# Unit 1: segment reporting

* 1. **Introduction**

It is customary for many companies to diversify their operations into a variety of related and unrelated industry areas. Financial analysts and other users of financial statements face difficulty in analyzing and interpreting financial statements prepared for diversified companies. The reason is that different industry segments can have differing growth potentials, capital requirements, and profitability characteristics. Some segments operate in a stable industry, and others in highly cyclical, or high demand industry.

In terms of capital requirements, the segment may operate in labor-intensive, modest capital requirements, or high capital intensive industry. As a result, it is not sound to combine all segments and evaluate the company’s growth potential and profitability. In order to make meaningful analysis, the total company financial data should be disaggregated into segments.

* 1. **objectives of segment reporting and applicable accounting standards**

According to FASB (statement No. 14), diversified companies should separately prepare reporting for each segment. In the view of the FASB, financial information about business segments will assist financial statement users in analyzing and understanding the financial statements of the enterprise by permitting better assessment of the company’s past performance and future prospects.

Generally, segment information is based on the totals of consolidated financial statements. Thus, the principles governing consolidations are used for segment reporting. In segment reporting, transactions between segments are not eliminated for purposes of segment disclosures with the exception of inter segment loans, advances and related interest. These items are generally excluded from segment assets and revenues.

* 1. **coverage of segmental reporting**

According to [[1]](#footnote-1)\*Financial Accounting Standard Board (statement No. 14), an enterprise may have to disclose data for one or more of the following areas:

1. Operations in different industries
2. Domestic and foreign operations
3. Export sales
4. Major customer

Each of these is explained in subsequent sections.

* + 1. **Operations in different industries**

A company may have segments in different industries. The company may not be required to report its operations in different industries. In order to determine whether the company must report its operations in different industries, several factors may be considered. The first factor is to identify the industry segments in which it operates. The aim is to identify a reportable segment. A reportable segment is a significant component of a company that provides related products and services primarily to unaffiliated customers. Besides, in order to be reportable, a segment has to meet one of the three tests → revenue test, operating profit test, and asset test.

**1. 3.1.1 Revenue test**

An industry segment is reportable if it meets the revenue test. The revenue test is met when an industry segment’s revenue is 10% or more of the combined revenue of all industry segments. Revenue includes inter segment sales and transfers. Interest is included in the revenue test if the assets on which the interest is earned are included in that segment’s identifiable assets. The interest includes interest on inter segment trade receivables, but does not include interest on intersegment loans and advances.

To illustrate, assume that Amtex company has 4 segments; namely, A, B, C, and D. tTeir sales are shown below:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | Segments | Total | Elimination | Consolidated |
| A | B | C | D |
| Sales to unaffiliated outsiders -Inter segments sales ---Total sales  | $40,000 10,000 | 20,00010,000 | 50,00020,000 | 1,000 - | 125,00040,000 |  -(40,000) | 125,000 |
| 50,000 | 30,000 | 70,000 | 15,000 | 165,000 | (40,000) | 125,000 |

The benchmark for a 10% revenue test is $16500 (i.e. 10% of 165,000).

 = 10% of total sales

Since the sales of segments A, B, and C are greater than the benchmark sales amount, they are considered segments Segment D is not a reportable segment because its revenue is less than 10% of the total sales of all segments (i.e 15,000).

**1.3.1.2 Operating profit test**

Operating profit is defined as an industry segment’s revenue minus all operating expenses. Operating profit includes expenses that relate to inter segment sales or transfers and expenses allocated among segments on a reasonable basis. Operating profit should not include revenues earned at the corporate level, general corporate expenses, interest expense (except for financial segments), domestic and foreign income taxes, income or loss from equity, investors, gain or loss on discontinued operations, extraordinary items, minority interest, and the cumulative effect of an accounting change. Intersegment interest expenses and revenues of an industry segment that is primarily financial in nature are included in determining the operating profit or loss of the segment.

The operating profit test is met when an industry segment absolute amount of its operating profit or loss is 10% or more of the greater, in absolute amount of (1) the combined operating profits of all industry segments that do not incur operating loss, or (2) the combined operating loss of all industry segments that did incur an operating loss.

To illustrate, assume that XYZ company has four segments; namely W, X, Y, & Z. Their operating profits/losses are shown below:

 Segments Corporate Consolidat

 W X Y Z Administration ed

Operating profit (Loss) Br(50,000) Br(10,000) Br. 90,000 Br. 70,000 – Br. 100,000

Equity investment income 15,000 - - - 25,000 ---------- 40,000

Corporate expenses \_ \_ \_ \_ (12,000) (12,000)

Interest (5,000) (5,000)

Totals Br (35,000) (10,000) 90,000 70,000 8,000 123,000

In order to determine the reportable segment using the operating profit test, the following steps can be followed:

Step 1: Add the profits of all segments that reported a profit. In this case, segment Y and Z reported a profit and their total operating profits are Br. 160,000 (i.e. 90,000 + 70,000 = Br. 160,00).

