European Securities and Markets Authority

Report

Review of European enforcers on the implementation of IFRS 8 – *Operating Segments*

9 November 2011 | ESMA/2011/372

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Date: 9 November 2011
ESMA/2011/372

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List of abbreviations and acronyms used in this report

EBIT	Earnings before interest and taxation
EBITDA	Earnings before interest, taxation, depreciation and amortisation
EC	European Commission
EU	European Union
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IFRS IC	International Financial Reporting Standards Interpretation Committee

Executive Summary

This Report provides the main findings of the review of European enforcers on the implementation of IFRS 8 – *Operating Segments* and ESMA's tentative recommendations to enhance the application of the standard.

On the basis of this review, the overall conclusion reached by European enforcers is that (i) the implementation of IFRS 8 resulted in a fairly similar level of information compared to its predecessor IAS 14 and that (ii) there is homogeneity in the issues faced by European enforcers when enforcing this standard. This stems from a combination of weaknesses in the standard and a failure to fully comply with its requirements by issuers.

Based on the approach detailed in paragraphs 20 to 23 of this report, four topics emerged as a result of the review:

— Identification of the chief operating decision maker (CODM): 41% of issuers reviewed for which such information was available identified the Board of Directors as the CODM although this body often includes non-executive members. This indicates that there might be some confusion caused with the definition of CODM in the standard;

— Aggregation of operating segments into reportable segments: ESMA observed that disclosures on aggregation of segments were explicitly mentioned by 29% of issuers only although IFRS 8.22(a) refers to this piece of information as an example that contributes to helping investors understand the entity's basis of organisation. The level of subjectivity in deciding how aggregation should be applied may lead to diversity in practice;

— Measurement basis for information presented under IFRS 8: 93% of issuers under review used IFRS as a measurement basis for segment information and 47% presented non-GAAP measures such as EBIT and EBITDA in the segment information. In many instances, information about allocation policies of profit or loss, assets and liabilities to reporting segments, definition of non-GAAP measures and the reconciliation between segment information and the amounts reported in the financial statements were not disclosed properly;

— Analysis of entity-wide disclosures: although 58 % of issuers in our sample provided information about revenues and non-current assets by geographical area in accordance with IFRS 8, ESMA noted that the notes to the financial statements rarely present information for individual foreign countries and that there is no common understanding on how the materiality concept should be applied in this context.

In addition, ESMA compared the quality and level of geographical segment information disclosed under IAS 14 and IFRS 8. On the basis of our review, few entities changed their reporting basis (from a focus on geographical areas to a focus on business segments or vice versa). There is also limited evidence that the quality of information provided on geographical areas is lower than what was previously reported under IAS 14 in the cases where the same basis applied.

As part of this review, ESMA also held some discussions with organisations representing financial analysts. Generally, the investor community is concerned that the segmental information reported may not be consistent with the way management really looks at the activities to run the business. Analysts also consider that the present level of reconciliations on a reportable basis required by the standard is unsatisfactory. Furthermore, the investor community is generally of the view that the information provided does not give meaningful information as it is not reported at a sufficiently low level of granularity.

Based on the findings of the review on the implementation of IFRS 8, ESMA's tentative recommendations and conclusions focus on:

— Proposals to amend the standard, in particular in relation to the disclosures on what is meant by the terms "chief operating decision maker", the application of aggregation criteria and the materiality concept when applied to entity-wide disclosures on geographical areas;

— Encouraging issuers to further improve their segment reporting disclosure in order to enhance clarity and transparency.

— Continuing to monitor the application and compliance with IFRS 8 followed by enforcement actions when necessary.

I Introduction

Background

1. In its working priorities for 2011, ESMA decided to carry out a post-implementation review of IFRS 8 – *Operating Segments*, based on the experience gained by European national competent authorities as part of their enforcement activities. This initiative was also prompted by issues that were identified in 2010 and which were submitted in a formal letter to the IASB proposing recommendations for the IASB's Annual Improvements Project.

2. When IFRS 8 was put forward for endorsement in the European Union, the European Parliament asked for a review on its implementation. In its Resolution adopted on 14 November 2007 the European Parliament requested the IASB to carry out a review of the implementation of IFRS 8 and the European Commission to follow closely the application of the standard and to report back to the Parliament no later than 2011[1].

3. Constituents urged the IASB since long to perform post-implementation reviews of the new standards or significant amendments to existing standards it issues and, in the case of European constituents, notably on IFRS 8. Since then, the IASB confirmed that it will conduct a post-implementation review on the standard. The review will focus on standard implementation on a worldwise basis, not just in Europe.

Objective

4. The objective of this Report is to provide an overview of the application of IFRS 8 requirements by European issuers and to indicate the areas posing significant challenges, be it to investors, preparers

[1] http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P6-TA-2007-0526&language=EN

and/or enforcers. This report has been prepared independently from the IASB or any other organisation.

5. In addition, the report aims to provide the European Commission with some of the information requested by the European Parliament with regards to the potential deficiencies claimed at the time of endorsement, such as the level of change in the geographical information communicated by companies or measures used for reporting entities performance.

II Scope of the report

Overview of IFRS requirements on operating segments

6. The core principle of IFRS 8 is to enable users of financial statements to evaluate the nature and financial effects of the business activities in which the entity engages and the economic environment in which it operates[2].

7. IFRS 8 specifies how an entity should report information about its operating segments in the financial statements. It also sets out requirements for related entity-wide disclosures about products and services, geographical areas and major customers.

8. IFRS 8 requires an entity to report financial and descriptive information about its reportable segments. Reportable segments are operating segments or an aggregation of operating segments that meet specified criteria. Operating segments are components of an entity about which separate financial information is available that is evaluated regularly by the Chief Operating Decision Maker (CODM) to make decisions about resources to be allocated to the segment and assess its performance. Generally, information is required to be reported on the same basis as it is used internally for evaluating operating segment performance and for deciding how to allocate resources to operating segments.

9. IFRS 8 also requires an entity to report limited information about geographical areas, unless the necessary information is not available and the cost to develop it would be excessive. The required disclosures include information on revenues from external customers attributed to the entity's country of incorporation and attributed to all foreign countries in total from which the entity derives revenue and non-current assets.

European enforcer's expectations at the time the IASB's Exposure Draft 8 - Operating Segments was exposed for comments in January 2006.

