

## Provision of Information to the IASB:

### Investigation on Segment Disclosures

- This report has been prepared based on the working group discussion organized by the ASBJ and the outcome of our field visit, this with the proposal made by the IASB chairman Sir David Tweedie at the first joint project meeting. We would be grateful if this report could contribute to the IASB's current project on the revision of IAS 14 Segment Reporting.
- The ASBJ has not yet decided to implement a management approach for segment disclosures by revising current Japanese standards. However, the ASBJ is going to investigate the issues on segment disclosures in light of the convergence of accounting standards. We would expect that the IASB not merely adopt the US GAAP as is, even if the management approach is implemented, so we would like the IASB to consider even more appropriate segment disclosures taking into consideration the issues dealt with in this report. We would be grateful if, in the near term, we could have your response to the results of our examination; if possible, during the second meeting on September 23.
- Section 1 of this report provides information on the progress of investigation at the ASBJ and Section 2 explains the current state in Japan and other issues including the research on segment disclosures of Japanese companies in practice. Issues to be discussed under the management approach are then provided in Sections 3 and 4. Section 3 specifies six points which we would recommend the IASB to investigate as a priority and notes some other issues for developing more pertinent disclosures. Furthermore, Section 4 summarizes our recommendations to the IASB as they relate to the usefulness of 'geographical segment information', based on the practices of the segment information disclosures by Japanese companies which have a large number of overseas transactions.

## 1. The Investigation at the ASBJ

- At the first joint project meeting between the ASBJ and the IASB held in March, the ASBJ agreed to provide the IASB, for the near term, information regarding the merits of the current Japanese GAAP and the issues in implementing the management approach, while the ASBJ and the IASB strive to reduce the differences between the standards for segment information in the future. This is in light of the IASB, which has taken segment disclosures as an item included in its short-term convergence project with the FASB, and intends to issue an exposure draft which converges with the management approach applied in SFAS 131 Disclosures about Segments of an Enterprise and Related Information.
- In accordance with the agreement at the first joint project meeting, the ASBJ set up in May a working group made up of ASBJ staff and parties involved with the capital markets (one analyst, two preparers, two auditors and one academic). This working group has so far held 4 meetings.
- In addition, from May to June the ASBJ staff conducted field visits to 11 companies related to capital markets (four users including capital markets analysts, five preparers, including three companies applying US GAAP and two companies applying Japanese GAAP, and two audit firms).

## 2. Japan's Current State and other Issues

- Under Japanese rules, disclosures for business segment information, geographical segment information and overseas sales are required. Specifically, the disclosures of sales (sales to external customers and internal sales or transferring amounts between segments), operating expenses, operating profits (or profits from ordinary activities), assets, depreciation and capital expenditures are required as business segment information. A disclosure of sales (sales to external customers and internal sales or transferring amounts between segments), operating expenses, operating profits (or profits from ordinary activities) assets are required (note) in the geographical segment information.

(note) Geographical segment information is prepared categorizing by country or area where a consolidated group has operating sites, similar to what paragraph 13 (a) of IAS 14 requires, and is different from the approach for overseas sales which categorizes based on the customers.

- Last year, the ASBJ conducted research on segment disclosures for 1,461 companies listed to First Section of the Tokyo Stock Exchange (the fiscal years ended from December 31, 2002 to December 30, 2003) in order to understand the current state of segment disclosures by Japanese companies. The results showed that the average number of disclosed segments is 2.69 based on the calculation in which non-segment-disclosing companies are regarded as single segment companies.
- There are 449 companies which omitted the disclosure of the segment information (component ratio: 30.7%; breakdown: 140 single segment companies, 309 companies which reported that sales, operating profit, or assets of one segment consist of more than 90 % of the total at the company level). The breakdown of the companies which disclose two or more segments (1,012 companies) consisted of 262 two-segment companies (17.9%), 354 three-segment companies (24.2%), 208 four-segment companies (14.2%), and 188 companies with 5 or more segments.
- There are Japanese SEC registrant companies which are exempt from US GAAP (SFAS 131) (note). These companies separately disclose segment information in accordance with Japanese GAAP, although a qualified opinion to the limited scope is provided in the auditor's report. Some companies which apply US GAAP (SFAS 131) disclose the geographical segment information as supplementary information.

(note) The reasons for the companies applying US GAAP which have been exempt from SFAS 131 are as follows:

- (1) US GAAP segment disclosures could detract from the comparability between Japanese companies and reduce the usefulness of the information for investors, since they generally provide segment disclosures in accordance with the segment disclosures requirements under Japanese GAAP.
- (2) It is not possible to make long-term comparisons in instances of frequently re-appraising the organizational structure.
- (3) US GAAP segment disclosures cannot be implemented unless the group is managed on a consolidated basis.
- (4) Since the information of each business unit is generally prepared under Japanese GAAP, items reconciled with US GAAP are included in the reconciliation amounts. If the reconciliation amounts become

large, it could impair the information's usefulness.

