

Mr Françoise Flores
Chairman
EFRAG
Square de Meeus 35
1000 Brussels
Belgium

EFRAG's call for evidence – Experiences with IFRS 8 – *Operating Segments*

Dear Ms Flores,

The European Securities and Markets Authority (ESMA) is pleased to provide you with the following comments in response to EFRAG's *Call for evidence – Experiences with IFRS 8 – Operating Segments*, which are aimed at improving the decision-usefulness of financial statements and the transparency and enforceability of IFRSs.

The European Securities and Markets Authority (ESMA) is an independent EU Authority that contributes to the protection of investors and promoting stable and well-functioning financial markets in the European Union (EU). ESMA achieves this aim by building a single rulebook for EU financial markets and ensuring its consistent application across the EU. ESMA contributes to the regulation of financial services firms with a pan-European reach, either through direct supervision or the active coordination of national supervisory activity.

As ESMA understands that the call for evidence aims to contribute to the IASB's post-implementation review, and that your call is modelled on the IASB's request for information, we attach a copy of our submission to the IASB's Request for Information.

It is the IFRS Foundation's (Foundation) objective to develop, in the public interest, a single set of high quality, understandable, *enforceable* and globally accepted financial reporting standards based upon clearly articulated principles. In line with the Foundation's commitment to the consistent application of IFRS, we believe that post-implementation reviews should at least



consider whether the standard meets the objectives of the Foundation. It should have particular attention for the enforceability of the standards and whether further improvements are possible to the standard in order to better achieve its objectives. ESMA, like EFRAG, strongly supports post-implementation reviews as they provide an opportunity to assess the effect of the standards on all stakeholders.

In November 2011, ESMA published a *Review of European enforcers on the implementation of IFRS 8 – Operating Segments* which analysed the IFRS consolidated financial statements of 118 European listed companies against most of the issues considered in the IASB's Request for Information. The review has been sent by the European Commission to the European Parliament in response to the latter's request for a post-implementation review on IFRS 8. A copy of the review is attached to this letter (Appendix III).

Based on that review, ESMA sent a letter to the IASB in April 2012 inviting the Board to consider the application of the aggregation criteria and the identification of the Chief Operating Decision Maker (CODM).

We welcome the Board's decision, and EFRAG's support of this, to propose improving the disclosure requirements regarding the aggregation of operating segments in the Exposure Draft *Annual Improvements to IFRSs 2010 – 2012* as this is one of the major issues encountered when enforcing IFRS 8. ESMA believes that the suggested disclosures will give investors a better understanding of the aggregation of operating segments.

However, we would appreciate EFRAG's support in strongly encouraging the Board to consider the identification of the CODM in practice as part of the post-implementation review. ESMA considers that the current definition of the CODM includes two different prerogatives (allocation of resources versus the assessment of performance), which are not always carried out by the same person, or group of persons, using the same set of information. We understand that investors, from the contacts we have had with them when performing our review, share ESMA's concern. Therefore, we would suggest modifying the definition of the CODM to highlight the operating nature of the function in the definition of the CODM.

In order to highlight the importance of a post-implementation review to achieve consistent application, we are providing you with some real-life examples encountered by European enforcers on IFRS 8 (Appendix II).



Our detailed responses are set out in Appendix I. We thank you for this opportunity to contribute to EFRAG's due process and we would be happy to discuss any of these issues with you.

Yours sincerely,

A handwritten signature in blue ink, consisting of a stylized 'S' followed by a vertical line and a horizontal stroke.

Steven Maijoor
Chair
European Securities & Markets Authority

A handwritten signature in blue ink, appearing to read 'J. Galbo' with a long, flowing tail.

Julie Galbo
Chair
ESMA Corporate Reporting Standing Committee



**APPENDIX I – ESMA’s detailed answers to the questions in the Request for view
*Post-Implementation Review: IFRS 8 Operating Segments***

Question 1: Are you comparing IFRS 8 with IAS 14 or with a different, earlier segment-reporting Standard that is specific to your jurisdiction?

