Ihre Ansprechpartner

Sehr geehrte Damen und Herren,

für Rückfragen zu der beigefügten Publikation „In depth“ zur Thematik
„A fresh look at IFRS 8, ‘Operating segments’“
stehen Ihnen folgende Ansprechpartner gerne zur Verfügung:

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In depth
A look at current financial reporting issues

A fresh look at IFRS 8, 'Operating segments'

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At a glance

Segment reporting is viewed as a compliance exercise by many entities and, as such, its importance is often overlooked by management. This guide explains the key requirements of IFRS 8, 'Operating segments', and discusses practical issues that have evolved over time. It also offers insights to the importance of segment reporting for telling the 'whole story' of an entity.

Why it's important

Almost all information contained in a set of consolidated financial statements is focused on providing users with:

a. the position of the entity as a whole; and
b. the key transactions during a recent period.

This information is useful because it helps investors to assess overall metrics (for example, sales trends, ability to control costs, liquidity, and success of major transactions such as a business combination). However, that information alone rarely tells the whole story.

How do we know? Simply read an earnings release from a large entity's website. It will discuss market share by product or geography, a significant contract with an individual customer, or capital expenditure for a growing division. Any one of these shows that the business is typically managed at a level lower than the consolidated entity. Management needs visibility into cross-sections of the entity to make strategic operating decisions – where to inject cash, reduce overheads, or expand marketing efforts. It is at this level that investors want detailed financial information.

Investors want to see the business through the eyes of management, so that they can make more accurate assessments of their favourite metric – future cash flows. They want to evaluate management's positioning within a certain industry or growth potential in a certain region. To do so accurately, they need information at the level at which management is making those decisions.

Segment reporting bridges the gap between the consolidated picture of the entity and management's perspective (often referred to as linking external reporting with internal reporting). At the highest level, segment reporting connects the financial statements with the information reported in management commentaries such as the Operating and Financial Review (OFR) or Management Discussion and Analysis (MD&A). In addition, segment disclosures provide a detailed look into:

- the level at which management allocates resources and assesses performance;
- how management distinguishes key product lines or service offerings;
- the geographical layout of key operations;
- customer concentration and dependence; and
- the status and/or performance of the business based on each of the above.

Operating segments

The foundation of segment reporting is the identification of operating segments. These represent the lowest level at which management monitors operations and makes decisions for the consolidated entity. All other aspects of segment reporting are driven by the operating segment determination.

An operating segment is defined as a component of an entity:

- that engages in business activities from which it can earn revenues and incur expenses;
- whose operating results are regularly reviewed by the entity's chief operating decision maker (CODM) to assess performance and allocate resources; and
- for which discrete financial information is available.

There are four key steps to determine an entity's operating segments:

1. Identify the CODM.
2. Identify their business activities.
3. Determine whether discrete financial information is available for the business activities.
4. Determine whether that information is regularly reviewed by the CODM.

Chief operating decision maker (CODM)

The CODM is a function that allocates resources to, and assesses the performance of, the operating segments. The position will vary from entity to entity, but the pertinent responsibilities are almost always maintained at the highest level of management.

The CODM might be an individual or a committee, depending on the organisation. Common examples include the CEO, the chief operating officer, the executive committee or the board of directors. However, a supervisory committee that simply approves management decisions is unlikely to be the CODM. The title(s) of the person(s) identified as CODM is not relevant, as long as it is the person(s) responsible for making strategic decisions about the entity's segments.

Business activities

Business activities in the context of segment reporting must be *capable* of earning revenue and/or incurring expenses for consideration of separate operating segments. Thus, the lack of any revenue and/or expense being allocated to a division does not preclude it from being a separate operating segment. Care should be exercised when determining whether an internally reported activity constitutes an operating segment.

Illustrative example 1 – Cost centres

Manufacturing entities that are managed by reference to operating cost centres might not record cost centre revenues because the entity's total customer revenues are not allocated on that basis. As long as discrete financial information is prepared and reviewed by the CODM, such components would be considered operating segments.

Illustrative example 2 – Vertically integrated operations

An entity might charge transfer prices between its stages of production (for example, with oil and gas entities). The fact that those transfer prices are not assessed by the CODM would not exempt such activities from being considered individual operating segments. The components of an oil and gas entity might include exploration, development, production, refining and marketing (if the CODM manages the entity in this way). Although some of these components might not have external revenues, this does not exempt them from being considered operating segments.

