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Financial Statements: A Kaleidoscope Of Parts: The Disaggregation of Enterprise Data

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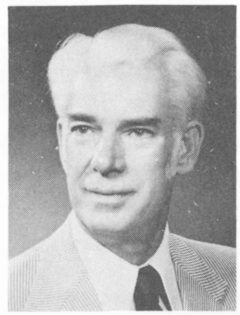
Financial Statements

A Kaleidoscope Of Parts:

The Disaggregation of Enterprise Data



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In recent years many business enterprises have increasingly broadened the scope of their activities into different industries, foreign countries, and markets. Investors, creditors, and other users of financial statements contend that the process of evaluating an enterprise's progress and projecting future earning power becomes more difficult as an enterprise expands its operations. Different industries, product lines, markets and geographical areas have differing rates of growth, profitability, and degrees of risk. Users contend that financial data must be disaggregated so that parts of an enterprise can be evaluated and, in turn, related to the enterprise as a whole.

Financial reporting for segments of a business involves reporting information on a less-than-total enterprise basis. Segments can be defined in terms of (1) organizational units (divisions, branches and subsidiaries of other legal and non-legal economic entities) or (2) areas of economic activity (industries, product lines, markets, or geographical areas). FASB Statement No. 14, effective for fiscal periods beginning after December 15, 1976, requires that financial statements of a business enterprise include information about the enterprise's operations in different areas of economic activity. Managerial decisions require information for various organizational units; financial statements are usually prepared for these units. When separate legal units are involved (subsidiaries) financial statements must be issued to owners and other users. When separate legal units are involved (subsidiaries) financial statements must be issued to owners and other users.

Background

Prior to FASB Statement No. 14 authoritative accounting literature dealt principally with financial statements prepared on a consolidated or total-enterprise basis. However, several pronouncements of FASB predecessors required business enterprises to report information on a less-than-total enterprise in a limited number of instances. ARB No. 43 required that a summary of assets and liabilities, income and losses for the year, together with the parent's equity therein, be provided for foreign subsidiaries. This information was required in all instances whether the subsidiary operations were included in consolidated statements or reported separately. FASB No. 8 on foreign currency translation left this requirement unchanged.

APB Opinion No. 18 paragraph .20 (c) reads, "When investments in unconsolidated subsidiaries are, in the aggregate, material in relation to financial position or results of operations, summarized information as to assets, liabilities, and results of operations should be presented in the notes or separate statements should be presented for such subsidiaries, either individually or in groups, as appropriate."

In APB Opinion No. 30 the board concluded that "Operations of a segment that has been or will be discontinued should be reported separately as a component of income before extraordinary items...". The gain or loss from disposal of the segment must be disclosed on the face of the statement with applicable income taxes on operations and disposal gain or loss shown. Revenues applicable to the discontinued operations should be separately disclosed in the footnotes. A segment may be a significant organizational unit, product, market area, customer, or class of customers.

The SEC issued line-of-business reporting regulations in 1969. The regulations applied to registrants with the SEC. World-wide operations were to be included. The information was to be reported annually if any segment equaled more than 10 percent of total operations for any enterprise with sales of over 50 million and 15 percent for enterprises with revenues under that amount. Operating revenues and expenses were reported for each major segment with major customers disclosed. No distinction was made between foreign and domestic sales.

In 1974 the Federal Trade Commission imposed limited line-of-business reporting for selected manufacturing companies. Reporting was required for domestic activities when segment revenues exceeded 10 million. Operating revenues, operating expenses, assets, and allocation of indirect

TABLE 1

Tests Applied To Determine Reportable Segments[1]

BASE ENTERPRISE	INDUSTRY SEGMENTS	FOREIGN OPERATIONS	MAJOR CUSTOMERS[2]	EXPORT SALES
Revenues	10%	10%	10%	10%
Identifiable Assets (net)	10%	10%		
Profit or Loss	10%			

[1]If any of the tests are met the segment becomes a reportable segment.

[2]A major customer is specified as a single, non-governmental customer, domestic government agencies in the aggregate, or foreign governments in the aggregate.

