

FASB | IASB Meeting**Project: Financial Performance Reporting****Paper Topic: Disaggregation of Functional Expenses and Internal View Approach to Disaggregation**

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Introduction

1. The purpose of this session is to update IASB members on the recent activities of the financial performance reporting (FPR) project, provide an update on recent outreach efforts, and receive feedback from the IASB on its current project activities.
2. The paper is structured into the following sections:
 - (a) Section 1: Background of the Project
 - (b) Section 2: Disaggregating Functional Expenses by Natural Components
 - (c) Section 3: Internal View Approach
 - (d) Section 4: Feedback Received – Internal View Approach.

Section 1: Background of the Project**Scope of the Project**

3. In September 2017, the Board¹ decided to add to its technical agenda a part of the performance reporting project that focused on disaggregation of performance information contained on the income statement. A separate part of the performance reporting project that focused on the structure of the

¹ Throughout this paper, the “Board” generally refers to the FASB.

income statement, including developing subtotals and totals, was retained on the Board's research agenda. The Board decided to prioritize its efforts on the disaggregation of performance information first, after which it would consider whether to conduct a project on structure, categories, and subtotals of the income statement. The Board reasoned that providing more disaggregated performance information may lessen the need to define certain subtotals, such as operating income.

4. After considering various disaggregation approaches, the Board decided to focus disaggregation on income statement expense lines, such as cost of sales (COGS) and selling, general, and administrative expenses (SG&A). The Board thought that because entities typically roll up internal information into those lines, then disaggregation of those lines would provide the most information for users. In fall of 2018, we conducted outreach on the operability of a requirement to disaggregate functional lines by natural components. The feedback received is discussed in Section 2.
5. Following outreach on disaggregation of functional expenses, the staff researched and analyzed an internal view approach to disaggregating expense information. This approach is discussed in Section 3 and Section 4.
6. This project is not seeking to address comparability between entities by defining the components of cost to be included in COGS and SG&A. The objective is to provide greater transparency of an entity through disaggregation.

History and Previous Standard-Setting Efforts

7. Over the years, FASB stakeholders have continually rated performance reporting as a high priority area in need of improvement. However, stakeholders' views on how it should be improved differed considerably.
8. The FASB and other accounting standard setters have undertaken many projects that, in some capacity, have focused on disaggregation of performance information and sought to structure the performance statement into categories and subtotal, such as operating income and financing income. We previously shared our disaggregation research proposals with the IASB in April of 2017.²
9. When deciding the project's scope, the Board sought to strike a balance between stakeholders' views and previous standard-setting efforts. It reasoned that disaggregation of COGS and SG&A lines may be the most viable of all the alternatives and could be prioritized in its future agenda. Undertaking structural changes to the income statement is important, although defining subtotals has been very difficult in previous efforts. Accordingly, the Board decided to retain this aspect on its research agenda and would return to this issue later.

² April 2017 IASB-FASB meeting: <https://www.ifrs.org/-/media/feature/meetings/2017/april/iasb/primary-financial-statements/ap28a-fpr-fasb-research-topic1.pdf>

10. We acknowledge that the scope of the IASB's primary financial statements project is much larger than the FASB's performance reporting project. We are interested in the IASB's efforts and plan to follow the development of the proposals and understand the feedback that the IASB receives.

Question for the IASB—Background

1. Do IASB members have questions or comments on the background of the FASB's FPR project?

Section 2: Disaggregating Functional Expenses by Natural Components

11. After deciding on the scope and adding the project to the technical agenda, the staff considered the Securities and Exchange Commission's (SEC) literature for commercial entities that requires presentation of COGS and SG&A. The staff leveraged the SEC guidance to help identify those lines to be disaggregated.
12. The staff also considered existing guidance in the not-for-profit (NFP) definition of natural expense classification³ in the *FASB Accounting Standards Codification*[®] Master Glossary.
13. The staff presented its terminology and working descriptions to the IASB in June of 2018,⁴ and provided a summary of the staff's initial deliberations for disaggregating COGS and SG&A lines, feedback received on the staff's working descriptions, and next steps.

