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| Project | **IFRS 8 *Operating segments*** |
| Topic | **Aggregation criteria and identification of the CODM** |

## Introduction

1. In April 2011 the Board received a request to make some minor improvements to IFRS 8 *Operating Segments*, with regard to the application of the aggregation criteria and the identification of the chief operating decision maker (CODM).

2. More specifically, the submitter thinks that:

   (a) the meaning of the term 'similar economic characteristics' in paragraph 12 of IFRS 8 is unclear and suggests including an additional disclosure in paragraph 22 of IFRS 8 requiring a brief description of both the operating segments that have been aggregated and the economic indicators that have been assessed.

   (b) the CODM's functions as defined in paragraph 7 of IFRS 8 (ie allocating resources and assessing performance) are not always carried out by the same person. The submitter suggests emphasising the CODM's 'operating' function (ie assessing performance) in paragraph 7; and

   (c) the CODM's use of judgement in identifying operating segments could sometimes 'circumvent' the 'core principle' in paragraph 1 of IFRS 8 (ie of providing users with useful information to evaluate an entity). The submitter suggests emphasising in paragraph 1 the presumption that management reviews the information that is reported to it.

3. The submitter suggests that the proposed clarifications should be included as part of the annual improvements project (AIP), because the post-implementation review of IFRS 8 will take place in the long term. The original submission is attached to this paper.

4. The Board asked the IFRS Interpretations Committee (the Committee) to consider this request and to make a recommendation to the Board on how it thought the Board should respond. The Committee discussed this request at its meeting in July 2011 and decided that rather than attempt to address these issues through an interpretation or annual improvement, it would be best to recommend that the Board consider this issue as part of a future post-implementation review of IFRS 8. The final wording of the July 2011 *IFRIC Update* reflects this decision and is shown in **Appendix A** of this paper.

5. In August 2011, the Committee received an unsolicited comment letter from the same submitter including some observations to the Committee's views as reflected in the July 2011 IFRIC Update regarding the a) aggregation of operating segments and the (b) identification of the chief operating decision maker. The staff has attached this letter to this agenda paper for the Board's consideration. The Committee will discuss this comment letter at the meeting on the 8–9 of September and we will update the Board with the result of that discussion.

## Purpose of this paper

6. The purpose of this paper is to provide a more detailed summary of the Committee's discussion regarding the issues raised by the submitter on IFRS 8 and ask the Board for its views in light of the Committee's recommendation not to address these issues through an interpretation or annual improvement. This paper:

   (a) provides background information and explains the issues raised by the submitter as follows:

(i) **Issue 1:** discusses the proposal to include an additional disclosure to paragraph 22 in IFRS 8 to clarify the meaning of 'similar economic characteristics' in paragraph 12

(ii) **Issue 2:** discusses:

- the operational vs. the strategic roles of the CODM in paragraph 7 of IFRS; and
- a modification to the 'core principle' in paragraph 1 of IFRS

(b) makes a recommendation to the Board and asks the Board whether it agrees with the recommendation.

(c) This paper also briefly comments on the submitter's response to the Committee's decision to consider the issues raised in the submission in a future post-implementation review of IFRS 8.

## Issue 1: Disclosure requirements to clarify the meaning of 'similar economic characteristics'

***Description of the issue***

7. IFRS 8 provides guidance for aggregating two or more operating segments into a single operating segment. In accordance with paragraph 12, segments can be aggregated when the segments have **similar economic characteristics** (emphasis added):

> 12 Operating segments often exhibit similar long-term financial performance if they have **similar economic characteristics. For example, similar long-term average gross margins for two operating segments would be expected if their economic characteristics were similar.** Two or more operating segments may be aggregated into a single operating segment if aggregation is consistent with the core principle of this IFRS, **the segments have similar economic characteristics,** and the segments are similar in each of the following respects:
>
> (a) the nature of the products and services;
>
> (b) the nature of the production processes;
>
> (c) the type or class of customer for their products and services;
>
> (d) the methods used to distribute their products or provide their services; and

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

8. According to the submitter the meaning of the term ‘similar economic characteristics in paragraph 12 is unclear because:

   (a) paragraph 12 mentions only one indicator (ie ‘long term average gross margins’) to assess whether operating segments have ‘similar economic characteristics’; in the submitter’s view other indicators should also be mentioned such as: sales growth, margins, or a combination of various indicators.

