Deloitte.

February 2006 – Special Edition

Audit

IAS Plus.

Published for our clients and staff throughout the world

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Proposals to revise requirements for reporting segment information

On 19 January 2006, the International Accounting Standards Board (IASB) issued Exposure Draft (ED) 8 **Operating Segments** which proposes to replace current requirements for reporting segment information under International Financial Reporting Standards (IFRSs).

The proposals are part of the IASB's efforts to converge IFRSs and US Generally Accepted Accounting Principles (US GAAP). ED 8, which would replace IAS 14 **Segment Reporting**, would require entities to adopt the same management approach to reporting on the financial performance of its operating segments as is required by the US Standard (SFAS 131 **Disclosures about Segments of an Enterprise and Related Information**).

Generally, the information to be reported would be the information that management uses internally to evaluate segment performance and to allocate resources to operating segments. That information might differ from amounts reported in the income statement and the balance sheet. The proposals would therefore require explanations of the basis on which the segment information is prepared, and reconciliations to the amounts presented in the income statement and the balance sheet.

Although these proposals are seen as relatively uncontroversial, they do involve significant changes from the principles underlying the reporting of segment information as currently contained in IAS 14. In particular, they could result in the use of non-IFRS measures for external reporting of segment information. The principal motivation for change is convergence with US GAAP – but it will be interesting to observe whether commentators agree that the proposed new standard is likely to result in the reporting of higher quality segment information.

If accepted, the proposed changes would come into effect from 1 January 2007. The IASB has requested comments on the ED on or before 19 May 2006.

Principal changes

Scope

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 ED proposes to extend that scope to include entities that hold assets in a fiduciary capacity for a broad group of outsiders – such as banks, insurance companies, securities brokers and dealers, pension funds, mutual funds and investment banking entities.

Note also that, in the Basis for Conclusions, the Board has indicated that there may be further proposals to extend the scope of the requirements on segment reporting to other entities – based on the proposed definition of public accountability that is being considered as part of its ongoing project on small and medium-sized enterprises (SMEs).

Identification of segments

IAS 14 requires identification of two sets of segments – one based on the product/services supplied by the entity and the other based on geographical areas. These segments are ideally based on those components for which information is already reported internally to senior management. However, if the internal reporting system is based neither on products/services nor on geography, the business and geographical segments of the entity for external reporting purposes will be determined based on factors listed in the Standard.

Under the proposals in the ED, segments are defined solely based on the structure of the entity's internal organisation.

The proposals in the ED would require entities to adhere more rigorously to the 'management approach' to segment reporting – i.e. segments are defined solely based on the structure of the entity's internal organisation, as follows:

> An operating segment is a component of an entity:
>
> a) that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity),
>
> b) whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, and
>
> c) for which discrete financial information is available.

The term 'chief operating decision maker' identifies a function, not necessarily a person. That function is to allocate resources to and assess the performance of the operating segments of an entity.

For practical purposes, not all components meeting the definition are reportable – the ED includes both aggregation criteria and quantitative thresholds for determining reportable operating segments.

Supporters of the proposed approach argue that defining segments based on the structure of the entity's internal organisation allows users to see an entity through the eyes of management, which enhances a user's ability to predict actions or reactions of management that can significantly affect the entity's prospects for future cash flows. In addition, the proposals should reduce the cost of reporting segment information externally because they would result in the reporting of segment information that is already generated for management's use. The perceived disadvantage of the proposed approach is that it may result in the reporting of segments that are not comparable between entities that are engaged in similar activities, and that are not comparable from year to year for an individual entity.

Measurement of segment information

IAS 14 requires segment information to be prepared using the accounting policies adopted for the financial statements of the entity. The ED proposes that this requirement be removed – so that the amount of each segment item reported will be the measure that is reported internally, irrespective of the basis of preparation.

The proposed standard would require entities to report a measure of profit or loss and total assets for each reported segment – but provides no further guidance on what measure should be reported. In contrast, IAS 14 currently defines segment revenue, segment expense, segment result, segment assets and segment liabilities – all of which are required to be reported.

