CHAPTER II

THEORETICAL FRAMEWORK

OF SEGMENT REPORTING
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2.1 INTRODUCTION

In the present era of globalization, the growing and rapid changes in business technology and economy have made a social compulsion for diversification and complexities of the business. Business entities have begun to diversify their business operation into multi-operational and/or multinational for spreading risk and taking the advantages of growth opportunities in different markets. This widespread movement toward diversification has led to a need for information about the various segments of an entity in addition to the consolidated financial statement about its overall performance. With this robust diversification and globalization, it is obvious that consolidated financial statement alone could no longer represent the overall view of the financial affairs precisely and correctly due to the different growth rate, profitability and risk of the operating segments. This complex globalized business atmosphere has also made a social demand to disclose the true and fair view of the financial affairs in a distinct and transparent manner for the greater interest of the stakeholders. On the other hand, consolidated statement also helps the management to hide detailed information about the various segments. Some segments may be running at a loss, but the consolidated statement merely shows the aggregated profit figure of all the segments as a whole. Due to these problems, users of the financial statements will face difficulties in evaluation of the entity’s performance and predict their future prospects. Therefore, to meet the needs of the stakeholders and the environment, it is necessary to provide segmental information along with the consolidated information.

The main objective of this chapter is to explore the theoretical fundamental of segment reporting along with the justification of whether segment reporting is a
necessary part of financial statement or not. To address the prime objective, this chapter has been segregated into ten sections. First section deals with the introduction which has very lucidly established the background for this chapter. Second section gives the concept of segment reporting. Third and fourth sections of this chapter have explained the need and benefits of segment reporting respectively. Various costs associated with segment reporting have been explored in fifth section of this chapter. Section six offers a logistic debate whether segment reporting is necessary or not. Seventh section has highlighted various basis of segmentation. Next section of this chapter has explained the process of segment reporting step-wise. Ninth section of this chapter has identified some problems in segment reporting. Finally the last section offers a logistic conclusion.

2.2 CONCEPT OF SEGMENT REPORTING

Consolidated financial statement alone not able to provide all the desired information and that’s why annual report additionally provide some financial and non-financial information by different types of industries or location or any other basis which would be relevant to the users. This disaggregated or segmented information is commonly known as Segment Reporting. It involves breaking down the enterprise into several parts or segments and reporting financial information for each of them. An entity can segment its operations into various ways but most common techniques are segmentation by industry and segmentation by location or by the combination of both.

2.3 NEED FOR SEGMENT REPORTING

Many users are affected directly by only one part of the enterprise. For example, employee’s security, pay and conditions will generally be more directly
dependent upon the performance of the specific part of the group in which they work than the performance of the group as a whole. Similarly host government will be primarily interested in the performance of the part of the enterprise that is located in their countries. Customers, suppliers and creditors will be more interested in that part of the enterprise with which they have connected. All of these users will therefore, want disaggregated information, such information will be especially important for users such as trade unions and developing country’s host government who lack the power to demand the information they want. Also it should be helpful to fulfill the following requirements:

1. Legal requirements.

2. Qualitative characteristics of financial statement.

3. Transparency of financial statements.

2.3.1 Legal requirement

As per part II of schedule VI to the Companies Act, 1956 certain disaggregated information are required which have been contained in the companies’ bill. Such disclosure requirements include:

- Disclosure of the amount and quantity of turnover by each class of goods.

- Disclosures of item wise breakup of the value and quantity of raw materials consumed by a manufacturing company.

- Disclosure of the value and quantity of the opening stock and closing stock of finished goods by each class by a manufacturing company.
• Disclosure of the value and quantity of the purchases, opening and closing stock by each class of goods traded by a trading company.

• Disclosure of the quantitative information about licensed and installed capacities and actual production by each class of goods.

Section 211(1) and 2 of the Companies Act 1956, states that every balance sheet should give a true and fair view of the state of affairs of the company at the end of financial year and every profit and loss account should give true and fair view of the profit or loss of the company for the financial year. The working group on the Companies Act (1997) has suggested inclusion of certain segment information in Director’s report.

The accounting standard board of ICAI has issued AS 17 for ‘Segment Reporting’. This standard came into effect in respect of accounting period commencing on or after 1st April, 2001 and it is mandatory in nature for the enterprises whose share or debts are listed or are going to be listed on any recognized stock exchange in India. Moreover, this standard is also mandatory for companies with an annual turnover of ₹ 50 crore or more.

Finally the stock market regulator SEBI had made quarterly segment reporting compulsory for all listed companies commencing from the quarter ended on 31st December, 2001 for better judgment of the trends in sales and operating income of the companies.

