

15 June 2006

Kil-Woo Lee
Project Manager
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UK

Dear Kil-Woo

Re: ED 8 *Operating Segments*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft 8 *Operating Segments*. This letter is submitted in EFRAG's capacity of contributing to the IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive IFRS on the issues.

We support the work that the IASB and FASB are carrying out to achieve convergence of accounting standards around the world, as long as that objective is not pursued at any cost. For that reason, we support generally the objective of this exposure draft, which is to propose changes to IFRS that will reduce the differences between IAS 14 and SFAS 131.

We support the use of the management approach to determine reportable segments, but we do not believe that the use of the 'management approach' for the measurement of operating segments should be made mandatory. Instead we suggest that companies should be permitted to continue to apply IFRS-measures if they prefer.

Our detailed comments are set out in the appendix to this letter

If you would like further clarification of the points raised in this letter, please do not hesitate to contact either me or Bart De Leeuw.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Question 1 – Adoption of the management approach in SFAS 131

The draft IFRS adopts the management approach to segment reporting set out in SFAS 131 *Disclosures about Segments of an Enterprise and Related Information* issued by the US Financial Accounting Standards Board.

Is this approach to segment reporting appropriate? If not, why not? What, if any, alternative approach would you propose?

We agree that the management approach is the most appropriate way to **determine** reportable segments. Such an approach enables users to view the entity's internal organisation and structures from the same perspective as management, which is presumably the perspective that management believes is the most useful way to manage the entity's operation. We also agree that the approach in the external financial statements ought to result in informative segment information, as it is likely that more detailed information about the different components of an entity will be reported if the reportable segments are those the management itself uses to manage the business. For those reasons we believe that the users of the financial statements will benefit from this approach to segmentation (which is already in IAS 14), because it will enhance their ability to understand and assess better the management actions.

However, the proposal to require the use of management's own **internal reporting data**, even if they are non IFRS compliant ('non IFRS compliant internal reporting data'), to report on those identified segments seems to us to be less straight-forward.

- Judging by the explanations in the exposure draft, it would appear that FASB decided that under its old segment reporting standard (SFAS 14) insufficient segmental information was being disclosed, particularly in the interim financial report, and that, to encourage an increase in the amount of segmental information provided, entities needed to be allowed to use the management approach both to segment identification and to measuring the financial performance and financial position of those segments. That may well have been the right decision in those circumstances at that time, but we think the position under IFRS is somewhat different and, as a result, it cannot simply be assumed that adopting the US approach in IFRS will improve the segmental information provided under IFRS.
- It is generally accepted that, if financial information is to be of use to users, it needs to be supported by detailed analyses and by explanations of the methodologies used; the internal consistency of the information is also important, as is the comparability of the information with that of other entities. (The last point has been argued several times by the IASB recently.) The proposal is that explanations of the methodologies used will be provided, that the aggregate of the segment information shall be reconciled to the primary financial statements, and that the nature of the reconciling items involved shall be disclosed. Such a disclosure provides users with some information but, unless users understand how much of the difference is attributed to which type of reconciling item and which segment is affected by what, it seems questionable how useful those disclosures will actually be.
- The exposure draft argues that an advantage of using internal reporting data is that it would enhance the consistency with the management commentary and with other annual report disclosures. We agree that it would be preferable if all the information in the annual report was prepared on the same basis; however, if more than one basis is used it is not clear to us why it is better that the segment information should be consistent with the management commentary

than with the primary financial statements.

- We note that in paragraph BC10 of the Basis for Conclusions the IASB argues that it is increasingly unlikely that there will be substantial differences between IFRS accounts and internal reporting data. If that were true, it would not really matter in the vast majority of cases whether the standard requires internal reporting data or IFRS measures to be used.
- We recognise that the exposure draft is offering almost full convergence between IFRS and US GAAP on segmental reporting and that, if we favour an approach that is different from that proposed in the exposure draft, we are in effect saying that we believe it is more important to adopt our favoured approach than it is to achieve convergence on this issue. Recommending an approach that will not achieve convergence when a convergence opportunity exists is not something that should be done lightly.

Having considered all these arguments carefully, we have not been persuaded that requiring the management approach for measuring segment data will, if the convergence effect is ignored, result in an improvement of the information provided.

Because we also support the efforts of convergence and see the point in decreasing the burden on companies listed in the US we propose to allow an option. An option means that those companies that are not US filers – being the majority of IFRS applicants - can continue to provide segmental information on the basis they used in 2005, if they should so wish.

In reaching this conclusion, we were particularly influenced by the following:

- We understand and support the objective of the short term convergence project, ie reducing differences between IFRSs and US GAAP that are capable of resolution in a relatively short time and can be addressed outside major project. We believe that the exposure draft is offering almost full convergence between IFRS and US GAAP on segmental reporting.
- At the moment companies are still struggling with the practical consequences of transitioning in their external financial reports to IFRS and, as a result, currently there might be substantial differences between IFRS accounts and internal reporting data. We are therefore seriously concerned about the IASB argument in the Basis for Conclusions that there will not be many differences between internal measures and IFRS measures. We are not sure how the Board has come to that conclusion, when one considers that the 2005 financial statements were the first IFRS statements for many entities. We would postulate that the Board's argument is likely to be the case in Europe in the future, but that it is not be the case at the moment.
- Many listed European companies made changes to their systems and procedures only recently to enable them to prepare segmental information based on IFRS measures. Few of those companies file in the US, so the vast majority are being asked to change their systems and procedures again for no real advantage.

