Operating segment disclosure practices of selected publicly listed companies in the Philippine manufacturing industry

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ABSTRACT

Accounting standard setters prescribed that entity should disclose information to enable users of its financial statements evaluate the nature and financial effects of the business activities in which it engages and the economic environment in which it operates. Disclosure of relevant information will help build transparency with stakeholders. Disclosures are designed to assist outside users of financial information for the purpose of making investments in the business. The purpose of this study is to show the outcome of the examination of selected publicly listed companies in the manufacturing industry's operating segment disclosure practices with regards their compliance with the financial reporting requirement embodied in International Financial Reporting Standard (IFRS) 8. A sample of ten (10) listed Philippine manufacturing companies is used in this research. This study made use of 2010 IFRS disclosure checklist. The results suggest that none of the companies complied with all of the disclosure requirements of IFRS8.

JEL Classification: M41

Keywords: Operating segment, reportable segment disclosures, Philippine Financial Reporting Standards, Chief Operating Decision Maker, entity-wide disclosures

INTRODUCTION

The increasing global relationship in market paved the way to diversification of firms' economic activities. Because of these multinational operations, communicating the performance of such entities to stakeholders is a challenge. It requires disaggregation of data to explain the trends and results of components of the entity that have been affected by different factors or that have different prospects (Klynveld Peat Marwick Goerdeler [KPMG], 2010). Usually, this disaggregated information is presented in the narrative form of the firms' notes to financial statements.

Financial statements are the principal means through which an entity communicates its financial position, financial performance and cash flows to a wide range of users, which include investors, employees, lenders, suppliers and other trade creditors, customers, government and their agencies, and the general public for decision-making. Each element of the financial statements must comply with the IFRS. Disclosure compliance to these accounting standards will facilitate transparency in financial reporting as well as comparability of financial information. This transparent reporting results to a relevant and reliable information available to decision makers. High quality financial information disclosed will benefit users in assessing the company's performance across borders.

In the light of the disclosure requirement, this study was conceived to check the disclosure practices of publicly listed manufacturing companies in the Philippines with regard to Philippine Financial Reporting Standard (PFRS) 8 - *Operating Segments*.

This study ascertains the entities compliance with the disclosure requirements of IFRS 8 through an examination of annual reports for the year 2010 using IFRS Disclosure Checklist developed by KPMG International.

Research Problem and Objectives

What is the extent of compliance of publicly listed manufacturing companies with regard to the provisions of PFRS 8 - *Operating Segments*?

The specific objectives of this study are: (1) to identify how the manufacturing industry discloses operating segment information; and (2) to evaluate the compliance of the manufacturing industry with the specific provisions of PFRS 8, the generally accepted accounting principle for operating segments in the Philippines.

LITERATURE REVIEW

Business operation is increasingly conducted across national borders; entities must be able to use their financial statements to communicate to its target users all over the world. In response to this, divergent national accounting practices are converging to an overall global standard (Stice, Stice & Skousen, 2007).

Accounting standards help preparers meet the information demands of stakeholders by providing guiding principles and limits for financial reporting. It enhances the comparability of financial reports among different companies. It also saves time and money through defining which methods, policies and principles to use and how much information to disclose in the financial report. Stakeholders benefit too by knowing what one set of accounting rules to apply to all companies.

The International Accounting Standards Board (IASB) develops a set of high quality, understandable, enforceable and globally accepted international financial reporting standards (IFRSs). These are now used for public reporting purposes in more than 100 countries.

IFRS 8 - *Operating Segments*

The basic principle of IFRS 8 is disclosure of information that enables users of its financial statements to assess the nature and effects of financial activities, which develops business and economic environments in which it operates. It sets outs segment disclosure requirement by entities whose debt or equity is traded on a public market (whether a stock exchange or foreign national, or an unorganized market, including local and regional markets), or to register, or is in the process of registering, its financial statements in a securities commission or other regulatory organization, in order to render some kind of instrument in a public market.

The intention of the International Accounting Standards Board (IASB) in implementing IFRS 8 is to allow investors and other users of financial statements to see the company's operations through the eyes of management ('the management-perspective approach') and enable investors understand the risks that management face each day and to assess how well those risks are managed (IASB, 2012). This approach results in several improvements on segment reporting. It increases the number of segments and more meaningful information available to users. It allows users to analyse firms "through the eyes of the management." It also reduces costs in obtaining segment information, and promotes consistency between information contained in Financial Statements and the information disclosed in the Management Report (Pardal & Morais, 2011).

