IFRS

STAFF PAPER

April 2018

Accounting Standards Advisory Forum

Project	Primary Financial Statements
Paper topic	Guidance on aggregation and disaggregation

CONTACT(S) Denise Durant dduarant@ifrs.org +44(0) 20 7246 6469

Purpose of this paper

1. The objective of this session is to:
   (a) provide the ASAF with an update on the Board's tentative decisions on aggregation and disaggregation; and
   (b) seek ASAF views on these tentative decisions and whether there are additional aspects that could be explored to improve the level of aggregation and disaggregation of line items in the primary financial statements and in the notes.

Structure of the paper

2. This paper includes:
   (a) Questions for ASAF members;
   (b) Background (paragraphs 3–5);
   (c) Section 1. Discussions on aggregation and disaggregation since March 2017 (paragraphs 6–33);
   (d) Section 2. Potential additional proposals to improve the level of aggregation and disaggregation (paragraphs 34–51); and
   (e) Appendix A— Summary of staff proposals.

Questions for ASAF members

We would welcome your views on any aspect of this paper and on other ways we could improve the guidance on aggregation and disaggregation in IAS 1 *Presentation of Financial Statements*. However, we would particularly like your advice on the following:

1. Do you have any comments on the Board's discussions and tentative decisions so far (paragraphs 6–33)? In particular:

- Do you think that the criteria we propose in paragraph 22 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?
- Do you share the view 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 proposed in paragraph 29?

2. Do you have any comments on the staff's additional proposals to improve the level of aggregation and disaggregation (paragraphs 34–50)? In particular;

- Do you agree with the staff proposal to consolidate into one list the characteristics that should be considered as a basis to identify dissimilar items (refer to paragraphs 39–40)?
- Do you agree with the staff proposal to add a principle indicating the basis for aggregating items into a group and disaggregating items from a group? (refer to paragraph 41)
- Do you think that the staff should propose introducing quantitative thresholds to promote more disaggregation of groups of items? If so, do you have any suggestions of how these thresholds could be developed? (refer to our discussion in paragraphs 42–47)
- Do you agree with the staff proposal to 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, as discussed in paragraphs 49–51?

Background

3. The outcome of our research and outreach activities (that we discussed with the Board at the November 2016 Board meeting and at the September 2017 Board meeting[1]) indicated that users think that some line items within the primary financial statements provide information that is too highly aggregated to be useful. For example, users noted that:

   (a) 'selling, general and administrative expenses' or 'cost of sales' are commonly presented as a single line item and not disaggregated by their natural components (eg labour cost, cost of materials, etc);

   (b) material 'other' categories (eg other assets, other liabilities, other operating cash flows, other expenses) are commonly presented without further disaggregation causing users concern that important information may be obscured or lost;

   (c) there is poor disaggregation in the analysis of expenses required in IAS 1 and a lack of consistency as to how this analysis is provided; and

   (d) entities tend to report only the minimum information required by IAS 1 rather than providing a more robust disaggregation of the entity's income and expenses.

4. Users stated that providing greater disaggregation of the information included in the primary financial statements would enable them to:

   (a) better compare this information across entities and within the same entity over time; and

   (b) to apply their assumptions to individual components in order to make better predictions about the prospects for future cash flows to the entity.

5. The concerns expressed by users led the Board to consider developing guidance on principles of aggregation and disaggregation of line items in the primary financial statements and in the notes. The Board discussed different topics on aggregation and

[1] A detailed summary of research and feedback received can be found in agenda paper 21A of November 2016 and Appendix A in agenda paper 21B of September 2017.

disaggregation at its March 2017 and September 2017 Board meetings as we explain below.

Section 1. Discussions on aggregation/disaggregation since March 2017

6. At the March 2017 Board meeting the staff suggested that entities may not always appropriately aggregate or disaggregate information in the primary financial statements for the following reasons:

   (a) IAS 1 uses but does not explain the notions of 'classification', 'aggregation', and 'disaggregation' and it does not explain the steps involved when applying these notions in the preparation of the primary financial statements and the notes; and

   (b) other IFRS Standards set out their own approaches to aggregation and disaggregation which are not necessarily consistent with IAS 1 and those approaches are not mentioned specifically in IAS 1.