Question 2 – Divergence from SFAS 131

Do you think that the draft IFRS should depart from the management approach in SFAS 131 by setting requirements for

- (a) the measurement of specified items or**
- (b) the disclosure of specified amounts that might otherwise not be given?**

If so, identify the requirements you would add and indicate what you see as the relative costs and benefits of any such requirements.

The IASB is in effect faced with a choice: either converge or adopt one of the various non-converged approaches available. As explained in our answer to question 1, we think the IFRS should be amended to enable convergence but it should not require entities that have already prepared segment information in accordance with existing IFRS and see no advantage in adopting the US approach to change.

Question 3 – Scope of the standard

The existing standard IAS 14 requires entities whose equity or debt securities are publicly traded and entities that are in the process of issuing equity or debt securities in public securities markets to disclose segment information. The draft IFRS extends the scope to include also entities that hold assets in a fiduciary capacity for a broad group of outsiders.

Do you agree with the scope of the draft IFRS? If not, why not?

The Basis for Conclusions reports that the Board considered extending the scope of the proposed standard to all entities defined in the SME project as publicly accountable, but eventually decided to extend it only to some unlisted publicly accountable entities (in particular those that hold assets in a fiduciary capacity). However, it does not explain:

- why the extension proposed is considered appropriate. This makes it difficult to comment on the proposal. Presumably the view has been taken that, say, customers depositing money at an unlisted bank are interested in exactly the same information about that bank that its shareholders would be interested in were the bank listed. We wonder whether that is really the case; in other words, we wonder whether segment information is really what the 'public' wants in at least some of these cases.
- how the standard would apply in at least some of the cases. For example, assume that the reporting entity is an unlisted conglomerate with a small banking subsidiary. It would appear that the group would be required to prepare segment information even though only one small part of the group acts as a fiduciary and even if the banking activity is shown as a single segment. We question whether this is really what is intended.

Similarly, we think it might be worth considering exactly what the standard would require, say, a mutual fund to provide in the form of segment information. It is not controversial that such entities should provide some sort of analysis of their investment portfolio, but it is less clear that the draft standard, if strictly applied, would actually require such disclosures.

We think it would also be useful if the standard could explain exactly what is meant by 'fiduciary'. This may be a well-understood notion in some countries, but would

appear to be a less understood term in some other countries.

The draft standard proposes that, if an entity that prepares its financial statements in accordance with IFRS is not required to provide segment information by this standard nevertheless chooses to provide segment information, it cannot state that the financial statements have been prepared in accordance with IFRS unless the segment information provided complies with the detailed requirements of this standard. We support this latter proposal.

Question 4 – Level of reconciliations

The draft IFRS requires an entity to provide, for specified items, reconciliations of total reportable segment amounts to amounts recognised by the entity in accordance with IFRSs. It does not require such reconciliations for individual reportable segments.

Do you agree with the level of reconciliations required in the draft IFRS? If not, indicate what you see as the relative costs and benefits of any other level of reconciliation.

The draft IFRS specifies the line items that should be dealt with in the reconciliations. We agree with the line items proposed.

Question 5 – Geographical information about assets

The draft IFRS requires an entity to disclose geographical information about non-current assets excluding specified items. It does not require disclosure of geographical information about total assets.

Do you agree with the requirement to disclose geographical information about non-current assets excluding specified items? If not, for which assets would you require geographical information to be given?

We agree with the approach proposed.

Question 6 – Consequential amendments to IAS 34 *Interim Financial Reporting*

The draft IFRS requires an entity to disclose more segment information in interim financial reports than is currently required, including a reconciliation of the total of the reportable segments' measures of profit or loss to the entity's profit or loss.

Do you agree with the consequential amendments made to IAS 34? If not, why not?

We agree with the proposed amendment to IAS 34; such information should be provided in interim financial reporting even if internal reporting data are not to be used to prepare the segment information in order to help users understand the nature and impact of items – or part of items – of revenue and expense not being allocated to individual segments.

Other comments

Finally, we express a concern about the quantitative thresholds as described in paragraphs 12-18 of the draft IFRS. Although we understand that setting such thresholds can help ensure that sufficient segments are shown, we think the inclusion of quantitative thresholds of this kind is not consistent with a principle based standard. We are also concerned that, by mentioning explicitly a 10 per cent

threshold, the effect might be to set some sort of precedent for determining materiality in other areas.

Including quantitative thresholds should not be understood as overriding basic and sound presentation principles defined in IAS 1 requirements. If, in addition to these basic requirements, quantitative thresholds are deemed helpful we believe they should only work on the basis of rebuttable presumptions, in order to avoid the well known “bright line” undesirable impacts.