segment note would cause competitive harm.

### *Costs*

6. The majority of the companies we spoke with stated that their systems do not compile information by function further disaggregated by nature. They went on to explain that internal allocations of different cost centers and services throughout a vertically integrated company make the compilation of this level of detail extremely costly.
7. They explained these allocations in the following manner: An entity has different departments that serve various functions and segments throughout the organization, such as information technology (IT) or real estate. The IT

department has various natural expenses such as depreciation and labor, but does not pass on those costs individually. Rather, they pass the cost as a single amount called “IT cost.” Thus, the nature of that expense, as the Staff Draft defines it, is lost.

8. To further complicate the process, within various cost centers are allocations from other cost centers. For example, the IT department may be allocated a certain amount of cost from the real estate cost center. Therefore, the allocations that are passed to the various functions and segments are a series of allocations for which the natural composition of the cost is lost.
9. In order to track all of the by nature expenses throughout the organization, significant system modifications would have to be made.

*Lack of relevance*

10. Many entities do not see value in information about by-nature expenses in the context of the different functions. They contend that that information does not offer predictive value and is not consistent with the benchmarks they set within their organizations.
11. Additionally, disaggregation of the information about assets, liabilities and cash flows in the segment note also presented problems. Because every company has a different structure for the stewardship over assets and liabilities, as well as central treasury functions or shared service centers, it was stated that these amounts would in many cases be meaningless and not comparable across entities.

*Competitive harm*

12. All of the US companies were concerned that the proposed level of disaggregation in the segment note would result in competitive harm. They cited the following issues:
  - (a) Costs of goods sold by segment will reveal gross margin information that would spur competitors to enter certain markets as well as put pressure on their pricing.
  - (b) Other costs by segment will reveal information to competitors about activities and strategies in which the company is engaged in.

- (c) Government contractors will suffer from scrutiny of margins.
  - (d) Companies that work with labor unions will suffer from scrutiny of margins.
  - (e) Segment disaggregation will provide entities outside the U.S. an unfair advantage (because the IASB is not proposing similar segment disclosures).
13. Although our outreach focused on out-of-pocket costs such as system and resource costs to compile the information, the companies expressed that competitive harm issues have a cost associated with them as well.
14. Some companies agreed that a greater level of disaggregation could be provided in the segment note without causing competitive harm, though their suggestions varied.

***Views of financial statement users***

15. Almost all of the analysts we met with believed the disaggregation of function and nature would be one of the most useful aspects of the project and would result in ‘powerful data’. They said this would have an immediate impact on the models they build as they could incorporate different rates for commodities, labor, depreciation, etc. They cited several benefits:
- (a) Most analysts thought that COGS was the most important by nature information they could have by segment because it would help them understand the cost drivers of the business.
  - (b) Some analysts noted that by-nature information would help them identify trends; for example, the components of an amount like SG&A might change even though total SG&A didn’t change.
  - (c) Financial analysts noted that most financial companies present information by nature currently. They said that the by- nature information for each segment would provide more granular information that could be helpful, especially for insurance companies and large banks with diversified business models (lending, investment banking and brokerage, asset management) where margins and inputs can vary greatly.
  - (d) Most analysts said while they currently try to use information in the MD&A to build more detailed models, it isn’t all that effective because the information, when reported, is usually reported as a net impact to

reported results (for example, steel prices affected gross margins by 20 basis points), but baseline numbers are not always known.

- (e) One analyst stated that knowing the by-nature expenses of an entity would be helpful in evaluating why one entity's cost structure is different than another and thus assist them in drawing comparisons that are more robust.
16. One group was not in favor of the by-nature information. They are comfortable with their estimates of by-nature costs using:
- (a) knowledge of the industries they cover;
  - (b) publicly available information about input prices (for example, steel);
  - (c) MD&A, and;
  - (d) earnings supplements.
17. Almost all of the analysts we spoke with supported the FASB approach for presentation of disaggregated income and expense in the segment note for entities with more than one segment.
18. Most analysts thought the FASB approach was best because they usually model and analyze the information by segment.
19. One analyst said a **consolidating** schedule would be the most preferred method of presentation and suggested a breakdown by line of business or segment.

