

FASB Emerging Issues Task Force

Issue No: 04-10

Title: Applying Paragraph 19 of FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*, in Determining Whether to Aggregate Operating Segments That Do Not Meet the Quantitative Thresholds

Document: Issue Summary No. 1*

Date Prepared: September 10, 2004

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Dates Issue Previously Discussed: N/A

Previously Distributed EITF Materials: N/A

References:

FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*
(FAS 131)

*** The alternative views presented in this Issue Summary are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination and it is ratified by the Board.**

Background

1. FAS 131 requires that a public business enterprise report financial and descriptive information about its reportable operating segments. Operating segments are components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. Generally, financial information is required to be reported on the basis that it is used internally for evaluating segment performance and deciding how to allocate resources to segments.

2. Paragraph 16 of FAS 131 requires that an enterprise report separate information about each operating segment that (a) has been identified in accordance with paragraphs 10-15 of that Statement or that results from aggregating two or more of those segments in accordance with paragraph 17 of that Statement and (b) exceeds the quantitative thresholds in paragraph 18 of that Statement. Paragraphs 19-24 of FAS 131 specify other situations in which separate information about an operating segment shall be reported. Operating segments (and aggregated operating segments) that are required to be reported separately are deemed "reportable segments." If an operating segment does not meet one of the quantitative thresholds in paragraph 18, paragraph 19 permits an entity to combine information about that segment with other operating segments that do not meet the quantitative thresholds to produce a reportable segment only if the operating segments share a majority of the aggregation criteria listed in paragraph 17. Refer to the flowchart in Exhibit 04-10 for an illustration of the above guidance.

3. Paragraph 17 of FAS 131 permits two or more operating segments to be aggregated into a single operating segment if aggregation is consistent with the objective and basic principles of FAS 131, if the segments have similar economic characteristics, and if the segments are similar in each 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.

4. The following example¹ illustrates how an enterprise should evaluate segments under FAS 131:

Assume that an enterprise has identified six operating segments. None of the segments meets all of the aggregation criteria in paragraph 17. Segments B and D have been identified as reportable segments based on the 10 percent threshold criteria for revenue in paragraph 18 of FAS 131. The revenue from external customers (there are no intersegment transactions) for each of the 6 segments is as follows:

	<u>Revenue</u>
Segment A	\$ 6
Segment B	38
Segment C	4
Segment D	35
Segment E	9
Segment F	<u>8</u>
Consolidated external revenues	\$ 100

In this example, the operating segments that do not meet the quantitative thresholds (Segments A, C, E, and F) may be combined with other segments that do not meet the quantitative thresholds if they meet the majority of the aggregation criteria in paragraph 17. However, those operating segments cannot be combined with the operating segments that meet the quantitative thresholds (Segments B and D).

5. Questions have arisen regarding how an enterprise should consider the aggregation criteria listed in paragraph 17 in applying the guidance in paragraph 19 to operating segments that do not meet the quantitative thresholds. Specifically, whether operating segments must always have similar economic characteristics *and* meet a majority of the remaining five aggregation criteria, items (a)-(e), listed in paragraph 17 or whether operating segments must meet a majority of all six aggregation criteria (that is, the five aggregation criteria, items (a)-(e), listed in paragraph 17 and similar economic characteristics).

¹ This example only includes revenue in its evaluation of quantitative thresholds for simplicity. Paragraph 18 of FAS 131 also requires entities to evaluate reported profit and losses and assets.

Accounting Issues and Alternatives

Issue 1: How an enterprise should evaluate the aggregation criteria in paragraph 17 of FAS 131 when determining whether operating segments that do not meet the quantitative thresholds may be aggregated in accordance with paragraph 19 of FAS 131.

View A: Operating segments that do not meet the quantitative thresholds can be aggregated if (1) aggregation is consistent with the objective and basic principles of FAS 131, (2) the segments have similar economic characteristics, and (3) the segments share a majority of the following aggregation criteria:

- 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.*

6. Proponents of View A believe that the more liberal aggregation criteria that permits aggregation of segments if a majority of the criteria are met only pertains to those criteria, items (a)-(e), listed in paragraph 17. These proponents believe that operating segments that do not meet the quantitative thresholds can be aggregated if (a) aggregation is consistent with the objectives and basic principles of FAS 131, (b) the segments have similar economic characteristics, and (c) the segments meet a majority of the five aggregation criteria, items (a)-(e), listed in paragraph 17 of FAS 131.

7. Proponents of View A believe that operating segments must always have similar economic characteristics to be aggregated under paragraph 17 and therefore they should always have similar economic characteristics to be aggregated under paragraph 19. The fact that the operating segments do not meet the quantitative thresholds should not permit aggregation when they do not have similar economic characteristics. These proponents point to paragraph 77 of FAS 131 which states:

The Board concluded that enterprises should be permitted to aggregate information about operating segments that do not meet the thresholds with information about other operating segments that do not meet the thresholds if a majority of the aggregation criteria in paragraph 17 are met. That is a more liberal aggregation provision than that for individually material operating segments, *but it prohibits aggregation of segments that are dissimilar*. [Emphasis added].

