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Segment Reporting

Financial Reporting Alert 14-3
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This alert discusses recent comments by SEC staff members regarding FASB Accounting Standards Codification Topic 280, *Segment Reporting* (ASC 280), and certain aspects of segment reporting that are expected to be the subjects of increased scrutiny by the SEC staff.

Background

Over the past several months, a number of SEC staff members have discussed recurring practice issues in segment reporting, including issues identified in the Financial Accounting Foundation's (FAF's) Post Implementation Review (PIR) report on FASB Statement 131.[1] Partly in response to the finding in the PIR report that technology advances have made the identification of operating segments more difficult, the SEC staff noted that its views about the information package provided to an entity's chief operating decision maker (the "CODM package") are evolving, and that its historical view may have overemphasized the importance of the CODM package. As a result, the SEC staff stated that it will renew its focus on the identification of the CODM and entity's organizational structure in determining operating segments. In addition, the SEC staff will continue to challenge whether aggregation of operating segments is consistent with the objectives and basic principles of ASC 280 and will question how entities determined that providing more detailed segment disclosures would detract from these objectives.

Given the SEC staff's evolving views on the application of ASC 280, we expect the staff to continue its focus on segment reporting. We also believe that it may revisit the conclusions reached in previous comment letters, particularly if the CODM package was a determinative factor.

Financial Reporting Considerations

Overview of Segment Reporting

ASC 280-10-10-1 states that the "objective of requiring disclosures about segments of a public entity and related information is to provide information about the different types of business activities in which a public entity engages and the different economic environments in which it operates to help users of financial statements do all of the following:

a. Better understand the public entity's performance

b. Better assess its prospects for future net cash flows

c. Make more informed judgments about the public entity as a whole."

ASC 280 requires that general-purpose financial statements include selected information reported on a single basis of segmentation. The method for determining what information to report is referred to as the management approach. ASC 280-10-05-3 states that the "management approach is based on the way that management organizes the segments within the public entity for making operating decisions and assessing performance. Consequently, the segments are evident from the structure of the public entity's internal organization, and financial statement preparers should be able to provide the required information in a cost-effective and timely manner."

ASC 280-10-05-4 further provides that the “management approach facilitates consistent descriptions of a public entity in its annual report and various other published information. It focuses on financial information that a public entity’s decision makers use to make decisions about the public entity’s operating matters. The components that management establishes for that purpose are called operating segments.”

Identifying Operating Segments

ASC 280-10-50-1 defines an operating segment as “a component of a public entity that has all of the following characteristics:

a. It engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same public entity).

b. Its operating results are regularly reviewed by the public entity’s chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance.

c. Its discrete financial information is available.”

According to ASC 280-10-50-5, the term CODM “identifies a function, not necessarily a manager with a specific title. That function is to allocate resources to and assess the performance of the segments of a public entity. Often the chief operating decision maker of a public entity is its chief executive officer or chief operating officer, but it may be a group consisting of, for example, the public entity’s president, executive vice presidents, and others.”

Recurring Practice Issue — Identifying the CODM

The SEC staff has noted recently in a number of forums that it expects to renew its emphasis on identifying an entity’s CODM. While most entities identify their chief executive officer (CEO) as their CODM, the SEC staff has noted that there could be instances in which, after responding to the staff’s questions, an entity changes its conclusion regarding the CODM, such as to a chief operating officer or to a committee. Because these individuals often review more disaggregated operating results than the CEO, such a change in the CODM can affect the entity’s conclusions about its operating segments. As a result, the SEC staff has indicated that it would also focus on understanding the management structure (e.g., through organizational charts or other information) supporting the person (or group) identified as the CODM.

A characteristic of an operating segment is that its operating results are regularly reviewed by the public entity’s CODM, who decides about resources to be allocated to the segment and assesses its performance.

Recurring Practice Issue — Identifying Information Provided to and Regularly Reviewed by the CODM

Historically, when evaluating an entity’s operating segments, the SEC staff has placed a great deal of emphasis on the information regularly provided to and reviewed by the CODM. The SEC staff would frequently request copies of the CODM package as well as the information provided to the entity’s board of directors and would attempt to reconcile that information to the entity’s operating segments.

In its December 2012 PIR review on FASB Statement 131, the FAF observed that “[a]dvances in information technology also make the guidance for determining operating segments more difficult to apply and audit. Technology allows more detailed financial information to be available to the CODM. The ability of the CODM to access more detail makes less clear what the CODM ‘receives’ and ‘regularly reviews.’ As a result, it might be more difficult to determine operating segments and less clear how to aggregate them.”

