Amendments to IFRS 8 *Operating Segments* and IAS 34 *Interim Financial Statements*

Issues paper

Objective

1 The objective of this session is to provide an overview of the forthcoming proposed amendments to IFRS 8 *Operating Segments* and IAS 34 *Interim Financial Statements* and seek preliminary views from EFRAG TEG on the proposals. An exposure draft is expected at the end of March 2017 and the views expressed at the session will form the basis of a draft comment letter.

Background

2 In July 2013, the IASB concluded its post-implementation review of IFRS 8 and published its report and feedback statement on that review.

3 IFRS 8 is substantially converged with the US GAAP equivalent literature Statement of Financial Accounting Standards (SFAS) 131 *Disclosures about Segments of an Enterprise and Related Information* (Accounting Standards Codification Topic 280 *Segment Reporting*), which was subject to a post-implementation review by the Financial Accounting Foundation (FAF) in 2012.

4 Both the IASB and the FAF concluded that the management perspective in IFRS 8 is the correct basis on which to identify and provide information about operating segments.

5 In January 2014, the FASB decided not to add to its agenda a project to amend SFAS 131. In August 2016, the FASB published an invitation to comment on its agenda consultation in which it asked for views on whether there were aspects of SFAS 131 that needed to be reconsidered. The FASB has not concluded its agenda consultation process at the date of this paper.

6 Nonetheless, the IASB concluded that there were some areas in IFRS 8 that needed further investigation, whist staying converged with the equivalent US GAAP requirements. The areas identified by the IASB can be summarised as:

(a) Area 1: identifying the chief operating decision maker (CODM);

(b) Area 2: identifying and aggregating operating segments into reportable segments;

(c) Area 3: increasing the number of reported line items;

(d) Area 4: the allocation of reconciling items to individual segments including improvements to the understandability of the segment reconciliation; and

(e) Area 5: the preservation of trend data on a change in composition of reportable segments (amendment to IAS 34 *Interim Financial Reporting*).

7 At its meeting in May 2015, the IASB discussed proposed amendments to IFRS 8 that responded to issues identified for further investigation in its post implementation review of the Standard undertaken in 2013. These issues were consistent with those reported by EFRAG to the IASB on the post-implementation review. The EFRAG Secretariat notes that the tentative proposals are mainly clarifications of the existing requirements in IFRS 8.

8 At its meeting in December 2015, EFRAG TEG discussed the IASB's tentative proposals and broadly agreed with them. However, there were some concerns with respect to the proposals/clarifications relating to the identification of the CODM and a suggestion that greater weight be placed on the allocation of resources function of the CODM, rather than focusing on the technical structure of the governing body.

9 The EFRAG User Panel also discussed the proposals at its meeting in December 2015. EFRAG User Panel members welcomed the IASB's efforts to clarify some of the important aspects of IFRS 8 and the information it should provide to users. However, some concerns and suggestions were noted in relation to the function of the CODM, consistent application of reportable segments, and the level of aggregation of information under IFRS 8 and which line items should be required to be disclosed.

Area 1: Identifying the CODM

Issues identified in the IASB's post-implementation review and additional outreach

10 The identification of the CODM plays an important part in the identification of operating segments in IFRS 8. IFRS 8 defines an operating segment and includes a reference to regular review by the entity's CODM in that definition.

11 Many respondents said that they found it difficult to identify the CODM and some were uncertain at what level that role should be in an entity's management hierarchy. Another issue reported was whether the role is principally strategic or operational because paragraph 7 of IFRS 8 refers to the allocation of resources, which many consider to be a strategic function. However, the title of the CODM seems to refer to operating decisions.

12 Findings from the post-implementation review identified that a number of entities identified the Board of Directors as the CODM, although the Board of Directors includes non-executives who are not actively involved in the decision-making process. On the other hand, in other jurisdictions, the CODM is usually identified as an individual such as the CEO or president of the entity. The IASB staff noted that paragraph 7 of IFRS 8 describes the role as 'a function, not necessarily a manager with a specific title'.

