FASB FINANCIAL ACCOUNTING STANDARDS BOARD

MEMO	Memo No.	**IASB Agenda Paper 21C**
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Project	**Financial Performance Reporting (FPR)**
Project Stage	**Initial Deliberations**
Issue(s)	**Disaggregation of Performance Information**

Purpose of This Memo

1. The purpose of this session is to update IASB members on the project, explain why the FASB decided on the current scope, and to discuss the feedback received as part of the staff's initial deliberations.

2. This paper is structured into the following sections:

   (a) Scope of the Project

   (b) History and Background of the Project

   (c) Feedback on the Project's Starting Point

   (d) Issue 1: Describing COGS and SG&A for Disaggregation

   (e) Issue 2: Describing Natural Component

   (f) Issue 3: Other Terminology—Departments and Allocations.

Scope of the Project

3. In September 2017, the Board[1] decided to add to the technical agenda part of the performance reporting project that focused on *disaggregation of performance information*. A separate part of the performance reporting project that focused on the structure of the income statement, including developing subtotals and totals, was retained on the research agenda. The Board decided to prioritize its efforts on the disaggregation of performance information first, after which it would return to focus on the 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 (discussed in the next section of this paper), the Board decided to focus on providing a disaggregation of lines, such as cost of sales (COGS) and selling, general, and administrative expenses (SG&A). Entities roll up and map internal information into those lines; therefore, existing systems and processes are already in place, which makes this alternative more viable, and likely less costly, than other disaggregation approaches.

5. To be clear, the composition of COGS and SG&A lines differs across entities. This project is not seeking to address comparability between entities. The objective is to provide greater transparency of an entity through disaggregation.

History and Background of the Project

6. 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.

7. 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.

[1] Throughout this paper the "Board" generally refers to the FASB.

8. Some of the historical consultation documents include:

FASB (1979)	• Reporting Earnings Task Force – Discussion Memorandum • Analysis of Issues Related to Reporting Earnings
FASB (1981)	• Conceptual Framework – Exposure Draft • Reporting income, Cash Flows and Financial Position
AICPA (1994)	• Jenkins' Committee Report • Special Committee on Financial Reporting
FASB and G4+1 (1998)	• G4+1 – Special Report • Reporting Financial Performance
UK ASB (2000)	• Exposure Draft • Reporting Financial Performance
FASB and IASB (2008)	• Joint Project – Discussion Paper • Preliminary Views on Financial Statement Presentation
FASB and IASB (2010)	• Joint Project – Staff Draft of an Exposure Draft • Financial Statement Presentation

9. Various disaggregation approaches or dichotomies were considered in these consultations, for example, (a) fix and variable, (b) direct and indirect, (c) recurring and non-recurring, (d) frequent and infrequent, (e) disaggregating based on measurement method.

10. The Board reasoned that rather than simply developing another consultation document that ultimately may not be successful, this project should first identify, research, and vet the alternatives for viability. The Board also asked that the approaches be linked to the concepts in the Conceptual Framework.

Disaggregation of Performance Information

11. During the research phase, the staff presented the Board with a number of disaggregation alternatives. These included:

(a) Redefine infrequency of occurrence in Subtopic 225-20 and disaggregate infrequent items

(b) Define and separate remeasurements

(c) Disaggregate functional lines, such as COGS and SG&A, into natural components

(d) Require reporting of certain minimum lines and performance information

(e) Developing guidance on the aggregation process and the characteristics to consider when aggregating into lines

12. For each of these alternatives, the staff researched the previous standard-setting attempts and sought to develop proposals for how to approach those forms of disaggregations.

13. We previously shared our disaggregation research proposals with the IASB in April of 2017.[2]

14. To be clear, we do not view the disaggregation of performance information as strictly a presentation concern. Presentation and disclosure outcomes both have merits.[3] The research phase focused on identifying and developing the alternatives. The placement or display of the disaggregation would be a decision for the active deliberation phase of the project.

Structuring the Performance Statement

15. The staff also presented the Board with several alternatives to developing an operating performance category and requiring an operating income subtotal in the income statement. These included:

    (a) A definition of operating activities

    (b) A description of operating activities.

16. The Board, FASB staff, and many with whom we performed outreach observed that requiring and defining a measure of operating performance would be difficult for financial services, banking, insurance, and conglomerate entities.