Partly in response to the FAF’s observation, the SEC staff has recently noted in a number of forums that its historical views regarding an entity’s CODM package are evolving and that in the past it may have overemphasized the importance of the CODM package. The SEC staff indicated that rather than viewing the CODM package as the determinative factor in identifying operating segments, it would consider the CODM package as only one of many factors in the determination.[2] Similarly, the SEC staff noted that it would not view the CODM package as a safe harbor for entities. That is, the staff might conclude that other, potentially conflicting information overcomes the absence of operating results in the CODM package for a potential operating segment. Entities should expect the SEC staff to:

- Question whether there are disaggregated operating results not included in the CODM package that are nonetheless regularly reviewed by the CODM.[3]
- Continue to review other publicly available information for consistency with the entity's segment disclosures, such as the information in the forepart of the Form 10-K (i.e., the business section and MD&A), the entity's Web site, analysts' reports, and press releases.[4]

The SEC staff's recent comments also serve to remind entities that the method used for segment reporting is the "management approach," which is based on an entity's internal organization, and that an entity's organizational charts may reflect its internal structure better than the information routinely provided to the CODM or CODM group, especially in light of the above-noted observation in the FAF's PIR report.

Aggregating Operating Segments

ASC 280-10-50-11 permits entities to aggregate two or more operating segments into a single operating segment "if aggregation is consistent with the objective and basic principles of [ASC 280-10], if the segments have similar economic characteristics, and if the segments are similar in all of the following areas . . . :

a. The nature of the products and services

b. The nature of the production processes

c. The type or class of customer for their products and services

d. The methods used to distribute their products or provide their services

e. If applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities."

It is presumed that users would prefer disaggregated information and that operating segments should be aggregated only if providing more detailed information would not enhance a user's understanding of the entity.

Recurring Practice Issue — Aggregating Operating Segments

ASC 280 requires disclosure if operating segments have been aggregated. When evaluating an entity's reported segments, the SEC staff has routinely requested clarification about whether operating segments have been aggregated and, if so, the analysis performed in concluding aggregation is appropriate. The SEC staff expects the entity's analysis to address whether aggregation is consistent with the objectives and basic principles of ASC 280 as well as how the entity determined that providing more detailed segment disclosure would detract from these objectives.

ASC 280-10-50-11 states that "[o]perating segments often exhibit similar long-term financial performance if they have similar economic characteristics. For example, similar long-term average gross margins for two operating segments would be expected if their economic characteristics were similar." There are no bright lines in the evaluation of whether two or more operating segments possess similar economic characteristics. That is, ASC 280 does not define the term "similar" or provide guidance on the time horizon of historical and expected future periods to be evaluated. ASC 280 provides “long-term average gross margins” and "sales trends” only as examples of the measures to be considered and does not indicate what other measures are acceptable[5] or what would be an acceptable spread between those measures. Accordingly, an entity is required to use significant judgment when it elects to aggregate operating segments, and good documentation of its judgment is paramount. Recent comments from the SEC staff suggest that challenges in this area will continue and that the staff may ask entities to explain and defend the reasonableness of the judgment they applied.

Next Steps

Given the SEC staff’s evolving views on segment reporting, we recommend that entities review how they determined their CODM, operating segments, and reportable segments and be prepared to support the conclusions they reached. Further, we recommend that management consider the potential effect that these matters may have on the entity’s documented policies, processes, and internal controls to determine whether any updates or changes are warranted.

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1 FASB Statement No. 131, *Disclosures About Segments of an Enterprise and Related Information* (codified as ASC 280).

2 Entities should consider all available information in determining how the CODM makes decisions to allocate resources and assess performance, including understanding the process and discussions that occur in the CODM’s regular meetings (weekly, monthly, or quarterly) with other members of management.

3 If the information in the CODM package is too high-level, the SEC staff will ask entities to explain how performance problems can be identified or alternative allocations of limited resources can be evaluated if the CODM does not use more disaggregated operating information.

4 Serious questions are raised when financial information released to analysts or the financial press differs from the information in the entity’s segment disclosures.

5 Entities may decide to look to other performance measures such as operating cash flows; return on assets, earnings before interest, taxes, depreciation, and amortization (EBITDA); inventory turnover; or other standard industry measures. These factors should be evaluated from both a historical and "expected future performance" perspective. However, an expectation of similar long-term economic performance is not sufficient alone; that is, "expected future performance" should not be evaluated only on the basis of future budgets (i.e., historical results should not be excluded). In addition, competitive, operating, and financial risks related to each business or industry type should be considered in the determination of whether two operating segments have similar economic characteristics. If operating segments are located in different geographical areas, entities may need to evaluate factors such as economic and political conditions, currency risks, and foreign exchange control regulations.