Discrete financial information

The definition of an operating segment requires discrete financial information to be available. The review of revenue-only data for a particular area of a business is unlikely to meet this definition for most entities. Yet, a full set of financial statements is not required to identify an operating segment. So what does qualify as discrete financial information?

The simple answer is that the CODM must have sufficient information to assess performance and allocate resources for the entity's business activities.

Observations from practice

Sufficiency of the discrete financial information is a judgemental area, but a few general guidelines have been observed in practice:

- A segment balance sheet is not necessary to conclude that discrete financial information is available.
- The requirement for discrete financial information can be met with operating performance information only, such as gross profit by product line or operating profit by region.
- Revenue-only data could be representative of the operating results in cases where product sales or service provisions involve minimal costs. Such circumstances are expected to be rare.

Reviewed regularly by the CODM

Identification of operating segments is driven by the discrete financial information that is reviewed regularly by the CODM (commonly referred to as the 'CODM pack'). This can often be a straightforward process for entities, as it might simply be the standard reporting pack provided to the CEO or the board on a recurring basis (often monthly). As the CODM will sometimes have access to a significant amount of readily available information, however, determining the discrete financial information used to assess performance and allocate resources might require further consideration. Entities with matrix-style or overlapping reporting might also need to do a further assessment.

For example, assume that the CODM reviews two sets of operating results – one by major product line and the other by geographical region. IFRS 8 provides three factors to consider when this situation arises:

1. The nature of business activities of each component.
2. The existence of managers responsible for each component.
3. The information provided to the board of directors.
(when the board is not the CODM)

Assessment of the above factors will typically draw out the prevailing 'management view' of the business; that is, one set of operating results will generally have more prominence in the internal reporting and/or management infrastructure. There are rare cases where operating segments lack clarity, even after these factors are considered. Those situations require significant judgement, and robust documentation of conclusions is recommended.

Entities can confirm their operating segments by asking the following questions:

- Do the identified operating segments realistically represent the level at which the CODM is assessing performance and allocating resources?
- Do these segments provide users of the financial statements with the information needed to evaluate the entity's business activities and the environment in which it operates?
- Are the identified operating segments consistent with other information that the entity produces, such as press releases, interviews with management, organisational charts, entity websites, management discussions and other public information about the entity?

Common components to consider

The determination of operating segments will be unique for each entity – each entity has an individual structure, management reporting, and other facts and circumstances to consider. However, industry trends and common practices around internal functions should be considered for comparability and consistency, especially because regulators often use this view as a basis for raising questions.

Illustrative example 3 – Can it be an operating segment?

Head office (corporate office)
Yes. A head office function that undertakes business activities (for example, a treasury operation that earns interest income and incurs expenses) could be an operating segment if its revenues earned are more than incidental to the activities of the entity and discrete financial information is reviewed by the CODM. A head office that only has incidental revenue and expense (for example, accounting, IT, HR and an employee restaurant) is unlikely to be an operating segment.

Research and development (R&D)
Yes, if discrete information is reviewed by the CODM. An entity's R&D function can be a vertically integrated operation in which the R&D activities serve as a component of the entity's business. The more integral R&D is for the business, the more likely it will be a driver of the operating segment determination. For example, it is common in the pharmaceutical and life science industry to have operating segments identified by the type of R&D performed.

Discontinued operation
Yes. A discontinued operation can meet the definition of an operating segment if it continues to engage in business activities that have discrete financial information reviewed by the CODM. A significant disposal (or disposal that is part of a broader reorganisation plan) would trigger a reassessment of operating segments for the business on a go-forward basis.

Reportable segments

Not all operating segments need to be disclosed separately. Reportable segments are the basis for disclosure of segment information in the financial statements, and they can comprise single operating segments or an aggregation of operating segments.

The process for determining reportable segments can be complex. A summary of the key steps follows:

- Identify the operating segments.

- Determine whether any operating segments meet *all* of the aggregation criteria and, if so, aggregate them (if desired).

- Review the identified operating segments and aggregated groups of operating segments to see if they individually meet the quantitative thresholds. Those that do are treated as reportable segments.

- For the remainder, check whether any of the identified operating segments or aggregated groups of operating segments have similar economic characteristics and meet a *majority* of the aggregation criteria. If they do, aggregate them and treat as reportable segments (if desired). Individual operating segments can also be treated as reportable segments, even if they are not aggregated with another segment or do not meet the quantitative threshold.

- Test whether the external revenues of the reportable segments identified represent 75% or more of the entity's external revenue. If they do, the remaining segments can be combined into a segment called 'All other segments'. If they do not, additional reportable segments must be identified until the total of reportable segments reaches the 75% point.