17. These ideas were also shared with the IASB in April of 2017.[4]

2016 FASB Agenda Consultation

18. In August 2016, the FASB issued an Invitation to Comment (ITC), *Agenda Consultation.* That document comprised four chapters identifying potential major financial reporting areas in need of improvement. Chapter 4, "Reporting Performance and Cash Flows," considered issues related to both disaggregating performance information and structure. The Board wanted to understand how important this topic was to stakeholders and how extensive any standard-setting project should be.

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[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

[3] In this paper, *presentation* means that the performance information appears as a line on the income statement. *Disclosure* means that the performance information appears in the notes or other locations.

[4] April 2017 IASB-FASB meeting: https://www.ifrs.org/-/media/feature/meetings/2017/april/iasb/primary-financial-statements/ap28b-fpr_fasb-research-topic2.pdf

Disaggregation of Performance information

19. The ITC discussed a number of potential standard-setting alternatives that focused on the disaggregation of performance information. These included (a) redefine the GAAP definition of *infrequency of occurrence* to apply a more conventional understanding of this term, (b) defining and disclosing remeasurements, and (c) disaggregating functional lines into natural components.

20. Many stakeholders commented that performance reporting is a priority area and recommended that improving the disaggregation of performance information should be a priority in the FASB's future agenda. Most of those stakeholders supported efforts to provide greater granularity in either a presentation or disclosure setting. However, they acknowledged that there were limitations in all the disaggregation alternatives discussed in the ITC. Several respondents supported more than one disaggregation alternative and advocated that the FASB could implement one or more alternatives to provide even greater granularity of information. Nevertheless, there was broad support for standardizing some aspects of disaggregation.

21. In contrast, a few respondents did not consider performance reporting or disaggregation a major area that needs improvement. Those with this view commented that users already have sufficient information to make informed decisions and the alternatives would not improve the way information is reported. Those respondents also expressed concerns about the cost and complexity of requiring more disaggregation of performance information through presentation or disclosure.

22. Most members of the FASB's Financial Accounting Standards Advisory Council and other advisory groups supported efforts to disaggregate performance information. Some suggested there is a broad need for more granularity and specificity on how preparers should provide performance information. Others, however, suggested that the FASB should focus on targeted improvements to the income statement because entities tend to self-regulate the level of disaggregation by industry.

23. Very few stakeholders mentioned the type of technical project that should address this issue. Most respondents were silent on whether disaggregation should be addressed as a separate project or as part of a broader, holistic project that considers both disaggregation and the structure of the performance statement.

Structure of the Performance Statement

24. The ITC also discussed several ways to structure the income statement into operating and nonoperating activities categories. These included (a) describing, not defining, operating activities, and allow for management to determine its composition through an accounting policy, (b) defining operating activities and provide detailed descriptions and examples, and (c) describe or define the composition of nonoperating activities. The ITC also asked whether the improvements to the

structure of the income statement should be holistic and aligned to a similar structure in the cash flow statement or focused only on the income statement.

25. *Holistic structural improvements to the performance statement*—Some respondents preferred to holistically recalibrate the structure of the performance statement. Those stakeholders believed that there should be various required categories and subtotals. Reasons for this view include:

  (a) An articulated set of principles underlying the structure and subtotals presented in the performance statement would be beneficial and currently is lacking in GAAP.

  (b) A structured statement would improve understandability across statements and lessen the need to resort to non-GAAP measures.

  (c) If structured, it could lead to the harmonization of the operating activities category with the cash flow statement.

26. These stakeholders appear to desire an overarching philosophy for organizing the performance statement that potentially aligns to the structure of the cash flow statement. If a full alignment is unachievable, many supported at least aligning operating activities between those two statements.

27. *Focused structural improvements only to the income statement*—Other respondents preferred that the FASB focus on one or two major areas of the income statement, but there was little desire to restructure the entire performance statement. These stakeholders believe that it is the income statement that is most in need of improvement.

28. *Do not standardize the structure of the income statement*—Some comment letter respondents did not support imposing a structure on the performance statement. Despite the conceptual shortcomings, the voluntary system of presenting a measure of operating performance is accepted in practice and users can analyze financial statements. A single model that describes operating activities or requires a standardized structure will add significant complexity. Previous standard-setting efforts have been unsuccessful. A holistic or focused project that defines *operating activities* across both the performance statement and cash flow statement is likely to have substantial resistance from many parties.

