ICAEW representation

# ICAEW REP 32/06

## OPERATING SEGMENTS

***Memorandum of comment submitted in May 2006 by the Institute of Chartered Accountants in England and Wales, in response to Exposure Draft ED 8 'Operating Segments', published for comment by the International Accounting Standards Board in January 2006.***

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## INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales ('the Institute') welcomes the opportunity to comment on the Exposure Draft ED 8 *Operating segments*, published for comment by the International Accounting Standards Board in January 2006. We have reviewed the Exposure Draft and set out below our response to its proposals.

## WHO WE ARE

2. The Institute is the largest accountancy body in Europe, with more than 127,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.

3. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry through the Financial Reporting Council. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy.

## OVERALL RESPONSE TO THE EXPOSURE DRAFT

4. We support the principle of basing segment reporting on the management approach. But SFAS 131 is an old standard that should be improved – for example it fails to support sum-of-the-parts valuations and it confuses rules and principles. So, ideally, we would have liked to see the IASB and FASB jointly develop a new standard that addresses the perceived flaws of both IAS 14 *Segment Reporting* and SFAS 131 *Disclosures about Segments of an Enterprise and Related Information*.

5. We do have concerns with ED 8 as it stands (and therefore indirectly with SFAS 131). We believe that ED 8 should be improved at this stage in the convergence process, in so far as these improvements are not inconsistent with SFAS 131. We would then urge the IASB and FASB to prioritise development of a joint standard on segment reporting.

## THE CONVERGENCE PROCESS

6. We support the IASB's overall objective of achieving one set of converged, high-quality global standards. While we agree that convergence is a priority consideration in developing new standards, and we accept that different issues will require different approaches to achieving this objective, we do not believe it

is appropriate to converge on a standard that leaves obvious room for improvement.

7. In the case of segmental reporting, the IASB's purported approach is, in effect, to adopt the equivalent SFAS (although we note that the proposals in the Exposure Draft appear to diverge further from SFAS 131 than is strictly 'necessary to make the terminology consistent with that in other IFRSs'). Given the flaws in SFAS 131, we question whether adopting it accords with the IASB's strategy of converging on the best possible standard. We believe that a number of improvements are required. We set out in below a number of areas in which the proposed standard needs improvement.

8. However, there are differences between IFRS and US GAAP as highlighted by the issue of the ED. It would not be helpful for businesses or users of financial statements if different segmental reporting was provided by the same company in order to comply with both IFRS and US GAAP. There would be potential for considerable duplication and confusion, particularly since management commentary relies on segmental reporting. Therefore, we place a higher priority on reducing differences than on making improvements that would create differences. And we do not, therefore, advocate making changes at this stage except where the resulting improvements would still be consistent with SFAS 131.

**MAJOR ISSUES**

9. Although segment reporting is sometimes regarded as the cuckoo in the financial reporting nest, we believe that it is central to providing an understanding of the business. It should therefore be a priority concern of standard setters. In our view, ED 8 lacks a strong underlying principle that would recognise the importance of segment reporting and underpin a robust standard. The objective of the standard should be to impart to the user an understanding of the profits, cash flows and net assets attributable to the different segments of the business in order to evaluate the performance of each segment. In particular, the standard should recognise that external analysts depend heavily on segmental analysis to perform (their main function of) sum-of-the-parts valuations. This can be best achieved by adopting the management approach to determining reportable segments, because this will best reflect management's own understanding of the business.

10. However, it is important that, in presenting segmented information, the sum of the segmented parts can be reconciled to the totals reported in the accounts. We therefore have reservations about allowing the financial information that is used internally for managing different operating segments to be the *only* information used for external reporting purposes where it is not based on GAAP. We specifically disagree with BC10 that 'It is increasingly unlikely that substantially different policies will be used to determine the amount reported in external financial statements and internal measures, and hence the segment information.'

In our view, the increasing use of fair values in GAAP could lead to an increasing divergence between externally reported numbers and accruals-based numbers used internally. Some companies may use tax-based internal measures. We would prefer a requirement for each type of reconciling item to be quantified for each segment.

11. As set out below in our answers to the specific questions raised by the Board:

- We do not support the proposal to require segmental information for the separate financial statements of a listed entity where they are included in a single financial report that also contains the consolidated financial statements (see paragraph 22 below).

- We do not support extending the scope of the standard to entities that hold assets in a fiduciary capacity (see paragraph 23 below).

- We do not agree that disclosure should be required for individual countries. SFAS 131 is not clear on whether such disclosure is required and we understand that aggregation is common in practice. We suggest that that this should be made clear in the IFRS (see paragraph 27 below).

