IFRS 8 *OPERATING SEGMENTS*

Article by Dr. Ciaran Connolly, Phd, BSSC, MBA, FCA, Examiner in Professional 2 Advanced Corporate Reporting

Introduction

The Financial Reporting Review Panel (FRRP) has raised concerns over the application of IFRS 8 *Operating Segments* and has asked a number of UK companies to provide more information. This is particularly in cases where only one operating segment is reported, but it appears that:

- the company/group has other businesses and operations in different countries;
- the operating analysis detailed in the narrative report varies from the operating segments provided in the financial statements;
- the responsibilities and titles of the executive management team hint at an organisational structure that is not reflected in its operating segments; and
- there is a contradiction between the commentary in the narrative report.

The FRRP has encouraged organisations to test their initial conclusions about their segmental reporting by considering the following questions:

1. What are the key operating decisions made in running the business?
2. Who makes these key operating decisions?
3. Who are the segment managers (as defined in IFRS 8) and who do they report to?
4. How are the organistion’s activities reported in the information used by management to review performance and make resource allocation decisions between segments?
5. Is any proposed aggregation of operating segments into one reportable segment supported by the aggregation criteria in the standard, including consistency with the core principle?
6. Is the information about reportable segments based on IFRS measures or on an alternative basis?
7. Have the reported segment amounts been reconciled to the IFRS aggregate amounts?
8. Do the accounts describe the factors used to identify the reportable segments including the basis on which the organisation is organised?
9. As a final question, management should ask themselves whether the reported segments appear consistent with their internal reporting and, if not, why not.

The FRRP draws attention to the fact that no exemption is given from any aspect of IFRS 8 on the grounds that disclosure would be commercially prejudicial.

Objective and Scope of IFRS 8

The core principle of IFRS 8 *Operating Segments* is that an organisation should disclose information to enable users of its financial statements to evaluate the nature and financial effects of the types of business activities in which it engages and the economic environments in which it operates.

IFRS 8 applies to the financial statements of any organisation whose debt or equity instruments are traded in a public market or who is seeking to issue any class of instruments in a public market. Other organisations that choose to disclose segment information should make the disclosures in line with IFRS 8 if they describe such disclosures as 'segment information'. IFRS 8 applies to financial statements beginning on or after 1st January 2009. While earlier application is permitted, the organisation must disclose that it is applying IFRS 8 early.

Reportable Segments

IFRS 8 requires an organisation to report financial and descriptive information about its *reportable segments*. Reportable segments are *operating segments* or aggregations of operating segments that meet specified criteria:

- its reported revenue, from both external customers and intersegment sales or transfers, is 10% or more of the combined revenue, internal and external, of all operating segments; or

- the absolute measure of its reported profit or loss is 10% or more of the greater, in absolute amount, of (i) the combined reported profit of all operating segments that did not report a loss and (ii) the combined reported loss of all operating segments that reported a loss; or

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

If the total external revenue reported by operating segments constitutes less than 75% of the organisation's revenue, additional operating segments must be identified as reportable segments (even if they do not meet the quantitative thresholds set out above) until at least 75% of the organisation's revenue is included in reportable segments. IFRS 8 has detailed guidance about when operating segments may be combined to create a reportable segment.

Operating Segments

An operating segment is a component of an organisation:

- that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same organisation);

- whose operating results are reviewed regularly by the organisation's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance; and

- for which discrete financial information is available.

The term chief operating decision maker is not specifically defined in IFRS 8 as it refers to a function rather than a title. In some organisations the function could be fulfilled by a group of directors rather than an individual. As a result, IFRS 8 has been criticised for leaving segment identification too much to the discretion of the organisation and therefore hindering comparability between financial statements of different organisations.

Not all operations of an organisation will necessarily be an operating segment (nor part of one). For example, the corporate headquarters or some functional departments may not earn revenues or they may earn revenues that are only incidental to the activities of the organisation. These would not be operating segments. In addition, IFRS 8 states specifically that an organisation's post-retirement benefit plans are not operating segments.

Example
X Limited has identified the following business components:

	Revenue		Profit	Assets
	External	Internal		
Business Component	€'000	€'000	€'000	€'000
1	160,000	Nil	20,000	100,000
2	Nil	90,000	10,000	60,000
3	20,000	Nil	2,000	8,000
4	16,000	Nil	1,000	6,000
Total	196,000	90,000	33,000	174,000

Based upon the above information, the following segments should be classified as reportable in accordance with IFRS 8:

- Components 1 and 2 would be separately reportable since they meet all three size criteria;

- Components 3 and 4 do not meet any of the size criteria and on the face of it are not separately reportable. The external revenue of component 1 is 82% of the total external revenue so the '75% threshold' is comfortably achieved. However if they had similar economic characteristics then when aggregated they would be over the 10% threshold for revenue and so could be reported as a combined segment.

