IFRS 8 Operating Segments - A Closer Look

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IFRS 8

Operating Segments -

A Closer Look

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The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) in the United States have undertaken a joint short-term convergence project with the objective of reducing differences between International Financial Reporting Standards (IFRSs) and US generally accepted accounting principles (US GAAP) that are capable of resolution in a relatively short time and can be addressed outside major projects. On 19 January 2006, the IASB issued Exposure Draft ED 8 *Operating Segments*. The IASB published ED 8, in early 2006 just after the conclusion of the memorandum of understanding (MoU) with FASB on their joint convergence program, which included segment reporting as a priority project. The inclusion of segment reporting in the convergence program had been controversial inside and outside the IASB and judged by some as unnecessary, because segment reporting is about disclosure rather than measurement and recognition, and therefore does not pose major difficulties of reconciliation between different systems of standards. Unlike for some other convergence projects which give rise to the drafting of new standards by the IASB and FASB jointly, the MoU indicated that the convergence of segment reporting would be attained by the alignment of the IFRS on existing US GAAP provisions. Thus, ED 8 was quickly released as a nearly identical standard to the existing FASB Statement No. 131 *Disclosures about Segments of an Enterprise and Related Information* (SFAS 131). On 30 November 2006, the IASB issued IFRS 8 *Operating Segments*, results from the IASB's comparison of IAS 14 *Segment Reporting* with SFAS 131.

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Background

Segment information is one of the most vital aspects of financial reporting for investors and other users. As most listed companies are complex, heterogeneous groups, segment information provide users the key to understanding corporate business models and economic dynamics. It allows external observers to understand the respective risks and value potentials of different lines of business, the synergies or inefficiencies that may make a group more or less than the sum of its parts, and the underlying corporate strategy. Segment reporting does not primarily pose measurement or recognition challenges and therefore tends not to be a primary focus of academic experts in accounting. Setting standards for segment information is also inherently divisive between preparers of financial statements (mostly listed companies) on the one hand, and investors and other users on the other hand. Precisely because segment information provides so many indications about business models and the economic reality of a company's operations, preparers generally desire to control it tightly, while users want it to be specifically objective and non-distorted. Segment information thus illustrates the tension at the core of the capital markets bargain, by which companies gain access to inexpensive capital in exchange of transparency about their situation and operations. This explains the vivid debates on segment reporting standards since the emergence of industrial conglomerates in the US in the 1960s. Unlike some other accounting issues, segment reporting standard-setting has never been a consensual matter. Also, segment reporting is inherently difficult to standardize. Operating segments are different from one company to another, and even within the same industry they do not necessarily correspond to exactly the same activities. Geographical segments, likewise, vary widely, as each company has its own way of considering international markets and establishing a presence in them. This explains the variety of approaches which coexist in this area.

Objective

The 'core principle' of IFRS 8 is that an entity should "disclose information to enable users of its financial statements to evaluate the nature and financial effects of the different business activities in which it engages and the economic environments in which it operates." The IFRS 8 requires an entity to adopt the 'management approach' to reporting on the financial performance of its operating segments. Generally, the information to be reported would be what management uses internally for evaluating segment performance and deciding how to allocate resources to operating segments. Such information may be different from what is used to prepare the income statement and balance sheet. The IFRS 8 therefore requires explanations of the basis on which the segment information is prepared and reconciliations to the amounts recognised in the income statement and balance sheet.

Scope

IFRS 8 applies to the separate or individual financial statements of an entity (and to the consolidated financial statements of a group with a parent):

• whose debt or equity instruments are traded in a public market; or

• that files, or is in the process of filing, its (consolidated) financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market.

Operating Segments

The concept of operating segments effectively replaces the primary and secondary reporting segments in IAS 14. To identify an operating segment, an entity must ensure that all of the following three criteria are present:

• it undertakes business activities from which it may earn revenues and incur expenses

• its operating results are reviewed regularly by the chief operating decision maker (CODM) (note that this describes a function rather than a person with a specific title), and

• discrete financial information is available.

An operating segment may also include "a component of an entity that sells primarily or exclusively to other operating segments of the entity."

Reportable segments

IFRS 8 has detailed guidance about when operating segments may be combined to create a reportable segment. This guidance is generally consistent with the aggregation criteria in IAS 14. In addition, there are prescribed entity-wide disclosures that are required even when an entity has only one reportable segment. These include information about each product and service or groups of products and services.

For an operating segment to be a reportable segment, it must exceed any one of three quantitative thresholds. The thresholds in IFRS 8 are the same as those required by IAS 14. An operating segment that does not meet any of these thresholds may still be reportable (and thus disclosed) if it is considered useful to users of the financial statements.

Aggregation criteria

IFRS 8 also allows operating segments to be aggregated into one reportable segment if:
a) aggregation is consistent with the core principle of IFRS 8;
b) the segments have similar economic characteristics; and
c) the segments are similar in each of the following respects:
i) the nature of the products and services;
ii) the nature of the production processes;
iii) the type or class of customer for their products and services;
iv) the methods used to distribute their products or provide their services; and
v) if applicable, the nature of the regulatory environment (e.g. banking, insurance, or public utilities).

