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AUSTRIAN FINANCIAL REPORTING AND AUDITING COMMITTEE

Comment Letter

Exposure Draft 8 Operating Segments

AFRAC

AUSTRIAN FINANCIAL REPORTING AND AUDITING COMMITTEE

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The AFRAC International Financial Reporting Standards Working Group prepares comment letters on recent IASB publications for final approval by AFRAC. Principal authors of this comment letter were David Grünberger, Peter Geyer and Helmut Kerschbaumer. More information about the Working Group and AFRAC is available under www.afrac.at.

AFRAC is available for further questions, which should preferably be sent by email to office@afrac.at or addressed to Austrian Financial Reporting and Auditing Committee (AFRAC), Schönbrunner Strasse 222–228/1/6, A-1120 Vienna, Austria. ".

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Outline

1. General comments

The Austrian Financial Reporting and Auditing Committee (AFRAC) welcomes the opportunity to comment on Exposure Draft 8 *Operating Segments* (ED 8) issued by the IASB in January 2006.

ED 8 has been issued with a view to achieving short-term convergence with the standards published by the US-Financial Accounting Standards Board. Before commenting on ED 8 in detail, AFRAC wants to express its strong support for the Board's objective of establishing a single set of global, high quality financial reporting standards.

2. Specific questions

Q1. *Adoption of the management approach in SFAS 131: the draft IFRS adopts the management approach to segment reporting set out in SFAS 131 Disclosures about Segments of an Enterprise and Related Information issued by the US Financial Accounting Standards Board. Is this approach to segment reporting appropriate? If not, why not? What, if any, alternative approach would you propose?*

AFRAC agrees with the approach taken by ED 8. The management approach increases transparency by presenting information relevant to management in its decisionmaking process. This contributes to a better understanding and evaluation of strategic and operative management decisions by external users of financial statements and increases the informational value of financial statements. Admittedly, the management approach relies on soft rules which can be misused to present biased information. However, much of the segment information now required by IAS 14 (geographic information and information on products and services) will still have to be presented – now within the entity-wide disclosures. These disclosures have to be measured according to IFRS. Therefore an entity will not be inclined to present misleading information in its segment report, because this could easily conflict with information presented in the entity-wide disclosures.

Under the proposed management approach, management will be expected to demonstrate that it relies on sound and specific internal information. This also creates peer pressure to present comparable, high-level segment information. This is especially true for entities operating under regulatory capital requirements (e.g., under Basel II). For those entities, capital requirements are a principal factor in management's financing and investment decisions, the pricing of financial products and the entities' risk management policies. However, regulatory reporting can deviate substantially from accounting systems based on IFRS. Users of financial statements would, therefore, benefit from segment information which is based on the existing regulatory accounting regime within the entity in question, in addition to the entity wide disclosures based on IFRS.

We note that the use of management information may reduce comparability of financial information across firms, and particularly firms in different countries. In contrast to the FASB, the IASB aims at developing global standards, and needs to consider national differences more than a national standard-setter such as FASB. Although worldwide application may reduce comparability between countries to a greater extent than may be apparent, given its use in the U.S., we believe that the benefits of the management approach still outweigh the costs overall.

Q2. *Divergence from SFAS 131: The wording of the draft IFRS is the same as that of SFAS 131 except for changes necessary to make the terminology consistent with that in other IFRSs. Do you think that the draft IFRS should depart from the management approach in SFAS 131 by setting requirements for*

(a the measurement of specified items or

(b) the disclosure of specified amounts that might otherwise not be given?

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

In general, AFRAC agrees with the the IASB's decision to use the wording of SFAS 131. However, ED 8.23(b) departs from the corresponding rules provided by

SFAS 131 in using the term "*non-current assets*" instead of "*long-lived assets*". AFRAC proposes to reconsider the deviation from SFAS 131. The term *"non-current assets"* refers to separate classification of assets on the face of the balance sheet. Instead of this classification, an entity might use a classification based on liquidity (IAS 1.51). The definition of non-current assets is based on certain time frames set out in IAS 1.57.

In practice, management usually monitors capital expenditure on long-term investments on a segment basis. Therefore, such information will be readily available and the cost of presenting it will usually be lower than the cost for long-term assets. In addition, capital expenditure on long-term investments has a higher informational value than additions to non-current assets. Long-term investments are a measure of resources intended to generate future income and cash flows (profit potential) as defined by IAS 7.16. **The time frames set out in IAS 1.57 constitute a very rough measure for long-term investments and would not allow the presentation of useful information on resources intended to generate future income and cash flows.**

Example: An account receivable with a maturity date of 13 months might be a non-current asset, while an account receivable with a maturity of 11 months might be a current asset (assuming the company's operating cycle is more than 12 months). In the first case the account receivable would be included in the expenditures on additions to non-current assets, and in the second case not. The usefulness of information based on such a distinction is a least questionable, since accounts receivable might not generate future income at all. For industrial companies, information about capital expenditure on long-term investments will be more meaningful than a mixed figure including non-current parts of working capital items.