In providing this information, please tell us:

- (a) what your current job title is;**
- (b) what your principal jurisdiction is; and**
- (c) whether your jurisdiction or company is a recent adopter of IFRSs.**

1. The European Securities and Markets Authority (ESMA) is an independent EU Authority that contributes to enhancing the protection of investors and promoting stable and well-functioning financial markets in the European Union (EU). ESMA achieves this aim by building a single rule book for EU financial markets and ensuring its consistent application across the EU. ESMA contributes to the regulation of financial services with a pan-European reach, either through direct supervision or through the active coordination of national supervisory activity.
2. European listed companies apply IFRS for their consolidated financial statements since 2005.

Question 2

What is your experience of the effect of the IASB’s decision to identify and report segments using the management perspective?

Investors: please focus on whether our initial assessment—that the management perspective would allow you to better understand the business — was correct. What effect has IFRS 8 had on your ability to understand the business and to predict results?

3. IFRS 8 requires companies to disclose segmental information in a manner consistent with the way management approaches the company’s activities, the so-called “management approach”. Companies are required to identify a 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 and to assess the performance of the operating segments.

4. The term CODM¹ 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.
5. 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 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 that it does only use the information provided to it for assessing performance but not for allocating resources 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.
6. 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.
7. In addition, 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 the financial statements. ESMA's review revealed that 51% of the issuers provided this information². 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 operating

¹ See ESMA's review paragraphs 24 to 35 and ESMA's comment letter to the Annual Improvements 2012 paragraphs 6 to 9.

² See ESMA's review paragraph 30

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 CODM appears to be inconsistent with their corporate governance responsibilities. This indicates that there might be some confusion caused with the definition in the standard.

8. An example of a challenge encountered by enforcers on the identification of the CODM in an entity reporting one operating segment is included in appendix II.
9. From the contacts we had with investors when performing our review we understood that they share ESMA's concern that the CODM differs significantly between entities and per industry, but more importantly is not who they expect it to be. We therefore would suggest modifying the definition of the CODM to highlight the operating nature of the function in the definition of the CODM.

Question 3

How has the use of non-IFRS measurements affected the reporting of operating segments?

Investors: please comment on the effect that the use of non-IFRS measurements has had on your ability to understand the operating risks involved in managing a specific business and the operating performance of that business. It would be particularly helpful if you can provide examples from published financial statements to illustrate your observations and enable us to understand the effects that you describe.

Measures presented³

10. ESMA's review shows that 47% of the sample used alternative performance measures such as EBITDA, non-current operating result or other adjusted figures. Entities state that excluding certain expenses from the disclosed measures and the use of alternative performance measures provides insight into how management reviews the performance of the segments. In 71% of the cases, ESMA noted that information about the nature of these non-recurring expenses and other reconciling items was disclosed in accordance with IFRS 8.

³ See ESMA's review paragraphs 59 to 71

Reconciliation segment by segment

11. IFRS 8 paragraph 28 requires reconciling the total reportable segments with the entity's figures and not a reconciliation segment by segment.
12. From its discussions with the investors' community, ESMA understands that a segment by segment reconciliation would be very useful for them as they would be able to understand the performance segment by segment and would thus promote comparison between entities. ESMA however realises that there is a cost associated with compiling such information which might in some cases not be available. ESMA would encourage the Board to further investigate this issue.

Question 4

How has the requirement to use internally-reported line items affected financial reporting?

Investors: please focus on how the reported line items that you use have changed. Please also comment on which line items are/would be most useful to you, and why, and whether you are receiving these.

Modification of the segments disclosed⁴

13. ESMA understands from discussions with the investors' community that the modification of segments is an issue when analysing the performance of an issuer. Indeed, it is difficult to follow the performance of the segments over several years when segments are modified without a detailed indication of the modifications performed.
14. IFRS 8 paragraph 25 requires the amounts to be allocated to the reported segment profit or loss on a reasonable basis, but does not specifically mention that this should be done in a consistent manner⁵. If an entity changes the structure of its organisation in a manner that causes the composition of its reportable segments to change, the corresponding information for earlier period, including interim periods shall be restated if practicable. The standard does however not provide guidance as to when the reallocation of specific assets among the individual segments must be disclosed in the segmental reporting.