*Frequency of information*

20. Most analysts thought the disaggregated information in the segment note should be required quarterly. They felt the benefit was reduced significantly if this information was provided once a year. One group would be satisfied with the information provided annually.
21. There was some concern that entities might reduce the number of segments if required to present more segment data.
22. Several users were sensitive to the competitive harm this information may cause. Therefore, they suggested a lesser level of disaggregation but still wanted more information presented across the segments.

***Field test results and/or feedback***

23. Many preparer field test participants expressed an understanding of the need for more disaggregation. Most of the field test participants from preparer groups felt the disaggregation guidance in the Staff Draft resulted in too much disaggregation and would not enhance communication of financial results for their companies. Most participants do not agree with the use of economic characteristics as a basis for further disaggregation of functional amounts. A majority of the participants thought that requiring functional amounts to be further disaggregated into relevant components (undefined) would be sufficient.
24. The majority of all field test participants did not agree that all reporting entities should provide additional levels of disaggregation in a single note (regardless of whether the entity provides a segment note).

***Other input received during outreach activities***

*Auditors*

25. During the outreach meetings held with the Big 4 public accounting firms, several concerns were raised about presenting information by function and by nature in the segment note. The primary issues were as follows:
  - (a) A perceived deviation from the management approach (Chief Operating Decision Maker) currently used in reporting segment information (Chief Operating Decision Maker) can result in amounts being disclosed that are not otherwise used and reviewed by management;
  - (b) Substantially all of their clients they discussed the Staff Draft with indicated that users of their financial statements do not request the proposed level of disaggregation, therefore the costs will significantly outweigh the benefits;
  - (c) The lack of convergence between the FASB and IASB on changes to segment reporting requirements will result in a lack of comparability, and;
  - (d) Concerns over potential disclosure overload and how the disclosures proposed in the Staff Draft will be affected by the FASB's Disclosure Framework project.
26. The firms also noted that considerable judgment will be required to evaluate the appropriate level of disaggregation that each entity reports. They also cited

increased audit costs associated with providing assurance over the additional amounts disclosed as well as initial audit costs to evaluate IT system upgrades and conversions. Other

***Financial service entity issues***

27. The majority of financial service entities present their income and expense by nature. Although detailed segment information is not required, users observed that some companies provide a fair amount of detail in their financial statements today; the users said that they find that information useful in their analysis.
28. An insurance analyst said the disaggregation they would want is on the balance sheet, and they don't think the disaggregation on the income statement would be achievable in a way that would make it meaningful since the underlying profit drivers are not clear.

**Possible alternatives**

29. Most preparers of financial statements acknowledged that some level of greater disaggregation was achievable in their statements of comprehensive income. However, they all questioned the by nature breakdowns within each functional expense line item and all expressed concern about further disaggregation in the segment note.
30. The users of financial statements with whom we met with were very supportive of more detail in the financial statements, especially at the segment level. It was clear that users of financial statements are looking for more details about income and expenses so they can understand fixed and variable costs and the key drivers of the business. This information will help them identify trends, perform break-even analyses, and estimate incremental margins. However, it is apparent that it would be close to impossible for many companies (especially large multinational entities) to provide by nature/by function information at the consolidated level (IASB) or the segment level (FASB).
31. During our outreach activities, we asked both users and preparers about other possible ways to provide detailed information about income and expenses. Although the focus was on expenses, users also expressed interest in more detail about revenue. The following alternatives were identified:

**Alternative 1:** Allow entities to use approximations of by-nature expenses within each function; for example, percentages used during the budget process for labor, materials, advertising, etc. That is, retain the proposal to disaggregate each functional expense by nature in the notes, but explicitly state that preparers can determine the by-nature components using an allocation process.

**Alternative 2:** Require only cost of sales to be further disaggregated by nature (for example, materials, labor, and overhead).

**Alternative 3:** Require a qualitative discussion in the notes to financial statements of the composition of each by-function income or expense line item. Do not require any disaggregation of functional income and expense line items by nature in the SCI or in the notes.

**Alternative 4:** Require disclosure of income and expense items disaggregated by nature in the notes (unless the statement of comprehensive income is disaggregated by nature). Do not require any disaggregation of functional income and expense line items by nature in the SCI or in the notes.

