

INTERNATIONAL FINANCIAL REPORTING BULLETIN 2011/16

ESMA'S REVIEW ON THE IMPLEMENTATION OF IFRS 8 – OPERATING SEGMENTS



Background

On 10 November 2011 the European Securities and Markets Authority (ESMA) published the outcome of a review of European enforcers on the implementation of IFRS 8 *Operating Segments*.

IFRS 8 became effective for financial statements for periods beginning on or after 1 January 2009. It superseded IAS 14 *Segment Reporting*. Enforcers expected that IFRS 8 (which is based on the financial information used internally by management) would lead to more relevant information being disclosed and an increased number of segments being reported. They also hoped that segment reporting under IFRS 8 would enable an easier cross referencing of the segmental information to the management commentary.

When IFRS 8 was put forward for endorsement the European Parliament asked for a review on its implementation no later than 2011.

This IFRB provides a summary of ESMA's report regarding the implementation of IFRS 8.

Summary of the Report

The reviews were performed on 2009 or 2010 financial statements of 118 European listed companies with a total market capitalisation of 700 billion Euros.

The overall conclusion reached by European enforcers is that:

- Implementing IFRS 8 resulted in a fairly similar level of information compared to IAS 14.
- European enforcers face homogeneous issues when they enforce IFRS 8. This results from weaknesses in the standard as well as from issuers failing to fully comply with the requirements of the standard.

ESMA's tentative recommendations and conclusions relate to:

- What is meant by chief operating decision maker (CODM).
- Application of the aggregation criteria.
- Materiality when applied to entity-wide disclosures on geographical areas.
- Encouraging issuers to further improve their segmental disclosure.
- Continuing to monitor application and compliance.

The complete report can be accessed at <http://www.esma.europa.eu/popup2.php?id=8054>

ESMA had already identified the issues about the application of the aggregation criteria and the identification of the CODM in 2010. ESMA asked the IASB in their letter of 13 April 2011 to consider them as part of the IASB's Annual Improvements project.

In its November 2011 meeting the Board considered the existing guidance on CODM in IFRS 8 and decided that no further clarification was needed.

However, the Board agreed to include an additional disclosure in IFRS 8 requiring a brief description of both the operating segments that have been aggregated and the economic indicators that have been assessed in order to conclude that the operating segments have 'similar economic characteristics'. The proposed amendment will be included in the next Improvements to IFRSs exposure draft.

STATUS

-

EFFECTIVE DATE

N/A

ACCOUNTING IMPACT

IASB intends to recommend additional disclosure around aggregation of operating segments.

ESMA's findings

Four main topics emerged as a result of the review:

1. Identification of the chief operating decision maker (CODM).
2. Aggregation of operating segments into reportable segments.
3. Measurement basis for information presented under IFRS 8.
4. Entity wide disclosures - Information about geographical areas.

These are considered below.

Identification of the chief operating decision maker (CODM)

IFRS 8 requires entities to disclose segmental information in a manner consistent with the way components are reported to the CODM (the so called through the eyes of the management approach). 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.

Of issuers reviewed, for which such information was available, 41% 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.

ESMA proposes that the operating nature of the function should be emphasised in the CODM definition. The standard could provide examples of evidence for identifying the operating nature such as organizational charts, lines of reporting and management bonus schemes.

Aggregation of operating segments into reportable segments

ESMA note that "the IFRS 8 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".

IFRS 8 Paragraph 12 lists the criteria that have to be similar for segments to be aggregated:

- Nature of the products and services.
- The nature of the production processes.
- The type or class of customer for their products and services.
- The methods used to distribute their products or provide their services.
- If applicable, the nature of the regulatory environment, for example, banking, insurance or public utilities.

However, significant judgement is required in determining whether all aggregation criteria are met.

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 and whether operating segments have been aggregated.

ESMA observed that disclosures on aggregation of segments were only given by 29% of issuers reviewed. For the majority of issuers reviewed it was not apparent whether operating segments had been aggregated or not.

The application of the aggregation criteria requires a significant amount of judgement. The level of subjectivity in deciding how aggregation should be applied may lead to diversity in practice. ESMA believes that additional disclosure about the assumptions and judgements made would provide users with important information as to whether the level of aggregation is appropriate.

Measurement basis for information presented under IFRS 8

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. 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 the measurements of the reportable segments' profit or losses and the entity's profit or loss.

Of the issuers reviewed 93% used IFRS as a measurement basis for segment information and 47% presented non-GAAP measures such as EBIT and EBITDA in the segment information. ESMA noted that 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. Also 43% of ESMA's sample combined the "all other segments" category with reconciling items in one line contrary to paragraph 16 of IFRS 8.

ESMA has not proposed improvements regarding the measurement basis as the problems identified relate to poor compliance with certain disclosure requirements of the standard. However ESMA encourages issuers to make improvements in their future financial reports. European national enforcers will continue to seek improvements through their enforcement activities.

Entity wide disclosures - Information about geographical areas

Paragraph 33 of IFRS 8 requires disclosure of information about an entity's geographic areas, regardless of the entity's organisation and number of reportable segments, unless the information is not available and the cost to develop it would be excessive. When revenues from external customers or non-current assets attributed to a foreign country are material IFRS 8 requires separate disclosure for that country.

Although 58% of issuers in the 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. Areas presented 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, the usefulness of disclosing revenue and non-current assets for those geographical areas could be questioned. ESMA believes that there is no common understanding on how the materiality concept should be applied in this context.

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.



Other Findings

ESMA compared the quality and level of geographical segment information disclosed under IAS 14 and IFRS 8. 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.

ESMA also held discussions with organizations representing financial analysts. Investors are concerned that the information reported under IFRS 8 may not be consistent with that used by management to run the business. Investors also asked for meaningful information presented on a less aggregated level.

This publication has been carefully prepared, but it has been written in general terms and should be seen as broad guidance only. The publication cannot be relied upon to cover specific situations and you should not act, or refrain from acting, upon the information contained therein without obtaining specific professional advice. Please contact your respective BDO member firm to discuss these matters in the context of your particular circumstances. Neither BDO IFR Advisory Limited, Brussels Worldwide Services BVBA, BDO International Limited and/or BDO member firms, nor their respective partners, employees and/or agents accept or assume any liability or duty of care for any loss arising from any action taken or not taken by anyone in reliance on the information in this publication or for any decision based on it.

Service provision within the international BDO network of independent member firms ('the BDO network') in connection with IFRS (comprising International Financial Reporting Standards, International Accounting Standards, and Interpretations developed by the IFRS Interpretations Committee and the former Standing Interpretations Committee), and other documents, as issued by the International Accounting Standards Board, is provided by BDO IFR Advisory Limited, a UK registered company limited by guarantee. Service provision within the BDO network is coordinated by Brussels Worldwide Services BVBA, a limited liability company incorporated in Belgium with its statutory seat in Brussels.

Each of BDO International Limited (the governing entity of the BDO network), Brussels Worldwide Services BVBA, BDO IFR Advisory Limited and the member firms is a separate legal entity and has no liability for another such entity's acts or omissions. Nothing in the arrangements or rules of the BDO network shall constitute or imply an agency relationship or a partnership between BDO International Limited, Brussels Worldwide Services BVBA, BDO IFR Advisory Limited and/or the member firms of the BDO network.

BDO is the brand name for the BDO network and for each of the BDO member firms.

© 2011 BDO IFR Advisory Limited, a UK registered company limited by guarantee. All rights reserved.

www.bdointernational.com