Interpreting This Feedback

29. When deciding the project's scope, the Board sought to strike a balance between stakeholders' views, yet was mindful of 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.

IASB's Primary Financial Statements Project

30. We understand that the IASB is exploring the following aspects in its project:

    (a) Disaggregation / Aggregation

    (b) Structure and subtotals

    (c) Alignment changes to other statements.

31. 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 to follow the development of the proposals and understand the feedback the IASB receives.

Feedback on the Project's Starting Point

32. After deciding on the scope and adding the project to the active agenda, the Board discussed how the project should approach disaggregating COGS and SG&A. The Board directed the staff to start with the Securities and Exchange Commission's (SEC) literature for commercial entities that requires presentation of COGS and SG&A to identify those lines that are to be the focus of the disaggregation. The Board reasoned that entities often describe COGS and SG&A in a way that is consistent with the SEC's regulations.

33. The approach also would need to describe the bases on which COGS and SG&A lines should be disaggregated. The Board directed the staff to focus on a disaggregation into natural components and suggested starting with the existing not-for profit (NFP) definition of *natural expense classification* in the Master Glossary.

34. The staff then developed terminology and working descriptions. We shared those ideas with our project resource group (PRG), which was assembled to assist us in providing feedback on this project. However, a number of PRG members queried whether a focus on COGS and SG&A was the ideal starting point.

Feedback from PRG members

35. Many users on the PRG supported the starting point of the project. They emphasized that a breakdown of COGS and SG&A would be useful because it would help develop more exacting questions as they try to understand a business. They acknowledged that the natural information may not be comparable across entities but providing this information would allow for a better understanding of how an entity is changing over time. This information may allow users to have a better ability to compare COGS and SG&A in one entity with another because they will have more insight into the line's composition.

36. Many users stressed that they need to be able to understand nonrecurring items and determine fixed versus variable costs. Some said they believe that natural information would help them determine those classifications. Other users on the PRG said they would prefer it if the Board approached the project from a different angle. One of the academic users specifically commented that this project should focus on aggregation, rather than disaggregation, that is how do expense items get combined into lines that are presented on the income statement.

37. Multiple users recommended that the Board approach the project by defining the composition of COGS and SG&A, because that would enhance comparability. Users also suggested that the project go further and define other certain investor related metrics, such as *recurring, nonrecurring,* and *operating*.

Preparers

38. Multiple preparers on the PRG questioned the starting point of the project; specifically, whether users would find a breakout of COGS and SG&A to be useful. Preparers also said that much of the information investors want is already in the MD&A section of the annual report. Preparers also stated that it would be useful to have some sort of profit measure defined, such as operating activities. They requested that the staff perform outreach with users to determine what type of additional information they were seeking in the context of this project.

Interpreting the PRG's Feedback

39. As noted above, before being added to the active agenda, this project had been on the research agenda for multiple years. The staff researched different ways in which the Board could improve the disaggregation of performance information. The Board considered all of these alternatives. The Board decided to focus on disaggregating COGS and SG&A because it thought this approach was the most viable of all the alternatives.

40. The staff also researched different ways in which the Board could create a category for operating performance and present an operating income subtotal. The Board decided that improving the structure of the performance statement is an important issue; however, it wanted to devote resources to improving disaggregation and would return to the issue of structure later.

41. The staff thinks that there is no new information or new view points on this matter. Users and preparers in the PRG have different opinions on where the project should concentrate its efforts. This has been a common issue in most previous standard-setting efforts and also is consistent with feedback from the 2016 ITC.

Feedback from FASB members

42. At the March 2018 meeting, the Board discussed the PRG's feedback and decided to continue to focus on a disaggregation of COGS and SG&A lines.

Question for the IASB
1. Do IASB members have questions on the scope of the project?

43. The remaining sections of this paper discuss the staff's initial deliberations for disaggregating COGS and SG&A lines, feedback received on the staff's working descriptions, and next steps.

