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19 November 2012

The Chairman
Australian Accounting Standards Board
PO BOX 204
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Dear Mr Stevenson

Ernst & Young's global submissions to the IASB on the Request for Information – Post-implementation Review: *IFRS 8 Operating Segments*

Please find enclosed Ernst & Young's global submission to the IASB on the above Request for Information.

Yours sincerely

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16 November 2012

Dear IASB members

Request for Information – *Post-implementation Review: IFRS 8 Operating Segments*

The global organisation of Ernst & Young is pleased to submit its comments on the Request for Information (RFI) on the post-implementation review of IFRS 8 *Operating Segments*. In Appendix 1 we respond to the questions the Board raised in the RFI. In Appendix 2 we comment on other aspects we believe to be relevant for the post-implementation review.

General comments

When finalising the standard, one of the IASB's primary expected benefits of IFRS 8 was that segment information disclosures would correspond to internal management reports and therefore reflect how an entity manages its business. The principle to base segment information disclosures on the management perspective is, in our view, providing useful and relevant information to users of the financial statements. We also believe that it facilitates management's communication of the entity's financial performance as segment information is consistent with internal reporting and disclosures in other parts of the annual report.

Our experience suggests that the number of segments reported in the segment information disclosures didn't change significantly as a result of transitioning to IFRS 8 when comparing to the primary segment information under IAS 14 *Segment Reporting*. In fact, our experience suggests most entities reported the same number of segments. Entities often have a product-based or geography-based management structure that was already partly or fully reflected in their segment information disclosures under IAS 14. As a result, the change to a management perspective usually did not significantly affect the basis on which segment information is disclosed.

Use of judgment

The main effect of introducing the management perspective is arguably the fact that it requires and allows for significant judgment. The impact of the judgment used, for example, in determining the 'chief operating decision maker' (CODM) or whether operating segments can be aggregated based on similar economic characteristics, can have a significant impact on how segment information is presented. In 2011 the IFRS Interpretations Committee provided some clarification on the definition of the CODM and referred to this post-implementation review regarding the aggregation criteria.

The Standard relies on the internal reporting to the CODM to determine operating segments. However, internal reporting to the CODM usually takes a variety of forms (verbal, paper-based, electronically, periodically, ad-hoc, etc.) and levels of detail. Furthermore, the formal reporting to the CODM does not necessarily reflect all information used by the CODM in its decision making process. As a result, the CODM may i) regularly review information that is not necessarily used in assessing the performance of and allocating resources to operating segments or ii) base its decisions on information never reported. Again, significant judgment is required in determining what information is relevant for the determination of operating segments.

We believe further clarification around these issues would be helpful, particularly as the use of judgment can have an impact beyond segment information disclosures, as outlined below.

Potential impact of segment reporting on goodwill impairment testing

IAS 36 *Impairment of Assets* requires goodwill acquired in a business combination to be allocated to the cash-generating units (CGU) or group of CGUs that is expected to benefit from the synergies of the combination. Paragraph 80(b) of IAS 36 requires the CGU or group of CGUs *"not to be larger than an operating segment as defined in paragraph 5 of IFRS 8 before aggregation"*. Identifying more operating segments would result in a lower threshold for goodwill allocation in a business combination. Generally, testing for goodwill at a higher, more aggregated level is less likely to result in impairment as highly profitable parts within the CGU can compensate for loss-making parts.

Two otherwise identical reporting entities can therefore have a different profit or loss, simply because, for example, the CODM is determined differently by the two entities. We believe this to be conceptually sound, as it would reflect how the entities manage their businesses. However, two different management structures would not change the underlying economic substance (i.e., cash flows) of otherwise identical reporting entities. It is unclear to us whether the IASB intended that judgment involved in determining operating segments should impact the reported profit or loss.

Should you wish to discuss the contents of this letter with us, please contact Leo van der Tas at +31 88 4075035.

Yours faithfully

Ernst & Young

APPENDIX 1 – Answers to the specific questions

Question 1:

Are you comparing IFRS 8 with IAS 14 or with a different, earlier segment-reporting Standard that is specific to your jurisdiction?

In providing this information, please tell us:
(a) what your current job title is;
(b) what your principal jurisdiction is; and
(c) whether your jurisdiction or company is a recent adopter of IFRSs.