2.3.2 Qualitative characteristics of financial statement

Qualitative characteristics are the attributes which make the information content of the financial statement useful to the users. According to the company law “truth and fairness” is the fundamental qualitative characteristics of the financial
statement and the International Accounting Standard Committee (IASC) has identified four principal qualitative characteristics: a) Understandability b) Relevance c) Reliability and d) Comparability. How segmental information required to maintain the qualitative characteristics of the financial statements can be explained below:

- When almost all firms become diversified in term of operation or location, the segment reporting becomes urgent needs of the stakeholders to easily understand the financial affairs of a reporting entity in a clear and crystal manner.

- A remarkable feature of the modern economy is growing of the diversified businesses that carry on business either in two or more line of business or in two or more geographical locations. The various industry segments or geographic area of location may have different rate of profitability, risk and opportunity for growth as a result consolidated financial statement fails to represent all relevant information to the users. So stakeholders cannot evaluate the performance and prospects of the diversified enterprise successfully without segmental information along with the consolidated information.

- Some segments may be running at a loss, but the consolidated statement merely shows the aggregated profit figure of all the segments as a whole. Thus consolidated statement is not reliable at all particularly for a diversified company as it hides some real fact of the loss suffering segments. Due to this problem, users of the financial statements do not merely rely upon consolidated statement for their
decision making purpose. Therefore, segment report along the consolidated statement enhances the reliability of the financial statement to the users.

- Segment report enables the users to make a comparison among the performance of various reportable segments within a particular reporting entity. But consolidated financial statement fails to produce this facility particularly for the diversified entity. So it can be said that segment report along with the consolidated financial statement ensure the comparability both intra entity and inter entity for a particular accounting period and even for a number of periods (i.e. both for vertical and horizontal comparison).

2.3.3 Transparency of financial statement

A financial statement should be transparent only when it produces the optimum quantum of reliable information. Optimum quantum means, such amount of information which is exactly required by the users for their decision making purposes. Reliability of information is a qualitative characteristic which has been discussed previously. To improve transparency in corporate reporting, it is necessary to include the segment information.

2.4 BENEFITS OF SEGMENT REPORTING

Information reported in the financial statement is the raw data which are used as input to the analyst who evaluate the risk and return profile of the reporting entity for investment and lending decision. Many conglomerates have expanded into more diversified business and some have entered overseas market. The various industry segments or geographic areas of operation of the company can have different rate of
profitability, different level and types of risks and different opportunities for growth. Results into their operation become so sophisticated that financial analyst demanded the segment information in addition to the consolidated statement. Benefits of the segment reporting would be understood better if we explore some of the national and international research studies on usefulness of the segmental data and their findings. Researches have shown that forecasts using segment information are more accurate than forecasts using only aggregated information, both in theory (Bamea & Lakonishok, 1980; Hermann & Thomas, 1997) and in practice (Emannuel, Garrod & Frost, 1989; Balakrishan, Harris & Sen, 1990; and Hermann, 1996). Segmental report improved accuracy and consistency of the analysts’ decision (Baldwin, 1984, & Garrod and Frost, 1989). In the year 1990, Doupnik and Rolfe demanded that segmental information would be beneficial particularly when segments disclosed were perceived to have different risk profile. Analysts’ decision on segmental data is significantly more accurate than that on the consolidated data (Kinney, 1971). Collins (1976) proved that segmental model significantly outperformed all the consolidated models. In UK Emmanuel and Pick (1980) supported that segment based turnover and earnings forecasts were more accurate than that of the random walk model based on the consolidated data. Almost all studies in this particular field that is usefulness of the segmental data supported the relevancy of the segment reporting along with the consolidated statement for better understanding.

In this regard, views of some accounting standard setters are relevant to be mentioned. Financial Accounting Standard Board highlights the benefits in SFAS 14 ‘Financial Reporting for Segments of a Business Enterprise’:
“The purpose of the (segment) information is to assist financial statement users in analyzing and understanding the enterprise’s financial statements by permitting better assessment of the enterprise’s past performance and future prospects.”

Institute of Chartered Accountants of India mentioned in its AS 17 ‘Segment Reporting’:

Segment reporting helps users of the financial statement:

- Better understanding of the performance of the enterprise;
- Better assessment of the risks and return of the enterprise;
- Make more informed judgments about the enterprise as a whole.

International Accounting Standard Board in its IFRS 8 ‘Operating Segment’ Stated 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.”