10. When the IASB issued Exposure Draft 8 - Operating Segments (ED 8) for comments in January 2006, enforcers acknowledged that the use of the management approach would probably contribute to an improvement in the relevance, the reliability, and as a consequence, the quality of segmental information[3]. It was assumed at that time that this approach would result in information provided to the public that management would recognise as its own measure of performance, consistent with established target plans and budget. But because budgets are generally prepared at segment level or at a lower

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[2] IFRS 8 paragraph 1

[3] CESR Letter 07-400 dated 2 July 2007 to the European commission: comments on question 2 b) and c).

level, there was an expectation that, theoretically, IFRS 8 would result in an increased number of segments being reported (as compared to IAS 14)[4].

11. In line with the above, enforcers did not disagree to the use of performance indicators reflecting the way business units are managed, evaluated, the way business leaders are appraised and incentivised, how investment decisions are made and later on assessed[5]. Enforcers' expectations were that the management choice could make it easier to cross reference segmental information to management commentary.

12. On these grounds, enforcers did not object to the ED allowing the presentation of segments measures that are not prepared in compliance with IFRS but are in compliance with other generally accepted accounting principles (GAAPs) or with group accounting principles if used for internal reporting. Enforcers were, however, concerned that such an option might result in a lower degree of comparability if the use of this option were to be widespread. This concern was reinforced by the provision on reconciliation between segments measures and IFRS figures from the primary financial statements. Because the ED provided only for a reconciliation of measures for total segments with the financial statements instead of a detailed reconciliation, enforcers were of the view that this provision could reduce comparability between entities.

13. As regards the criteria for aggregating operating segments into reportable segments, enforcers identified that the term "economic similarity" needed to be clarified because there is a potential for different interpretations in this area. This had been identified as providing excessive latitude to preparers, with the underlying risk that these terms would contribute to reducing the number of reportable segments.

14. Enforcers were of the view that the quantitative thresholds provided in ED 8 paragraph 13 are useful and necessary safeguard which would mitigate the risk mentioned above that preparers might not report the full number of reportable segments. In this context, enforcers were cognisant of the guidance in the ED which noted that an issuer should consider whether a practical limit has been reached when there are ten or more reportable segments.

15. Moreover, European enforcers identified a potential risk with the concept of the CODM, for which enforcers believed divergent practices might emerge. In its letter to the European commission, ESMA (at that time CESR) underlined the fact that if clarification were needed in this area, such a clarification might come from IFRS IC [6].

Issues selected for review

16. The approach used in selecting areas covered in this report was mainly based on enforcement issues that emerged from the review of financial statements in 2009 and 2010. In addition, some of the aspects included in the Resolution of the European Parliament have also been included in this review.

17. The following topics are covered in detail:

    a. *Identification of the Chief Operating Decision Maker* – this is an essential step in the application of IFRS 8 as it helps identifying operating segments. We have analysed at which level the

[4] IFRS 8 paragraphBC6 noted that most of the academic findings on segment reporting found that the application of SFAS 131 (on which IFRS 8 is based) increased the number of reported segments and provided more information.
[5] CESR Letter 07-400 dated 2 July 2007 to the European commission: comments on question 2 b).
[6] CESR Letter 07-400 dated 2 July 2007 to the European commission: comments on question 4

function of the CODM has been identified by the issuers and the factors that supported such a judgement.

b. *Aggregation of operating segments into reportable segments* – IFRS 8 permits aggregation of operating segments if they have similar economic characteristics and comply with specific aggregation criteria. ESMA looked into more detail how issuers applied those requirements when aggregating segments.

c. *Measurement basis for information presented under IFRS 8* – IFRS 8 allows presentation of segment information based on data produced for internal reporting, for which the measurement basis might be different from IFRS. We examined whether issuers are presenting information based on IFRS or another GAAP. This section also includes an analysis of the measures most-frequently used by entities, such as EBIT, EBITDA or other financial indicators not specifically required by the standard.

d. *Analysis of entity-wide disclosures* – IFRS 8 requires disclosure of information on products and services, geographical areas and major customers. We assessed to which extent entities complied with these requirements and the level of detail of the information provided.

e. *Comparison of geographical segment information disclosed under IAS 14 and IFRS 8* – IFRS 8 asks only for one dimension of operating segments based either on geography or on businesses. Under the previous standard (IAS 14) an entity was required to identify and provide financial information for both operating and geographical segments. We considered whether a loss in the value of information reported on geographical areas occurred with the introduction of IFRS 8.

Communication with financial analysts

18. In addition to the reviews of reports and accounts performed by European national enforcers, ESMA has discussed issues with investor representatives from the Corporate Reporting Users Forum (CRUF) and from the French Society of Financial Analysts (SFAF).

19. The concerns expressed by investors about some IFRS 8 requirements are however in some cases divergent. The outcome of these discussions is further discussed in section VIII.

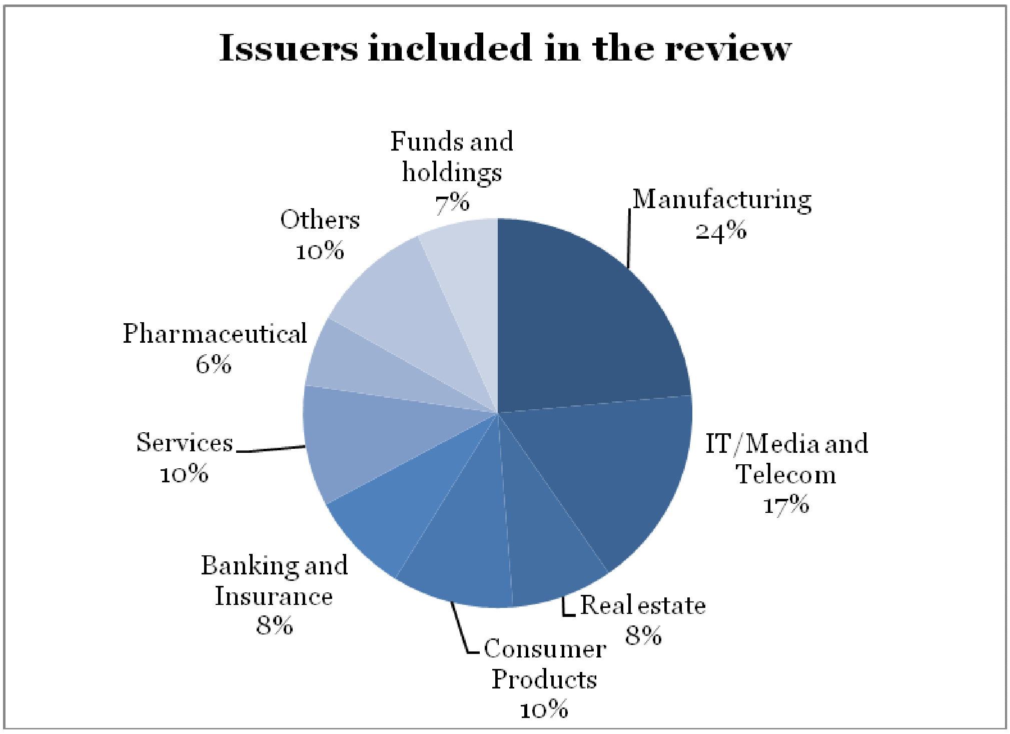
Scope of the entities under review

20. The analysis in this report has been prepared on the basis of a review of financial information of 118 European listed entities preparing consolidated financial statements under IFRS, two of which are exclusively bond issuers.