TABLE 2

Information To Be Reported For Each Reportable Segment

SEGMENT INFORMATION REQUIRED	INDUSTRY SEGMENT	FOREIGN OPERATIONS	MAJOR CUSTOMERS	EXPORT SALES
Revenues	yes	yes	yes	yes
Operating Profit or Loss	yes	yes	no	no
Identifiable Assets (net)	yes	yes		
Amount of depr., depletion & amort. expense	yes			
Capital expenditures	yes			
Equity in Net Income of Unconsolidated sub. whose operations are integrated with segment	yes			
Description of Industry	yes			

expenses must be reported upon the request of the commission. A number of companies are challenging the FTC's line-of-business reporting program through legal proceedings.

Companies reporting line-of-business informaton have steadily increased since 1971. The majority of the firms report by product line and by division with only small numbers reporting by industry or type of customer and geographic area.

FASB No. 14

In December 1976 the FASB issued Statement No. 14, "Financial Reporting For Segments Of A Business Enterprise". It states that the purpose of segment information is to assist users in analyzing and understanding financial statements. The Board is reconsidering use in predicting, comparing and evaluating past performance and future prospects. Information about an enterprise's operations in different industries and different areas of the world and the extent of its reliance on export sales and major customers should be useful in judging past operation and assessing future prospects. Such information is probably of limited usefulness for interenterprise comparison. Differences in the basis or bases of disaggregation, accounting for intersegment sales or transfers, and allocating common costs lessen the comparability of interfirm statements.

The statement applies when an enterprise issues a "complete set of financial statements that present financial position at the end of the enterprise's fiscal year and results of operations and changes in financial position . . . in conformity with generally accepted accounting principles." The statement also applies when an enterprise issues for an interim period a complete set of financial statements that are expressly described as presenting financial position, results of operations, and changes in financial position in conformity with GAAP. However, if only summary amounts are presented segment informaton is not required. APB Opinion No. 28 does not require complete financial statements for interim periods. It specifies what information must be reported when summarized financial information is issued to security holders in compliance with SEC regulations. However, it encourages publicly traded companies to publish balance sheet and funds flow data as well as income statement data.

Segment reporting in complete interim statements is required for interim periods within fiscal periods beginning after December 15, 1976. Many interim statements issued during 1977 contain segment information. The interim reporting requirement has occasioned much discussion in the first three quarters of 1977. Guidelines for applying the statement to interim statements are lacking. In December 1977, the FASB issued an amendment to Statement No. 14 that eliminates the requirement to disclose segment information in interim statements. The board reconsidered the applicability of that statement to interim statements and proposed that any requirement for segment reporting in interim statements be deferred and considered in the project on interim financial reporting. (In April of 1976 a task force on interim financial reporting was appointed. The Board plans to issue a Discussion Memorandum which will be issued early in 1978 with public hearings and an Exposure Draft by the end of that year. 1979 is the target date for a final statement.)

Statement No. 14 requires that financial statements prepared in conformity with GAAP include certain information relating to:

A) The enterprise's operations in different industries
B) Its foreign operations and export sales
C) Its major customers

An industry segment is defined as a component of the company providing a product of service (or a group of products and services) primarily to unaffiliated customers for a profit.

Reportable Segments

The tests applied to determine reportable segments are shown in Table 1. If industry reportable segments, as identified by the tests shown in that table, do not constitute at least 75 percent of the consolidated revenues additional segments must be identified as reportable segments until the 75 percent test is met. However, enterprise data need not be segregated if an enterprise operated predominantly or exclusively in a single industry and the dominant industry segment accounts for 90 percent of the combined revenue, operating profit or loss, and identifiable assets.

The information to be presented for each reportable segment is outlined in Table 2. The information may be reported within the body of the statements with explanatory footnotes, entirely in the notes to the financial statements, or in a separate schedule included as an integral part of the statements. Revenue and operating profit must be reconciled to corresponding amounts in the consolidated statement of operations, and identifiable assets reconciled to consolidated total statements. Appendix F in the statement contains illustrative statements.

Controversies and Problems Surrounding Statement No. 14

Identifying Reportable Segments. The Statement discusses a number of approaches for identifying industry segments, such as the categories of the Standard Industrial Classification Manual and the Enterprise Standard Industrial Classification, presently existing profit centers, and certain common factors that characterize related products and services. However, the Board concluded that none of the approaches are universally applicable and that management must exercise considerable judgment in determining industry segments, but they are to be determined on a world-wide basis to the extent that it is practical to do so.

