



SEPTEMBER 2007

EU ADOPTION OF THE IFRS 8 STANDARD ON OPERATING SEGMENTS

**Note for the ECON Committee of the
European Parliament 21 September 2007**

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EU Adoption of the IFRS 8 Standard on Operating Segments

Presentation by Nicolas Véron, Research Fellow at Bruegel
to the Economic and Monetary Affairs Committee of the European Parliament
19 September 2007

Background Note¹

EXECUTIVE SUMMARY

The IFRS 8 standard on operating segments was included in the IASB-FASB convergence program in February 2006 and subsequently adopted by the IASB in November 2006, in spite of widespread negative sentiment about it among investors and other users of financial statements, which the IASB should have given attention to but chose to ignore. Compared with what is provided under the existing standard IAS 14, the management approach on which IFRS 8 is based is not accompanied by sufficient safeguards to ensure that segments reflect economic reality and convey a proper understanding of risks. There are no requirements to make segment information consistent with consolidated information, which may negatively impact the value of the former. And geographical information is likely to be lost.

The Commission's Report on IFRS 8 does not provide an adequate basis for informed decision, due to severe methodological flaws and insufficient disclosure of feedback received by the Commission during the consultation phase. The current process which may lead to IFRS recognition in the United States does not provide a convincing argument to adopt IFRS 8 in view of the standard's shortcomings. To defend the objective of high-quality standards, the European Union should not adopt the current version of IFRS 8.

This note is intended for use by the Economic and Monetary Affairs (ECON) Committee of the European Parliament following the presentation I was invited to give on 19 September 2007, in an open coordinator meeting chaired by Joseph Muscat MEP and John Purvis MEP. The note's content is essentially the same as my oral presentation during that meeting, with additional quotes from written sources.

Bruegel is a European think tank devoted to international economics, which started operations in Brussels in 2005 with the support of a number of European member state governments and international companies. Bruegel aims to contribute to the quality of economic policymaking in Europe through open, fact-based and policy-relevant research, analysis and discussion. Its current research programme includes a variety of projects, including some which specifically relate to capital markets and financial regulation. Detailed information is available on www.bruegel.org.

My testimony on IFRS 8 is based on several sources, which include my own experience as chief financial officer of a publicly-listed company in 2000-2002, which at the time reported under French accounting standards and additionally adopted US GAAP for group

¹ A list of acronyms is included at the end of this note.

accounting purposes in mid-2001; my experience as a freelance consultant since 2002, with several assignments related to financial reporting matters; research underlying the publication of a book on accounting with two coauthors, in French in 2004 and in English with extensive revisions in 2006²; research at Bruegel since 2006, which led to the publication in April 2007 of a policy paper about IFRS adoption³; numerous discussions with market participants since the early 2000s in a variety of contexts; and research specifically undertaken for the purpose of this testimony.

IFRS Adoption Background

The background of the debate over IFRS 8 is the momentous adoption of IFRS in the European Union and other jurisdictions around the world since the early 2000s. While the international accounting standard-setting organization (then known as IASC) was established as early as 1973, it is important to remember that the spread of IFRS as a publicly-enforced financial reporting language is extremely recent. As recently as 2003, only about 5% of the world's 500 largest listed companies (FT Global 500 sample) used IFRS as their primary reporting language, and most were in jurisdictions in which public authorities were primarily focused on the enforcement of local accounting standards ('local GAAP') rather than IFRS. By contrast, in 2006 as many as 38% of the FT Global 500 companies used IFRS (as published by the IASB, or as adopted by local jurisdictions) as their primary reporting language. In most of the cases, the relevant securities regulators had by then become focused on IFRS enforcement. An additional 15% of the 2006 FT Global 500 reported under systems of accounting standards (such as Canadian GAAP, South Korean GAAP or Japanese GAAP) which are set to eliminating differences with IFRS in the coming half decade. Meanwhile, the share of the Global 500 reporting under US GAAP fell from 53% to 44% between 2003 and 2006, mirroring the declining proportion of US-headquartered companies in the sample⁴. In a matter of a few years, IFRS has grown from a relatively marginal presence to being the dominant financial reporting language for global companies.

The core reason for the IFRS' spectacular success so far is their orientation towards the needs of investors and other users of financial information, which is explicitly stated in article 10 of the International Accounting Standards Committee's 1989 Framework for the preparation and presentation of financial statements (or 'IASB Framework'⁵) and has been mostly maintained by the IASC until 2001 and by the IASB since that date. By enhancing the degree of trans-national and trans-sectoral comparability between companies, IFRS have provided a financial reporting language uniquely adapted to the needs of investors and other users in a globalizing financial market.

The catalyst for the recent IFRS spread has come from the European Union, which displayed extraordinary leadership in its decision to adopt IFRS, enshrined into EU law through Regulation 1606/2002 of July 2002. This decision can be argued as having triggered or decisively facilitated the adoption of IFRS in other jurisdictions such as Australia, Norway, Switzerland, Hong Kong, Singapore and China, and soon Israel, Brazil, Canada, South Korea or Japan among others – as well as the proposed IFRS recognition in the United States which is currently being discussed under the aegis of the SEC. Moreover, in the European Union the transition from local GAAP to IFRS in 2005-06 has been orderly and professionally managed, and a vast majority of investors and other users now consider that IFRS adoption and use has brought significant progress compared with the earlier situation. Therefore, the success of IFRS so far can be attributed both to market (investor) demand, and to EU leadership.

² *L'Information financière en crise* (Odile Jacob, 2004); *Smoke & Mirrors, Inc.: Accounting for Capitalism* (Cornell University Press, 2006); co-authored with Matthieu Autret and Alfred Galichon

³ *The Global Accounting Experiment*, Bruegel Blueprint series (April 2007), available on www.bruegel.org

⁴ I am grateful to Martín Saldías Zambrana at Bruegel for his research assistance in assembling the numbers quoted in this paragraph, based on FT Global 500 rankings available on www.ft.com.

