IFRS 8 OPERATING SEGMENTS: GENERAL CONSIDERATIONS REGARDING THE MANAGEMENT APPROACH

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Abstract:

The aim of this paper is to discuss some general considerations regarding the management approach contained in International Financial Reporting Standard (IFRS) 8 Operating Segments, issued by International Accounting Standards Board (IASB) in November 2006. Using this approach, the IASB promoted a disaggregated information based on the internal organization of the entity, in order to contribute to more relevant segment information by allowing the users to analyze companies' performances through the management view and, thus, supporting a better consistency between the segment information represented in the financial statements and the information disclosed in the internal management reports.

Key words: *IFRS 8, operating segments, the management approach.*

JEL classification: M41.

1. Introduction

In order to explore new markets or to reduce operating risks, many companies have diversified their operations, developing various lines of businesses and operating in different geographic locations.

For these companies, segmental information is an essential management instrument because it allows management to monitor performance, allocate resources and conceive profitable market strategies (Grand Thornton, 2009). On the other hand, it helps financial statements users better understand the entity's performance, assess its future profitability, and make more informed judgments about its activity as a whole (Li, 2013).

Segmental reporting has always been a matter of concern for standard setters, being mandatory for entities that engage in more than one significant business to provide information concerning their business segments and/or geographic areas.

In this regard, International Accounting Standards Board (IASB) issued the IFRS 8 *Operating Segments*, which became effective for accounting periods starting on or after 1 January 2009. This Standard replaced International Accounting Standard (IAS) 14R (Revised 1997) *Segment Reporting* and converged, except for minor differences, with Statement of Financial Accounting Standard (SFAS) 131 *Disclosures about Segments of an Enterprise and Related Information*, issued by the Financial Accounting Standards Board (FASB). IFRS 8 was endorsed for use in the European Union in November 2007.

The core principle of IFRS 8 requires an entity to: *"...disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates"* (IFRS 8, para 1).

The Standard introduces a '*management approach*' for identifying and measuring the financial performance of an entity's operating segments, meaning that reported segment information is based on the information used internally by management.

The management approach is based on the way in which management organizes the segments within the entity for making operating decisions and assessing performance. The segments are evident from the structure of the entity's internal organization and the information reported internally to the chief operating decision maker (CODM).

This is a different approach from IAS 14R and has the potential to emphasize sensitive information to users of financial statements as well as to the competitors. In that way,

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financial statements users are able to see the entity through the eyes of management (KPMG, 2010). Consequently, management needs to understand the requirements of IFRS 8 and think carefully about what the required disclosures say about the way that they manage the business (Grand Thornton, 2009).

2. Differences between IFRS 8 and IAS 14R

The essential difference between IFRS 8 and IAS 14R refers to the identification of the segments. IAS 14R required identification of two sets of segments, one of them being based on related products and services, and the other on geographical areas. IAS 14R regarded one set as primary segments and the other as secondary segments. On the contrary, IFRS 8 requires segments to be identified based on the management approach that is related to the internal reports that are regularly reviewed by the chief operating decision maker for purposes of evaluating performance and making resource allocation decisions (IFRS 8, IN11).

The primary reason for the change in reporting segment information is to enable financial statements users to evaluate the entity's information from the management perspective.

The objective of IAS 14R was to establish principles for segment reporting by line-of-business and by geographical areas. The criteria for defining operating segments and disclosing related information were not limited solely for management reporting purposes. Therefore, according to IAS 14R, entities could prepare different types of segment information, the information viewed internally by management and the information reported externally. In many cases, these different sets of reporting caused concerns to financial statements users in that the flexibility in the application of the segment definition under IAS 14R provided few relevancies on how a company manages its segment operations (Li, 2013).

IFRS 8 fundamentally changes the reporting of segment information on a company's financial statements. It requires much of the management information to be published externally so that investors, analysts and other users of entities' financial statements can review the entity's operations from the same perspective as management.