The segment information disclosed internally to Chief Operating Decision Maker (CODM) for his decision-making process should be provided to external users (Pardal & Morais, 2011). The CODM is not a title or position but rather a function of allocating resources to segments and assessing its performance.

According to IFRS 8, an operating segment is a component of an entity:

> *(a) that develops business activities from which you can get regular income and incur expenditure (including ordinary income and expenses for transactions with other components of the same entity); (b) whose operating results are reviewed on a regular basis by the highest authority in decision-making base of the entity, to decide on resources to be allocated to the segment and assess its performance and; (c) in relation to which information is available financial differentiated.*

The operating segments often show long-term financial performance if the firms have similar economic characteristics. They can add two or more segments operating in a single operating segment if aggregation is consistent with the basic principle of this IFRS; the segments have similar economic characteristics and are similar in each of the following aspects: (a) the nature of products and services; (b) the nature of production processes; (c) the type or category of customers that is intended its products and services; (d) the methods used to distribute their products or provide their services; and (e) if applicable, the nature of the regulatory environment to subject, for example, banking, insurance or utilities.

IFRS 8 uses the quantitative threshold (10 percent) to determine which of the operating segments are reportable and should be reported separately. The operating segments that do not meet any of the previous quantitative thresholds segments may still be disclosed separately, if the leadership believes that it might be useful for users of financial.

The summary of required disclosures for operating segments is shown in Table 1.

Table1. IFRS 8 disclosure requirements

Information Required
General information
Profit or loss
• regular income from external customers • regular income from transactions with other operating segments of the same entity • interest income • interest expense • depreciation and amortization • significant items of income and expenditure disclosed in accordance with paragraph 86 of IAS 1 Presentation of Financial Statements • participation of the entity in the profit and loss partners and joint ventures accounted for under the equity method • spending or income tax on earnings • significant non-cash items other than those of depreciation and amortization
Assets

• the amount of investments in associates and joint ventures in which counted under the equity method, • the amount of additions * non-current assets other than financial instruments, deferred tax assets, assets relating to post-employment benefits and rights arising from insurance contracts
Liabilities
Measurement
Reconciliations
• Segments' revenue to the entity's revenue • Segments' operating profit or loss to the consolidated operating profit or loss • Segments' assets to the entity's assets • Segments' liabilities to the entity's liabilities • Segments' amounts for every other material item of information disclosed to the corresponding amount for the entity.
Restatement of previously reported information

Paragraphs 32 to 34 of IFRS 8 set out additional entity-wide disclosure requirements. The rational for this by IASB is that some entities' business activities are not organised on the basis of differences in related products and services or differences in geographical areas of operations. Such an entity's reportable segments may report revenues from a broad range of essentially different products and services, or more than one of its reportable segments may provide essentially the same products and services. Similarly, an entity's reportable segments may hold assets in different geographical areas and report revenues from customers in different geographical areas. Also, it could be more than one of its reportable segments may operate in the same geographical area.

The summary of required disclosures for operating segments is shown in Table 2.

Table 2. Entity-wide disclosures

Information required
Products and services
• Revenue from external customers for each product and service based on entity financial statements measures
Geographic areas
• revenue from external customers attributed to the country of domicile and all foreign countries • non-current assets other than financial instruments, deferred tax assets, assets relating to post-employment benefits and rights deriving from insurance contracts located in the country of domicile and all foreign countries
Key customers

IFRS 8 superseded IAS 14 Segment Reporting. Entities apply the IFRS in its annual financial statements for the years beginning on or after January 1, 2009.

The Concept of Accounting Standards' Compliance

There are several studies conducted to check and measure the compliance of business entities to IASs/IFRSs that normally look for the explanatory factors for compliance or non-compliance with the provisions of the accounting standards.

Mardini, Crawford and Power (2012) assessed on the impact of IFRS 8 on the disclosures of Jordanian listed firms, and ascertained the extent to which segmental information provided under IFRS 8 in 2009 differs from segmental disclosures under IAS 14 in 2008. Mardini et al (2012) used a sample of 109 listed companies in their research. They determined that IFRS 8 has significant impact on the manner of which entities disclosed segmental information. According to them, companies disclosed more items for each operating segments. Also, their findings showed that over one-third of the sample companies changed their definition of segments upon the adoption of the new segmental standard. It resulted in several improvements in the level of segmental disclosures for the Jordanian listed companies.