7. After a review of the requirements in IAS 1 on aggregation and disaggregation, the staff proposed to address the following five issues:

   (a) Issue 1.1. Lack of definitions of 'classification', 'aggregation', and 'disaggregation' (paragraphs 10–13);

   (b) Issue 1.2. Lack of descriptions of 'function' and of 'nature' (paragraphs 14–16);

   (c) Issue 1.3. Should the choice between the by-function and by-nature methods for presenting an analysis of expenses be retained? (paragraphs 17–22);

   (d) Issue 1.4. Lack of clarity on the requirement to disclose additional information on the nature of expenses when using a 'function of expense' method (paragraphs 23–29); and

   (e) Issue 1.5. Flexibility on the location of an analysis of expenses (paragraphs 30–33).

8. Below is a brief summary of the Board's discussions, including:

   (a) a description of the issue identified;

   (b) why the issue identified is a problem; and

   (c) how the Board has tentatively decided to approach the issue identified.

9. For a full discussion of the issues identified above refer to the staff proposals in March 2017 (Agenda Paper 21C) and September 2017 (Agenda Paper 21B) and for the Board's tentative decisions in regards to these proposals refer to IASB *Update* of March 2017 and IASB *Update* of September 2017.

1.1) Lack of definitions of 'classification', 'aggregation', and 'disaggregation'

Current requirements in IAS 1

10. Paragraph 30 of IAS 1 describes the process of 'classification and aggregation'. In accordance with this process an entity:

    (a) classifies and aggregates information into classes of items (on the basis of their similar function or nature); and

    (b) forms appropriate line items.

11. However, the requirements in paragraphs 29 –30 of IAS 1 do not explain the notions of 'classification', 'aggregation', and 'disaggregation' or the steps involved when applying those notions in the preparation of the primary financial statements and the notes.

What is the problem?

12. A lack of guidance on what is meant by the terms 'classification', 'aggregation' and 'disaggregation' means preparers have different interpretations of what is meant by these terms. Moreover, users may find it difficult to understand the criteria used by preparers for aggregating or for disaggregating information.

How has the Board tentatively decided to approach the issue?

13. The Board has discussed proposals that could guide the aggregation and disaggregation of information in the financial statements. The Board tentatively

decided to develop, along the lines of the staff proposals discussed at the March 2017 meeting (refer to paragraphs A1–A3 in Appendix A):

(a) principles for aggregation and disaggregation in the financial statements;

(b) definitions of the notions ‘classification’, ‘aggregation’ and ‘disaggregation’; and

(c) guidance on the steps involved in applying ‘classification’, ‘aggregation’ and ‘disaggregation’ when preparing financial statements.

1.2) Lack of descriptions of ‘function’ and of ‘nature’

Current requirements in IAS 1

14. Paragraph 99 of IAS 1 allows a choice in the presentation of an analysis of expenses in the statement(s) of financial performance either by using a ‘function of expense’ method or a ‘nature of expense’ method. IAS 1 does not describe the meaning of ‘function’ or ‘nature’ in this context.

What is the problem?

15. Our research and results of our outreach activities indicated a lack of consistency between companies in the analysis of expenses presented by preparers and poor disaggregation. This could be attributed to a lack of understanding of what ‘function’ or ‘nature’ mean, leading to different interpretations of the terms. Furthermore, users find it difficult to understand the criteria used by preparers for aggregating or for disaggregating information by function and/or by nature.

How has the Board tentatively decided to approach the issue?

16. The Board has tentatively decided to describe the meaning of ‘function’ and of ‘nature’ along the lines of the staff proposals discussed at the September 2017 meeting (refer to paragraph A4 in Appendix A).

1.3) Should the choice between the by-function and by-nature methods for presenting an analysis of expenses be retained?

Current requirements in IAS 1

17. Paragraph 99 of IAS 1 allows an entity to choose between two different methodologies (ie the ‘function of expense’ method or the ‘nature of expense’ method), whichever provides information that is more reliable and relevant for the entity.

What is the problem?

18. Our research and results of our outreach activities indicated that:

    (a) preparers and users find both methodologies useful (ie management chooses the methodology that conveys the most useful information about the business; users find information both by function and by nature useful for their analysis).

    (b) the entity’s business activities appear to play an important role in choosing between the methodologies. For example, the staff observed that manufacturing companies more commonly use a classification by function whereas service companies more commonly use a classification by nature.