Aggregation

Aggregation of one or more operating segments into a single reportable segment is permitted (but not required), based on certain criteria. Two or more operating segments can be aggregated if *all* of the following are met:

- aggregation is consistent with the core principle that the result is to provide information that enables users to evaluate the nature and financial effects of the business activities in which the entity engages and the economic environments in which it operates;

- the segments have similar economic characteristics; and

- the segments are similar in each of the following respects:
  - the nature of products and services;
  - the nature of production processes;
  - the type or class of customer for the products and services;
  - the methods used to distribute the products or provide the services; and
  - where applicable, the nature of the regulatory environment – for example, banking, insurance or public utilities.

The aggregation assessment requires significant judgement and is often challenged by regulators. Typical areas of challenge include disclosures that there is only a single reportable segment, or instances where information is presented with a higher level of disaggregation in the front half of the annual report. Emphasis should be given to 'similar economic characteristics', as the phrase implies a very high degree of similarity across all key characteristics in practice. Management might deem a few economic characteristics to be the most relevant for a given industry or geography; however, this judgement should not override a broad assessment of all criteria above, especially if several of the other economic characteristics are dissimilar.

New disclosure requirements An Annual Improvement introduced a new disclosure requirement that entities should provide a brief description of operating segments aggregated in this way. Disclosure will also need to be provided for the economic indicators assessed in determining that the operating segments shared similar economic characteristics. The amendment is effective for periods beginning on or after 1 July 2014

Illustrative example 5 – Can it be aggregated?

Operating segments based on geography
Yes. Operating segments determined on a geographic basis can be aggregated if they meet the aggregation criteria. However, this might present a problem for combining individual countries since, in addition to assessing the financial performance and risks of the underlying products comprising the segment, an entity must also consider the economic conditions (including inflation), exchange control regulations and underlying currency risks associated with the countries when it is determining whether the economic characteristics are similar. Furthermore, even if individual countries were to be aggregated, the entity-wide disclosures required by IFRS 8 mean that revenues and assets are required to be disclosed for each material foreign country.

Start-up with mature business
Yes. Economic characteristics of a start-up are unlikely to align with any portion of a mature business. However, the 'similar characteristic' criterion might be met if the future financial performance (including the competitive and operating risks) of the start-up business is expected to converge and be similar to that of one of the entity's mature business segments. The guidance does not specify a period required for this convergence, but we have observed regulators challenging this assertion if it is meant to occur over a long time period.

Quantitative thresholds

Single operating segments or aggregations of operating segments (where permitted) must be treated as reportable segments when they exceed certain quantitative thresholds. These limits are based on a comparison of segment revenues, profit or loss, and assets with the comparable figures for all segments.

The thresholds are used as minimum reporting requirements; an entity is permitted to report smaller operating segments (or aggregated groups of operating segments) if it chooses to do so. Reporting smaller segments is common in the technology and media industries as a way to highlight a new line of business that does not have significant assets or revenues in an early period of operation.

Information about an operating segment or about a permitted aggregation of operating segments is required to be reported where it meets *any* one of the following quantitative thresholds:

- The operating segment's reported revenue, including both sales to external customers and inter-segment sales or transfers, is 10% or more of the combined revenue, internal and external, of all operating segments.

- The absolute amount of its reported profit or loss is 10% or more of the greater, in absolute amount, of:
    - the combined reported profit of all operating segments that do not report a loss; and
    - the combined reported loss of all operating segments that report a loss.

- Its assets are 10% or more of the combined assets of all operating segments.

Illustrative example 6 – Quantitative thresholds

IndustrialCo has operating segments A–F; the revenues (internal and external), profits and assets are set out below. IndustrialCo needs to determine how many reportable segments it has. The figures are in the same proportions as in the previous year.

Segment	Total revenue	Profit/loss	Total assets
A	11,000	2,000	25,000
B	7,500	1,000	15,500
C	3,000	(1,000)	10,500
D	3,500	(500)	7,000
E	4,000	600	7,000
F	1,500	400	3,500
	30,500	**2,500**	**68,500**

Segments A, B, D and E clearly satisfy the revenue and assets tests, and they are separate reportable segments.

Segment C does not satisfy the revenue test, but it does satisfy the assets test and it is a reportable segment.