Pardal and Morais (2011) analyzed the new segment disclosures characteristics under the adoption of IFRS 8 in Spain. They investigated the segment items disclosed and the level of compliance with the standard. They also explored the factors, which are associated with higher levels of compliance with the standard and concluded that firm size is statistically related to higher levels of disclosure; and that higher profitability is statistically related to lower disclosure scores.

KPMG (2010) surveyed on the segment disclosure practices of 81 companies in 17 countries prepared under IFRS 8. Their findings indicated that the average number of reportable segments had increased under IFRS 8. They found more than half of all companies surveyed disclosed a measure of segment profit that excluded certain items like interest, depreciation, amortization or one-off items. Also, there was some consistency within some sectors on the variety of measures disclosed across their survey.

Salendrez (2008) studies balance sheet disclosures of ten selected publicly listed food companies in the Philippines. The said study identified the top five not fully complied with accounting standards by ten-selected food companies. PAS 1 *Presentation of Financial Statements* has a 100percent non-compliance rate while PAS 38 *Intangible Asset* has 70percent non-compliance rate. PAS 2 *Inventories* has 60percent non-compliance rate; PAS 12 *Income Taxes,* PAS 24 *Related-Party Disclosures* and PAS 36 *Impairment of Assets* have 40percent non-compliance rate; and PAS 19 *Employee Benefits* and PAS 28 *Investment in Associates* have 30percent non-compliance rate. She noted that one of the reasons of non-compliance includes the rising complication of accounting IAS/IFRS, which has become increasingly more complex and subjective in recent years, requiring procedural proficiency to understand and apply. There have been rapid changes to various standards arising from improvements and union projects.

Ferrer (2008) conducted Income Statement compliance audit of ten selected publicly listed corporations in the Philippine manufacturing industry and concluded that the ten companies failed to completely conform to new accounting standards. The income statements reviewed were not well presented and important details were concealed. Also Tugas (2008) investigated the compliance of ten selected companies belonging to the mining industry with provisions of IAS 36 Impairment of Assets. He concluded that all of the companies failed to fully comply with the provisions of the Standard.

Hodgdon et al. (2008) performed a study on compliance with IFRS disclosure requirements and individual analysts' forecast errors using a sample of non-U.S. firms that claim to comply with the disclosure requirements of IFRS. They examined whether varying levels of disclosure compliance in 1999 and 2000 annual reports affect analysts' forecasts of earnings for the years ending December 2000 and 2001 respectively. In fact, their research was the first study to examine the effects of firm-level disclosures on the properties of individual financial analysts' forecasts in an international setting. Their findings provided support for the viewpoint that the extent of compliance with accounting standards is as important as the standards themselves, and they corroborated to the results of prior studies that find disclosure as an important determinant of forecast accuracy.

According to Street and Gray (2001), there is a significant extent of non-compliance with IAS especially in the case of IAS disclosure requirements. Regarding factors associated with compliance with IAS disclosure requirements, there is a significant positive association with a U.S. listing/filing and/or non-regional listing, being in the commerce and transportation industry, referring exclusively to the use of IAS, being audited by a Big 5+2 firm, and being domiciled in People's Republic of China (PRC) or Switzerland. Also, there is a significant negative association with being domiciled in France, Germany, or other Western European countries. As regards compliance with IAS measurement and presentation standards, there is a significant positive association with exclusive reference to the use of IAS, being audited by a Big 5+2 firms, and being domiciled in PRC Additionally, there is a significant negative association with being domiciled in France or Africa.

Most of the studies regarding compliance are made on European nations and the United States; studies concerning the Association of South East Asian Nations (ASEAN) are very limited. The Philippines have fully adopted the IAS/IFRS in 2005, which restrict organizations into choosing accounting methods that are in accordance with generally accepted accounting principles (GAAP, a move that will help address the need for comparable financial reports and harmonization (Dizon, Miranda, & Pineda, 2007).

The study of Hope (2003) documented that annual report disclosures are more positively related to forecast accuracy when a firm is followed by few analysts consistent that the annual report constitutes a relatively larger part of a firm's overall communication process when analyst following is low. He also found evidence consistent with the usefulness of enforcement being greater in environments in which firms are allowed to choose among a larger set of accounting methods.

Framework and Methodology

The following framework (Figure 1) was used in conducting this study.