19. However, in our review of a sample of financial statements[2] we could not find the reasons why a particular methodology is considered useful for particular entities.

How has the Board tentatively decided to approach the issue?

20. The Board tentatively decided at its September 2017 Board meeting to retain the choice for presenting an analysis of expenses.

21. To add more discipline to how an entity makes its choice of methodology and how that choice is applied the Board tentatively decided to develop criteria that entities could follow to determine whether the by-function or by-nature methodology provides the most useful information to users.

[2] This analysis was presented in Agenda Paper 21A of November 2016.

Staff suggestions for criteria that entities could follow for choosing a methodology

22. The staff are developing criteria that entities could follow to determine whether by-function or by-nature presentation provides the most useful information about their business. The criteria could be as follows (this list should be treated as non-exhaustive):

> **Staff suggestions for criteria that entities could follow to determine whether by-function or by-nature presentation provides the most useful information about their business**
>
> (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; or
>
> (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.

1.4) Lack of clarity on the requirement to disclose additional information on the nature of expenses when using a 'function of expense' method

Current requirements in IAS 1

23. Paragraph 104 of IAS 1 requires an entity choosing the 'function of expense' method to 'disclose additional information on the nature of expenses, including depreciation and amortisation expense and employee benefits expense'; only a few natural items are specifically required in this paragraph. Paragraph 103 of IAS 1 adds that 'allocating costs to functions may require arbitrary allocations and involve considerable judgement'.

What is the problem?

24. In our review of a sample of financial statements we observed that about half of the entities using the 'function of expense' method did not provide additional information on the nature of expenses despite the requirement in paragraph 104 of IAS 1[3].

25. 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.

26. During our outreach activities, users favoured having break-downs of particular 'functional' items (ie cost of sales) into their different 'natural' components, as those break-downs:

    (a) lead to greater comparability through more granular information; and

    (b) allow users to apply their assumptions to different components of the statement(s) of financial performance enabling them to make better predictions of the prospects for net future cash flows.

How has the Board tentatively decided to approach the issue?

27. As we mentioned in our analysis of Issue 1.3 (above) the Board tentatively decided to develop criteria that entities could follow to determine whether the by-function or by-nature methodology provides the most useful information to users. The Board tentatively decided that 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.

28. Some Board members further observed that the requirement in paragraph 104 of IAS 1 (emphasis added) 'to disclose additional information *on the nature of expenses*, including depreciation and amortisation expense and employee benefits expense' could be further clarified to avoid misinterpretations about its meaning.

[3] Refer to the table below paragraph 23 of Agenda Paper 21A of November 2016.

Staff proposal about how paragraph 104 of IAS 1 could be further clarified

29. The staff think 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’).

1.5) Flexibility on the location of an analysis of expenses

Current requirements in IAS 1

30. Paragraph 99 of IAS 1 allows entities to present the analysis of expenses either in the statement(s) of financial performance or in the notes. Paragraph 100 of IAS 1 encourages entities to present it in the statement(s) of financial performance.

What is the problem?

31. Our research and results of our outreach activities indicated that there is diversity in practice on the presentation of an entity’s analysis of expenses. For example some entities present this analysis on the face of the primary financial statements, others present the analysis in the notes; or preparers present very little analysis on the statement(s) of financial performance. Users are concerned that they cannot always find a coherent and full analysis of expenses easily and would rather have that analysis in a single place.

How has the Board tentatively decided to approach the issue?

32. To add more discipline to the presentation of this analysis and address the concerns expressed by users, the Board tentatively decided to prescribe the location of the analysis of expenses by *requiring* an entity (and not just *encouraging* the entity) to present its ‘primary’ analysis of expenses (ie either a 'function of expense' method or a ‘nature of expense’ method) in the statement(s) of financial performance.

33. When an entity’s ‘primary’ analysis is by function, the entity should provide the additional information on the nature of expenses in a single note so that users can access this information more easily.

<u>Section 2.</u> Potential additional proposals to improve the level of aggregation and disaggregation

34. The staff think that further guidance could be developed in the following areas:

    (a) <u>Issue 2.1.</u> Consolidating into one list the characteristics for aggregation and disaggregation (paragraphs 35–41);

    (b) <u>Issue 2.2.</u> Introducing quantitative thresholds to promote more disaggregation of groups of items (paragraphs 42–47); and

    (c) <u>Issue 2.3.</u> Developing a principle to clarify the location of financial information in the primary financial statements or the notes (paragraphs 48–51).