Segment F does not satisfy the revenue or the assets test, but it does satisfy the profits test because its profit of 400 is 10% of the greater of the absolute amount of losses of those segments in loss (1,500) and those that either break even or make a profit (4,000 including segment F). Therefore, segment F is a reportable segment.

Consistent measures

Some doubt might arise as to which level of profit or loss should be used when assessing these thresholds. Entities often use 'operating profit' and other measures in internal reporting. Common examples include (but are not limited to):

- earnings before interest, taxes, depreciation and amortisation (EBITDA);
- adjusted EBITDA;
- core earnings;
- profit before tax;
- profit for the period after tax; and
- profit adjusted to exclude certain unusual items.

All of the metrics above are considered 'Non-GAAP' and would not be included in the financial statement disclosures without reconciliation. However, the segment reporting relies on the management view of the business. One of the measures above might be the only profit measure reviewed by the CODM on a regular basis (without reconciliation) and, as such, that measure should be used to assess the quantitative thresholds.

Additional questions might arise when segments report different profitability or balance sheet metrics to the CODM. A consistent measure should be developed to assess the quantitative thresholds in these cases. Regular reports to the CODM do not need to be altered, but the consistent metric must be evaluated to determine appropriate disclosure. This metric should be applied even if the CODM does not use that measure for evaluating a particular segment's performance.

Aggregation at a smaller level

Multiple operating segments that do not meet any of the quantitative thresholds (and are not otherwise deemed as separate reportable segments by management) could be aggregated into a single reportable segment when they have similar economic characteristics and share a *majority* of the aggregation criteria noted above.

Note - This second assessment is different from the initial aggregation of operating segments described above. The baseline for reportable segments has already been determined at this point in the process. Aggregation of operating segments at this level allows management to disclose together similar smaller pieces of the business that might be related or dependent.

One last threshold to test

External revenue attributable to identified reportable segments must represent at least 75% of consolidated external revenue for the entity. Additional operating segments should be identified until this threshold is reached, if it was not met by the reportable segments identified up to this point. The guidance does not prescribe how additional operating segments are identified to reach this threshold, and an entity is not required to select the next largest operating segment. The entity should select the most meaningful operating segment, based on both quantitative and qualitative factors. However, disclosure of the most significant operating segments is likely to be the easiest to support.

What to do with everything else

Information on other business activities and operating segments that are not reportable segments should be combined and disclosed under a heading 'All other segments'.

The 'All other segments' category should be shown separately from other reconciling items (such as elimination of inter-segment revenue and profits) when reconciling the segment information to figures reported in the entity's income statement and balance sheet. The guidance also requires a description of the sources of revenue included in the 'All other segments' category.

Note - An immaterial non-reportable segment cannot be aggregated with a reportable segment unless the aggregation criteria have been met. The standard does not allow for a materiality decision to alter how reportable segments are identified.

Segment disclosure requirements

The segment reporting disclosure requirements focus on providing investors with information about the nature and financial results of business activities, as viewed by management, and insight to the economic environment in which an entity operates.

The disclosure requirements are summarised below (refer to IFRS 8 for the full list).

Type of requirement	Required disclosures
General information	• Description of the factors used to identify the reportable segments (include the overall basis of organisation – for example, geographical or product line). • The types of products and services from which each reportable segment earns its revenues. • *Management judgements in applying the aggregation criteria[1]:* o *description of operating segments that have been aggregated; and* o *economic indicators that have been assessed.*
Information about reportable segment profit or loss; assets and liabilities; and basis of measurement	• A measure of profit or loss. • A measure of total assets and liabilities (if provided to the CODM). • A number of specific disclosures (for example, revenues from external customers). • Explanation of the measurement of the segment disclosures. • The basis of accounting for transactions between reportable segments. • The nature of differences between the measurements of segment disclosures and comparable items in the entity's financial report (for example, accounting policy differences).
Reconciliations	• Totals of segment revenue, segment profit or loss, segment assets and segment liabilities, and any other material segment items to corresponding totals within the financial statements.
Entity-wide disclosures	• Revenues from external customers for each product and service, or each group of similar products and services. • Revenues from external customers attributed to the entity's country of domicile and attributed to all foreign countries from which the entity derives revenues. • Revenues from external customers attributed to an individual foreign country, if material. • Non-current assets (other than financial instruments, deferred tax assets, post-employment benefit assets, and rights arising under insurance contracts) located in the entity's country of domicile and in all foreign countries in which the entity holds assets. • Non-current assets in an individual foreign country, if material. • Extent of reliance on major customers, including details if revenue from any customer is greater than 10% of the entity's revenue.

