Segment Reporting Lessons From A Recent SEC Action

By **Yafit Cohn, Karen Hsu Kelley and Michael Nathan, Simpson Thacher & Bartlett LLP**

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On Nov. 7, 2016, the U.S. Securities and Exchange Commission instituted and settled cease-and-desist proceedings against PowerSecure International Inc., a provider of products and services to electric utilities that was formerly a public company, for allegedly failing to accurately identify and report its segments as required by U.S. generally accepted accounting principles.[1] PowerSecure, which neither admitted nor denied the SEC's findings, agreed to pay $470,000 to settle the charges.


Yafit Cohn


Karen Hsu Kelley


Michael Nathan

GAAP's Segment Reporting Requirement

Pursuant to the Financial Accounting Standards Board's Accounting Standards Codification 280, each public company is required to disclose certain information regarding its reportable segments, each of which consists of one or more operating segments, in both annual financial statements and financial statements for interim periods. The purpose of the segment reporting requirement is to help users of financial statements to better understand the company's performance, "[b]etter assess its prospects for future net cash flows" and "[m]ake more informed judgments about the public entity as a whole."

ASC 280 provides guidance on how to identify a public entity's operating segments and specifies that, in determining what information to report, public entities should rely on the "management approach" — an approach that is "based on the way that management organizes the segments within the public entity for making operating decisions and assessing performance." Thus, according to ASC 280, "the segments are evident from the structure of the public entity's internal organization."

Consistent with this central principle, ASC 280 defines an operating segment as a component of a public entity that has all of the following characteristics:

- The component engages in business activities from which it may earn revenues and incur expenses, including revenues and expenses relating to transactions with other components of the same public entity;

- The operating results of the component are reviewed regularly by the entity's "chief operating decision maker" (CODM) to make decisions regarding allocation of resources to the component and to assess the component's performance; and

- Discrete financial information regarding the component is available.

ASC 280 clarifies that the term "chief operating decision maker" refers to a specific function within the company that allocates resources to and assesses the performance of the company's segments, rather than a manager with a specific title. As explained in ASC 280, the "chief operating decision maker" is often the company's chief executive officer or chief operating officer, but it may also be a group of individuals, such as one consisting of the company's president, executive vice presidents and others.

Pursuant to ASC 280, public entities are required to report separately information regarding each "reportable segment" — i.e., an operating segment that meets certain criteria delineated in the accounting standard.[2]

The SEC's Enforcement Action

In its cease-and-desist order against PowerSecure, the SEC alleged that, from 2012 to 2014, the company did not properly apply the management approach articulated in ASC 280 and, consequently, "failed to disclose segment level financial results at a sufficiently disaggregated level of the organization." This failure, in turn, allegedly contributed to PowerSecure's incorrect identification of reporting units for purposes of testing for goodwill impairment and rendered untrue management's conclusion that the company had effective internal accounting controls.

1. Failure to Appropriately Identify Operating and Reportable Segments

From 2012 through the first quarter of 2014, PowerSecure disclosed one reportable segment — the Utility & Energy Technologies segment — when, according to the SEC, "it should have identified and reported multiple segments." First, the SEC found that the company had misapplied ASC 280, incorrectly determining that there was no "discrete financial information available below the Utility & Energy Technologies" level. PowerSecure had allegedly claimed that because "certain operating expenses were not allocated amongst its business units with precision below gross profit," ASC 280's "discrete financial information" criterion was not met. According to the SEC, however, to meet the "discrete financial information" criterion, "a business component need only have a measure of profit or loss available[,] and gross profit is sufficient." Additionally, the SEC explained, ASC 280 does not specify the level of precision at which costs must be allocated within a company.

