

Insights into MFRS 8

Identifying Operating Segments

High quality management accounts are essential to enable management to monitor how they are performing and how they need to allocate their resources. This is particularly key for entities that operate in a variety of classes of business, geographical locations, regulatory or economic environments or markets. MFRS 8 ‘Operating Segments’ aligns external reporting through the identification and reporting of operating segments with what is reported internally by management.

Our ‘Insights into MFRS 8’ series considers some key implementation issues and includes interpretational guidance in certain problematic areas. We also include several examples illustrating the Standard’s requirements. This article sets out the requirements when identifying operating segments.

In many cases, identifying operating segments will be straightforward. However, in some situations the guidance may not give a clear answer. For example, the Chief Operating Decision Maker (CODM) may use more than one set of segment information or the segment characteristics may apply to two or more overlapping sets of components. In these and other situations judgement is required to determine how best to meet MFRS 8’s core principle.



Definition of an operating segment

Operating segments are components of an entity with the following three characteristics:

- the component engages in business activities from which it may earn revenues and incur expenses
- the component's operating results are regularly reviewed by the CODM to make decisions about resources to be allocated to the segment and assess its performance, and
- discrete financial information is available for the component.

In addition, an operating segment may engage in business activities for which it has yet to earn revenues, for example, start-up operations may be operating segments before earning revenues.

This approach focuses on how management has organised the entity to make key operating decisions and to assess performance. Using the above criteria to identify operating segments may be straightforward for many entities. However, in less obvious situations each aspect of the definition needs careful consideration. A number of the practical issues are discussed below.

Practical issues in identifying operating segments

The following sections look at some of the most common difficulties in identifying operating segments seen in practice, taking each characteristic in turn. Before applying each characteristic, it is important to be clear who is the CODM.

Chief Operating Decision Maker (CODM)

A key aspect in determining an entity's operating segments is to identify its CODM. MFRS 8 explains that the term 'chief operating decision maker' is intended to mean a function rather than an executive with a specific title. The function is that of allocating resources to operating segments and assessing their performance.

In many entities, it will be clear the CODM is the chief executive. Identifying the CODM can however be more problematic because the applicable function depends on the entity's management structure and processes. The CODM function may for example be carried out by the entity's chief executive, chief operating officer, senior management team or the board of directors. Typically, the CODM will be the highest level of management at which decisions are made, but if a supervisory body is required to provide approval for those decisions then judgement is needed as to whether this supervisory body is the CODM.

However, entities should challenge their identification of the entire board as fulfilling the role of the CODM where such a board has both executive and non-executive directors. As the focus of MFRS 8 is to report the management information that is used to make operating decisions concerning the allocation of resources as well as monitoring performance it seems to contradict what the role of a non-executive director is from a corporate governance perspective.

Segment managers

Certain decisions about resource allocation are inevitably delegated by the CODM and are made at a lower level, by a segment manager for instance. The term 'segment manager' is used to describe a function rather than a specific person. The segment manager is responsible for maintaining direct communication with the CODM to discuss operating activities, financial results, forecasts, or plans for the segment. In certain instances, the CODM may also be the manager for a particular segment.

The relationship between the roles of CODM and segment managers needs to be reviewed carefully to identify when a segment manager is included within the function of CODM. If the CODM is a group of individuals, including segment managers, the identification of operating segments is typically made at a lower level, resulting in the identification of additional operating segments.

Example 1 – Identifying the CODM

Entity A's management organisation consists of a Chief Executive Officer (CEO) who oversees two Chief Operating Officers (COOs) who are responsible for two separate continental regions, each consisting of multiple countries. Each country engages in revenue-generating business activities and discrete financial information is available for each country.

The identification of the CODM either as the individual CEO or as the group consisting of the CEO and COOs in this example rests on whether the CEO individually makes the decisions about resource allocation and performance assessment or whether this is done by the management group.

Scenario 1: CEO is identified as CODM

The COOs regularly review operating results for the individual countries within their respective regions to assess performance and to decide how to allocate their regional resources to individual countries. The COOs report regularly to the CEO, providing summaries of their regional operating results and other financial information but reporting individual country information only by exception (ie when outside defined parameters or when requested by the CEO). The CEO then makes decisions as to how to allocate resources to the two continental regions managed by the two COOs.