   (b) it is difficult to draw a line to distinguish between what is ‘similar’ and ‘not similar’.

   (c) the application of the aggregation criteria requires the use of judgement, and so deciding whether two segments are economically similar is difficult and subjective and leads to diversity in practice.

9. The submitter does not suggest amending paragraph 12 but instead proposes adding subparagraph 22(c) requiring the disclosure of management’s judgements in determining the operating segments that shared economic characteristics, as follows (proposed new text is underlined):

> 22 An entity shall disclose the following general information:
>
> (a) factors used to identify the entity’s reportable segments, including the basis of organisation (for example, whether management has chosen to organise the entity around differences in products and services, geographical areas, regulatory environments, or a combination of factors and whether operating segments have been aggregated), and
>
> (b) types of products and services from which each reportable segment derives its revenues
>
> (c) <u>where operating segments have been aggregated, the judgements made by management in the application of the aggregation criteria in paragraph 12. In particular, a brief description of both the operating segments that have been aggregated and the economic indicators assessed, including the measurement range considered to be similar (for example: profit margin spreads, sales growth rates etc.), in determining that they share similar economic characteristics.</u>

10. In the submitter's view explaining the basis for such aggregation would:

    (a) enable securities regulators to challenge issuers more effectively on the adequacy of their segmental reporting;

    (b) enable users to:

        (i) understand how operating segments have been aggregated; and

        (ii) determine whether an entity has made an appropriate assessment of the aggregation criteria referred to in paragraph 12 of IFRS 8; and

    (c) improve financial reporting and reduce diversity in practice.

11. The following section contains a summary of the analysis presented to the Committee in July 2011 along with a summary of the main comments expressed by Committee members at that meeting. Our full analysis of the issues raised was set out in Agenda Paper 11, which can be found on the public website.

***Staff analysis***

12. We observe that paragraph 12 in IFRS 8 does not elaborate upon the meaning of 'similar economic characteristics' except to say that operating segments having similar economic characteristics would be expected to exhibit similar long-term financial performance; for example similar long-term average gross margins.

13. We agreed with the submitter's proposal for supplementing the current disclosure requirements in paragraph 22(a) of disclosing the factors used to identify the entity's reportable segments, because:

    (a) the disclosure of how operating segments have been aggregated and the basis for such aggregation is not explicit enough in paragraph 22(a); and

    (b) the proposed additional disclosure requirement is not a new disclosure in IFRS 8; instead, it is specifying the type of information that should be included where operating segments have been aggregated, as part of the information already required by paragraph 22(a)

14. Consequently, we proposed the inclusion of a more specific requirement in IFRS 8 to disclose the basis for aggregating operating segments in the way proposed by the submitter (refer to paragraph 9, above).

***The Committee's recommendation***

15. At the July 2011 Committee meeting a majority of the members of the Committee disagreed with the staff's recommendation because they think that this additional disclosure is not needed. In the view of these members, adding a new disclosure to paragraph 22 appears to:

    (a) question or mistrust the use of management's judgement, being that the latter is a basic principle in IFRS 8 when reporting segment information; and

    (b) be enhancing the possibility of detecting non-compliance with the requirements in IFRS 8, rather than assuring that the objective of IFRS 8 has been met.

16. In the view of some Committee members, regulators could require the proposed additional disclosure in paragraph 22(c) as part of their own enforcement measures. For example, if a regulator has concerns or questions on the way an entity is aggregating operating segments, it could ask an entity to provide a full explanation of this information.

17. Other members think that adding a new disclosure could have a negative impact in the preparer's community, because it could contribute to an information overload.

18. Other members were concerned that any potential amendment to paragraph 22 of IFRS 8 (either by amending paragraph 22(a) or by adding a new subparagraph 22(c)) could cause inconsistencies with the existing guidance in US GAAP in Topic 280-10-50 *Segment Reporting* in the *FASB Accounting Standards Codification*®.