13 Some investors and regulators observed that disclosure of the CODM would provide useful insight into how decisions are made and how the entity's activities are managed, and also increase enforceability by identifying those responsible for the decisions made.

IASB tentative decisions and proposals

14 To address the concerns about identifying the CODM in practice, the IASB will propose to include additional guidance in IFRS 8 to emphasise that:

(a) The term CODM identifies a 'function' that makes the **most significant operating decisions** as well as some strategic decisions about allocating resources to and assessing the performance of the operating segments of an entity.

(b) The **CODM can be an individual or a group**, such as a board or a managing committee. This will depend on the entity's management structure and how it is influenced by local governance requirements which might require that decisions are made by an individual, as opposed to a group.

(c) **A group can be identified as a CODM even if it includes** members that do not participate in all the decisions that the CODM is authorised to make, such as **non-executive members**. The key factor is that the CODM 'group' is the one that makes the most significant operating decisions as well as some strategic decisions.

15 The IASB also proposes that an entity should **disclose the title of the individual or a description of the group which represents the CODM**.

EFRAG Secretariat analysis and preliminary views

16 EFRAG's response to the post-implementation review noted similar issues to those reported to the IASB. In particular, users and regulators of financial statements thought that it was not always clear how companies identified the CODM and the role of non-executive directors in the context of decision-making. Users also observed that operating segment information obtained through management discussions was not always consistent with the information reported in the financial statements and sometimes reported at a different level of detail. Preparer respondents did not report significant challenges with identifying the CODM of an entity.

17 When EFRAG TEG discussed the role of the CODM at its December 2015 meeting, some EFRAG TEG members echoed the concerns of some respondents to the IASB's review of IFRS 8 about whether or not the allocation of resources was at an operating or strategic level. Some EFRAG TEG members thought that the reference in IFRS 8 to the CODM making decisions about allocation of resources was clearly strategic. One EFRAG TEG member questioned the need to look at a 'function' rather than individuals. The view of this member was that the allocation of resources determined the structure, and the constraints with which decision makers at operating level had to work with, so suggested the IASB should look at that instead.

18 The EFRAG Secretariat agrees that the tentative proposals will help solve the issues (some of) associated with the role and identification of the CODM. We acknowledge that some users would like to have a clearer view of the CODM and its function. However, we agree that there are drawbacks in developing a precise description of the role of the CODM as this will largely depend on how a company is structured and managed. Therefore the language to describe the CODM needs to accommodate all entities and their management structure. For similar reasons, we agree that the function of the CODM should not prohibit non-executive members. This is in line with the views expressed by EFRAG TEG at its meeting in December 2015.

19 Overall, we think that the IASB's forthcoming proposed clarifications on the CODM will address concerns reported by constituents, including EFRAG.

Question to EFRAG TEG members

20 Do EFRAG TEG members agree with the tentative proposal in paragraph 14 on the identification of the CODM and do you think it addresses the concerns identified in the review of IFRS 8? If you do not agree, what alternatives or suggestions would you propose?

Area 2: Identifying and aggregating operating segments into reportable segments

Issues identified in the IASB's post-implementation review and additional outreach

21 Under IFRS 8, operating segments are identified based on the way in which financial information is organised and reported to the CODM. Aggregation of two or more operating segments into a single reportable segment is permitted only if the segments have similar economic characteristics and are similar with respect to, for example, the nature of products and services sold and type of customer.

22 Aggregation of operating segments was one of the major concerns identified in the IASB's review of IFRS 8. Many constituents, in particular users, indicated that too much aggregation takes place, in a way that does not assist them in their use of valuation models. Auditors and regulators confirmed similar difficulties in practice.

23 Some respondents noted difficulties with the meaning of 'similar economic characteristics', and argued that the example in paragraph 12 of IFRS 8 of a gross margin percentage is not a good one. For example, two divisions of an entity having a similar gross margin percentage can be the outcome of the arithmetic effect on each division of differing economic characteristics, instead of the gross margin being a single, similar economic characteristic in its own right.