Also, IFRS 8 requires judgement in its application. Management should consider the key principle as it determines its segment disclosures rather than relying on a set of rules (PricewaterhouseCoopers, 2008). The key concept is that the entity should provide information used by management that will allow users to understand the entity's main activities, where those activities are located and how well those activities are performing.

Other important change concerns the measurement of segment information. IAS 14R required segment information to be prepared according to the accounting policies adopted for the preparation and presentation of the consolidated financial statements. IFRS 8 requires the amount reported for each segment item to be the measure reported to the chief operating decision maker for the purposes of allocating resources to that segment and assessing its performance (IFRS 8, IN13). Operating segments are measured as reported to management.

In contrast to IAS 14R, IFRS 8 does not define segment revenue, segment expense, segment result, segment assets and segment liabilities, but requires an explanation of how segment profit or loss, segment assets and segment liabilities are measured for each operating segment.

As a consequence, under IFRS 8 entities have more discretion in determining what is included in segment profit or loss, being limited only by their internal reporting practices (de Graaf, 2011).

Table no. 1. Differences between IFRS 8 and IAS 14R

	IFRS 8 ***Operating Segments***	**IAS 14R** ***Segment Reporting***
Reporting segments	Management approach Operating segments are identified based on the internal reporting of financial information to the CODM.	Risk and rewards approach Reporting segments are identified based on the dominant source and nature of an entity's risk and rewards that are products / services, or geographical areas.
	Includes components that sell primarily to other components.	Looks only to external revenue.
Measurement	Operating segments are measured as reported to management. Requires explanations on how disclosure items for each operating segment, such as profit or loss, segment assets and segment liabilities, were measured.	Measures used in financial statements. Defines how to measure disclosure items, such as segment revenue and expenses, segment asset and liabilities.
Disclosure	Requires disclosure about factors used to identify the operating segments and explanations on the types of products or services from which the reportable segment derives its revenues. Requires disclosure of how much of the segmental information is reviewed by the CODM.	Specifies the items that must be disclosed for each reportable segment.

3. Benefits and concerns regarding the management approach

Several advantages as well as concerns have been expressed regarding the usefulness of the management approach adopted by the IFRS 8.

The report of the Directorate-General for Internal Market and Services – a service of European Commission - regarding the analysis of potential effects of IFRS 8 endorsement in EU, points out the potential benefits of the Standard (European Commission, 2007). Some of these are summarized below:

- The use of the management approach has a positive effect on the quality of the segment information, increasing its usefulness and relevance. This approach has the advantage of grounding the definition of segments in corporate practice (Véron, 2007). Users generally see value in the management approach so long as it does not lead to distortion of the economic depiction of operations.
- The increased usefulness and relevance of the segment information based on the management approach outweigh concerns expressed about the comparability of financial reports. IAS 14R did not always ensure comparability and stability of segmental information. Moreover, comparability is not the criterion that should necessarily prevail over the accurate presentation of organisational structures and risk exposures.
- IFRS 8 appropriately addresses the global needs of financial statements' users for geographical disclosures and does not reduce this information in practice compared to IAS 14R.
- IFRS 8 provides appropriate segment reporting rules for smaller listed companies. All listed companies, regardless of size, should provide similar information as the needs of

investors do not substantially differ based on company size. Therefore, there is no reason for special rules concerning segment reporting for these entities.

The management approach should be less expensive for entities, as it includes information already prepared for internal reporting purposes (Mantziou, 2013). The IASB maintains that, because the segment information required to be disclosed are readily available, it should help entities save time and money.

At the same time, many concerns about the management approach have been expressed, considering primarily the competitive harm that may occur by disclosing too much internal information (Mantziou, 2013; Li, 2013). The disclosure of certain confidential information raises management concerns that potential competitive prejudice would be generated by unveiling strategic plans of the company to competitors. Also, the disagreement on adopting the management approach is based on the opinion that the segment information was most useful for investors when it was based upon economically similar or related product/service lines or geographical factors, as IAS 14R required.