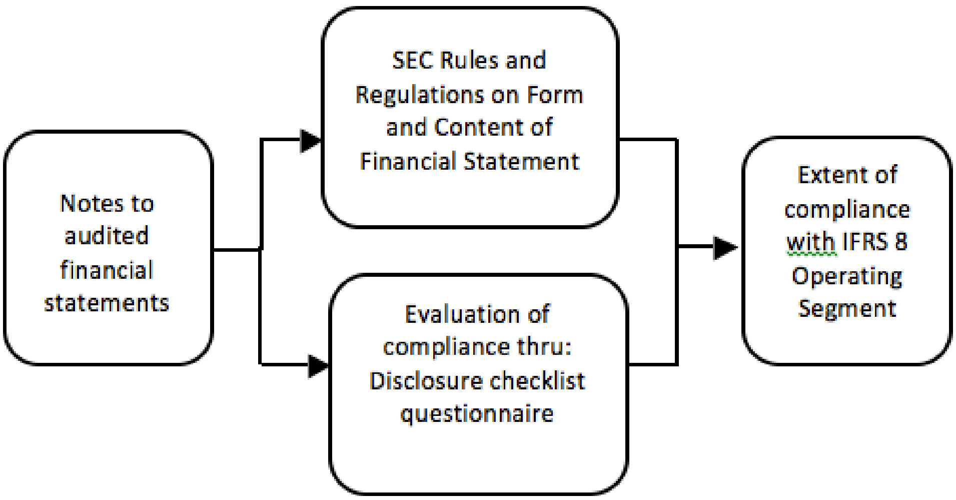

Figure 1. Framework of the study

Security and Exchange Commission – A Regulatory Body

The Securities and Exchange Commission (SEC) has the authority to make, amend, and rescind accounting rules and regulations as may be required to carry out the provisions of the Securities Regulation Code. To implement the law, the SEC issued SRC Rules 68 and 68.1 setting forth the accounting and auditing requirements for financial statements to be submitted to the SEC.

SRC Rule 68, Rules and Regulations Covering Form and Content of Financial Statements, is generally applicable to all corporations registered with the SEC. It requires that financial statements filed with the SEC be prepared in accordance with GAAP in the Philippines. This rule requires covered companies to include in their financial statements certain disclosures in addition to those required under the Philippine GAAP. Starting 2005, all companies must comply with the IFRS.

As required by SEC, all registered corporations must submit annual financial statements. The complete set of financial statements comprises: (1) a balance sheet; (2) an income statement; (3) a statement of changes in equity showing either all changes in equity, or changes in equity other than those arising from transactions with equity holders acting in their capacity as equity holders; (4) a cash flow statement; and (5) notes, comprising a summary of significant accounting policies and other explanatory notes. According to PAS 1 paragraph 13, "financial statements shall present fairly the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Framework. The application of IFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation."

Data Collection and Processing

The study covers the ten (10) companies, which were randomly selected out of the forty-three (43) listed companies under the manufacturing sector of the Philippine Stock Exchange.

The financial statements covering 2010 accounting period were utilized for the research as basis for testing the extent of compliance to accounting standards particularly to IFRS 8. The 2010 financial statements were used because IFRS 8 became effective only in January 1, 2009. It is descriptive in nature and examines the content of the 2010 notes to financial statements of the listed corporations in the manufacturing industry. From the annual reports, the notes to financial statements disclosed the accounting policies that each company adopts.

The publicly listed manufacturing companies are not identified by names so that their interests will be protected. Instead, codes M1 to M10 are used to conceal the identity of each corporation.

Of the ten (10) annual reports of manufacturing companies reviewed, four were audited by Manabat Sanagustin & Co., three by Sycip Gorres Velayo & Co., and one by Punongbayan Araullo. All were given unqualified opinion (this means that the financial position and results of operations of the companies audited were fairly presented in accordance with the generally accepted accounting principles) by their respective external auditors. The total assets of the 10 companies included in the study are presented in Table 3.

Table 3. List of manufacturing companies reviewed showing their total assets.

Name of Company	Total Assets (in PHP)	Auditor's Opinion
M1	4,082,153,525	Unqualified
M2	87,121,000,000	Unqualified
M3	2,424,243,615	Unqualified
M4	264,268,065	Unqualified
M5	32,774,879,608	Unqualified
M6	2,293,785,070	Unqualified
M7	326,323,636,399	Unqualified
M8	4,615,499,148	Unqualified
M9	164,240,944,473	Unqualified
M10	4,489,478,233	Unqualified

Note: *Anonymous company name is used in the presentation of findings.*

Instrumentation

This study made use of 2010 International Financial Reporting Standards Disclosure Checklist prepared by KPMG. The questionnaire summarises the recognition and measurement requirements set out in IFRS.

