

Query No. 8

Subject: Segment Reporting.¹

A. Facts of the Case

1. An unlisted public limited company is engaged in the business of manufacturing products on contract basis. The turnover of the company for the financial year 2009-10 was Rs. 260 crore. The company manufactures engineering products, castings, etc. as per the design, engineering standards and specifications prescribed by the customers. The company manufactures industrial valves under brand name of its customer at USA. The company also manufactures castings both machined and unmachined and supplies the same to tractor and auto sector. Again, these are components used by manufacturers of tractors, trucks, etc. The company also supplies components to a public sector undertaking for use in earth moving equipment. According to the querist, the company has only one product sold in its brand name, i.e., gear boxes which account for less than 3% of the turnover. The company has not more than 12 customers who either use components supplied by the company in their own products, for example, tractor, truck, earth moving equipment, etc. or sell the products under their own brand name and the end customer does not recognise the company.
2. The querist has stated that the geographical distribution of the sales of the company is also restricted to one country/region. For example, more than 95% of valves are supplied to USA. Castings are sold in India with a small portion of export.
3. The querist has also stated that the financial statements presented and reviewed by the Board is for the company as a whole without any segmentation. Bank facilities are also arranged based on the financials of the company as a single segment organisation. Banks have accepted this position.
4. Based on these facts, the company has given the following note under Notes on Accounts in the published statement of annual accounts:

“Segment Reporting

The company has confirmed that they are operating as a single business and geographical segment. As such, there are no reportable segments as per Accounting Standard 17 on ‘Segment Reporting’.”

This is the settled position from the financial year 2001-02 to 2009-10. The company had a change of auditors recently and they desire that the position should be re-examined. The querist has stated that to be consistent, the company would prefer to continue the present practice.

¹ Opinion finalised by the Expert Advisory Committee on 03.06.2011.

B. Query

5. On the facts and circumstances stated above, the querist has sought the opinion of the Expert Advisory Committee as to whether it is in order to continue the present practice of treating the business as a single segment, i.e., contract manufacturing.

C. Points considered by the Committee

6. The Committee, while answering the query, has considered only the issues raised in paragraph 5 above and has not touched upon any other issue arising from the Facts of the Case. The Committee also wishes to state that in the absence of the facts related to risks and returns associated with various products of the company or various regions/countries in which the company operates, the Committee is, hereinafter, laying down broad principles to be applied while identifying the reportable segment as per the provisions of AS 17.

7. The Committee notes that as per the provisions of Accounting Standard (AS) 17, 'Segment Reporting', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'), the components of an enterprise that are required to be reported separately have to first fall within the definitions of the terms 'business segment' or 'geographical segment' before being considered as 'reportable segments' as per the threshold criteria laid down in paragraph 27 of AS 17, notified under the Rules. In this context, the Committee notes the definitions of the terms 'business segment' and 'geographical segment' as per AS 17, notified under the Rules, which provide as follows:

“5.1 A business segment is a distinguishable component of an enterprise that is engaged in providing an individual product or service or a group of related products or services and that is subject to risks and returns that are different from those of other business segments. Factors that should be considered in determining whether products or services are related include:

- (a) the nature of the products or services;***
- (b) the nature of the production processes;***
- (c) the type or class of customers for the products or services;***
- (d) the methods used to distribute the products or provide the services; and***
- (e) if applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities.”***

“5.2 A geographical segment is a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components

operating in other economic environments. Factors that should be considered in identifying geographical segments include:

- (a) similarity of economic and political conditions;*
- (b) relationships between operations in different geographical areas;*
- (c) proximity of operations;*
- (d) special risks associated with operations in a particular area;*
- (e) exchange control regulations; and*
- (f) the underlying currency risks.”*

8. The Committee also notes that paragraphs 7 and 8 of AS 17, notified under the Rules, provide as follows:

“7. A single business segment does not include products and services with significantly differing risks and returns. While there may be dissimilarities with respect to one or several of the factors listed in the definition of business segment, the products and services included in a single business segment are expected to be similar with respect to a majority of the factors.”

“8. Similarly, a single geographical segment does not include operations in economic environments with significantly differing risks and returns. A geographical segment may be a single country, a group of two or more countries, or a region within a country.”

9. The Committee also notes paragraph 12 of AS 17, notified under the Rules, which is reproduced below:

“12. The predominant sources of risks affect how most enterprises are organised and managed. Therefore, the organisational structure of an enterprise and its internal financial reporting system are normally the basis for identifying its segments.”