19. Consequently, a majority of the Committee members decided that rather than attempt to address this issue through an annual improvement, it would be best to

recommend that the Board consider these issues as part of a future post-implementation review of IFRS 8.

## Issue 2: The CODM function

***Description of Issue 2a: strategic vs operational roles of the CODM***

20. The submitter thinks that in in practice, the CODM's functions as defined in paragraph 7 (ie allocating resources and assessing performance) are not always carried out by the same person. For example:

    (a) the CODM is often a Management Board, which focuses on strategic decisions (ie a 'resource allocation' function); whereas

    (b) a segment manager focuses on operational decisions (ie an 'assessing performance' function)

21. The submitter thinks that the focus of the CODM's functions should be more operational (ie 'assessing performance') than strategic (ie 'resource allocation'). Consequently, the submitter suggests amending the definition of the CODM in paragraph 7 to:

    (a) emphasise its functions of making decisions of an operating nature and assessing the performance of an operating segment; and

    (b) delete the reference to the CODM's function of allocating resources to the operating segments.

22. The submitter's proposed amendment to paragraph 7 is shown below (proposed new text is underlined and proposed deleted text is struck through):

> 7 The term 'chief operating decision maker' identifies a function, not necessarily a manager with a specific title. That function is to <u>be involved in making operating decisions within an operating segment and</u> ~~allocate resources to and~~ assess<u>ing</u> the performance of the operating segments of an entity. Often the chief operating decision maker of an entity is its chief executive officer or chief operating officer but, for example, it may be a group of executive directors or others <u>who may individually or collectively assess the performance of an operating segment and be involved in the making of operating decisions</u>.

***Staff analysis***

23. We disagreed with the submitter's proposal to emphasise the CODM's involvement in making operating decisions because in accordance with paragraph 7 the CODM fulfils two distinct but related functions (ie performance assessment and resource allocation) being that the former function is more operating in nature and the latter function more strategic in nature. We think that both functions are brought together in paragraph 7 to describe the roles that the CODM performs.

24. We observed that in such cases where two different individuals or groups within an entity perform separately the 'operating function' and the 'strategic function' (for example a chief executive officer (CEO) taking on a 'strategic function' and a segment manager taking on an 'operating role') the identification of an operating segment should take into account the views from both the CEO and the segment manager to ensure that this identification is based on the manner resources are allocated and on how performance is assessed.

25. We also disagreed on deleting the CODM's function of 'allocating resources to the operating segments' because the CODM is a decision-maker and is actively involved in reviewing information of both an operating and strategic nature as paragraph 5(b) in IFRS 8 indicates (emphasis added):

> 5(b) An operating segment is a component of an entity, **whose operating results are regularly reviewed by the entity's chief operating decision maker** to make decisions about **resources to be allocated to the segment and assess its performance.**

26. In addition, paragraph 9 of IFRS 8 notes that the CODM generally discusses operating activities, financial results or other plans for the segment with the 'segment manager' or even the CODM might also fulfil the role of segment manager.

27. We observed that the fact that paragraph 7 depicts the 'CODM' more as 'a function than a manager with a specific title' takes for granted the fact that the

CODM could vary across entities. For example, while one entity might consider its chief executive officer to be its CODM, another entity might consider a full board of executives to be its CODM, and that this identification will depend on specific facts and circumstances applying to each entity.

28. Consequently, we disagreed to make any amendment to paragraph 7 of IFRS 8.

***The Committee's recommendation***

29. The Committee agrees with the staff's recommendation not to make any amendment to paragraph 7 of IFRS 8. The Committee observes that sometimes, in practice, the CODM's functions (ie allocating resources and assessing performance) are carried out by multiple persons and that all such persons involved in those activities would be part of the CODM group. One member was concerned, though, that the latter affirmation could be interpreted to mean that information provided to any of those persons would be considered information provided to the CODM. For example, this member thinks that the information that the CODM receives about two divisions in his role of line manager should not be considered as information provided at the CODM level, if at the CODM level, the resources are allocated and performance is assessed by combining those two divisions instead of each division being considered at an individual basis.