2.1) Consolidating into one list the characteristics for aggregation and disaggregation

Current requirements in IAS 1

35. Paragraph 29 of IAS 1 requires an entity to 'present separately each material class of similar items. An entity shall present separately items of a dissimilar nature or function unless they are immaterial'.

36. IAS 1 mentions a few additional characteristics for aggregating or disaggregating items in specific financial statements (besides the characteristics of 'function' and 'nature' mentioned in paragraph 29 of IAS 1). These characteristics are:

    (a) the liquidity of assets (IAS 1, paragraph 58(a));

    (b) the timing of liabilities (IAS 1, paragraph 58(c));

    (c) how an item is measured (IAS 1, paragraph 59); and

    (d) frequency, potential for gain or loss and predictability (IAS 1, paragraphs 86 and 101).

37. Paragraph 98 of IAS 1 provides examples of circumstances that would give rise to the separate presentation of items of income or expense (eg write-downs of inventories, restructurings, disposals of items of property, plant and equipment or litigation

settlements). However, in these examples it is not so clear what the common characteristic is.

What is the problem?

38. Our research and results of our outreach activities have indicated a lack of consistency between companies in the analysis of expenses presented by preparers and poor disaggregation. We think that this could also be attributed to a lack of understanding of the characteristics that make items dissimilar.

A potential approach

39. Our proposal would be to include in one single list the characteristics of 'function' and 'nature' (mentioned in paragraph 29 of IAS 1) as well as the characteristics we have identified in paragraph 36 of this paper. We think that having those characteristics in a single location in IAS 1 would provide a better understanding of what makes an item dissimilar from another, thereby allowing entities to:

    (a) take a more structured approach to aggregating items and facilitating the classification of items; and

    (b) identify the natural components that comprise the entity's functional activities in the statement(s) of financial performance.

40. The list could also include other characteristics mentioned in other IFRS Standards as we think that these characteristics could be useful as a basis to identify dissimilar items. For example we could include:

    (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; 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.

41. We could also include a principle indicating the basis for aggregating items into a group and disaggregating items from a group. For example, the principle could state:

> 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.

2.2) Introducing quantitative thresholds to promote more disaggregation of groups of items

42. At the September 2017 Board meeting the staff suggested that a way to overcome the over-aggregation of line items could be to introduce quantitative thresholds for disaggregation. Some Board members appeared to support exploring the introduction of quantitative thresholds.

How could quantitative thresholds be developed?

43. A threshold is 'a level, rate, or amount at which something comes into effect'[4]. Developing a threshold implies defining:

(a) a numerator (ie the specific items to which the threshold would apply, for example, different revenue categories (ie revenue from sales, revenue from rentals, revenue from services);

(b) a denominator (the line item total or subtotal that would serve as a basis for determining if the threshold has been met or not; for example, 'total revenue'); and

(c) determining a limit for the threshold (eg the threshold would require the reporting of revenue categories that exceed 10 per cent or more of the total revenue).

44. The staff has recently performed outreach activities with some national standard-setters and with some 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:

[4] We consulted the online version of the Oxford Dictionary.

(a) The U.S. Securities and Exchange Commission (Article 5 of Regulation S-X (Rule 5-03 -Income Statements)[5] 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. Any revenue categories that are individually 10 percent or less of total revenues may be combined into one line[6].

(b) The Brazilian Corporate Law nº 6.404/1976, art. 176, § 2º'requires in Article 2, that similar accounts be grouped in the financial statements and small balances be aggregated, provided that their nature is indicated and does not exceed 0.1 (one tenth) of the value of the respective group of accounts.

What are the advantages or disadvantages of introducing thresholds?

45. An advantage of introducing thresholds in IAS 1 would be more disaggregation as adding thresholds could potentially 'force' the disaggregation of some line items.

46. One disadvantage is that the introduction of thresholds could override the materiality judgement (ie items that management consider immaterial would be required to be separately presented because they exceed the threshold). In addition, some might object to a rules-based rather than principles-based approach (however, this may be less of a concern for presentation requirements, than it would be for recognition and measurement requirements).

47. 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.