In this case, the CEO is identified as the CODM. The operating segments are identified as the two continental regions overseen by the two Chief Operating Officers (segment managers).

Scenario 2: CEO plus COOs are identified as CODM

The COOs regularly review operating results for the individual countries within their respective regions to assess performance. The COOs report regularly to the CEO, providing summaries of their regional operating results and other financial information, supported by an analysis of results broken down by country. The CEO and the COOs then negotiate together to agree how to allocate resources to the regions and countries.

In this case, the CODM is identified as a group consisting of the CEO and the two COOs. The operating segments would be identified at the country – not the continental – level, resulting in a larger number of operating segments.

Review for changes to the identity of the CODM

Once a CODM has been identified, it is important to reconsider if they still have the role following any business re-organisations, acquisitions or disposals. A change to the function that is undertaken by the CODM may also affect the identification of operating segments. The implications of a change in operating segments will be considered in our article '**Insights into MFRS 8 – Further practical application issues**' which will be released later.

Practical insight – Changes to information provided to the CODM

If partway during the reporting period, the information provided to the CODM changes, it is usual to provide the revised segment information for the entire reporting period. MFRS 8 requires entities to restate comparatives to the revised segment information unless it is too costly to do so. In our view, it is typical such changes are structured in advance before the actual change is made, and therefore entities are prepared thus making the restatement not too costly.

Components engaged in business activities

MFRS 8 makes clear it is not necessary for a component of a business to actually earn revenues in order to be identified as an operating segment. The component merely needs to be capable of earning revenues or incurring expenses either currently or in the future. Consequently, the following components of the business may be identified as operating segments if discrete financial information is available, and the operating results are regularly reviewed by the CODM.

Pre-operating activities

MFRS 8 includes, as an example of a possible operating segment, start-up operations which may engage in business activities for some time before they generate revenues.

Corporate functions

A head office or other corporate function may be an operating segment. An example is a head office function that undertakes business activities (such as a treasury operation that earns significant investment income and incurs expenses), if the revenues earned are more than incidental to the activities of the entity.

In contrast, a head office function that undertakes activities such as finance and accounting, information technology and human resources (which are normally non-revenue generating, or earn only incidental revenues) would not usually be an operating segment. Examples of incidental revenues include interest income and expenses, and realised and unrealised foreign exchange gains and losses.

The distinction between the two situations is not always clear-cut and so requires management judgement. Even if the revenues are considered incidental, MFRS 8 does not preclude a corporate function or other similar segment from being a reportable segment if management believes the additional information may contribute to a better understanding of the entity.

Components with outputs transferred exclusively to other segments

Some entities may be managed on the basis of cost centres or have vertically integrated activities where the output from the cost centre or from one stage of production is used as the input to another business component or production stage. For example, in the oil industry, most or all of the crude oil production of an entity may be transferred internally to the entity's refining and retailing operations. In such businesses, information about the components engaged in each stage of production may be useful for the users of the financial statements, as different activities within the entity might have significantly different prospects for future cash flow. The definition of operating segments in MFRS 8 includes components of an entity that sell primarily or exclusively to other operating segments of the entity.

Even if a component transfers all of its output to another entity without charging any transfer price, this does not preclude the component from being identified as an operating segment, as long as the other criteria are met.

Example 2 – R&D cost centre with no reported revenue

Entity A has a research and development (R&D) department that is managed as a cost centre and for which discrete financial information is regularly presented to the CODM. The R&D activities are not incidental to the activities of the entity. The R&D department provides an important service to two different manufacturing segments, which would otherwise have to pay external suppliers for similar services. The costs of the R&D department are not recharged to the manufacturing segments but the CODM reviews its operating results to assess whether to continue to perform the R&D activities in-house or to outsource them.

The R&D department satisfies the conditions to be identified as an operating segment.

