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Segment Reporting: a slip-up that should be corrected

Segment information is the bread and butter of the financial analyst. The advantages that derive from being listed on a stock market long ago overcame the reluctance of companies to disclose segment information. In 1997, two different approaches were unveiled: the European IAS 14, under which segments are identified by their internal characteristics, and the American SFAS 131, based on internal reporting. In November 2006, the IASB decided to replace the IAS 14 standard by IFRS 8, despite objections from end users, in particular from the SFAF (the French Society of Financial Analysts). SFAF will use this column to put forward its arguments on the subject and present to readers the proposals that the EFFAS Financial Accounting Commission submitted to the CESR.

Segment Information has long been one of the primary concerns of investors, and particularly financial analysts, as it gives them a better understanding of companies or groups with different activities or locations.

To take an exaggerated example, a group with two different activities, one of which is struggling while the other is enjoying buoyant growth, would give a distorted picture of reality if it presented these activities as a single unit in its consolidated financial statements.

In such a case, investors' understanding of the situation, the risks and the steps that need to be taken would be seriously distorted if seen only through this aggregated view.

Investors have therefore long sought to obtain additional financial information to improve their understanding of companies.

THE USA: AN APPROACH BASED ON COMPROMISE

In the USA, the need for this type of information was felt particularly keenly in the mid sixties when conglomerates and multinational companies began to emerge. The first rule was a methodology published by the SEC in 1969 and made compulsory in 1970 for all segment information contained in the SEC yearly forms (the famous 10-K). In 1976, the newly created (in 1973) FASB published the first standard for segment information, SFAS 14, which thus became compulsory for US groups. It should be noted that this first standard took as a basic principle (1) that the information published by the group at the level of each segment should be consistent with that published at the consolidated level, and defined the different segments on the basis of the products and services sold by the industry (2).

It should also be added that segment information was not made compulsory (3) for interim (quarterly) accounts

In the early nineties, awareness of the limits of segment information as published under SFAF 14, both among regulators (4) and American analysts (AIMR) (5), led to a revision of the 1976 standard. In 1997 this revision resulted in a new standard, SFAS 131 (6), which replaced SFAS 14. One of the most important issues for analysts was to obtain segment information with quarterly accounts and, to a lesser extent, a finer segmentation (a larger number of segments).

In the end, the solution adopted for this standard was based on a compromise that can be summed up as follows: in exchange for quarterly segment information (7), the constraints imposed on the definition of segments and published aggregates were relaxed. The definition of segments and the definition of segment profit were therefore left to management: segments are defined according to the group's internal organisation and segment profit (8) is the one used in internal reporting. The SFAS 131 (9) standard is still in force in the USA today.

We should also note that the debates in the USA on this subject even-

SFAF's answers to the IASB and and EFRAG discussion papers as well letters regarding the positions of SFAF and EFFAS can be found on the http://www.sfaf.com Web site, under Association, Commission comptabilité et analyse financière (IFRS 8).

tually overcame widespread reluctance on the part of companies, which had regularly emphasised the confidential nature of some of this segment information, the publication of which is compulsory for listed companies.

It is now generally accepted that this argument is untenable: a listed company that wants to have access to a market where it can obtain capital at a reduced cost must accept increased transparency with regard to its shareholders.

IASB: CONVERGENCE ABOVE ALL

On the IASB side, the standard for segment reporting, IAS 14 (Segment Reporting) was published in 1997. Although it was contemporary with the American SFAS 131 standard, it followed a different approach on two central points. First, segments are identified according to their specific characteristics rather than internal reporting: these are activities, each of which has their own risk and reward. Second, the main element of segment reporting, profit, is defined as an operating result rather than as the measure used by management for its internal reporting. This standard was validated by the European Commission on July 16th, 2003 for use within the European Union for listed companies from January 1st, 2005.