Step 2. Add the losses of all segments that reported a loss. In the forgoing example, segments W and X have reported a loss. The total losses of both segments are Br. 60,000 (i.e 50,000 + 10,000 = 60,000).

Step 3. Determine the benchmark to identify reportable segment

 Benchmark = 10% of total operating profit, or

 = 10% of total operating losses, i.e.

 = 10% x 160,000 = 16,000

 = 10% x 60,000 = 6,000

Step 4. Identify the reportable segment

The greater of the benchmark determined in step 3 is Br. 16,000. Thus, a segment whose operating profit is 10% or more is reportable. As a result, segment W, Y, and Z are reportable because their operating profits or losses are greater than Br. 16,000.

**1.3.1.3 Asset test**

The asset test is met when an industry segment’s identifiable assets are 10% or more of the combined identifiable assets of all industry segments. Identifiable assets include tangible and intangible assets (including good will) used exclusively by an industry segment and an allocated portion of assets used jointly by two or more industry segments. In the determination of segment’s identifiable assets, asset valuation allowances should be taken into account. Asset valuation allowances include allowance for doubtful accounts, accumulated depreciation, marketable securities valuation allowance, and inventories valuation allowances.

The identifiable assets of the segment should not include assets maintained for general corporate purposes and inter segment loans, advances, or investments, except for those of a financial segment.

To illustrate, suppose that the identifiable assets of XYZ company’s segments are shown below (in thousands):

Segments Elimi Consolid

W X Y Z Corporate Total nations ated

Identifiable assets Br 40 50 300 90 – 480 - 480

Investments (inter segment) - - 20 – 60 80 – 80

Corporate \_ \_ \_ \_ 10 10 – 10

Loans (inter segment) 5 4 - - 8 17 (17) –

Totals 45 54 320 90 78 587 (17) 570

Besides, it is assumed that none of the segments is financial segment.

To identify reportable segment, the following steps can be followed:

Step 1. Compute the total identifiable assets of all segment

 Total identifiable assets = 480,000

Step 2. Determine the benchmark

 Benchmark = 10% of total identifiable assets

 = 10% x 480,000

 = 48,000

Step 3. Identify a reportable segment

A reportable segment is one whose identifiable assets are 10% or more of total identifiable assets of all segments. Since their identifiable assets are grater than Br. 48,000, segments X, Y, and Z are reportable segments.

## Evaluation of reportable segments

According to statement No. 14 of FASB, an industry segment is considered reportable if it meets either revenue test, operating profit test, or asset test. However, the statement also specified additional rules and criteria for a final determination of a reportable segment. These rules and criteria include:

1. The segment should not be considered reportable when it meets only one of tests but is not expected to meet the test in the future.
2. A segment that does not meet any of tests may be considered reportable if it has been reportable in prior years and is expected to meet one or more of the tests in the future.
3. The combined reportable segments must represent a substantial portions (at least 75%) of the total operations of the enterprise. For example, if the total revenue of reportable segment is less than 75% of the total revenues of all industry segments, additional segment must be identified as reportable segment.
4. If the number of reportable segments exceeds 10, it may be appropriate to combine the most closely related industry segments in to broader reportable segments with a view of reducing their numbers.

### Check your progress 1.1

1. What is an industry segment?
2. What is reportable industry segment?
3. The following data is selected for the segments of Crown Company for the year ended December 31, 2003:

 Segments

 J K L M N

Revenues 21,000 6500 32,000 3100 17,000

Operating profit (loss) 1,200 (300) 7500 200 6700

Identifiable assets 34000 3800 22,000 7200 5900

**Required:** Determine

* 1. Which, if any, of these segments would qualify as reportable segments?
	2. Whether a substantial portion of crown company’s total operations is represented by reportable segments.

**1.3.2 Foreign operations**

According to FASB statement No. 14, multinational companies are required to disclose domestic as well as significant foreign operations. Multinational companies are those companies that establish their own plants in different countries over the world. Foreign operations (for multinational companies) include those operations that are located outside a “home country” and which produce revenue either:

* + by unaffiliated customer sales
	+ by inter company sales

Foreign operations do not include the operation of unconsolidated subsidiaries and investees.

