TBH Consulting LLC

Segment Reporting: Understanding ASC 280

Executive Summary

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I. Understanding Segment Reporting

Introduction to ASC 280

The FASB has long recognized the importance of readily available and quality segment information to the users of financial statements. As such, it has set the accounting standards for business segment reporting in Topic 280 of its Accounting Standards Codification. Under ASC 280, public entities are required to disclose certain disaggregated information about their operating segments in their annual and interim financial statements.

> The objective of ASC 280 is to provide information on the business activities and economic environment of a company to help users of the financial statements better understand entity performance, assess future net cash flows, and ultimately make more informed judgments about the entity as a whole.

The required information for segment reporting ultimately provides a more detailed lens of the entity's regular financial statements. Investors and other financial statement users view segment disclosures as being imperative to their investment decisions, enabling them to gain a more complete picture of a firm's operations.

Overview of operating segments

Entities are often organized into multiple components or segments that are used to effectively manage resources. A segment is a component of a business that generates its own revenues by creating its own product, product lines, or service offerings. A segment could also be a division, subsidiary of an entity, or geographic area. It may also be engaged in business activities where it has not yet recognized revenue. In general, if a unit of a business can be lifted out of the larger company and remain a self-sufficient entity, then it may be classified as a business segment.

Scope and exclusions

The disclosure guidance in Topic 280 applies to public entities only.

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> Non-public entities that are considering becoming public in the future should consider segment reporting requirements.

Segment reporting is not always required for parent companies, subsidiaries, joint ventures, or investees accounted for by the equity method if those entities' separate company statements are included in consolidated or combined financial statements that are part of either a financial report or filing issued by a public entity. Refer to ASC 280-10-15-3 for all scope exclusions.

Implications for non-public entities

If non-public entities elect to voluntarily provide segment information, they must follow the standards set by ASC 280 and include the required segment disclosures for all periods presented. Further, they must also use the guidance under ASC 280 to determine operating segments when identifying reporting units for purposes of allocating goodwill and testing for goodwill impairment, as required by ASC 350.

Complexities of ASC 280

Two primary concerns of investors:

- Companies that report an inappropriately determined number of segments, whether too few or too many.
- Companies that provide limited segment disclosures for their segments, such as only revenue and margin detail.

Segment disclosures for public entities continue to be an area of frequent comment and discussion for the SEC staff. Moreover, when the FASB periodically surveys investors about what areas within U.S. GAAP should be improved, segment reporting is frequently near the top of the list.

One difficult issue that the FASB recognizes is that key financial metrics valued by management and analysts vary drastically by industry. Therefore, the standard does allow some built-in flexibility to accommodate for this while remaining specific and tailored enough that sufficient information is provided across industries for investors.

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Investors and other users of the financial statements rely on the use of segment reporting to make investment decisions.

For example, an entity may determine that certain divisions represent segments while others do not. This may lead to incomplete information that would not provide a sufficient picture for investors. The opposite issue may exist as well with excessive disaggregation. To mitigate this, the FASB Board has established broad guidelines that are specific enough to enable and guide management through the process of effectively determining the appropriate segment disclosures needed for their business. Though the standard is a roadmap, the journey through the process of evaluation and determination is complex, and therefore management is required to exercise a great deal of significant judgment. Companies should go through a contemporaneous and robust exercise of compiling appropriate internal supporting documentation for their segment reporting assertions to avoid the pitfall that the SEC staff may assert an insufficiency in their historical reporting.

FASB updates – ASU 2023-07

In November 2023, the FASB released an update on *ASC 280 – Segment Reporting*. The FASB determined it was appropriate to provide even further disclosure requirements for segment reporting.

The FASB initially released FASB Statement No. 131, Disclosures about Segments of an Enterprise and Related Information in 2012. The report noted that most investors were content with the current disclosures, but some were seeking additional disclosures.

In 2016, stakeholders provided additional feedback, specifically the need for disclosures related to management's approach to segment reporting.