In answering to your RFI we are comparing IFRS 8 to IAS 14.

In responding to the questions directed to investors and preparers, we respond from the perspective of our role as auditors and advisers to preparers.

Question 2:

What is your experience of the effect of the IASB's decision to identify and report segments using the management perspective?

The RFI sets out the Board's expected primary benefits of adopting the management approach, that were:

(a) entities will report segments that correspond to internal management reports;
(b) entities will report segment information that will be more consistent with other parts of their annual reports;
(c) some entities will report more segments; and
(d) segment reporting will be less burdensome on preparers because only one segment-reporting process would be required for both internal and external reporting.

The principle to base segment information disclosures on the management perspective is, in our view, providing useful and relevant information to users of the financial statements. We also believe that it facilitates management's communication of the entity's financial performance as segment information is consistent with internal reporting and disclosures in other parts of the annual report.

Already before transitioning to IFRS 8, entities often had a product-based or geography-based management structure that was partly or fully reflected in their primary segment information disclosures under IAS 14 (in fact, might have even been required by paragraph 33 of IAS 14). As a result, the change to a management perspective did not significantly affect the basis on which segment information is disclosed. Our experience suggests that most entities reported the same number of segments before and after implementing IFRS 8 when comparing to the primary segmentation in IAS 14.

Under IAS 14 entities were required to provide primary and secondary segment information based on a set of rules applicable to all entities. Some might be of the view that a change to a management based approach to provision of segment information decreases comparability between different entities. However, we believe the management approach gives users of financial statements insights into how managements of different entities are making decisions about their respective businesses. This should ultimately increase the comparability between different entities as the reporting allows insight into how the business actually is managed, and not only comparability between standard setter determined components that are not necessarily relevant in understanding how the business is organised.

Basing the segment information on the management perspective requires and allows for significant judgment. The impact of the judgment used, for example, in determining the CODM or whether operating segments can be aggregated based on similar economic characteristics, can have a significant impact on how segment information is presented. More importantly, the use of judgment can have an impact beyond segment information disclosures (e.g., at what level goodwill allocated to CGUs is tested for impairment). While we believe this to be conceptually sound, it is unclear to us whether the potential consequences outlined in Appendix 2 of this comment letter were intended.

Question 3:

How has the use of non-IFRS measurements affected the reporting of operating segments?

In our experience, segment information disclosures of most entities are based on IFRS measurements. This is somewhat unexpected as there was a general perception prior to the introduction of IFRS 8 that managements often use other than IFRS measures as a basis in its decision making process (also for the reasons outlined in the RFI). This obviously begs the question as to whether the general perception was correct or whether there is a disconnect between the internal reporting to the CODM (on which segment information is based) and the information actually relevant for decision making. As already outlined in the cover letter, internal reporting to the CODM can never include all information used by the CODM in makings its decisions. Therefore, when assessing whether the intended benefits identified by the Board have been achieved, the Board should bear in mind that the standard relies on the internal reporting to the CODM which can only be a proxy of the information actually relevant for decision making.

Many entities use not only one measure of profit or loss, but also a combination of different financial and non-financial key performance indicators to assess performance of their operating segments and allocate resources to them. Examples include key measures based on capital invested such as return on capital employed (ROCE); value-based approaches such as economic value added (EVA); free cash flow or orders on hand. Paragraph 26 clarifies that in those cases entities should use the measurement principles most consistent with IFRS as basis for their segment information disclosures. Consequently, those other key performance indicators would not need to be disclosed, although, the standard does not prohibit their disclosure. However, in the most extreme case, where the CODM bases its decisions solely on, for example, a value-based management, the internal reporting to the CODM would have to exclude all financial statement related numbers to allow a segment information disclosure that really reflects how management views the business. In other words, it may be that non-IFRS measures are playing a more significant role than it appears from the segment information disclosures.

Question 4:

How has the requirement to use internally-reported line items affected financial reporting?

We believe the linkage between information included in internal reporting and the segment information has generally streamlined an entity's reporting processes and also facilitates its external communication.

However, as explained in our response to questions 2 and 3 and in Appendix 2, IFRS 8 may also have introduced incentives to structure the internal reporting in a particular way to achieve an accounting effect, even though it may not appropriately be reflecting how the businesses are managed.