Issue 1: Describing COGS and SG&A for Disaggregation

44. The project needs to describe what is a COGS line in a way that will capture the nuances in entity-specific labels. A 2010 study performed by the American Institute of Certified Public Accountants (AICPA),[5] summarized the common captions used in practice as follows:

	2009	**2008**	**2007**	**2006**
Single Caption				
Cost of Sales	175	170	215	219
Cost of Goods Sold	78	80	94	92
Cost of Products Sold	51	50	66	72
Cost of Revenues	32	30	43	38
Elements of Cost	13	11	15	11
Other Captions	80	79	74	79
Subtotal	**429**	**420**	**507**	**511**
Multiple Captions	71	80	93	89
Grand Total	**500**	**500**	**600**	**600**
% Using Multiple Captions	***14%***	***16%***	***16%***	***15%***

[5] 2010 AICPA Accounting Trends & Techniques, *Presenting and Analyzing Financial Reporting Practices*, paragraph 3.35, Table 3-5.

45. Article 5 of the SEC's Regulation S-X applies to commercial and industrial entities and is the default category. Banks and insurance companies that follow Article 9 and Article 7 of Regulation S-X are not currently part of this effort.

46. Rules 5-03(b)1 and (b)2 of Regulation S-X require the following information to be presented in respect of revenue and COGS:

> (b) If income is derived from more than one of the subcaptions described under §210.5-03.1, each class which is not more than 10 percent of the sum of the items may be combined with another class. If these items are combined, related costs and expenses as described under §210.5-03.2 shall be combined in the same manner.
>
> 1. *Net sales and gross revenues*. State Separately:
>
> (a) Net sales of tangible products (gross sales less discounts, returns and allowances), (b) operating revenues of public utilities or others; (c) income from rentals; (d) revenues from services; and (e) other revenues….
>
> 2. *Costs and expenses applicable to sales and revenues.*
>
> State separately the amount of (a) cost of tangible goods sold, (b) operating expenses of public utilities or others, (c) expenses applicable to rental income, (d) cost of services, and (e) expenses applicable to other revenues. Merchandising organizations, both wholesale and retail, may include occupancy and buying costs under caption 2(a). Amounts of costs and expenses incurred from transactions with related parties shall be disclosed as required under §210.4-08(k).

47. The staff intends for all cost of revenue lines to be within scope of the disaggregation. That is, lines that represent the cost of tangible goods sold, cost of services, and expenses applicable to rental income would require disaggregation, even if an entity presents multiple lines.

Working Description for COGS

48. The staff developed the following a working description of what is a COGS line using the same examples as the Regulation S-X requirements and intended for the working description to be broad enough to cover the different entity-specific labels across industries, including real estate, service industries, and conglomerates.

> ***Cost of Sales Line(s):*** *Caption(s) and amount(s) that represent the cost of revenue. Such lines and similar terms would include (a) cost of tangible goods sold, (b) operating expenses of utility companies, (c) expenses applicable to rental income, (d) cost of services, and (e) expenses applicable to other revenues*

Feedback from PRG members

49. A few PRG members were confused about whether the staff was trying to define the composition of COGS and SG&A or to permit a self-defined approach. The intention of the working description is to identify the lines currently presented by the entity, not define the line's composition.

Users

50. Users on the PRG generally found the description of cost of sales to be straight forward and easy to apply because entities are already doing it for SEC purposes. One user suggested specifically linking the staff's description to the SEC's literature. Multiple users noted that the SEC's literature seemed out of date and queried whether it would be better if the project were to describe cost of sales independently from Regulation S-X. Another suggested using generic language, such as the cost of providing products and services.

51. One user noted that it may be unclear how the description would apply for a conglomerate with a financing arm. This also was mentioned by preparers.

Preparers

52. Preparers on the PRG also found the description of cost of sales understandable and supported leveraging the SEC's guidance. Some preparers suggested that the staff go even further and cross reference the SEC's guidance in the working descriptions. Multiple preparers also questioned whether the SEC description was outdated and queried its fitness for business models involving licensing, cloud computing, and other services. One preparer suggested that the objective of the project should be updating the SEC's definitions. The application to conglomerates with finance arms also was questioned. For example, one preparer queried whether the cost of finance income line would be captured by the working description. A few preparers questioned why only utility companies were specifically identified

53. A number of preparers suggested that the term *direct costs* be used in the FASB's working descriptions.

Interpreting the PRG's Feedback

54. The staff acknowledges that there are several issues outstanding at this time. First, whether conglomerates with a financing arms would form part of the disaggregation. For example, whether cost of finance income forms part of the project.

