Hong Kong Financial Reporting Standards:

HKFRS 8 "Operating Segments" and HKAS 34 "Interim Financial Reporting"

(Relevant to PBE Paper I – Financial Reporting)

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Disclosure has an important role to play in financial reporting. This article explains two disclosure standards: HKFRS 8 "Operating Segments" and HKAS 34 "Interim Financial Reporting". Operating segment reporting is of particular relevance for large entities operating in diverse businesses. Interim reporting aims to provide in a succinct manner, timely and reliable financial information for the interim period since the last reporting in the annual reporting cycle.

Both standards apply to entities whose equity or debt securities are publicly traded (e.g. on the Stock Exchange of Hong Kong Main Board and GEM) and to entities that are in the process of issuing equity or debt securities in public securities markets.

HKFRS 8 "Operating Segments"

Core principle of HKFRS 8

HKFRS 8 begins by stating that its core principle is that "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". To meet its core principle, HKFRS 8 sets out the requirements for disclosure of information about an entity's operating segments and also about the entity's product and services, the geographical areas in which it operates, and its major customers.

Replacement of HKAS 14

HKFRS 8 was issued in March 2007 to replace HKAS 14 "Segment Reporting", and is effective for accounting periods beginning on or after 1 January 2009, with early adoption permitted.

Management approach

HKFRS 8 requires the adoption of a strict management approach. It requires entities to disclose segment information based on the operating segments identified internally for management control. Information about these operating segments to be reported is essentially also the same as that reviewed by management (referred to as the chief operating decision maker (CODM) in HKFRS 8). Users of HKFRS 8 segment information are thus able to see an entity "through the eyes of management", which enhances a user's ability to predict actions or reactions of management that can significantly affect the entity's prospects.

Operating segments

HKFRS 8 defines operating segment as a component of an entity:

- that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity[1]);
- whose operating results are regularly reviewed by the entity's CODM to make decisions about resources to be allocated to the segment and assess its performance; and
- for which discrete financial information is available.

HKFRS clarifies that not every part of an entity is necessarily an operating segment. For example, a corporate headquarter which does not earn revenues may not be an operating segment. Also, the CODM is meant to identify a function, not necessarily a manager with a specific title.

Reportable segments

Not all operating segments identified under the management approach are reportable. HKFRS 7 requires separate information be reported for each operating segment (either being identified under the management approach or resulting from aggregating two or more segments in accordance with the aggregation criteria) that exceeds the quantitative thresholds.

Aggregation criteria

HKFRS 8 states that two or more operating segments may be aggregated into a single operating segment if **ALL** of the following conditions are met:

1. The aggregation is consistent with the HKFRS 8 core principle.
2. The segments have similar economic characteristics (e.g., long-term average gross margin).
3. The segments are similar in the nature of their products/services, production processes, and customer types, methods to distribute/provide their products/services, and nature of their regulatory environment.

Quantitative thresholds

HKFRS 8 requires entities to report separate information about an operating segment that meets **ANY** of the following:

1. Its reported revenue, including both sales to external customers and inter-segment sales, is 10% or more of the combined revenue (internal and external) of all operating segments.
2. The absolute amount of its 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.
3. Its assets are 10% or more of the combined assets of all operating segments.

Insignificant segments that do not meet any of the 10% thresholds may still be considered reportable and separately disclosed if management believes that such separate disclosure is useful to users of financial statements.

Insignificant segments may be combined to produce a reportable segment only if they share a majority of the aggregation criteria.

75% external revenue test

If the total external revenue reported by the reportable segments identified by the aggregation criteria and quantitative thresholds constitutes less than 75% of the entity's external revenue, additional reportable segments shall be identified (even if they do not meet the 10% threshold criteria) until at least 75% of the entity's external revenue is included in the reportable segments.

Practical limit to number of reportable segments

HKFRS 8 suggests that when the number of reportable segments increases to above 10, the entity should consider whether a practical limit has been reached and the segment information reported may become too detailed.

"All other segments"

Information about other business activities (not-operating-segments, e.g. corporate headquarters) and not-reportable operating segments are combined and disclosed in an "all other segments" in the reconciliation of information reported in the entity financial statements.

Disclosure requirements

HKFRS 8 requires the disclosure of the following:

1. General information
    - Factors used to identify the reportable segments
    - Types of products/services of each reportable segment
2. Information about the reportable segments
    - Segment profit or loss
    - Segment assets and liabilities
    - Particular segment revenue and expense items (when these amounts are included/ provided for review by the CODM), which include:
        - Revenues from external customers
        - Inter-segment revenues
        - Interest revenue
        - Interest expense
        - Depreciation and amortization
        - Share of profit or loss of associates and joint ventures
        - Income tax expense
        - Material items
    - Explanation of the basis of measurement (which in some circumstances may not be IFRS-based numbers)
3. Reconciliations of the totals of segment revenues, segment profit or loss, segment assets and liabilities and other disclosure items to corresponding amounts (IFRS-based) reported in the entity financial statements. Reconciling items include adjustments for the existence of not-reportable operating segments (as included in "all other segments") and differences arising from different accounting policies.