8. Proponents of View A believe that FAS 131 is aimed at disaggregation and that permitting operating segments to be aggregated without having similar economic characteristics would not be consistent with the objectives and basic principles of FAS 131; that is, to provide information about the different types of business activities in which an enterprise is engaged and the different economic environments in which it operates in order to help users of financial statements better understand the enterprise's performance, better assess its prospects for future net cash flows, and make more informed judgments about the enterprise as a whole. They believe aggregating operating segments that do not have similar economic characteristics would impair a user's understanding of the enterprise's financial results and prospects.

View B: Operating segments that do not meet the quantitative thresholds can be aggregated if (1) aggregation is consistent with the objective and basic principles of FAS 131 and (2) the segments share a majority of the following aggregation criteria:

- a. Similar economic characteristics*
- b. The nature of the products and services*
- c. The nature of the production processes*
- d. The type or class of customer for their products and services*
- e. The methods used to distribute their products or provide their services*
- f. If applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities.*

9. Proponents of View B believe that the more liberal aggregation criteria that permits aggregation of segments if a majority of the criteria are met pertains to those criteria, items (a)-(e), listed in paragraph 17 and similar economic characteristics. These proponents believe that

operating segments that do not meet the quantitative thresholds can be aggregated if (a) aggregation is consistent with the objectives and basic principles of FAS 131 and (b) the segments meet a majority of the six aggregation criteria comprised of items (a)-(e) in paragraph 17 and similar economic characteristics. These proponents believe that operating segments need not have similar economic characteristics to be aggregated under paragraph 19.

10. Proponents of View B believe that the literal reading of paragraph 19 does not suggest that economic characteristics have to always be similar to permit aggregation of operating segments that are not quantitatively significant. Rather, the language suggests that a majority of all the aggregation criteria (including economic characteristics) in paragraph 17 should be met. Proponents of View B believe that permitting operating segments to be aggregated without having similar economic characteristics would be consistent with the objectives and basic principles of FAS 131; that is, to provide information about the different types of business activities in which an enterprise is engaged and the different economic environments in which it operates in order to help users of financial statements better understand the enterprise's performance, better assess its prospects for future net cash flows, and make more informed judgments about the enterprise as a whole. These proponents believe the benefit of disclosing quantitatively insignificant segments would be insufficient to justify the cost of compiling information for disclosure.

11. They believe aggregating operating segments that do not have similar economic characteristics would not impair a user's understanding of the enterprise's financial results since the operating segments do not meet the quantitative thresholds in paragraph 18. FAS 131 requires an enterprise to report separately information about an operating segment if that segment meets any of the specified quantitative thresholds. Proponents of View B believe that this threshold test effectively requires enterprises to report financial information for those significant operating segments that investors would focus on in making investment decisions. The fact that operating segments that are not quantitatively significant are aggregated even if they do not have similar economic characteristics would likely not impact those investment decisions. View B proponents acknowledge that there may be instances in which a segment that is not quantitatively significant would, if omitted, change a user's decision about that segment so

significantly that it would change the user's decision about the enterprise as a whole even if the segment meets a majority of the aggregation criteria. In those instances, View B proponents believe that segment should not be aggregated. That view is consistent with paragraph 78 of FAS 131, which states:

An understanding of the material segments of an enterprise is important for understanding the enterprise as a whole, and individual items of segment information are important for understanding the segments. Thus, an item of segment information that, if omitted, would change a user's decision about that segment so significantly that it would change the user's decision about the enterprise as a whole is material even though an item of a similar magnitude might not be considered material if it were omitted from the consolidated financial statements. Therefore, enterprises are encouraged to report information about segments that do not meet the quantitative thresholds if management believes that it is material. Those who are familiar with the particular circumstances of each enterprise must decide what constitutes material.

12. Additionally, these proponents believe the application of paragraph 21 becomes difficult if segments that do not meet the quantitative thresholds must have similar economic characteristics. Paragraph 21 requires information about other business activities and operating segments that are not reportable to be combined and disclosed in an "all other" category separate from other reconciling items in the reconciliations. This guidance is particularly needed when there are numerous segments which are essentially the same (for example, stores, radio stations, or newspapers). For example, assume an enterprise has fifteen or more operating segments, none of which meet the quantitative thresholds and only a few of which may have similar economic characteristics but all of which meet a majority of the aggregation criteria, items (a)-(e), listed in paragraph 17. Paragraph 20 of FAS 131 requires at least 75 percent of consolidated revenue to be included in reportable segments. In situations in which there are numerous segments that do not meet the quantitative thresholds in paragraph 20, it is unclear which segments would be disclosed separately in order to meet the 75 percent threshold, considering the practical limit in paragraph 24.