[1] Disclosure of these judgements and descriptions of aggregated segments is required as a result of the amendments to IFRS 8 in the Annual Improvements to IFRSs 2010–2012 cycle, and these disclosures are required for annual periods beginning on or after 1 July 2014. Earlier application is permitted. If an entity applies this amendment to IFRS 8 for an earlier period, it should disclose that fact.

Observations from practice

Several aspects of these disclosure requirements are often overlooked or misunderstood. The following points highlight, for clarity, some specific aspects of the guidance:

- Disclosures that require the presentation of information that the CODM receives are mandatory, because the guidance has a presumption that the CODM is receiving the information for a reason and, as such, it is important enough to disclose.
- Specifically, entities are required to disclose profit and loss information if it is provided to the CODM, even if the item is not included in the CODM profit and loss metric. For example, the CODM might use an 'operating profit' metric for reportable segments that does not include depreciation. However, if depreciation is provided to the CODM in other information, it is a required disclosure.
- Interest income must be disclosed separately from interest expense, unless the majority of the reportable segment's revenue is from interest and the CODM relies on the net figure for decision-making.
- Segment disclosure information is not required to use the same accounting policies as the consolidated financial statements. Segment information should be presented on the same basis that is provided to the CODM internally. This includes non-GAAP measures and currency selection. The reconciliations to the consolidated information will give visibility to the changes and might be complex if the CODM reviews information that is a significant departure from the financial statement balances.
- Multiple measures of profit, assets, and/or liabilities might be provided to the CODM. The metric most relied on by the CODM for assessing performance and allocating resources should be used. When two or more measures are equally relied on, the measure most consistent with the information in the consolidated financial statements should be disclosed.
- Although an entity might consider information to be commercially sensitive, the standard does not contain a 'competitive harm' exemption.

Changes to the business

The standard does not specify a trigger, nor does it mandate timing, for the reassessment of reportable segments. However, management should consider at each reporting date whether the current operating segment disclosure continues to be appropriate. Several types of changes to a business might alter an entity's segment reporting, including:

- a change in CODM;
- a change in CODM pack;
- a change in organisational structure (for example, restructuring);
- a purchase or disposal of a significant group of business activities; or
- changes in the budgeting process and level at which budgets are set.

Many changes will be obvious because they have a significant impact on the management of the entity; some are more subtle. Moves in an organisational chart might not be emphasised internally, especially if top-level oversight remains the same. However, changes in personnel can create new segment management (for example, where there was one, now there are two) or reduce it (one person promoted to oversee two others). All changes should be evaluated to determine if operating segments have changed. If they have, the effects of those changes on reportable segments should also be assessed.

Comparative periods must be restated to show the historical information on the basis of the segment reporting in the current period.

More than disclosure

Segment reporting links investors with management's view of the entity like no other aspect of the financial statements. Often, much of the information disclosed is discussed to some extent in the management commentaries of annual reports, but the framework of segment disclosures is the most consistent representation of internal reporting and the only one required to reconcile to the consolidated financial statements.

Operating segments are the foundation to this bridge between external reporting and internal reporting and, as such, they influence more than just disclosure.

Business combinations and disposals

Significant business combinations or disposals can have a major impact on future operations. Segment reporting provides investors with visibility into how the transaction is expected to affect the entity, which areas of the entity will be affected and, in the case of business combinations, which areas are expected to receive the most benefit (for example, allocation of goodwill suggests future synergies and cost savings).

Impairment testing

Operating segments are used as a constraint to determine the level at which impairment testing is performed for both tangible and intangible assets:

i. Goodwill allocation

- Goodwill generated from a business combination must be allocated to a cash-generating unit (CGU) or group of CGUs, but the guidance explicitly states that this allocation cannot be performed at a level greater than an individual operating segment. The impairment testing of goodwill follows this allocation, so any goodwill allocated to a segment must be supported by that segment alone.
- A change in operating segments might arise from a change in management structure. Where there is a resulting change in the way that goodwill is monitored internally, it would be acceptable to reallocate goodwill to the modified CGUs for the purposes of impairment testing.

ii. CGU determination

- Based on the guidance for goodwill allocation, the guidance clearly indicates that a CGU cannot be larger than an operating segment. Impairment testing of tangible assets is performed at the CGU level and of intangible assets at the same level or as a group of CGUs. This constraint prevents cash flows of multiple operating segments from supporting groups of assets.

Questions?

PwC clients who have questions about this *In depth* should contact their engagement partner.

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