55. Second, the staff understands that real estate investment trusts may have some difficulty applying the working description. The staff decided to add language to clarify that it is not defining what should be in COGS, but acknowledged that preparers determine the composition of COGS lines through their internal accounting policy.

56. Accordingly, the staff revised the working description as follows:

> ***Cost of Sales Line(s)*****:** *Caption(s) and amount(s) that represent the cost of revenue. Such lines and similar terms would include (a) cost of tangible goods sold, (b) operating expenses of utility companies, (c) expenses applicable to rental income, (d) cost of services, and (e) expenses applicable to other revenues. For public entities, it is the line or lines that are presented in compliance with Rule 5-03(b)2 of Regulation S-X. An entity determines the composition of its cost of sales line(s).*

Selling, General, and Administrative Expenses

57. In the staff's research of public and private company financial statements, it observed that entities commonly present information about SG&A in a variety of ways. These include a single caption and amount for SG&A expenses, or separate caption and line for selling expense and another line for general and administrative expenses.

58. The 2010 study by the AICPA summarized the common SG&A captions used in practice as follows:

	2009	2008	2007	2006
Single Caption				
Selling, general, and administrative	300	298	347	348
Selling and administrative	70	70	96	107
General and/or administrative	98	94	122	109
Selling	40	33	44	39
Grand Total	**508**	**495**	**609**	**511**
Total Entities	**500**	**500**	**600**	**600**

59. In a review of public company financial statements, some companies present the line for "sales and marketing" and then additionally present a line for "general and administrative expenses." Some companies present a separate marketing expense line (not a "sales and marketing expense" line).

60. Rule 5-03(b)4 of Regulation S-X requires the presentation of the following line for commercial and industrial companies:

> 4. *Selling, general and administrative expenses.*

61. There is no additional guidance about the composition or description of this line.

Working Description for SG&A

62. The staff initially developed the following working description:

> ***Selling, General and Administrative Line(s)*****:** *Caption(s) and amount(s) that represent the entity's selling, general, and administrative expenses. Such lines include (a) selling expenses, (b) general and administrative expenses, or (c) some other combination of these expenses or similar terminology, such as sales or marketing.*

Feedback from PRG members

Users

63. Users on the PRG found the working description to be straight forward. Some users were confused why only marketing was singled out as being a part of SG&A. Even though it is a current disclosure requirement, another user suggested requiring research and development to be presented as a line. Multiple users commented that separating selling expenses from SG&A would be useful.

Preparers

64. Preparers of the PRG found the working description understandable. They also questioned the specific identification of marketing expenses and suggested that the staff consider defining *marketing expense* as well as adding other common types of expenses to the working description. Some preparers also argued that breaking apart selling expenses from SG&A would cause competitive harm.

65. One preparer noted that if research and development expense (R&D) is included in SG&A, when disaggregating SG&A, users would be unable to observe what natural expenses specifically relate to R&D; rather, it would report the natural components of the whole line. These preparers seemed to query the value of entity-wide natural components and preferred departmental natural components.

66. The staff heard a variety of views on whether marketing is similar to a selling expense. Some preparers agreed with the staff's interpretation that marketing expense is similar to a selling expense whereas others view it as distinct.

67. One auditor on the PRG also said that if the Board wants to specifically call out marketing, then it would need to be defined. In discussion with one firm, representatives noted that the Board may need to clarify which items should be included in SG&A, as the staff had done for marketing.

Interpreting the PRG's Feedback

68. After discussion with the PRG, the staff understands that whether marketing is a part of selling expense may depend on a how a company looks at marketing expense. It was not the staff's intent

to define what marketing is. The staff considered this when it revised the working description. The staff also added language to link the description to Regulation S-X. The proposed description is as follows:

> ***Selling, General, and Administrative Line(s):*** *Caption(s) and amount(s) that represent selling, general, and administrative expenses. Such lines include (a) selling expenses, such as sales and marketing expense, (b) general and administrative expenses, or (c) similar terminology. For public entities, it is the line or lines that are presented in compliance with Rule 5-03(b)4 of Regulation S-X.*
>
> *An entity determines the composition of its selling, general, and administrative line(s).*

Feedback from FASB members

69. The purpose of developing working descriptions of COGS and SG&A is to identify those lines that are the focus of the disaggregation. Board members discussed that tying the descriptions to the SEC's specific literature can cause some challenges about the suitability of the literature to new types of business activities. Accordingly, at the March meeting, the Board directed the staff to develop a principles-based approach to describing these lines, for example describing COGS and SG&A as the lines on the income statement that represent the following activities:

(a) Activities associated with the cost of revenue or fulfillment of performance obligations

(b) Activities associated with marketing, selling, and general and administrative expenses.

