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Project **Financial Statement Presentation**

Topic **Appendix A – Disaggregation of Income and Expense Items**

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## INTRODUCTION

1. This paper details what the staff learned in its outreach concerning disaggregation of the statement of comprehensive income (SCI) and includes alternatives for the guidance presented in the Staff Draft.

## 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
  - (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 SCI 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 disaggregation permitted for each reportable segment.
  - (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 SCI or disclose that information in a separate note.

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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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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 SCI. The FASB Staff Draft would require that information be disclosed by segment for a multi-segment entity.

## WHAT WE HEARD DURING OUTREACH ACTIVITIES

### Field Visit Input

5. Field visit companies are opposed to presenting information by function and further by nature for the following reasons (which are expanded on in paragraphs 6-14):
  - (a) System costs associated with 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 not currently possible. To modify systems and processes to compile these details would be extremely costly.
7. The companies explained these allocations in the following manner: An entity has different departments, such as information technology (IT) or real estate, that

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serve various functions and segments throughout the organization. The IT department has various natural expenses such as depreciation and labor, but does not pass on those costs individually to each segment or function that consumes the services of its department. Rather, they pass the cost on as a single amount called “IT cost.” Thus, the nature of that expense, as the Staff Draft defines it, is lost once it is allocated.

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 this information does not offer predictive value and is not consistent with the benchmarks they set within their organizations.
11. Many preparers said disaggregation of the information about assets, liabilities and cash flows in the segment note also presented problems. Since every company has a different structure for the stewardship over assets and liabilities, central treasury functions and/or shared service centers, these amounts would in many cases be meaningless and not comparable across entities.

### **Competitive Harm**

12. All of the U.S. companies were concerned that the proposed level of disaggregation in the segment note would result in competitive harm. They cited the following issues:

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- (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 such as SG&A might change even though total SG&A did not change.

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- (c) Financial service entity analysts noted that most financial companies currently present information by nature. 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 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). The baseline numbers for that cost is 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 of analysts 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
  - (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 and Other User Concerns**

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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. While supportive of more disaggregation, some constituents raised concerns that the proposals would result in too much detail on the face which would obscure the key messages. The constituents would be in favour of a principle that allows disaggregation to be disclosed in the notes.
24. 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.
25. The majority of 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).

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## Other Input Received During Outreach Activities

### Auditors

26. 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 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
  - (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.
27. 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.

### Financial Services Entity Issues

28. The majority of financial service entities present their income and expenses 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.

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29. 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.

## STAFF ANALYSIS AND POSSIBLE MODIFICATIONS

30. 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 utility of the "by-nature" breakdowns within each functional expense line item and all expressed concern about further disaggregation in the segment note.
31. Additionally, it would be very costly for many companies (especially large multinational entities) to provide by-nature/by-function information at the consolidated level (IASB) or the segment level (FASB).
32. The users of financial statements with whom we met 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.
33. 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 receiving 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



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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 SCI 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 SCI 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.

34. The first three alternatives retain some disaggregation of functional expenses by nature. For the FASB proposal, these modifications would be disclosed by segment.

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35. 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.
36. However, the first three alternatives do not address the issue of competitive harm or relevance to how management would choose to describe their business.
37. 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.
38. 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 expenses 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.
39. 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
40. The may ask the boards to consider modifying the requirements of the Staff Draft to provide disaggregation using alternative presentation and/or disclosure as detailed in paragraph 33. It may also ask the boards to consider modification to the definition of “nature” to make disaggregation by-function and by-nature more operational.

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41. The staff thinks that considering the modifications detailed in this appendix would be responsive to the cost concerns raised during the outreach period while still providing users with the benefits of disaggregated information.