Multinational companies may group operations in individual foreign countries. The basis of grouping may be:

* + proximity
	+ economic affinity, or
	+ similarity in business environment

As indicated above, multinational companies are required to disclose only significant foreign operations. Foreign operation is said to be significant if it meets either of the following two tests:

***1. Revenue test***

Revenue from sales to unaffiliated customers is 10% or more of consolidated revenue. In this case, if the revenue from sales to unaffiliated customers is 10% or more of consolidated revenue, the operation should be reported separately.

## Example

Intel Telecommunication Company has subsidiaries in three different African countries. The sales results of domestic and foreign operations are shown below (in thousands)

 Domestic Kenya Uganda Togo Combined Elim Consoli

 nations dated

Sales to unaffiliated

Customers 4000 1500 5000 700 11,200 – 11200

Inter area sales 500 – 200 – 700 (700) –

Total revenue 4500 1500 5200 700 11,900 (700) 11,200

Revenue test benchmark = 10% of consolidated revenues

 = 10% x 11,200 = 1120

Domestic operations, Kenya operation, and Uganda operation are reportable operations because their revenue from sales to unaffiliated customers is greater than 10% of consolidated revenue. Togo’s operation is not reportable because its sales ($700) are less than 10% of consolidated revenue.

***2. Asset test***

If asset test is followed, the operation’s identifiable assets should be 10% or more of consolidated assets in order to be reportable.

## Example

Intel Telecommunication Company has subsidiaries in three different African countries. The assets of domestic and three foreign operations are shown below: (in thousands)

##### Domestic Kenya Uganda Togo Combined Eliminations Consolidated

Identifiable assets $20,000 5000 10,000 3000 38,000 – 38,000

Investments Affiliates 7000 – 2000 9,000 – 9000

General corporate assets 12,000 12,000 – 12,000

Inter area advances 4000 1000 - - 5,000 (5000) –

Total assets 43,000 6000 12000 3000 64,000 (5000) 59000

Assets test benchmark = 10% of consolidated assets

 = 10% x 59000 = 5900

On the basis of asset test, only domestic Kenya and Uganda operations are reportable because their identifiable assets are greater than the asset test benchmark of $5900. Togo operation is not separately reported.

Generally, for all separately reportable operations as well as for the combined areas, revenues, profitability information, and identifiable assets must be disclosed.

## Check your progress 2

1. What is meant by foreign operations?
2. What is multinational company?
3. Assume that more corporation has operations in South Africa and three African countries. (In thousands)

 Benin Ghana Cameron Domestic

Sales to unaffi

liated customers 4000 8000 5000 18,000

Inter area sales 2000 3000 – 6000

Identifiable assets 10,000 15,000 11,000 25,000

General corporate assets 16,000

###### Required

Identify an operation that requires separate disclosure under the following tests:

* 1. revenue test
	2. asset test

**1.3.3 Export sales**

Are foreign operations and export sales the same? No. Foreign operations and export sales are not the same although it is not easy to identify the boundary between them. In general, as defined earlier, foreign operations are those operations that are located outside a “home country” and which produce revenue from either sale to unaffiliated customers or to members of a group of companies. On the other hand, export sales represent revenues generated aboard from services provided by domestic offices. Export sales is said to occur if the company’s domestic operations sell to unaffiliated foreign customers. Export sales should be disclosed in total and when appropriate by geographic area if such sales are at least 10% of the company’s consolidated revenue.

**1.3.4 Major customer**

According to Statement of Financial Accounting Standard (SFAS No. 30), a major customer is one that provides a firm with 10% or more of the company’s revenue. Major customer could be business concerns, domestic government entity, or foreign government entity. According to the statement, the company has to disclose sales to major customers.

* 1. **The position of security and exchange commission (sec) on segment reporting**

With respect to segment reporting, Financial Accounting Standard Board and SEC agreed in most cases except the following:

1. FASB requires segmental data only for those years for which a complete set of financial statements is prepared, where as SEC requires segmental data for three years historical period.
2. FASB requires the reporting of major customers if sales represent 10% or more of total revenue, where as SEC requires identification of major customer or customers if the loss of such a customer or customers would have a materially adverse effect on the enterprise.

## Check your progress 1–3

* 1. Export sales and foreign operations are one and the same. True/False.
	2. Foreign operations generate revenue from aboard by providing service through domestic offices. True/False.
	3. Export sales are not disclosed if they represent 8% of the consolidated revenue of the company.
	4. A major customer may be:
1. Business concern
2. Domestic government entity e. a and b only
3. Foreign government entity
4. All of the above
5. a and b only
	1. If the sales from a customer is 12% of the company’s revenue, it should be disclosed. True/False
	2. Unlike SEC, FASB requires segmental data of three years historical data. True/False
	3. There is no disagreement between SEC and FASB on the disclosure of major customers.