⁵ The IASB Framework and its translations into European languages are available on www.ec.europa.eu.

However, these remarkable achievements should not hide the severe tensions that remain under the surface, and whose mention is relevant to the debate about IFRS 8.

One challenge is for the IASB to ensure continued acceptance and legitimacy. Given its light framework of governance and funding, maintaining independence from dominant influences and accountability to stakeholders is a first-order priority for the international standard-setter. Its effectiveness is challenged by the fast-moving financial environment and the gaps that still remain in the current set of IFRS, such as on insurance contracts or financial statement presentation. Its responsiveness to users' needs is not a matter of consensus, as the case of IFRS 8 illustrates. And the convergence process with US GAAP, which was given accelerated impetus by a memorandum of understanding (MoU) between the IASB and the US Financial Accounting Standards Board in February 2006, is far from universally accepted as an appropriate framework for setting the current standard-setting agenda.

Other challenges relate to endorsement, enforcement and implementation issues. This is the case in virtually all jurisdictions that have adopted IFRS, and specifically in the European Union as a consequence of its unique internal diversity. There is no consensus among market participants that the current legal and regulatory arrangements will be sufficient to bring the level of comparability which had been hoped to result from the introduction of IFRS, even after the inevitable hesitations of the initial few years. Concerns about the quality of financial reporting under IFRS have not been assuaged. Many see a risk of fragmentation of practices along national lines, or of insufficient control of assumptions underlying complex measurements or model-based accounting entries.

Even though the use of IFRS has now spread largely beyond Europe, the European Union has an important responsibility in managing these tensions and ensuring the success of what is still, at this point of time, an experiment. By assuming leadership in IFRS adoption, the EU has also accepted de facto leadership in the endorsement and implementation of the standards, and must now rise to the corresponding obligations. In particular, its decisions to adopt or not adopt particular standards have worldwide resonance.

Segment reporting

This section is not meant as a comprehensive discussion of all accounting questions related to segment information, but as a summary that may be helpful to inform the MEPs' analysis.

Segment information is one of the most vital aspects of financial reporting for investors and other users. As most listed companies are complex, heterogeneous groups, segment information provide users the key to understanding corporate business models and economic dynamics. It allows external observers to understand the respective risks and value potentials of different lines of business, the synergies or inefficiencies that may make a group more or less than the sum of its parts, and the underlying corporate strategy. Segment reporting does not primarily pose measurement or recognition challenges and therefore tends not to be a primary focus of academic experts in accounting. But it is no less essential to users for that. If anything, its importance is enhanced by the adoption of IFRS: users find in segment information a real-economy depiction of a company's operations which is complementary to the complex measurements and calculations involved under IFRS in accounting for, say, goodwill impairment or financial instruments.

Setting standards for segment information is also inherently divisive between preparers of financial statements (mostly listed companies) on the one hand, and investors and other users on the other hand. Precisely because segment information provides so many indications about business models and the economic reality of a company's operations, preparers generally desire to control it tightly, while users want it to be specifically objective and non-distorted. Segment information thus illustrates the tension at the core

of the capital markets bargain, by which companies gain access to inexpensive capital in exchange of transparency about their situation and operations. This explains the vivid debates on segment reporting standards since the emergence of industrial conglomerates in the US in the 1960s. Unlike some other accounting issues, segment reporting standard-setting has never been a consensual matter.

Also, segment reporting is inherently difficult to standardize. Operating segments are different from one company to another, and even within the same industry they do not necessarily correspond to exactly the same activities. Geographical segments, likewise, vary widely, as each company has its own way of considering international markets and establishing a presence in them. This explains the variety of approaches which coexist in this area.

Historically, after the initial attempts of the late 1960s the first fully-fledged segment reporting standard has been SFAS 14 (part of US GAAP), adopted by FASB in 1976. SFAS 14 was mirrored in the corresponding international accounting standard, IAS 14. It was based on the so-called industry approach, under which each segment was meant to correspond to a broadly recognized industrial sector. This approach was initially developed for industrial conglomerates such as GE or ITT, but over time proved inadequate for certain groups, especially those with vertically integrated operations for which the industry lens is not the best through which value creation can be observed and understood. Therefore, in the late 1990s both FASB (in the US) and the IASC (at international level) revised their respective standards. This led to the adoption of SFAS 131 in the US, and of the revised international standard, also known as IAS 14, in 1997. In SFAS 131, FASB adopted the so-called management approach, under which the accounting segments shall correspond to the divisions used for management reporting purposes inside the company. By contrast, in the revised IAS 14 the IASC adopted the so-called risks-and-rewards approach, under which the accounting segments shall correspond to a meaningful division of a company's operations in terms of different levels of risk and potential of value creation. IFRS 8, adopted by the IASB in November 2006 (see below), was modeled on SFAS 131 and is very similar to it. As IAS 14 was adopted by the European Union in 2003 (regulation 1725/2003), the current discussion on the EU adoption of IFRS 8 involves a comparison between IAS 14 and IFRS 8, or between IAS 14 and SFAS 131 as the latter provides the basis on which IFRS 8 was modeled.

A first set of questions relates to the definition of operating segments and to the respective merits of the management approach and the risks-and-rewards approach. Put simply, the management approach has the advantage of grounding the definition of segments in concrete corporate practice, with the risk of it being subject to manipulation (because it is ruled by managerial discretion) or to unnecessary instability or inconsistency due to the vagaries of management fads. The risks-and-rewards approach has the advantage of providing objective economic criteria for segment definition, with the risk of additional cost of preparing the data (if it is not readily available to management) and of disconnect from daily corporate practice. Users generally see value in the management approach so long as it does not lead to distortion of the economic depiction of operations. The two approaches are far from contradictory. Indeed, IAS 14 encourages the use of management segments if they meet the test of similar risks and rewards. In many cases, the two approaches may lead to the same definition of segments. All the same, it is worth remembering that the aims of financial accounting differ fundamentally from those of management accounting, and there is no reason that indicators used internally to measure performance and set individual incentives are always the most adequate for external investors to form investment decisions.

