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Primary Financial Statements

Guidance on aggregation and disaggregation

Objective

- 1 The objective of this agenda paper is to discuss aspects that could be explored by the IASB to improve the analysis of expenses by function and by nature and the level of aggregation and disaggregation of line items in the primary financial statements and in the notes.

Presentation by function and by nature

Criteria for presentation of expenses by function and by nature

- 2 Paragraph 99 of IAS 1 states that expenses recognised in profit or loss should be analysed either by nature (raw materials, staffing costs, depreciation, etc.) or by function (cost of sales, selling, administrative, etc.).
- 3 The IASB Staff research and outreach activities indicated that preparers and users find both methodologies useful and the entity's business activities appear to play an important role in choosing between the methodologies. However, in their review of a sample of financial statements, the IASB Staff could not find the reasons why a particular methodology was considered useful for particular entities.
- 4 In September 2017 the IASB discussed whether it should retain the choice between the by-function and by-nature methods for presenting an analysis of expenses and tentatively decided to continue to require an entity to provide an analysis of expenses using the methodology that provides the most useful information to users.
- 5 To add more discipline to how entities make their choice of methodology and how that choice is applied, the IASB tentatively decided to develop criteria for entities to assess whether the by-function or by-nature methodology provides the most useful information to users. One of those criteria would be that a function of expense analysis would not be appropriate if an entity is unable to allocate natural components to the functions presented on a consistent and non-arbitrary basis.
- 6 For the April 2018 ASAF meeting, the IASB staff suggests the following criteria:
 - (a) the method that gives the best representation of the key drivers of profitability;
 - (b) the method that most closely matches how management report internally to the board or key decision makers;
 - (c) peer industry practice where there has been a convergence around key metrics that are facilitated by one method rather than another;
 - (d) evidence of the preferences of users; and
 - (e) where the allocation of expenses to functions would be arbitrary, then a 'by nature' method should be favoured.

Clarification of paragraph 104 of IAS 1 on 'by nature' disclosures

- 7 Paragraph 104 of IAS 1 requires an entity that chooses the by-function analysis to disclose additional information on the nature of expenses, including depreciation and amortisation expense and employee benefits expense.
- 8 In the IASB Staff review of a sample of financial statements they observed that about half of the entities that used the by-function method did not provide additional information on the nature of expenses despite the requirement in IAS 1.
- 9 Feedback received from preparers on the 2010 *Financial Statement Presentation Staff Draft* indicated that some preparers were unable to disclose additional information on the nature of expenses when classifying expenses by function due to limitations in their accounting systems or were only able to allocate natural components to the entity's functions in an inconsistent way.
- 10 In September 2017, some members of the IASB considered that the requirement in paragraph 104 of IAS 1 could be further clarified to avoid any misinterpretations.
- 11 For the April 2018 ASAF meeting the IASB staff considers that paragraph 104 of IAS 1 could be clarified to indicate that entities that provide a by-function analysis should be required to provide a by-nature disaggregation of each of the functional line items (rather than simply stating that an entity should 'disclose additional information by nature').

EFRAG Secretariat analysis

- 12 The EFRAG Secretariat is supportive of the IASB tentative decision in September 2017 (Appendix 1) to describe the meaning of 'function' and 'nature' of expense when presenting the analysis of expenses in the statement(s) of financial performance. This would generally increase clarity of the terms for preparers and would result in consistent application of the categories across different entities and over different reporting periods.
- 13 The EFRAG Secretariat also supports to retain the choice for presenting an analysis of expenses by classifying the expenses based on either their nature or their function within the entity. The choice of classification gives entities the possibility to reflect their operations in a way that the management views and runs its business.
- 14 The EFRAG Secretariat also supports improving paragraph 100 to require entities (and not encourage) to present the analysis in paragraph 99 in the statement(s) presenting profit or loss and other comprehensive income.
- 15 However, based on our limited analysis of the financial statements of non-financial entities a number of companies use a combined approach by mixing the by nature and function presentation. Therefore, we suggest the IASB to consider such cases before concluding the criteria focused the methodology that provides the most useful information to users.
- 16 The EFRAG Secretariat also highlights that the criteria mentioned in paragraph 6 above might, in certain cases, conflict with each other and that the IASB could consider explaining which criterion is more relevant (e.g. hierarchy).
- 17 Finally, instead of focusing on whether an entity is able to allocate natural components to the functions presented on a consistent and non-arbitrary basis, we note that paragraph 99 of IAS 1 already states an entity shall select the presentation by nature or function based on 'whichever provides information that is reliable and more relevant'. We believe that this criteria is more relevant.
- 18 In regard to clarification of 104 of IAS 1, the EFRAG Secretariat considers that if the IASB assesses that such clarification is needed, it could be addressed within annual improvements process.