2018 Field Visits

14. During the second half of 2018, the staff and Board members conducted field visits at a sample of companies to understand (a) how they aggregate their consolidated information into COGS and SG&A lines that are presented on the income statement and (b) how they internally analyze those lines.
15. The staff conducted outreach with seven public companies (including small and large, as well as older traditional companies and newer technology companies). In addition to public company feedback, the staff conducted private company outreach, including a discussion with the Private Company Council (PCC) and one private company. Finally, the staff met with a not-for-profit preparer who had adopted Accounting Standards Update No. 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profits*, to understand the challenges it faced when implementing the new requirements to disaggregate expenses by both function and nature.

³Natural Expense Classification

A method of grouping expenses according to the kinds of economic benefits received in incurring those expenses. Examples of natural expense classifications include salaries and wages, employee benefits, professional services, supplies, interest expense, rent, utilities, and depreciation.

⁴ June 2018 IASB-FASB meeting: <https://www.ifrs.org/-/media/feature/meetings/2018/june/iasb/ap21c-pfs.pdf>

16. The purpose of visiting with companies was to learn how natural and functional components of income and expenses are reflected in their accounting systems and processes and the degree to which the integrity of those components is retained as the information flows from individual general ledgers to the trial balance and consolidated statements during the consolidation process.

Challenges to Disaggregating Summarized Line Items

17. As expected, there were challenges that made disaggregation of summarized expense line items difficult and costly for almost all companies. The staff identified three main challenges related to disaggregating functional line items into their natural components. Those challenges are:
- (a) Consolidation Process and Variety of Accounting and Reporting Systems
 - (b) Allocations
 - (c) Acquisitions.

Consolidation Process and Variety of Accounting and Reporting Systems

18. During the consolidation process, local ledgers are combined to develop consolidated financial statements and other managerial reports at a company-wide level. The consolidation process takes information that is tracked in different ways across local ledgers and maps it into a centrally located general ledger or accounting data warehouse. This centralized general ledger database supports the production of internal and external financial reporting and/or a management reporting system.
19. Depending on how the consolidation process functions, it can challenge a company's ability to produce disaggregated summarized line item information for several reasons.
20. First, preparers stated that the consolidation process of local ledgers is designed to produce the income statement in accordance with current financial reporting requirements and focuses on developing correct functional line items—COGS and SG&A—rather than tracking the natural components that make up the summarized line items. Information from local ledgers might be mapped to the general ledger on a summarized basis rather than with its original natural identity. Therefore, the consolidation process is not designed to retain or track information on the natural identity of those costs. Natural component information can be lost while complex accounting systems feed the general ledger system. This is particularly true when, as several companies explained, management does not use disaggregated expense information when making decisions.
21. To disaggregate summarized expense information across an organization, a preparer would need either to (a) coordinate and track the necessary information, such as natural expense components, in all accounting systems in the same way or (b) map the detailed required information, in this case the natural expense components by functional line, from each local ledger to the centralized general ledger. When there are multiple accounting systems across one company (typically because of

different informational needs resulting from decentralized management), this can result in difficulty disaggregating summarized line items by natural component.

22. Second, the consolidation process may not be an automated process and may involve manual entries that complicate disaggregation of income statement expenses. Adjusting entries are required in the consolidation process and those entries frequently are made at a summarized level, such as eliminations and other consolidating entries. In those cases, the natural identity of expenses was not tracked to the consolidated general ledger.
23. When the consolidation process occurs using summarized financial information and does not track the natural components of expenses, it can prevent a company from providing disaggregated COGS and SG&A line items into natural components without potentially significant manual intervention and system redesign costs.