A second set of questions relates to the granularity of operating segments, and correspondingly the level of detail provided to users of financial statements about the company's operations. On this count, IAS 14 and IFRS 8 are similar in their philosophy and effects. Neither leads to the disclosure of as many segments as most investors would like; and both are resented by small- or medium-sized enterprises (SMEs) which feel that their smaller size would justify providing fewer segments than larger corporate entities (additional disclosures required by IFRS 8 are also specifically resented by SMEs).

However, investors have constantly insisted that as SMEs also may cover a variety of different lines of activity, segment reporting is as much justified for them as for the largest groups.

A third set of questions relates to the content of segment information, in other words the financial disclosures which are made for each segment once defined under one or the other approach. On this, IFRS 8 (as SFAS 131) allows for much more discretion than IAS 14, which requires consistency with definitions of financial aggregates in the consolidated financial statements. By contrast, IFRS 8 allows for inconsistent aggregates, e.g. the use of EBITDA or other 'pro forma' measures of performance which are not used in the consolidated financial statements. From this perspective, IFRS 8 would arguably lead to larger difficulties if adopted in the EU than SFAS 131 does in the US, because the US have relatively homogeneous national business practices and a single, authoritative financial reporting enforcement agency, the SEC. By contrast, EU member states have widely diverging traditions of financial reporting and no unity of accounting enforcement, which may lead to severe inconsistencies in the content of segment information given the low level of safeguards provided by IFRS 8. The risk is to end up with ad hoc segment information which conveys much less understanding about performance and risk than what is currently provided under IAS 14.

A fourth set of questions relates to geographical information. IAS 14 requires a number of geographical disclosures by all companies. By contrast, IFRS 8 allows companies to avoid providing geographical information on grounds of the cost of producing it. Indeed, my research practice at Bruegel on large global companies (much of which relies on listed companies' geographical disclosures⁶) suggests that the quality of geographical information is generally higher for EU companies using IAS 14 than for US companies using SFAS 131. Geographical information is important to financial users to understand risks, especially those linked to country or regional factors, such as those risks which materialized during the Asian or Russian crises of the late 1990s. Finally, geographical information is also of high interest to non-financial stakeholders such as NGOs or corporate social responsibility observers, even though under the IASB Framework their needs have less priority than those of financial users for consideration in the standard-setting process.

To summarize, each of the two standards (IAS 14 as already adopted by the EU, and IFRS 8 as considered for adoption) has benefits and shortcomings. Preparers (listed companies) overwhelmingly tend to have a preference for IFRS 8, which leaves them more discretion to define segments and segment information as they desire, imposes lower costs for the production of segment data, and restricts the need for geographical disclosures which companies are generally reluctant to provide, not least because of their potential politically sensitive nature. Users (including investors among them) overwhelmingly tend to have a preference for IAS 14, which brings them a more reliable and stable definition of segments, significantly higher comparability and reliability of segment information, a less distortable basis for valuation and risk assessment, and the additional benefit of continuity as it is already implemented by EU companies since 2005. Auditors are somewhat divided internally, with technicians tending to prefer IAS 14 but commercial and institutional arguments weighing in favour of IFRS 8. The next section graphically attests this general picture, with reference to both the responses to the consultation on Exposure Draft 8 by the IASB in 2006, and the responses to this year's consultation on IFRS 8 by the European Commission.

IFRS 8 Adoption Process

In addition to the content of the segment reporting standard, it is relevant for MEPs to give consideration to the process under which it was adopted by the IASB and examined by the EU. The description of this process illustrates the challenges of users' involvement

⁶ See for example *Farewell National Champions*, Bruegel Policy Brief 2006/04 (June 2006), available on www.bruegel.org.

in accounting standard-setting. Investors and other users of financial statements are the key constituency to whose needs the standards are proclaimed to respond, but there is a significant asymmetry between the resources they commit in the standard-setting process and those of other stakeholder groups. This is significant as we noted in the previous section that segment reporting is a matter on which preparers' and users' viewpoints may diverge markedly.

The IASB process (2006)

The IASB published its exposure draft (ED) on operating segments, or ED8, in early 2006 just after the conclusion of the already mentioned memorandum of understanding (MoU) with FASB on their joint convergence program, which included segment reporting as a priority project. The inclusion of segment reporting in the convergence program had been controversial inside and outside the IASB and judged by some as unnecessary, because segment reporting is about disclosure rather than measurement and recognition, and therefore does not pose major difficulties of reconciliation between different systems of standards. Unlike for some other convergence projects which give rise to the drafting of new standards by the IASB and FASB jointly, the MoU indicated that the convergence of segment reporting would be attained by the alignment of the IFRS on existing US GAAP provisions. Thus, ED8 was quickly released as a nearly identical standard to the existing SFAS 131.

It is to be noted that the February 2006 convergence MoU, which has been the dominant driver of the IASB's agenda since then, has itself been submitted to no consultation of stakeholders. Only individual projects listed in the convergence program have given rise to consultations under the IASB's due process, including ED8 in the course of 2006, about which a number of letters were received by the IASB in the spring of 2006 and published on the IASB's website.

I have reviewed several of these letters, notably those from the big four audit networks, the CFA Institute (which represents financial analysts worldwide), the Corporate Reporting User Forum (CRUF, which assembles prominent global asset management firms), EFRAG, Fidelity International, HSBC, the Institute of Chartered Accountants of England & Wales (ICAEW), the UK Investment Management Association (IMA), HSBC, the Quoted Companies Alliance (QCA), the Société Française des Analystes Financiers (SFAF), Standard & Poor's (S&P), and a later letter from George Soros on behalf of the Open Society Institute. The picture that emerges is a marked absence of consensus on the timing of the IFRS 8 project, including with consideration to the IASB-FASB convergence program; the content of the standard, including the shift to the management approach; and the direction it means for IFRS. Following are selected excerpts from some of the most authoritative and representative respondents.