Additional entity-wide disclosures

Because the segment information disclosed under the management approach may, for some entities, not distinguish sufficiently between the different products/services, geographical areas and major customers, HKFRS 8 requires certain "entity-wide" disclosures to be made:

1. External revenues from individual products/services.
2. External revenues and non-current assets from/in individual geographical locations.
3. External revenues from individual major customers (each contributes 10% or more of an entity's revenues).

Illustrations from HKFRS 8 Implementation Guidance (simplified)

1. The following table illustrates in a simplified manner the suggested format for disclosing information about reportable segment information. As in the full

	Car parts $	Motor vessels $	Soft-ware $	Electronics $	Finance $	All other segments $	Totals $
Revenue from external customers	3,000	5,000	9,500	12,000	5,000	1,000	35,500
Inter-segment revenues	-	-	3,000	1,500	-	-	4,500
Reportable segment profit	200	70	900	2,300	500	100	4,070
Reportable segment assets	2,000	5,000	3,000	12,000	57,000	2,000	81,000

illustration contained in the HKFRS 8 Implementation Guidance, amounts illustrated below are assumed to be the amounts in reports used by the CODM.

2. Continuing with the information from above table, the following illustrates the reconciliation for one of the disclosed items: reportable segment profit.

Reconciliation of profit	$
Total profit for reportable segments	3,970
Profit of "all other segments"	100
Elimination of inter-segment profits	(500)
Amounts not allocated to segments	
Corporate expenses	(250)
Adjustment to pension expense in consolidation	(250)
Income before income tax expense	3,070

3. The following illustrates the additional entity-wide disclosures on geographical information and major customers; as the illustrated entity's reportable segments are based on differences in products and services (car parts, motor vessels etc.), no additional disclosures of revenue information about products and services are required.

Geographical information	Revenues	Non-current assets
	$	$
United States	23,200	11,000
China	6,300	10,000
Other countries	6,000	3,000
Total	35,500	24,000

Information about major customers
Revenues from one customer in the entity's software and electronics segments represent approximately $5,000 of the entity's total revenues.

HKAS 34 "Interim Financial Reporting"

Objective of HKAS 34
The objective of HKAS 34 is to prescribe the minimum content of an interim report and the principles for recognition and measurement in a complete or condensed set of financial statements for an interim period, so that users can have a frequent and timely as well as a reliable assessment of the performance of an entity.

Interim financial report
HKAS 34 defines an interim financial report as a financial report containing a complete set of financial statements (as described in HKAS 1 "Presentation of Financial Statements") or a set of condensed financial statements (as described in HKAS 34) for an interim period shorter than a full financial year.

Minimum components of interim financial report
HKAS 34 requires that when an entity opts for the condensed format, the interim report shall include, at a minimum, the following components:

- a condensed statement of financial position;
- a condensed statement of comprehensive income[2];
- a condensed statement of changes in equity;
- a condensed statement of cash flows; and
- selected explanatory notes.

Condensed statements
HKAS 34 explains that condensed statements should include, at a minimum:

- each of the headings and subtotals that were included in its most recent annual financial statements;
- selected explanatory notes; and
- basic and diluted earnings per share, on the face of the condensed statement that presents the components of profit or loss[3] for the interim period.

Example – Condensed statement of cash flows
HKAS 1 "Presentation of Financial Statements" prescribes the minimum items that have to be presented on the faces of statements of financial position and comprehensive income. In a way, they are therefore difficult to "condense". Complete and condensed statements of financial position and comprehensive income therefore look very much the same. This is not the case with statements of cash flows as HKAS 7 "Cash Flow Statements" contains no such prescription. For better illustration of a condensed statement, this article chooses to show a condensed statement of cash flows as below.

	2007
	$m
Net cash used in operating activities	(10,911)
Net cash used in investing activities	(2,690)
Net cash from financing activities	10, 824
Net decrease in cash and cash equivalents	(2,777)
Cash and cash equivalents at 1 January 2007	8,310
Cash and cash equivalents at 31 December 2007	5,533

Selected explanatory notes
As users of an entity's interim report will also have access to the entity's most recent annual report, in all likelihood not all of the notes in the annual report are required for interim reporting purposes, since this would result in repetition. Instead, it is more meaningful to disclose at an interim date any transactions and events that are significant to an understanding of the changes in financial position and performance of the entity since the last annual reporting. These include:

- a statement that the same accounting policies and methods of computations are followed in the interim financial statements as compared with the most recent annual financial statements or, if those policies or methods have been changed, a description of the nature and effect of the change;
- explanatory comments about the seasonality or cyclicality of interim operations;
- the nature and amount of items affecting assets, liabilities, equity, net income, or cash flows that are unusual because of their nature, size or incidence;
- the nature and amount of changes in estimates of amounts reported in prior periods, if those changes have a material effect in the current interim period;
- certain segment information; and
- material events subsequent to the end of the interim period.