21. Selection of issuers whose accounts were subject to this review comes out of enforcement activities of 9 European countries with the largest capital markets in Europe. The reviews were performed on 2009 or 2010 financial statements. The primary activity and market capitalisation of the issuers played no part in the selection process. Total market capitalisation of the sample is about 700 million Euros. The market capitalisation of the smallest and largest issuer was 0.4 million euro and 95 300 million euro respectively.

22. The findings from this review were shared with the other European enforcers (18 countries) to ensure that the matters identified in this report represent a balanced view of issues arising in Europe. ESMA would like to underline that the fact that a particular aspect of the standard has not been addressed in this report does not necessarily mean that there is full compliance with that specific requirement or that no further improvements are possible. Equally, the results in this survey may not represent a balanced view on compliance with the standard because of the bias inherent in the sample of entities selected.

23. The 118 issuers included in the review belong to different industries:



III Identification of the Chief Operating Decision Maker

IFRS requirements

24. The standard requires companies to disclose segmental information in a manner consistent with the way management approaches the company's activities, the so called through the eyes of the management approach. Companies are required to identify a Chief Operating Decision Maker (CODM) to whom the information is presented. The standard defines the CODM as a function, not necessarily a manager with a specific title. That function is to allocate resources to and assess the performance of the operating segments of an entity[7].

[7] IFRS 8 paragraph 7

25. In the basis for conclusions of IFRS 8 the IASB noted that the primary benefits of the management approach are that entities will report segments that correspond to internal management reports, entities will report segment information that will be more consistent with other parts of their annual report, some entities will report more segments and entities will report more segment information in interim reports. It also noted the standard should reduce the cost of providing disaggregated information for many entities because IFRS 8 uses segment information that is generated for management's use.[8] IFRS 8 paragraph BC4 states that the requirements of SFAS 131 (on which IFRS 8 is based) are based on the way that management regards an entity, focusing on information about the components of the business that management uses to make decisions about operating matters.

Findings

26. The term Chief Operating Decision Maker suggests that the person or function so designated should be involved in making operating decisions. Yet the reference to resource allocation decisions suggests that they may also make strategic decisions.

27. The results of this review indicates the following distribution in terms of identification of the CODM, for the issuers for which this information was available for review :

— 23% of the population has identified the Management Board ;

— 41% have identified the Board of Directors (which includes both executive and non-executive directors);

— 36% have identified the Strategic Committee, the Chief Executive Officer or the Managing Director as CODM.

28. From this information it could be noted that entities often consider the Board of Directors as the CODM. In practice, the Board generally focuses on strategic decisions whereas operational decisions may be made at a lower level by the segment manager who is directly accountable to and maintains regular contact with the CODM / the Board. It appears in practice that allocating resources and assessing performance may not always be carried out by the same persons or using the same set of information.

29. When comparing the number of segments before and after the application of IFRS 8 in the sampled accounts, we noticed that 9 entities decreased the number of operating segments. Some of these cases were justified by changes in the business structure (divestments or new acquisitions) or in the internal operational structure of the organisation. In practice, some of the issuers included in our sample claimed that the management does not use the information reported to it. We have also observed a case where an additional layer had been introduced in the company's organisation in order to reduce the number of reportable segments.

[8] IFRS 8 paragraph BC9

Conclusions

30. Although IFRS 8 does not explicitly require that the person or the group of persons identified as the CODM should be disclosed in the notes to financial statements, 51% of the issuers included in our review provided this information. A significant number of entities have identified the Management Board as their CODM. It also appears in practice that some issuers have concluded that the CODM is the board of directors, a body that comprises both executive and independent non-executive directors. As a result, as operating segments are identified on the basis of information used by the CODM there is a risk, in such cases, that the operating segment disclosures are based on less detailed information. The fact that non-executive directors are often present in a body identified as the chief operating decision maker appears to be inconsistent with their corporate governance responsibilities. This indicates that there might be some confusion caused with the definition in the standard.

31. In practice, it appeared in some cases that the judgements applied to the identification of CODM may have resulted in a reduction of the number of operating segments, thereby not achieving the objectives of IFRS 8 as described in the core principle.

Proposed solution/ Recommendation

32. Consideration could be given to amending the definition of the CODM. To reduce the potential for confusion or too much leeway in defining the CODM, we propose that the operating nature of the function should be emphasised in the CODM definition.

33. Examples could also be provided in the standard to provide supportive evidence for identifying the operating nature, such as the organizational chart, lines of reporting and management bonus schemes.

34. In February 2011 ESMA sent a letter to the IASB[9] in which we asked it to consider amending the definition of the CODM and proposed that the operating nature of the function should be emphasised in the definition in order to reduce the potential for confusion or misuse. In addition, we believe that the standard should clarify that there is a presumption that management reviews the information that is reported to it. We believe this clarification has the potential to reduce diversity in practice, ensuring better compliance to the standard's core principle as well as enhancing the enforceability of IFRS 8.

35. During its July 2011 meeting the IFRS Interpretations Committee noted that practice reveals that sometimes the CODM's prerogatives (i.e. allocation of resources and assessment of performance) are carried out by different persons involved in those activities who could be indicated by the entity as being part of the CODM function. The Committee also noted that when the Board of Directors of an entity is considered to be the CODM, this would not normally include non-executive directors because of the role of the CODM in taking operating decisions, to which non-executive directors typically do not participate. Consequently, the Committee decided to refer this issue to the Board for consideration as part of the future post-implementation review of IFRS 8 because it did not think that this issue should be addressed by an interpretation or as part of the Annual Improvements process. Following the IASB's meeting held in September, the staff decided to look further into this issue as part of the post-implementation review on IFRS 8.