- From the CFA Institute letter, which is based on an extensive empirical survey (18 May 2006): "the current [ED8] proposal will not result in sufficient segment disclosures"; "convergence with SFAS 131 is premature" and "occurring in the wrong direction"; "unfortunately, it has been our experiences with tracking US firms that apply SFAS 131, that geographical information for operating segments is often not disclosed. If disclosure is discretionary, then often the information is not provided. In the case of geographical information, we believe *strongly* [their emphasis] that the information should be required whether or not it is currently available. As indicated in the 2006 survey, **82%** [their emphasis] of respondents believe that geographical information should be provided for segment disclosures"; "Overall, we are disappointed in the segment information currently available under SFAS 131 and believe it to be inferior to the information required by IAS 14".
- From the CRUF's letter (19 May 2006): "we would ideally like to see a joint IASB/FASB project to improve on both standards rather than simply adopting SFAS 131 largely unchanged. If the IASB does not wish to do this then we would agree with the adoption of SFAS 131 only if accompanied by the improvements that we outline below" [which were not included in the final version of IFRS 8]; "We do not

agree with the level of reconciliation required in ED 8. We believe that the reconciliation to GAAP figures should be done at the level of the individual segments”.

- From Deloitte’s letter (12 May 2006): “Segmental reporting is solely a disclosure requirement, and so does not affect reconciliations between IFRS and US GAAP. [...] If the two Boards [IASB and FASB] believe IAS 14 *Segment Reporting* needs improving, they should do so by considering the advantages and disadvantages of both it and SFAS 131, rather than converge to a single standard that has not proved to be superior, and we believe to be inferior”; “we believe that the move to ED 8 is not only an unnecessary change, but also a step backwards”.
- From the EFRAG letter (15 June 2006): “Having considered all these arguments [about the choice of the management approach by FASB in the 1990s; (in)consistency between segment information and consolidated financials; (in)consistency between management information and IFRS financial reporting; the need for giving precedence to the management’s view; and the convergence program] carefully, we have not been persuaded that requiring the management approach for measuring segment data will, if the convergence effect is ignored, result in an improvement of the information provided”. EFRAG then suggests a change to the standard which in its view would allow a positive opinion on its endorsement, but this change was not subsequently adopted by the IASB in the final version of IFRS 8.
- From the HSBC letter (22 May 2006): “The draft IFRS [8] is a mixture of principles and rules, however we find the approach too rules-based and prescriptive. We understand that the draft IFRS is in effect intended to bring in the current US approach to segmental reporting as part of the convergence agenda, but it is disappointing that the opportunity was not taken to achieve a more effective balance of clear principles with a minimum of detailed rules, in the manner that has been achieved with other recent [IFRS] standards. It is necessary for us to add that it is disappointing the Board does not seem to appreciate the necessity for a period of stability following the initial implementation of IFRS”.
- From the ICAEW letter (May 2006): “We do have concerns with ED 8 as it stands (and therefore indirectly with SFAS 131). We believe that ED 8 should be improved at this stage of the convergence process, in so far as these improvements are not inconsistent with SFAS 131. We would then urge the IASB and FASB to prioritise development of a joint standard on segment reporting”; “segment reporting (...) is central to providing an understanding of the business. It should therefore be a priority concern of standard setters. In our view, ED 8 lacks a strong underlying principle that would recognize the importance of segment reporting and underpin a robust standard”.
- From the QCA letter (a forum of smaller listed companies, 16 May 2006): “QCA (...) believes (...) ED8 to be an unwelcome and unnecessary addition to the rapidly changing financial reporting regime”; “SFAS 131 is a disclosure standard and therefore does not affect the reconciliation of IFRS amounts to US GAAP, though additional disclosures might be needed to comply with US GAAP. QCA does not believe therefore that ED8 is necessary. Additionally QCA questions the usefulness and relevance of a management approach to segmental reporting. We believe that in adopting a management approach there is significant risk that information reported would not be prepared in accordance with accepted GAAP and that summarized information would be distorted by the aggregation of unlike items”.
- From the Standard & Poor’s letter (19 May 2006): “We are very supportive of convergence of global accounting standards and IFRS-US GAAP convergence, but at the same time do not believe there is an immediate need in that context, to replace IAS 14 with a near replica of SFAS 131”; “simply replacing the existing IAS 14 with SFAS 131 is not a solution we support. We appreciate the Board’s desire to eliminate IFRS-US GAAP reconciliation differences but segment reporting does not impact the reconciling items, as there is already a specific exemption for foreign registrants using IFRS (or other home country GAAP) from the requirement to reconcile the segment

amounts to US GAAP"; "Segment reporting is a very valuable disclosure for users of the financial statements and in an attempt to force convergence the Board should not lose the opportunity to enhance the overall quality of segment disclosures".

Despite the absence of consensus in favour of IFRS 8, the IASB decided to adopt in November as IFRS 8 a text which was virtually identical to ED 8. Two full-time Board members, Gilbert Gélard and James Leisenring, expressed dissent, "because [IFRS 8] does not require a defined measure of segment profit or loss to be disclosed and does not require the measure of profit and loss reported to be consistent with the attribution of assets to reportable segments". The dissenting opinion includes the comment that "Messrs Gélard and Leisenring also believe that the changes from IAS 14 are not justified by the need for convergence with US GAAP. IAS 14 is a disclosure standard and therefore does not affect the reconciliation of IFRS amounts to US GAAP, though additional disclosure from what is required now by IAS 14 might be needed to comply with US GAAP".

