PRACE NAUKOWE UNIWERSYTETU EKONOMICZNEGO WE WROCŁAWIU
RESEARCH PAPERS OF WROCŁAW UNIVERSITY OF ECONOMICS nr 290 • 2013

Performance Measurement and Management ISSN 1899-3192

Edward Nowak
Wrocław University of Economics

OPERATING SEGMENTS FOR REPORTING PURPOSES AND RESPONSIBILITY CENTRES FOR PERFORMANCE EVALUATION PURPOSES

Summary: Designation of operating segments is discussed in companies diversified for the purpose of financial reporting and performance evaluation. The problem under study is shown from the viewpoint of financial accounting norms and existing management accounting solutions. The analysis incorporates regulations contained in the International Financial Reporting Standard 8 (IFRS 8) – Operating Segments and Polish accounting legislature. What is also addressed is the problem of company operational segmentation into responsibility centres. Correlations between operating segments (reporting) and responsibility centres (performance evaluation) are shown to support the postulate of convergence of the two aspects of company operation.

Keywords: financial reporting, operating segments, responsibility centres, performance evaluation.

1. Introduction

Large business entities, such as multi-site and multi-industry companies and international corporations, typically conduct a wide range of business activities. Such diversification of business activities may apply to subjective, objective and spatial dimension. This creates a need for relevant economic information to gauge company performance in individual aspects of its operation, targeted for different stakeholders, both internal and external.

Conventional financial reports provide aggregated information on performance and financial standing of a company as a whole. Consolidated financial statements supply additional information on performance of individual subsidiaries of a holding group. However, this type of information is too synthetic to provide reliable evaluation of performance by type of business activity. Company stakeholders – owners, creditors, lenders, contractors – require more accurate and detailed information.

Information on the course and the results of different business activities is also required by company management and administration. Company success is closely related to performance of its constituent units; therefore, each type of business activity should be evaluated separately. The resulting information may then be used as a basis for strategic and operational decision-making.

This paper addresses the problem of company segmentation by type of business activity as reflected in a company accounting system, in particular – the role of operating segments in the accounting system and contrasting approaches to company segmentation observed in financial accounting and management accounting. The principal thesis of this paper can be expressed as follows: information on operating segments should be adjusted to the specific needs and requirements of internal and external stakeholders. The research objective is addressed by means of literature studies and analyses of accounting and financial reporting regulations, both domestic and international.

2. Segmentation of business activities and the company information system

Globalization of operations, internationalization of economies and increased market competition stimulates conglomeration and development of large business organizations. The competitive advantage of large companies is typically related to scale advantage. Furthermore, the need to compete with increased market pressure fosters business diversification. This is manifested mainly through extending subjective areas of activities and company product structure, increasing spatial coverage and conquering new markets.

Company size can be measured by various criteria. This is why no universal definition of a large company can be provided. Oftentimes, the size and complexity of a business entity is defined in quantitative terms, such as the number of employees, the value of assets, income, production capabilities and market share. Consequently, evaluation of a company size can only be presented in relation to a given criterion or a set of criteria.

For the purpose of this deliberation, a company size is evaluated in relation to its accounting system of information. Therefore, the operational definition of a large company must take into consideration the notion of system complexity [Nowak 2001]. In this sense, and from the viewpoint of accounting information recipients, a company is defined as large if it surpasses the potential of recipients to perceive and utilize information for decision-making purposes. Consequently, the accounting information system should be adjusted to the size and complexity of an organization, as well as to information requirements of its various stakeholders.

The quality of the accounting information system can be improved only by adjusting its structure to the complex subjective and objective systems of company's business activities. The primary instrument of such adjustment is the operating segmentation. It should reflect, on the one hand, the complexity of the organization and, on the other hand, the information requirements of its internal and external stakeholders.

The need for segmentation of operations in the accounting system is a direct result of company operating diversification, since the latter leads to an increase of information requirements as they relate to various aspects of company activities. This information should reliably reflect company performance in all the aspects to enable precise evaluation of those activities and their impact on return measured across an organization.