**SPECIFIC QUESTIONS**

**Question 1 – Adoption of the management approach in SFAS 131**

*The draft IFRS adopts the management approach to segment reporting set out in SFAS 131* Disclosures about Segments of an Enterprise and Related Information *issued by the US Financial Accounting Standards Board.*

*Is this approach to segment reporting appropriate? If not, why not? What, if any, alternative approach would you propose?*

12. We agree in principle that the management approach to segment reporting is appropriate.

13. As set out in paragraph 10 above, we see dangers in allowing internal measures for segments to be used for external reporting purposes where they diverge from GAAP. The exposure draft claims that internal measures are more likely to be consistent with narrative reporting (as in the MD&A). This may well be true, but the purpose of segment reporting is not only to augment the MD&A. The purpose of segment reporting is also to shed further light on the financial information in the primary financial statements. It is therefore essential that segment information based on internal measures is reconciled with the GAAP-based external financial statements. The exposure draft proposes that this reconciliation should be based on the aggregated segment information and that the nature of the reconciling items should be disclosed. Depending on the nature and quantum of the

reconciling items, this may be inadequate for imparting an understanding of the performance of individual segments. We would prefer a requirement for each type of reconciling item to be quantified for each segment.

14. It is important that the management approach is applied effectively and that preparers do not aggregate segments inappropriately to disguise poor performance. We suggest that this is why the FASB felt it necessary to augment SFAS 131 with additional rules. We question whether ED 8 can function as a standalone standard without additional guidance.

15. Although the management approach purports to result in more segments being reported, we question whether this has been the case in practice: additional guidance is therefore required on identifying segments. The Board should examine the key principles that underlie the approach to:

- identification of operating segments;
- measurement of quantitative thresholds when operating segments use different non-IFRS compliant internal reporting measures;
- aggregation of operating segments that do not meet the quantitative thresholds.

16. The Board should address some of the practical problems that have arisen from applying SFAS 131 in the US environment. The Board should consider the material issued by the FASB - in the form of FASB 'Q&A 131 - Segment Information: Guidance on Applying Statement 131' and Emerging Issues Task Force (EITF) 04-10, 'Determining Whether to Aggregate Operating Segments That Do Not Meet the Quantitative Thresholds' - and analyse the key principles that need to be better explained in the primary text of the standard. We suggest some detailed wording changes in the Appendix.

17. We believe that the convergence process would be significantly enhanced if the IASB and the FASB examined these issues jointly and issued identical standards.

18. We also believe the standard should require management to disclose the rationale of the segmental structure, explaining in particular how this relates to the business.

19. A further area where guidance may be required is in determining appropriate criteria for allocating amounts to segments. IAS 14 creates a stronger imperative for allocating than does ED 8. Arbitrary allocation that is not used in management reporting should be discouraged, but an appropriate level of disaggregation should be achieved, consistent with GAAP. The use of a central or Head Office segment can be useful in this regard and should be supported by the standard.

**Question 2 – Divergence from SFAS 131**

*The wording of the draft IFRS is the same as that of SFAS 131 except for changes necessary to make the terminology consistent with that in other IFRSs.*

*Do you think that the draft IFRS should depart from the management approach in SFAS 131 by setting requirements for*

*(a) the measurement of specified items or*

*(b) the disclosure of specified amounts that might otherwise not be given?*

*If so, identify the requirements you would add and indicate what you see as the relative costs and benefits of any such requirements.*

20. We would require certain specified disclosures, although we do not see them as departing from the management approach. As set out in paragraphs 10 and 13 above, we believe that the IFRS should require reconciliation to GAAP at segment level. We would also require disclosure of segmented operating cash flows, where they are monitored by management and therefore readily available.

**Question 3 – Scope of the standard**

*The existing standard IAS 14 requires entities whose equity or debt securities are publicly traded and entities that are in the process of issuing equity or debt securities in public securities markets to disclose segment information. The draft IFRS extends the scope to include also entities that hold assets in a fiduciary capacity for a broad group of outsiders.*

*Do you agree with the scope of the draft IFRS? If not, why not?*

21. We agree that the scope of the IFRS should include entities whose equity or debt securities are publicly traded and entities that are in the process of issuing equity or debt securities in public securities markets. The scope of the standard should not be extended to unlisted entities, pending the outcome of the SME project.

22. We are concerned at the proposal to require segmental information for the separate financial statements of a listed entity where they are included in a single financial report that also contains the consolidated financial statements. Such disclosure is scoped out of IAS 14 (see paragraph 6) and we do not understand why this exemption has not been extended to the proposals in ED 8. Such an exemption would be consistent with the management approach, because group management considers performance of the group as a whole, not at a legal entity level. Furthermore we, cannot see any benefit to users in the requirement. Individual parent companies (and wholly-owned subsidiaries that do not have

listed debt) should be exempted from segmental disclosure if such disclosure is made in the consolidated accounts.

23. We also question the value of extending the scope of the standard to entities that hold assets in a fiduciary capacity. It is not clear exactly what would qualify to be scoped in under this requirement; in many cases, anyway, such entities would not have multiple operating segments. Nor would such information be particularly useful to users. We note that SFAS 131 does not have a similar extension of scope and it is not mirrored elsewhere in IFRS. All in all, we can see no reason for this particular requirement.