Questions for EFRAG TEG-CFSS

- 19 Does EFRAG TEG-CFSS consider that the criteria proposed in paragraph 6 of this paper are helpful to determine whether a by-function or by-nature presentation provides the most useful information about an entity's business?
- 20 Does EFRAG TEG-CFSS that paragraph 104 of IAS 1 (which requires an entity to disclose additional information on the nature of expenses when classifying expenses by function) is unclear and should be further clarified as in paragraph 11 of this paper?

Improve the level of aggregation and disaggregation

Characteristics that should be considered for aggregation and disaggregation purposes

- 21 Paragraph 29 of IAS 1 requires an entity to 'present separately each material class of similar items. An entity shall separately present items of a dissimilar nature or function unless they are immaterial.
- 22 IAS 1 mentions a few additional characteristics for aggregating or disaggregating items in specific financial statements. These characteristics are:
 - (a) the liquidity of assets (paragraph 58(a) of IAS 1);
 - (b) the timing of liabilities (paragraph 58(c) of IAS 1);
 - (c) how an item is measured (paragraph 59 of IAS 1); and
 - (d) frequency, potential for gain or loss and predictability (paragraphs 86 and 101 of IAS 1).
- 23 Paragraph 98 of IAS 1 provides examples of circumstances that would give rise to the separate presentation of items of income or expense (e.g. write-downs of inventories, restructurings, disposals of items of property, plant and equipment or litigation). However, in these examples it is not so clear what the common characteristic is.
- 24 The IASB Staff research and outreach activities have indicated a lack of consistency between companies in the analysis of expenses presented by preparers and poor disaggregation.
- 25 For the April 2018 ASAF meeting the IASB staff proposes to include in one single list the characteristics of 'function' and 'nature' mentioned in paragraphs 29 as well as the characteristics mentioned in paragraphs 58(a), 58(c), 59, 86 and 101 of IAS 1 (as in paragraph 22 above).
- 26 The list could also include other characteristics mentioned in other IFRS Standards as these could be useful as a basis to identify dissimilar items. For example, the IASB staff suggests including:
 - (a) similar economic characteristics, such as the nature of the products, services, or production processes; the type or class of customer; the methods used to distribute products or provide services, and the nature of the regulatory environment (paragraph 12 of IFRS 8 *Operating Segments*);
 - (b) the nature, characteristics and risks of the asset or of a liability; the level of the fair value hierarchy within which the fair value measurement is categorised (paragraph 94 of IFRS 13 *Fair Value Measurement*); and
 - (c) the characteristics mentioned in paragraph B89 of IFRS 15 *Revenue from Contracts with Customers* for identifying different revenue categories.
- 27 Finally, the IASB Staff suggested including a principle indicating the basis for aggregating items into a group and disaggregating items from a group. For example:

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Items are presented within a group of items on the basis of one or more similar characteristic(s). A group of items should be further disaggregated if an entity identifies that the items in the group have other characteristics that are dissimilar and if this further disaggregation leads to the disclosure of material information.

Introducing quantitative thresholds to promote more disaggregation of groups of items

- 28 In September 2017 the IASB staff suggested that a way to overcome the over-aggregation of line items could be to introduce quantitative thresholds for disaggregation. Some IASB members supported exploring the introduction of quantitative thresholds.
- 29 The IASB staff performed an outreach activity with some national standard-setters and regulators to obtain information about their local requirements on aggregation and disaggregation. The feedback received revealed that some standard setters or regulators include in their local regulations quantitative thresholds that require further disaggregation of specific line items. For example, the U.S. Securities and Exchange Commission requires the separate presentation of revenue categories (ie operating revenues, income from rentals, revenues from services or other revenues) that exceed 10 percent of total revenues.
- 30 An advantage of introducing thresholds in IAS 1 would be more disaggregation as adding thresholds could potentially 'force' the disaggregation of some line items.
- 31 One disadvantage is that the introduction of thresholds could override the materiality judgement. In addition, some might object to a rules-based rather than principles-based approach. Another disadvantage is that developing thresholds might not be easy as it would imply defining numerators, denominators and limits for the thresholds, which could be a challenging and controversial task.