[9] See Appendix 1

IV Aggregation criteria

IFRS requirements

36. The management approach in IFRS 8 should allow users of the entity's accounts to review its operations from the same perspective as management. The aggregation criteria modify the management approach enabling a company to avoid separately reporting information about operating segments which have similar economic characteristics such that they can be expected to have essentially the same future prospects and separate disclosure of each segment would not add significantly to a user's understanding.

37. The aggregation criteria in paragraph 12 are cumulative, i.e. all criteria, where relevant, must be satisfied for a company to aggregate the operating segments. However, significant judgement is required in determining whether all aggregation criteria are met.

38. Paragraph 22(a) of IFRS 8 requires disclosure of the factors used to identify the entity's reportable segments, including the basis of the entity's organisation (for example, whether management has chosen to organise the entity around products and services, geographical areas, regulatory environments, or a combination of that) and whether operating segments have been aggregated.

Findings

39. Our review identified that 35 issuers disclosed the fact that two or more operating segments had been aggregated into a single operating segment. Out of these 35, 27 explained the factors considered in applying the standard's aggregation criteria. The disclosures, however, tend to be boilerplate and often repeat the wording used in the standard (explaining that the segments were economically similar, had similar products and customers…) without further detail. It is also not clear which factors have been considered in the determination that operating segments share similar economic characteristics. This is generally observed irrespective of whether the business is managed by products and services or on a geographical basis.

40. However, for the majority of the issuers reviewed (83) it was not apparent from the information disclosed in the financial statements whether operating segments had been aggregated or not.

41. We did not observe any evidence of issuers reporting an unreasonably large number of reportable segments. Equally, we did not observe issuers reporting a significantly greater number of segments compared to the information reported under the previous accounting standard IAS 14 (please refer to section VII for more details on this aspect).

42. We are sceptical whether the segmental information reported by the majority of issuers reflects the detailed internal management information used in the business to make operating decisions. The segment information reported is probably at a greater level of aggregation and this may result from the application of the aggregation criteria. Where the aggregation criteria have been correctly applied, it is clear that the aggregated information is of use to users of the accounts. However, when the criteria have not been applied correctly, the degree of divergence from the information used in-

ternally and that reported in the financial statements will significantly reduce its usefulness for users of the financial statements.

43. The fact that operating segments have been aggregated is not always apparent from disclosures in the financial statements, but may, come to the attention of enforcers when there are apparent inconsistencies between the (narrative) management report and the financial statement disclosures. It is not uncommon for management reports (or MD&A) to provide detailed discussions on many different activities that are not presented as reportable segments in the financial statements.

44. When challenged by enforcers, issuers will often explain the factors considered in determining that all of the aggregation criteria had been met. Such an analysis is largely based on the significant judgements required in determining whether economic characteristics are similar or if products and services are similar between segments.

45. Some enforcers have identified that issuers appear to misunderstand the requirements in the standard. These issuers seem to be determining what segments to report without applying the requirements in the standard concerning the identification and subsequent aggregation of operating segments.

46. Certain issuers justify their judgement that operating segments are economically similar but such an argumentation tends to refer to the example provided in the standard that the segments had similar long term average gross margins. However, we often observe that the operating segment performance indicator used is determined on a different basis (different from the gross margin). When business is managed on a geographical basis, enforcers quite often observe that risks resulting from currency are not taken into account in the determination of operating segments.

Conclusions

47. Reporting of segment information at the appropriate level of aggregation plays an important role in allowing users of financial statements to understand the performance of the business, to make cash-flow forecasts of the entity and to enable comparisons with other entities.

48. Our review highlights that, generally, judgements made in applying the aggregation criteria, which by their nature must be significant, were not disclosed as significant judgements in the notes to the financial statements. We believe that this is because there is no explicit requirement in the standard to do so. Paragraph 122 of IAS 1 (Revised), 'Presentation of Financial Statements', requires disclosure of significant judgements made in applying the issuer's accounting policies that have the most significant effect on the amounts recognised in the financial statements. However, as the application of IFRS 8's aggregation criteria does not have any effect on the amounts recognised in the statement of financial position, the disclosure requirement in paragraph 122 of IAS 1 may not be seen to apply.

Proposed solution/ Recommendation

49. The application of the aggregation criteria requires a significant amount of judgement. For instance, the criteria allow "professional judgment" of whether an aggregation is consistent with the core

principle of IFRS 8 in deciding how aggregation can be applied, if at all. Deciding if two segments are sufficiently economically similar to aggregate can be difficult and subjective in some cases.

50. This level of subjectivity may lead to diversity in practice with some companies deciding to aggregate more by combining segments which should be reported separately. The level of subjectivity applied by management may often not be apparent from the disclosures given under IFRS 8 paragraph 22.

51. ESMA believes that additional disclosure requirements concerning the judgements made would provide users with important information as to whether the level of aggregation is appropriate. It would also require management to consider more closely whether the divergence in economic indicators disclosed truly represents economic similarity.

52. Rather than seeking the development of detailed rules concerning the application of the aggregation criteria, ESMA believes that clear disclosures of the assumptions and judgements made in their application would be an improvement to financial reporting. In the light of this, additional disclosures were proposed to the IASB[10] in the letter sent by ESMA in February 2011.

53. As part of its due process the IASB asked for views from the IFRS IC on ESMA's letter. At the July 2011 meeting, IFRS IC staff proposed the inclusion of a more specific requirement in IFRS 8 to disclose the basis for aggregating operating segments as proposed in our letter.

54. However, a majority of IFRS IC members disagreed with the staff recommendation and thought that additional disclosure was not needed. In the view of these members, adding a new disclosure to paragraph 22 appears to question or mistrust the use of management's judgement, being that the latter is a basic principle in IFRS 8 when reporting segment information and would be enhancing the possibility of detecting non-compliance with the requirements in IFRS 8, rather than assuring that the objective of IFRS 8 had been met. The Committee recommended that the issue was addressed in the future post-implementation review.

55. ESMA wrote to IFRS IC in August 2011 disagreeing with their decision and urged them to consider dealing with the matter as part of the annual improvements project. At the September 2011 meeting, the Committee noted that certain aspects concerning the application of the aggregation criteria could be clarified and would update the IASB at its September meeting on the Committee's discussions.

V Measurement basis

IFRS requirements

56. The standard requires that the amount of each segment item reported should be the measure reported to the CODM for the purposes of making decisions about allocating resources to the segment and assessing its performance[11] .

57. Explanations and reconciliations are then required to enable users of financial statements to understand the measurement basis chosen by the management and the nature of any differences between

[10] See Appendix 1
[11] IFRS 8 paragraph 25

the measurements of the reportable segments' profit or losses. In addition, financial statement preparers must reconcile certain financial statements line items (including revenue, the entity's profit or loss measure) to the related total reportable segments amounts.

