

## Navigating the Maze of Segment Reporting for Retail & Consumer Companies

Financial Accounting Standards Board Statement No. 131 (SFAS 131), *Disclosures about Segments of an Enterprise and Related Information*, is intended to give analysts and other financial statement users a view of the company "through the eyes of management" by looking to a company's internal management reporting structure as the basis for determining the company's external segments.

The proper identification of segments continues to be an area of focus for the SEC staff, resulting in numerous restatements for companies across industries, including retailers and consumer products manufacturers (Retail & Consumer companies). The importance of the issue is twofold: (1) for public companies – the proper identification of operating segments and the potential aggregation of operating segments into reportable segments affects footnote disclosures and levels at which Management's Discussion and Analysis is presented to investors in the financial statements, and (2) for public and nonpublic companies – the proper identification of operating segments is essential to the company's proper

identification of reporting units for purposes of allocating goodwill and for goodwill impairment analyses under SFAS 142, *Goodwill and Other Intangible Assets*. In fact, incorrect application of SFAS 131 is not just a disclosure issue; in some cases, the change in the identification of operating segments can also result in a significant change in allocation of goodwill and significant changes to goodwill impairment charges. Therefore, the proper identification of operating segments is an important consideration for nonpublic companies as well as for public companies.

Companies continue to receive SEC comment letters that contain similar segment questions. The SEC's comments on segment reporting can be broadly grouped into the following categories:

1. Identification of the chief operating decision maker (CODM)
2. Identification of operating segments
3. Aggregation of multiple operating segments
4. Identification of reporting units

### Segment Documentation

Robust, contemporaneous documentation of the accounting analysis of segment reporting and the decisions made is imperative. Questions Retail & Consumer companies should ask themselves as they document their analysis include, but are not limited to, the following:

- Who is the CODM?
- What does the CODM receive?
- Is the information the CODM receives consistent with the company's operating segments, and if not, can they be reconciled?
- Who does the CODM meet with on a regular basis?
- What are the operating segments?
- What evidence exists to support that aggregated segments have similar economic characteristics?
- What information is included on the company's website, in press releases, and in MD&A? Is this information consistent with the operating segments?

## Identifying the CODM

The SEC staff continues to focus on the approach used by companies to identify the CODM, including questioning whether the CODM is a group of individuals, as opposed to one individual. Generally, decisions about a company's overall resource allocation to different areas of its business are made at the highest level of management, notwithstanding that certain decisions may be made at lower levels of management where more detailed disaggregated information is reviewed. However, depending on the individuals involved in assessing performance and making decisions about overall resource allocation, the CODM can be, for example, the chief executive officer or chief operating officer, or a group consisting of the company's president and executive vice presidents. If the CODM is a group of individuals (e.g., CEO, CFO, and regional presidents), the identification of operating segments may need to be at a lower level.

A presumption is held by the SEC staff that all of the information received by the CODM (i.e., the CODM reporting package) is also used to assess performance and allocate resources. The SEC staff has consistently challenged an argument that even though a CODM receives the entire reporting package, the CODM does not use all of it in operating the business. Companies should be able to reconcile the number of operating segments and segment disclosures with the information contained within the CODM reporting package.

## Identifying operating segments

Determining the appropriate operating segments involves a careful analysis of information, including but not limited to, the CODM reporting package, organizational charts, website information, and press releases. Companies should be able to reconcile the information contained in these documents to the number of operating segments.

## Regular Assessment of Operating Segments

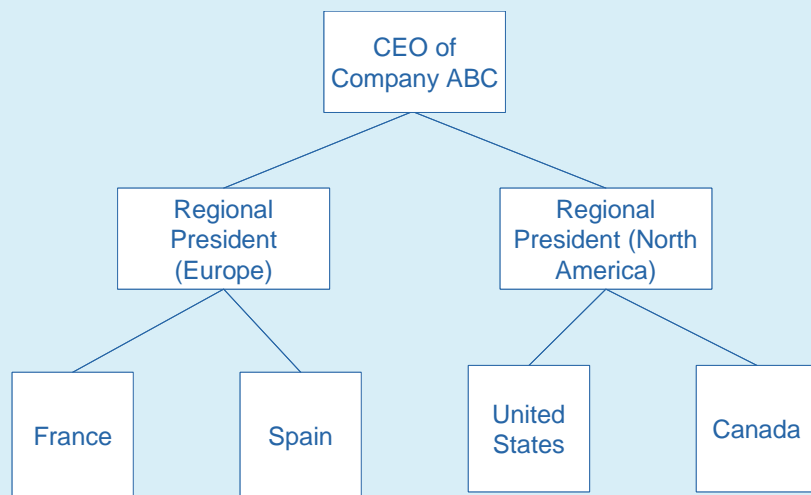
An analysis of operating segments and reporting units should not be a one-time phenomenon. Companies should regularly reassess their operating segments and segment disclosures for adequacy, particularly when certain transactions or events occur, including:

- Significant acquisitions
- Significant disposals
- Changes in management
- Structural changes to the organization
- Changes in reporting (i.e., changes to the CODM report)

## Aggregating multiple operating segments

When aggregation of two or more operating segments is being considered, the specific facts and circumstances must be carefully evaluated to ensure SFAS 131 objectives and aggregation criteria are met. Stringent conditions should be met in order to aggregate multiple operating segments into a reportable segment. Only operating segments that have economic characteristics so similar that they can be expected to have essentially the same future prospects should be aggregated. With respect to similar economic characteristics, the similarity of two operating segments should be carefully evaluated from both a historical and expected future performance perspective. The SEC staff has aggressively challenged registrants in this area and has indicated that the similarities of performance indicators must be historically demonstrated, and there must be an expectation that the financial performance will remain similar in the future.