Interests in joint operations and joint ventures

Joint arrangements (JA) take many different forms and structures and the level of management involvement by an investor can also vary widely. In some situations, particularly in jointly controlled operations, the CODM of the investor regularly reviews the operating results and performance of the JA to decide what resources to allocate to the JA and how they should be managed. Consequently, the JA may be identified as an operating segment when applying the criteria in MFRS 8.

Interests in associates

The investor in an associate does not control the way that resources are used within an associate (instead, it has significant influence). However, the investor's CODM may review the associate's operating results and performance to assess whether to sell or hold the investment. It could be argued this sell or hold decision meets the resource allocation part of the definition of an operating segment. Under this view, an investment in an associate may be an operating segment (provided the other criteria are met).

Our view is an associate is usually classed as an investment, rather than a component of the reporting entity, and is not generally identified as an operating segment for MFRS 8 purposes. We also note that information regarding associates users of the financial statements might require is specifically required by MFRS 128 'Investments in Associates and Joint Ventures'.

Discontinued operations

A discontinued operation can meet the MFRS 8 definition of an operating segment, if it continues to engage in business activities during the period it is classified as held for sale.

MFRS 5 'Non-current Assets Held for Sale and Discontinued Operations' sets out the disclosure requirements where a non-current asset (or disposal group) has, during the period, either been classified as held for sale or has been sold. When the entity reports segmental information in accordance with MFRS 8, the entity discloses the reportable segment in which the non-current asset (or disposal group) classified as held for sale or sold is presented.

If an operating segment is classified as held for sale or discontinued, then the disclosures required by MFRS 8 for reportable segments will no longer apply and instead only those disclosures required by MFRS 5 need be given. Consequently, the measures for this segment will be aggregated with other non-reportable segments in the 'all other segments' category. This is discussed in our article '**Insights into MFRS 8 – Segment Information to be disclosed**' which will be released later.

Post-employment benefit schemes

Post employment benefits schemes are specifically excluded from being identified as operating segments.

Operating results regularly reviewed

An important criterion for identifying operating segments is the operating results are regularly reviewed by the entity's CODM to make decisions about resources to be allocated to the segment and assess its performance. MFRS 8 does not define 'regularly' so judgment may be needed to decide if this condition is met. In practice, if the CODM reviews information on a quarterly or more frequent basis, this is expected to satisfy the condition.



Data available at different levels

A CODM may receive a monthly reporting pack containing high level information on the major business lines or geographical areas, with more detailed information on individual businesses or cash generating units (CGUs) available on request (a 'drill down by exception' approach). MFRS 8 looks to the level regularly reviewed by the CODM. In this case, the monthly reporting pack would then be the basis to identify segments rather than the 'drill down' data.

In practice, care will be needed to assess factors such as the frequency of review at the more detailed level. For example, the CODM may decide a long-term, regular review of specific, underperforming components is needed.

Important information not reported to the CODM

In some situations, significant management information that could affect decision-making is not reviewed by the CODM (effectively a corporate governance weakness). MFRS 8 bases segments on what is actually reviewed, not what ought to be reviewed in accordance with best practice. In an extreme scenario the resulting reduction in the segment disclosures may alert financial statement users to possible weaknesses in the internal reporting systems.