Findings

58. As part of reviews performed by the enforcers, we identified the following accounting practices relating to the measurement basis in IFRS 8 which can be divided into the following categories:

    a. The measurement basis used to disclose performance of operating segments, including the type of GAAP and the extent of non-GAAP measures;

    b. Reconciliations between the aggregate segment information and the amount reported in the income statement and balance sheet.

<u>a) Measurement basis used to disclose performance of operating segments</u>

59. Of the sample of issuers reviewed, 93% of entities mentioned explicitly the use of IFRS as measurement basis of segment reporting information. Only three entities opted to report local GAAP figures, two of which reported both local GAAP and IFRS figures.

60. Undefined non-GAAP profit measures were also observed in 47% of segment reporting under review. 27% of the entities presented individual segment results, frequently excluding items which the issuers deemed to be non-recurring or not directly related to segment results, such as restructuring expenses, exceptional items, amortisation and/or impairment of intangibles resulting from purchase price allocation processes, and share-based payments expense. In addition to the "Non current operating result" or "adjusted figures" which take into account the above-mentioned exclusions, the non-GAAP measures which were mostly common used by the issuers are Earnings before Interest, Tax, Depreciation and Amortisation (EBITDA) (14%) and Capital expenditure (CAPEX) (15%).

61. The exclusion of certain expenses from the measures and the use of non-defined GAAP profit measures provide insight into how management reviews the performance of the segments. In 71% of cases, we noted that information about the nature of these non-recurring expenses and other reconciling items was disclosed in accordance with the standard[12].

62. In certain cases, we also identified the reallocation of specific assets among the individual segments from one period to another. For example, in one instance a real estate company reclassified one property from one operating segment into the column "other". The property was subsequently sold and a significant loss was recognised. As a result, this loss was excluded from the results of the original operating segment.

63. IFRS 8 paragraph 25 requires the amounts to be allocated to reported segment profit or loss on a reasonable basis, but does not specifically mention that this should be done in a consistent manner. Nevertheless we note that IAS 1 paragraph 45 provides a general requirement for consistent presentation of the items in the financial statements. Paragraph 29 of IFRS 8 provides specific guidance

[12] IFRS 8 Paragraph 27

concerning the restatement of previously reported segmental information. It requires restatement of the corresponding information for earlier periods in the case of a change of the internal organisation, if practicable. Hence, the standard indicates that restating segments is not an unexpected occurrence. The standard does not, however, provide guidance as to when the reallocation of the segments must be disclosed in the segmental reporting.

64. The measurement basis and the extent of segment information included in the financial statements should reflect that which the CODM uses to make decisions about resources to be allocated to the segment and to assess its performance. We noted one case in which the information reviewed by the CODM was significantly less than the extensive segment information provided in the consolidated financial statements. There is no specific requirement that additional information may not be presented in consolidated financial statements. Indeed, the core principle encourages entities to provide information necessary to enable financial statement users to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

b) Reconciliations between the aggregate segment information and the amount reported in the income statement and balance sheet

65. IFRS 8 paragraph 16 requires information about other business activities and operating segments that are not reportable to be combined and disclosed in an “all other segments” category separately from other reconciling items in the reconciliations prescribed in paragraph 28. However, we noted that 43% of the sample combined the information from “all other segments” and other reconciling items (inter-segments eliminations, unallocated assets or liabilities).

66. Regarding certain measurement and reconciliation disclosures, we identified missing reconciliations of the total assets in the reportable segments to the assets in the consolidated financial statements as well as unallocated group assets and group liabilities.

67. In certain instances, companies did not comply with the requirement in IFRS 8 paragraph 23(a) and (b) to present separately revenues from external and internal customers to the extent such information is reviewed by the CODM.

68. We also identified entities that did not provide certain information required in IFRS 8 paragraph 27, such as information about the allocation of financial liabilities and related interest as well as differences between measurement of the reportable segment liabilities and the entity's liabilities presented in the statement of financial position.

Conclusions

69. In accordance with the standard, the amount of each segment item reported should be the measure reported to the CODM for the purposes of making decisions about allocating items to the segment and assessing its performance. It follows, therefore, that these internal measures may be on a different basis than IFRS. In the light of this, it is important that issuers provide clear explanation of how these measures are defined and how they can be reconciled with the IFRS figures reported in the financial statements. Such information should facilitate comparisons between the segment in-

formation from different entities in order to evaluate their relative financial position, performance and changes in financial position by reportable segment.

70. This review shows that the quality of disclosures concerning the measurement basis of segment information and reconciliations to reported IFRS figures requires improvement, particularly in the following areas:

— clearer explanation of how revenue, profit or loss, assets and liabilities are allocated to reportable segments (IFRS8 paragraph 27);

— provide more transparency about reconciling items which are too often combined with segments which do not meet the criteria to be presented as separate reportable segments under paragraphs 11-19 of the standard; *and*

— improve descriptions of all changes that have occurred in the segment information since the previous year (definition of key terms, allocation of activities to segments, etc…)

Proposed solution/ Recommendation

71. The review indicates, generally, poor compliance with certain disclosure requirements of the standard. Issuers are encouraged to make improvements in their future financial reports and European national enforcers will continue to seek improvements through their enforcement activities.

VI Analysis of entity wide-disclosures

IFRS requirements

72. Paragraphs 32 to 34 of IFRS 8 require disclosure of information about an entity's products and services, geographic areas, and major customers, regardless of the entity's organisation and number of reportable segments.

73. IFRS 8 paragraph 32 requires entities to report revenues from external customers for each product and service, or each group of similar products and services, unless the necessary information is not available and the cost to develop it would be excessive, in which case that fact should be disclosed.

74. Paragraph 33 of IFRS 8 requires disclosure of certain geographical information, unless the necessary information is not available and the cost to develop it would be excessive. An entity is required to report revenues attributed to its country of domicile and attributed to all foreign countries in total from which it derives revenues. If revenues from external customers attributed to an individual foreign country are material, those revenues shall be disclosed separately. The basis of allocating revenues from external customers to foreign countries should also be disclosed. An entity is also required to disclose certain non-current assets that are located in its country of domicile and those located in all foreign countries in total in which it holds assets. If assets in an individual foreign country are material, those assets should be disclosed separately.

Findings on information about products and services

75. Enforcers generally noticed a good level of compliance, from the entities sampled, with this particular disclosure requirement.

Findings on information on geographical areas

76. A majority of the issuers under review (58%) reported geographical information on revenues from external customers and information on non-current assets in accordance with the standard.

