

# Making sense of a complex world\*

## IFRS 8 Operating Segments



## Objectives and scope of this paper

Reporting on the performance of operating segments continues to be a critical area of focus for investors and regulators. As telecommunications companies adopt the new International Financial Reporting Standard, IFRS 8 *Operating Segments*, they may face challenges in defining and reporting segmental information. This paper is intended to provoke thought and identify some of the issues that companies may encounter as they apply the provisions of the standard; it is not intended to resolve all the issues that are raised.

## Background on IFRS 8 *Operating Segments*

IFRS 8 requires that companies implement a 'management approach' to reporting the financial performance of their operating segments, thus aligning segmental disclosures more closely with information contained in internal reporting packages. Application of the standard is required for all annual reporting periods beginning on or after 1 January 2009, with early adoption permitted.

The standard replaces IAS 14 *Segment Reporting* and aligns the requirements of segmental reporting with the US equivalent standard, SFAS 131 *Disclosures about Segments of an Enterprise and Related Information*.

The standard applies to companies that either are listed or are in the process of listing, but a consequential amendment to IAS 36 *Impairment of Assets* (see section 4 below) applies to all companies, regardless of whether they are required to apply IFRS 8.

# 1. Identifying the CODM is a critical step in meeting the requirement to disclose segmental information as it is viewed by management

The standard requires companies to disclose segmental information in a manner consistent with the way that management regards the company (“through the eyes of management”). Companies can do so by focusing on information that management utilises to assess performance and to make resource-allocation decisions. Identifying the company’s chief operating decision maker (CODM) appropriately, therefore, is imperative. Companies should carefully consider the following questions:

- (1) who is the CODM?
- (2) what information is the CODM reviewing? and
- (3) what is the company communicating to external parties, such as investors and creditors?

In identifying the CODM, a company should remember that those filling the role of the CODM could be either a group of individuals, such as the board of directors or one of its subcommittees, or a single executive or member of management.

Although the principles of IAS 14 drew on a company’s internal organisational and management structure as well as its system of internal financial reporting, in practice differences between a company’s internal reporting package and its external segment disclosures were not uncommon. Under IAS 14, a company’s financial statements reported segments based on related products, services and geographical areas, though companies typically tracked operating performance at a more granular level.

Adopting IFRS 8 may result in the identification of more operating segments, as the CODM may review more components of the business. For instance, a cost centre or new business activity that earns little or no revenue, such as WiMAX, FTTH, WiFi or managed services, could qualify as an operating segment under IFRS 8 if discrete financial information is prepared and reviewed by the CODM. Additionally, IFRS 8 carries over the requirement for external revenue from reportable segments to constitute at least 75 per cent of the company’s total revenue; otherwise, additional operating segments need to be identified as reportable segments.

IFRS 8 provides for certain aggregation criteria based upon similarities in the:

- Nature of the products and services
- Nature of the production processes
- Type or class of customer
- Methods used to distribute products and services
- Nature of the regulatory environment

The aggregation concept detailed on the previous page is consistent with the guidance outlined in SFAS 131. For example, it is common for integrated telecommunications companies to prepare a CODM package that includes financial information by network (fixed, mobile, satellite) and product line (voice, data, video) and that further disaggregates the information on a geographic basis (regions or markets). Historically, under US Generally Accepted Accounting Principles (US GAAP), the aggregation criteria generally have allowed telecommunications companies to maintain segmental disclosures by network (fixed, mobile, satellite). Each company adopting IFRS 8, however, will need to consider its own circumstances, which includes analysing the information reported to the CODM.

As will be discussed in section five, of the few operators that have adopted IFRS 8 early, some were undergoing reorganisations and took the opportunity to implement the standard simultaneously. That makes it difficult to isolate the impact of IFRS 8 on the nature and number of segments reported. Nevertheless, the following table illustrates how the segmental information presented by four companies changed on adopting IFRS 8 early, in 2007.