Allocations

24. The final challenging aspect of the consolidation process involves moving costs from one area of a company to another in a process called “allocations.” Allocations are used, for example, to transfer expenses to the part of the entity that benefits from the incurrence of such expense. This is common when certain activities are managed centrally. Allocations frequently complicate a company’s ability to disaggregate summarized line items because they are often made in a way that does not retain the identity of the underlying natural expense category. For example, a company may show an “Intercompany Transfer” item without denoting the underlying natural identities of the many costs within the lump sum transfer.
25. Overall, companies most consistently mentioned allocations as a major issue. No company had a solution for the problems posed by allocations.

Acquisitions

26. Acquisitive companies introduced additional challenges related to the increased number and variety of systems and the complexity of consolidation and allocation processes. When a company acquires another company, it acquires new accounting systems, a new local ledger to consolidate, and must determine how, if at all, to allocate costs to or from the new acquisition. These challenges are similar to those described in the previous section. However, these issues are intensified because of acquisitions.
27. Several companies described that if they decide to convert the acquired company to its accounting system/chart of accounts, it usually takes a minimum of one year to convert. During the transition period, companies must manually map accounts and transactions to its general ledger database, further obscuring the underlying natural components.

Mitigating Company Characteristics

28. For those companies that had the ability to disaggregate summarized line items by natural component, with minimal effort, there were several characteristics that respondents identified as essential to that ability. Those characteristics helped to mitigate the effects of the challenges identified above and eased the burden to provide disaggregated summarized line information.
29. Preparers identified the following mitigating characteristics:
 - (a) Centrally Managed Chart of Accounts
 - (b) Efficiency in Bringing Acquisitions on a Company's Platform.
30. While mitigating characteristics did not address all the challenges that companies faced, they led the staff to believe that, while costly, it would be possible for some firms to disaggregate functional line items by natural component. Not all companies displayed those characteristics.

Centrally Managed Chart of Accounts

31. Some companies explained that their chart of accounts is managed centrally, meaning that all divisions and lower-level systems use a consistent chart of accounts.
32. The staff found that managing the chart of accounts centrally allows a company to track information throughout the accounting system because all the transactions were consistently categorized, and this consistency may support the ability to disaggregate summarized line items. Additionally, the staff found that the consistent use of chart of accounts made it easier to consolidate different systems into the general ledger.

Efficiency in Bringing Acquisitions on a Company's System

33. The decision to bring a new acquisition onto a company's platform and the ability to do so efficiently increased the company's ability to disaggregate summarized line items into natural components.
34. Even when a company is committed to integrating acquisitions, the transition phase before an acquisition is fully integrated challenges its ability to disaggregate summarized line items by natural components. During transition, a company will map an acquisition's accounting system onto the company's general ledger and if this process is done at a summarized level, it inhibits the ability to disaggregate because the natural components of an acquisition's summarized lines are not tracked to the general ledger.

Internal Uses of Disaggregated Information

35. Preparers indicated a variety of uses of disaggregated expense information. There was consensus among respondents that management views performance information on a more disaggregated level than is presented on the income statement in the financial statements.

36. The availability of disaggregated expense information is driven by management style and needs, which varies across firms.

Staff Interpretation

37. Given the significance of the challenges identified, the staff presented potential alternatives to the Board. The Board decided to pursue two alternatives following an internal view approach to disaggregating performance information. These alternatives were largely built on the feedback related to internal uses of performance information during the 2018 field visits.

Question for the IASB—Disaggregation of Functional Lines by Natural Component

1. Do IASB members have questions on the 2018 field visits or the feedback received on the disaggregation of functional lines items by natural component?