77. Those issuers which did not comply with this requirement generally disclosed only revenue by geographical areas and omitted the information required for certain non-current assets. 5% of these issuers did not disclose any information about geographical areas at all. As regards the lack of information about non-current assets, explanations provided by issuers show that (i) this information was not always available at a geographical level and that (ii) in some cases, this information was considered not material to require disclosure.

78. We observe that the notes to the financial statements rarely present separate information for individual foreign countries but most of the time the information is presented between the country of domicile and other broad geographical areas. Therefore, the number of geographical areas reported varies from zero to 8. Those areas would generally include large geographical areas such as subcontinents, continents, group of continents and/or others including a mixture of countries/areas. Since issuers sometimes aggregate countries with different rates of growth or different economic characteristics[13], the usefulness of disclosing revenue and non-current assets for those geographical areas could be questioned.

79. Lastly, we noted that all the issuers under review disclosed the basis they have adopted for attributing revenues to countries to enable financial statement users to understand the geographical information provided as required by the standards.

Findings on Information about major customers

80. The results of the review indicate that in 22% of the cases, entities provided information about the extent of their reliance on their major customers as mentioned in IFRS 8 paragraph 34, which requires issuers to report whether 10 % or more of their revenues result from transactions with a single external customer. However, it is often difficult to assess whether this piece of information is overlooked or whether the threshold of 10 % was not reached.

81. We observed that information about dependence on major customers is usually available in management reports.

82. Generally speaking, issuers appeared to have no difficulty in defining their major customers on the basis of the threshold defined by the standard. However, some issuers belonging to the “funds and

[13] I.e : the United-States, Australia, United Kingdom, Netherlands, South Korea, Norway, and Northern and Central Europe aggregated in a same geographical area.

holdings" industry expressed concerns about the definition of "major customers" in the context of their activity. Most of them consider that the revenues mentioned in paragraph 34 of IFRS 8 are revenues from investments and therefore they presented the major shareholders of their funds as being the major customers of the entity. However, on the basis of this review, ESMA is not in a position to assess whether this interpretation is widespread in this industry.

Proposed solution/ Recommendation

83. When revenues from external customers or non-current assets attributed to an individual foreign country are material, IFRS 8 paragraph 33 requires separate disclosures for this country. Since the concept of materiality is very subjective, ESMA believes that the emphasis should be placed on disclosures that would help users understand the judgements made by management in determining the level of materiality applied. An alternative view would be to set up a threshold such as has been done in the case of information about major customers.

VII Comparison of the segmental geographical information under IAS 14 and IFRS 8

IFRS requirements

84. The management approach in IFRS 8 removed the requirement of having both primary and secondary segment format. Instead, if an entity has determined that its operating segments are based on products and/or services then it does not need to provide additional geographical segment information other than the specific entity-wide disclosures specified above.

85. When IFRS 8 was endorsed in Europe, there was a debate on whether the geographical information that would be provided under the new standard would be less than what was previously disclosed under IAS 14. A comparative analysis has to take into account both technical and empirical data.

86. In our review, we have focused on analysing whether the entities sampled have changed their primary segments identified under IAS 14 when applying IFRS 8, if they indicated such change in the financial statements and whether there was a change in the level of geographical information included in the financial statements.

87. From the list of 118 entities included in the sample, we noted that:

- 19% of entities used geographical areas as a basis for their operating segment reporting
- 60% of entities based their reportable operating segments on business lines.
- 11% of entities had mixed or matrix structure
- 6% of entities presented a single reportable segment
- and 4% of entities did not comply with IFRS 8 requirements since no segment information was included in the financial statements

Entities previously reporting geographical areas as primary segments under IAS 14

88. A comparison of the two standards showed that there were no significant differences between the disclosure requirements for an entity that identified geographical areas as its primary reporting format under IAS 14 and as operating segments under IFRS 8.

Findings

89. Of the entities sampled, 22 entities reported geographical areas as their primary reporting format under IAS 14. The following observations were made following their adoption of IFRS 8:

— 86% of entities (19) maintained geographical basis for IFRS 8 purposes; out of these one entity increased the number of reportable segments;

— Only 3 entities which had previously reported segments using geography as primary segments disclosed information based on geographical areas under IFRS 8. Two of these have presented less geographical information than under IAS 14. The third entity has changed its reporting because it disposed of one of its activities.

— All 22 entities complied with the disclosure requirements. Therefore for these entities there has been no decrease in the quality of geographical information following the adoption of IFRS 8 (except for the two entities which aggregated operating segments and presented less reportable segments according to IFRS 8).

Entities previously reporting geographical areas as secondary segments under IAS 14

90. Reporting requirements under IAS 14 with respect to geographical information when used as secondary segments were more limited than when used as primary segments. In terms of information provided by entities presenting segment information based on business, IFRS 8 only requires revenues and non-current assets to be disclosed, whereas IAS 14 required additional information on investments in property, plant and equipment and intangibles assets and on the composition of each geographical segment.

Findings

91. 71 entities used business lines as primary segments under IAS 14 and as operating segments after the adoption of IFRS 8. For these entities the following facts can be observed:

— 74% of entities have maintained the same number of segments under both standards;

— 19% have increased the number of operating segments presented under IFRS 8;

— And 6% decreased the number for reasons other than the disposal of activities; *and*

— One entity presented segmental information for the first time on the grounds that the scope of IFRS 8 is broader than that of IAS 14.

Entities with a matrix or mixed organisation structure

92. The sample of entities under review included two entities with a matrix organisation. These entities have presented the information required under IFRS 8 for both geographical and business segments.

93. The sample of entities under review included 11 entities with a mixed structure of operating segments, based on both products/services and geographical segments. Two out of these 11 entities justified this presentation as being the result of a change in the internal management structure of the company.

Conclusions

94. On the basis of the results of our analysis, there is limited evidence that the quality of information provided on geographical areas is lower than what was previously reported under IAS 14. On the other hand, the review shows a trend towards grouping countries when information is reported according to geographical areas.

95. Based on evidence from our sample only six entities changed their reporting basis, out of which one is due to divesting in some activities.

VIII Other issues related to the application of IFRS 8

Other issues identified by the enforcers

96. During the course of our review and discussions within EECS, other issues were identified by national enforcers but have not been analysed in detail in this report:

- *Definition of operating results*: Paragraph 5 of IFRS 8 states that "an operating segment is a component of an entity….(b) whose operating results are regularly reviewed by the entity's operating decision maker…". The notion of operating results is not necessarily interpreted in the same way by the issuers, since is not explicitly defined under IFRS. For example, there are cases when such notion has been interpreted as referring to gross margin.