As a result of that feedback, the FASB issued *ASU 2023-07 Segment Reporting (Topic 280): Improvements to Reportable Segment Disclosures* expanding disclosure requirements for segment reporting.

The amendments in ASU 2023-07 can be summarized as follows:

- A public entity will disclose on an annual and interim basis, significant segment expenses provided to the Chief Operating Decision Maker (CODM).
- A public entity will disclose on an annual and interim basis an amount for

other segment items and the description. Other segment items represent the difference between segment revenue less segment expenses disclosed.

- A public entity will continue to provide established disclosures under ASC 280.
- For a public entity, if the CODM looks at other metrics in addition to measurement principles under GAAP, those should be disclosed.
- A public entity will disclose the title and position of the CODM as well as how the reported measure(s) are assessed by the CODM.
- A public entity with only one reportable segment will provide all disclosures initially established by ASC 280 and the updates made by ASU 2023-07

Additional requirements of ASU 2023-07 are included in the discussion below.

> These updates are applicable for public entities for the fiscal year beginning after December 15, 2023. The updates should be applied retrospectively to prior periods presented.

II. Applying the Key Steps

Determine appropriate reporting

An entity should follow each of the below key steps to navigate and apply the guidance for segment reporting:

1. Determine the CODM
2. Determine Operating Segments
3. Determine Aggregation of Segments
4. Determine Reportable Segments
5. Appropriate Disclosures for Reportable Segments
6. Appropriate Disclosures on an Entity-Wide Basis

Step one: determine the CODM

Identifying an entity's CODM is the first step in determining operating segments because those disclosures are based on how the CODM manages the entity's business operations. The CODM serves as a function as opposed to a title and the decision-making responsibility is typically designated to a person or group of people within the entity's highest levels of management that are responsible for determining the overall resource allocation and performance assessment of operating segments. Identifying the CODM is a key aspect in determining a company's operating segments and will vary from one entity to the next based on each one's unique facts and circumstances.

Entities must continually reassess the proper person or group of people who serve this role. Some typical key operating decisions that indicate authority and thus may assist in identifying the CODM include the following:

1. *Approving operating budget and forecasts*
2. *Entering into significant contracts*
3. *Hiring of key management or executive personnel*
4. *Making significant capital investment decisions, and/or*
5. *Changing company-wide strategies*

The CODM must not be confused with a segment manager who has more direct control over daily segment operations. Commonly, it is the case that a segment manager is accountable to and in direct contact with the CODM regarding the specific segments and reporting units that they oversee.

The updates in ASU 2023-07 require that an entity disclose the title and position if an individual is the CODM or the name of the group determined to be the CODM.

Step two: determine operating segments

The CODM is responsible for identifying which of the entity's components are to be considered as operating segments via the management approach. The management approach uses managerial information previously generated (to assess internal operating results) to base the evaluation of components in accordance with how management structures, organizes and operates the business. Under this approach, a component is considered an operating segment if it possesses **all** three of the following characteristics:

1) It engages in business activities from which it may earn revenues and incur expenses.

2) Its operating results are regularly reviewed by the entity's CODM to make decisions about resources to be allocated to the segment and assess its performance.

3) Its discrete financial information is available.

The analysis of one characteristic often assists in the analysis of another.

Regarding the first characteristic, business activities need not sell goods and services to external parties to qualify as relevant business activities because internal sales also qualify. Additionally, a component does not have to recognize revenues in order to be considered as an operating segment, so long as it merely has the ability to recognize them. This broad definition enables operating segments to include start-up operations, vertically integrated operations, and unconsolidated businesses. However, not every component is necessarily considered an operating segment; for example, corporate headquarters and pension plans would not be considered reportable segments.

The second characteristic requires information to be provided to and reviewed by the CODM to assess segment performance and determine proper allocation of resources. This task can be difficult when an entity produces reports that vary in the presentation of their business activities due to the overlapping of two or more components for which managers are held responsible for.