The amount of each segment item reported will be the measure that is reported internally, irrespective of the basis of preparation.

Opponents of these proposals argue that the use of non-IFRS measures for external reporting of segment information, and the absence of defined measures for those items that are reported, could undermine the credibility of the financial statements and mislead users. The IASB, however, has concluded that the requirements included in the ED for an explanation of the measurements of segment profit or loss and segment assets, and for reconciliations of the segment amounts reported to the amounts presented in the entity's financial statements, will enable users to understand and judge appropriately the basis on which the segment amounts were determined.

Disclosure

The ED segregates its disclosure requirements into: general information; information about profit or loss and assets; reconciliations; and entity-wide disclosures. The most noteworthy of the proposals are summarised in the table below.

In general, entities might find it easier to report the amounts proposed under the ED, in comparison to those currently required under IAS 14, because they would not need to adapt amounts already reported internally. However, certain of the additional entity-wide information specified for disclosure may be viewed as commercially sensitive.

In particular, the proposed requirement to disclose the extent of reliance on major customers is likely to be controversial. The ED proposes, among other requirements, that entities be required to disclose the amount of revenues earned from each customer responsible for 10 per cent or more of the entity's revenues (although the identities of those customers need not be disclosed).

General information	The following information: • factors used to identify the entity's operating segments, including the basis of organisation; and • types of products and services from which each reportable segment derives its revenues.
Information about profit or loss and assets	A measure (unspecified) of profit or loss and total assets for each reportable segment. A number of specified income statement headings for each reportable segment – if the amounts are included in the measure of segment profit or loss reviewed by the chief operating decision maker (or are otherwise regularly provided to the chief operating decision maker). For each reportable segment – (if the amounts are included in the determination of segment assets, or otherwise are also reviewed by the chief operating decision maker): • the amount of investment in associates and joint ventures accounted for by the equity method; and • total expenditures for additions to non-current assets other than financial instruments, deferred tax assets, post-employment benefit assets and rights arising under insurance contracts. All measurements of segment profit or loss and segment assets to be explained, including: an explanation of the nature of any differences between amounts reported for segment purposes and those for the entity as a whole; the nature and effect of any changes from prior periods in the measurements used; and the nature and effect of any asymmetrical allocations to reportable segments.
Reconciliations	The following reconciliations to be provided, with all material reconciling items separately identified and described: • the total of the reportable segments' revenues to the entity's revenue; • the total of the reportable segments' measures of profit or loss to the entity's profit or loss before income tax expense or income and discontinued operations;

Reconciliations (continued)	• the total of the reportable segments' assets to the entity's assets; and • the total of the reportable segments' amounts for every other material item of information disclosed to the corresponding amount for the entity. (For example, an entity may choose to disclose liabilities for its reportable segments, in which case the entity would reconcile the total of reportable segments' liabilities to the entity's liabilities if the segment liabilities are material).
Entity-wide disclosures	The proposed standard would require an entity, including an entity with a single reportable segment, to disclose information for the entity as a whole about its products and services, geographical areas and major customers. This requirement applies, regardless of the entity's organisation, if the information is not included as part of the disclosures about segments.

Interim reporting
The ED proposes to expand significantly the requirements for segment information at interim reporting dates. Because amounts reported will be consistent with those reported internally, the Board has concluded that it will now be possible to expand segment information in interim reports without undue cost or delay.

Effective date
If accepted, the proposals would be effective for annual financial statements for periods beginning on or after 1 January 2007, with earlier application encouraged.

Transitional provisions
The ED proposes that segment information for prior years that is reported as comparative information in the first year of application of the new standard should be restated in line with the requirements of the new standard, unless the necessary information is not available and the cost to develop it would be excessive.

Comment deadline
The comment deadline for the proposals is 19 May 2006.

Designed and produced by The Creative Studio at Deloitte, London.

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