As part of its convergence program with the USA, the IASB decided to revise this standard in 2004, in order to close the gap between the IAS-IFRS standards and the FAS. At that time, some analysts [10] expressed their misgivings regarding an evolution towards the SFAS 131 standard. The IASB published its report in January 2006 in the usual form of an exposure draft. The IASB's proposals were an almost exact copy of the SFAS 131 standard, and in particular retained the management approach, which results in internal organisation taking precedence over the intrinsic characteristics of activities in determining the segments, as well as the publication of a profit measure defined by management (as used for its internal reporting). The reconciliation with an IFRS accounting aggregate (operating result) only occurred at the consolidated level rather than at the level of each segment.

Due to specific problems of applying the IFRS in the European environment: the measure of profit for internal use is very often determined on the basis of national accounting references which can still vary significantly from country to country. For example, a Swedish Ebitda has every chance of being different to a Maltese Ebitda!

End users were almost unanimous in expressing their misgivings or even open criticism regarding the replacement of IAS 14 by this cut-and-paste of SFAS 131. SFAF, in its letter [11], expressed its opposition to this project. First, leaving the choice of how to identify segments to management would result in the information changing with each internal reorganisation (whereas the activities themselves may not have changed) [12]. The effect of this is to considerably limit the interest of this information. Conversely, identifying segments on the basis of identical risks and rewards, as in the IAS 14 standard, is reckoned to bring greater stability. Second, the possibility of using an aggregate not defined under IFRS (for instance Ebitda before marketing costs) to quantify the profitability of each segment is necessarily misleading and also seriously diminishes the interest of comparisons with the segments of another company. This is a key point for financial analysts if they are to be able to assess correctly the performance of each segment. The loss of this comparability between companies is all the more shocking since the main goal of using IFRS standards is to provide better comparability. Furthermore, other professional associations of accounting infor [13] or the CRUF [14], underlined the need for reconciliation between the profit aggregate used (and published) by management and the IFRS aggregate (operating result). Finally, although the IASB project amounts to a cut-and-paste of the American SFAS 131 standard, the American society of analysts (CFA Institute, formerly AIMR)[15] explicitly says that the convergence should be in the opposite direction and that SFAS 131 should be replaced with IAS 14. The CFA Institute even goes on to add that this project is flawed because it does not require publication of a measure of segment profit or loss as defined under IFRS. In spite of these hardly positive comments from end users, on whose behalf the IASB is supposed to be working[16], the IASB decided to stick to its project and published the final text in November 2006 under the name IFRS 8 Operating Segments.

A HEALTHY REACTION FROM EUROPEAN USERS

Faced with this surprising situation, at the beginning of 2007, some professional associations, which had taken a stance during the debates, decided to bring the case before the European Commission.

Indeed, applying IFRS in Europe leads to further specific problems: the measure of profit for internal use is often determined on the basis of national accounting standards, which still vary significantly from country to country. For example, a Swedish Ebitda has a good chance of being different to a Maltese Ebitda! Some letters that were made public expressly stated that the IFRS 8 standard is a step backward compared with the existing IAS 14 standard [17] and recommended that the European Commission not make the IFRS 8 standard compulsory within the European Union [18]. Following these protests from end users as well as a request from the European Parliament [19], the European Commission launched a public enquiry [20] on IFRS 8, which resulted in an extremely bland report [21] on the subject. In the end, the European Commission decided to validate the IFRS 8 standard for application within the European Union.

CAN WE LIVE WITH THIS STANDARD?

Since the European Commission has validated IFRS 8, its use is bound to become more widespread [22] and for end users this poses the crucial question of how to make sure that this change does not result in a sharp deterioration in the quality and interest of segment reporting. Given these high stakes, the EFFAS Financial Accounting Commission sent an official letter [23] to the CESR (Committee of European Securities Regulators) to suggest a solution that would limit the negative impact of this new standard. The main proposal is that a reconciliation be required at each segment level between the segment profit as used by management and an IFRS aggregate (an operating result). The need for this had already been emphasised by the CRUF in its letter to the IASB two years earlier. Companies in the European Union would therefore apply IFRS 8 while still supplying some extra information, which would help maintain an acceptable level of quality in segment reporting. It is worth noting that the IAS 14 standard has been used in the European Union since 2005 without any major difficulties and this clearly shows that producing this information (IFRS profit measure) does not pose any serious problems.