Segmentation of company operating areas involves separating distinct areas of business activities (operating segments). Each segment should be based on an area of specialization, which can be translated into competitive advantage. The resulting structure of operating segments should reflect the areas deemed crucial from the viewpoint of company performance and success. Therefore, operating segmentation can be seen as an important element of company's strategic analysis. Proper segmentation should lead to identification of key domains of business operation – sources of company's competitive advantage [Koch 1994, pp. 223–226].

Operating segmentation should be also reflected in the accounting information system. Economic information from individual segments is of great value to both external and internal actors. This is why information on operating segments should be generated by both the financial accounting subsystem and the subsystem of management accounting. In the case of financial accounting, the main source of economic information is the financial reporting by operating segment. In the case of management accounting, it is the responsibility accounting. At the same time, it is important to integrate the external and internal reporting subsystems applying to various operating segments.

The next part of this study will address the structure of economic information by operating sector adjusted to the structure of the accounting information system.

3. Financial reporting by operating segment

Financial reporting by operating segment is a subject of separate regulations on financial accounting and external financial reporting. The scope of regulatory provisions in domestic legislature and international regulations and standards of the profession. The prevailing trend in this respect is to increase the amount of information on operating segments to be disclosed in the obligatory financial reports. This trend is a direct result of the increased requirements of various stakeholders (owners, contractors, creditors, customers, etc.) on information that may be used for decision-making purposes.

Financial reporting by operating segment is a supplement and an elaboration of traditional financial reporting of business entities. It involves obligatory disclosure of information on financial result and economic standing of a company in the most important areas of its activities. The main purpose of financial reporting by segment is to provide more detailed information to external stakeholders, particularly – investors. This type of information can be used as a basis for risk identification in decision-making and resource allocation processes.

The most important regulation applying to financial reporting by segment is the International Financial Reporting Standard 8 (IFRS8) "Operating Segments", published in 2006. This standard superseded the recommendations of IAS 14 "Reporting Financial Information by Segment". In 1981 the International Accounting Standards Committee issued the International Accounting Standard 14 "Reporting Financial Information by Segment", updated in 1996 and 1997.

The issuance of IFRS 8 "Operating Segments" was a result of the International Accounting Standards Committee's intention to limit the discrepancies between IFRS and US GAAP (Generally Accepted Accounting Principles). In particular, the Committee's intention was to bring the recommendations in line with the guidelines contained in the US Statement of Financial Accounting Standards No. 131 (SFAS 131) "Disclosures about Segments of an Enterprise and Related Information". The IRFS 8, similarly to SFAS 131, adopted the so-called managerial approach to segmentation, largely increasing the utility of disclosed information.

The International Financial Reporting Standard 8 specifies the requirements of information disclosed on operating segments in obligatory annual financial reports as well as disclosure of selected information at interim reporting dates. In addition, the IFRS 8 indicates detailed information to be disclosed about products, services, geographical areas and major customers. The standard stipulates that an economic entity discloses in its financial reports information that is relevant and usable for the purpose of evaluation of financial effects of economic activities and the impact of economic environment in which a company operates. Information to be disclosed is both of financial and descriptive character [*International*… 2010, pp. A306–310].

Required disclosures of the IFRS 8 include:

- general information about company operating segments,
- information on financial result, assets and liabilities by segment,
- reconciliations of the totals segment revenues, reported segment profit or loss, segment assets, segment liabilities, and other material items to corresponding items in entity's financial statements.

IFRS 8 sets detailed criteria and quantitative thresholds to be used as a basis for identification of reportable segments, in terms of revenue, profit or loss, and assets. It must be noted that the IFRS 8 distinguishes two forms of segments:

- operating segments, defined as components of an entity's internal structure of organization,
- reporting segments, corresponding to operating segments that meet specified criteria and quantitative thresholds, as well as or aggregations of segments which by themselves do not meet such criteria and/or thresholds.