**Question 4 – Level of reconciliations**

*The draft IFRS requires an entity to provide, for specified items, reconciliations of total reportable segment amounts to amounts recognised by the entity in accordance with IFRSs. It does not require such reconciliations for individual reportable segments.*

*Do you agree with the level of reconciliations required in the draft IFRS? If not, indicate what you see as the relative costs and benefits of any other level of reconciliation.*

24. As set out above, we would require the financial information presented for each segment to be reconciled to GAAP. The benefit of such disclosure would be to give the user a clearer explanation of how the reconciling items relate to the risk profile of the business. The IASB should investigate whether this would involve significant costs.

25. We note that where an entity reports each operating segment using different recognition and measurement bases for segment revenue, profit or loss or assets, the entity will be required to reconcile each individual reportable segment to the amounts recognised by the entity in accordance with IFRSs

**Question 5 – Geographical information about assets**

*The draft IFRS requires an entity to disclose geographical information about non-current assets excluding specified items. It does not require disclosure of geographical information about total assets.*

*Do you agree with the requirement to disclose geographical information about non-current assets excluding specified items? If not, for which assets would you require geographical information to be given?*

26. While a case can be made for requiring disclosure of current assets on a geographical basis, we are on balance content with disclosure of revenues and

non-current assets. However, we have other reservations about the proposals, as set out below.

27. The ICAEW has consistently championed better disclosure of business risk, and we regard geographical segmentation in general as a proxy for disclosure of risk. The purpose of geographical disclosure, as we see it, is to identify risks such as currency exposure or politically-influenced trading uncertainties. We do not, therefore agree that disclosure should be made for individual countries. In keeping with our view that geographical disclosure is about disclosure of risk, we believe that aggregation into political, economic or currency areas should be allowed where this reasonably reflects the risk profile of the business. Where a business operates in many different countries, providing the required disclosures for each one is likely to be both confusing for users and onerous for preparers. We suggest also that such disclosure would be a departure from the management approach, as the strategy of the business will involve grouping geographical risk for decision making. We understand that in practice disclosure for individual countries is not generally made under SFAS 31, and we suggest that the IFRS should explicitly make it clear that it is not required.

**Question 6 – Consequential amendments to IAS 34 *Interim Financial Reporting***

*The draft IFRS requires an entity to disclose more segment information in interim financial reports than is currently required, including a reconciliation of the total of the reportable segments' measures of profit or loss to the entity's profit or loss.*

*Do you agree with the consequential amendments made to IAS 34? If not, why not?*

28. We agree.

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**APPENDIX:**
**SUGGESTED AMENDMENTS TO THE DRAFT STANDARD**

1. We suggest the following amendments to the draft IFRS. In particular, the Board should examine the key principles that underlie the approach to:

- identification of operating segments;
- measurement of quantitative thresholds when operating segments use different non-IFRS compliant internal reporting measures;
- aggregation of operating segments that do not meet the quantitative thresholds.

**Identification of operating segments**

2. To address FASB Q&A 131 – Segment Information: Guidance on Applying Statement 131 – Question 3, we propose the following change to the draft IFRS, paragraph 5.

**Paragraph 5**

Not every part of an entity is necessarily an operating segment or part of an operating segment. ~~For example,a~~ A corporate headquarters or ~~some~~ functional department~~s~~ may not earn revenues or may earn revenues that are only incidental to the activities of the entity and would not be an operating segment~~s~~. On the other hand, a corporate division that earns revenues (for example, a treasury operation that earns interest income) and has available discrete financial information and whose operating results are reviewed regularly by the chief operating decision maker should be considered an operating segment. Even if the revenues are considered to be incidental, such a division should be considered an operating segment if management believes the additional information may contribute to a better understanding of the entity. For the purposes of this [draft] IFRS, an entity's post-employment benefit plans are not regarded as operating segments.

**Quantitative thresholds and aggregation of operating segments**

3. To address FASB Q&A 131 – Segment Information: Guidance on Applying Statement 131 – Question 9, we propose the following change to the draft IFRS, paragraph 12.

**Paragraph 12**

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.

(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.

(c) Its assets are 10 per cent or more of the combined assets of all operating segments.

In the event that segments are evaluated based on different measures of segment profit or loss, the threshold criterion of paragraph 12 (b) should be applied to a consistent measure of segment profit or loss that is determined for internal reporting purposes for each segment, whether or not that measure is consistently used by the chief operating decision maker for purposes of evaluating segment performance. This would not affect the requirement in paragraph 20 (b) to disclose the actual measure of segment profit or loss that is used by the chief operating decision maker for the purpose of evaluating each reportable segment.

Operating segments that do not meet any of the quantitative thresholds may be considered reportable, and separately disclosed, if management believes that information about the segment would be useful to users of the financial statements.

4. To address EITF 04-10: Determining Whether to Aggregate Operating Segments That Do Not Meet the Quantitative Thresholds, we propose the following change to paragraph 13.

**Paragraph 13**

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 listed in paragraph 11.