Company	Primary segments under IAS 14 in 2006	Reportable segments under IFRS 8 in 2007
Deutsche Telekom	<ul style="list-style-type: none"> <li>• Mobile communications</li> <li>• Broadband / Fixed network</li> <li>• Business customers</li> <li>• Group headquarters &amp; shared services</li> </ul>	<ul style="list-style-type: none"> <li>• Mobile communication Europe</li> <li>• Mobile communications USA</li> <li>• Broadband / Fixed network</li> <li>• Business customers</li> <li>• Group headquarters &amp; shared services</li> </ul>
KPN	<ul style="list-style-type: none"> <li>• Fixed – Consumer</li> <li>• Fixed – Business</li> <li>• Mobile – Netherlands</li> <li>• Mobile – E-Plus</li> <li>• Mobile – BASE</li> </ul>	<ul style="list-style-type: none"> <li>• Netherlands – Consumer</li> <li>• Netherlands – Business</li> <li>• Netherlands – Getronics</li> <li>• Netherlands – Wholesale &amp; operations</li> <li>• Mobile – Netherlands wholesale</li> <li>• Mobile – E-Plus</li> <li>• Mobile – BASE</li> </ul>
TeliaSonera <sup>1</sup>	<ul style="list-style-type: none"> <li>• Sweden</li> <li>• Finland</li> <li>• Norway</li> <li>• Denmark</li> <li>• Baltic countries</li> <li>• Spain</li> <li>• Eurasia</li> <li>• Russia</li> <li>• Turkey</li> </ul>	<ul style="list-style-type: none"> <li>• Mobility services</li> <li>• Broadband services</li> <li>• Integrated enterprise services</li> <li>• Eurasia</li> </ul>
COLT Telecom Group S.A.	<ul style="list-style-type: none"> <li>• United Kingdom</li> <li>• Germany</li> <li>• France</li> <li>• Strategic Markets</li> </ul>	<ul style="list-style-type: none"> <li>• Major Enterprise</li> <li>• SME</li> <li>• Wholesale</li> </ul>

<sup>1</sup>Note that TeliaSonera's secondary segmental analysis in 2006 comprised mobile and fixed communications  
All information is sourced from the individual operator's 2007 annual report



Given the standard's focus on aligning internal and external information, the question could be raised as to whether companies may seek an opportunity to reorganise their existing internal reporting package, so that it is more consistent with segmental information as previously reported to external parties. On the other hand, internal reports need to be sufficient to enable management to run the business effectively. Organising such reports solely for financial reporting purposes may fail to achieve this objective.

Companies should consider feedback from analysts and others regarding existing disclosures of operating segment performance, as well as the investor community's expectations regarding segmental disclosures. In a survey conducted by PwC in a number of major capital markets, segmental information ranked at the top of the list in terms of its importance to analysts. The survey respondents saw segmental information as the greatest gap in reporting today, and many commented that the companies that report well in this area have an opportunity to differentiate themselves from peers<sup>2</sup>.

Information in the company's website, articles, publications, press releases, business disclosures and other management commentary also should be considered, as inconsistencies between such information and segmental disclosure could weaken investors' trust in the disclosure, as well as trigger the attention of regulatory bodies. In particular, non-IFRS management reporting policies will have to be explained to reconcile segmental information with IFRS figures: differences in revenue or cost recognition policies may be a challenge to robust, clear financial communication with investors.

In assessing the appropriateness and adequacy of segmental disclosure within a company's financial statements, regulators have long focussed on a company's internal reporting package and other information provided to the CODM, regardless of whether the individual(s) uses the information regularly or not. For instance, in the US, the Securities and Exchange Commission (SEC) often requests registrants to provide a copy of their internal CODM package to supplement review of the company's segmental disclosures. Differences identified between a company's internal CODM package and external disclosures have led the SEC to require companies to amend existing or future filings to correlate with their internal reporting information. European regulators already have been focussing on segmental reporting, under IAS 14. They have focussed on the consistency of the description of the business in the 'front half' of the annual report and other information provided by companies with the segment information in the notes to the financial statements.

Most telecommunications companies report earnings before interest, taxes, depreciation and amortisation (EBITDA) or a similar profit measure within their CODM packages; as a result, they will be required to disclose such measures within the segmental disclosures upon adopting IFRS 8. While this is a key difference between IFRS 8 and IAS 14, a similar transition was identified upon the adoption of SFAS 131 in the US. Historically, the SEC staff has accepted, and even required, such non-GAAP measures to be disclosed if reported within the company's CODM package. In such instances, a company should also explain the importance of the non-GAAP measure, how it is used in the organisation and how it reconciles back to GAAP.