The EU process (2006-07)

EFRAG's report on IFRS 8 to the European Commission was delivered on 16 January 2007 after a brief consultation, part of which was conducted during the holiday period of late December 2006. It recommends adoption of IFRS 8 but notes internal dissent and that "some EFRAG members however remained unconvinced that it was an improvement". EFRAG was established by the private sector in 2001 and is currently structured around a Technical Expert Group (TEG) of 12 voting members, of which 6 auditors, 4 preparers of financial statements, one academic and one sell-side financial analyst. EFRAG has a User Panel of 14 members but these have no role in TEG appointments and do not take part in votes. Therefore, although EFRAG brings together high-quality technical expertise, it cannot be considered to represent the voice of users in standard-setting discussions.

Following EFRAG's advice the Accounting Regulatory Committee of the EU met in February and unanimously voted in favour of adopting IFRS 8.

In early 2007 the Commission selected independent experts to form the Standards Advisory Review Group (SARG) in order "to ensure objectivity and proper balance of the European Financial Reporting Advisory Group's (EFRAG) opinions" and "to assess whether the endorsement advice given by the EFRAG is well balanced and objective". SARG first met on 2 March 2007. However, the Commission did not ask SARG to comment on IFRS 8.

In the meantime, a number of investor groups and other stakeholders alerted the EU institutions about their concerns regarding the adoption of IFRS 8. As a consequence, the European Parliament's ECON Committee tabled a motion expressing its concern on 18 April 2007. On 24 April 2007, the Commission sent a letter to the ECON Committee Chair, committing to delay the enforcement decision until 30 September 2007 at the earliest and to carry out further consultations and an impact assessment (following this letter the motion was not subjected to a vote by MEPs). The Commission then published a questionnaire and collected responses from a variety of stakeholders groups, which form the main basis for its Report on IFRS 8⁷.

The European Commission deserves much praise for its remarkable work carried out since the late 1990s to prepare and help implement the EU decision to adopt IFRS. Thanks to the Commission's efforts, the Regulation 1606/2002, which governs IFRS adoption, and subsequent regulations and other texts have been adopted in due time and provide a strong basis for the use of IFRS in the EU. Given these remarkable achievements, it is disappointing that the Commission's Report on IFRS 8 is based on a flawed approach to consultation, and fails to provide an adequate basis for informed decision.

⁷ European Commission, *Endorsement of IFRS 8 Operating Segments: Analysis of Potential Effects – Report*, Ref. MARKT F3 D(2007), 3 September 2007

As explained above, segment reporting is a matter in which the interests and viewpoints of investors and other users of financial information may diverge markedly from those of preparers and other stakeholders. The Commission implicitly recognized this by complementing its general questionnaire with subsequent questionnaires specifically targeted at users on the one hand and preparers on the other hands. The Commission also rightly describes criticisms to IFRS 8 by stakeholder groups in section 4.2 of the Report, when reporting on the IASB and EFRAG consultations. It is all the more unfortunate that these viewpoints are not reported separately in the subsequent section 6, which presents the feedback received by the Commission on its own consultation, even on questions which were asked separately to preparers on the one hand and users on the other hand. The Report systematically uses language such as “the majority of commentators consulted by the Commission Services have indicated that” or “the majority of respondents to our consultations believe that”, without indicating to which category of stakeholders these respondents belong.

Annex 1 of the Report gives statistics on respondents but these include a catch-all ‘Organisations’ category which mixes users, preparers, auditors and other stakeholder interests. Furthermore, the categorization is partly inaccurate. For example, Annex 7 shows Bear Stearns, Banca Carige, Nordnet Bank AB, or the Cyprus Institute of Chartered Accountants being classified as ‘users’, which does not correspond to generally accepted practice. Helpfully, Annex 7 also displays a complete list of 180 respondents (numbered 1 to 186) which can be ranked as follows, using generally accepted stakeholder categories. Preparers: 94 (52%); NGOs and individuals: 36 (20%); auditors and standard-setters: 31 (17%); public institutions and universities: 10 (6%); investment firms and user groups: 9 (5%). These numbers imply that a point that would be shared only by preparers could qualify as that of “the majority of respondents”. Statements such as “the majority of commentators believe that the segment information provided under IFRS 8 is more relevant and more useful for users of accounts” (page 17) are technically accurate but could prove seriously misleading. The primary device for understanding users’ views should be to look specifically at users’ responses, even if these are outnumbered by other stakeholders. Other participants’ views on user interests could be also reported, but as complementary information. As earlier expressed, user firms and organizations tend to be much smaller and have fewer technical staff than those which represent the interests of preparers or have dominant commercial links with preparers, such as the audit community. This obvious fact should have been taken into account by the Commission in its Report.

The 9 respondents which respond to usual characterization as users of financial statements, outside the NGO community, are, in alphabetical order at listed by the Commission: EFFAS (the European Federation of Financial Analyst Societies); Eumedion (an organization of Dutch institutional investors); Fidelity Investments (a global investment management firm); Governance for Owners LLP (GO), and Hermes Investment Management Ltd (two investment funds); ICGN (the International Corporate Governance Network, which brings together institutional investors from around the world); the UK Investment Management Association (IMA); the UK National Association of Pension Funds (NAPF); and the Société Française des Analystes Financiers (SFAF)⁸. Of these nine respondent, seven (EFFAS, Eumedion, GO, Hermes, ICGN, NAPF, SFAF) can be considered essentially independent from other stakeholders’ interests, while two (Fidelity and IMA) depend on preparers for a significant share of their client base (in IMA’s case, of the client and shareholder base of its member firms).

Seven of the nine letters from investment firms and user groups are overwhelmingly critical of IFRS 8. The remaining two are Fidelity, which recommends endorsement, and IMA, which changed its stance from negative in March 2007 to positive (although with lingering reservations) in June. Following are selected excerpts from the letters.