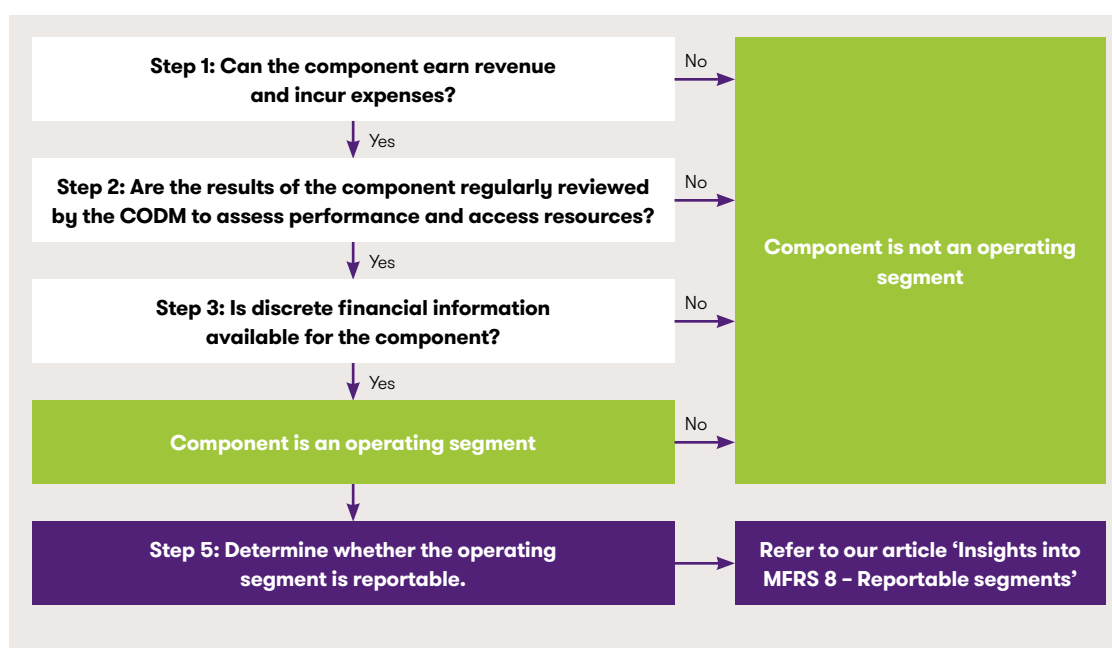
Press releases and other publicly available information

In some cases, an entity may provide regular press releases, analysts reports or other publicly available information relating to components of the business (for example management commentaries on components within quarterly trading updates or accompanying the annual financial statements). This type of information suggests the results of these components are likely to be reviewed by the CODM and are considered significant by senior management. Consequently, regulators or other users of the financial statements may raise questions if the segments identified in the financial statements do not align readily with those identified for other reporting purposes.

Management commentary

In some cases, an entity may provide a detailed explanation of the financial performance and position of key components of its business in the management commentary that accompanies the financial statements. The provision of such a commentary might suggest to both regulators and users of the financial statements that discrete financial information concerning these components may be regularly used by the CODM. Accordingly, where segmental information has been reported on a different basis in the financial statements, entities should consider whether doing so is consistent with the disclosure objective of the Standard.

Summary of characteristics that identify operating segments



Level of discrete information available for CODM review

The definition of an operating segment requires discrete financial information to be available to the CODM. The level of detail needed by the CODM to assess performance and allocate resources to segments is considered to determine whether this condition is met.

Only gross profit margin data is available

The definition of a segment in MFRS 8 uses the phrase ‘operating results’ but it is not clear whether this means net operating result or can be taken to mean gross operating result. As MFRS 8 takes a ‘management approach’ to identifying operating segments, then if the CODM decides that gross margin information is sufficient to use for performance measurement and resource allocation decisions then this is the level of operating results that is used to identify segments.

Only revenue data is available

In some entities, the CODM will review data on the revenues earned by a component but they would not review cost or profitability data. For most entities, the review of revenue-only data is not sufficient for decision-making related to resource allocation or performance evaluation of a segment, unless the costs needed to generate such revenues is insignificant or is so stable it does not vary significantly with the level of revenue generated. Consequently, components are unlikely to be identified as operating segments based on only revenue information. However, it is not impossible the result of a segment is represented by its revenue if that is the information is predominantly used to monitor performance and allocate resources. For example, the CODM may review weekly sales reports that will inform as to what actions may be required in certain locations to improve performance.

Only cash flow data is available

In some circumstances, the CODM may only receive information with respect to the cash flows of components of the business, rather than profit figures. In our view, the cash flow information may provide management with a sufficient proxy for profitability. If so, this would be sufficient to satisfy the requirement for discrete financial information.

No segment statement of financial position data is available

A review by the CODM of the operating results of a component is one of the criteria for identifying segments in MFRS 8. In many cases, this requirement can be met with operating performance information only, such as revenue and gross profit by product line. The allocation of assets is not a criterion for the component to be considered an operating segment.