The third characteristic requires that relevant and discrete information be available for management and the CODM to use on a regular basis. The term discrete indicates that the information is distinguishable on its own and is both measurable and reportable. The information must be sufficient in detail for the CODM to be able to both conduct their review and analysis of segment performance and make resource allocation decisions. Whether the information is sufficient in detail or not depends on the financial metrics that the CODM uses and finds meaningful for purposes of carrying out their function. Thus, it is helpful to identify what financial metrics the CODM uses to fulfill their responsibilities.

For example, detailed information about revenue and expenses is most often expected. The level of detail may vary, however, especially across different industries. Different financial statement lines may be scrutinized at different levels. Further, the CODM may not require discrete information regarding assets and liabilities for a component to be designated as an operating segment. Ultimately, what meaningful information is relevant to one entity may not be relevant to the next, and thus required metrics for discrete information are not standardized.

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Judgment is necessary in determining the operating segments and their appropriate structure for segment reporting purposes, and thus the CODM must carefully consider the entity's facts and circumstances.

As a part of the ASU 2023-07 updates, a company would need to disclose, for each segment, the significant expense categories and amounts that are regularly provided to the CODM. These include segment expenses provide to the CODM and expenses that can be easily determinable from amounts provided to the CODM.

Step three: determine aggregation of segments

Aggregation is not required by ASC 280, but rather is optional. Once operating segments are identified, an entity may subject them to aggregation criteria to determine which of them could be combined to form one single operating segment. The purpose of aggregation is to simplify presentation and apply the same treatment for similar operating segments in the disclosures.

However, individually significant information lost in aggregation could obscure the understanding of a financial statement user. Thus, criteria must be carefully applied. The aggregation criteria applied aims to prevent the aggregation of individually significant information. The ability to meet the criteria is dependent on an entity's specific facts and circumstances, all of which the CODM must assess. The aggregation of operating segments is only appropriate when **all** of the following criteria are met:

- They have similar economic characteristics.
- Aggregating them is consistent with the objective and basic principle of Topic 280.
- They are similar in five specified areas:
  - Nature of products and services
  - Nature of the production processes
  - Type or class of customer for their products or services
  - Methods used to distribute their products or provide their services
  - Nature of the regulatory environment (if one exists)

As the standard does not provide much guidance on how to apply the first criterion, it is generally recommended that entities assess factors that are entity-specific and based on the primary factors that the CODM uses in allocating resources to individual segments. Gross margins, EBITDA, and key performance indicators typically are useful metrics for comparison of economic similarities.

Aggregation is consistent with the objective and basic principles of Topic 280 if it leads to segment disclosures that provide information about the different types of business activities in which the entity engages and the different economic environments in which it operates. Through the assessment of this second criteria, it is important to consider information such as available industry reports and other analyses reviewed by financial statement users that may provide insight into how a reasonable investor would view the entity, as well as factors that indicate whether information is significant enough to be reported individually or combined. Typically, if the other two criteria are met, the criteria to meet the objectives and basic principles of Topic 280 is also usually met.

The five specified areas in the third criterion target qualitative similarities between segments. Entities with products and services similar in nature most likely will have similar degrees of risk, opportunities for growth and end uses. Consideration of the internal financial reporting and overall operations of an entity may also be necessary.

Some factors to consider for aggregation are:

- Production process
- Shared production resources such as labor, facilities, and materials
- Customer type
- Regulatory environment

These factors should be considered across segments to determine if aggregation is appropriate.

Step four: determine reportable segments

Each operating segment identified is analyzed to determine whether it is to be considered a reportable segment. The guidance under ASC 280 provides a framework that includes tests that contain quantitative thresholds designed to determine the materiality of the segment in relation to the company as a whole. If an operating segment meets the threshold for any one of the three tests, then it is determined to be material, and therefore must be individually disclosed as a reportable segment. The three quantitative tests include the following:

- The revenue test – Operating segment represents 10% of the combined revenue of all operating segments.
- The profit or loss test – Operating segment's profit or loss is at least 10% of the greater of, in absolute amounts, the combined reported profit of all operating segments that did report a profit, or the combined reported loss of all operating segments that did report a loss.
- The asset test – Operating segment's assets are at least 10% of the combined assets of all operating segments.
    - If the CODM does not receive asset information by segment, the test need not be performed.