- Furthermore, in collecting information for the United States, we noted that Berger and Hann ( [2003]<sup>1</sup> ) researched 2,999 companies which restated segment information in prior periods by applying SFAS 131. According to the research, there were 2,335 single segment companies (77.9%) and 664 companies with two or more segments (22.1%) when SFAS 14 Financial Reporting for Segments of a Business Enterprise was applied. However, restated segment information from applying SFAS 131 shows that the number of the former has decreased to 1,792 (59.8%) and the number of the latter has increased to 1,207 (40.2%). In other words, there are 543 companies which reported two or more segments by applying the management approach, but would have reported as single segment companies if the industry approach had been applied (23.3% of 2,335 single segment companies under SFAS 14). This provides evidence showing that the implementation of the management approach was effective in increasing the number of segments. Also, additional evidence showed that the error range for forecasted income by security analysts was reduced after the implementation of SFAS 131. This indicates that the management approach could be effective in improving the information's usefulness. However, the majority of the number of increases consisted of a range from 1 to 2, and 3 or more increases amounted to only 10% of the total. It should be also noted that there were companies, although small in number, for which the number of disclosed segments decreased.
- Based on the above research on Japanese companies, we believe that segment disclosures should be improved as they provide important information to investors. However, based on empirical analysis about the implementation of SFAS 131 in the United States, the research does not necessarily result in the drastic increase of the number of disclosed segments although it is expected to be effective in increasing the number of companies providing segment disclosures. In this respect and in light of the convergence of accounting standards, the ASBJ will continue to discuss with the IASB which method works for the improvement of segment disclosures, including the aggregation criteria.

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<sup>1</sup> Philip G. Berger and Rebecca Hann. "The Impact of SFAS No.131 on Information and Monitoring." Journal of Accounting Research Vol.41, No.2, May 2003. "Segment Profitability and the Proprietary Costs of Disclosures." Working Paper, August 2003.

### 3 . Investigation on the Management Approach by SFAS 131

#### (1) Issues to be Discussed Further

The management approach has the following merits:

- The users are able to look at the company's management through the eyes of a chief operating decision maker.
- The use of internal reporting reduces costs incurred by preparers.
- Consistency with non-financial information is facilitated.

At the working group discussion and during field visits, some people -- primarily users -- supported the management approach from the above merits.

On the other hand, through the current investigation at the ASBJ, there is a general concern that the current management approach is not a perfect solution for segment disclosures. Specifically, we would propose the following points to be investigated at the IASB for seeking even more appropriate segment disclosures given that the management approach is implemented.

#### **Measures of Profitability**

- (a) It is difficult to achieve comparability between companies as different measures of profitability are likely to be disclosed (e.g. operating profit, profit before income tax, profit after tax, EBITDA, etc. which are based on a company-specific management accounting methodology). In some cases, where the numbers based on the management accounting is not readily understandable for investors, a mere disclosure of such specific methodology for the preparation of the segment information might not be sufficient. We believe that in cases where a company applies its specific measure, more attention should be paid to trying to provide a description which does not mislead the users of financial statements.

#### **Measurement for Segment Revenues and Segment Profits and Losses**

- (b) The measurement for segment revenues and segment profits and losses could be provided by non-GAAP numbers depending on the method applied by the companies' management accounting. In a context where financial statements information is required to 'present fairly a company's financial condition and performance', it is concerning that a mere disclosure of a detailed reconciliation with the amounts in the profit and

loss under GAAP could provide the information for investment decision which helps more proper understanding about a company's performance and more proper assessment of the prospect of future cash flows.

We believe that the informational value is harmed if consistency between the information in the income statement and the segment information is significantly deficient. Consideration should be given as to what additional information can be disclosed, even under the management approach, before issuing the exposure draft. Some measures should be considered for when external sales in the segment information differs from that in the income statement, for instance providing the reason for the difference in sales based on GAAP and its amounts according to segment.

#### **Treatment for Segment Assets Information by Disclosure based on the Management Approach**

- (c) Under SFAS 131, the segment assets should be disclosed only when they are included in the segment information reported to the chief operating decision maker, i.e., when the asset information is not included in the segment information reported to the chief operating decision maker, it merely becomes necessary to disclose this fact in accordance with paragraph 29 of SFAS 131. However, since information on the assets is essential to assess the profitability, the informational value of the segment information might be reduced in comparison with the "business segment information" under current IAS 14 unless the disclosure of segment assets is required. Thus, while based on the management approach, we believe that the treatment of the disclosure of information on segment assets should also be investigated in line with the information needed by investors before issuing the exposure draft.