13. Additionally, proponents of View B believe it is not clear how users of the financial statements will be provided with the most relevant information to make an informed judgment on the enterprise as a whole when certain of the segments, which are essentially the same

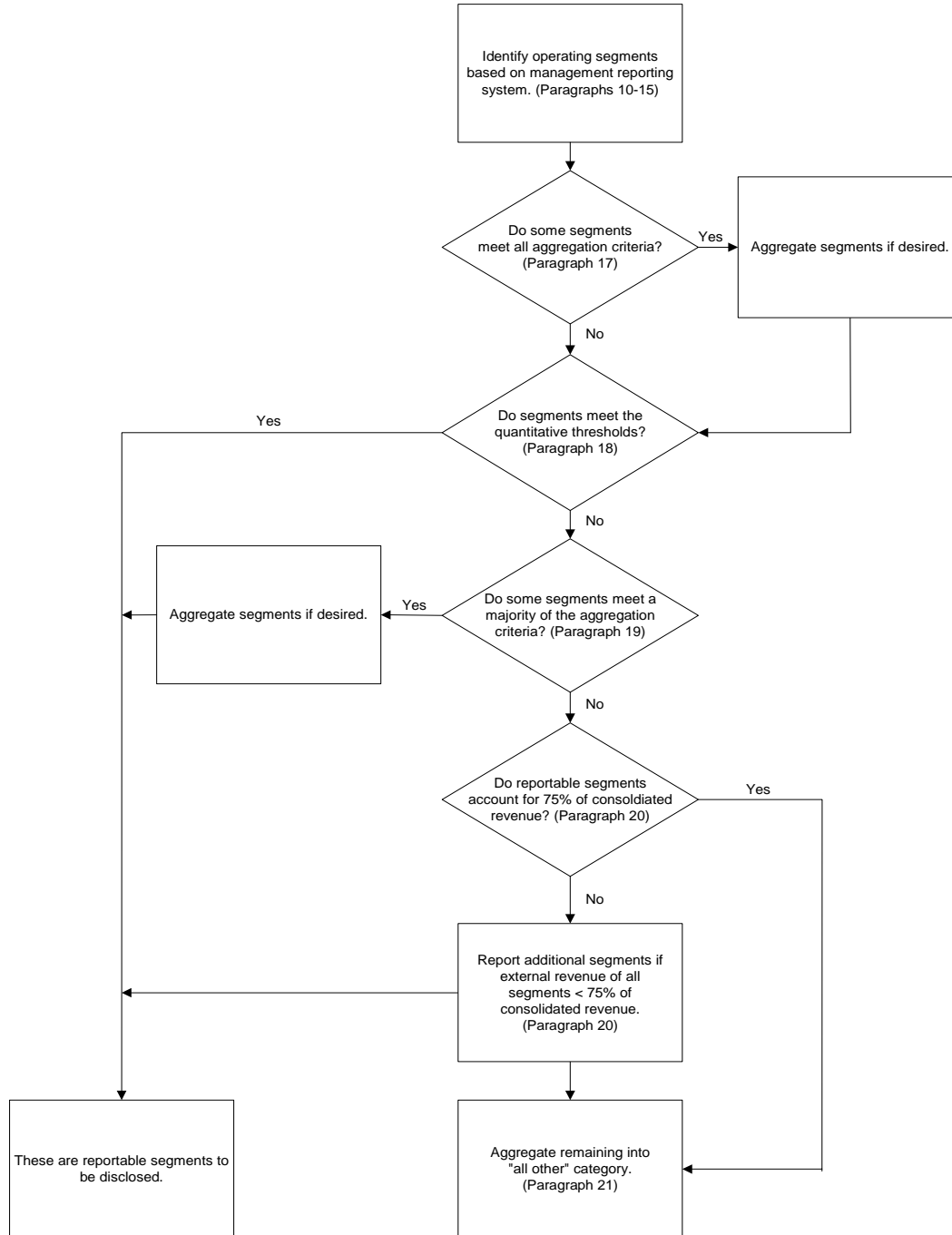
qualitatively and are quantitatively insignificant, are disclosed separately while others are combined. Considering the practical limit discussed in paragraph 24 of FAS 131, disclosure of up to 15 segments in the example provided above as separate reportable segments may be overly detailed and not meaningful. Furthermore, View B proponents believe that disclosure of that many segments would not appear to promote a meaningful Management's Discussion and Analysis section, which should generally focus on each relevant, reportable segment and on the registrant as a whole.

Transition

14. The consensus reached by the Task Force at the September 29–30, 2004 EITF meeting should be effective no later than fiscal years ending after October 13, 2004 (date of Board ratification). The corresponding information for earlier periods, including interim periods, shall be restated unless it is impractical to do so. Restatement of previously issued financial statements is required.

Exhibit 04-10

IDENTIFYING REPORTABLE OPERATING SEGMENTS²



² The following diagram illustrates how to apply the main provisions for identifying reportable operating segments as defined in FAS 131. The diagram is a visual supplement to the written standards section. It should not be interpreted to alter any requirements of FAS 131 nor should it be considered a substitute for the requirements.