These qualitative tests are based on amounts reported to and reviewed by the CODM, as such, the aggregate of all combined operating segments may not be equal to the consolidated amounts reported in the financial statements. This is due to eliminations and other amounts that would not be included in operating segment information.

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Aggregated operating segment data may differ from consolidated financial information.

An operating segment is considered insignificant if it does not meet any of these three quantitative criteria. There are three potential treatments for an insignificant operating segment, depending on the nature of the segment. Those treatments are illustrated as follows:

- Combine with other insignificant operating segments if the conditions in section 280-10-50-13, the aggregation criteria, are met.
- Classify it as a reportable segment if:
  - The 75% test (of consolidated revenues) in section 280-10-50-14 is not met and more reportable segments therefore need to be identified.
  - It was one in the immediately preceding period and is of significance even though it no longer meets the reportable segment criteria.
  - Management believes the information about the segment remains to be qualitatively material.
- Report it in an "all other" category.

Step five: appropriate disclosures for reportable segments

The required disclosures for reportable segments for annual and interim financial statements can be summarized into three categories – 1) General Information, 2) Information about Profit or Loss and Assets, and 3) Reconciliations.

The information in these categories is disclosed for each period in which an income statement is presented. Further, reconciliations related to balance sheet amounts are made for each year in which a balance sheet is presented.

General Information:

The requirements for general information provide financial statement users with context over management's approach to segment disclosures and are particularly important when an entity is organized as a single operating segment. These factors are generally described in broad terms. Even if reportable segments are not structured with products or services as the identifying factor, it is nonetheless also required to disclose the types of products and revenue for each reportable segment. Additionally, any operating segments that have been aggregated must be disclosed.

The information on the details of the identification of the CODM required by ASU 2023-07 is included in the General Information section.

Information about profit/loss and assets:

Information about profit and loss must be reviewed by the CODM for each reportable segment. Any information not reviewed by the CODM should be excluded from the profit or loss measure used in segment disclosures. Although an entity is not required to restate its financial information to reflect a change in measurement of segment profit or loss, presentation of all segment information on a comparable basis is preferable.

For each income statement year presented, the following must be disclosed:

- Revenues from external customers
- Revenues from transactions with other internal operating segments
- Interest revenue
- Interest expense
- Depreciation, depletion, and amortization
- Unusual items, including unusual events and transactions
- Equity in net income of investees accounted for by the equity method
- Income tax expense or benefit
- Significant noncash items other than depreciation, depletion, and amortization expense

Total assets of each reportable segment must be presented separately. Consistent with guidance within ASC 280, the measurement used must be the same measurement reviewed by the CODM.

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Liabilities are not required to be disclosed under ASC 280; rather, they are only required for segment reporting under IFRS.

Along with total assets, there are two additional items that must be separately disclosed by reportable segment if they are regularly provided to the CODM. The first is the amount of investment in equity method investees. The second relates to the total expenditures for additions to a segment's long-lived assets aside for the exceptions listed in ASC 280-10-50-25.

ASU 2023-07 requires disclosures over significant expense categories and amounts that are regularly provided to the CODM. Qualitative and quantitative factors should be considered when determining what categories of segment expenses and amounts are considered significant. If any significant expense amounts provided to the CODM can be computed from the information provided in other segment disclosures, those amounts should be disclosed in both annual and interim financial statements. For example, ratios and percentages may be regularly provided to the CODM in the form of key performance indicators. If a key performance indicator were to embed expense amounts that are easily determinable, the significant expenses must be computed and then disclosed.

Under ASU 2023-07, an entity is now required to disclose amounts for Other Segment Items for each reportable segment including a qualitative description of the items.

For each reportable segment,

an entity is required to disclose segment profit or loss, segment assets, related products and services, measurement criteria, and other related useful information.

However,

it is not required under U.S. GAAP to report segment cash flows.