# 1.5 Summary

The users of financial statements are interested in segment reporting in order to analyze and interpret the firm’s past performance and to make predictions regarding the firm’s future prospects. Given certain guidelines, most firms (except closely held companies) are required to report segment information.

All segments are not reportable. In order to determine the reportable segment, the firm’s profit centers are the focus. There are three types of tests in identifying a reportable segment; namely, revenue test, operating profit test, and asset test. If the revenue of the segment is 10% or more of the combined revenue of all industry segments, it is reportable.

According to profit test, a segment is said to be reportable if its operating profit or loss is 10% or more of the combined if its operating profit or loss of all segments. On the other hand, using asset test, if the segment’s identifiable assets are 10% or more of the combined identifiable assets of all segments, the segment is reportable.

A segment is said to be dominant if its revenues, operating profit, and assets comprise more than 90% of the firm’s revenues, operating profits, and assets. In this case, only dominant segment is reportable.

Firm’s operating on multinational basis are required to disclose their foreign operations and export sales if they constitute 10% or more of the total revenues of the firm.

If a customer provides 10% or more revenue to the firm, it is called a major customer, and should be disclosed.

# 1.6 Answers to check your progress exercises

## Check your progress 1.1

* 1. A business segment is a component of a business enterprise whose activities represent a separate major line of business or class of customer.
	2. Reportable industry segment is a significant component of an enterprise that provides related products and services primarily to unaffiliated customers provided it meets either a revenue test, an operating profit test, or an asset test.
	3. (a) Reportable segment using:

Revenue test: J, L, and N

Operating profit test: J, L, and N

Asset test: J and L

(b) The reportable segments represent a substantial portion of the enterprise’s operations because:

- 75% of total revenue of the enterprise = 59700

- Total revenue of reportable segments = 70,000

Since total revenues of reportable segment exceed 75% of total revenue of the enterprise, it is said to be reportable.

## Check your progress 1.2

1. A Foreign operations are those operations that are located outside a “home country” and which produce revenue from either sales to unaffiliated customers, or to members of a group of companies.
2. Multinational company is a company, which operates on international basis in the form of establishing a plant in other countries and/or export of service by domestic offices.
3. a. All operations are reportable separately

 b. All operations are reportable separately

## Check your progress 1. 3

1. False 3. True 5. True 7. False
2. False 4. D 6. False

## 1.7 Model examination Questions

1. In segment reporting, inter segmental transactions are not eliminated. True/False
2. Which of the following items are excluded from segment assets and revenues in segment reporting?
	1. Inter segment loans
	2. Inter segment advances
	3. Interest on inter segment loan
	4. All of the above
	5. a and b only
3. According to revenue test, a segment is said to be reportable if its revenue is less than 10% of the combined revenue of all industry segments. True/False
4. In revenue test, inter segment sales should be excluded from segment revenue. True/False
5. When revenue test is used in identifying reportable segment, segment revenue does not include:
	1. Inter segment transfers
	2. Inter segment sales
	3. Interest on inter segment trade receivables
	4. Interest on inter segment loans
	5. a and d only
6. When operating profit test is used in identifying reportable segment, segment profit includes all of the following except:
	1. Expenses related to inter segment sales
	2. Inter segment interest expenses
	3. Expenses allocated among segments
	4. Revenues of an industry segment
	5. Revenues earned at corporate level
7. When operating profit test is employed in identifying reportable segment, segment profit excludes all of the following except:
	1. General corporate expense
	2. Inter segment interest expense
	3. Corporate interest expense
	4. Domestic and foreign income taxes
	5. Gain or loss on discontinued operations
8. The asset test is said to be met when an industry segment’s identifiable assets are 10% or more of the total assets of industry. True/False
9. Which of the following items is (are) not considered in the determination of the segment’s identifiable assets?
	1. Assets maintained for general corporate purpose
	2. Goodwill identifiable with the segment
	3. Allowance for doubtful account on segment receivables
	4. Accumulated depreciation on segment’s fixed assets
	5. All of the above except d.
10. Although a given segment does not currently meet any test but expected to meet one of the test in the future, it would be a reportable segment. True/False
11. Which of the following is not the basis of grouping multinational companies?
	1. similarity in business environment
	2. proximity
	3. economic affinity
	4. all of the above
	5. none of the above
12. Operations of unconsolidated subsidiaries should be excluded from foreign operations. True/False
13. Which of the following test is not used in identifying foreign operations?
	1. operating profit test c. revenue test
	2. asset test d. expense test e. a and d
1. \* FASB → Financial Accounting Standard Board [↑](#footnote-ref-1)