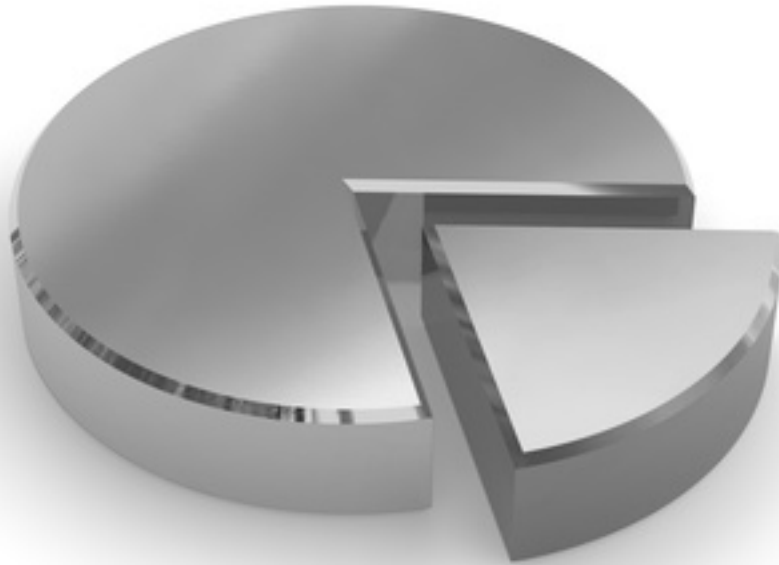


June 2010



## Reporting Units

### Determination of Reporting Units when Testing Goodwill for Impairment

Goodwill is recorded as a result of many business combinations. For years, goodwill was amortized over a period not more than 40 years. Beginning in 2001, goodwill is no longer amortized, but rather tested for impairment. Due to the unique nature of goodwill, which is measured as the residual amount in acquisition accounting, the test for impairment is complex.

*Accounting Insights* is a publication of McGladrey & Pullen, LLP and should not be construed as accounting, auditing, consulting, or legal advice on any specific circumstances or facts. The contents are intended for general information purposes only. You are urged to consult your McGladrey service provider concerning your situation and any specific questions you may have.

## Introduction

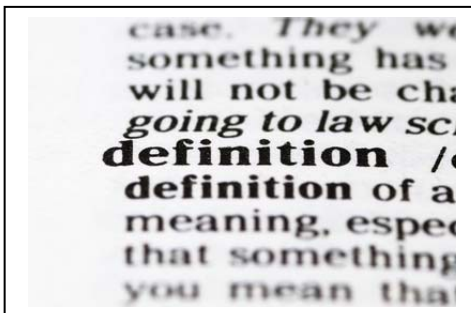
FASB Accounting Standards Codification (ASC) Topic 350, *Intangibles – Goodwill and Other*, (from FASB Statement No. 142, *Goodwill and Other Intangible Assets*) requires goodwill to be tested for impairment at least annually using a two-step process. The purpose of step one is to act as a “screen” to identify potential impairment by measuring the fair value of a reporting unit and comparing this fair value to the reporting unit’s carrying amount. This paper is intended to assist in the determination of an entity’s reporting units when testing goodwill for impairment.

## Important Terminology

There are a number of important terms that must be understood in order to determine an entity’s reporting units. These include:

- Operating segment;
- Reportable segment; and
- Reporting unit.

While the definitions of these terms are not inherently difficult, they are often misunderstood and confused with one another.