Any disclosure requirements resulting from standards and interpretations that have been issued beyond December 31, 2010 are not included in the checklist. This disclosure checklist does not apply to condensed interim financial statements prepared in accordance with IAS 34 - Interim financial reporting.

RESULTS AND DISCUSSION

Compliance with IFRS 8

All companies asserted in their notes that financial statements comply in all material respects with IAS and IFRS, but analysis of data showed that none of the companies surveyed has fully complied with all of the disclosure requirements of IFRS 8. Or, they should have disclosed the rationale for exclusion why they have omitted the some details.

Based on IFRS 8.20 to 8.36, there are at least 36 items listed companies should disclose about segments information. It is interestingly to note that M7 has almost complied completely with all disclosures; only, it failed to present interest expense. This finance cost cannot be offset against interest income since majority of the segment's revenues are not from interest.

The highest compliance achieved was 97.2 percent (35 items out 36) by one company. Three companies have 88.9 percent (32 items out of 36) compliance on the provisions of segment disclosures while two companies have the lowest compliance of 36.1percent (13 items out of 36).

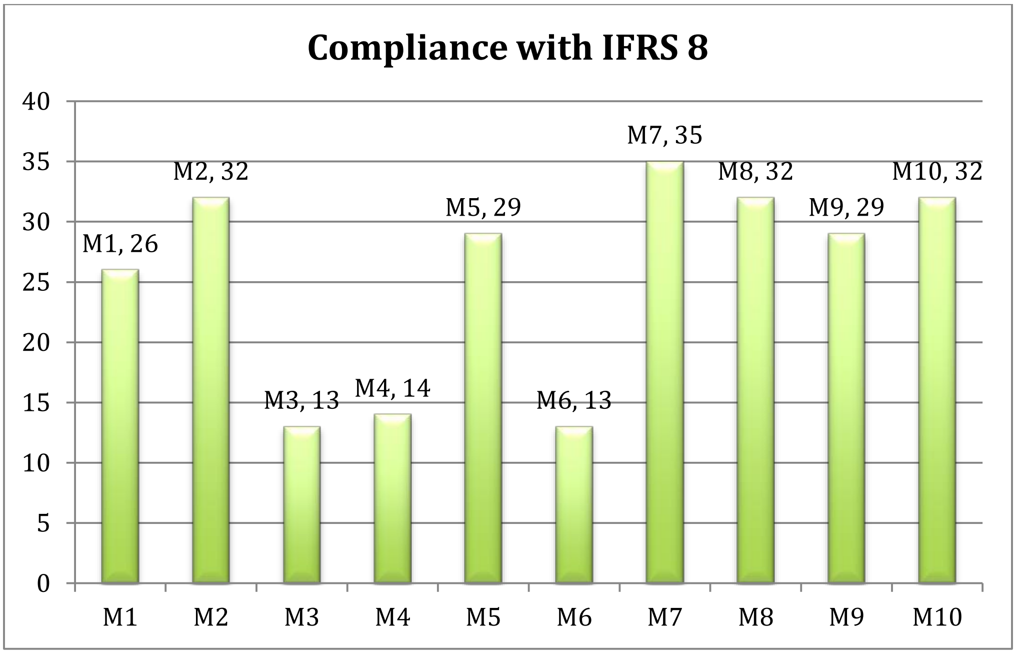

Figure 2. Analysis of compliance to IFRS 8 of ten manufacturing companies

Summary of Findings

All of the ten companies disclosed information that enables users of its financial statements assesses the nature and effects of financial activities, which develops business and economic environments in which it operates**.** They provided general information about the factors used to identify the entity's reportable segments, including the basis of organization; and types of products and services from which each reportable segment derives its revenues. Also, all of them reported comparative information to conform to the requirements of IFRS 8.

Eight companies disclosed the changes in the structure of its internal organization in a manner that caused the composition of its reportable segments to change. It is presumed that disclosures or restatement of previously reported information are not required when the necessary information is not available and the cost to develop it would be excessive.

Eight companies disclosed information about reported segment liabilities. Eight companies provided information about reported segment profit or loss, including specified revenues and expenses included in reported segment profit or loss. Six of them failed to disclose the entity's interest in the profit or loss of associates and joint ventures accounted for by the equity method even though financial reports showed their investment in associates.

