EFRAG

European Financial Reporting Advisory Group

Jörgen Holmquist
Director General
European Commission
Directorate General for the Internal Market
1049 Brussels

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Dear Mr Holmquist,

Adoption of IFRS 8 *Operating Segments*

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on the adoption of IFRS 8 *Operating Segments*, which was published by the IASB on 30 November 2006. It was issued in draft as ED 8 and EFRAG commented on that draft.

IFRS 8 replaces IAS 14 *Segment Reporting*. Both standards set out requirements for the disclosure of information about an entity's operating segments. As the wording of IFRS 8 is the same as that of US SFAS 131 *Disclosures about Segments of an Enterprise and Related Information*, the effect of replacing IAS 14 with IFRS 8 is to converge IFRS with US GAAP, except for some minor differences. IFRS 8 becomes effective for annual periods beginning on or after 1 January 2009, with early application permitted.

EFRAG has carried out an evaluation of IFRS 8. As part of that process, EFRAG issued a draft version of this letter for public comment and, when finalising its advice and the content of this letter, it took the comments received in response into account. EFRAG's evaluation is based on input from standard setters, market participants and other interested parties, and EFRAG's discussions of technical matters are open to the public.

EFRAG supports IFRS 8 and has concluded that it meets the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards that:

i. it is not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

ii. it meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

For the reasons given above, EFRAG believes that it is in the European interest to adopt IFRS 8 and, accordingly, EFRAG recommends its adoption. (EFRAG's reasoning is explained in the attached 'Appendix—Basis for Conclusions'.)

On behalf of the members of EFRAG, I should be happy to discuss our advice with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix
Basis for Conclusions

Set out below is the basis for the conclusions reached and the recommendation made on IFRS 8 Operating Segments *by EFRAG*.

1 When evaluating IFRS 8, EFRAG asked itself three questions:

(a) Are the requirements in the IFRS consistent with the IASB's Framework for the Preparation and Presentation of Financial Statements (the Framework)?

(b) Would the IFRS's implementation result in an improvement in accounting?

(c) Does the accounting that results from the application of the IFRS meet the criteria for EU endorsement?

2 Having formed tentative views on the issues and prepared a draft endorsement advice letter, EFRAG issued that draft letter for comment on 6 December 2006 and asked for comments on it by 5 January 2007. EFRAG has considered all the comments received in response, and the main comments received are dealt with in the discussion in this appendix.

Are the requirements in the IFRS consistent with the IASB's Framework for the Preparation and Presentation of Financial Statements (the Framework)?

3 IFRS 8 is a disclosure standard. In other words, it has no impact on the way income, expenses, assets, liabilities or equity are recognised, measured or presented in the financial statements.

4 The Framework says very little about disclosure and therefore it is not meaningful to discuss whether a disclosure standard is inconsistent with the Framework.

Would the IFRS's implementation result in an improvement in accounting?

5 The IASB already had a segment reporting standard prior to issuing IFRS 8: IAS 14 *Segment Reporting*. IAS 14 required entities within its scope to segment their activities in accordance with the criteria laid down in the standard, and then to disclose certain information about those segments using IFRS accounting policies.

6 This approach was not the approach adopted in the US, where FAS 131 *Disclosures about Segment of an Enterprise and Related Information* requires entities within its scope to segment their activities to reflect the way they are segmented for internal reporting purposes, then to disclose information about those segments using the accounting policies applied for internal management purposes (internal measures). In other words, FAS 131 requires entities to provide segment information of the business as viewed 'through the eyes of management' (the so-called 'management approach').

7 In the interests of convergence, the IASB and FASB decided that they should adopt the same approach to segment reporting and that this should be achieved by the IASB replacing its existing standard with an IFRS that, as far as possible, copies FAS 131 word-for-word. The wording of IFRS 8 is the same as that of FAS 131 except for the differences mentioned in BC60 of the Basis for Conclusions of the standard.

8 As explained above, IFRS 8 is in essence different from IAS 14 in two important respects: Firstly, the requirements determining how the segments are to be identified have changed. In practice the result will in many cases be the same, but in theory under the old standard an entity could have had under certain circumstances to segment its business in a way that did not reflect how the business was run, resulting in the need to produce information for the segment reporting that was not used for any other purpose. EFRAG agrees that it is more useful to segment the business in the same way it is segmented for management purpose, because management will want to segment the business in a way that gets to the heart of its activities and the way they are best understood.

