A Glimpse at Operating Segment

There is a growing focus of transparency in the bedrock of corporate financial reporting. Relevant information is required by stakeholders - investors, analysts and other users of financial statements for evaluating the sustainability and growth of a company. In this context, financial reporting has evolved over the period. Where an entity which operates in an environment with variety of classes of business, geographical locations, regulatory or economic markets, segment information provides an essential tool for good management as it will help the management to take well informed decisions and will help in developing strategies which will help the management to exploit opportunities. The segment information not only provides valuable inputs to the management, it also acts as an important tool in external reporting as it helps to explain the factors which contributes to the result of an entity. Read on to know more…

Background and Scope:

In order to provide the users of the financial statement with more meaningful disclosures which would also facilitate a better understanding of the financial statements, Ind AS 108 requires disclosures relating to operating segment.

Ind AS 108 is applicable to all companies covered by the reporting requirements of Ind-AS; except when a financial report includes both the consolidated and standalone financial statements of a parent, the segment disclosures are required only in the consolidated financial statements.

The core principle of this standard is the disclosure of information that enables users of an entity's financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environment in which it operates. The core principle is considered when forming judgements about how and what information is disclosed.

Segment Reporting is the reporting of the operating segments of a company in the disclosures accompanying the financial statements. Segment Reporting is intended to give information to investors, creditors, and other stakeholders regarding the financial performance of the significant operating units of a company and on this basis decisions related to the company are made.

An operating segment is a component of an entity:

- that engages in business activities from which it may earn revenue and incur expenses (including revenues and expenses relating to transactions with other components of the same entity),
- whose operating results are regularly reviewed by the entity's Chief Operating Decision Maker (CODM) to make decisions about resources to be allocated to the segment and assess its performance, and
- for which discrete financial information is available.

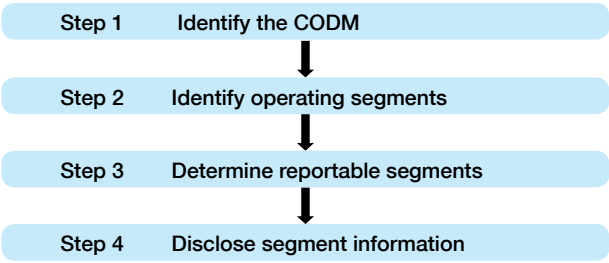
CA. Supreet Sachdev and CA. Pawan Kejriwal

(The authors are members of the Institute who may be contacted at pkkejriwal@gmail.com.)

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.

Ind AS 108 requires segment disclosure based on the components of the entity that management monitors in making decisions about operating matters. Such components (operating segments) are identified on the basis of internal reports that the entity's CODM regularly reviews in allocating resources to segments and in assessing their performance.

Segment information can be understood through the four step process defined in the standard:



Step 1- Identifying the CODM

The term 'CODM' identifies a function, not necessarily a manager with a specific title. That function is to allocate resources to and assess the performance of the operating segments of an entity. Often the CODM of an entity is its chief executive officer (CEO) or chief operating officer (COO) but, it may be so determined that a group of executive directors or executive committees or similarly titled committees could be determined to be the CODM. In this regard, the following may be noted:

- The CODM of an entity is usually the highest level of the management eg:- CEO or COO etc.
- The CODM function may not be restricted to a single individual, it can include a group of executive directors, executive vice presidents or others.
- A group of executives who merely approve management decisions would not represent a CODM if they are not involved in allocating resources. The CODM is required to allocate resource and assess the performance of the operating segment.
- An entity cannot have more than one CODM.

Once a CODM has been identified, it is necessary to reconsider the identification as and when appropriate or at the time of a business acquisition, disposal etc.

Identifying the CODM may require judgment

Deciding *'who the CODM will be'* can be difficult at times and therefore judgment is needed to ensure that the right person has been identified as CODM. The CODM is responsible for the allocation of resources and assessing the performance of the entity's operating segments. The CODM's identity will not always be clear and will depend on the entity's structure. Hence, the CODM will vary from entity to entity.

The segment identification and measurement is based on the review mechanism of the entity's financial information by the CODM who may be an individual or a group of individuals. Companies including IBM and Microsoft have identified their CEO as their CODM (*Source: Global Annual Report 2016*); Wipro has identified Chairman and Managing Director as their CODM and Tata Consultancy Services has identified their CEO and Managing Director as meeting the criteria of CODM (*Source: IND AS Financial Statements Q1-2017.*)

An operating segment generally has a segment manager who is directly accountable to and maintains regular contact with the CODM to discuss operating activities, financial results, forecasts, or plans for the segment. The chief operating decision maker also may be the segment manager for some operating segments. A single manager may be the segment manager for more than one operating segment. The function of segment manager is a key indicator where several components of an entity would meet the criteria for identifying operating segments, but segment managers are held responsible for only one of those components. In that situation only the component for which they are held responsible is an operating segment.

Key difference between Ind-AS 108 and AS-17 and on identification of segments– Ind AS 108 requires segments to be identified based on the manner in which the entity's financial information is reviewed by the CODM as against previously where segments were identified and measured based on risks and returns of an entity's different products or services for a business segment and different economic environments for a geographic segment.