30. The Committee also notes that the CODM should be identified as a group that normally would not include non-executive directors because of the role of the CODM in making operating decisions. Some members think that this is clear in the last sentence of paragraph 7 in IFRS 8 when it states that (emphasis added) '*often* the CODM is its CEO or chief operating officer, but it may be a group of *executive* directors or others'. However, some members disagree and think that it is unclear whether or not paragraph 7 excludes or not non-executives from the CODM group and think this should be made clear in this paragraph.

31. Other members were concerned that any potential amendment to paragraph 7 of IFRS 8 would cause inconsistencies with the existing guidance in US GAAP in

Topic 280-10-50 *Segment Reporting* in the *FASB Accounting Standards Codification*®.

32. Consequently, the Committee decided that rather than attempting to address the issues raised by the submitter regarding the identification of the CODM through an Interpretation or annual improvement, it would be best to recommend that the Board consider this issue as part of a future post-implementation review of IFRS 8.

### *Description of Issue 2b: modification to the 'core principle' in IFRS 8.1*

33. The submitter raises another concern on the CODM's use of judgement in identifying operating segments because the use of judgement could sometimes 'circumvent' the 'core principle' in paragraph 1 of IFRS 8 (of providing users with useful information to evaluate an entity). The submitter suggests that this could happen, for example, when an entity applies its judgement in such a way as to reduce the number of operating segments by focusing on the level at which members of the CODM collectively monitor performance, rather than the level at which those same members individually monitor performance.

34. To address this concern, the submitter suggests a modification to the 'core principle' in paragraph 1 to emphasise that there is a presumption that management reviews the information reported to it and that information disclosed by an entity under IFRS 8 is the information that is used by an entity to 'assess performance'. The submitter's proposed amendment to paragraph 1 is shown below (proposed new text is underlined):

> 1 An entity shall disclose information <u>used to assess performance</u> to enable users of its financial statements to evaluate the nature and financial effects of the <u>different</u> business activities in which it engages and the <u>different</u> economic environments in which it operates.

### *Staff analysis*

35. We observed that on the basis of paragraph 5 of IFRS 8, segment information is closely related to the information that is regularly reviewed by the CODM (in assessing the resources to be allocated to the segment and in assessing its

performance). We disagreed with the proposed amendment to paragraph 1, because we think that the emphasis in paragraph 1 of IFRS 8 should remain as it is, by highlighting the generation of information that enables users to make more informed decisions, instead of highlighting the nature of the information reviewed by the CODM. On this basis, the staff did not recommend any amendment to paragraphs 1 in IFRS 8 as proposed by the submitter.

***The Committee's recommendation***

36. The Committee agrees with the staff's recommendation not to make any amendment to paragraph 1 of IFRS 8.

## Staff summary

37. On the basis of the assessment under the existing annual improvements criteria (refer to the staff's assessment in paragraph 34 of Agenda Paper 11 of July 2011), and based on its discussion at the July 2011 meeting, the Committee recommended the Board to consider the issues submitted as part of a post-implementation review of IFRS 8.

## The submitter's reply to the Committee's views

38. In August 2011 the Committee received an unsolicited comment letter from the submitter on the Committee's tentative views on the issues raised. The submitter expresses its disagreement with the Committee's decision to recommend the Board to consider the issues raised as part of a post-implementation review of IFRS 8 as the submitter believes that:

(a) it would be beneficial if both issues raised (ie aggregation criteria and identification of the CODM) are clarified before a post-implementation review of IFRS 8 takes place; and

(b) it is not clear how and when the post-implementation review to IFRS 8 will take place.

39. The submitter confirms its strongly-held view that the Committee should recommend the Board to deal with both issues as part of the annual improvements project, as follows:

    (a) include a more specific requirement in IFRS 8 to disclose the basis for aggregating operating segments in paragraph 22 of IFRS 8 as proposed by the submitter (refer to Issue 1 in this paper); and

    (b) reconsider the definition of CODM (refer to Issue 2 in this paper). The submitter is concerned that in practice, some issuers have concluded that their CODM is a board of directors comprising both executive and independent non-executive directors which could result in operating segment disclosures that are based in less detailed information.

## Staff conclusion and recommendation

40. We note that the submitter disagrees with the Committee's conclusions and continues to think that both issues submitted should be addressed through annual improvements. We will discuss this further with the Committee at its meeting on 8–9 September and report the results of this discussion to the Board.