**Alternative 5:** Require a narrative disclosure of key drivers and information about fixed/variable costs in the notes. This is similar to the requirement in IAS 1 to disaggregate by function or nature on the face and disclose additional information about the nature of expenses in the notes (unless the statement of comprehensive income is disaggregated by nature). Do not require any disaggregation of functional income and expense line items by nature in the SCI or in the notes.

**Alternative 6:** Require disaggregation of the by-function or by-nature income and expense line items presented on the SCI by segment in the notes. Do not require any disaggregation of functional income and expense line items by nature in the SCI or in the notes.

32. The first three alternatives retain some disaggregation of functional expenses by nature. For the FASB proposal, these modifications would be disclosed by segment.
33. The first three alternatives should enable an entity to achieve a greater level of disaggregation while not incurring the same amount of systems-related costs from which the Staff Draft would have resulted.
34. However, the first three alternatives do not address the issue of competitive harm or relevance to how management would choose to describe their business.



35. Alternatives 4 and 5 propose a separate view of by-nature information. This type of disaggregation may be achievable for some entities and therefore reduce the costs to present by-nature information. Alternatives 4 and 5 also may not create the same level of competitive harm that the Staff Draft or Alternatives 1-3 may create. However, there is question as to whether Alternative 4 would be useful or relevant to how management views the business. For the FASB proposal, these modifications would be disclosed by segment.
36. Alternative 6 provides additional decision useful information by presenting line items in the SCI across segments rather than presenting more detail about the components of the income and expense presented in the SCI. This alternative therefore requires disaggregation by function **or** by nature in the SCI, similar to how information is tracked by management today.
37. Most companies indicated that the type of information needed for Alternative 6 was available and that this type of segment information would be similar to how management views their business. Furthermore, users have expressed that this information would be useful for their analysis. However, some companies have stated that this level of disaggregation would result in competitive harm.

**Discussion questions—disaggregation**

1. Do the WG members think the IASB and FASB requirement for presenting disaggregated information about income and expenses should be the same? If so, should that information be in the segment note or in a separate note in a single column.
2. Do the WG members think the boards should retain the disaggregation guidance in the Staff Draft for income and expense items? If yes, why? If no, do you prefer any of the alternatives presented?

**Discussion questions—disaggregation (continued)**

3. The IASB does not want to address segment reporting until IFRS 8 comes up for post implementation review. However, users are unanimous in their desire for more segment information. Should the IASB consider changes to segment reporting in this project similar to the FASB?

## Appendix A (excerpt from Staff Draft)

### Disaggregating Income and Expense Items

**140. An entity shall disaggregate and present its income and expense items by function within each section and category in the statement of comprehensive income so that the information is useful in understanding the activities of the entity and in assessing the amount, timing, and uncertainty of future cash flows (see paragraph 0).**

141. Disaggregation by function may include disaggregating income and expense items into those generated by selling goods, research and development, manufacturing, marketing, business development, and administration. For an entity that engages in both manufacturing activities and providing services, disaggregation by function also may include disaggregating revenue and expenses between manufacturing and service activities.

**142. An entity shall disaggregate its income and expense items by their nature within the related functional grouping to the extent that the information is useful in assessing the amount, timing, and uncertainty of future cash flows. As described in paragraphs 0 and 0, income and expense items disaggregated by nature shall be presented in the statement of comprehensive income or disclosed in the notes.**

143. Disaggregation by nature within a functional grouping may include, for example, disaggregating total cost of sales into materials, labor, transportation, and energy costs. Disaggregation by nature within a functional grouping may also include, for example, disaggregating revenue from selling goods into wholesale and retail components.

**144. An entity with more than one reportable segment that provides a segment disclosure in accordance with Topic 280 shall disclose its income and expense items for each segment disaggregated by nature in its segment note. An entity shall determine on a segment-by-segment basis the by-nature information that is useful in understanding the activities of the entity and in assessing the amount, timing, and uncertainty of future cash flows. Consequently, the by-nature information disclosed in the segment note may differ across reportable segments. [FASB only]**

**145. To present that by-nature information in context, an entity shall present its by-nature income and expense items grouped by function in the segment note if it disaggregates its income and expense items by function in the statement of comprehensive income. [FASB only]**

146. An entity that does not provide a segment disclosure in accordance with Topic 280 (either because it has only one reportable segment or is otherwise exempt from that Topic) may disclose its income and expense items disaggregated by nature in the notes to financial statements rather than present that information in the statement of comprehensive income. An entity that discloses its information by nature in the notes shall present that information grouped by the same functions presented in the statement of comprehensive income. [FASB only]

#### IASB version

146. An entity may disclose its income and expense items disaggregated by nature in the notes to financial statements rather than present that information in the statement of comprehensive income. An entity that discloses its information by nature in the notes shall present that information grouped by the same functions as those presented in the statement of comprehensive income.