⁴ See ESMA's review paragraphs 62, 63, 96 and 99.

⁵ It should be noted that IAS 1 – *Presentation of Financial Statements* paragraph 45 provides a general requirement for consistent presentation of the items in the financial statements.

15. When the allocation of operating segments to reportable segments is changed without providing a satisfactory level of understandable explanation in the notes to financial statements to justify this decision, this lack of information casts doubt over the reliability and the relevance of segment information.
16. 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.

Segment “Other”⁶

17. According to IFRS 8 paragraph 13, operating segments can be combined when they do not meet specific thresholds. In that case, the sources of the revenue included in the ‘all other segments’ category shall be described (IFRS 8 paragraph 16). In many cases, the elements presented in the segment “other” are not detailed. ESMA suggests to add that the elements not allocated to an operating segment (such as holding costs, restructuring costs, impairment ...) should be described in the notes.
18. For example, we note that the impairment of goodwill is sometimes allocated to the segment “other”.

Question 5

How have the disclosures required by IFRS 8 affected you in your role?

Investors: please provide examples from published operating segment information to illustrate your assessment of the disclosures relating to operating segments. Do you now receive better information that helps you to understand the company’s business? Please also comment on the specific disclosure requirements of IFRS 8—for example, those relating to the identification and aggregation of operating segments; the types of goods and services attributed to reportable segments; and the reconciliations that are required. It would also be useful to indicate whether you regularly request other types of segment disclosures.

19. As mentioned in ESMA’s review, entity-wide disclosures are generally given with a good level of compliance with IFRS 8 requirements.⁷

⁶ See ESMA’s report paragraphs 62

Revenues from external customers – Non-current assets for a foreign country

20. ESMA's review mentioned that 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. ESMA believes that the emphasis should be placed on disclosures that would ask for the description of the judgements made by management in determining whether revenues from an individual foreign country are material. An alternative view would be to set up a threshold such as in the case of information about major customers.

21. In addition we believe that reporting revenues from external customers attributed to the entity's country of domicile and non-current assets located in the country of domicile does not always result in decision-useful information, especially when the country of domicile is a small country and the issuer's activities abroad.

Missing information

22. 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.

⁷ See ESMA's report paragraphs 72 to 83

Question 6

How were you affected by the implementation of IFRS 8?

Investors: please focus on whether the way in which you use financial reports has changed as a result of applying IFRS 8. Please explain to us what that effect was and the consequences of any changes to how you analyse data or predict results.

23. ESMA's review did not identify many changes in the reporting of operating segments in financial statements between IAS 14 and IFRS 8⁸.
24. ESMA compared the quality and level of geographical segment information disclosed under IAS 14 and IFRS 8. On the basis of its review, few entities changed their reporting basis (from a focus on geographical areas to a focus on business segment or vice versa). There is also limited evidence that the quality of the information provided on geographical areas is lower than what was previously reported under IAS 14 in the cases where the same basis applied.

⁸ See ESMA's report paragraphs 88 to 90.

APPENDIX II – Extracts of IFRS 8 enforcement cases

Question 2 – CODM (decision published EECS/0112-05)