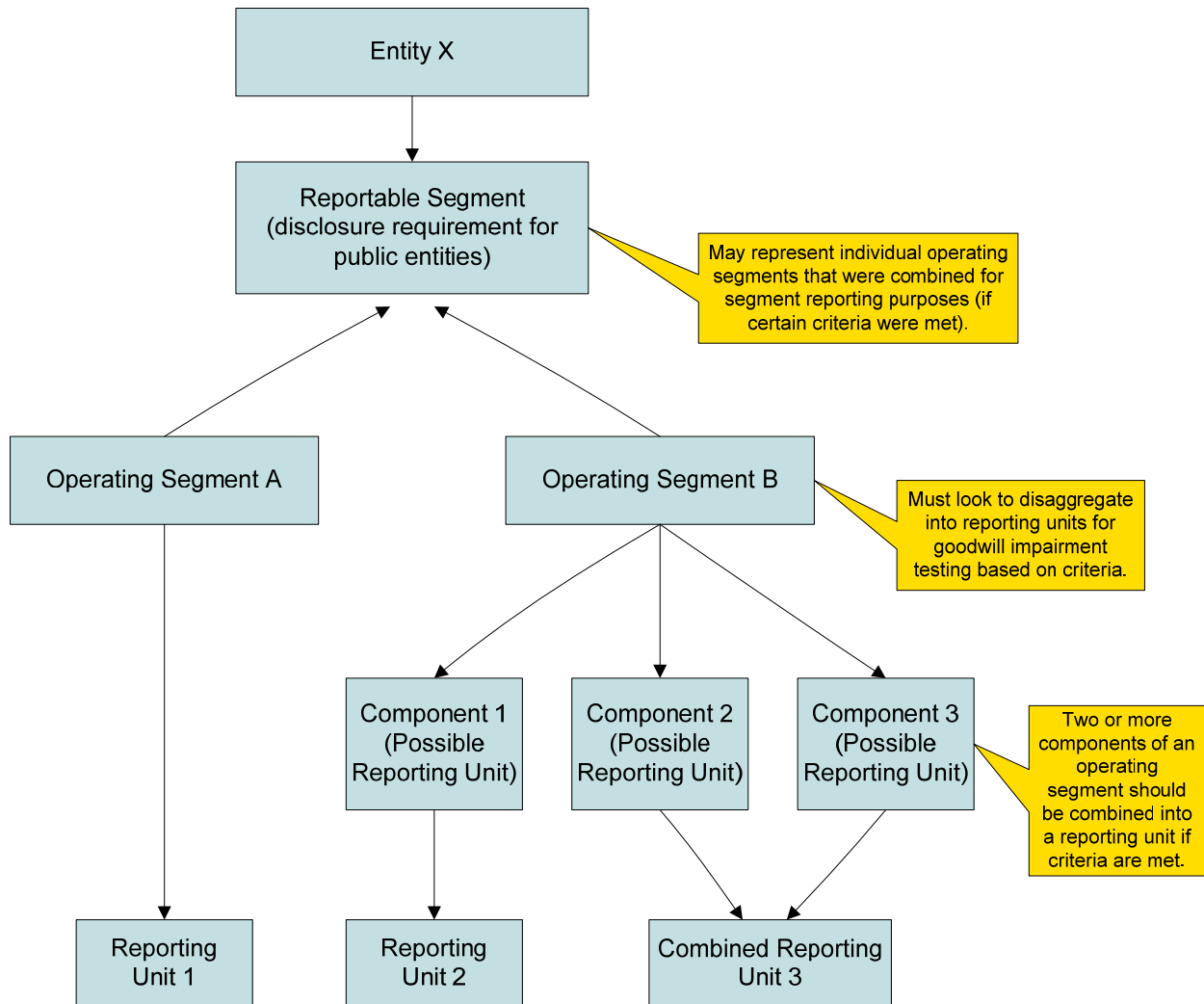
An *operating segment* is defined as a component of a public entity with certain other characteristics that will be discussed later in this paper. While the formal definition refers to “public entity” since it was issued in the segment reporting standard, nonpublic entities must also

apply the concept. One of the reasons an operating segment may be confused with a reporting unit is the fact that both may be considered components. A reporting unit can be a component of an operating segment while an operating segment is a component of a public entity. Furthering the potential confusion is the fact that in certain instances the two terms may be referring to the same thing, as a reporting unit may be the same as an operating segment.

A *reportable segment* refers to the operating segments for which certain information must be presented separately in the financial statements of a public entity. When certain criteria are met, two or more operating segments can be aggregated into a reportable segment for disclosure purposes. For purposes of goodwill impairment testing, reportable segments are not relevant. However, we briefly address this term in this paper as it may be confused with reporting units due to their similar names. Furthermore, entities may incorrectly use their reportable segments as the starting point in determining reporting units rather than their operating segments.

The last term to discuss is a *reporting unit*, which is an operating segment or one level below an operating segment (known as a component of an operating segment). Therefore, to determine its reporting units, an entity’s operating segments must first be identified. While this may appear obvious based on the definition of a reporting unit, nonpublic entities may be surprised to learn this and it can be confusing to them for a number of reasons. Among these reasons are that the definition of an operating segment refers specifically to public entities only. In addition, the standard in which operating segments are defined (ASC 280, *Segment Reporting*) is only applicable to public entity segment disclosures. Therefore, other than for purposes of goodwill impairment testing, a nonpublic entity has no reason to identify its operating segments.