The Committee notes from the above that to identify business and geographical segments, the enterprise needs to evaluate whether the risks and returns of different components are different as per the factors stated in the definitions of the terms ‘business segment’ and ‘geographical segment’. The organisational structure of an enterprise and its internal reporting system are normally the basis for identifying the segments, subject to their fulfilling the criteria prescribed in the aforesaid definitions.

10. The Committee notes from the Facts of the Case that the company is engaged in the manufacturing of different types of engineering products/components, castings, valves, etc. These products are both machine-made and hand-made. Further, many of these products are manufactured as per the specifications of the clients for either use in the products of the clients or for selling these products in the clients’ brand name and some of these are sold by the company in its own name. However, the information about whether the risks and returns associated with the various products in which the company deals in, are different, is not clear from the Facts of the Case. In this context, the Committee notes from the above-reproduced definition of ‘business

segment' and other provisions of AS 17 that if various products of the company are subject to different risks and returns, these would constitute different business segments. For instance, in the extant case, some of the products manufactured by the company, for example, in the case of valves, sales are restricted to a single customer and accordingly, the risks and returns in such cases where the company is relying on a single customer may be different from the risks and returns of a product where the company is not so relying on a single customer. Similarly, risks and returns in case of products manufactured by machines may be different from the products which are hand-made. Thus, the Committee is of the view that considering the nature of the products produced, production processes involved in manufacturing and type or class of customers, the company should evaluate that whether there can be different business segments in the present case.

11. Similarly, in the context of geographical segments, while, on one hand, the querist has stated that the geographical distribution of the sales of the company is restricted to one region, on the other hand, it is stated that more than 95% of the valves manufactured by the company are supplied to USA. Further, castings are sold in India with a small portion of export. However, the information as to whether or not the risks and returns associated with the different regions/countries in which the company supplies its products are different, is not clear from the Facts of the Case. In this context, the Committee is of the view that there may be different pricing strategies, credit risks and exchange control regulations involved for domestic and international sales. In such a case, the risks and returns in different geographical regions may be different and accordingly, the different geographical regions may be considered as different geographical segments in the present case. The Committee is also of the view that geographical segments may also be identified by segregating its total turnover into domestic sales and international sales irrespective of the nature or kind of the products being sold. Thus, the Committee is of the view that considering the above-mentioned factors, the company should evaluate that whether there can be different geographical segments in the present case.

12. After identifying various business and geographical segments as discussed above, in the view of the Committee, the company should decide whether these segments can be considered as reportable based on the requirements of paragraphs 27 to 29 of AS 17, notified under the Rules, which provide as follows:

“27. A business segment or geographical segment should be identified as a reportable segment if:

- (a) its revenue from sales to external customers and from transactions with other segments is 10 per cent or more of the total revenue, external and internal, of all segments; or***
- (b) its segment result, whether profit or loss, is 10 per cent or more of***
 - (i) the combined result of all segments in profit, or***
 - (ii) the combined result of all segments in loss, whichever is greater in absolute amount; or***
- (c) its segment assets are 10 per cent or more of the total assets of all segments.***

28. A business segment or a geographical segment which is not a reportable segment as per paragraph 27, may be designated as a reportable segment despite its size at the discretion of the management of the enterprise. If that segment is not designated as a reportable segment, it should be included as an unallocated reconciling item.

29. If total external revenue attributable to reportable segments constitutes less than 75 per cent of the total enterprise revenue, additional segments should be identified as reportable segments, even if they do not meet the 10 per cent thresholds in paragraph 27, until at least 75 per cent of total enterprise revenue is included in reportable segment.”

From the above, the Committee is of the view that if the segments of the company meet the above-reproduced threshold criteria, the company should report the same as business and/or geographical segments as discussed above as per the other requirements of AS 17. The Committee is also of the view that if it is concluded that there is neither more than one business segment nor more than one geographical segment, segment information is not required to be disclosed. The fact that there is only one ‘business segment’ and ‘geographical segment’ should be disclosed by way of a note as per the requirements of Explanation to paragraph 38 of AS 17, notified under the Companies (Accounting Standards) Rules, 2006.

D. Opinion

13. On the basis of the above, the Committee is of the opinion that the company should identify the reportable business and/or geographical segments based on the considerations stated in paragraphs 9 to 12 above.