Reconciliations of balance sheet amounts for reportable segments to the entity's balance sheet amounts are required for each date at which a balance sheet is presented. Information for prior periods shall be restated. Not all companies complied on this requirement especially the reconciliation of other material items. Paragraph 28 of IFRS mandated that all material reconciling items should be separately identified and described.

The measurement base for each segment items shall be the measure reported to the chief operating decision maker for the purposes of making decisions about allocating resources to the segment and assessing its performance. At a minimum, an entity shall disclose (a) the basis of accounting for any transactions between reportable segments; and (b) the nature of any differences between the measurements of the reportable segments' profits or losses and the entity's profit or loss before income tax expense or income and discontinued operations. Only 50 percent of the companies examined complied on these provisions.

On segment assets, all companies disclosed total assets on all segments reported but failed to disclose about the measure of segment assets reviewed by the CODM or are otherwise regularly provided to the CODM. Only three of them reported the amount of investment in associates and joint ventures accounted for by the equity method and the amounts of additions to non-current assets other than financial instruments, deferred tax assets, postemployment benefit and rights arising under insurance contracts.

Less than 50 percent of the manufacturing companies complied on the entity-wide disclosure requirements. Only six companies provided information about their major customers. While only three companies reported on non-current assets other than financial instruments, deferred tax assets, post-employment benefit assets, and rights arising under insurance contracts located in the entity's country of domicile; and located in all foreign countries in total in which the entity holds assets. Table 4 summarizes the provisions of IFRS8 not complied with by ten manufacturing entities.

Table 4. Summary of findings as to compliance with IFRS 8 disclosure requirements of selected listed companies in manufacturing industry in the Philippines

Required disclosures	Frequency
General information	10
Profit or loss	7.3
Assets	5.7
Liabilities	8
Measurement	5.5
Reconciliations	7.3
Restatement of previously reported information	10
Entity-wide	4.6

CONCLUSION AND RECOMMENDATIONS

A financial reporting system supported by high quality accounting standards is fundamental to trade and industry development. The implementation of the standards and monitoring on the compliance will persist to be taxing.

Nonetheless, after the first year of the IFRS 8 effectivity, the results of the study showed that all of the 10 manufacturing firms examined have their operating segments based on their products and services. It is interesting to note that one of the companies investigated had 97.2 percent compliance with the provisions of IFRS 8. We can posit that firm compliance is higher for firms with international or global operation and is also associated to firm size in terms of total assets. This is consistent with the findings of Pardal and Morais (2011).

The study shows that almost all of the manufacturing companies reviewed did not identify who the CODM was or which internal function it related to and this supports the findings of Mardini, Crawford, and Power (2012). The preparers of the financial information need to be clear on who the CODM is to ensure that information, which is communicated to users can be understood and interpreted appropriately (Mardini et. al., 2012).

On the other hand, based on the companies reviewed, the compliance level of listed companies has improved. Regulators like the SEC should be given credit for continuously monitoring the adherence of listed companies to the financial reporting standards. It is also noted that, being audited by top five auditing firms in the Philippines contributed to the increased conformity to the accounting standards. This supports the findings of Street and Gray (2001) that one of the key factors associated with levels of compliance consist of being audited by a Big 5+2 firm in the United States.

The researcher suggests that the increased level of compliance should not be a reason for regulators to be complacent in the implementation of international reporting and auditing standards. If they ensure greater compliance with accounting standards, there is ample scope for further improvement. However, penalties exist for those contravening the law, and the law needs to be enforced to maximize compliance (Al-Shammari, 2005).

In addition, accounting standard setters should simplify some provisions of the standards so that it is well and thoroughly understood by preparers of financial reports. The diverse reporting needs of different categories of companies, including those of small and medium enterprises must be taken into consideration. These require a highly simplified set of standards to encourage compliance at these levels (Salendrez, 2008).

Moreover, the education process needs to be addressed, as this equips preparers and auditors with the tools they need to understand and participate in the financial reporting process. Accountants need to continuously evaluate and improve their skills set so as to remain competitive. In this regard, the Philippine Institute of Certified Public Accountants (PICPA) and professional association of CPAs in public practice, commerce and industry, and academe must be persistently strengthened so that their members are continually updated to the recent developments in international reporting standards. To achieve this, providers of continuing professional education for accountants should not only conduct lectures but also give workshops on the application of those standards.

Furthermore, for researchers, they may consider to investigate the compliance by unlisted companies where the nature of reliance on accounting information can be quite different (Al-Shammari, 2005). Future researchers may possibly include publicly accountable firms in other industries not considered in this study.

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