Interim report periods
Because the interim report is part of the larger annual report, the measurement for interim reporting shall be made largely on a year-to-date basis. Interim reports are to include interim financial statements (complete or condensed) for periods as follows:

- a statement of financial position as of the end of the current interim period and a comparative statement of financial position as of the end of the preceding financial year (two columns),
- statements of comprehensive income for the current interim period and cumulatively for the current financial year to date, with comparative statements of comprehensive income for the comparable interim periods (current and year-to-date) for the preceding financial year (four columns for quarterly and two columns for half-yearly statements of comprehensive income), and
- a statement of changes in equity and a statement of cash flows for the current financial year to date, with comparative statements for the comparable year-to-date period of the preceding financial year (two columns).

This is illustrated below for an entity whose current financial year end is 31 December 2007:

	Current financial year (year ended 31 Dec 2007)		Comparative preceding financial year (year ended 31 Dec 2006)	
	Interim period	Year-to-date	Interim period	Year-to-date
Statement of financial position				
e.g. 3rd quarterly	at 30 Sep 2007	–	at 31 Dec 2006	–
e.g. half-yearly	at 30 Jun 2007	–	at 31 Dec 2006	–
Statement of comprehensive income				
e.g. 3rd quarterly	3 m to 30 Sep 2007	9 m to 30 Sep 2007	3 m to 30 Sep 2006	9 m to 30 Sep 2006
e.g. half-yearly	6 m to 30 Jun 2007	–	6 m to 30 Jun 2006	–
Statement of changes in equity /Statement of cash flows				
e.g. 3rd quarterly	9 m to 30 Sep 2007	–	9 m to 30 Sep 2006	–
e.g. half-yearly	6 m to 30 Jun 2007	–	6 m to 30 Jun 2006	–

Materiality issue

HKAS 34 requires that materiality for interim reporting purposes shall be assessed in relation to the interim period's financial data, not prior year or forecast annual data. It is therefore quite possible that some items separately reported in the interim statements (because they are material) may not be presented in the same way in the subsequent full-year annual report that includes that same interim period.

Same accounting policies for annual statements

For consistency reasons, HKAS 34 requires that interim financial statements shall be prepared using the same accounting policies that have been used in its annual statements, except for accounting policy changes made after the date of the most recent annual financial statements, which will be reflected in the next annual financial statements.

Revenues received seasonally

HKAS 34 requires that seasonality factors should not be smoothed out of the financial statements. For example, many retail stores experience higher annual revenues during holiday periods, and the interim financial statements should faithfully report this kind of seasonality. In other words, revenues should be recognized as they occur.

Cost incurred unevenly

As with revenues received seasonally, costs incurred unevenly should not be anticipated or deferred. They should be recognized as they are incurred. For example, the cost of a planned major periodic overhaul that is expected to occur late in the year should not be anticipated for interim reporting purposes unless there is a true liability in that interim period. Similarly, the cost of a major advertising campaign incurred early in the year for the benefit of annual sales should not be spread over the year; instead it should be expensed in the interim period during which it is incurred.

Greater use of estimates

HKAS 34 acknowledges that interim measurements may rely on estimates to a greater extent than measurements of annual financial data. Two of the examples provided in Appendix C of HKAS are repeated as follows:

- Inventory: Full stock-taking and valuation procedures may not be required for inventories at interim dates. Estimates based on sales margins may be sufficient.
- Revaluations and fair value accounting: Professionally qualified independent valuers may not be required to provide fair values of property, plant and equipment (carried at revalued amounts) and investment properties at interim dates. Estimates made by management may be sufficient.

Conclusion

Two disclosure standards, HKFRS 8 "Operating Segments" and HKAS 34 "Interim Financial Reporting" are covered in this article. Management-based disaggregated information about operating segments is relevant to assessing the prospects of entities involved in diverse businesses. Timely and reliable information from interim reports, often in the "condensed" form, is also relevant for similar assessments. Both standards therefore aim to enhance the relevance of reported information so that external users of financial statements can make better decisions.

Notes

1. *Thus, a component that sells primarily or exclusively to other components of the entity is included in the definition of an operating segment if the entity is managed that way.*
2. *A condensed statement of comprehensive income can be presented as either (i) a condensed single statement; or (ii) a condensed separate income statement and a condensed statement of comprehensive income.*
3. *Components of profit or loss are presented in either (i) a condensed single statement of comprehensive income; or (ii) a condensed separate income statement.*