[5] The SEC requires other quantitative thresholds for other items of income and expense and other assets/liabilities that we have not reflected in our analysis.

[6] https://www.sec.gov/divisions/corpfin/ecfrlinks.shtml. Refer to Article 5, Rule 5-03 – Income Statements.

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

What is the problem?

48. Paragraph 30 of IAS 1 states that (emphasis added) 'an item that is not *sufficiently material* to warrant separate presentation in those statements may warrant separate presentation in the notes'. We observe that the use of the term 'sufficiently material' in paragraph 30 of IAS 1 is 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.

Our proposal

49. We do not think that the location of a line item is a question of whether the line item is material or not. In fact, materiality is an absolute term—either something is material or it is not. Instead, we think that it is the role or purpose of the primary financial statements and the notes that determines the location of the information.

50. We observe that paragraphs 3.22 and 3.28 in Section 3 of the Discussion Paper *Disclosure Initiative—Principles of Disclosure*), suggest descriptions of the roles of the primary financial statements and the notes. Our proposal would be to require an entity to consider these different roles in deciding the location of financial information (ie the primary financial statements or the notes). These roles are as follows:

    (a) the role of the primary financial statements is to provide a structured and comparable summary of an entity's recognised assets, liabilities, equity, income and expenses, which is useful for:

        (i) obtaining an overview of the entity's assets, liabilities, equity, income and expenses;

        (ii) making comparisons between entities and reporting periods; and

        (iii) identifying items or areas within the financial statements about which users of the financial statements will seek additional information in the notes.

(b) the role of the notes is to:

(i) provide further information necessary to disaggregate, reconcile and explain the items recognised in the primary financial statements; and

(ii) supplement the primary financial statements with other information that is necessary to meet the objective of financial statements.

51. The feedback received on the Discussion Paper was generally supportive of these proposed descriptions of the roles. See February 2018 Agenda Paper 11G.

Appendix A –Summary of staff proposals

A1. For the March 2017 Board meeting, the staff developed the following principles for aggregation and disaggregation:

> Principle 1: 'Items that share similar characteristics should be classified and aggregated together'.
>
> Principle 2: 'Items that are dissimilar from other items should not be combined with other items and should be separated or disaggregated'.
>
> Principle 3: 'Aggregation and disaggregation in the financial statements should not obscure relevant information or reduce the understandability of the information presented and should also contribute to a faithful representation of the items presented'.

A2. The staff proposed defining the notions of 'classification', 'aggregation' and 'disaggregation' on the basis of the descriptions of 'classification' and 'aggregation' included in paragraphs 7.10 and 7.14 of the *Conceptual Framework for Financial Reporting* Exposure Draft (published in May 2015). The staff proposed that these definitions be as follows:

> Classification is the sorting of assets, liabilities, equity, income and expenses and cash flows on the basis of shared characteristics.
>
> Aggregation is the adding together of individual items that share characteristics and are classified together.
>
> Disaggregation is the separation of an item or group of items into dissimilar component parts.

A3. The staff proposed that the guidance on the steps involved in applying 'classification', 'aggregation' and 'disaggregation' when preparing financial statements be as follows:

> The primary financial statements and the notes are a result of classification, aggregation, disaggregation and summarisation, where an entity:
>
> (a) classifies information into groups or classes of items (on the basis of similar characteristics) or separates items that have dissimilar characteristics;
>
> (b) aggregates or disaggregates such information so that it faithfully represents and makes understandable the information it purports to represent; and

> (c) summarises information in the notes to the level of detail needed to meet the IFRS disclosure objectives and requirements.
>
> These steps conclude with the presentation of condensed and classified data in the primary financial statements and in the notes.

A4. At the September 2017 Board meeting the staff proposed to describe the 'nature of expense' method and the 'function of expense' method as follows:

> The nature of expense method provides information about expenses arising from the main inputs that are consumed in order to accomplish an entity's business activities—such as expenses related to materials (raw material purchases), employees (labour and other employee benefits), equipment (depreciation) or intangibles (amortisation)—without reference to how these are allocated to functions within the business.
>
> and
>
> The function of expense method allocates and combines expense items according to the activity from which the item arises.
>
> For example, cost of sales is a functional line item that may combine the following natural line items: raw material costs, labour and other employee benefit costs, depreciation or amortisation. These expenses all arise from the entity's production activities.