Question for the IASB
2. Do IASB members have questions or observations on how the FASB staff is attempting to describe what are COGS and SG&A lines?

Issue 2: Describing Natural Components

70. The project will need to describe how COGS and SG&A lines should be disaggregated. The Board directed the staff to focus on a disaggregation into natural components. This memo does not attempt to describe at what level the natural items within COGS and SG&A should be disaggregated.

71. At the December meeting, the Board directed the staff to start with the existing NFP definition of *natural expense classification* in the Master Glossary, which is stated as follows:

> ***Natural 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.*

Working Description for Natural Components

72. One concern the staff has with the current NFP definition is that it only addresses *expenses*. It does not include the gains, losses, and other income items that are often included within COGS and SG&A.

73. If the project was to directly incorporate the NFP definition, only expenses would be disaggregated out of COGS and SG&A. The staff thinks this is too narrow. In the end, the staff decided to add the following statement that includes the other performance elements:

> ***Natural Component:*** *A grouping of expenses according to the kinds of economic benefits received in incurring those expenses. For purposes of displaying natural components, this description also includes gains, losses, and certain income items that may be combined within COGS or SG&A, for example, foreign exchange gain or loss, impairment loss, and building insurance recovery income.*
>
> *Examples of natural components within a cost of revenue line include cost of products sold, inventory losses, salaries, wages and employee benefits, occupancy, utilities, shipping and handling, and depreciation and amortization*

Feedback from PRG members

Users

74. Users on the PRG generally supported a disaggregation into natural components. Multiple users said that disaggregating COGS and SG&A lines even one level down into natural components would be helpful. One user noted that the working description is inherently subjective because companies may define natural components differently. However, that user noted that even a noncomparable display of the natural components would be helpful.

75. Multiple users questioned the term *economic benefits* and found it to be subjective. For example, one user argued that employee wages and outsourcing derive the same economic benefit and group them together, even though it would be useful for an investor to have those reported separately. He went on to express that every extra piece of information is useful in forecasting and benchmarking.

Preparers

76. Preparers on the PRG questioned whether natural information would be useful to users. One preparer noted that reporting wages only one level down may not be useful because, for example, wage growth in Indonesia is different from wages in New York City.

77. Multiple preparers suggested that the staff consider basing the disaggregation using a management approach, similar to segment reporting. However, others argued that this information would not be comparable across companies. One preparer stated that although the management view seems to conflict with comparability, the two concepts actually work together. That is because the way

managements look at their respective companies is often similar within an industry, and each industry often has common expense drivers. They emphasized that a management view together with materiality thresholds would be very powerful.

78. In contrast, one preparer observed that management does not review SG&A and COGS on a disaggregated basis into natural components. Management may review fragments of the natural components or may review information based on departments. Therefore, if there was to be a disclosure of natural components, it would not tie into the consolidated SG&A or COGS lines.

79. Multiple preparers also noted that even though many companies have global accounting systems, pulling together all of their natural components could be difficult. That is because there is diversity in how to classify items across subsidiaries and departments within an entity. Also, subsidiaries within a consolidated group often look at natural components differently so there may not be comparability within a group.

80. Another preparer noted that the list of examples in the working description is helpful, but it may result in preparers potentially giving more weight to certain items when they should instead be breaking out their most significant items. They also supported disaggregating natural components because it would help them see how their competitors are managing their companies.