The quantitative threshold to qualify the operating segment (or aggregation of segments) as a reporting segment is set at 10% or more of the combined reported revenue, profit or loss, or assets of all the operating segments of an entity. Operating segments, in line with IFRS 8 recommendations, are not subject to information disclosure. However, such obligation to disclose information in financial reports applies to all reporting segments. Management may choose to interpret operating segments as reporting segments even if they do not meet the above criteria, when information on such segments is deemed significant for the chief operative decision maker.

Polish legislature on accounting and financial reporting does not provide for detailed regulations of information disclosure by segment. The Accounting Act (annex 1) specifies that product structure (forms of activities) and geographic structure of net revenues from sale of products, commodities and resources should be annexed to financial reports [The Accounting Act… 1994]. This regulation is in accordance with the criteria of operating segments defined in the International Financial Reporting Standard 8 [Sojak, Jankowska 2007, p. 11; Nowak 2012]. However, the above provision specifies neither detailed guidelines nor criteria for segmentation for financial reporting purposes.

Similar regulations in respect to operating segments apply to the Polish law of public companies, as set down in the government order on disclosure requirements of prospectuses and summaries. The order specifies financial information on operating segments to be disclosed in explanatory notes attached to the profit and loss account. These include information on the distribution of sale revenues by product structure and geographic location. More detailed requirements apply to disclosure of operating segment information in consolidated financial reports of capital groups. These include information on principles of segmentation, segment structure, valuation of revenues, expenses, results, assets and liabilities, as well as methods of determining transfer pricing [Government order… 2002].

This author's analysis of legal regulation suggests that Polish legislature on accounting and financial reporting lacks precise recommendation of principles to be employed in segmentation. It also lacks recommendation of best practices in respect to valuation of financial report items by segment. Consequently, economic entities operating in Poland should follow the recommendations set down in the IFRS 8 "Operating segments", where applicable.

4. Responsibility centres and management accounting

Management accounting is a system of reporting economic information addressed to company managerial staff. Its main objective is to provide information as required for the internal purpose of planning and performance evaluation, and decision-making processes at various levels of company management. Internal reports – their structure, layout and content – are adjusted to the system of management employed in a given company, as well as the requirements of users of such information. Report structure is also related to the specificity of company activities and to the organizational structure of a company.

Large companies are typically subject to decentralization of a management system, namely: segregation into internal organizational units (centres) of responsibility. This form of decentralization of management structure requires delegation of decision making powers to lower levels of company organization structure. At the same time, the appointed structural units are burdened with responsibility for realization of tasks resulting from delegated powers.

Centres of responsibility are determined based on the assumption that economic activities of companies can be segmented according to a wide range of criteria, such as organization, object, subject, geographic location, distribution, tasks, and so forth. It should be noted that each isolated segment of activities requires an individualized approach to strategy, operational specificity and management methods. One of such methods is the management accounting by responsibility centres or, in simple terminology, responsibility accounting. This form of management accounting represents a structure of planning/controlling/information/reporting addressed to specific responsibility centres. This requires determination of operational specificity as well as isolation of factors (parameters) allocated to each centre. Since individual centres are responsible for realization of allocated objectives and tasks, responsibility accounting must take into consideration the activities of each individual internal unit, regarded as a responsibility centre [Nowak 2001].

In terms of their range of powers and responsibilities, the following types of responsibility centres are distinguished:

– cost centres,
– revenue centres,
– profit centres,
– investment centres.

Evaluation of performance and task realization of each centre requires some form of performance measurement and evaluation. Synthetic measures of responsibility centres' performance are determined by the range of responsibilities allocated to them, such as: overhead cost, revenue, financial result and return on investment. Performance evaluation, on the other hand, is based on comparison of actual performance against performance targets set down in a company budget. In other words, deviation from a performance target is the primary instrument for evaluation of performance by a responsibility centre.

Another important element of responsibility accounting is the reporting of performance. Reports in this respect should provide top-managers with information on factual realization of tasks allocated to each responsibility centre. Performance reporting by responsibility centre should follow a predetermined schedule, depending on information requirements of top-managers and the duration of activities under evaluation. Typically, performance reports are presented monthly, with additional reports presented at the end of each cycle of activities under evaluation [Lew 2012].

