# Client Update

# SEC Enforcement Action Puts Spotlight on Segment Reporting

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The SEC staff continues to focus on segment reporting in comment letters and recently brought an enforcement action against a company due to the company's alleged failure to properly identify its reportable segments in its SEC periodic reports. Issuers, particularly those about to begin preparing their annual report on Form 10-K, should review their segment reporting analysis and documentation to confirm that they comply with the applicable accounting standards.

Since the beginning of 2012, the SEC staff has raised questions about segment reporting in over 2,000 comment letters. Most recently, following an exchange of comments and responses with PowerSecure International, and a revision by PowerSecure of its prior period segment reporting, the SEC instituted and settled a cease and desist order against PowerSecure for violations of the reporting, books and records, and internal control provisions of the Securities Exchange Act of 1934 arising out of PowerSecure's alleged failure to properly identify its reportable segments.[1] PowerSecure was fined $470,000 as part of the settlement of the SEC's claims.

## BACKGROUND

The determination of a company's reportable operating segments under United States generally accepted accounting principles ("US GAAP") is governed by Accounting Standards Codification Topic 280, *Segment Reporting* ("ASC 280"), which adopts the so-called "management approach," predicated on the manner in which management organizes the segments for making operating decisions and assessing performance. ASC 280 defines an operating segment as a component of a public entity that has all of the following characteristics:

[1] See *In the Matter of PowerSecure International, Inc.*, Exchange Act Release No.79256 (November 7, 2016).

- It engages in business activities from which it may earn revenues and incur expenses;
- Its operating results are regularly reviewed by the Chief Operating Decision Maker ("CODM") to make decisions about resources to be allocated to the segment and assess its performance; and
- Its discrete financial information is available.

ASC 280 sets forth additional guidance for the determination of reportable segments. The term CODM refers not to a specific title within the organization but rather to the function of allocating resources to and assessing performance of the segments of a public entity. Further, an operating segment generally has a segment manager, who is directly accountable to and maintains regular contact with the CODM to discuss operating activities, financial results, forecasts, or plans for the segment. Finally, if the CODM uses more than one set of operating segment information, other factors can be used to determine a public entity's operating segments, including the nature of the business activities of each component, the existence of management responsible for them, and information provided to the board of directors.

## THE SEC CEASE AND DESIST ORDER

After selling one of its two previously identified reportable segments, PowerSecure identified only one reportable segment, Utility & Energy Technologies, in its SEC filings beginning in 2013. The SEC alleges in the order that PowerSecure misapplied ASC 280 by identifying only one reportable segment and should have disclosed as many as seven segments. The order states that PowerSecure determined it had only one segment based on the facts that (1) there was no discrete financial information available below the Utility & Energy Technologies level, and (2) the CODM did not regularly review operating results below the Utility & Energy Technologies level to assess performance and make resource allocations.

The SEC order states that PowerSecure concluded that the "discrete financial information" requirement was not met because certain operating expenses were not allocated among its business units with precision below gross profit. In the SEC's view, however, this requirement is satisfied if a business component has "a measure of profit or loss available and gross profit is sufficient for this purpose." Further, according to the SEC, ASC 280 does not specify the level or precision at which costs must be allocated.

The SEC further alleged that PowerSecure improperly concluded that its CEO, who was the CODM for purposes of ASC 280, did not regularly review operating results below the consolidated Utilities and Energy Technologies level to make decisions about resource allocation and assess its performance. The SEC pointed

to several factors that belied this conclusion: (1) the CEO received, on a monthly basis, financial results that reflected a measure of profitability on a more granular level than the Utilities and Energy Technologies level; (2) the CEO met, on a quarterly basis, with the leader of each business unit to discuss operations, sales forecasts and financial performance; (3) some of the business units had budgets and forecasts and their leaders received incentive compensation based, in part, upon the results of their business unit; and (4) the board of directors received, on a quarterly basis, discrete financial information below the consolidated level, presented by the chief financial officer, together with commentary by the CEO.

In addition to the misapplication of ASC 280, the SEC alleged that the failure to properly identify its reportable segments contributed to PowerSecure's erroneous application of ASC Topic 350, *Intangible-Goodwill and Other* ("ASC350"), by identifying too few reporting units for purposes of testing goodwill impairment. According to the order, "As a result, goodwill impairment was tested at a higher level in the organization than required by ASC 350, which could have resulted in PowerSecure's failure to recognize a goodwill impairment loss." The order, however, does not identify any actual goodwill impairment loss that PowerSecure failed to recognize appropriately.

As a result of these misapplications of US GAAP, the SEC alleged that PowerSecure violated the reporting and books and records requirements of the Securities Exchange Act as well as the requirements to maintain effective disclosure controls and procedures and effective internal control over financial reporting. In cataloging PowerSecure's miscues, the SEC noted that "PowerSecure did not have a segment reporting policy, and there was limited documentation of its application of the segment reporting requirements."

## IMPLICATIONS

While PowerSecure is undoubtedly an egregious example, given the SEC's ongoing focus on reportable segments, reporting companies should consider reviewing their segment determinations for compliance with ASC 280. The analysis should be properly documented with a reasonably detailed description of the basis on which the company believes it has complied with ASC 280. When a company determines that it is appropriate to make any changes to its reportable segments, the reasons for the change, including any changes in the business, organizational structure, available financial information or other relevant factors, should be appropriately documented and accurately disclosed.

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Please do not hesitate to contact us with any questions.