Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Alert

Updates on financial reporting and auditing

Issue 10 (September 2010)

Dear Members,

Operating segments: a management approach

The first application of a new standard is often a challenge. In the professional standards monitoring programme, we focus on the first time applications of new or revised financial reporting standards when reviewing published financial statements. This alert summarizes common issues noted on application of HKFRS 8, *Operating Segments*, which became effective for annual periods beginning on or after 1 January 2009. This alert will help you apply HKFRS 8 and enhance the quality of financial statements disclosures on operating segments.

<u>Overview</u>

HKFRS 8 supersedes HKAS 14 *Segment Reporting*. It sets out requirements for segment disclosures by entities whose debt or equity instruments are publicly traded. It also applies to entities that file or are in the process of filing financial statements with a regulatory body for purpose of issuing any instrument in a public market. If a financial report contains both consolidated financial statements and the parent's separate financial statements, segment information is required only for the consolidated financial statements.

The main change from HKAS 14 is the adoption of the management approach to report on the financial performance of operating segments. The information reported will be what management uses internally in deciding how to allocate resources to segments and evaluating segment performance. This enables users to review an entity's operations from the same perspective as management. In contrast, HKAS 14 required disclosures of two sets of segments (business and geographical) under a risks and returns approach.

<u>Key matters to be considered in applying HKFRS 8</u>

1. Who or what is the entity's chief operating decision maker?

Operating segments are determined on the basis of information that is reported internally to the chief operating decision maker. The chief operating decision maker is responsible for allocating resources and assessing the performance of the entity's operating segments. Therefore the first step is to properly identify this function, because this is a function, not necessarily a person with a specific title. It may also be a group of persons, e.g. board of directors. As the chief operating decision maker varies from entity to entity, disclosure of the identity of chief operating decision maker is relevant for users of financial statements in understanding the entity's operations.

2. What are the entity's operating segments?

Operating segment is defined in HKFRS 8 as a component of an entity:

- that engages in business activities from which it may earn revenue and incur expenses,
- whose operating results are regularly reviewed by the entity's chief operating decision maker for assessing the entity's performance and decision making on resource allocation and
- for which discrete financial information is available.

Members should note that the determination of a cash-generating unit for impairment testing under HKAS 36 cannot be larger than an operating segment before aggregation.

HKFRS 8 does not distinguish between revenues and expenses from transactions with external parties and those within the group. That means that it is possible for internal businesses with no external revenues to be identified as operating segments. Under HKAS 14, such internal businesses would not have been regarded as segments for reporting.

Members should ensure that management commentary in other parts of the annual report (e.g. management discussion and analysis, directors' report) is consistent with segment disclosures. We occasionally found inconsistencies where management approach under HKFRS 8 had been adopted for segment disclosures but other reporting still used descriptions and wording reflecting HKAS 14 requirements brought forward from previous years.

3. How to determine a reportable segment?

Although HKFRS 8 uses management approach, it is not a free form. Members need to conform to aggregation criteria and quantitative thresholds in preparing segment disclosures. We recommend members refer to the diagram appended to HKFRS 8 IG 7 which visualizes the flow for identifying reportable segments.

- *Aggregation criteria*

Reportable segments are operating segments or aggregations of operating segments. An entity has to satisfy all the aggregation criteria (HKFRS 8 paragraph 12) before it can aggregate two or more operating segments.

HKFRS 8 requires disclosures of factors used to identify reportable segments. Information and reasons for aggregation were often not disclosed.

If auditors note that only one operating segment is reported by their audit clients, they should question the clients about the basis for determination of operating segment and assess whether any operating segments are inappropriately aggregated.

- *Quantitative thresholds*

An operating segment shall be separately identified and reported if it exceeds any of the 10 percent quantitative thresholds of combined revenue, profit or loss, or assets of all operating segments as stated in HKFRS 8 paragraph 13. Profit or loss here means the greater, in absolute amount, of (i) the combined reported profit of all operating segments that did not report a loss and (ii) the combined reported loss of all operating segments that reported a loss.

It is also important to note that combined external revenue reported by operating segments shall be at least 75 percent of total revenue of the entity. There is no limit on the maximum number of reportable segments that an entity can disclose. However management should consider whether segment information will become too detailed if the number of reportable segments exceeds 10 (HKFRS 8 paragraph 19).

4. What segment information is required to be disclosed?

In addition to the above areas, other common missing disclosures are:

- *Information about profit or loss, assets and liabilities*

- HKFRS 8 requires an entity to report on a measure of segment profit or loss for each reportable segment. Measures of other items (e.g. segment liabilities and particular income and expenses) for each reportable segment are only required to be disclosed if such measures are regularly provided to the chief operating decision maker.

- HKFRS 8 specifically requires separate reporting for interest revenue and interest expense, **unless** majority of segment revenues are from interest **and** the chief operating decision maker uses net interest revenue to assess operating results. We have reviewed financial statements of banks which, as would be expected, reported segment interest revenues on net basis, but the fact that the chief operating decision maker had relied on net interest revenues for decision making was not disclosed.

- Missing disclosures of the basis of accounting for any transactions between segments.

- Absence of explanation of nature of differences, such as accounting policies and policies in allocation of corporate costs, between measurements for segment purposes and for the entity as a whole.

- *Reconciliations*

Since segment disclosures are prepared using management approach, it may not coincide with the way information is reported externally and so may not agree with the corresponding totals recorded in the statement of financial position and statement of comprehensive income. Therefore HKFRS 8 requires reconciliation of segment information to these two statements.

All material reconciling items shall be separately identified and described. We noted an extreme occasion that the sum of reconciling items for segment liabilities accounted for over 70 percent of the corresponding total liabilities of the entity, but no disclosures of the nature of such items were made.

- *Entity-wide disclosures*

HKFRS 8 also requires entity-wide disclosures (HKFRS 8 paragraphs 32 to 34) including information about the entity's products and services, geographical areas in which the entity operates and hold assets and major customers. Amounts reported in entity-wide disclosures shall be based on the financial information that is used to produce the entity's financial statements, rather than using the management approach.

Examples of insufficient entity-wide disclosures are: no disclosure of the fact that revenue attributed from a single customer amounted to 10 percent or more of the entity's revenues; and no disclosure of respective contribution of external revenues from the entity's country of domicile and foreign countries.

Members are reminded that entity-wide disclosures apply to all entities that are subject to HKFRS 8 including those that have a **single** reportable segment. This may occur where entities' business activities are not organized on the basis of differences in products and services or differences in geographical areas of operations.

Improvements to HKFRSs

Members should note that as a part of *Improvements to HKFRSs 2009*, HKFRS 8 was amended to require an entity to disclose a measure of segment assets **only if** that amount is regularly provided to the chief operating decision maker. This amendment is effective for annual periods beginning on or after 1 January 2010.

Sincere regards,

Chris Joy
Executive Director
Hong Kong Institute of Certified Public Accountants

CPA: *The Success Ingredient*