<sup>2</sup>Corporate reporting: Is it what investment professionals expect? PricewaterhouseCoopers, November 2007

In its 2007 financial statements, TeliaSonera presented a segmental analysis of EBITDA that excluded non-recurring items. It went on, though, to disclose a segmental analysis of non-recurring items, amortisation, depreciation, impairment losses and income from associates and joint ventures, arriving at a segmental measure of operating income that was consistent with the amount of operating income shown on the face of the income statement. In contrast, Verizon Communications, which reports under SFAS 131, included the following detailed reconciliation of segmental income to total income in 2007, highlighting a number of items that are excluded from segmental income.

Net Income	(dollars in millions)		
	2007	2006	2005
Segment income – reportable segments	\$ 5,300	\$ 4,601	\$ 4,125
Debt extinguishment costs (see note 11)	–	(16)	–
Merger integration costs (see note 8)	(112)	(146)	–
Sales of business and investments, net (see note 2)	5	(541)	336
Extraordinary item (see note 2)	(131)	–	–
Access line spin-off related charges (see note 2)	(80)	–	–
Taxes on foreign distributions (see note 6)	(610)	–	(206)
Cumulative effect of accounting change (see note 1)	–	(42)	–
Verizon Center relocation, net (see note 3)	–	(118)	8
Severance, pension and benefit charges (see Note 3)	(477)	(258)	(95)
Domestic print and Internet yellow pages directories business spin-off costs (see note 2)	–	(101)	–
Lease impairment and other items (see note 3)	–	–	(133)
Tax benefits (see note 3)	–	–	336
Income from discontinued operations, net of tax (see note 2)	72	1,398	1,370
Corporate and other	1,554	1,420	1,656
Consolidated net income – reported	\$ 5,521	\$ 6,179	\$ 7,397

Source: Verizon Communications 2007 Annual Report

The standard contains no ‘competitive harm’ or ‘seriously prejudicial’ exemption and requires the disclosure of information that is provided to the CODM, regardless of whether such information is commercially sensitive. While adopting the standard could result in expanding the number of segments requiring disclosure, which centres on the management approach, comparability among companies within the telecommunications industry could vary, as each company may analyse its respective businesses differently.

## 2. The performance of operating segments must be reconciled with the financial statements, and resources that segments share must be allocated in a way consistent with the CODM package

Within any telecommunications company, it is likely that certain resources (assets and costs) will be used by multiple segments. Examples of such shared resources could include:

- Network assets and associated costs (e.g. depreciation, operating and maintenance costs)
- Customer care / call centres
- Distribution channels (company stores, sales force, agents and resellers)
- Pension costs and related liabilities
- Intangible assets such as licences or franchise rights

The assets listed above might be allocated to individual segments for internal reporting purposes, or they might be reported separately. Following the principles described in section 1, the measures of profit and assets used in the CODM package form the basis of segmental reporting under IFRS 8. Hence, any allocation of jointly used assets to reportable segments cannot be arbitrary and must be presented in a manner consistent with the CODM package. Additional disclosure showing how certain costs, assets or liabilities are, or are not, allocated among the segments may be helpful.

Additionally, IFRS 8 requires a company to provide a reconciliation of segmental operating performance—primarily revenues, profit or loss, assets and liabilities—to amounts in the company’s consolidated financial statements. (Note that, presuming that a proposed amendment to the standard is finalised as drafted, assets and liabilities are disclosed only if they are reported to the CODM.) All material reconciling items must be separately identified and described. The explanation should be sufficient to allow users to understand any differences between the segment measures and the IFRS-compliant financial statements. Furthermore, as allocations should follow a company’s CODM package, differences in allocation methodologies may be identified between comparable companies.

For instance, in the telecommunications industry, certain companies may choose to allocate network costs across multiple segments within their CODM package, while other companies may not allocate these costs. We have noticed a trend among European operators: a number either have or are in the process of restructuring internally to more of a customer focus, and are moving away from the traditional structure of running separate fixed line, mobile, Internet etc. business divisions. The internal reporting, and hence reportable segments, are thus changing. With this type of organisational structure, networks are more likely not to be allocable to individual segments, and with that a significant level of associated costs (operation and maintenance, engineering time and depreciation) may not be allocable on a reliable basis. This trend could lead to additional challenges for investors when attempting to understand and compare similar businesses’ performance.

### 3. Some companies may find that proportionately consolidated joint ventures qualify as an operating segment

Certain telecommunications companies report proportionately consolidated joint ventures and equity accounted associates, and questions have arisen as to how these joint ventures and associates should be reflected within segmental disclosures. We believe that where a company (1) manages its joint venture operations or associates separately and (2) meets the criteria of IFRS 8 for identifying operating segments, the joint venture operations qualify as an operating segment<sup>3</sup>. In these instances, the asset and profit/loss information (reported to the CODM) regarding the joint venture or the associate's activities that comprise the segment are therefore disclosed.