Section 3: Internal View Approach

Background

38. Presently, we are pursuing two internal view alternatives—one alternative looks to disaggregate total consolidated expenses and the other focuses solely on the disaggregation of COGS and SG&A expense lines.
39. Some entities explained that they do not internally manage COGS and SG&A; instead, these firms focus on total expenses broken down by natural component. The two alternatives are meant to capture information on the operability of an internal view approach for entities that use disaggregated information about COGS and SG&A expense lines and entities that use a disaggregation of total consolidated expenses.
40. The Board intends to conduct outreach with preparers to understand any operability concerns related to the internal view approach and provide an understanding of the outcomes under both alternatives.
41. The issues related to an internal view approach include the following:
- (a) What Are the Advantages and Disadvantages of an Internal View Approach?
 - (b) Issue 1: Whose View Should Be Considered?
 - (c) Issue 2: What Expense Information, or Which Lines, Should Be Disaggregated?
 - (d) Issue 3: How Should Expense Information Be Disaggregated into Components?
 - (e) Issue 4: What Information Should Be Considered as Internally Viewed?

Advantages and Disadvantages of an Internal View Approach

42. The staff views the following advantages of an internal view approach:
- (a) First, the internal view approach would provide an additional layer of expense information that users are seeking. The resulting disaggregation of expense information could have better confirmatory value as users draw conclusions about an entity's past performance and better predictive value as users forecast future profitability. The information from an internal view approach would allow a user to perform more detailed historical trend analysis within an entity, which could be helpful in predicting future cash flows.
 - (b) The approach could help investors and other financial statement users develop more precise questions as they try to understand a business, such as whether a certain expense is variable or fixed, operating or nonoperating, recurring or nonrecurring, and regular or irregular without requiring the Board to define those terms. Users would have the information to ask these questions without the Board needing to define those concepts.
 - (c) The approach would allow financial statement users to see what expense information is used by management internally.
 - (d) The approach would be flexible enough to apply to many types of entities and management styles and would allow management to provide information that is relevant for its entity.
 - (e) By leveraging the disaggregated expense information currently used by management, the approach would minimize costs of developing system capabilities to disaggregate expense information by nature that were identified during the 2018 field visits. An internal view approach would rely on the expense information that systems currently produce for management's internal view of expense information, whether by nature or by function, department, geography, or other combination.
43. The staff views the following disadvantages of an internal view approach.
- (a) The internal view approach may lead to information that is not comparable across entities. While the information would be consistent over time for a given entity, the internal view would not lead to uniform disaggregation across entities because each entity may view its expenses in a different format.
 - (b) The expense information disclosed would depend on the structure of internal reporting to management.
 - (c) The internal view approach may result in competitive harm concerns from preparers because it could result in the disclosure of sensitive financial information. An internal view approach may require the disaggregation of significantly more expense information depending on an entity's management style; the approach might have a disparate effect on entities whose management style is more detail oriented compared with those who manage by exception or on a more summarized basis.

Issue 1: Whose View Should be Considered?

44. The internal view approach could require an entity to disaggregate income statement expense information on the basis of how it is viewed by management.
45. In order to disaggregate total consolidated expenses on an income statement for an entity, the internal view should identify the perspective of the individual or individuals who review or analyze the consolidated expenses of an entity as a whole. Specifying “consolidated expenses” should limit the individuals described as management to those who are focused on an entire entity’s performance. Most lower-level management, for example, department or segment managers, would review and analyze expense information for the areas of the entity for which they are responsible rather than expense information for the whole entity. Therefore, lower-level management should not be identified by the description of management.
46. Identifying management at an appropriate level will prevent the internal view from identifying a cumbersome number of individuals in an entity’s management structure or forcing the entity to consider every employee’s internal view of expense information in determining what amount of disaggregation to provide.
47. The staff considered adopting the guidance describing the chief operating decision maker⁵ (CODM) function as identified in Topic 280, Segment Reporting of the Codification, to describe management; however, as described, the function of CODM is not compatible with the internal view approach because it is focused on operating segments rather than consolidated expenses. The function of management as described by the internal view approach would apply to single-segment entities and private companies, whereas the CODM function is relevant only for public business companies with multiple operating segments. While the management function identified by the internal view approach is a different function than the CODM function identified by the management approach in Topic 280, the individual(s) identified by the term *management* may or may not be the same individuals identified in Topic 280 as the CODM for some public business companies.
48. In early outreach, the concept of management was a source of confusion. The staff has reconsidered this issue and is conducting outreach with the basis of the internal view focused around various purposes for disaggregated expense information. This issue is discussed further in Section 4.