The following chart visually represents an example depiction of the relationship of these terms to one another:



## Operating Segment Determination

Operating segments are determined based on an entity's existing internal reporting structure. As a result, the operating segments of two entities that are direct competitors in the same line of business may be completely different. A component of a public entity must have each of the following characteristics in order to be considered an operating segment:

- It engages in business activities from which it may earn revenue and incur expenses (including those resulting from intercompany transactions);
- 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.

The first characteristic is met by many components within an entity, other than those such as an entity's headquarters or certain functional departments that do not earn revenues other than those that are incidental to the entity's business. For example, even a component that is in a startup phase of operations and has yet to earn revenues could be considered to meet this characteristic as it may earn revenues in the future.

The second and third characteristics are the more difficult items to evaluate and are often considered together. The keys to evaluating these characteristics are determining who the CODM is and then evaluating what discrete financial information the CODM regularly reviews in making decisions about allocating resources and assessing the performance of a component.

An entity's CODM is the person or group of people who are responsible for allocating resources to and assessing the performance of the entire entity. Typically this will be the CEO or the COO, but it can be a group of people if these responsibilities for the entity as a whole are ultimately shared. Once the CODM is determined, an entity must evaluate the manner in which the CODM uses the entity's financial results beginning with determining which discrete financial information the CODM receives by component.

Discrete financial information is considered to be any measure of a segment's profit or loss. While this may be as much as a full income statement in certain cases, it can be as little as gross margin information to qualify as discrete financial information. Such information does not need to be computed in accordance with generally accepted accounting principles. This is often misunderstood by entities and can result in the identification of many more operating segments than expected. Furthermore, discrete financial information does not need to include any balance sheet information. While a balance sheet for each reporting unit is necessary to test goodwill for impairment (and the guidance in ASC 350 discusses how assets and liabilities should be assigned to a reporting unit for this purpose), the lack of one at the entity component level is not a reason for a component to not meet the definition of an operating segment.

In practice there is a presumption that if a CODM receives discrete financial information for a component, that information is used to make decisions about resources to be allocated to the segment and assess its performance. This presumption may be overcome if it can be demonstrated by the entity that the CODM does not utilize the information for that purpose. However, based on public comments by regulators as well as our interactions with them, overcoming this presumption is difficult, and assertions that the CODM receives information but does not use it are met with a high level of skepticism.

There may be cases in which a CODM receives and evaluates discrete financial information for overlapping components of an entity. For example, a CODM may receive discrete financial information on a product-line basis as well as on a geographic basis. In these cases, other factors must be considered in determining the appropriate operating segments, such as the nature of the business activities of each component, the existence of managers responsible for a component, as well as the information received by the entity's Board of Directors. If there are managers specifically responsible for geographic regions but none specifically responsible for each product line, the operating segments would be based on geography. If there are managers for both

geographies and product lines, the product lines would be considered the operating segments.

## Reporting Unit Determination

As noted earlier, a reporting unit is an operating segment or one level below an operating segment (a component). Although ASC 280 may allow for the aggregation of operating segments based on similar economic characteristics or certain quantitative thresholds, any aggregation of operating segments is strictly relevant to the determination of reportable segments and does not change an entity's operating segments. As a result, any aggregation that occurs is not relevant for purposes of determining operating segments or reporting units.

Once operating segments are determined as discussed previously, they become the starting point for determining reporting units. A reporting unit will either be the same as the operating segment or one level below it, but can never be on a more consolidated basis than the operating segment. For example, if an entity determines it has three operating segments, there can be no fewer than three reporting units. Special emphasis is placed on this as nonpublic entities in the past may have initially skipped the determination of operating segments altogether prior to determining reporting units, in which case their reporting units may have been identified incorrectly.

A component of an operating segment must meet all of the following criteria to be considered a reporting unit:

- It constitutes a business;
- Its discrete financial information is available; and
- Segment management regularly reviews its operating results.