Disclosure (summary)

1. How the organisation identified its operating segments and the types of products and services from which each operating segment derives its revenues.

2. Reported segment profit or loss, including certain specified revenues and expenses included in segment profit or loss, segment assets and segment liabilities and the basis of measurement.

3. Reconciliations of the totals of segment revenues, reported segment profit or loss, segment assets, segment liabilities and other material items to corresponding items in the organisation's financial statements.

4. Organisation-wide disclosures even when an organisation has only one reportable segment.

5. Analysis of revenues and certain non-current assets by geographical area.

6. Information about transactions with major customers.

IFRS 8 requires that current period and comparative segment information be reported consistently. This means that if a segment is identified as reportable in the current period but was not in the previous period then equivalent comparative information should be presented unless it would be prohibitively costly to obtain. IFRS 8 gives organisations discretion to report information regarding segments that do not meet the size criteria. Organisations can report on such segments where, in the opinion of management, information about the segment would be useful to users of the financial statements.

Example

Extract from the group and parent company financial statements of Marks and Spencer Group plc for the 53 weeks ended 3 April 2010
(http://annualreport.marksandspencer.com/financial-statements/accounts-notes/note2.aspx - accessed 1st July 2010).

2. Segmental information

The Group has adopted IFRS 8 – 'Operating Segments' with effect from 29 March 2009. IFRS 8 requires operating segments to be identified on the basis of internal reporting about components of the Group that are regularly reviewed by the chief operating decision maker to allocate resources to the segments and to assess their performance. In contrast, the predecessor Standard (IAS 14 – 'Segment Reporting') required the Group to identify two sets of segments (business and geographical), using a risks and rewards approach, with the Group's system of internal financial reporting to key management personnel serving only as the starting point for the identification of such segments.

The chief operating decision maker has been identified as the executive directors. The executive directors review the Group's internal reporting in order to assess performance and allocate resources. The operating segments are UK and International which are reported in a manner consistent with the internal reporting to the executive directors.

The UK segment consists of the UK retail business and UK franchise operations. The International segment consists of Marks & Spencer owned businesses in the Republic of Ireland, Europe and Asia, together with international franchise operations.

The executive directors assess the performance of the operating segments based on a measure of operating profit. This measurement basis excludes the effects of exceptional items from the operating segments as well as gains or losses on the disposal of assets. Central costs are all classified as UK costs and presented within UK operating profit. The executive directors also monitor revenue within the segments. To increase transparency, the Group has decided to include an additional voluntary disclosure analysing revenue within the reportable segments.

The following is an analysis of the Group's revenue and results by reportable segment:

	53 weeks ended 3 April 2010			52 weeks ended 28 March 2009		
	Management	Adjustment[2]	Statutory	Management	Adjustment[2]	Statutory
	£m	£m	£m	£m	£m	£m
General Merchandise	4,186.2	(34.2)	4,152.0	3,944.4	(26.1)	3,918.3
Food	4,455.5	(39.6)	4,415.9	4,282.3	(36.3)	4,246.0
UK revenue	8,641.7	(73.8)	8,567.9	8,226.7	(62.4)	8,164.3

Wholesale	297.7	–	297.7	272.3	–	272.3
Retail	673.1	(2.1)	671.0	627.2	(1.7)	625.5
International revenue	970.8	(2.1)	968.7	899.5	(1.7)	897.8
Group revenue	9,612.5	(75.9)	9,536.6	9,126.2	(64.1)	9,062.1
UK operating profit[1]	701.2	–	701.2	652.8	–	652.8
International operating profit	142.7	–	142.7	116.1	–	116.1
Group operating profit (adjusted)	843.9	–	843.9	768.9	–	768.9
Profit on property disposals			8.1			6.4
Exceptional costs			–			(135.9)
Exceptional pension credit			–			231.3
Group operating profit			852.0			870.7
Finance income			12.9			50.0
Finance costs			(162.2)			(214.5)
Profit before tax			702.7			706.2

1. UK operating profit includes a contribution of £30.4m (last year £24.8m) in respect of fees received from HSBC in relation to M&S Money.
2. Adjustments relate to revenue items recognised in cost of sales for management accounting purposes.

Other segmental information:

	2010			2009		
	UK £m	International £m	Total £m	UK £m	International £m	Total £m
Additions to tangible and intangible assets (excluding goodwill)	360.0	29.3	389.3	611.8	40.2	652.0
Depreciation and amortisation	398.7	29.2	427.9	384.4	24.6	409.0
Assets	6,242.7	910.5	7,153.2	6,530.8	727.3	7,258.1