- *Re-allocation of operating segments between reportable operating segments*: The standard is not clear on how to present segment information in the case re-allocation occurred close to the end of the reporting period. Presentation of all items according to the new organisational structure might not reflect the way the activities have been run during the financial period.

Issues identified as part of our discussions with analysts

97. As part of our meetings with members from CRUF and SFAF, we have identified that some of the issues raised by the analysts related to matters identified as part of our review process, but there are also new issues coming from the analysts' perspective.

98. The issues presented below are provided for information only, but we have not required any empirical evidence and they are obviously not representative for the sample used for our review. They reflect only the point of view of analysts (unless otherwise mentioned) and do not involve any judgement from our side with respect to their level of relevance from an enforcement point of view.

99. Analysts share the view that segment information is of crucial importance for investors and that they have a specific focus on it as part of evaluating the performance of entities. On the other hand, the concerns commonly shared by analysts we have contacted refer to the following elements:

i. *'Over-aggregation' of operating segments:* Some issuers tend to minimise the number of reportable segments presented in the notes to the financial statements and therefore avoid providing meaningful information at the level of operating segments. The concept of *similar economic characteristics* is not always properly applied and in some cases it is not clear if there are any similarities at all. There are cases in which the application of this notion has been done in such way that entities reported just one segment. This 'over-aggregation' has implications over the disclosures on profit or loss, assets and liabilities which are not as valuable as they should be and therefore analysts believe that a threshold should be used in order to limit the level of aggregation.

ii. *Changes in the aggregation of operating segments:* In addition, some issuers sometimes changed the allocation of operating segments to reportable segments from one year to another without providing a satisfactory level of understandable explanation in the notes to financial statements to justify their decision. This lack of information casts into doubt the reliability and the relevance of segment information.

iii. *Quality of segment information:* There are concerns over some issuers overriding the principle of "through the eyes of management", meaning that information reported in the financial statements is deliberately withheld by the management. It seems that there are situations in which there are significant differences between what is communicated to the Board and what goes further to the shareholders.

iv. *Use of non-GAAP measures:* There is an increasing use of non-GAAP measures and adjusted figures resulting in a growing need for more precise reconciliation between IFRS 8 figures and financial statements. Analysts consider that the present level of reconciliations on a total reportable segment basis required by the standard is unsatisfactory. When responding to ED8, analysts had already explained to the IASB that reconciling only total reportable segments amounts to amounts presented in the financial statements would not provide the necessary and useful information.

v. *Additional information*: Analysts had expected to obtain more information on operating cash flows, operating assets ratios, working capital and debt by segment; especially as this information is essential for the CODM in the process of allocation of resources and assessment of the performance of the operating segments of an entity.

vi. *Geographical information*: Geographical splits made by issuers often do not represent the real way in which businesses are managed; which questions the usefulness and the relevance of such segment information. In most of the cases, the entities are run on the basis of their business and not on the basis of their geographical implementation.

Other issues

100. In addition to the issues indicated above, there were some elements on which there were diverging views coming from analysts:

i. *Management approach:* While CRUF welcomes the introduction of management approach, SFAF considers that this has some drawbacks by allowing entities to combine heterogeneous businesses or geographical areas resulting in segment information of poor quality. In view of the limited nature of the information, such information does not enable financial statements users to evaluate accurately the performance of the relevant activities included under one operating segment.

ii. Non-GAAP measures: As far as non-GAAP measures and so-called “adjusted figures" are concerned, analysts from SFAF observed that some indicators are not only poorly defined by issuers, they are sometimes inconsistent from one year to another.

Appendix I ESMA proposal for improvements to IFRS 8 – *Operating Segments*

European Securities and Markets Authority

Date: 13 April 2011
ESMA/2011/117

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

ESMA proposal for improvements to IFRS 8 – *Operating Segments*

Dear Sir David,

The European Securities and Markets Authority (ESMA) is an independent EU Authority that contributes to safeguarding the stability of the European Union's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as by enhancing investor protection.

ESMA has considered through its standing committee on Corporate Reporting the difficulties faced by securities regulators on IFRS 8 – *Operating Segments* and would like to make some recommendations for minor improvements. On the basis of IFRS enforcement decisions on that standard discussed between European enforcers participating in the European Enforcers Coordination Sessions (EECS), ESMA has identified two enforcement issues which we would like to bring to your attention for further consideration: the application of the aggregation criteria and the identification of the chief operating decision maker.

We acknowledge the fact that the IASB already has a congested work plan and that there are more pressing accounting matters to be resolved before segmental reporting is likely to make it onto the Board's agenda. We understand that a post-implementation review on IFRS 8 is likely to be conducted by the Board and intend to respond to that review ensuring that European securities regulators contribute to the ensuing debate on the information to be provided to users of financial statements. We would be happy to explore any proposals of how that input could be best achieved.

We however believe that our proposals contained in this letter could achieve an improvement to financial reporting in the short term if they were to be considered through the IASB's Annual Improvements Project. The proposed minor amendments would enable securities regulators to challenge issuers more effectively on the adequacy of their segmental reporting. In ESMA's view, such enforcement action would contribute to a change in market behaviour and result in an improvement for users of financial information in this important area.

Our detailed proposals are set out in the Appendix to this letter.

I would be happy to discuss all or any of these issues further with you.

Yours sincerely,

Fernando Restoy
Chairman of ESMA's Corporate Reporting Standing Committee

APPENDIX – ESMA's proposed improvements to IFRS 8 – *Operating Segments*

I. Aggregation of Operating Segments

Description of the issue identified

1. IFRS 8 paragraph 12 states that operating segments may be aggregated if all of the aggregation criteria are met.

2. Neither the standard itself nor the basis for conclusions provide any further guidance on what is meant by the term 'similar economic characteristics' or how it should be applied. The only reference in the standard is to similar long term average gross margins as an indicator of similar economic characteristics. This is probably because the standard is based upon an original standard designed for use in the US which has a single internal market and where there would consequently have been minimal need to think about detailed factors defining what similar economic characteristics mean in a geographical context because the only relevant market was the US one.

Difficulties encountered

3. Practical difficulties are being encountered regarding where to draw the line between "similar" and "not similar". Clearly the Board must have intended that this would differentiate some operating segments from others, but at what level?

4. It is the issuer's primary responsibility to provide an answer to this question. Judgement is needed in defining criteria that will help assess how operating segments should be aggregated. The criteria might relate to the overall rate of growth of the economy in separate economic areas. They could also relate to sales growth, margins, other performance indicators or a combination of various indicators.