Step 2- Identifying an Operating Segment

The operating segments are identified based on the

way in which financial information is organised and reported to the CODM. An operating segment is identified by Ind AS 108 as a component of an entity:

- that engages in business activities from which it may earn revenues and incur expenses, including revenues and expenses related to transactions with other components of the same entity;
- whose operating results are regularly reviewed by the entity's CODM to allocate resources and assess its performance; and
- for which discrete financial information is available.

Implementation Challenges- Identifying an Operating Segment and the appropriateness of aggregating operating segments can be difficult

There could be a situation that in some entities, some managers are responsible for different product and service lines worldwide, whereas other managers are responsible for specific geographical areas. The CODM regularly reviews the operating results of both sets of components, and financial information is available for both. In that situation, the entity shall determine which set of components constitutes the operating segments by reference to the core principle.

If operating segments are based on geography, the individual country may be aggregated for segments which have similar economic characteristics.

A discontinued operation is considered an operating segment if it continues to engage in business activities; the operating results are regularly reviewed by the CODM; and discrete financial information is available to facilitate the review. During the year ended 31st March 2015, General Electrics (GE) had discontinued operations primarily related to their financial service business as a result of their GE Capital Exit Plan. The details of the operations were reported under their 'Capital' segment. Details of the discontinued operations were disclosed in the financials as at 31st March 2015.

A head office function that undertakes a treasury operation that earns interest income and incurs expenses may be considered as an operating segment as long as its revenues earned are more than incidental to the activities of the entity, and discrete financial information is reviewed by the CODM. A head office function which includes functions such as Accounting, IT, Human Resources etc. that earns revenue that is purely incidental to the entity's activities is not an operating segment and not part of one of the reportable segments. Such functions should be reported in the reconciliation of the segment totals as 'other reconciling items'. The Allianz Group has among its reportable segments a segment namely corporate and other, which includes its holding and treasury functions. The holding and treasury function includes the management and support of the businesses through its strategy, risk, corporate finance, treasury, financial reporting, controlling, communication, legal, human resources, technology, and other functions (*Source: Global Annual Report 2015*).

Operating segments could be identified on a number of different basis such as customer, product, service, geographic, legal entity, etc. The below examples could help understand the various operating segments across industries:

S. No.	Basis	Company	Industry	Segments identified		Source	Basis of preparation
1	**Product based segmentation**	Apple Inc	Electronics	-iPhone -iPad -Mac	-Services -Others	Unaudited condensed consolidated statement of operations for the quarter ended 30th September 2016	IFRS
2	**Service based segmentation**	Larsen & Toubro Limited	Multiple	-Infrastructure -Power -Heavy Engineering -Electrical & Automation -Hydrocarbon	-IT & Technology Services -Financial Services -Developmental Projects -Others	Unaudited standalone financial results for the quarter ended 30th June 2016	Ind AS
3	**Geographic segmentation**	InterGlobe Aviation Limited	Transport	-Domestic	-International	Statement of unaudited financial results for the quarter ended 30th June 2016	Ind AS
4	**Customers**	TATA Consultancy Services Limited	Information Technology	-Banking, Financial Services and Insurance -Manufacturing -Retail and Consumer Business	-Communication and Media Technology -Others	Ind AS Standalone financial statement for the quarter ended 30th September 2016	Ind AS

Step 3- Determination of a Reportable Segment

A reportable segment is a portion of business that generates its own revenue and incurs expenses and has its own assets and liabilities. An entity shall report separately, information about each operating segment.

Quantitative Thresholds

An entity shall report separately, information about an operating segment that meets any of the following quantitative thresholds:

- Its reported revenue, including both sales to external customers and intersegment sales or transfers, is 10% or more of the combined revenue, internal and external, of all operating segments or;
- The absolute amount of its segment reported profit or loss is 10% or more of 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 or;
- Its assets are 10% or more of the combined assets of all operating segments.

Information about other business activities and operating segments that are not reportable shall be combined and disclosed in an "all other segments" category separately from other reconciling items though sources of revenues included in this segment is required to be described.

However, operating segments that do not meet any of the quantitative thresholds may be considered reportable, and separately disclosed, if management believes that information about the segment would be useful to users of the financial statements.

If an operating segment is identified as a reportable segment in the current period in accordance with the requirement of this Standard, segment data for a prior period presented shall be restated to reflect the newly reportable segment as a separate segment, even though it did not satisfy the requirements in the previous period. The previous period may not be shown unless the necessary information is not available and the cost to develop it would be excessive.

If the total external revenue reported by operating segments constitutes less than 75% of the entity's revenue, additional operating segments shall be identified as reportable segments (even if they do not meet the above criteria) until at least 75% of the entity's revenue is included in reportable segments.

If an operating segment is identified as a reportable segment in the current period in accordance with the requirement of this Standard, segment data for a prior period presented shall be restated to reflect the newly reportable segment as a separate segment, even though it did not satisfy the requirements in the previous period. The previous period may not be shown unless the necessary information is not available and the cost to develop it would be excessive.