The relevancy of the segment reporting can be better judged through its implications on the stock market, as it is a well-known fact that stock is a real mirror which reflects all the facts that have taken place in the economy and in turn the fact reported in the financial statement. So in this regard if we found that segmented report has the power to influence the stock market then it can be easily concluded that it is an essential part of financial reporting. Studies of stock market effect of segment information fall into two main categories: a) market reaction to segmental reporting and b) comparison of the success of investment made with and without segment information. Various research studies using analysis of variance to test for change in
market risk or companies betas, found that disclosure of segmental data had the effect of significantly reducing risk. For example, Simonds and Collins (1978 & 1979) had proved that segmented data were significantly reducing beta. In 1972 Kinney had found from his study that beta and accounting risk were significantly co-related. In the line of Kinney, Mohr (1983 & 1985) used segmented data to estimate entity’s relative investments in each type of industrial activity to compute an accounting-based measure of beta which was regressed on the market beta. She found a significant positive linear relationship between the two risk measures, with the strongest association between market beta and an accounting beta based upon segmented assets compare to that of either segmented sales or earnings. Another study conducted by Pointer and Douphinik (1996) had concluded that there is a significant relationship between geographic segment information and market risk measures.

On the other side, an alternative approach has been made to compare the return generated by two investment strategy, one based on aggregated data and other based upon segmented data. The first of these studies was completed by Collins (1975). His sample consists of 92 companies, of these companies 35 had disclosed no information about their segments while the rest had disclosed their financial information segment-wise. A consistent investment strategy was followed for buying shares if segment based forecast earnings exceeds those from consolidated models and selling if the reverse held. The segment based strategy yielded significant gains for companies that had not disclosed segment information earlier. In contrast, insignificant gains were made for those companies that had disclosed segment wise information previously, that implying that the market had used this segment information when it was first disclosed. Prodhan (1986) examined 15 companies that
had disclosed segment information from 1973 and 21 companies that disclosed such information for the first time in December 1977. Using interrupted time-series analysis, he proved that changes in beta were significantly related to segment disclosures. In the period 1973 to 1977, those companies which had disclosed segment data had significantly higher betas than those which did not. After 1977, when both groups disclosed segment data, there was no difference in their betas. After considering various studies on this field, it is found that the results of these studies were more or less same. Thus at least from the above discussion, it is very clear that segmented data have an eminence effects on the stock market reaction.

It should be noted that the main goal behind the additional segmented information along the consolidated statement is twofold. On the one hand, the objective is to assist users better to forecast of future prospects by permitting a better understanding of past performance. On the other hand, the objective is to make all concerned parties aware of the impact that had changed in activities might on the entity as a whole. Hence, finally if we judge from various stakeholders view point, segment information along the aggregated information would be useful in the following respects:

2.4.1 For the Reporting Entity

Under this head, the internal benefits of the enterprise should be discussed. This means how managers, owners and company itself benefit from segmental reporting.

- Segment reporting may lead to release of some important hidden data that are otherwise aggregated in consolidated statement. Segmented statement and consolidated statement both are complementary to each
other for making a more informed assessment of the past performance and for establishing an accurate forecast of future prospects. Performance prospects, risk, growth and all others requisite parameters are varying by not only the nature of investment but also by geographical location. Therefore, segment information is increasingly considered as an essential part of the financial report. Segmental information along the consolidated information enhances the understandability of the entity’s performance and future prospects or comparability of the performance of individual segment with those of the similar entities.

- Disclosure of segment information removes the imperfection of the investment market and enables the market to function properly through playing an important role of allocation of scarce resources in an economy. It also helps the management for resources distribution or allocation among the various segments of the company in the optimum way, on the basis of performance of various segments. Thereby it ensures the manager to perform in the interest of the society and investors.

- Segment information enables the analysts to understand better the uncertainty surrounding the expected future cash inflow and therefore, the risk relates to an investment or a loan to an enterprise that operates in different industries and markets. Each line of the business is affected not only by the general economic conditions but also by some special industries factors like, volume, price, raw material cost etc. Each
segment is likely to have different profit margin, rate of growth, return on investment etc. So each segment must require to study separately to forecast the segment earnings and that of the entity as a whole. Thus segmental information is essential to the analytical process for enhancing the accuracy of the investment and credit decision.

- Segment information would tend to adjust the price of the entity’s share according to the information released. Simonds and Collins (1978) found a significant reduction in risk for those firms disclosing segmental profit. Subsequently another study conducted by Dhaliwal, Spicer and Vickry (1979) proved a reduction in the cost of equity capital for the firms disclosing segmental profit for first time.

- Segment reporting is desirable in published annual report of diversified entity to present true and fair result of their business activities and to help investors to make proper investment decision.

- Each entity tries to maximize its value through an efficient management and use of its available scare resources. Management can take better decision only when the real scenarios of the enterprise are provided in the financial statement otherwise, it is impossible for the manager to take a rational judgment. So segment reporting becomes helpful to the manager. On the other hand every investor wants to verify the efficiency of the use and management of funds allocated to it. This evaluation can most accurately be made on the basis of segmented information. It enables to compare the financial performance of various segments and at the same time performance of
the managements by segments. Therefore, management will attempt to act as efficiently as possible.