Other segment items represent the difference between reported segment revenues minus significant segment expenses disclosed minus reported segment profit and loss. These items are other items included in profit and loss of a reportable segment but are not reported to the CODM.

An entity is required to include an explanation of the nature of expenses the CODM uses to manage operations.

An entity will provide an amount and qualitative description of other segment items for each segment even if the entity does not separately report significant segment expense categories.

Similar to other reportable segment information, the aggregate amount of other segment items or significant segment expenses do not need to reconcile to reported consolidated financial statements.

Reconciliations:

All significant reconciling items shall be separately identified and described in the segment disclosures. Additional required reconciliations are listed in ASC 280-10-50-30 for items such as profit and loss of segments, assets of the segments, and significant items of the segments back to the amounts disclosed by the public entity. For example, the amount of each significant adjustment to reconcile accounting methods used in determining segment profit or loss to consolidated amounts shall be separately identified and described.

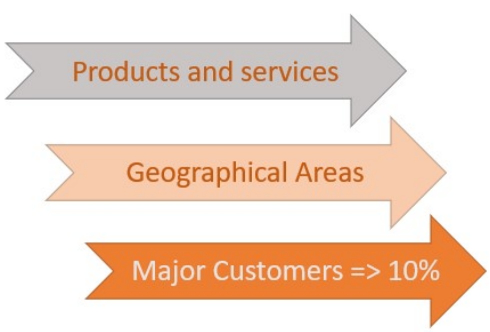
ASU 2023-07 does not require reconciliations of the other segment items disclosed.

Step six: appropriate disclosures on an entity-wide basis

Entity-wide disclosures are only required for annual financial statements and are intended to provide supplemental information about an entity's revenues and long-lived assets even if the information is not used by the CODM to manage the entity. These disclosures should enhance information regarding products, services, and geographical operations across the entity. If any required information is already disclosed, the entity would not have to repeat it.

Disclosure of information about products and services becomes particularly important when an entity has identified a single operating segment.

The following disclosures apply to all public entities regardless of the number of reportable segments:



Management must use judgment to determine what is reasonably considered as 'similar' to one another. While the guidance offers no bright-line test to determine materiality, a threshold of 10% is recommended and commonly used as a useful guideline for determining the materiality of revenues from products and services.

The purpose of geographic information is to provide information regarding the risks and uncertainties in certain geographic areas. Companies must disclose revenues from external customers that are attributable to the entity's home country and all foreign countries if the amount is material. Management must disclose the long-lived assets that are located in the entity's home country, all foreign countries in total for which the entity holds assets, and individual foreign countries if the amount is material. Exceptions to the disclosures of long-lived assets are included in ASC 280-10-50-41b.

Information regarding an entity's customer base provides insight regarding the extent of a company's reliance on its major customers, and therefore where there may be a significant concentration of risk. The guidance in ASC 280 establishes a 10% threshold of total annual revenue for identifying and disclosing major customers. However, the identity of the major customer does not need to be disclosed. In certain cases, determining who the customer is may not be straightforward and will require judgment. This is commonly the case when it comes to related party entities.

III. Presentation Requirements for Segment Reporting

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Segments are required to align with the company's reporting structure and be reported based on how management internally evaluates the operating performance of the company's business units or segments.

The elected accounting principles for the consolidated financial statements should be consistently applied in preparing the financials the segment information disclosed. An entity's segment disclosures in its annual report should be consistent with those in other published information about the entity, such as its website, press releases, and investor presentations.

Industry specific reporting

Certain industry guidance in the Codification include a Subtopic focused on industry-specific segment reporting disclosure requirements and issues. For example, specific guidance is included within *ASC 924 for Entertainment – Casinos, ASC 908 for Airlines, ASC 932 for Extractive Industries – Oil and Gas, ASC 954 for Health Care Entities*, and so on. If applicable to your business, please refer to these other sections for more industry-specific detail and requirements.

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CONTACT US

For more information on this or other topics please email us at:

info@tbhconsulting.com