## Questions to the Board

| Question—Aggregation criteria and identification of the CODM |
|---|
| 1. Subject to the results of the Committee future discussion on these issues, does the Board agree with the Committee's recommendation to consider the issues raised in the submission as part of a post-implementation review of IFRS 8? If not:<br><br>1a. Does the Board want to (i) add a disclosure requirement to paragraph 22 of IFRS 8 (ie paragraph 22 (c)) and/or (ii) make amendments to paragraphs 1 and 7 of IFRS 8 to clarify the definition of the CODM in the way proposed by the submitter? |

# Appendix A— July IFRIC Update (IFRS 8)

A1. The Committee published its views on the issues submitted regarding IFRS 8 in the **July 2011** ***IFRIC Update***. These views do not represent Committee's tentative agenda decisions and are not subject to public comment.

**IFRS 8 *Operating Segments*—aggregation of operating segments and identification of the chief operating decision maker**

The International Accounting Standards Board (the Board) received a request to make improvements to IFRS 8, with regard to the application of the aggregation criteria and the identification of the chief operating decision maker (CODM). More specifically, the request asked the Board to:

a. include an additional disclosure in paragraph 22 of IFRS 8 requiring a brief description of both the operating segments that have been aggregated and the economic indicators that have been assessed in order to conclude that the operating segments have 'similar economic characteristics' in accordance with paragraph 12 of IFRS 8; and
b. emphasise in paragraph 7 of IFRS 8 the 'operating nature' of the function of the CODM and to clarify in paragraph 1 of IFRS 8 that there is a presumption that management reviews the information that is reported to it.

The Board asked the Interpretations Committee to consider this request and to make a recommendation to the Board on how it thought the Board should respond.

The Committee noted that the additional disclosure requested in the first issue appears to be designed to enhance the possibility of detecting non-compliance with the requirements in IFRS 8. However, it is not clear that such a disclosure is necessary to meet the objective of IFRS 8.

With regard to the second issue, the Committee observed that sometimes, in practice, the CODM's functions (ie allocating resources and assessing performance) are carried out by multiple persons and that all such persons involved in those activities would be part of the CODM group. The Committee also noted that the CODM would not normally include non-executive directors because of the role of the CODM in making operating decisions, which non-executive directors typically do not participate in.

The Committee decided that rather than attempting to address these issues through an Interpretation or annual improvement, it would be best to recommend that the Board consider these issues as part of a future post-implementation review of IFRS 8.

European Securities and Markets Authority

Date: 22 March 2011
ESMA/2011/BS/annex 3

**Sir David Tweedie**
**Chairman**
**International Accounting**
**Standards Board**
**30 Cannon Street**
**London EC4M 6XH**
**United Kingdom**

## ESMA proposal for improvements to IFRS 8 – *Operating Segments*

Dear Sir David,

The European Securities and Markets Authority (ESMA) is an independent EU Authority that contributes to safeguarding the stability of the European Union's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as by enhancing investor protection.

ESMA has considered through its standing committee on Corporate Reporting the difficulties faced by securities regulators on IFRS 8 – *Operating Segments* and would like to make some recommendations for minor improvements. On the basis of IFRS enforcement decisions on that standard discussed between European enforcers participating in the European Enforcers Coordination Sessions (EECS), ESMA has identified two enforcement issues which we would like to bring to your attention for further consideration: the application of the aggregation criteria and the identification of the chief operating decision maker.

We acknowledge the fact that the IASB already has a congested work plan and that there are more pressing accounting matters to be resolved before segmental reporting is likely to make it onto the Board's agenda. We understand that a post-implementation review on IFRS 8 is likely to be conducted by the Board and intend to respond to that review ensuring that European securities regulators contribute to the ensuing debate on the information to be provided to users of financial statements. We would be happy to explore any proposals of how that input could be best achieved.

We however believe that our proposals contained in this letter could achieve an improvement to financial reporting in the short term if they were to be considered through the IASB's Annual Improvements Project. The proposed minor amendments would enable securities regulators to challenge issuers more effectively on the adequacy of their segmental reporting. In ESMA's view, such enforcement action would contribute to a change in market behaviour and result in an improvement for users of financial information in this important area.