- From the diversified or disaggregated financial report the owner of enterprise can easily understand about working of the business, risk profile of the business, return profile of the various segments and overall performance of the enterprise as a whole. On the basis of this information they can also assess the future growth prospects of the enterprise.

- It also helps to the research and development department of the enterprise as they can analyze the problem and prospects of the enterprise on the basis of various segment reports. This should be helpful to the enterprise as a whole in the long run perspective.

2.4.2 For Other Stakeholders

Stakeholders are the parties who have interest in the financial scenario, prospects and result of the enterprise. These stakeholders are investors, creditors, suppliers, employees, economy, government, society, customers, regulatory bodies, security analysts, academics, researchers, environmental protection organizations and special interest lobbying groups. Some important stake holder’s benefits are given below:

- **Investors** are of two types - shareholders and the potential investors. From the disaggregated financial information the shareholder can understand business of the enterprise and the effect of operating result on share price as well as long term solvency of the enterprise through sustainability of cash flow earning. On the other hand potential
investors can understand operational efficiency and financial health of the enterprise and also the risk-return profile. So from this disaggregated financial information, potential investors can take his or her decision whether to invest or not. Investors get all desired information from the disaggregated financial information according to their right. In this regard one research study has been found that investors perceive segmental data to help them in forecasting future consolidated revenue and net income.

- **Creditors** are external stakeholders of the enterprise. So they required some information about liquidity and solvency of the enterprise so that they get back their money in proper time. They are also interested about the profitability of the firm which would help to understand the future potentiality of the enterprise. Hence financial statements should be in disaggregated form such that external stakeholder creditors may also be served.

- **Suppliers** are those who supply raw materials to the enterprise. Sometime suppliers supply something in credit. Then suppliers are very much interested about liquidity and solvency of the business enterprise so that their dues can be recovered in stipulated time. Also they have interest about profitability of the firm which can help to assess the future profitability of the firm; as his own business profitability very much depends on the potentiality of the reporting enterprise. Hence, from the disaggregated financial information suppliers get all their desired information about the enterprises.
Employees are human resources of the enterprise. They are very much essential in nature as they maintain all other resources of the enterprises in a proper way. Without employees no enterprises can run. So it is duty of the enterprise to see that its employees survive in a proper way. From the disaggregated financial statement employees can assess their desirable information like their own performance, total salary or wage sheet, overall performance of the group in which they work. It is a support to understand their position in the group as well as in the firm. If the performance of enterprise is high but the remuneration of the employees is very low then they can protest against the remuneration policy and also they can compare their own wages with others. That can only be possible if employees get information about the performance of enterprise segment-wise. Also from this detailed report they can understand their growth prospects and security of their position.

Economy is the part of external environment of the enterprise. From segment wise report it can understand about the high and low profitable segments. On the basis of this information it transfers the resources from loss-making segments to the profit-making segments for proper utilization of resources. It can also assess the impact of the result of these enterprises on the GDP rate for taking any economical decision.

Government can understand the overall revenue and the process of resource allocation from segment wise information. In this way it can
be sure about the economic resources allocation and the amount of its own revenue that is direct and indirect tax. This information helps in ascertaining and maintaining good health of the capital market and the economy through good corporate governance. It also helps the government for formulating a better economic policy.

- **Society** can get to know about employment opportunities, environmental controls, community involvements and consumerism as well as about the contribution to the social projects like construction of roads, establishment of schools, colleges, research institutions, hospitals etc. from the segment wise information. As business entity is in itself a social entity, so it has some social responsibilities. In this regard entity itself can also get some benefits like, if it gives donation to any other organization for the purpose of any research then this segment wise report helps to receive the tax incentives. Negative social effect caused by the corporate enterprises may be quantified stating the use of irreplaceable resources and nature of pollution caused. Action taken and cost involved for pollutions control should be reported as an item of social benefit.

### 2.5 COSTS OF SEGMENT REPORTING

Financial reporting is an economic activity. In principle, how much efforts need to be spent is dependent on the amount of benefits accrued from it. It is self-evident that financial statement can be made more reliable and more useful if more resources are allocated for their preparation. The problem is that costs are incurred by the enterprises whereas the direct benefits are received by users, not by the
enterprises. The enterprises may be indirectly benefited but these benefits are very insignificant and difficult to measure. Different kinds and sources of costs can be perceived. The cost of segmental reporting is broadly divided into two heads: a) Direct Cost (i.e. processing cost) generated directly from the reporting task itself; and b) Indirect costs stemming from the publication of more information which are discussed below:

a) Direct Cost

A company cannot ignore the generating cost of segment wise information. The direct costs can be linked to the reporting process itself, for instance, the time necessary to translate and allocate data to a more detailed or disaggregated level. Determination of segment wise results need detailed record keeping, allocation of joint cost and also segment wise assets determination which require much time. Thus, to produce all the financial information segmental wise, require much time, paper, sound qualified accountant etc. which have some extra costs under the head of processing costs of the financial report. It also includes direct costs originating from compilation, incremental audit costs, and misinterpretation of the information by users (Gray et al., 1990). In this connection one notable thing is that the cost of determination of reportable segment is high for the countries where segments cannot freely determine with compare to that of the other countries. This processing cost motivates the manager to conceal the segment wise information. Although for companies with an internal structure organized around segments and sub-segments, these additional costs will not be so considerable because most detailed information is
already available for planning and internal control purposes. With the increasing computerization and automation of information processing and management, the additional costs resulting from elaborating this information will continue to be decreased.

b) Indirect cost

Indirect costs are actually stemming from the publication of more information in the segment report which attract competitors’ attention on certain profitable opportunities. That means segmental reporting is a source of competition. Due to this stiff competition enterprises may have to suffer a loss or sacrifice a certain proportion of their profit. It also impinges aggressive attitude to the employees and trade unions for bargaining with the entity particularly in the time of determination of their salary as they obtained more detail insight into the performance of the segment to which they are attached. So it is a great part of cost for segmental reporting. The two folded view of this cost are i) Proprietary costs- Managers face proprietary costs of segmental reporting if the revelation of a segment that earns high abnormal profits attract more competitors and hence reduce the segments’ abnormal profits and ii) Agency cost- Managers face agency costs of segmental reporting if the revelation of a segment that earns low abnormal profits reveals unresolved agency problems and ultimately leads to heightened external monitoring. Ultimately this cost also motivates the manager to conceal the segment wise information.
2.6 DEBATE ON SEGMENT REPORTING

There are two schools of thought regarding the usefulness of segment reporting. One school is in favor of the segment reporting where as other is in against of it. This deviation in view arises from the basic question that is whether the consolidated financial statement of a conglomerate entity alone sufficiently provides the adequate and relevant information to the users or not (i.e. there is a need for more disaggregated information). In other words, whether segment reporting is necessary or a burden to the reporting entity for unnecessary provision of data. There are many arguments in opposition to the segment reporting, some of which are:

- Investment made in the company but not in a single segment, so company wise information is sufficient to take the decision and segment information is not relevant to the investor decisions.
- Segment reporting may mislead the users, as it is based on many estimates, assumptions and arbitrary allocation; especially this problem is raised when joint cost and transfer price are involved. There are definite reliability problem of segment reporting due to these arbitrary judgments.
- Reporting entity has to bear the extra cost for developing, preparing and providing segmental information and also it is a cause of the competitive disadvantages.

In this regard some important objections are rightly articulated by Prof. R. K. Mantz (1968). The more important objections are:

- Confidential information would be revealed to competitors;
- It would cause customers to challenge prices to the disadvantage of the company.
• It may mislead to the external users as it is prepared for internal management purpose often include arbitrary judgment which are known only to the internal managers.

• Cost of segment reporting could be significant particularly where it is not prepared previously.

• Uniform reporting might call for additional expenses in reporting because arbitrarily defined segment may not fairly represent the operations. Arbitrary reporting requirement might in turn leads to arbitrary rules for the business activities.

On the other hand other group opines some counter arguments most of which attempt to defuse the objections of the opponents:

• Although investor deposited in a company but not in a segment, still segment wise information is very useful for better analyzing the risk-return profile as a conglomerate company composed by a number of segments.

• Misleading is an inherent problem of the accounting system, so it is not an exception for the segment reporting also. So users being aware of limitations of accounting, may arrive at right decision. And this information is not for careless users but for competent users who have at least potential to understand.

• The question of reliability is not only for the segment reporting but too for the overall financial reporting. Segment information is a rearrangement of information which had included in the consolidated report. So the information reported in segment report does not go beyond the boundaries of accounting.
• No doubt it has some preparation costs and it is quite natural that every economic activity has some costs. But the cost of processing segment information is not a strong argument because, internally a conglomerate company always analyses its segmental information for internal management purposes. This disaggregated information actually reproduced in segment report for external users. For segment reporting purpose it may require some reclassification but not entail substantial report. So the marginal cost of segment reporting is very negligible. Hence, it is an artificial attempt to conceal the detailed information.

• Cost of competitive disadvantage is also not a very strong argument because segment reporting rules and regulations are applicable to all the conglomerate companies. So the cost of comparative disadvantages kept balanced.

• Segment report may share some confidential information to the competitors but it is also justifiable in some situations. For example, in a new production process, high competition may become a leading motivating factor to motivate each and every entity to innovate some new process of production so that they can intact their profit potentiality. So competition some time act as a mother of innovation as a result, society get the highly sophisticated product at a low cost.