The first criterion regarding being considered a business was recently changed in practice as a result of the issuance of FASB Statement No. 141R, *Business Combinations* (codified in ASC Topic 805), which changed the definition of a business. A business is considered to be an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of

dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants. While this is not the focus of this paper, it should be noted that the new definition of a business is expected to result in more components of an operating segment being considered businesses. It should also be noted that this criterion is not required to be met when determining operating segments.

The second and third criteria are similar to those discussed previously for operating segments with one major difference being the level of management whose perspective is being evaluated in the review of the discrete financial information. While when determining operating segments the perspective was that of the CODM, for purposes of determining reporting units it is segment management. Segment management is directly accountable to and maintains regular contact with the CODM to discuss operating activities, financial results, forecasts, or plans for the individual operating segment. Segment management may be one person or a group of people that manages the operating segment as a whole. In some cases segment management may even be the CODM. The importance of identifying segment management cannot be overemphasized as it is an area where wrong conclusions often are reached.

For example, assume an entity determined it has only a single operating segment. In this situation, in most cases there will only be one reporting unit as the CODM will also typically be segment management. If the CODM reviews only one set of discrete financial information in the CODM role, they can only review that same set of discrete financial information in the segment management role. Furthermore, if an entity determines it has three separate individuals each managing a portion of the single operating segment, but none of the three individuals manages the overall business or manages the entire entity together as a group, it is not appropriate to identify them as segment management. If these three managers worked jointly to manage the entire entity, then in some fact patterns they may collectively be considered segment management of the company's single operating segment.

In certain situations, the components of an operating segment should be aggregated into one combined reporting unit for purposes of determining the level at which to test goodwill for impairment. However, this aggregation can never be higher than the operating segment level, and components of different operating segments (or operating segments themselves) may not be combined to form a reporting unit. For example, assume a company has identified three operating segments and each of those operating segments was determined initially to have two components. When evaluating whether these components can be aggregated into operating segments, this must be done within each operating segment such that at the highest level there would be three reporting units which are equivalent to the three operating segments. An entity could not, for example, combine two components of one operating segment with two components of another operating segment to form one reporting unit.

The components of an operating segment should be aggregated into a single reporting unit if they have similar economic characteristics such as long-term gross margins. To conclude that aggregation is appropriate, the following areas should be evaluated along with economic characteristics in terms of the similarity of each of these items in the different components of an operating segment:

- Nature of the products and services and production processes
- Type or class of customer for products and services
- Product distribution and service provision methods
- Nature of regulatory environment
- Manner and nature of business operations

Furthermore, other factors that would be indicative of components that are economically similar include when (a) goodwill is only recoverable from the components working together, or (b) the components extensively share assets and other resources, including research and development projects.

Unlike the criteria for determining operating segments and reporting units however, if the components are economically similar, only a majority of the above items need to be met to aggregate the components into a single reporting unit. Entities should consider these items and weigh the evidence for aggregation when making their conclusion.

For additional information related to goodwill impairment see the following McGladrey & Pullen publications:

- [Assigning Assets and Liabilities that Relate to Multiple Reporting Units when Testing Goodwill for Impairment](#)
- [MD&A Disclosures for Impairment of Goodwill and Long-Lived Assets](#)
- [Carryforward of a Reporting Unit's Fair Value when Testing Goodwill for Impairment](#)
- [Goodwill Impairment Application Issues](#)
- [Goodwill Impairment Testing in Today's Economy](#)

#### About McGladrey & Pullen, LLP

McGladrey is the brand under which McGladrey & Pullen, LLP and RSM McGladrey, Inc. serve clients' business needs. The two firms operate as separate legal entities in an alternative practice structure. McGladrey & Pullen is a licensed CPA firm providing assurance services. RSM McGladrey provides tax and consulting services.

McGladrey & Pullen, LLP and RSM McGladrey, Inc. are members of the RSM International ("RSMi") network of independent accounting, tax and consulting firms. The member firms of RSMi collaborate to provide services to global clients, but are separate and distinct legal entities which cannot obligate each other. Each member firm is responsible only for its own acts and omissions, and not those of any other party.

McGladrey, the McGladrey signature, The McGladrey Classic logo, *The power of being understood*, *Power comes from being understood* and *Experience the power of being understood* are trademarks of McGladrey & Pullen, LLP and RSM McGladrey, Inc.



Experience the power of being understood.<sup>SM</sup>