9 More controversially, the requirements determining the accounting policies that should be used to produce the segment information have changed. Under IAS 14 entities were required to use IFRS measures; but under IFRS 8 they use internal measures. One result is that the segment information will show the business in the way that the business looks at itself. Another result however is that the segment information will not necessarily be prepared on the same basis as the primary financial statements; and might instead be prepared using measures that the IASB has decided should not be used in, or are not sufficient in themselves for, preparing the primary financial statements.

10 EFRAG members had different views as to whether this second change would improve the quality of the financial statements. Some thought it would. Some of those who thought it would not result in an improvement in the segment information were nevertheless comforted by two other things.

(a) Because the change meant that the segment information was easier and quicker to produce, one result of the change was that the IASB was now able to require that quite a bit more segment information should be provided in the interim financial statements; and

(b) The change will lead to convergence with US practice on this issue.

Some EFRAG members however remained unconvinced that it was an improvement.

Does the accounting that results from the application of the IFRS meet the criteria for EU endorsement?

11 Finally, EFRAG considered whether IFRS 8 would result in information that:

(a) is contrary to the ‘true and fair principle’ set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

(b) does not meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management, and

whether it is in the European interest to adopt IFRS 8.

12 Notwithstanding the concerns that some EFRAG members had about whether it represented an improvement in financial reporting, EFRAG had no doubt that the resulting information would be relevant and reliable. There were some concerns though as to whether the comparability criterion was met, because the adoption of a ‘through the eyes of management’ approach to the identification of segments

and the use of internal measures meant that the comparability of the segment information would not necessarily be high.

(a) EFRAG formed the view that on the issue of identifying segments the existing requirements already allowed a fair degree of flexibility and, as a result, this change has not involved a significant deterioration in the comparability of the information.

(b) There is no doubt that the second change—allowing the use of internal measures—would result in less comparability than hitherto. However, EFRAG reasoned that the 'comparability' criterion was not intended to be viewed in isolation and literally.

  (i) If that were the case the EU would not be able to endorse any IFRS that adopted a 'through the eyes of management' approach, even though many believe that such an approach can result in more relevant information than approaches that result in more comparable information. That suggests that in applying the criteria trade offs of one characteristic against another ought to be acceptable.

  (ii) It also seemed important to take into account the way in which the information is used. EFRAG understands that users do not generally expect segment information to have a high degree of comparability because every company is organised differently, meaning that their segments and segment information will also be different.

  Viewed in this context EFRAG concluded that the comparability of the information was not an issue.

13 EFRAG also considered whether IFRS 8 met the understandability criterion. This was a potential issue because an effect of IFRS 8 is that entities could prepare their segmental information on a basis that is different from that of the information set out in the primary financial statements and the other notes to the financial statements and would reconcile the segmental information with the information in the rest of the financial statements on a global basis, rather than segment-by-segment. Requiring entities to include in their financial statements information prepared on a basis that is different from that of the rest of the financial statements does not, when taken in isolation, improve the understandability of the information package. However, EFRAG believes that requiring them to show the activities and financial position of their segments from the perspective that management views those activities and financial position *does* improve understandability. Furthermore, requiring more segment information in interim financial statements also enhances the understandability of the information provided as a whole. For those reasons, EFRAG concluded that IFRS 8 met the understandability criterion.

14 EFRAG also concluded that there was no reason to believe that the information resulting from IFRS 8 would be contrary to the true and fair principle.

15 Finally, EFRAG considered whether adoption of IFRS 8 would be in the European interest. EFRAG believes adoption of IFRS 8 for use in Europe would be in the interests of the vast majority of persons and bodies with an interest in financial reporting in Europe, because compliance with IFRS 8 should be less burdensome than compliance with IAS 14, because it has made it possible to extend the amount of segment information provided in interim financial statements and because it results in convergence between practice in Europe and the US. However, EFRAG also noted that, although the issue had not been raised during

EFRAG's consultation on its endorsement advice, some smaller listed companies have in the past been concerned that compliance with IFRS 8 would result in them having to disclose commercially sensitive information about themselves. The financial reporting regime in Europe for listed entities does not differentiate between big listed entities and smaller listed entities; all listed entities, regardless of their size and complexity, are required to prepare their consolidated financial statements in accordance with EU-adopted IFRS. Thus, when EFRAG considers whether adoption of IFRS 8 would be in the European interest, it has to consider the issue from the perspective of Europe generally. Adoption of certain standards may not be in the interests of some European preparers, but if adoption is in the interests of the vast majority of persons and bodies with an interest in financial reporting in Europe EFRAG believes it will be in the interest of Europe generally. EFRAG believes that is the position in this case.