Alert # 2006/03
Issued 6 February 2006

Accounting Alert

Analysis of the latest accounting developments delivered to you via e-mail

Operating segments exposure draft issued

The exposure drafts are now freely available on the IASB and AASB websites

The International Accounting Standards Board has issued exposure draft ED 8 'Operating Segments' which proposes to replace IAS 14 'Segment Reporting'. The AASB has consequently issued ED 145 'Operating Segments'.

The proposed amendments result from the IASB's joint short-term convergence project with the US Financial Accounting Standards Board.

This Accounting Alert provides an Australian perspective on some of the key proposals and their impacts.

Overview

Segment reporting to better match internal reporting

The proposed amendments would require an entity to adopt a modified 'management approach' to reporting on the financial performance of its operating segments. The information to be reported would be consistent with that used internally by management for evaluating segment performance and deciding how to allocate resources to operating segments, subject to certain aggregation criteria and quantitative thresholds for determining reportable operating segments. As a result, the measurement of such information may be different from that used to prepare the income statement and balance sheet. To ensure users understand the information and its limitations in the context of the entity's financial statements, explanations of the basis of preparation and reconciliations to amounts recognised in the income statement and balance sheet will be required.

Key considerations include:

- segmentation will be more consistent with internal management reports
- a greater number of segments are likely to be disclosed
- potential inconsistent measurement between segment information and other information in the financial report.

Scope

AASB 114 currently applies to all general purpose financial reports of for-profit entities. This is an extension of scope compared to the international Standard. ED 145 proposes to change the Australian scope to be consistent with the IASB, and it is proposed to be applicable only to the following entities:

In Australia, application to be limited to disclosing entities and entities that hold assets in a fiduciary capacity for a broad group of outsiders

- that have filed or are in the process of filing their financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market
- that hold assets in a fiduciary capacity for a broad group of outsiders, such as a bank, insurance company, securities broker/dealer, pension fund, mutual fund or investment banking entity. (This is a scope extension compared to IAS 14.)

Reportable operating segments

Under the proposals 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.

Defining segments based on the structure of an 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, given the information is already generated for management's use it is expected the incremental cost of providing information for external reporting should be relatively low.

'Chief operating decision maker' is not defined and may represent a function, being the allocation of resources to and assessment of performance of operating segments. Therefore, the chief operating decision maker may be the CEO/CFO, but it may also be a group of directors.

Segmentation based on products and services takes precedent over geography where both methods used internally

As a result of the definition of operating segments the distinction between primary and secondary segments disappears. However, some entities report based on various overlapping components e.g. products and services and geography. Where information is available and reviewed under both segmentation methods, operating segments should always be reported based on products and services.

In terms of the aggregation of segments, the quantitative thresholds and criteria are similar to IAS 14, but given the change in definitions additional segments may be disclosed, in particular vertically integrated segments, although it is likely that any more than 10 segments is not practical.

Measurement of segment information

Allocation of information to segments may not be in accordance with accounting principles

Much more freedom is proposed in the measurement of segment information disclosed. No longer are segment revenues, expenses, results, assets and liabilities defined but the amount of each operating segment item reported should be the measure reported to the chief operating decision maker for the purpose of allocating resources to the segment and assessing its performance. This may mean that certain adjustments/eliminations recognised when preparing financial statements are ignored, the allocation basis may not be consistent with A-IFRS principles (e.g. cash v accrual) because some accounting principles are not intended to apply at a segment level, and that there is not consistency between the allocation to profit versus assets, for example.

An explanation of the measurements of segment profit or loss and segment assets for each reportable segment will be required. Also, when the measurement basis is different to A-IFRS principles, reconciliations will be required between the total of the reportable segment amount and the equivalent amount for the entity, disclosing all material reconciling items.

Disclosures

The disclosure of segment information would change considerably under the proposals. Firstly, because of the loss of primary and secondary segments, key disclosures will be provided only for the operating segments. At a minimum, for each reportable segment an entity shall disclose:

- factors used to identify the entity's reportable segments
- types of products and services from which each reportable segment derives its revenues
- a measure of profit or loss, including an explanation of the measurement basis
- a measure of total assets, including an explanation of the measurement basis.

Additional disclosures of certain profit and loss items would also be required where either included in the measure of segment profit or loss or otherwise regularly reported to the chief operating decision maker.

Additional disclosures will be required even for an entity with a single reportable segment

Reconciliations of various reportable segment totals to entity totals are also required.

Even entities with only a single reportable segment will be required to disclosure information for the entity as a whole about its products and services, geographical areas and major customers.

When are these changes proposed to take effect?

The changes are proposed to commence from 1 January 2007

The proposals are scheduled to apply to annual reporting periods beginning on or after 1 January 2007, with the restatement of comparative information. Early adoption is encouraged, however, entities are only permitted to apply the Standard from the beginning of the annual period commencing on or after the date the Standard is issued (timing of which is still unknown).

Comment period

The IASB has requested comments on ED 8 by 19 May 2006. The AASB has requested comments on ED 145 by 20 April 2006 so that comments can be taken into account in the AASB's own submission to the IASB.

Feedback and assistance

We welcome your feedback on the matters covered in this Accounting Alert – please email your comments to accounting_alerts@deloitte.com.au

For assistance in applying the requirements outlined in your organisation, please contact your local Deloitte office or contact our Lead National Technical Partner, Bruce Porter on +61 (0) 3 9208 7490 or by e-mail to bruporter@deloitte.com.au