⁸ I am a member of the ICGN’s Accounting and Auditing Practices Committee, and I attend the meetings of the SFAF’s Accounting and Financial Analysis Committee. However, I did not take any leading role in drafting the ICGN’s and SFAF’s respective contributions in the Commission’s consultation on IFRS 8.

- From the EFFAS letter (29 June 2007): "Regarding the relevance of the published segment information, IFRS 8 seems to imply that the geographical breakdown is of much less importance. Actually, in several occasions (Asian or Russian crisis...), geographic information turned out to be the most important one. In those cases, moving from IAS 14 to IFRS 8 will clearly suppress the relevant information"; "Providing information in the management approach will allow two companies with identical businesses to have different segments for reporting just because they are organised or managed in different ways. Identifying segments on the basis of similar risk and reward should avoid this situation: companies with identical businesses should report identical segments. Lastly, we believe that segments based on management vision will inevitably change more often segment definition than with a definition of segments based on similar risk and rewards"; "Moving from IAS 14 to IFRS 8 will thus reduce considerably the comparability of segment information, which would be a considerable loss for users of financial information"; "on the longer term, it [replacing IAS 14 with IFRS 8] will make analysts less comfortable with segment reporting information and will result in valuations with discounts".
- From the Eumedion letter (29 June 2007): segment information "is undeniably of increasing importance"; "In converging standards, quality should be the decisive factor. Where there is no agreement between the regulators and/or endorsers, reason should prevail. In those instances, it is better to have two standards which are considered equivalent than one standard, perceived – at least by an important segment of the users – as being of lower quality".
- From the Fidelity letter (not dated): "The key for us as shareholders in looking at the standards for financial statements is the core principle in IFRS: '*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.*' Provided that IFRS 8 is implemented in a way which is consistent with this principle, then we believe that the European Commission should endorse IFRS 8".
- From the Governance for Owners letter (29 June 2007): "We are also concerned that the information prepared under IFRS 8 would not be as reliable, comparable or understandable as that prepared under IAS 14"; "Of course, we are focusing on a minority of companies that are probably trying to conceal poor performance. But these are exactly the companies that will exploit loopholes. It seems to us that it would be much easier to misapply IFRS 8 than IAS 14 and thus misrepresent business activities"; "In summary, we believe that the 'management approach' taken in IFRS 8 has some merit but that as drafted the standard allows too much discretion with too few checks on executive management".
- From the Hermes letter (not dated): "We believe that there is a negative cost/benefit balance from a shift from IAS 14 to IFRS 8 because there is a minimal cost differential but – unless the appropriate checks and balances are put in place – a significant reduction in benefits".
- From the first ICGN letter (9 May 2007): "IFRS 8 removes the risk and reward criteria that are in IAS 14 for assessing the sufficiency of information that is presented (or not presented) to shareowners and public markets, and also in the wider public interest. IFRS 8 also removes geographical segmentation, which is undoubtedly important for investors"; "The risk with IFRS 8 is not about strong companies, but about those that have management who are not delivering, or have something to hide, which could then be passively assented to by non-executives and auditors due to the prescription of the standard allowing it". From the second IFRS letter (29 June 2007): "The ICGN does not believe that convergence itself is a sufficient objective to justify replacing a superior standard with a less effective one if there is any threat to investment returns or investor protection. Convergence should occur by attaining the highest quality. Overall, IAS 14 is a stronger standard in respect of identifying business risk and financing risk, and then disclosing this"; "We recommend the EU

keep IAS 14 as the endorsed standard until it can be demonstrated that a clearly improved standard should be implemented”.

- From the first IMA letter (9 March 2007): “we believe it would be premature for the Commission to consider endorsing IFRS 8 and US requirements for segmental reporting, and that it should defer such a decision until these matters have been further progressed and a better consensus achieved”. From the second IMA letter (29 June 2007): “from the perspective of our members as investors in major companies whose securities are traded on regulated markets, IMA has certain reservations which were set out in our letter to the Commission dated 9 March 2007. While we continue to have these reservations, we do not believe that they should stand in the way of the broader aim of convergence and in particular, the proposed consultation announced by the SEC on 24 April 2007 on changes to its rules to allow the use of IFRS in financial reports filed by foreign private issuers registered with the [Securities and Exchange] Commission”.
- From the first NAPF letter (15 March 2007): “in addition to the specific weaknesses, the thinking behind IFRS 8 is a harmful precedent for any standard. [...] Convergence should be about maintaining standards and preferably raising them. In this instance we see standards potentially lowered, to the detriment of shareholders”; “The IASB has said that IFRS 8 will not need to be adopted until 2009. In view of the fact that the convergence path may well change, given the SEC’s planned review, it would seem wise for the EU not to adopt IFRS at this time”. From the second NAPF letter (3 July 2007): “Since the NAPF wrote to the Commission on IFRS 8 [on 15 March], it is now clearer to us that the governance principles underpinning IFRS 8 may be contrary to the principles and the requirements set out in Directive 2006/46/EC, for financial information and non-financial information applying to all EU member states. The NAPF is also concerned with the lack of objective economic risk and reward criteria in IFRS 8, whether it means that businesses may be obscured by amalgamation, or in some circumstances being a contributory factor to not being consolidated at all”.
- From the SFAF letter (28 June 2007): “We consider that the management approach is much less relevant, reliable, comparable, understandable and useful than information prepared under IAS 14”; “We consider that IFRS 8 is not an improvement versus IAS 14. Maintaining IAS 14, as this standard has been used by quoted companies for over two years, should not be a cost/benefit issue. From our point of view, the benefits associated to the implementation of IFRS 8 are much lower than with IAS 14”; “We consider that a well documented segment information on a geographical basis is missing in IFRS 8”.