**147. An entity that disaggregates income and expense items both by function and by nature in a note shall, as a minimum, present its information by function in the statement of comprehensive income.**

**148. An entity may choose not to disaggregate its income and expense items by function if that disaggregation is not useful to users of financial statements in understanding the entity's activities and the amount, timing, and uncertainty of future cash flows. In those circumstances, an entity shall disaggregate its income and expense items by nature and present that information in the statement of comprehensive income.**

149. Disaggregation of income and expense items by function is useful in understanding the various activities required to convert an entity's resources into cash. Understanding those activities is particularly useful in assessing the amount, timing, and uncertainty of future cash flows for an entity that develops and produces tangible products. However, for entities that provide services rather than develop and produce tangible products, the conversion of resources into cash happens almost simultaneously. Therefore, for those entities disaggregation of income and expense items by function often does not provide any incremental information about the amount, timing, and uncertainty of future cash flows.

## Appendix B Excerpt from IAS 1

### Information to be presented in the statement of comprehensive income or in the notes

97 **When items of income or expense are material, an entity shall disclose their nature and amount separately.**

98 Circumstances that would give rise to the separate disclosure of items of income and expense include:

- (a) write-downs of inventories to net realisable value or of property, plant and equipment to recoverable amount, as well as reversals of such write-downs;
- (b) restructurings of the activities of an entity and reversals of any provisions for the costs of restructuring;
- (c) disposals of items of property, plant and equipment;
- (d) disposals of investments;
- (e) discontinued operations;
- (f) litigation settlements; and
- (g) other reversals of provisions.

99 **An entity shall present an analysis of expenses recognised in profit or loss using a classification based on either their nature or their function within the entity, whichever provides information that is reliable and more relevant.**

100 Entities are encouraged to present the analysis in paragraph 99 in the statement of comprehensive income or in the separate income statement (if presented).

101 Expenses are subclassified to highlight components of financial performance that may differ in terms of frequency, potential for gain or loss and predictability. This analysis is provided in one of two forms.

102 The first form of analysis is the ‘nature of expense’ method. An entity aggregates expenses within profit or loss according to their nature (for example, depreciation, purchases of materials, transport costs, employee benefits and advertising costs), and does not reallocate them among functions within the entity. This method may be simple to apply because no allocations of expenses to functional classifications are necessary. An example of a classification using the nature of expense method is as follows:

Revenue		X
Other income		X
Changes in inventories of finished goods and work in progress	X	
Raw materials and consumables used	X	
Employee benefits expense	X	
Depreciation and amortisation expense	X	
Other expenses	X	
Total expenses		(X)
Profit before tax		X

103 The second form of analysis is the ‘function of expense’ or ‘cost of sales’ method and classifies expenses according to their function as part of cost of sales or, for example, the costs of distribution or administrative activities. At a minimum, an entity discloses its cost of sales under this method separately from other expenses. This method can provide more relevant information to users than the classification of expenses by nature, but allocating costs to functions may require arbitrary allocations and involve considerable judgement. An example of a classification using the function of expense method is as follows:

Revenue		X
Cost of sales		(X)
Gross profit		X
Other income		X
Distribution costs		(X)
Administrative expenses		(X)
Other expenses		(X)
Profit before tax		X

## IASB/FASB Staff paper

- 104 An entity classifying expenses by function shall disclose additional information on the nature of expenses, including depreciation and amortisation expense and employee benefits expense.**
- 105 The choice between the function of expense method and the nature of expense method depends on historical and industry factors and the nature of the entity. Both methods provide an indication of those costs that might vary, directly or indirectly, with the level of sales or production of the entity. Because each method of presentation has merit for different types of entities, this Standard requires management to select the presentation that is reliable and more relevant. However, because information on the nature of expenses is useful in predicting future cash flows, additional disclosure is required when the function of expense classification is used. In paragraph 104, 'employee benefits' has the same meaning as in IAS 19.