81. Many preparers also expressed confusion with the term *economic benefits* because it is unclear how an impairment loss or a foreign exchange loss is a grouping of items according to the "economic benefits" received. Auditors on the PRG also suggested using a different term than *economic benefits.* One auditor suggested changing the language to *goods and services acquired.*

Interpreting the PRG's Feedback

82. As a result of the feedback, the staff revised the working description to help clarify the confusion brought on by using the wording *economic benefits* and also clarified the inclusion of gains and losses:

> ***Natural Component:*** *A grouping of expenses, gains, losses, or income according to the kinds of goods or services received by the entity, such as employee benefits, or according to a similar source or event that results in the item's recognition, such as depreciation and impairment loss.*
>
> *Examples of natural components that could be within a cost of revenue line include the cost of products sold, inventory losses, salaries, wages and employee benefits, occupancy, insurance, utilities, shipping and handling, depreciation and amortization, and certain foreign exchange losses.*

Feedback from FASB members

83. At the March Board meeting, FASB members discussed different approaches for describing the basis for disaggregating COGS and SG&A lines. Some questioned whether a description of *natural component* was needed. Several Board members suggested basing the disaggregation on the way an entity internally reviews the components or the accounting system information that maps and allocates the components into those lines.

84. Requiring the disaggregation to be based on natural components means deciding on whether allocations and departmental information also should be broken into natural components (discussed in the next section). If users are seeking information about COGS and SG&A one level down, then perhaps a more cost-effective approach should consider the existing systems and processes that preparers already have in place that roll up and map consolidated information into those lines.

Issue 3: Other Terminology—Departments and Allocations

85. In previous standard-setting attempts, it has been explained that in a simple business an entity will often manage and track its costs naturally. However, once an entity grows, it often chooses to track some costs departmentally. It has been explained that entities tend to monitor and track some costs departmentally once the organization grows to a point where a centralization of activities is more economical for the entity as a whole.

86. A department may include, for example, IT, legal, treasury, human resources, research and development, and production and manufacturing. An entity may choose to present information departmentally, such as research and development expense.

Allocations

87. Allocations are one of the most challenging aspects to disaggregating COGS and SG&A into natural components. In previous standard-setting attempts, this issue was not addressed and was an area for which respondents had several questions and concerns about the Board's intent. Before the PRG feedback, the staff understood there to be at least three types of allocation phenomena:

    (a) Recognized natural items that are allocated and capitalized into the cost of an asset (capitalized costs)

    (b) Recognized natural items that are allocated to departments (departmental allocations)

    (c) Recognized natural items that are allocated, estimated, and charged to a line (variances).

Allocations and Capitalized Costs

88. Based on previous standard-setting efforts, the staff thinks that it would be helpful to describe what is meant by *allocations* and *cost capitalization* and suggests the following working description:

> ***Capitalized Costs:*** *An allocation of direct or estimated natural or departmental costs that are included in the measurement of an asset. For example, an allocation of employee benefits, salaries and wages and borrowing costs that are attributed to the cost of constructing a long-lived asset.*

89. If the Board decides to disaggregate COGS and SG&A into natural components, it would need to decide if, and how, the capitalized costs that eventually flow through to the income statement would be disaggregated into natural items.

Departmental Allocations

90. In large multinational corporations, it is common to internally allocate shared costs, such as legal, HR, and IT expenses, to various departments throughout the organizational structure. However, many accounting systems do not track the original nature of these expenses once they have been allocated.

91. Assume that an entity has a legal department that provides legal services to the research and development department, marketing department, in-house real estate team, HR group, and the board of directors. The legal department's expenses include (a) salaries of its legal employees, (b) allocation of occupancy costs, and (c) allocation of overhead costs and depreciation. When legal services are provided to other departments within the organization, the legal department's expenses are allocated to those departments on a systematic basis under a single amount called "legal cost."

92. The IT department may provide services to the legal department for a specific IT support system and recharge some of its expenses under a single amount called "IT cost." In other words, the original natural expenses of salaries, occupancy, and depreciation get lost after they have been allocated and recharged to other departments. In previous standard-setting efforts, preparers were uncertain how to disaggregate COGS into natural components when significant allocations occur throughout the organization.

93. The staff suggests the following working description for this type of allocation:

> ***Departmental Allocations:*** *The allocation of natural costs to a department. For example, an allocation of employee benefits, salaries and wages, depreciation, and occupancy to the research and development department. Departmental allocations also can include the apportionment of one department's costs to another department. For example, an allocation of the costs of a legal department to the research and development department.*

Allocations and Variances

94. As part of inventory standard costing, estimates are often made for expected costs or rebates and form part of the inventory unit cost. For example, an entity may estimate an expected supplier rebate that forms part of the unit cost. The supplier rebate is based on annual volume purchases. The expected supplier rebate is updated for the actual rebate. The difference is a variance that is then allocated between the COGS line and the inventory assets.