Developing a principle to clarify the location of financial information in the primary financial statements or the notes

- 32 Paragraph 30 of IAS 1 states that 'an item that is not sufficiently material to warrant separate presentation in those statements may warrant separate presentation in the notes'. The IASB staff considered the use of the term 'sufficiently material' in paragraph 30 of IAS 1 confusing because it implies that information separately presented on a primary financial statement is 'more material' than information in the notes. It also does not provide entities with clear guidance that helps them to determine when it is appropriate to present an item separately in the primary financial statements or in the notes.
- 33 The IASB Staff considered that the location of a line item should not depend on whether line item is material or not. The IASB Staff viewed that materiality is an absolute term—either something is material or it is not. Therefore, in their view the *role* or *purpose* of the primary financial statements and the notes should determine the location of the information.
- 34 In the IASB's Discussion Paper *Disclosure Initiative—Principles of Disclosure* ('the DP'), paragraphs 3.22 and 3.28 suggest descriptions of the roles of the primary financial statements and the notes. For the April 2018 ASAF meeting, the IASB staff suggested that entities should be required to consider these different roles when deciding the location of financial information (i.e. the primary financial statements or the notes).
- 35 According to the DP, the role of the of the primary financial statements is to provide a structured and comparable summary of an entity's recognised assets, liabilities, equity, income and expenses, whereas the notes serve the purpose to provide further information necessary to disaggregate, reconcile and explain these items and to supplement the primary financial statements with other information that is necessary to meet the objective of financial statements.

EFRAG Secretariat analysis

- 36 The EFRAG Secretariat considers that having a list of characteristics for aggregation and disaggregation of line items in the primary financial statements in a single place within IAS 1 could bring clarity to preparers and improve consistent application and useful information for users.
- 37 The EFRAG Secretariat observes that when aggregating or disaggregating line items in the primary financial statements it could be useful for preparers to have a structured hierarchy of characteristics to be considered.
- 38 Nonetheless, the EFRAG Secretariat considers that reflecting the guidance in paragraph 12 of IFRS 8 *Operating Segments* in IAS 1 might lead to too much disaggregation (if to consider for example the nature of the products, services, or production processes; the type or class of customer, etc.).
- 39 In addition, we consider that the principle in paragraph 27 could be further clarified, particularly the notion that 'items should be further disaggregated if an entity identifies that the items in the group have other characteristics that are dissimilar and if this further disaggregation leads to the disclosure of material information'. In particular, the IASB could better explain the notion of 'characteristics that are dissimilar'.
- 40 The EFRAG Secretariat does not support introducing quantitative thresholds for disaggregation of group of items. We believe that a principle-based rather than rule-base guidance should be developed to address the over-aggregation of line items.
- 41 The EFRAG Secretariat supports the IASB staff proposal to clarify the location of financial information on the basis of the roles of the primary financial statements and the notes. This will help entities when deciding on the location of the financial information. The EFRAG Secretariat observes that the term 'sufficiently material' in paragraph 30 of IAS 1 may need to be revised in order to remove any connotation to different levels of materiality.

Questions for EFRAG TEG-CFSS

- 42 Does EFRAG TEG-CFSS agree with the IASB staff proposal to:
- (a) consolidate into one list the characteristics that should be considered as a basis to identify dissimilar items;
 - (b) add a principle indicating the basis for aggregating items into a group and disaggregating items from a group;
 - (c) introduce a quantitative threshold to promote more disaggregation of groups of items? If so, do you have any suggestions of how these thresholds could be developed; and
 - (d) develop a principle to clarify the location of financial information on the basis of the roles of the primary financial statements and the notes developed in the *Disclosure Initiative—Principles of Disclosure* project?

Appendix 1: IASB tentative decisions

<p>General guidance on classification, aggregation and disaggregation</p>	<p>IASB March 2017 meeting</p> <p>The IASB tentatively decided to develop, along the lines suggested in Agenda Paper 21C:</p> <ul style="list-style-type: none"> (e) principles for aggregation and disaggregation in the financial statements; (f) definitions of the notions ‘classification’, ‘aggregation’ and ‘disaggregation; and (g) guidance on the steps involved in applying ‘classification’, ‘aggregation’ and ‘disaggregation’ when preparing financial statements.
<p>Analysis of expenses by function and by nature</p>	<p>IASB September 2017 meeting</p> <p>The IASB tentatively decided to:</p> <ul style="list-style-type: none"> (h) describe the 'nature of expense' method and the 'function of expense' method used to analyse expenses required by paragraph 99 of IAS 1 Presentation of Financial Statements. (i) continue to require an entity to provide an analysis of expenses using the methodology, either by-function or by-nature, that provides the most useful information to users. (j) develop criteria that entities could follow to determine whether a by-function or by-nature methodology provides the most useful information to users. One of those criteria would be that a function of expense analysis would not be appropriate if an entity is unable to allocate natural components to the functions presented on a consistent and non-arbitrary basis. (k) provide no requirement for entities that use the ‘nature of expense’ method to provide additional information using the ‘function of expense’ method. (l) require an entity to present its primary analysis of expenses in the statement(s) of financial performance and disclose in a single note any additional information required about expenses (ie an analysis by nature when an entity uses a 'function of expense' method).