• One argument about the disclosure of low performance segment is that it helps the enterprise for getting the various government subsidies. It is also a supportive document to deduct this loss from another segment profit for calculating the net taxable income from business.
• Segment report cannot enhance the competition as it is only release the result of the reportable segment (i.e. profit or loss) but not the strategy. It does not indicate either any strategic weakness or strengths or plan for new product or area. So there is no question of competitive disadvantages.

• The performance of the entity is actually depending on some non-financial factors like the managerial skill, technical know-how, nature of its facilities, patents etc. But these information cannot obtain from any financial report even not from the consolidated report. So segment report could not be a source of competitive disadvantages.

• Segment report not only enriches the external users rather it acts as an important control on corporate managers as they bound to justify the result of their stewardship. Results into elimination of the substandard operation which leads to the ultimate benefit of the investors or of the economy as a whole. As it requires to disclose the disaggregated information for external users so it insists to improve the internal accounting procedures that will provide the more useful information to the internal manager particularly for evaluation of various segments’ performance.

• Sometime segment reporting is based on many estimates, assumptions and arbitrary allocation which may mislead the users, especially this problem is raised when joint cost and transfer price are involved. In this regard some experts suggested to disclose the contribution (i.e. before allocation of common cost) instead of net profit. But there is also some counter arguments like management may not be enthusiastic in performing their activity in an efficient manner if its cost has to disclose separately and also it leads to
mismanagement. If any entity has disclosed the define profit then this may create another problems like misinterpretation and lack of comparability. It is imponderable that whether this objection is valid or not but these are the risks incident to progress.

- For ensuring adequate standard of disclosures, standard setters could not rule arbitrarily on its own but co-operate with independent and private accountants. In this regard one thing is notable that absolute uniformity in reporting may mislead the users so the viable first steps would be nourishing public confidence in annual report which is essential to expand the capital pool.

- The single segment company gives a wide range of disclosure about its only segment. So the law of equality demands that a multi segment company will also disclose its financial information segment wise.

Finally, it is necessary to put forward the observation made by David Solomons (1965). Profit reporting by segments has three important purposes:

1. To guide divisional executives in making decisions.
2. To guide top management in making decisions.
3. To enable top management to apprise the performance of divisional manager.

Therefore, segment wise result ensures the better management decision and thereby lower cost as it is an essential element of divisional control. That is why, almost all nations of the world have issued the accounting standard on it and made it mandatory to prepare the segment report along with consolidated report.
2.7 BASES OF SEGMENTATION

An important problem in segment reporting is to determine how a conglomerate company should be diversified into defined segments for reporting purposes. Accounting and finance literature highlights a great deal of confusion over determination of segments. There are several basis of diversification like product, service, customer, geographical area, legal entity etc. Some important basis of segmentation are explained below:

A. Organisation Division

A division is a separate profit responsibility center which has been specified in the organization chart or the company’s operating structure. It is a part of the company where management has been decentralized by delegating authority for a comparatively broad range of functions to each divisional head. This basis of segmentation for external financial reporting is a useful basis because: i) it is mostly used for internal reporting and managerial control purposes, ii) data are often easily available for external reporting, and iii) auditors feel very easy to verify the segment wise data. But it is criticized on some logical grounds; firstly it is useful for the internal managers but may not be relevant to the external users, secondly it does not maintain the uniformity in segmentation as there are so many concepts of division such as geographical area, legal entities, product etc. and thirdly company could change its organization chart or structure which may ask to change the division as a result segment data on the basis of organizational division not be comparable from period to period and lose its consistency.
B. Basis of Business Activities

Generally on the basis of business activities, one company can be classified in three ways; in terms of a) industry group, b) product line and c) individual product or service. Industry group wise segment is that distinguishable component of an enterprise which provides different group of related products or services. The products or services are related if they are same either in nature or in production process or for same types of customers or in methods of distribution or in the nature of environment. A product line refers to major business line or operating activity in which an entity is engaged. It is relatively narrow group of related products in comparison to the industry and it is difficult to draw a distinction line between industry segment and product line segment. For example, manufacturing of furniture & fixture might be regarded as industry group whereas office furniture, household furniture, public building etc. are regarded as product line. Segmentation may also be done on the basis of individual product or service. For example, office furniture division can again be disaggregated into chairs, sofas, desks etc. generating units. This product or service based information is more useful in making predictions and analyzing entity’s profit potentiality and risk profile even though it allows unrealistic allocation which make the segments figure unreliable.