Quantitative thresholds

An entity shall report separately information about an operating segment that meets any of the following quantitative thresholds:
a) its reported revenue, including both sales to external customers and intersegment sales or transfers, is 10 per cent or more of the combined revenue, internal and external, of all operating segments; or
b) the absolute amount of its reported profit or loss is 10 per cent or more of the greater, in absolute amount, of (i) the combined reported profit of all operating segments that did not report a loss and (ii) the combined reported loss of all operating segments that reported a loss; or
c) its assets are 10 per cent or more of the combined assets of all operating segments.
An entity may combine information about operating segments that do not meet the quantitative thresholds with information about other operating segments that do not meet the quantitative thresholds to produce a reportable segment only if the operating segments have similar economic characteristics and share a majority of the aggregation criteria.
If the total external revenue reported by operating segments constitutes less than 75 per cent of the entity's revenue, additional operating segments shall be identified as reportable segments (even if they do not meet the criteria) until at least 75 per cent of the entity's revenue is included in reportable segments.
Information about other business activities and operating segments that are not reportable shall be combined and disclosed in an 'all other segments' category separately from other reconciling items in the reconciliations required.
The sources of the revenue included in the 'all other segments' category shall be described.
If management judges that an operating segment identified as a reportable segment in the immediately preceding period is of continuing significance, information about that segment shall continue to be reported separately in the current period even if it no longer meets the criteria for reportability.

Disclosure requirements

An entity shall disclose information to enable users of its financial statements to evaluate the nature and financial effects of the types of business activities in which it engages and the economic environments in which it operates.
To give effect to the principle, an entity shall disclose the following for each period for which an income statement is presented:
• general information –
a) factors used to identify the entity's reportable segments, including the basis of organisation; and
b) types of products and services from which each reportable segment derives its revenues.
• information about reported segment profit or loss, including specified revenues and expenses included in reported segment profit or loss, segment assets, segment liabilities and the basis of measurement; and
• reconciliations of the totals of segment revenues, reported segment profit or loss, segment assets, segment liabilities, and other material segment items to corresponding entity amounts.

Additional disclosures required by IFRS 8 are:
• for all entities:
- information about products and services
- information about geographical areas, and
- information about major customers
• the factors used to identify an entity's reportable segments
• for each reportable segment (when these amounts are included in either the segment profit or loss reviewed by the CODM or otherwise provided for review by the CODM):
- interest revenue
- interest expense
- material items of income and expense disclosed in accordance with paragraph 86 of IAS 1 *Presentation of Financial Statements*
- the entity's interest in the profit or loss of associates and joint ventures accounted for by the equity method
- income tax expense or income
• segment liabilities, if such information is reviewed by the CODM
• amounts of additions to non-current assets, other than financial instruments, deferred tax assets, post-employment benefit assets and rights under insurance contracts, if included in the segment assets reviewed by the CODM or otherwise provided to the CODM
• information about:
- the basis of accounting for transactions between reportable segments
- the nature of any differences between the measurements of the reportable segments' (when such differences are not clear from the reconciliations):
• revenues and the entity's revenues
• profit or losses and the entity's profit or loss

• assets and the entity's assets
• liabilities and the entity's liabilities
• amounts for every other material item of information disclosed and the corresponding amount for the entity
- the nature of any changes from prior periods in the measurement methods used and the effect, if any
- the nature and effect of any asymmetrical allocations to reportable segments (for example, allocation of depreciation expense without the allocation of the depreciating asset to that same reportable segment).

Measurement

IFRS 8 does not define measures such as segment result and segment assets. Disclosures are therefore required to explain the measurement basis used and how the segment amounts reconcile to the amounts reported in the financial statements.

The amount of each segment item reported shall be the measure reported to the CODM for the purposes of making decisions about allocating resources to the segment and assessing its performance. Adjustments and eliminations made in preparing an entity's financial statements and allocations of revenues, expenses, and gains or losses shall be included in determining reported segment profit or loss only if they are included in the measure of the segment's profit or loss that is used by the CODM. Similarly, only those assets and liabilities that are included in the measures of the segment's assets and segment's liabilities that are used by the CODM shall be reported for that segment. If amounts are allocated to reported segment profit or loss, assets or liabilities, those amounts shall be allocated on a reasonable basis.

If the CODM uses only one measure of an operating segment's profit or loss, the segment's assets or the segment's liabilities in assessing segment performance and deciding how to allocate resources, segment profit or loss, assets and liabilities shall be reported at those measures. If the CODM uses more than one measure of an operating segment's profit or loss, the segment's assets or the segment's liabilities, the reported measures shall be those that management believes are determined in accordance with the measurement principles most consistent with those used in measuring the corresponding amounts in the entity's financial statements.