24 Some users thought that IFRS 8 could include more examples of economic characteristics to ensure that inappropriate aggregation is reduced. For instance, similar levels of revenue growth, exposure to similar currency fluctuations, inflation or specific markets, or use of specific industry key performance indicators (KPIs) are examples of similar economic characteristics that could be added to the guidance.

25 Furthermore, users of financial statements raised concerns that an entity did not always identify the same segments in the financial statements and other parts of its reporting package. Some regulators and auditors shared this concern and suggested providing additional guidance in IFRS 8 to remind preparers that the information produced under the management perspective should be consistent with other reported information.

IASB tentative decisions and proposals

<u>Aggregation criteria</u>

26 The IASB will propose to emphasise that two or more operating segments may be aggregated into a single operating segment if, **and only if:**

(a) aggregation is consistent with the core principle of IFRS 8;

(b) the segments have similar economic characteristics; and

(c) the segments are similar in each of the following respects:

  (i) the nature of the products and services;

  (ii) the nature of the production processes;

  (iii) the type or class of customer for their products and services;

  (iv) the methods used to distribute their products or provide their services; and

  (v) if applicable, the nature of the regulatory environment, for example, banking insurance or public utilities.

27 The IASB considered defining 'similar characteristics' but was not convinced it would work especially because previous attempts by the FASB staff had been

unsuccessful. Instead, the IASB will propose to **introduce guidance in IFRS 8** to help in the assessment of whether two segments exhibit similar long-term financial performance, and thus have similar characteristics. For example, if two operating segments are deemed to have similar economic characteristics, it might be expected that they would have similar revenue growth, similar return on assets and similar long-term average gross margins.

Consistent identification of reporting segments

28 The IASB will explain that it is expected that an entity will identify the same segments in its financial statements as in other parts of its annual reporting package. Where segments differ, the IASB **will propose to introduce a requirement for an entity to explain when and why segments it has identified in the financial statements differ from segments identified in other parts of the annual reporting package**. The IASB also decided to clarify what might constitute an entity's 'annual reporting package'.

Disclosure

29 Finally, the IASB will **propose to allow an entity to disclose segment information beyond that reviewed by the CODM** if that helps the entity meet the core principle in IFRS 8.

EFRAG Secretariat analysis and preliminary views

30 The issues reported to EFRAG during the review of IFRS 8 were similar to those reported to the IASB. In summary, users were generally unsatisfied with the basis of aggregation of operating segments (for example reporting two segments – production and retail – without any information that allowed users to analyse profit margins by type of product). Preparers however did not share this concern and argued that if multiple activities were aggregated into a single segment, it was intended to reflect the entity's management structure and based on what is reported to the entity's CODM.

31 The EFRAG Secretariat is therefore supportive of the proposal to clarify when aggregation of reporting segments is permitted in IFRS 8 and to provide more clarify on the concept of 'similar economic characteristics'. We agree that it would be difficult to define 'similar economic characteristics' in a Standard that reports through the eyes of management. Such characteristics would vary by industry and by company.

32 Paragraph 22 (aa) of existing IFRS 8 already requires disclosure of the judgements made by management in applying the aggregation criteria, including a brief description of the operating segments that have aggregated and the economic indicators used for aggregation. In addition, paragraph 22 (b) requires disclosure of the types of products and services from which each reportable segment derives its revenues. In our view, this disclosure if applied correctly, should help to address the concerns reported by users.

33 Furthermore, we think that the proposal to require an entity to explain the reasons why the segments an entity has identified in its financial statements differ from segments identified in other parts of its annual reporting package will help address the concern expressed by users on the consistency of segment information.

Question to EFRAG TEG members

34 Do EFRAG TEG members support the tentative proposals in paragraphs 26 to 29, and if not why not and what alternatives do you suggest?