C. Market Structure

One entity can again be segmented on the basis of market structure as different markets have different degree of risk and profitability. Generally profit potentiality of an entity depends on whether the entity supplies to
manufacturers, or middleman, or consumers or high proportion of sales made to the government. Information for different markets is useful to the users particularly in determining the future growth and stability of the entity. In this regard one thing is notable that whatever may be the basis of segmentations, if 10% or more of the revenue of an entity earned from sales to any single customers, that fact and amount of revenue from each such customers have to be disclosed separately.

D. Geographical Segments

According to AS 17, it is a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from other components operating in other economic environment. It can be made either on the basis of location of assets or on the basis of location of the customers. Geographical segment should reflect different prospects of growth, rate of profitability and degree of risk in various parts of the world and even in various parts of the domicile country.

2.8 PROCESS OF SEGMENT REPORTING

Process of segment reporting varies from standard to standard. As per IFRS 8 ‘Operating Segment’ the steps involved in the process are i) Identification of chief operating decision maker; ii) Identification of operating segments; iii) Aggregation of operating segments; iv) Determination of reportable segment; and v) Segment disclosure information. Whereas the steps under AS 17 ‘Segment reporting’ are i) Selecting a basis of segmentation; ii) Identification of reportable segments; iii)
Determination of reporting format; and finally iv) Disclosures for each reportable segments which have been explained below:

i) Selecting a Basis of Segmentation

From the above discussion it is clear that one entity can diversify into various ways particularly for the external reporting purpose. But from these alternatives the best way of segmentation should require to be selected so that it would be relevant to the external users for their decision making purposes. Among many basis of segmentation, industry segmentation is widely recognized as a most appropriate basis. Most of the experts believe that industrial segments can clearly reflect different rates of profitability, diverse degree of risk and varying opportunities for growth of the entity as a whole. In the choice of segmentation basis there is a conflict between uniformity and relevancy. According to the uniformity norms it will be better to identify one segmentation basis for all types of entities, but many researchers have proved that one basis of segmentation for all entities lose the relevancy to the users. On the other hand if we consider the relevancy norms then the basis of segmentation should be varied from one entity to another, that’s mean there will be no uniformity in determination of the segments. In this regard one important argument is the uniformity in determining of segmentation basis is not necessary at all because of users uses the segmental information for evaluating the enterprise but not to compare a segment of one enterprise with a similar segment of the other enterprise.

It is the responsibility of management to determine the segmentation basis for external reporting purposes on the basis of their judgment. This judgment is made upon the analysis of so many factors like types of products or services, rate of
profitability, risk, growth, operating and market area and even special regulators’ requirements in some special cases.

**ii) Identifying Reportable Segment**

After an entity has been classified into various segments, it is important to identify the reportable segments which are significant enough to disclose separately in the external report. Almost all the accounting standards mention same guidelines on identifying reportable segment. A reportable segment is that segment if either i) Its revenue is 10% or more of the total revenue of all segments or ii) Its result is 10% or more of the greater in an absolute amount of: a) The combined profits of all segments. b) The combined losses of all segments or iii) Its assets are 10% or more of the total assets of all segments.

If total external revenue attributable to reportable segment constitutes less than 75% of the total enterprise’s revenue, additional segment should identified as a reportable segment even if the above condition is not met until at least 75% of the total enterprise’s revenue.

**iii) Determination of Reporting Format**

After identifying the reportable segment, the next step is to determination of reporting format. The primary and secondary segment reporting format is determined on the basis of dominant source and nature of an enterprise’s risk and return. An enterprise’s primary segments are business segments if its risks and returns are affected predominantly by the products and services of the enterprise. In the contrary, the enterprise’s primary segments are geographical segments if its risk and return are affected predominantly by its geographical area in which it operates. When the exact predominant source and nature of and enterprise’s risk and return cannot be
determined then it should use business segments as primary segments and geographical segments as secondary segments. Detailed segment disclosures are required for the primary segments and less detailed disclosures are required for secondary segments.

iv) Disclosures

Now it is to be identified, what segment information should be disclosed for each reportable segments of a diversified company? Disclosures mainly depend on the reporting format that is whether it is primary reporting format or secondary reporting format. If it is primary reporting format then detailed information has to be disclosed with compare to that of the secondary format. Although the basic disclosure requirements are more or less same in various accounting standards throughout the world but still they quite vary from standard to standard. Standard wise details disclosure requirement will explain in the next chapter. Here only the disclosure requirements of AS17 issued by ICAI can be explained below:

i) Disclosure requirement for primary segment

- Segment revenue with a break-up of sales to external customers and from transaction with other segment.
- Segment result.
- Total caring amount of segment assets.
- Total amount of non-cash expenses such as provision and unrealized foreign exchange gain and losses that were included in segment expenses and therefore deducted in measuring segment result.
- Total amount of segment liabilities.
- The total amount of depreciation and amortization in respect of segment assets for the period should be disclosed.
- Total cost incurred during the period to acquire segment assets (tangible and intangible).