#### **Internal Management Reports for Disclosure**

- (d) When multiple sets of internal management reports on segments are provided to the chief operating decision maker, the question is raised about which management reports should be disclosed externally. At the preparers' discretion, it is possible to reduce the number of disclosed segments. Although this issue is somewhat related to the Practical

Guidelines, we believe that the IASB should consider providing some guidance on this point before the standard is finalized because this could otherwise create an inconsistency in practice.

### **Aggregation Criteria for Determining Segmentation Disclosures**

- (e) We believe that in the management approach the greatest possibility for arbitrary judgment on the part of the preparer is in the aggregation criteria. As the management approach may not, depending on the application of the aggregation criteria, result in an increase in the number of segments, we believe that measures should be investigated to preserve the substance of the segment information disclosure as seen through the eyes of management. We think that the IASB should investigate this point and the issue of guidance before the standard is finalized because it could otherwise create inconsistency in practice.

### **Confidential Information and External Reporting**

- (f) The use of internal reporting for external reporting without any adjustment will improve the transparency of the company management. However, this also results in requiring the disclosure of significantly important information related to business development or strategy (e.g., information on specific client companies). This fact might cause the companies to restructure the internal management system itself in order to avoid the disadvantaging its business operations, and therefore accounting standards can constrain the management method and the performance evaluation method which companies internally use. We believe that the treatment for disclosing such confidential information should be investigated even under the US GAAP approach at the IASB before issuing the exposure draft.

## **(2) Other issues to Be Noted**

Furthermore, we appended some other points besides the 6 issues stated above which arose in the course of the investigation at the ASBJ. These would also be investigated if the IASB has the flexibility to deal with them at this stage.

- (a) As the management approach is based on the internal management system operated by each company, there is a possibility of only disclosing segments by geographical area or legal entity depending on each company's management policy. Such disclosure reduces

the informational value in comparison with the “business segment information” under current IAS 14.

- (b) Under the management approach, the information is provided using the management methodology of each company. In cases where the management reviews the operating revenue by each segment but the expense is reported in total at the company-wide level, a single segment could be disclosed. Such disclosure also reduces the informational value in comparison with the “business segment information” under current IAS 14.
- (c) In actual practice, there is ambiguity in determining who the “chief operating decision makers” are.
- (d) If a company applies an internal management system to include its group businesses on a consolidated basis, it may disclose its internal management numbers externally. As such, the management approach does not impose additional costs in comparison with the disclosures under current standards. However, the following cases might cause additional operations (costs).
  - a. When a company does not apply an internal management system such for group business units on a consolidated level, the additional operation (reconciliation and its analysis) will be incurred by the company.
  - b. When changes to the internal organization of a company affect the segmentation, the segment information in prior periods should be restated in order to provide the useful information for investors. In this case, the additional operations offset the cost effectiveness provided by the merits of the management approach to preparers, and it could impose more costs in some cases.
- (e) Under SFAS 131, the disclosure of assets in each geographical area and overseas sales is required. In the annual reports by US listed companies, this information is sometimes disclosed in the same table. However, while the disclosure of assets in each geographical area amounts to information about the location of the assets, overseas sales amounts to information about the location of customers. Thus, it would be preferable that a format or description should be contrived in order to avoid the possibility of misleading investors.

#### 4 . Usefulness of the Disclosure of “Geographical Segment Information”

- ( 1 ) As already mentioned in the preceding section of this report, geographical segment information is always required under Japanese GAAP. Some users of



financial statements question its usefulness, as it does not provide the information about geographical profits to end customers. However, we believe that it provides useful information for investors to understand overseas business developments and the country risks as it indicates the size of the company's operating sites, their locations in terms of its sales (operating profits), and its assets. Moreover, it is practical for preparers as it is calculated by simply aggregating the numbers of each operating site.

- (2) In terms of information on assets in the geographical information, SFAS 131 requires the disclosure of tangible assets, while the IASB is looking into the disclosure of fixed assets , which includes intangible assets. Japanese GAAP requires total assets. However, risk assets are not limited to fixed assets, but are also included in current assets. As it is preferable to understand the overview of the geographical operation not from the aspect of asset transferability but from the view of how much capital is invested in that area, it is worth considering the disclosure of total assets as under Japanese GAAP. We also believe that it is necessary to consider disclosures as to the nature of the existence of risk assets in each area (or each country).

In consideration of these points, we believe that, even if the IASB changes the segment disclosure to one based on the management approach as per SFAS 131, the IASB should further investigate whether the disclosure of geographical information is required, or which is more appropriate for disclosure from the viewpoint of its usefulness as investment information.