Aggregation Criteria

Operating segments often exhibit similar long-term financial performance if they have similar economic characteristics. For example, similar long-term average gross margins for two operating segments would be expected if their economic characteristics were similar. Two or more operating segments may be aggregated into a single operating segment if aggregation is consistent with the core principle of this Ind-AS, the segments have similar economic characteristics, and the segments are similar in each of the following aspects:

(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.

Companies such as Infosys, aggregate and disclose enterprises in Hi-tech, enterprises in Life Sciences, Healthcare and Insurance under one Business segment HILIFE. (*Source: Ind AS Financial Statements for the quarter ended 31 December 2016*)

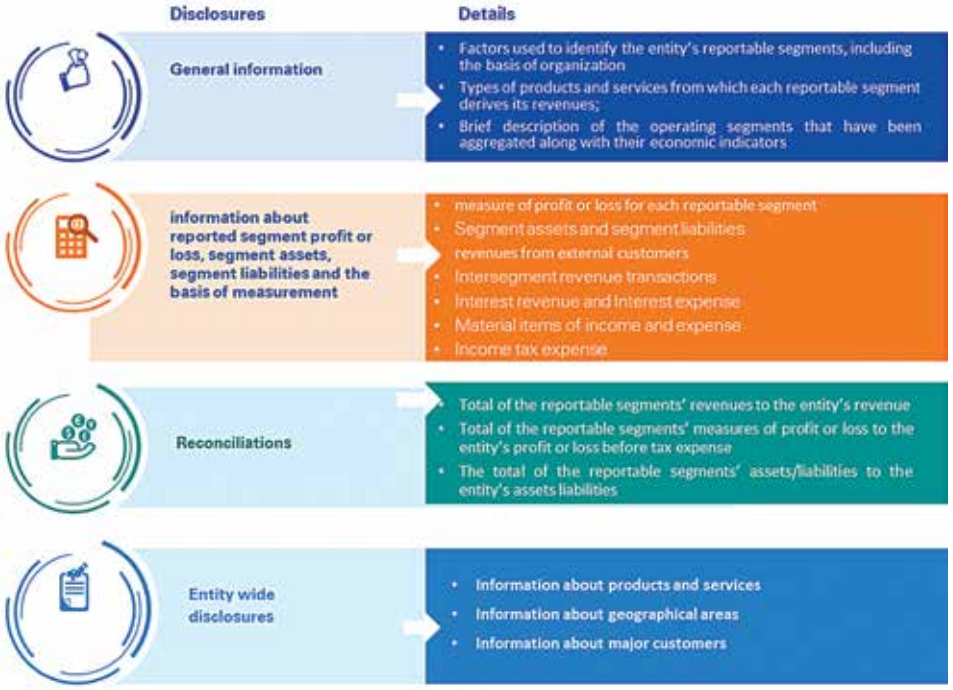
Practical Difficulties- Changes in composition of Reporting Segments- Events might occur- e.g. a significant internal re-organisation or implementation of a new financial reporting system- that change the composition of the operating and thus reporting segments. In these cases, the financial results may be grouped and reported differently to the CODM. These events require careful understanding

of changes and appropriate reporting. The reported segments reflect the revised/re-organised view of the company. Infosys Limited in March 2016 re-organised its internal reporting structure and thus re-aligned its operating segments. Extract from financial statements "Effective April 1, 2015, the Company reorganised its segments to support its objective of delivery innovation. Consequent to the internal reorganisation, Growth Markets(GMU) comprising enterprises in APAC (Asia Pacific) and Africa have been subsumed across the other verticals and businesses in India, Japan and China are run as standalone regional business units (*Source: Infosys Financial Statements 31 March 2016*).

Key difference between Ind-AS 108 and AS-17 in relation to Reportable Segments and Aggregation Criteria– Under the New Standard two or more operating segments may be aggregated into a single operating segment if the segments have similar economic characteristics and the segments are similar in aspects such as nature of products/ services, production process, class of customers etc.

Step 4: Required Disclosures in the Financial Statement of a Company

An entity shall 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. An entity shall disclose the following information:



Key difference between Ind-AS 108 and AS-17 in relation to disclosure on major customers– The current standard requires that if revenues from transactions with a single external customer amount to 10 per cent or more of an entity's revenues, the entity shall disclose that fact, the total amount of revenues from each such customer, and the identity of the segment or segments reporting the revenues. The entity need not to disclose the identity of the major customer or the amount of revenues that each segment reports from that customer. There was no such disclosure requirement under the previous standard.

Under the new Standard two or more operating segments may be aggregated into a single operating segment if the segments have similar economic characteristics and the segments are similar in aspects such as nature of products/services, production process, class of customers etc.

Conclusion

Segment Reporting has evolved with convergence with IFRS. This is expected to enable the reader of the financial statements to have more in-depth insight into how things are looked at from the boardroom. This results in not only a better understanding of the thought process behind management decisions but also amounts to better monitoring of these decisions. Greater transparency amounts to greater accountability leading to better understanding of the company to a stakeholder which is the key objective of this Disclosure Standard. ■