**ii) Disclosure required for secondary segment**

If an enterprise’s primary segment is business segment, it should also report the following information:

- Segment revenue from external customers by geographical area based on the geographical location of its customers whose revenue from sales is 10% or more of enterprise revenue.
- Total caring amount of segment assets for each geographical segment (which are 10% or more of the total assets to all geographical segments).
- The total cost incurred during the period to acquire segment assets for each geographical segment whose segment assets are 10% or more of the total assets of all geographical segments.

If an enterprise’s primary segment is geographical segment, it should also disclose the following information:

- Segment revenue from sales to the external customers.
- The total carrying amount of segment assets.
- Total cost incurred during the period to acquire segment assets (both tangible and intangible).
iii) Other Disclosures

- An enterprise should present a reconciliation statement between the information disclosed for reportable segment and the aggregated information in the enterprises financial statement.

- Inter segment transfer should be measured on the actual price which has been employed for such transfer. The basis of inter segment transfer pricing and change therein (if any) should be disclosed in the financial statements.

- Change in accounting policies adopted for segment reporting those have a material effect on segment information should be disclosed.

- An enterprise should indicate the type of product and services included in each reported business segment and indicate the composition of each reported geographical segment.

2.9 PROBLEMS IN SEGMENT REPORTING

The difficulties of segment reporting actually relates to the implementation. Some of these problems are listed below:

- **Basis of Segmentation**

  How a diversified company should be classified into various segments and what would be the optimum basis are not clear to the accountant. Although most of the accounting standard on segment reporting suggested some way to identify the basis but these are not unique and not reasonable for all types of companies. There are no such clear and precise concept of segmentation basis like industry, product, location and market. The identified segments may vary in terms of their profitability, growth and risk with their
basis of determination. Reportable segment should be selected on realistic and viable basis from operating view point so that the users should able to better judge the future success of the entity.

- **Allocation of Common Items**

  Common items need to be apportioned among the various reported segments on reasonable and reliable basis. But problem is in the apportionment of some joint costs which have no such logical basis of distribution like research and development expenses. It is also a great problem to distribute the common assets, liabilities and equity among the reportable segments. Although some items can be allocated on a rational basis but others may be distributed by whim. Because of this diversity, the segment reporting loses its comparability and reliability. Really it has no such correct solution; if these common items shown as an unallocated aggregated amount then segmented information become incomplete and on the other hand if these are allocated arbitrarily then it loses its objectivity and relevance.

- **Inter Segment Transfer Price**

  Transfer price is the price at which one segment transfers its products/services to other segments within the same entity. There are several methods of transfer price and with the methods the price has been changed. Although the market based segment price is better some extent but it is difficult to determine particularly when there is no open market for that particular output. On the other side, if cost based price has been employed then the revenue of the supplying segment is understated. In the same manner
each and every method has some loopholes that is why there is not an appropriate method of transfer pricing which will be entirely satisfactory.

- **Comparability**

  Due to problem relating to its technical feasibility, segment reporting loses its comparability and relevancy to the users. There are so many technical problems, some of these are already being explained like determination of segments, allocation of joint cost and transfer pricing mechanism. These problems, do not undermine its potential relevancy as its main aim to promote more informed judgment for the entity as a whole not for the segment itself. So, although it hampers the comparability at segment level in some extent but it is helpful for comparison at firm level.

- **Integrated Activities**

  Sometime an entity is so integrated that it is not even possible to diversify into number of segments. The integration may be vertical or horizontal in nature. Problem of vertically integrated entity is that there is no external market for intermediate goods and that of the horizontally integrated entity is the recognition of separate activities cannot be supported. As a result the segment report becomes meaningless and unjustifiable.

- **Management Conservatism**

  Generally managers are conservatism in nature; they are not intended to disclose segment report voluntarily unless and until there is any regulatory compulsion. They also try to consciously manipulate the identification of reportable segments if the existing regulation gives discretions to the
management. That means manager always try to conceal the disaggregated information.

2.10 CONCLUSION

With the robust diversification and globalization of the entity, the consolidated financial statement alone is not enough to serve the purpose of the stakeholders for taking any economic decision. Due to these needs of the users and thrust of the time, segment reporting becomes into the reality by the obvious regulatory requirements of the society. Although initially many fingers were raised against this detail reporting but by the time, all of such arguments have been refuted that very rightly reflected when a number of standard have already been issued by several national and international standard setters. Like other area of accounting, segment reporting has also become as an important part of the financial reporting. Despite some technical difficulties, segment reporting is definitely a right step in the right direction towards improving the quality of financial statements. Gradually these problems should be disappeared by continuous practice and it would serve the purpose for which it is advocated.