5. As enforcers, we have seen financial statements where operating segments have been aggregated into one or several reporting segments but where no explanation has been provided as to which individual operating segments had been aggregated, nor any explanation of whether an assessment had been made of whether the aggregation of the segments was compliant with IFRS 8 paragraph 12.

Proposed solution/ recommendation

6. The application of the aggregation criteria requires a significant amount of discretion. For instance, they allow "professional judgment" of whether an aggregation is consistent with the core principle of IFRS 8 in deciding how aggregation can be applied, if at all. Deciding if two segments are sufficiently economically similar to aggregate them can be difficult and subjective in some cases.

7. This level of subjectivity leads to diversity in practice with some companies deciding to aggregate more than others in the process combining segments which probably should be reported separately. Additionally, the level of subjectivity applied by management may not be apparent from the disclosures given under IFRS 8 paragraph 22 either.

8. Therefore, ESMA believes that emphasis should be put on disclosures that would help users understand the judgements made by management in deciding whether operating segments can be aggregated. As a consequence, we would suggest a limited amendment to paragraph 22 as follows (paragraph (c) below):

"An entity shall disclose the following general information:

a) factors used to identify the entity's reportable segments [...]

b) types of products and services from which each reportable segment derives its revenues.

c) <u>where operating segments have been aggregated, the judgements made by management in the application of the aggregation criteria in paragraph 12. In particular, a brief description of both the operating segments that have been aggregated and the economic indicators assessed, including the measurement range considered to be similar (For example, profit margin spreads, sales growth rates etc.), in determining that they share similar economic characteristics."</u>

9. ESMA believes that the additional disclosure requirements concerning the judgments made will provide users with important information that will enable them to reach their own judgements as to whether the level of aggregation is appropriate. It will also require management, and auditors, to consider more closely whether the divergence in economic indicators disclosed truly represents economic similarity.

II. Identification of Chief Operating Decision Maker

Description of the identified issue

10. The core principle of IFRS 8 is to enable users of financial statements to evaluate the nature and financial effects of the business activities in which the entity engages and the economic environments in which it operates.

11. The standard requires companies to identify the function of the Chief Operating Decision Maker ("CODM") and goes on to explain that the CODM is the function that regularly reviews results to make decisions about resources to be allocated to the segment and to assess its performance. It appears in practice that allocating resources and assessing performance may not always be carried out

by the same persons or using the same set of information. For example, the argument has been raised with us that information was obtained but not used for allocating resources.

12. However, in the basis for conclusions the IASB explains that it concluded that the management approach was the most appropriate basis for the disclosure of segmental information. IFRS 8 paragraph BC4 states that the requirements of SFAS 131 (on which IFRS 8 is based) are based on the way that management regards an entity, focussing on information about the components of the business that management uses to make decisions about operating matters.

13. This definition creates confusion and conflicts with the objective cited by the IASB when issuing IFRS 8 that the individual(s) who decide(s) what resources to allocate to segments review segment performance on an irregular basis[1] and where they allocate resources based on only information aggregated at a consolidated level.

14. Based on the definition in IFRS 8 paragraph 7, the CODM is often the Management Board. In practice, the Management Board focuses on strategic decisions whereas operational decisions may be made at a level below the CODM by the segment manager who is directly accountable to and maintains regular contact with the CODM.

15. The rather general definition of a CODM means that management's judgement must be applied to identify operating segments. Such judgements may be directed in such a way as to reduce the number of operating segments, thereby circumventing the core principle of IFRS 8. For example, we have identified situations in which a company apparently assigns one reporting segment to each member of the Board in order to claim that the CODM (the Board) monitors the entity's whole activities and not the separate segments. The argument used is that resources are allocated and performance is reviewed at a higher, more aggregated level. The operational structure within the company, however, remains unchanged; all operating segments are organized and performance is assessed as it was prior to the assignment of specific "responsibilities" to the individual Board members.

Difficulties encountered

16. The term Chief Operating Decision Maker suggests that the person so designated should be involved in making operating decisions. Yet the requirement that they make resource allocation decisions suggests that they, in fact, predominately make strategic decisions. Diversity in practice is likely to result given this potential for confusion.

17. This potential for confusion may also allow for possible misuse of the standard. IFRS 8 was designed to provide useful information to financial statement users, allowing them to evaluate the nature and

[1] IFRS 8.5(b) states that the "operating results are regularly reviewed by the entity's chief operating decision maker", but this notion is subjective.

financial effects of the business activities in which a company engages and the economic environments in which it operates. If, for example, management can claim that it simply does not use the information reported to it or can simply add an aggregation layer to the company's organisation in order to reduce the number of operation segments despite the operational structure within the company remaining unchanged, then the core principle of IFRS 8 would not be met.

Proposed solution / recommendation

18. Consideration could be given to amending the definition of the CODM. To reduce the potential for confusion or misuse, we propose that the operating nature of the function should be emphasised in the CODM definition. Examples can also be provided in the standard to promote the use of objective evidence in identifying "operating nature", such as organisational charts, lines of reporting and management bonus schemes. In addition, the standard should clarify that there is a presumption that management reviews the information reported to it. We believe this clarification would reduce potential diversity in practice, ensuring better adherence to the standard's core principle as well as enhancing the enforceability of IFRS 8.

19. To achieve the necessary clarifications detailed above, we suggest the following minimal wording changes to the text of IFRS 8 which could be considered in conjunction with the Annual Improvements Project:

Amendment to the core principle: IFRS 8 paragraph 1

20. An entity shall disclose the information used to assess performance 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 different economic environments in which it operates.

Proposed amendment to IFRS 8 paragraph 7

21. The term 'chief operating decision maker' identifies a function, not necessarily a manager with a specific title. That function is to be involved in making operating decisions within an operating segment and ~~allocate resources to and~~ assessing the performance of the operating segments of an entity. Often the chief operating decision maker of an entity is its chief executive officer or chief operating officer but, for example, it may be a group of executive directors or others who may individually or collectively assess the performance of an operating segment and be involved in the making of operating decisions.

Proposed amendment to the basis for conclusions

22. The information set which should be used for the purpose of reporting information about operating segments should be the one that is used to assess the performance of operating segments. The in-

formation set would, therefore, be the one used by the individual or group of individuals, who may not regularly meet, as the basis for making such decisions. There is a rebuttable presumption that the CODM reviews the information set that he receives.

23. Organisational charts, lines of reporting and management bonus schemes may assist in identifying operating segments.