Usefulness of Information. The nemesis of how financial statements are used in investment and lending decisions again appears. Some contend that information on a less-than-total-enterprise basis is not useful to creditors and investors. They argue that lenders and investors should be concerned with overall results as reported in consolidated financial statements. They also contend that segment information is too analytical or interpretive to be classified as accounting information and does not belong in financial statements. The Board concluded that the information called for is not analytical or interpretative and is already contained in the accounting records and that segment information is merely a rearrangement (that is, disaggretion) of information.

Verifiability. APB Statement No. 4 identifies verifiability as one of the qualitative objectives of financial statements. Paragraph 90 of that statement says: "Verifiable financial accounting information provides results that would be substantially duplicated by independent measurers using the same measurement methods." Critics of FASB Statement No. 14 argue that the disaggregated information is not susceptible to the same degree of verifiability as consolidated information. This argument weakens when one realizes that the segment information is a part of the total reported in consolidated statements. Then the critical question to be addressed is whether the aggregated information is sufficiently verifiable to be included in the consolidated statements.

Applicability to all enterprises. The statement applies to all enterprises regardless of their size or whether the securities are publicly traded. The Board believes that there are no fundamental differences in the types of decisions and the decision-making process of those who use the statements of smaller or privately held corporations. The AICPA Committee on Generally Accepted Accounting Principles for Smaller and/or Closely Held Businesses recommended in its August 1976 report that in some instances reporting practices might be different for closely held enterprises. (Some of the requirements on interim statements only apply to publicly held companies that must meet the SEC reporting requirements.

Harm to Competitive Position. Another argument that always arises when more disclosure is required is that disclosure about industry segments will cause harm to an enterprise's competitive position. The required disclosures about an industry segment are no more detailed or specific than the disclosures typically provided by an enterprise that operates in a single industry. The statement does not require the identification of major customers as proposed in the exposure draft. After considering the many protests that identification of major customers could be competitively harmful to either the enterprise or the customer the Board dropped that requirement.

Processing Costs. Anytime new reporting requirements are added the cost of compiling the information increases. Since the information needed to report by segments is already in the information system, costs should not appreciably increase. Reporting costs will increase since new schedules will be required.

Unallocable Expenses and Revenues. Fortunately, the Statement does not require net income from each segment. The exposure draft had called for net profit contribution after all operating expenses including those allocable to segments on a reasonable basis as well as those directly traceable. The Board concluded that it is not always practical to allocate all expenses and decided that disclosure of the profit and loss contribution should not be required. However, an enterprise can make such disclosure if it so wishes.

Auditor's Opinion. There appears to be no question as to whether segment information in the annual consolidated financial statements is covered by the auditor's opinion since Paragraph 28 states that information required on the reportable segments must be included in the body of the statement, in footnotes to the statements, or in a separate schedule that is included as an integral part of the statements. In interim statements when the information may be in summary form, the auditor rarely expresses an opinion. However, if interim statements are complete financial statements, attested to by the auditor, the segment information would also be included in the auditor's opinion.

New SEC Proposals

On May 10, 1977, SEC issued proposed new rules on segment financial information. The purpose of the proposed amendments is to coordinate the information required in SEC registration statements and reporting forms with the industry segment information required by FASB Standard No. 14. In essence, the SEC's proposed amendments indicate acceptance of the Statement and, if adopted, would result in elimination of the line-of-business disclosures currently required in many SEC filings. However, the SEC has proposed to expand the disclosures required by Statement No. 14 in several areas. Since the effective date for the proposed rules is for fiscal years beginning after December 15, 1976, it appears that we can expect their finalization before the end of 1977.

Conclusion

Financial statements for annual periods ending after December 15, 1976, must contain disaggregation information. Many enterprises already publish some of the required information. Presently, the interim statement requirements are unsettled. It appears that the SEC will require all of the information called for in Statement No. 14. The Statement should be studied in depth by all accountants facing the preparation of reports that require disaggregation.