

## IFRS 8 in trouble - country-by-country reporting is the...

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IFRS 8, "Operating Segments" has been applied to some 2008 financial statements of quoted companies and to all their 2009 interim statements.

The standard has been controversial since its adoption was proposed. This is not, unlike other International Financial Reporting Standards a truly European standard. IFRS 8 was lifted straight from US GAAP as a political gesture to the US Federal Accounting Standards Board to show the process of alignment of standards would not mean US GAAP would be completely subsumed by the IFRS.

The difficulty was that [academic research](#) had already shown that the US equivalent of IFRS 8 (called SFAS 131) had been bad news for shareholders.

So it looks like it is also proving to be now the standard has been put into use in Europe. In its pronouncement of 2010 the [Financial Reporting Review Panel](#) of the Financial Reporting Council has said it is concerned about how companies are reporting the performance of key parts of their business in the light of the introduction of IFRS 8. It requires some understanding of IFRS 8 and its predecessor, International Accounting Standard 14, to see why.

IFRS 8 requires companies to provide an analysis of profit, assets and liabilities so that investors can see the performance of the principal operations or "segments" of the reporting entity. The new standard requires management to define the company's operating segments in accordance with how its operations are managed in practice. In this way the IASB sought to respond to criticisms of IAS 14 (the previous standard), to reduce the ability of management to disguise poor performance of a part of the business, and to enable investors to review a company's operations from the same perspective as management. IAS 14 supposedly did this by focussing primarily on the disclosure of segment data by geographic location (usually by continent) with business focussed data being treated as secondary.

However, in doing so IAS 14 had some considerable advantages over IFRS 8:

→? All trade had to be allocated to a segment so that segment reports had to reconcile to the full financial statements. This is not required under IFRS 8 where only 75% of trading need be segment reported;

→? The same accounting standards had to be used for IAS 14 segment reports as for the main financial statements. This would seem logical. It is not a requirement of IFRS 8 — so its segment data can offer a completely different view from the rest of the audited financial statements.

→? ISA 14 segments were to an extent mandatory assisting comparison between entities and over time. IFRS 8 segments are created by the company at will. There is no reason why they need ever be consistent.

The resulting problems are already coming to light. The FRRP has apparently reviewed a sample of 2009 interim accounts and 2008 annual accounts (when they had early applied the standard) and has asked a number of questions about the implementation of IFRS 8. In particular they have asked a number of companies to provide additional explanations where:

- \* only one operating segment is reported, but the group appears to be diverse with different businesses or with significant operations in different countries;
- \* the operating analysis set out in the narrative report differs from the operating segments in the financial statements;
- \* the titles and responsibilities of the directors or executive management team imply an organisational structure which is not reflected in the operating segments; or
- \* the commentary in the narrative report focuses on non-IFRS measures whereas the segmental disclosures are based on IFRS amounts.

The FRRP has encouraged Boards of Directors to test their initial conclusions about their segmental reporting by considering the following questions:

- \* What are the key operating decisions made in running the business?
- \* Who makes these key operating decisions?
- \* Who are the segment managers (as defined in the standard) and who do they report to?
- \* How are the group's activities reported in the information used by management to review performance and make resource allocation decisions between segments?
- \* Is any proposed aggregation of operating segments into one reportable segment supported by the aggregation criteria in the standard, including consistency with the core principle?

- \* Is the information about reportable segments based on IFRS measures or on an alternative basis?
- \* Have the reported segment amounts been reconciled to the IFRS aggregate amounts?
- \* Do the accounts describe the factors used to identify the reportable segments including the basis on which the company is organised?

As a final question, the FRRP has reminded management to ask themselves whether the reported segments appear consistent with their internal reporting and, if not, why not.

The nature of these questions is pretty damning. It suggests that at least in some cases the FRRP believes management is misleading shareholders.

Those, like me, who criticised the adoption of IFRS 8 from the outset predicted this would happen: the US research, which I have summarised [here](#) showed that managers, when not monitored by shareholders, will make self-maximizing decisions which may not be in the best interest of those shareholders. These decisions include aggressively growing the firm, which reduces profitability and destroys firm value. They used geographic earnings disclosures to examine this issue. Statement of Financial Accounting Standards No. 131 (SFAS 131), which is almost identical to the controversial new IASB standard IFRS 8 let them do so. Under its provisions US companies could abandon geographic disclosure of earnings and other key data. They expected that such non-disclosure potentially reduced the ability of shareholders to monitor managers' decisions related to foreign operations.

Using a sample of U.S. multinationals with substantial foreign operations, they found that geographic non-disclosing firms experienced greater expansion of foreign sales, produced lower foreign profit margins and had lower firm value in the post-SFAS 131 period when compared to companies that continued to disclose geographic earnings. These differences did not exist in the pre-SFAS 131 period and did not relate to domestic operations. Compellingly, the only variable they could find that explained this was disclosure of geographic data.

In other words, IFRS 8 and its US equivalent are bad for shareholders because directors wilfully mislead them whilst pursuing their own aggressive agendas in vain pursuit of self —glorification.

There is an alternative: for some years I have been promoting the idea of country-by-country reporting. This version of segment reporting would require disclosure of the following information by each Multinational Corporation (MNC) in its annual financial statements:

1. The name of each country in which it operates;

2. The names of all its companies trading in each country in which it operates;
3. What its financial performance is in every country in which it operates, without exception, including:
  - ? Its sales, both third party and with other group companies;
  - ? Purchases, split between third parties and intra-group transactions;
  - ? Labour costs and employee numbers;
  - ? Financing costs split between those paid to third parties and to other group members;
  - ? Its pre-tax profit;
4. The tax charge included in its accounts for the country in question split as noted in more detail below;
5. Details of the cost and net book value of its physical fixed assets located in each country;
6. Details of its gross and net assets in total for each country in which it operates.

Tax information would need to be analysed by country in more depth requiring disclosure of the following for each country in which the corporation operates:

1. The tax charge for the year split between current and deferred tax;
2. The actual tax payments made to the government of the country in the period;
3. The liabilities (and assets, if relevant) owing for tax and equivalent charges at the beginning and end of each accounting period;
4. Deferred taxation liabilities for the country at the start and close of each accounting period.

This is real segment reporting, disclosing who does what, where and with what attached risk. The added value is enormous and for the first time people would be able to meaningfully assess the risk they engage in when trading with a multinational corporation. In addition, the whole issue relating to transfer pricing abuse would be exposed.

It's for the last reason that many of the world's most significant development charities support country-by-country reporting and the OECD is now looking at the issue, which already has the support of the EU Parliament.

As IFRS 8 fails to deliver the demand for country-by-country reporting can only grow.