Our detailed proposals are set out in the Appendix to this letter.

I would be happy to discuss all or any of these issues further with you.

Yours sincerely,

Fernando Restoy
Chairman of ESMA's Corporate Reporting Standing Committee

## APPENDIX – ESMA's proposed improvements to IFRS 8 – *Operating Segments*

### I. Aggregation of Operating Segments

#### *Description of the issue identified*

1. IFRS 8 paragraph 12 states that operating segments may be aggregated if all of the aggregation criteria are met.

2. Neither the standard itself nor the basis for conclusions provide any further guidance on what is meant by the term 'similar economic characteristics' or how it should be applied. The only reference in the standard is to similar long term average gross margins as an indicator of similar economic characteristics. This is probably because the standard is based upon an original standard designed for use in the US which has a single internal market and where there would consequently have been minimal need to think about detailed factors defining what similar economic characteristics mean in a geographical context because the only relevant market was the US one.

#### *Difficulties encountered*

3. Practical difficulties are being encountered regarding where to draw the line between "similar" and "not similar". Clearly the Board must have intended that this would differentiate some operating segments from others, but at what level?

4. It is the issuer's primary responsibility to provide an answer to this question. Judgement is needed in defining criteria that will help assess how operating segments should be aggregated. The criteria might relate to the overall rate of growth of the economy in separate economic areas. They could also relate to sales growth, margins, other performance indicators or a combination of various indicators.

5. As enforcers, we have seen financial statements where operating segments have been aggregated into one or several reporting segments but where no explanation has been provided as to which individual operating segments had been aggregated, nor any explanation of whether an assessment had been made of whether the aggregation of the segments was compliant with IFRS 8 paragraph 12.

#### *Proposed solution/ recommendation*

6. The application of the aggregation criteria requires a significant amount of discretion. For instance, they allow "professional judgment" of whether an aggregation is consistent with the core principle of IFRS 8 in deciding how aggregation can be applied, if at all. Deciding if two segments are sufficiently economically similar to aggregate them can be difficult and subjective in some cases.

7. This level of subjectivity leads to diversity in practice with some companies deciding to aggregate more than others in the process combining segments which probably should be reported separately. Additionally, the level of subjectivity applied by management may not be apparent from the disclosures given under IFRS 8 paragraph 22 either.

8. Therefore, ESMA believes that emphasis should be put on disclosures that would help users understand the judgements made by management in deciding whether operating segments can be aggregated. As a consequence, we would suggest a limited amendment to paragraph 22 as follows (paragraph (c) below):

"An entity shall disclose the following general information:

a) factors used to identify the entity's reportable segments [...]

b) types of products and services from which each reportable segment derives its revenues.

c) <u>where operating segments have been aggregated, the judgements made by management in the application of the aggregation criteria in paragraph 12. In particular, a brief description of both the operating segments that have been aggregated and the economic indicators assessed, including the measurement range considered to be similar (For example, profit margin spreads, sales growth rates etc.), in determining that they share similar economic characteristics."</u>

9. ESMA believes that the additional disclosure requirements concerning the judgments made will provide users with important information that will enable them to reach their own judgements as to whether the level of aggregation is appropriate. It will also require management, and auditors, to consider more closely whether the divergence in economic indicators disclosed truly represents economic similarity.

## II. Identification of Chief Operating Decision Maker

### *Description of the identified issue*

10. The core principle of IFRS 8 is to enable users of financial statements to evaluate the nature and financial effects of the business activities in which the entity engages and the economic environments in which it operates.

11. The standard requires companies to identify the function of the Chief Operating Decision Maker ("CODM") and goes on to explain that the CODM is the function that regularly reviews results to make decisions about resources to be allocated to the segment and to assess its performance. It appears in practice that allocating resources and assessing performance may not always be carried out

by the same persons or using the same set of information. For example, the argument has been raised with us that information was obtained but not used for allocating resources.