We should also consider the exposure draft ED9 *Joint Arrangements*, published by the International Accounting Standards Board in September 2007, which sets out proposals for the presentation of interests in joint arrangements. Essentially, ED9 proposes eliminating the proportionate consolidation of a jointly controlled entity. A company that finds itself moving from proportionate consolidation to equity accounting may also want to consider the impact on its internal management reporting. As mentioned above, IFRS 8 requires disclosing segmental information on the same basis as it is provided to the company's CODM. Accordingly, if the CODM is presented with information prepared using proportionate consolidation, then that basis should be presented in the segmental information and reconciled to the primary financial statements.

<sup>3</sup>A practical guide to segment reporting, PricewaterhouseCoopers, September 2008



## 4. The interaction of IAS 36 and IFRS 8 could create challenges in evaluating impairment, particularly in respect of goodwill

IFRS 8 amends IAS 36 to state that the highest group of cash generating units to which goodwill may be allocated is an operating segment as defined by IFRS 8. Whilst IFRS 8 applies to companies that are either listed or in the process of listing, the amendment to IAS 36 applies to all companies, regardless of whether they are required to apply IFRS 8.

The amendment is applicable to annual reporting periods beginning on or after 1 January 2009; however, because it should be applied retrospectively impairment tests may need to be re-performed for comparative periods, unless impracticable. Impairments thereby identified in prior periods should be reflected in the income statement for the year to which they relate. For example, if an impairment test in 2009 over comparative periods reveals an impairment of goodwill in 2008, the impairment expense should be reflected within the 2008 income statement.

This interplay between IAS 36 and IFRS 8 is similar to the one between SFAS 142 *Goodwill and Other Intangible Assets* and SFAS 131 as it relates to reporting units under US GAAP. This issue could present some unique challenges for first-time adopters in the telecommunications industry, as goodwill allocated to cash generating units, in periods prior to adoption, may well have been placed at a level different from the operating segments as defined under IFRS 8. Consequently, particular attention should be given to the aggregation criteria, discussed in section 1, upon first-time adoption and during subsequent reorganisations (see section 5).

Companies should also carefully consider whether their cash generating units are consistent with this amendment in advance of impairment reviews under IAS 36, as well as during any initial purchase price allocation under IFRS 3 *Business Combinations* for future business combinations. This amendment of IAS 36 could lead companies to reconsider their historical determination of the level at which they allocated goodwill to groups of cash generating units, which in turn could impact the outcome of subsequent impairment reviews.

Impairment evaluations could differ between tangible assets and goodwill. While goodwill should not be tested at a level higher than an operating segment as defined by IFRS 8, certain tangible assets may be tested at a level higher than an operating segment. For instance, questions have arisen as to how an operator's network should be tested for impairment if it is not a separate operating segment monitored by the CODM, but rather is used by several other operating segments. In such instances, where the network does not generate sufficiently independent cash flows from other segments, it should be regarded as a corporate asset for IAS 36 impairment testing purposes. Where allocation of the network to operating segments is not possible due to the lack of a reasonable and consistent allocation basis, it is acceptable to treat the network as a corporate asset and to test it for impairment on a higher level than operating segments (for example, at the level of the whole economic entity). This could involve testing for impairment at multiple levels, which could prove complex.

## 5. Corporate reorganisations could have a direct impact on segment disclosures

As the CODM package directly impacts segmental disclosures, companies should monitor changes in the CODM or the CODM reporting package and how such changes could affect segmental reporting.

We have reviewed the disclosures of the few telecommunications and technology companies that have adopted IFRS 8 early. Some, such as KPN, TeliaSonera and COLT Telecom, were undergoing reorganisations and took the opportunity to implement the standard simultaneously, thereby amending their segmental disclosures to reflect the recent reorganisation. Upon adopting IFRS 8, and upon implementing reorganisations in the future that could impact reportable segments, companies should reflect the new corporate structure and segmental disclosures in both the current year and comparative information.

Companies should understand the impact that reorganisations could have not only on existing segment disclosures, but also on goodwill. As operating segments change, the requirement of the standard to align cash generating units with operating segments may result in a triggering event that could indicate potential impairment of goodwill under IAS 36.

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