Also, paragraphs 31 to 34 require entity-wide disclosures which in our experience are often not included in the reporting to the CODM. In other words, to a certain extent, entities still need to collect data for pure disclosure purposes only.

Question 5:

How have the disclosures required by IFRS 8 affected you in your role?

See our response to Question 6.

Question 6:

How were you affected by the implementation of IFRS 8?

As outlined above and in Appendix 2, IFRS 8 has introduced an element of judgment into financial reporting which, consequently, impacts the audit of financial statements.

APPENDIX 2 – Comments on other aspects we believe to be of importance for the post-implementation review

The definition of the CODM

We believe that the determination of the CODM should be first and foremost a matter of fact, i.e. the person or function allocating resources to and assessing the performance of operating segments. However, to a certain extent this is also influenced by other factors such as the type of decision to be made or the legal requirements in the respective jurisdiction or requirements regarding corporate governance. For example, certain jurisdictions place the responsibilities of managing an entity on the Board of Directors (BoD), which could include the responsibility over allocating resources to and assessing the performance of operating segments. Moreover, the BoD might not be able to delegate certain elements of that responsibility to an operating management (such as a chief executive officer or a management committee). On the other hand, corporate governance rules in those jurisdictions would often require the BoD to also have a governance and oversight role, which doesn't seem to fit within the definition of a CODM.

We believe the reference to the 'chief operating decision maker' is somewhat misleading, as it seems to indicate that this person or function is at an operating (i.e. lower) level. However, decisions about allocating resources can also be of a strategic nature. The same could, at least to a certain extent, also apply to the assessment of performance. At its July 2011 meeting, the IFRS Interpretations Committee added some clarity around this issue. However, further clarification would be helpful.

Internal reporting and its impact on determining operating segments

The requirement in paragraph 5(b) of IFRS 8 that operating results have to be regularly reviewed by the CODM in order to qualify as operating segment, requires some sort of formal reporting to the CODM. However, internal reporting to the CODM usually takes a variety of forms (paper-based, electronically, periodically, ad-hoc, etc.) and levels of detail. The CODM would also often have access to a management reporting system, which usually presents information on a very condensed (i.e. group) level but also allows for drill-down to much more detailed information. Consequently, the CODM may regularly review information that is not necessarily used in assessing the performance of and allocating resources to operating segments. Significant judgment is required in determining what information is relevant for the determination of operating segments.

Further, as outlined below, IFRS 8 may also have introduced incentives to structure the internal reporting in a way to achieve a particular accounting effect, even though it may not appropriately be reflecting how the businesses are managed.

Potential impact of identified operating segments to goodwill impairment testing

IAS 36 requires goodwill acquired in a business combination to be allocated to the cash-generating units (CGU) or group of CGUs that is expected to benefit from the synergies of the combination. Paragraph 80(b) of IAS 36 requires the CGU or group of CGUs *"not to be larger than an operating segment as defined in paragraph 5 of IFRS 8 before aggregation"*.

Identifying more operating segments would result in a lower threshold for allocating goodwill arising in a business combination . Generally, testing for goodwill at a higher, more aggregated level is likely to result in less impairment as highly profitable parts within the CGU could support parts with lower or no profitability. Therefore, increasing the number of operating segments would at the same time also increase the risk of impairment for each of the segments.

This could lead to situations in which two otherwise identical reporting entities could have a different profit or loss, simply because, for example, the CODM is determined differently by the two entities. We believe this to be conceptually sound, as it would reflect how the entities manage their businesses. On the other hand, two different management structures would not change the underlying economic substance of the otherwise identical entities. We are not sure whether this consequence was intended.

Interaction between management discussion and analysis and segment information

The RFI seems to assume that the segment information disclosures and the basis for determining and aggregating operating segments should be consistent with information presented in other parts of the annual report, such as the management commentary or management discussion and analysis. This was also one of the Board's expected benefits at the time of issuing the standard (see paragraph BC9 of IFRS 8).

We generally believe that information presented in the segment information disclosures should be consistent with information presented in other parts of an entity's annual report. However, we don't think that all information disclosed outside the financial statements necessarily needs to be consistent with the segment information disclosures. There are usually no requirements on how information about an entity's business has to be discussed or presented in information outside the financial statements. For example, we believe there might well be arguments why an entity wishes to discuss a certain part of a segment in more detail in the management discussion and analysis without that part necessarily becoming an operating segment.