Area 3: increasing the number of reported line items

Issues identified in the IASB's post-implementation review and additional outreach

35 Paragraphs 23 and 24 in IFRS 8 require disclosure of a number of identified line items in relation to profit or loss, assets and liabilities, if those line items are regularly provided to the CODM or are included in the measure of profit and loss reviewed by the CODM.

36 Paragraph 28 of IFRS 8 requires five line items to be disclosed, including every other material item of information disclosed about reported operating segments, to be reconciled. It also requires all material reconciling items to be separately identified and disclosed.

37 Feedback from the post-implementation review of IFRS 8 indicated that some investors thought that the use of internally reported line items does not always provide them with the information they need to make comparisons across entities. They would prefer to see specific line items mandated for disclosure.

38 Some investors suggested that IFRS 8 should require companies to disclose all the line items laid out in IFRS 8, unless it was impracticable to do so. Some other users suggested linking the line items presented to the contents of the management commentary.

39 Further IASB Staff outreach conducted in 2014 confirmed the concerns previously expressed by users. Users generally wanted information on particular line items that explained the link between cash flows and profit or loss - for example, depreciation and amortisation, non-recurring items, capital expenditure information.

40 However, there were different views about which line items should be disclosed, as the importance of different line items varies by industry and extending the number of line items in IFRS 8 would not necessarily result in more relevant information for investors (for example, this would lead to the potential for boiler-plate disclosure). Some cautioned against linking the contents of the management commentary, which does not form part of the financial statements, with the disclosures required in the financial statements.

IASB tentative decisions and proposals

41 The IASB tentatively decided that mandating the disclosure of items that are not reviewed by or regularly provided to the CODM would be seen as a departure from the management perspective that underlies IFRS 8.

42 The IASB will propose to add a paragraph in IFRS 8 to say that **entities are allowed to disclose items in addition to those required by the Standard** if those additional line items would help the entity to meet the core principle of IFRS 8. This additional information may include information that is not reviewed by or regularly provided to the CODM.

EFRAG Secretariat analysis and preliminary views

43 The feedback EFRAG received from users was broadly in line with that of the IASB. Our preliminary view is that the IASB proposal in paragraph 42 will help address the concerns reported by users and members of the EFRAG User Panel. We agree with the reasoning of the IASB that requiring a set of predetermined line items to be disclosed would seem inconsistent with the management approach in IFRS 8. Furthermore, it would be difficult to establish which line items an entity should disclose given the different views expressed by users depending on the company and industry they represent.

Question to EFRAG TEG members

44 Do EFRAG TEG members support the tentative decision in paragraph 41 and the tentative proposal in paragraph 42 in relation to the lines items reported, and if not why not and what alternatives do you suggest?

Area 4: the allocation of reconciling items to individual segments and improvements to the reconciliations

Issues identified in the IASB's post-implementation review and additional outreach

45 IFRS 8 requires a reconciliation of the operating segment information with the information in the IFRS financial statements.

46 Some investors requested that reconciliations should be prepared segment-by-segment. Preparers and others, however, claim that segment-by-segment reconciliation in some cases might result in non-systematic allocations (when for instance there is no systematic basis available) and reduce the value of the operating segment information provided.

47 The FASB staff reported that this was not an area of concern for entities that report in accordance with US GAAP. The explanation being that the operating segment information reported should be in accordance with the management perspective; a requirement to allocate all reconciling items would not represent the internal information used by management.

IASB tentative decisions and proposals

48 The IASB **will propose to clarify** that in providing reconciliations of total reportable information an **entity is required to describe all material reconciling items in sufficient detail** to enable users of financial statements to better understand the effect of these items on individual reportable segments.

49 The IASB was reluctant to propose adding additional examples to the implementation guidance because this could give rise to boilerplate disclosures. However, to address user requests to increase the understandibility of the reconciliation, it **tentatively decided to include the following examples of reconciling items to IFRS 8**: (a) measurement differences, (b) elimination of intersegment revenue and receivables and (c) amounts that are not allocated to the reportable segments (for example expenses of a corporate natures).