An entity shall provide an explanation of the measurements of segment profit or loss, segment assets and segment liabilities for each reportable segment.
At a minimum, an entity shall disclose the following:
a) the basis of accounting for any transactions between reportable segments;
b) the nature of any differences between the measurements of the reportable segments' profits or losses and the entity's profit or loss before income tax expense or income and discontinued operations (if not apparent from the reconciliations described);
c) the nature of any differences between the measurements of the reportable segments' assets and the entity's assets (if not apparent from the reconciliations described);

d) the nature of any differences between the measurements of the reportable segments' liabilities and the entity's liabilities (if not apparent from the reconciliations described);
e) the nature of any changes from prior periods in the measurement methods used to determine reported segment profit or loss and the effect, if any, of those changes on the measure of segment profit or loss; and
f) the nature and effect of any asymmetrical allocations to reportable segments.

Reconciliations

Reconciliations of balance sheet amounts for reportable segments to the entity's balance sheet amounts are required for each date at which a balance sheet is presented. An entity shall provide reconciliations of all of the following:
a) the total of the reportable segments' revenues to the entity's revenue;
b) the total of the reportable segments' measures of profit or loss to the entity's profit or loss before tax expense (tax income) and discontinued operations; However, if an entity allocates to reportable segments items such as tax expense (tax income), the entity may reconcile the total of the segments' measures of profit or loss to the entity's profit or loss after those items.
c) the total of the reportable segments' assets to the entity's assets;
d) the total of the reportable segments' liabilities to the entity's liabilities if segment liabilities are reported; and
e) the total of the reportable segments' amounts for every other material item of information disclosed to the corresponding amount for the entity.
All material reconciling items shall be separately identified and described.
For example, the amount of each material adjustment needed to reconcile reportable segment profit or loss to the entity's profit or loss arising from different accounting policies shall be separately identified and described.

Restatement of previously reported information

If an entity changes the structure of its internal organisation in a manner that causes the composition of its reportable segments to change, the corresponding information for earlier periods, including interim periods, shall be restated unless the information is not available and the cost to develop it would be excessive.
The determination of whether the information is not available and the cost to develop it would be excessive shall be made for each individual item of disclosure.
Following a change in the composition of its reportable segments, an entity shall disclose whether it has restated the corresponding items of segment information for earlier periods.
If an entity has changed the structure of its internal organisation in a manner that causes the composition of its reportable segments to change and if segment information for earlier periods, including interim periods, is not restated to reflect the change, the entity shall disclose in the year in which the change occurs segment information for the current period on both the old basis and the new basis of segmentation.

Differences with IAS 14

Compared with what is provided under the existing standard IAS 14, the management approach on which IFRS 8 is based is not accompanied by sufficient safeguards to ensure that segments reflect economic reality and convey a proper understanding of risks. There are no requirements to make segment information consistent with consolidated information, which may negatively impact the value of the former. And geographical information is likely to be lost.

IFRS 8 removes the risk and reward criteria that are in IAS 14 for assessing the sufficiency of information that is presented (or not presented) to shareowners and public markets, and also in the wider public interest. IFRS 8 also removes geographical segmentation, which is undoubtedly important for investors.

IFRS 8 states that a component of an entity that sells primarily or exclusively to other operating segments of the entity will meet the definition of an operating segment if the entity is managed in that manner. IAS 14 limited reportable segments to those that earn a majority of their revenue from sales to external parties and did not require the different stages of a vertically integrated entity to be identified as separate segments.

In contrast to IAS 14, IFRS 8 does not define segment revenue, segment expense, segment result, segment assets and segment liabilities, nor does it require segment information to be prepared in conformity with the accounting policies adopted for the entity's financial statements. As a consequence, entities will have more discretion in determining what is included in segment profit or loss under IFRS 8, limited only by their internal reporting practices.

Effective date

IFRS 8 is mandatory for annual financial statements for periods beginning on or after 1 January 2009, although earlier application is permitted. Once IFRS 8 is effective, segment reporting under IFRS and US GAAP will be converged except for some minor differences.

Post issue Developments

As part of its deliberations leading to IFRS 8, the IASB considered comments by a coalition of over 300 non-governmental organisations (NGOs) known as the Publish What You Pay campaign, which asked for the scope of the IFRS to be extended to require additional disclosure on a country-by-country basis. Because the IFRS was developed as a short-term convergence project, the IASB decided that country-by-country disclosure should not be addressed in the IFRS. Instead, the matter will be raised with international bodies that are engaged with similar issues.

Conclusion

IFRS 8 requires senior management to report according to the highly ambiguous test of the form of divisional information they usually show themselves. IFRS 8 carries a heavy implication that management processes and decisions alone are sufficient to secure sufficiency in financial reporting. The risk with IFRS 8 is not about strong companies, but about those that have management who are not delivering, or have something to hide, which could then be passively assented to by non-executives and auditors due to the prescription of the standard allowing it.

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