Issue 2: What Expense Information, or Which Lines, Should Be Disaggregated?

49. The Board could focus the disaggregation requirement under an internal view approach in two ways:
 - (a) Alternative 1: Focus on Disaggregation of COGS and SG&A Expense Lines

⁵**280-10-50-5** The term *chief operating decision maker* identifies a function, not necessarily a manager with a specific title. That function is to allocate resources to assess the performance of the segments of a public entity. Often the chief operating decision maker of a public entity is its chief executive office or chief operating office, but it may be a group consisting of, for example, the public entity’s president, executive vice presidents, and others.

(b) Alternative 2: Focus on Disaggregation of Total Consolidated Expenses.

Alternative 1: Focus Disaggregation on COGS and SG&A Expense Lines

50. Alternative 1 would focus the disaggregation requirement only on COGS and SG&A expense lines presented on the income statement. An entity would be required to identify the line or lines that represent its COGS and SG&A expense lines and disaggregate those on the basis of the internal view approach.
51. Descriptions of cost of revenues line(s) and SGA line(s) were adapted from SEC Regulation S-X descriptions to help entities identify the desired lines for disaggregation on the income statement. They are intended to be broad enough to cover various entity-specific labels across industries, including real estate, service industries, and conglomerates.

52. Under this approach, multiple lines for the same entity could represent cost of revenues or selling, general, and administrative expenses and be identified for disaggregation. Currently, preparers determine the composition of COGS and SG&A expense lines through their internal accounting policies, which would not change under this alternative.

Alternative 2: Total Consolidated Expenses

53. Under Alternative 2, an entity would focus disaggregation efforts on total consolidated expenses. This means that entities would disaggregate total consolidated expenses on the basis of how they are viewed internally rather than only focus disaggregation requirements on COGS and SG&A expense lines presented on the income statement.
54. Some entities manage their business on the basis of consolidated natural expenses or some other way and do not view COGS and SG&A expense lines on a more disaggregated basis than is presented on the income statement. This alternative was developed to address those entities. The internally viewed natural components may not easily relate to COGS and SG&A expense lines on the income statement.

Issue 3: How Should Expense Information Be Disaggregated into Components?

55. An internal view approach would need to determine into what components the expense information should be disaggregated. The requirement could be a pure internal view based on exactly what management views or whether the requirement could allow for some aggregation.
56. The staff has three alternatives related to the expense components. They are:
- (a) Alternative 1: Disaggregate into All Internally Viewed Components
 - (b) Alternative 2: Disaggregate into All Internally Viewed Components with Aggregation Criteria
 - (c) Alternative 3: Disaggregate into Significant Components.

Alternative 1: Disaggregate into All Internally Viewed Components

57. The internal view approach could require that management present all the COGS and SG&A expense line components that are internally viewed. The components would be defined by management and would be based on whatever measurement model is used internally. Under Alternative 1, an entity would present exactly what is viewed internally without any aggregation or filtering. If management views many components, this could be a significant amount of information.

Alternative 2: Disaggregate into All Internally Viewed Components with Aggregation Criteria

58. To provide relief for entities that would have to disclose a large number of components, the internal view approach could specify some aggregation criteria. The aggregation criteria could be based on the principles in the Chapter 7, *Presentation*,⁶ of the FASB's Conceptual Framework or consider aggregation criteria (for example, a 10 percent aggregation threshold or a practical limit) similar to how Topic 280 has developed aggregation criteria.

Alternative 3: Disaggregate into Significant Components

59. Under Alternative 3, the internal view approach could require that entities disaggregate COGS and SG&A expense lines into the significant components that are viewed internally by management. Management would define which components are significant and measurement would be based on whatever model is used internally.