Description of the issuer's accounting treatment

25. The issuer is a shipping company for chemical products, transporting a wide variety of cargoes such as organic chemicals, non-organic chemicals, clean and dirty petroleum products, vegetable oils and lube oils in trade lanes worldwide. Its fleet comprises vessels bought or held under a finance lease. Each vessel has from four to 30 tank-containers. This implies that a vessel can carry different types of cargoes and can be chartered on behalf of several customers at the same time. Even though the size varies, the vessel can sail almost anywhere. The issuer's strategy is to be a supplier of freight-services and not a tonnage provider (i.e. lessor of vessels).
26. The issuer identified the entire board of directors ('the board') as CODM. The board consists of both executive and non-executive directors. All important operating and strategic decisions are made by the board. Decisions made by the board, include among others, decisions related to investing and disposing of vessels and decisions relating to financing. Some board members are dedicated to specific tasks related to the operations of the company. Important stakeholders are represented on the board, including the major shareholder who has sufficient voting shares to veto decisions of the board.
27. Monitoring of performance and profitability by the board is carried out based on consolidated figures. The board receives monthly consolidated financial statements, including a statement of financial position and income statement. The income statement presents monthly actual figures, monthly budget figures, together with actual and budget figures "year to date".
28. In addition, the board receives information of "time charter equivalent" (TCE) per day for the entire fleet and for five classes of vessels based on their size. TCE per day is calculated by dividing freight income less voyage related expenses (bunkers and port charges/fee) by number of available days in a fixed period. The issuer considered TCE per day to be a type of revenue figure and not an operating results figure. TCE per day is calculated without including expenses other than bunker expenses and port charges. Although TCE per day was reported monthly for classes of vessels and the figure is useful for following up the level

of revenue, TCE is not used to assess performance of the entity. Consequently, the issuer believed the figure was not suitable to allocate resources to classes of vessels.

29. The issuer operates on an integrated basis with a single business activity; transportation of chemicals. The vessels are not dedicated to specific cargoes or trade lanes, and the business is not organised according to the size of the vessels or types of tanks. The issuer has centralised operating functions, including freight contracting and technical management. The vessels are monitored as a portfolio due to the fact that the vessels are not dedicated to a specific cargo or specific geographical area. The board reviews operating results only on a consolidated basis.
30. Consequently, based on the information received and the operating results reviewed by the CODM, the issuer identified one operating segment – “*Chemical tankers*”.

The enforcement decision

31. The enforcer did not disagree with the accounting treatment of the issuer that identified the board of directors as the CODM and identified only one operating segment.

Rationale for the enforcement decision

32. According to paragraph 7 of IFRS 8 the function of the CODM is to allocate resources to and assess the performance of the operating segments of an entity. The issuer’s board reviews and assesses performance based on the monthly information described above. The management did not receive information of operating results at a lower level than the consolidated level. The information received by the management was similar to the information received by the board, but included some additional details. No income statement information was provided to the management at a lower level than the consolidated income statement and balance sheet.
33. In addition to consolidated operating results, the board received monthly information of TCE per day for each of the five classes of vessel based on their capacity. The enforcer questioned if TCE per day was an operating result, referred to in paragraph 5 of IFRS 8, which was regularly reviewed by the CODM to allocate resources and to assess performance and hence whether the issuer had five operating segments. However, it appeared that TCE was not suitable to allocate resources to classes of vessels.

34. Consequently, the enforcer concluded that the information and explanation provided supported the issuer's conclusion that the entire board of directors was identified as the CODM and the entire fleet represented one operating segment in accordance with IFRS 8. The conclusion in respect of there being only one segment was supported by the fact that there were no segment managers identified, as indicated in paragraph 9 of IFRS 8.

Question 5 – Entity-wide disclosed (decision published EECS/1209-07)

Description of the issuer's accounting treatment

35. The issuer, whose shares are listed and traded on an unregulated market, early applied IFRS 8 'Operating Segments' in its December 2007 financial statements as part of its transition to IFRS.
36. The accounts did not disclose certain information required by IFRS 8, on the grounds of commercial sensitivity. The omitted information included the segmental analysis of revenues from external customers; the operating segments responsible for revenue from major customers, and the measure of profit or loss reported to the CODM.
37. The auditors' opinion was qualified on the basis of disagreement in relation to non-compliance with IFRS 8.

The enforcement decision

38. The enforcer found that the accounts did not comply in all respects with the requirements of IFRS 8.

Rationale for the enforcement decision

39. When challenged, the issuer argued that making the specific disclosures required by IFRS 8 might affect its competitive position.
40. The enforcer noted that IFRS 8 does not provide for a 'competitive harm' exemption. Paragraph 44 of the Basis for Conclusions for the standard explains that the IASB concluded that such an exemption would be inappropriate because it would provide a means for broad non-compliance with the IFRS.