95. The staff suggests the following working description for this type of allocation:

> ***Variances:*** *The allocation of an updated estimate to COGS or SG&A. For example, the allocation of an amount recognized in the income statement that represents an updated estimate for items, such as a supplier rebate, derivative gains or losses, import costs, and manufacturing and labor costs between COGS, SG&A, and inventory or other assets.*

96. Again, if the Board is to disaggregate COGS and SG&A into natural components, it would need to decide if, and how, the variances that are allocated directly to the income statement and the variances that eventually flow through to the income statement when the asset is derecognized would be disaggregated into natural components.

Feedback from PRG members

Users

97. The staff heard a number of different views from users on the usefulness of allocations. Some users on the PRG supported breaking apart the allocation into natural components to understand the constituent parts, others supported understanding the amount attributed to allocations on the whole. Finally, some users' views differed depending on the allocation. One user emphasized that he would find it frustrating if preparers reported allocations instead of natural components. Another user said knowing departmental allocations within SG&A and COGS would help show a company's inefficiencies. Knowing those amounts would be useful for adjusting COGS for better forecasting and would help investors understand management's point of view about how much costs should be allocated to each department.

98. One academic user commented that he does not support disaggregating the allocations that are capitalized into the cost of an asset and views disaggregation of variances as unnecessary. However, departmental allocations are more difficult. He offered no solutions but recognized that this would be a significant impediment to the project.

Preparers

99. Most preparers on the PRG expressed the desire for the Board not to break apart allocations. Its usefulness was questioned and its complexity emphasized. Preparers also explained that the more costs move across the business, the more difficult it becomes to obtain the natural information. The cost center receiving the allocation usually does not know the natural identify of the allocated items. One company suggested that, instead, the staff explore requiring a disclosure on how allocations are done at the company.

100. One company explained the different types of allocation phenomena that occur in its business and referred, in particular, to cost of revenue allocations. The company also explained that allocations also occur in other ways: (a) costs allocated to segments and (b) costs allocated to legal subsidiaries. In those instances, there are "nested allocations." For example, stock compensation may be allocated to the IT department. The IT department allocates its costs to the real estate department, who in turn allocates some of its costs to different segments or to legal subsidiaries. The natural information loses its identity.

Interpreting the PRG's Feedback

101. Most of the feedback on allocations did not critique the staff's working descriptions; rather, preparers emphasized the complexity of allocations and how difficult they would be to break apart. Users provided mixed feedback on the usefulness of breaking apart allocations.

102. The staff learned that there are additional types of allocation phenomena that had not been considered. We developed the following additional descriptions of these allocation phenomena:

> ***Product and Service Cost Allocations*****:** *The allocation of costs related to revenue to one or more cost of revenue lines. For example, a hotel may allocate depreciation, maintenance, insurance, employee costs, occupancy, and utilities between the cost of food and beverages sold in the hotel restaurant and the cost of services to provide accommodation services.*
>
> ***Legal Subsidiary Allocations*****:** *The allocation of natural or departmental costs to a legal subsidiary of a parent entity. For example, an allocation of the costs of a research and development department in the United States to the legal subsidiaries in Canada, Australia, and the United Kingdom.*
>
> ***Segment Allocations*****:** *The allocation of costs to a segment. For example, an allocation of employee benefits, depreciation, and occupancy to a reportable segment. Segment allocations also can include the apportionment of departmental costs to a reportable segment, for example, an allocation of the costs of a legal department to a reportable segment.*

Feedback from FASB members

103. As noted above, requiring the disaggregation of COGS and SG&A to be based on natural components means deciding on whether allocations and departmental information should also be broken into natural components. Some FASB members questioned whether perhaps a more cost-effective approach would be to consider the existing systems and processes that preparers already have in place that roll up and map consolidated information into those lines. This would be in lieu of needing to decide whether each type of allocation and departmental expenses are broken apart.

104. Accordingly, the Board directed the staff to perform additional outreach with public business entities to understand (a) if, and how, an entity reviews the components of COGS and SG&A lines for internal reporting purposes, (b) on what level the accounting information systems track the components, and (c) how the components are rolled up into consolidated lines.

Question for the IASB
3. Do IASB members have questions or observations on allocations and departmental expenses?