Issue 4: What Information Should Be Considered as Internally Viewed?

Information Sets

60. Because entities will utilize many types of information to manage its operations, and the information sets used and management style will vary across entities, the internal view approach could describe the types of information sets to consider when determining how expense information is disaggregated.
61. The internal view approach would encourage entities to focus on:
- (a) Periodic earnings and performance reporting packages, including monthly and quarterly reports
 - (b) Management reporting, including monthly and quarterly reports
 - (c) Budget reporting, including variance analysis and budget-to-actual reports
 - (d) Expense analysis supporting Management's Discussion and Analysis (MD&A) trend reporting.

Multiple Views

62. An entity might identify multiple internal views of expense information and would need to decide which view provides the basis for disaggregation.
63. For example, an entity might view COGS and SG&A expense lines disaggregated both by nature and by departments or subfunction. Of the available information sets, the entity would decide which view to provide as its internal view.

⁶https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176168366904&acceptedDisclaimer=true

Follow-On Issues

64. The internal view may have several follow-on issues including its relationship to MD&A trend analysis, the basis of internally viewed information, the location of disaggregated information between the face of the financial statements or notes, any restatement requirements and its interaction with segment reporting. The staff plans to discuss these issues with the Board later in the project.

Section 4: Feedback Received – Internal View Approach

65. Following the April 2019 Board meeting, the staff received feedback on the internal view approach, including feedback from the Private Company Council (PCC) and Small Business Advisory Committee (SBAC) among others.

Clarifying the “Management Function”

66. As mentioned above, early feedback indicated that the working description of a “management function” was confusing. The goal of the “management function” was to identify a function of management related to expense information, which would help identify a person that carries out that function and finally the information sets used by that individual that would determine the disaggregation of expense information.
67. Feedback indicated that respondents were confused by the term *function* in the description and focused on the types of people that use disaggregated expense information in an entity rather than the “function” that was description in the “management function.” As a result, the staff removed the description of the “management function” from the outreach materials. Instead, the staff focused on gathering information about the various purposes of disaggregated consolidated expense information in an entity.
68. The staff ultimately intends that the internal view approach would identify or describe a specific purpose related to disaggregated income statement information. This identified or described purpose would help an entity to identify a specific internally used information set to support that purpose, and that information set would determine the disaggregation of expense information reported.

Clarifying “Total Consolidated Expenses”

69. The staff realized that the description used in the outreach materials for “total consolidated expenses” was confusing. The staff replaced that phrase with “total income statement expenses (or a significant subtotal of income statement expenses)” to better communicate the alternative with respondents.

Other Feedback

70. Overall, throughout the 2019 internal view outreach preparers indicated that disaggregated consolidated expense information is available and used on a regular basis for multiple purposes in

their entities. SBAC members indicated that there are many different ways that disaggregated consolidated expenses are used within an entity. This is consistent with feedback received during the 2018 field visits.

71. Preparers expressed concern about the frequency of restatements that could result under an internal view approach. Preparers indicated that internally viewed information sets may change for several reasons. First, the information sets may change to capture new information related to changes in business needs or changes in the larger business environment. Additionally, SBAC members explained that the person who uses the information sets for the specified purpose may change or may request different disaggregated expense information to make decisions.
72. Many respondents expressed concern about the comparability of disaggregated expense information reported under an internal view approach between entities. While respondents acknowledged that this information might increase the trend information available within a single entity, they expressed that this information may not help with resource allocation decisions between various entities.
73. Various practitioners expressed concerns about the auditability of an internal view approach and focused on how they might grow comfortable with determining a single information set that is used to support a particular purpose as proposed under the internal view approach.

Question for the IASB—Internal View Approach Analysis and Feedback

1. Do IASB members have questions on the Board's current pursuit of the internal view approach or feedback received?