In commenting on ED (Exposure Draft) 8 *Operating Segments* (issued by the IASB in January 2006), there were arguments that it is inferior to IAS 14R because segment information does not have to be reported on the same basis as the financial statements using IFRS. To counter this criticism, the final IFRS 8 required increased disclosure regarding the basis on which the information has been prepared. Overall, the IASB believed the benefits of the management approach, together with some expanded disclosure, would outweigh the lack of comparability that might arise (Ernst & Young, 2009).

Other concern relates to the content of segment information that is the financial disclosures which are made for each segment. IAS 14R required consistency with definitions of financial aggregates in the consolidated financial statements. IFRS 8 allows for much more discretion and for inconsistent aggregates, e.g. the use of EBITDA or other measures of performance which are not used in the consolidated financial statements. From this perspective, concerns were expressed that IFRS 8 would lead to larger difficulties if adopted in the EU because EU member states have diverging traditions of financial reporting and no unity of accounting enforcement (Véron, 2007).

Also, there might be severe inconsistencies in the content of segment information because the frequent internal reorganisations would result in a loss of trend data.

Geographical information is important to financial users to understand risks, especially those linked to country or regional factors. Regarding the geographical information, IAS 14R required a number of geographical disclosures by all companies. On the contrary, IFRS 8 allows companies to avoid providing geographical information on grounds of the cost of producing it. Geographical segments are required to the extent that they are considered as operating segment regularly reviewed by the CODM.

In order to address the concerns expressed regarding the implementation of IFRS 8, IASB has conducted a post-implementation review process beginning with Q1 2012. The report was published in July 2013. IFRS 8 was the first Standard that was subject to a post-implementation review by the IASB. The key findings are summarized below:

- regarding the use of the management approach, the information provided to the post-implementation review confirmed many of the IASB's expectations when it issued IFRS 8, making easier the communication by management with investors;

- the incremental costs of the implementation of IFRS 8 were low;

- general opinion of the preparers was that the Standard meets their expectations; also auditors, accounting firms, standard setters and regulators generally support the Standard, but have made some suggestions to improve its application; and

- investors views were mixed. Some of them preferred to have information about how management views the business, according to the IFRS 8 requirements. When all aspects of an entity's reporting align so that operating segment information in the financial statements, management commentary and presentations to analysts all agree, this provides more detailed, integrated information to them. Still, other investors expressed concerns about a segmentation process that is based on the management approach. In their opinion, this approach creates the premises for reporting segments in such a way as to obscure the entity's true management structure or to mask loss-making activities within individual segments (IASB, 2013).

4. Conclusions

Under IFRS 8, the reported segment information is required to be the information actually used by management for making operating decisions and evaluating performance of the business segments.

The Standard requires the amount reported for each operating segment item to be the measure reported to the chief operating decision maker for the purposes of allocating resources to the segments and assessing its performance.

The adoption of the management approach results in the disclosure of information for segments in substantially the same manner as it is reported internally and used by the entity's CODM.

The management approach means that:

- the way entities identify segments and measure and present segment information could change;
- there might be more diversity in reported segment information;
- segment information may not be measured in accordance with IFRS – entities are required to reconcile segment financial information to the consolidated financial statements; and
- entities are no longer need to prepare two sets of information for internal and external reporting (PricewaterhouseCoopers, 2008).

Adopting the management approach has benefits and disadvantages. Some of the benefits are the following: achieves convergence with US GAAP, that is SFAS 131; improves users' ability to predict future results and cash flows; points out risks that management think are important; is less expensive, as it includes information already prepared for internal reporting purposes. Concerns are related to the following aspects: inconsistent segments may be reported between entities, because the internal organization of each entity might differ; frequent internal reorganizations would result in a loss of trend data; and the segment information disclosed is measured on the basis used for management reporting, thus non-IFRS measures used by management may not be understood.

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