These are substantial, diverse views, which overwhelmingly contradict the view expressed by “the majority of commentators” in the Commission’s consultation, according to which “the segment information provided under IFRS 8 is more relevant and more useful for users of accounts”. It is regrettable that the Report does not display them in a meaningful way, and instead exclusively uses a quantitative approach of counting responses which does not reflect the diversity of stakeholders. Of course, the point of view of preparers of financial statements is a legitimate one in the debate about segment reporting, but in the interest of standards quality it should not form the sole basis for policy decision.

It is also unfortunate that the Commission did not publish the responses it received on its website at the same time as it published its own Report on IFRS 8. By acting so, the Commission did not comply with best practices of market consultation. I thank the Commission for gracefully providing me some of the contributions quoted above, at my request after the presentation on 19 September. But the broader public should have been allowed to read them as well and in due time.

The Transatlantic Context

Because segment reporting is about disclosure, in the notes attached to the financial statements rather than in the financial statements themselves, it does not feature high in discussions related to reconciliation between different systems of accounting standards. For companies with dual listing, it is actually most often possible to produce segment information which is consistent with both IAS 14 and SFAS 131, or which requires only minor reconciliation adjustments. Therefore, the sometimes heard argument that not adopting IFRS 8 would create significant reconciliation problems is overblown. Indeed, the fact that segment reporting is about disclosure and not about recognition or measurement leads to question why it has been included as a priority project in the IASB-FASB February 2006 MoU on convergence at all, as illustrated by comments from various market participants (see quotes in the previous section, e.g. Deloitte, QCA, S&P) and by the already quoted dissenting opinion of Gilbert Gélard and James Leisenring within the IASB. Standard & Poor's actually indicates that "there is already a specific exemption for foreign registrants using IFRS (or other home country GAAP) from the requirement to reconcile the segment amounts to US GAAP", although I have not had the opportunity to verify the exact form of this apparently existing exemption.

Moreover, the previous section illustrates that concerns about IFRS 8 are not limited to European stakeholders, but are shared by many users across the Atlantic. The previously quoted letters from the CFA Institute and the International Corporate Governance Network, perhaps the two most authoritative organizations that represent users of financial information at global level, were both signed by executives based in the United States. And James Leisenring, one of the two IASB dissenters on IFRS 8, is well known in the accounting community for frequently heralding 'American' views in standard-setting debates. When he states that "the changes from IAS 14 are not justified by the need for convergence with US GAAP. IAS 14 is a disclosure standard and therefore does not affect the reconciliation of IFRS amounts to US GAAP", his voice carries weight.

Several participants have expressed the view that if the EU chose not to adopt IFRS 8 shortly, it would endanger the process of IFRS recognition which is underway in the United States. In 2005, the SEC agreed on a 'roadmap' to eliminate by 2009 the so-called reconciliation requirement, under which foreign issuers currently must reconcile (explain the differences in) their financial statements with US GAAP, for those issuers which report their financials using IFRS. On 30 April 2007, at a Transatlantic summit in Washington DC, accounting standards were mentioned by José Barroso in the presence of George Bush and Angela Merkel as being part of a high-level Transatlantic regulatory convergence agenda, as SEC Chairman Christopher Cox had publicly emphasized the day before. On 20 June 2007, the SEC approved for public comment a proposal to accept financial statements from foreign issuers using IFRS without having to reconcile them to US GAAP. In addition, on 7 August 2007 the SEC published a concept release requesting comment on whether US issuers should also be allowed to publish financial statements using IFRS rather than US GAAP.

But this sequence of events illustrates the robustness of the process by which the SEC may recognise IFRS, rather than its fragility. In fact, the spectacular steps forward made in 2007 came just *after* the European Commission decided to delay the decision-making process on IFRS 8 on 24 April 2007, following the expression of concern by MEPs. The US authorities are perfectly informed of European developments and have nevertheless decided to proceed. Indeed, because segment reporting (for the above mentioned reasons) is not a contentious reconciliation item, the fact that it is adopted or not in the EU is unlikely to have a significant influence on the mutual recognition discussion – unlike, say, the 2004 EU carve-out in IAS 39, or possible future controversies on the accounting treatment of business combinations.

Actually, the opposite view could be defended. The biggest risk to IFRS recognition in the US is not a failure by the EU to adopt all standards, but a perception that IFRS are not standards of the highest quality. In this respect, the actual decrease in quality, which in my opinion is brought by replacing IAS 14 with IFRS 8, may do more harm than good to

the long-term prospects of IFRS accounting in the United States. Congress has so far been non-committal about the Executive Branch's and the SEC's initiatives on accounting standards convergence. But there is always a risk of this discussion acquiring a political dimension, especially at a time when Congress and the Executive Branch do not share the same orientation. If congressional democrats were to intervene in accounting, they would be likely to do so on behalf of investors' interests, and from this point of view the replacement of IAS 14 with IFRS 8 would not weigh in positively for IFRS.

Ultimately, the European position in the Transatlantic debate on convergence and mutual recognition is best served by adopting the highest-quality standards in the EU, and ensuring high-quality implementation as well – a matter not directly related to IFRS 8 but which should also feature high among European policymakers' priorities⁹. This is evidenced by the original 'Roadmap' document of 2005, in which then SEC Chief Accountant Donald Nicolaisen outlines the philosophy and criteria of eventual IFRS recognition in the United States¹⁰.

As a consequence, and in spite of the often heard argument, my opinion is that convergence and US recognition of IFRS are not compelling arguments in favour of adoption of IFRS 8 in the EU, especially when weighed against the significant shortcomings of IFRS 8 compared with the presently applicable standard IAS 14.

Timing considerations

It is sometimes argued that the EU should urgently make a decision in favour of IFRS 8. However, I see no reason to rush towards a decision. Unlike, say, reporting for insurance contracts (for which the current standard IFRS 4 is explicitly transitional and unsatisfactory when weighed against the IASB Framework and the objectives set out in Regulation 1606/2002), segment reporting is already covered by an existing standard, IAS 14, which is certainly not perfect but far from low-quality. Moreover, implementation of IAS 14 has only recently started and for the sake of high-quality financial reporting, it would be beneficial to let practice under IAS 14 stabilise over the next few years. This would also be beneficial to users, for which yet another change of standards in a short period of time would create unnecessary difficulties in analyzing and understanding the information disclosed by companies.