## Identification of the CODM and Operating Segments



If the CODM is the CEO, the company may have only two operating segments (Europe and North America); however, if the CODM consists of the CEO and the Vice Presidents of the Europe and North America regions, the company may have four operating segments (France, Spain, United States and Canada).

When aggregating operating segments, companies should consider the following factors:

- Similar economic characteristics (e.g., long-term average gross margins, return on assets, and sales trends)
- The nature of products and services
- The nature of the production process
- The type of class of customer for products and services
- The method used to distribute products and services
- If applicable, the nature of the regulatory environment

## Identifying Reporting Units

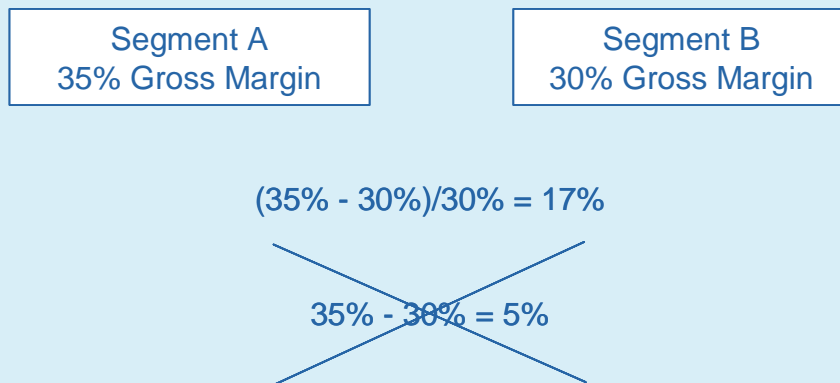
Operating segments are the cornerstone of goodwill impairment testing. SFAS 142, paragraph 31 stipulates that although an entity may not be required to report segment information in accordance with SFAS 131, the entity is nonetheless required to test goodwill for impairment at the reporting unit level. Therefore, companies must identify their operating segments in accordance with SFAS 131 for purposes of determining their reporting units. Goodwill is tested for impairment at the reporting unit level, which cannot be higher than the operating segment level.

Because goodwill must be tested for impairment at the reporting unit level, the interaction between operating segments, reporting

units, and components is significant. A reporting unit may be an operating segment or a component of an operating segment if the component constitutes a business for which discrete financial reporting information is available and segment management regularly reviews the operating results of that component. A component can be aggregated only with other components of the same operating segment (provided that the components have similar economic characteristics) for purposes of determining a reporting unit under SFAS 142. A component of one operating segment cannot be aggregated with a component of a different operating segment, regardless of whether the components have similar economic characteristics.

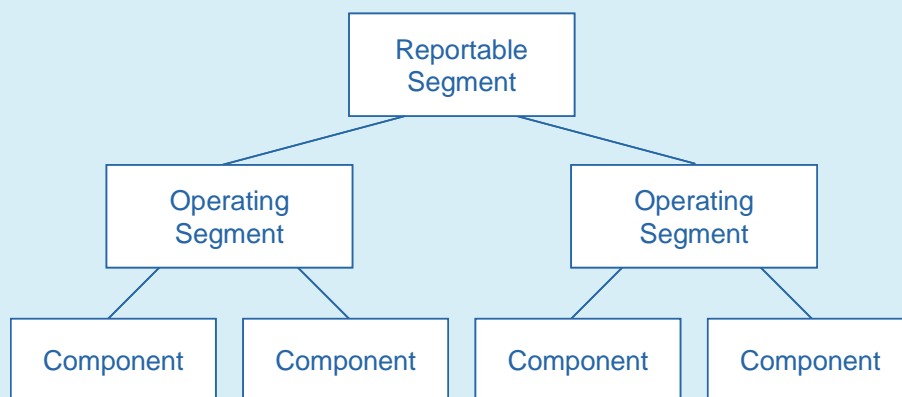
### Example: Long-term Average Gross Margins

The SEC staff has consistently challenged the aggregation of operating segments with gross margins that vary by more than five percent. The five percent difference should be calculated **as the percent difference** between the two margin percentages.



While other facts and circumstances need to be considered, the two segments in this example may not meet the aggregation criteria.

## Understanding the Interaction Between Operating Segments, Reporting Units, and Components



**Reportable Segment** – an Operating Segment or an aggregation of Operating Segments pursuant to paragraph 17 of SFAS 131

**Operating Segment** – a Component of an enterprise based on internal management pursuant to paragraph 10 of SFAS 131

**Reporting Unit** – an Operating Segment, a Component one level below an Operating Segment, or an aggregation of Components that are economically similar pursuant to paragraph 30 of SFAS 142

**SFAS 142 Component** – a unit one level below the Operating Segment pursuant to paragraph 30 of SFAS 142 (constitutes a business under Emerging Issues Task Force Issue 98-3, *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business*, for which discrete financial information is available and segment management regularly reviews operating results)

While segment reporting poses unique and challenging analysis and documentation requirements, the disclosure information is critical to investors in understanding a company's different components and the different economic environments in which it operates. Retail & Consumer companies should be mindful of the requirements in this area and the continued focus on this area by the SEC staff and should seek to provide information which will help users of financial statements better

understand the company's performance, better assess its prospects for future net cash flows, and make informed judgments about the company as a whole.

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