EFRAG Secretariat analysis and preliminary views

50 EFRAG Secretariat notes that users and preparers that responded to EFRAG's consultation on IFRS 8 provided similar comments to those reported to the IASB; although users said that a breakdown of summarised material line items was made available on request.

51 Our view is that the IASB proposal to describe material reconciling items and including examples of which reconciling items might be useful to include in the reconciliation, should help address the concerns reported by users, including EFRAG User Panel members, without imposing additional costs to preparers.

Question to EFRAG TEG members

52 Do EFRAG TEG members support the tentative proposals in paragraphs 48 and 49 and if not why not and what alternatives do you suggest?

Area 5: the preservation of trend data on reorganisation (amendment to IAS 34)

Issues identified in the IASB's post-implementation review and additional outreach

53 Feedback from the post-implementation review of IFRS 8 confirmed that segment trend analysis is an important tool for users of financial statements. Many investors model data collected over a number of years to predict an entity's future performance. Frequent internal reorganisations prevent investors from carrying out trend analyses as part of their decision-making process.

54 Paragraph 29 of IFRS 8 requires comparative information for earlier periods to be restated whenever an entity changes the composition of its reportable segments (for example because of a restructuring or internal reorganisation).

55 Some investors requested three to five years of restated comparative segment information after an internal reorganisation. For other investors information for the previous year is more important that information that is several years old. These investors argued that when an entity changes segments during the year, investors must wait until the end of the year to see the full effect on comparative information.

56 However, requiring three or five years of comparative information could be onerous for preparers and costly to audit.

57 The FASB Staff had indicated that this area was less of an issue for investors in US registrants (they are already required to provide two years of comparative information).

IASB tentative decisions and proposals

58 The IASB did not agree with requiring three or five years of restated operating segment information mainly because the additional burden on preparers may be disproportionate to the benefit to users of financial statements. However it acknowledged that requiring restatement for the previous period only would be a good compromise.

59 The IASB therefore tentatively decided to propose an amendment to IAS 34 to require that as part of its first interim report following a change in the composition of an entity's reportable segments, the entity should **present restated segment information for all of the interim periods both of the current financial year and the prior financial years.** The IASB also plans to add an exception from this requirement in case the information is not available and the costs to develop it would be excessive.

60 Generally speaking, the IASB thought that this proposal would not require the preparation of any additional information—the restatements that are currently required would simply be presented earlier, instead of quarter-by-quarter or every six months. Presenting the required restatements as part of the first interim reporting process following a reorganisation would enable investors to update their models on initial reorganisation and enable them to maintain any trend information in a timely manner.

61 The IASB proposal can be illustrated as follows:

(a) if the composition of an entity's reportable segments was changed on **1 January**, its interim financial report for the period ending 31 March (ie first quarter) would be the first to be prepared on the basis of the new composition of reportable segments. That interim report would be required to include restated segment information for **each of the four quarters of the prior annual reporting period**.

(b) if the composition of an entity's reportable segments was changed on 1 April, its interim financial report for the period ending 30 June (ie second quarter) would be the first to be prepared on the basis of the new composition of reportable segments. That interim report would be required to include **restated segment information for each four quarters of the prior annual reporting period in addition to presenting information for the first quarter of the current year** based on the new composition of reportable segments.

EFRAG Secretariat preliminary views

62 The EFRAG Secretariat thinks that the proposed amendment to IAS 34 will provide users with relevant trend information following a reorganisation and is unlikely to have a major impact on costs to preparers.

63 We agree that it could be costly for preparers to restate the related information for the previous three or five years and there is a question about whether so many years of prior information would be relevant to users, especially if it required a significant use of hindsight.

Questions to EFRAG TEG members

64 Do EFRAG TEG members agree with the IASB tentative decision in paragraph 5859?

65 Do EFRAG TEG members support the IASB proposals in paragraph 59 and if not why not and what alternatives do you suggest?

66 At this stage, do EFRAG TEG have any other comments on the forthcoming amendments to IFRS 8 and IAS 34?