Furthermore, IFRS 8 is in any event not meant as the final standard on segment reporting. Actually, it has become clear this year that the project on 'Financial Statements Presentation' (previously known as 'Performance Reporting', on how to present financial statements in order best to display companies' situation and performance) would include wide-ranging changes in segment information. This project had been frozen for some time and has only recently been revived under the leadership of FASB. It is likely that the debates on Financial Statements Presentation will last several years before the corresponding new IFRS standard is adopted by the IASB. But it also means that, were the EU not to adopt IFRS 8, this would not create a permanent difference with IFRS as published by the IASB. Supposing the new Financial Statements Presentation standard, which may be ready early in the next decade, is of high quality and is adopted by the EU, the difference created by the non-adoption of IFRS 8 will have been temporary, and to the benefit of the quality of financial reporting in the EU.

⁹ I discuss the issue of IFRS implementation in Europe at length in *The Global Accounting Experiment* (Bruegel, April 2007). In this essay, I suggest setting up a European Accounting Agency or European Chief Accountant, which would be in charge of ensuring consistency in implementation across borders between different European countries, and of issuing relevance guidance to reach this aim. Such a reform would also strengthen Europe's voice in global accounting debates and would reinforce the sustainability of IFRS adoption in the EU.

¹⁰ Donald Nicolaisen, "A Securities Regulator Looks at Convergence", published in *Northwestern Journal of International Law and Business*, 25 (3), April 2005

Policy Recommendation

In accounting discussions and decisions, the highest objective of the EU should be to defend high-quality standards for investors and other users. This has been the driver behind the adoption of IFRS since 2002, which so far has represented a uniquely successful assertion of leadership by the European Union. By contrast, were standard-setting not primarily driven by this quality objective, the very rationale for IFRS adoption would be threatened.

The IASB has generally been effective in producing high-quality standards, but has lapsed in the case of IFRS 8, as is well illustrated by generally negative user sentiment about this standard. While the reasons for this lapse are not entirely clear, they may include the willingness to give precedence to short-term convergence with US GAAP over standards quality in the eyes of investors and other users. This is not in the best interests of users and of the IFRS project itself, which critically depends on user support.

One could argue (and several market participants have suggested) that the European Union should adopt IFRS 8 for the sake of convergence, and then issue additional requirements to correct that standard's weaknesses. These could include a test to ensure that the definition of segments is economically relevant; a requirement for consistency between segment information and consolidated financial statements; and a requirement for meaningful geographical information. However, under the current EU institutional setting it is difficult to see which EU authority could achieve this. Especially, CESR does not yet have a track record of issuing authoritative financial disclosure requirements, which have traditionally been in the hands of national securities regulators. Therefore, while this option has attractions, I do not see how it could be effectively implemented in the short term, and I do not think IFRS 8 should be adopted without such additional requirements.

In most advanced economies, it is not usually the role of Parliament to intervene directly in accounting standard-setting decisions. However, EU arrangements have given the European Parliament a voice in the IFRS adoption process. In my opinion, this voice should be used actively only in (hopefully) rare cases when all other actors in the chain of decision-making have failed to defend the objective of high-quality standards in the interests of users of financial information. It is my opinion that IFRS 8 presents such a case.

The EU has assumed crucial leadership by triggering the worldwide adoption of IFRS. It must rise to the corresponding responsibility by defending the objectives of IFRS standard-setting. Adoption decisions are one of the main tools in the EU's hands to that aim (the other main tool would be to ensure consistent implementation of IFRS within the EU and thus prove that the IFRS' promise of comparability is credible). The tool provided by the adoption mechanism under Regulation 1606/2002 should not be used lightly, but nor should it be considered irrelevant. It should not be used for defensive purposes or the protection of special local interests, but for the benefit of the entire community by ensuring that any temptation to compromise on standards quality is met vigilantly and firmly.

As a consequence, my recommendation is for the European Union not to adopt the current version of IFRS 8.



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21 September 2007

Glossary of Acronyms

CESR	Committee of European Securities Regulators
CFA	Certified Financial Analyst
CRUF	Corporate Reporting User Forum
DC	District of Columbia
EBITDA	Earnings before Interest, Tax, Depreciation and Amortization
ECON	Economic and Monetary Affairs Committee of the European Parliament
EFFAS	European Federation of Financial Analyst Societies
EFRAG	European Financial Reporting Advisory Group
EU	European Union
FASB	Financial Accounting Standards Board of the US
GAAP	Generally Accepted Accounting Principles
GO	Governance for Owners LLP
IAS	International Accounting Standards
IASB	International Accounting Standards Board (since 2001)
IASC	International Accounting Standards Committee (1973-2001). The acronym remains in use by the IASC Foundation, created in 2001
ICGN	International Corporate Governance Network
ICAEW	Institute of Chartered Accountants of England and Wales
IFRS	International Financial Reporting Standards
IMA	Investment Management Association
MEP	Member of the European Parliament
MoU	Memorandum of Understanding
NAPF	UK National Association of Pension Funds
QCA	Quoted Companies Alliance
S&P	Standard & Poor's
SARG	EU Standards Advisory Review Group
SEC	US Securities and Exchange Commission
SFAF	Société Française des Analystes Financiers (French Society of Financial Analysts)
SFAS	Statement of Financial Accounting Standard: denomination of some of the rules that collectively form US GAAP
SMEs	Small and Medium-sized Enterprises
TEG	Technical Expert Group (within EFRAG)
UK	United Kingdom of Great Britain and Northern Ireland
US	United States of America