Performance reports of responsibility centres should contain: factual values, planned values and the deviation between the two. Information presented in performance reports is then subject to detailed analysis, aimed at identification of reasons for any observed deviation from performance targets. At the same time, corrective actions are determined to alleviate negative deviations and supporting actions are postulated to reinforce positive ones. Therefore, internal performance reports play an active role in guiding the activities of responsibility centres without limiting to passive transmission of information. This is why the study of responsibility accounting should take into consideration the individual objectives of each centre and the type of decisions required of company top management in response to centres' performance. Proper identification of managerial information requirements is, therefore, a precondition for applicability of performance reports in decision making.

5. Integration of financial reporting and management accounting by segment

Financial information on various segments of company operation serves different purposes. On the one hand, it is disclosed to external stakeholders – mainly to investors – in the course of obligatory financial reporting procedures. On the other hand, financial information on performance of responsibility centres is presented to internal stakeholders for the purpose of internal evaluation. Consequently, the principles and criteria for isolation of operating segments and responsibility centres may be dissimilar.

From the viewpoint of coherence and effectiveness of a reporting system, it may be useful to integrate external financial reporting with internal performance reporting by segment of activities. This postulate is reinforced by the adoption of the so-called managerial approach to operating segmentation, as recommended in the IFRS 8 standard. In this approach, operating segments are identified based on the internal organizational structure of an enterprise. Here, operating segments represent isolated units of company organizational structure which participate in business activities and, at the same time, generate cost and revenue. Moreover, results of segment operation should be analysed and evaluated by company managers and used as a basis for decision making and resource allocation.

Operating segments determined in accordance with the above approach are largely similar to responsibility centres created for the purpose of performance evaluation. Each operating segment may be considered a self-contained responsibility centre, with clearly delegated powers and responsibilities. Therefore, it may be treated as a cost, revenue, profit or investment centre. For example, if a given operating segment is allocated with asset resources, it may be regarded as an investment centre. This approach may be used in enterprises characterized by wide differentiation – in objective, subjective or distribution terms.

Operating segments or aggregated operating segments are considered reporting segments if they satisfy the quantitative thresholds set down in applicable standards. The IFRS 8 standard recommends disclosure of information on such segments for the purpose of performance evaluation and resource allocation. Thus, reporting segments corresponding to larger operating segments may be regarded as profit centres or, in some cases, as investment centres. Furthermore, while reporting segments that represent aggregated operating segments may not be interpreted as responsibility centres, it seems viable to consider individual operating segments of the larger reporting segment as responsibility centres.

The problem of integrating the structures of reporting by segment with those of responsibility accounting may also be approached from a different perspective. Information presented by reporting segment – in accordance with the managerial approach – is related to the organization structure of an enterprise. In enterprises characterized by a decentralized management system, company structure conforms to the structure of responsibility centres. This structure determines controlling and performance evaluation processes. Hence, in most cases, responsibility centres may be interpreted as operating segments. Reporting segments, on the other hand, may be represented by individual responsibility centres or aggregated centres, based on recommended criteria.

Reporting segments based on the structure of responsibility centres are a particularly viable alternative in the case of diversified enterprises, since they represent strategic business units of relative independence. Such units often provide dissimilar products or operate in different geographic locations. At the same time, strategic business units are managed separately, with managers responsible for the unit's performance and reporting financial information to the parent. The reported information is evaluated by parent management on a regular basis. This approach is largely similar to the recommendations set down in the IFRS 8.

Integration of financial reporting by operating segment with organizational structure by responsibility offers a range of advantages. For one, the task of determining reporting segments based on organizational structure is by far more transparent. Measurement and evaluation of performance in this approach are more objective and unambiguous. Another important merit is the reduced cost of acquisition of information to be disclosed in obligatory financial reporting, since information may easily be presented at a proper level of detail, as required for external reporting purposes. Also, the need for duplication of similar information for different purposes is effectively eliminated. All the above features contribute to the overall quality improvement of a company reporting system.