Second, the SEC found that PowerSecure misapplied ASC 280 by PowerSecure concluding that its CODM — its CEO — "did not regularly review operating results below the consolidated level to make decisions about resource allocations and to assess performance." In fact, PowerSecure's CEO had allegedly received monthly financial results for units below the consolidated entity level and met quarterly with "each business unit leader to discuss operational issues, sales forecasts, and financial performance." Furthermore, some of those business unit leaders received incentive compensation based, in part, on the results of their respective business units. Finally, the company's board of directors allegedly received discrete financial information below the Utility & Energy Technologies level from the company's chief financial officer, with commentary by the CEO.

According to the SEC, PowerSecure's violation of GAAP's segment reporting requirements negatively affected the company's investors. For the first quarter of 2014, PowerSecure reported an unexpected loss, which it attributed primarily to "inefficiencies in the Utility Services group," a business unit within PowerSecure's single segment. As the SEC observed, since the company only reported one segment from 2012 through the first quarter of 2014, "investors did not have the benefit of reviewing profitability metrics for its various business units and service lines" although this information was available to the company's management and board.

Subsequently PowerSecure amended its segment reporting disclosure in the second quarter of 2014 to describe three segments. Nonetheless, according to the SEC, its disclosure was not in accordance with GAAP, as "PowerSecure failed to contemporaneously identify which of its business units met the ASC 280 definition of an operating segment, which should have resulted in the identification of seven — rather than three — operating segments in 2014."

2. Effect on Goodwill Impairment Testing and Internal Accounting Controls

According to the SEC, PowerSecure's "failure to properly identify its operating segments was a contributing factor that led PowerSecure to erroneously identify fewer reporting units for purposes of testing for goodwill impairment than required in ASC Topic 350, Intangibles — Goodwill and Other." Because under GAAP, at a minimum, each of PowerSecure's operating segments should have been deemed a reporting unit for purposes of ASC 350, goodwill impairment at the company was allegedly tested at a higher level than required by ASC 350, "which could have resulted in PowerSecure's failure to recognize a goodwill impairment loss."

Additionally, according to the SEC, in each of PowerSecure's Forms 10-K from 2012 to 2014, the company included management's erroneous conclusion that it had both effective disclosure controls and procedures and effective internal control over financial reporting. In fact, however, PowerSecure allegedly "lacked sufficient internal accounting controls to adequately monitor its compliance with the segment reporting requirements under GAAP," as evidenced in part by the company's lack of a segment reporting policy and its limited and vague documentation of its application of ASC 280. Indeed, in its Form 10-K for the 2015 fiscal year, PowerSecure disclosed that management reassessed the company's disclosure controls and procedures for 2012 through 2014 and concluded that they were not effective due to a material weakness in the company's internal control over financial reporting as a result of the company's misapplication of GAAP's segment reporting requirements.

Significance of the Enforcement Action

While not explicit in the SEC's order, it appears that PowerSecure's failure to disclose to investors inefficiencies in one part of its business before disclosing a loss, as well as its failure to take impairment charges due to its aggregation of businesses under its single reportable segment, may have been key factors in the SEC's determination to pursue an enforcement action in this instance. That said, the enforcement action against PowerSecure serves as a crucial reminder of the importance of complying with GAAP in identifying a public entity's operating and reportable segments. The action underscores that, though there is an element of judgment involved in determining a company's operating segments, such judgment must be applied in accordance with the management approach outlined in ASC 280. Discrepancies between the operating segments identified by the company and the level at which discrete financial information is available internally to the CODM is an indication that the company's operating segments may not be in compliance with ASC 280. As highlighted by the SEC's cease-and-desist order, public companies should also adequately document their application of GAAP's segment reporting requirements. Finally, when a public company determines to modify its operating segments, it is vital that the company confirm that there has been a corresponding change in the information made available to the CODM.

Yafit Cohn is an associate, and Karen Hsu Kelley and Michael Nathan are partners, in the New York office of Simpson Thacher & Bartlett LLP.

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[1] See In the Matter of PowerSecure International Inc., Release No. 34-79256 (Nov. 7, 2016).

[2] Additionally, if specified criteria are met, public companies may report results from aggregating two or more operating segments.