12. However, in the basis for conclusions the IASB explains that it concluded that the management approach was the most appropriate basis for the disclosure of segmental information. IFRS 8 paragraph BC4 states that the requirements of SFAS 131 (on which IFRS 8 is based) are based on the way that management regards an entity, focussing on information about the components of the business that management uses to make decisions about operating matters.

13. This definition creates confusion and conflicts with the objective cited by the IASB when issuing IFRS 8 that the individual(s) who decide(s) what resources to allocate to segments review segment performance on an irregular basis1 and where they allocate resources based on only information aggregated at a consolidated level.

14. Based on the definition in IFRS 8 paragraph 7, the CODM is often the Management Board. In practice, the Management Board focuses on strategic decisions whereas operational decisions may be made at a level below the CODM by the segment manager who is directly accountable to and maintains regular contact with the CODM.

15. The rather general definition of a CODM means that management's judgement must be applied to identify operating segments. Such judgements may be directed in such a way as to reduce the number of operating segments, thereby circumventing the core principle of IFRS 8. For example, we have identified situations in which a company apparently assigns one reporting segment to each member of the Board in order to claim that the CODM (the Board) monitors the entity's whole activities and not the separate segments. The argument used is that resources are allocated and performance is reviewed at a higher, more aggregated level. The operational structure within the company, however, remains unchanged; all operating segments are organized and performance is assessed as it was prior to the assignment of specific "responsibilities" to the individual Board members.

***Difficulties encountered***

16. The term Chief Operating Decision Maker suggests that the person so designated should be involved in making operating decisions. Yet the requirement that they make resource allocation decisions suggests that they, in fact, predominately make strategic decisions. Diversity in practice is likely to result given this potential for confusion.

17. This potential for confusion may also allow for possible misuse of the standard. IFRS 8 was designed to provide useful information to financial statement users, allowing them to evaluate the nature and financial effects of the business activities in which a company engages and the economic environ-

[1] IFRS 8.5(b) states that the "operating results are regularly reviewed by the entity's chief operating decision maker", but this notion is subjective.

ments in which it operates. If, for example, management can claim that it simply does not use the information reported to it or can simply add an aggregation layer to the company's organisation in order to reduce the number of operation segments despite the operational structure within the company remaining unchanged, then the core principle of IFRS 8 would not be met.

***Proposed solution / recommendation***

18. Consideration could be given to amending the definition of the CODM. To reduce the potential for confusion or misuse, we propose that the operating nature of the function should be emphasised in the CODM definition. Examples can also be provided in the standard to promote the use of objective evidence in identifying "operating nature", such as organisational charts, lines of reporting and management bonus schemes. In addition, the standard should clarify that there is a presumption that management reviews the information reported to it. We believe this clarification would reduce potential diversity in practice, ensuring better adherence to the standard's core principle as well as enhancing the enforceability of IFRS 8.

19. To achieve the necessary clarifications detailed above, we suggest the following minimal wording changes to the text of IFRS 8 which could be considered in conjunction with the Annual Improvements Project:

*Amendment to the core principle: IFRS 8 paragraph 1*

20. An entity shall disclose the information used to assess performance to enable users of its financial statements to evaluate the nature and financial effects of the different business activities in which it engages and the different economic environments in which it operates.

*Proposed amendment to IFRS 8 paragraph 7*

21. The term 'chief operating decision maker' identifies a function, not necessarily a manager with a specific title. That function is to be involved in making operating decisions within an operating segment and ~~allocate resources to and~~ assessing the performance of the operating segments of an entity. Often the chief operating decision maker of an entity is its chief executive officer or chief operating officer but, for example, it may be a group of executive directors or others who may individually or collectively assess the performance of an operating segment and be involved in the making of operating decisions.

*Proposed amendment to the basis for conclusions*

22. The information set which should be used for the purpose of reporting information about operating segments should be the one that is used to assess the performance of operating segments. The information set would, therefore, be the one used by the individual or group of individuals, who may

not regularly meet, as the basis for making such decisions. There is a rebuttable presumption that the CODM reviews the information set that he receives.