The postulate for integration of financial reporting with internal reporting has been clearly articulated in recent years. Stakeholders of business entities expect more detailed information than that presented in traditional financial reports. In addition, the demand for specific, processed information on financial performance remains in clear contrast with limited quality of information presented on P&L accounts, balance sheets or cash flow statements. Lastly, stakeholder decision-making processes are more and more dependent on non-financial information. Internal reports reflecting the subjective and objective structure of an enterprise are the main source of information for the above purposes.

6. Conclusions

Financial information on company performance in various segments of its operation is required by different stakeholders. They are used for the purpose of an in-depth analysis of company performance and as a basis for business decisions. It helps stakeholders recognize specific risks involved in resource allocation and investment decisions. Another important determinant is the use of factors influencing the rate of return on investment.

It turns out after the above analysis that the Polish legislature on accounting and financial reporting does not provide for detailed regulations of information disclosure by segment. The analysis of legal regulation suggests that Polish legislature on accounting and financial reporting lacks precise recommendation of principles to be employed in segmentation. It also lacks recommendation of best practices in respect to valuation of financial report items by segment.

Reporting performance by operating segment plays an increasingly important role in the system of company financial reporting. Consequently, the system should be designed to provide applicable information to all stakeholders, both internal and external. From the viewpoint of effectiveness of a company reporting system, it is important to provide a unified and coherent structure of reports produced for those groups. This postulate can be met by integrating the operating segmentation used for the purpose of financial reporting with that of responsibility centres used for the purpose of internal performance evaluation.

References

Government order of 19 March 2002 superseding the order on disclosure requirements of prospectuses and summaries, Off. J. of 11 April 2002, No. 36, pos. 328.

International Financial Reporting Standards, International Accounting Standards Board (IASB), London 2010.

Koch R., *The Financial Times Guide to Management and Finance. An A-Z of Tools, Terms and Techniques*, Pitman Publishing, London 1994.

Lew G., Pomiar dokonań w ośrodkach odpowiedzialności, [in:] E. Nowak (Ed.), *Pomiar i raportowanie dokonań przedsiębiorstwa*, CeDeWu, Warszawa 2012.

Nowak E., Rachunkowość zarządcza w obliczu decentralizacji zarządzania przedsiębiorstwem, [in:] E. Nowak (Ed.), *Rachunkowość w zarządzaniu zdecentralizowanym przedsiębiorstwem*, PWE, Warszawa 2001.

Nowak E., *Zarządcze aspekty sprawozdawczości finansowej według segmentów działalności*, Prace Naukowe Uniwersytetu Ekonomicznego we Wrocławiu, nr 251, Wrocław 2012.

Sojak J., Jankowska M., MSR 14, *Sprawozdawczość segmentów działalności*, Difin, Warszawa 2007.
Statement of Financial Accounting Standards No. 131, *Disclosures about Segments of an Enterprise and Related information*, Financial Accounting Standards Board, Horwalk 1997
The Accounting Act of 29 September 1994, Off. J., 2002, No. 76, pos. 694, with amendments.

SPRAWOZDAWCZE SEGMENTY DZIAŁALNOŚCI A OŚRODKI ODPOWIEDZIALNOŚCI ZA DOKONANIA

Streszczenie: Artykuł jest poświęcony wyodrębnianiu segmentów działalności w przedsiębiorstwach zdywersyfikowanych na potrzeby raportowania i oceny dokonań. Problematyka ta została ukazana w świetle norm rachunkowości finansowej oraz rozwiązań z zakresu rachunkowości zarządczej. Analizie zostały poddane regulacje zawarte w Międzynarodowym Standardzie Sprawozdawczości Finansowej nr 8 „Segmenty operacyjne" oraz w krajowych przepisach prawnych z zakresu rachunkowości. Ponadto wskazano na segmentację działalności przedsiębiorstw na potrzeby wyodrębnienia ośrodków odpowiedzialności. Jednocześnie ukazano relację między sprawozdawczymi segmentami działalności a ośrodkami odpowiedzialności, zwracając uwagę na potrzebę konwergencji rozwiązań w tym zakresie

Słowa kluczowe: sprawozdawczość finansowa, segmenty działalności, ośrodki odpowiedzialności, dokonania przedsiębiorstwa.