AFRAC would therefore propose either the use of a more general term in ED 8.23(b), such as the term *"assets that are expected to be used during more than one period"* currently used in IAS 14.57. As an alternative, the term *"expenditure for additions to long-term investments"* might be used, in line with IAS 7.16(a).

Q3. *Scope of the standard: The existing standard IAS 14 requires entities whose equity or debt securities are publicly traded and entities that are in the process of issuing equity or debt securities in public securities markets to disclose segment information. The draft IFRS extends the scope to include also entities that hold assets in a fiduciary capacity for a broad group of outsiders. Do you agree with the scope of the draft IFRS? If not, why not?*

The IASB notes it *"considered extending the scope of the proposed IFRS to all entities that have public accountability rather than just entities whose securities are publicly traded."* In general, AFRAC would agree to extending the scope to publicly accountable entities. However, it is not clear whether the term "fiduciary capacity" actually reflects public accountability.

First, the wording can imply that only fiduciary contracts over specific assets are within the scope. The board should clarify whether "fiduciary capacity" is to be interpreted as a broad term relating to an economic function or whether the term refers to the specific financial service of issuing fiduciary contracts over specific assets.

The Board might also clarify the relationship between the term "fiduciary capacity" and the subsequent examples of banks, insurance companies etc. Do banks or insurance companies generally act in a fiduciary capacity in the meaning of the draft standard or only those banks or insurance companies that issue fiduciary contracts?

The Board might further clarify whether the ED only covers an entity whose "fiduciary capacity" constitutes the main business purpose or also an entity to which fiduciary activities are incidental to its main business activities.

Q4. *Level of reconciliations: The draft IFRS requires an entity to provide, for specified items, reconciliations of total reportable segment amounts to amounts recognised by the entity in accordance with IFRSs. It does not require such reconciliations for individual reportable segments. Do you agree with the level of reconciliations required in the draft IFRS? If not, indicate what you see as the relative costs and benefits of any other level of reconciliation.*

The reconciliation for each reportable segment to the corresponding amounts based on IFRS could improve the usefulness of the segment report. Apart from management's perspective on segments, this would provide information on each segment's contributions to the entity's total financial information. However, such reconciliation would not only include remeasurements to amounts based on IFRS, but also eliminations of intra-group transactions (consolidation). To achieve this result, all segment information would have to be IFRS-based. In other words, costs and efforts for reconciling each segment to IFRS would be quite similar to the costs and efforts incurred if the segment information was prepared based on IFRS in the first place.

AFRAC agrees with the "level of reconciliations" proposed in ED 8. More detailed reconciliations on a segment level would involve high cost as compared with the benefit obtained for the users of financial statements.

Q5. *Geographical information about assets: The draft IFRS requires an entity to disclose geographical information about non-current assets excluding specified items. It does not require disclosure of geographical information about total assets. Do you agree with the requirement to disclose geographical information about non-current assets excluding specified items? If not, for which assets would you require geographical information to be given?*

AFRAC agrees with the proposed requirements. However, the term non-current assets should be amended (see our answer to question 2).

Q6. *Consequential amendments to IAS 34 Interim Financial Reporting: the draft IFRS requires an entity to disclose more segment information in interim financial reports than is currently required, including a reconciliation of the total of the reportable segments' measures of profit or loss to the entity's profit or loss. Do you agree with the consequential amendments made to IAS 34? If not, why not?*

AFRAC agrees with the proposed amendments to IAS 34.

Specific Comments to Paragraph 11

According to ED 8.11, aggregation of similar operating segments requires similar economic characteristics as well as similarity in each of five additional aspects. All those aspects have to be present as a precondition for aggregation. This cumulative requirement is too strict and could in many cases prevent aggregation of economically similar operating segments. This would lead to overly detailed segmentation and conflict with ED 8.18. AFRAC therefore proposes the reformulation of the third sentence in ED 8.11 as follows:

Two or more operating segments may be aggregated into a single segment if aggregation is consistent with the core principle of this [draft] IFRS, <u>and</u> the segments have similar economic characteristics <u>based on</u> ~~, 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.

Specific Comments to Paragraph 23

ED 8.23 reads as follows: *"An entity shall disclose the following about each reportable segment if the specified amounts are included in the determination of segment assets reviewed by the chief operating decision-maker or are otherwise regularly provided to the chief operating decision maker, even if not included in the determination of segment assets: …"*

The wording of this paragraph is complex and ambiguous. The words "*even if not included in the determination of segment assets*" seems to contradict the words "*if the specified amounts are included in the determination of segment assets*" and it is not clear how the conditional phrases relate to each other. AFRAC therefore suggests the reformulation of this paragraph.