23. Organisational charts, lines of reporting and management bonus schemes may assist in identifying operating segments.

European Securities and Markets Authority

Date: 23 August 2011
ESMA/2011/272

**IFRS Interpretations Committee**
**30 Cannon Street**
**London, EC4M 6XH L**
**United Kingdom**

# The IFRS Interpretations Committee's tentative agenda decision on IFRS 8 *Operating Segments* – aggregation of operating segments and identification of the chief operating decision maker

The European Securities and Markets Authority (ESMA) is an independent EU Authority that contributes to safeguarding the stability of the European Union's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as by enhancing investor protection.

ESMA has considered, through its Standing Committee on Corporate Reporting, the tentative decision of the IFRS Interpretations Committee not to address the issues related to 1) the *aggregation of operating segments and 2) identification of the chief operating decision maker* in the context of the application of *IFRS 8 – Operating Segments* either through an Interpretation or an annual improvement, but to recommend that the IASB should consider the issues as part of its planned post-implementation review of IFRS 8 – *Operating Segments*.

ESMA does not support the Committee's decision to recommend the Board to consider these issues as part of the future post-implementation review of IFRS 8 as we believe that it would be beneficial if both issues could be clarified earlier. In addition, it remains unknown precisely how and when post-implementation reviews will be carried out and more importantly what the timescale might be for dealing with any improvements identified as being needed.

## Additional disclosures on aggregated operating segments

We strongly support the proposal to include an additional disclosure in paragraph 22 of IFRS 8 requiring a brief description of both the operating segments that have been aggregated and the economic indicators that have been assessed in order to conclude that the operating segments have 'similar characteristics' in accordance with paragraph 12 of IFRS 8. This in, our view, would improve both the quality of information and the rationale provided to investors to help them understand an issuer's approach to segmental reporting.

Paragraph 22(a) already contains a requirement to disclose the factors used to identify the entity's reportable segments, including the basis of organisation and suggests as an example, the disclosure of whether operating segments have been aggregated. However, in our view the requirement in this paragraph is not explicit enough.

We have seen several instances in financial statements where operating segments have been aggregated into one reporting segment but where no further disclosures are provided as to which individual operating segments have been aggregated or any description of whether an assessment has been made of whether the aggregation was in line with paragraph 12 of IFRS 8: information that helps investors to better understand the risks associated to the different business activities and the judgement applied by the management in assessing whether the criteria are met.

ESMA therefore agrees with the recommendation of the Interpretations Committee's staff that the basis for such aggregation is not necessarily apparent in paragraph 22 and not necessarily triggered by the application of paragraph 17(c) of IAS 1 – *Presentation of Financial Statements*. Consequently, we agree on including a more specific requirement in IFRS 8 to disclose the basis for aggregating operating segments. In our view this additional disclosure is not a new disclosure to that required by paragraph 22 of IFRS 8; instead, it is specifying the type of information that should be included where operating segments have been aggregated, as part of the information already required by paragraph 22(a).

**Identification of the Chief Operating Decision Maker (CODM)**

ESMA believes that further consideration should be given to the definition of the Chief Operating Decision Maker (CODM). It appears in practice that allocating resources and assessing performance may not always be carried out by the same persons or using the same set of information. It also appears in practice that some issuers have concluded that their CODM is their board of directors comprising both executive and independent non-executive directors. As operating segments are identified on the basis of information used by the CODM there is a risk that the operating segment disclosures are based on less detailed information included in board papers. The fact that non-executive directors are often identified as operating decision makers, which appears to be contradictory to their governance responsibilities, indicates that preparers appear to be confused by the definition in the standard and this could be easily resolved either by way of interpretive guidance or an annual improvement.

It is important for ESMA that the standard provides useful information to investors allowing them to evaluate the nature and financial effects of the business activities in which a company engages and the economic environments in which it operates. This is achieved through issuers reporting the information used internally to make operating decisions.  For all but the most straightforward of businesses this is unlikely to be based on the consolidated income statement which is the claim by issuers that report a single segment but, in fact, can result from confusion over the identification of the CODM.

To conclude, ESMA would strongly encourage the IFRS Interpretations Committee to recommend the Board to deal with both issues as part of the annual improvements project.

I would be happy to discuss all or any of these issues further with you.

Yours sincerely,

Julie Galbo
Chair of ESMA's Corporate Reporting Standing Committee