Indeed, MFRS 8 envisages in some situations an entity might allocate depreciation expense to a segment without allocating the related depreciable assets. Similarly, MFRS 8 also acknowledges in some situations the CODM will often not review segment liabilities and may not review segment asset data.

Matrix organisations

The approach for identifying an operating segment in MFRS 8 focuses on how management has organised the entity to make key operating decisions and to assess performance. Based on the above criteria, identifying operating segments may be obvious for many entities. However, some entities produce multiple sets of reports detailing business activities in different ways, representing a matrix-management approach.

In a matrix form of organisation, components of an entity may overlap with different aspects of components for which managers are responsible, with both being reported to the CODM. For example, some regional managers may be responsible for product and service lines worldwide and others may be responsible for different geographical areas. The CODM regularly reviews the operating results of both sets of components and financial information is available for both. In this sort of situation, it is more difficult to determine clearly which set of components should be identified as the entity's operating segments. Under MFRS 8, the management approach requires the entity to determine which set of components represent the operating segments by reference to the Standard's core principle. This core principle requires the entity to disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

Consequently, when the CODM reviews more than one set of information, other factors should be considered in identifying the components that constitute operating segments. In particular, factors such as the nature of the business activities of each component, the existence of managers responsible for them, and how information is presented to the board of directors (ie those charged with governance) may aid in the operating segment identification.

Example 3 – Identifying segments in a matrix organisation

An entity sells food and grocery products through wholesale and retail operations in two geographical markets in Europe and North America. There is discrete financial information available for each selling activity for each product in each country in each geographical region.

The CODM reviews a monthly management pack that contains a summary of the wholesale and retail operating results in each region. More detailed breakdowns of the sales and operating results by product-line and by country is available but is only reviewed by the CODM by exception.

For each of the wholesale and retail operations, there is a global sales director who is responsible for all worldwide sales and to whom each regional sales manager reports. There are also global operating directors responsible for each of the wholesale and retail activities worldwide. The sales directors report to these operating directors, who in turn report directly to the CODM, which in this case is the chief executive officer.

The management reporting structure reflects the entity's priority to improve the profitability of individual product-lines. The CODM believes improving and maintaining product quality is the key to achieving this and that different geographical markets will respond similarly to product improvements, but the wholesale and retail sales will react differently.

In this situation, both the sales markets and the geographic areas may meet the criteria for operating segments set out in MFRS 8. They are components of the entity that engage in business activities for which there is discrete financial information available and whose operating results are reviewed regularly by the CODM. Therefore, other factors need to be taken into account and judgement applied to determine which components should be reported as operating segments.

In this case, the management structure reflects the CODM's emphasis on product-lines (or business units responsible for those products) rather than geographical locations. The wholesale and retail operating directors report directly to the CODM and are likely to be classed as 'segment managers'. The regional sales managers and global sales directors do not report direct to the CODM so would probably not be regarded as segment managers. Changes in product quality are not expected to result in different reactions in different geographic regions, suggesting the economic environment in the wholesale and retail markets are more significant than those of the geographic regions.

Therefore, it is likely for this entity, the operating segments would be identified as the wholesale and retail segments.

The process described above (applying the core principle and professional judgement as necessary) will result in the identification of the operating segments. Entities are of course able to report additional segmental information if they choose to do so. For example, in the scenario above the operating segments are business units and management may elect to provide additional information on a geographic basis. Although not required by MFRS 8, a matrix presentation can be very useful to users of the financial statements.

MFRS 8 also requires some entity-wide disclosures which are discussed in our article '**Insights into MFRS 8 – Entity Wide Disclosures**' which will be released later.

Only one operating segment identified

One common issue identified in practice is where only one operating segment is identified. Entities still need to apply the requirements of MFRS 8 if they only have one operating segment.

Practical insights – Groups

The segment reporting for the subsidiaries can be different to that of the overall group. It is possible management information is provided in a different way for the subsidiaries and therefore the segment information is not binding for the main group and different thresholds may apply.



How we can help

We hope you find the information in this article helpful in giving you some insight into MFRS 8. If you would like to discuss any of the points raised, please speak to your usual Grant Thornton contact.