Following the unnecessary change made by the IASB in adopting the IFRS 8 standard, European financial analysts have quite clearly demonstrated that they can initiate proposals that genuinely help to bolster market transparency.

The ball is now in CESR's court and analysts can only expect that this turn of events will stand as a lesson so that in the forthcoming major accounting debates, the opinion and views of end users and particularly of financial analysts is taken into account from the outset. ■

(1) SFAS 14, Financial Reporting of a Business Enterprise, § 6, page 5, December 1976.
(2) SFAS 14, Financial Reporting of a Business Enterprise, § 11 à 15, pages 8 and 9,December 1976
(3) SFAS 14, Financial Reporting of a Business Enterprise, § 4, page 5, December 1976.
(4) SFAS B Research Report, « Reporting Disaggregated Information », February 1993.
(5) AIMR, Financial Reporting in the 1990s and Beyond, page 5, 1993.
(6) SFAS 131, Disclosure about Segments of an Enterprise and Related Information, June 1997
(7) SFAS 131, Disclosure about Segments of an Enterprise and Related Information, § 33, page 13, June 1997
(8) The standard also requires the publishing of other segment information such as turnover, depreciation, capex… …
(9) We should note that only one of the seven members of the FASB, M. Jim Leisenring, was opposed to this compromise. Nine years later, as a member of the IASB, he also opposed the IFRS 8 standard.
(10) Particularly some members of EFFAS during a meeting of the Analyst Representative Group on June 15th 2004 with members of the IASB.
(11) Letter dating from May 18th 2006 signed by Alain Cazalé, Chairman of SFAF and Franck Ceddaha, Chairman of SFAF's Accounting and Financial Analysis Commission. Available on the www.iasb.org Website along with other comment letters on Segment Reporting, under n° 150.
(12) This point was also raised by Fidelity in its letter to the IASB. Available on the www.iasb.org Website along with other comment letters on Segment Reporting, under n° 174.
(13) Investment Management Association, Available on the www.iasb.org Website along with other comment letters on Segment Reporting, under n° 162
(14) Corporate Reporting User Forum, created by Steven Cooper (UBS) and Peter Elwin (Cazenove) in 2005, gathering together end users mainly in London. Available on the www.iasb.org Website along with other comment letters on Segment Reporting, under n° 149.
(15) Mainly, page 4 : « Decision to converge with SFAS 131 (…) is premature and that convergence is occurring in the wrong direction »; and page 5: « We believe that ED 8 is flawed because it does not require a defined measure of segment profit and loss ». Available on the www.iasb.org Website along with other comment letters on Segment Reporting, under n° 99.
(16) See the conceptual frame of the IASB, mainly § 6 et § 9. On this point, we can also regret the almost constant absence of account users within the board of the IASB.
(17) International Corporate Governance Network, letter to the Internal Market Department of the European Commission, dated May 9th 2007, available on the www.icgn.org website.
(18) Investment Management Association, letter to the Internal Market Department of the European Commission dated March 9th 2007, available on the www.investmentuk.org website.
(19) The European Parliament was given powers regarding validation of the IFRS standards for the European Union at the beginning of 2007 and IFRS 8 was the first standard to be subject to this new procedure.
(20) The contributions of EFFAS and SFAF are available on the www.ec.europa.eu website
(21) Mainly the unanimous response from end users which had been consulted through a specific enquiry form seems to have been left out.
(22) Some European companies have already chosen to base their segment information on IFRS 8 although the standard only becomes compulsory in 2009. On this subject, see the surprising choice made in the beginning of 2007 by the Dutch Telecom company KPN.
(23) Letter dated February 6th 2008 signed by Javier de Frutos (Chairman of the FAC) and Friedrich Spandl (deputy chairman of the FAC),
(24) Sent to Fernando Restoy, Chairman of the CESR-Fin. Available on the www.effas.com Website.