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Information Overlooked: When Segment Reporting Can Enhance Reliability of a Transfer Pricing Analysis

The authors examine a category of comparable data often overlooked—companies' segment reporting—and illustrate the potential impact of including this data as a comparability adjustment for comparable company benchmarks.



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Transfer pricing practitioners and tax authorities often overlook potentially valuable and reliable information in the form of comparables' segment reporting when conducting benchmarking analyses. While public companies make segment disclosures on Form 10-K, filed to the U.S. Securities and Exchange Commission, or in annual reports, screening criteria applied to select comparable companies typically do not include or apply to reportable segments.

This article explores the merits of comparable company segmentation as a comparability adjustment for comparable company benchmarks. When sufficient data are available, segmentation potentially enhances the comparability of benchmarks and improves the reliability of arm's-length evaluation of controlled transactions. As is true with all aspects of transfer pricing, use of segment data is fact-driven, and there is no universal standard on how to apply segment information as a comparability adjustment; thus, in the authors' view, its use should be evaluated on a case-by-case basis.

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Tax Authorities' Views

Although the U.S. Section 482 regulations acknowledge that it is not possible to find perfect comparables that engage in the "same transaction under the same circumstances"[1] as the tested party, the regulations also provide for comparability adjustments to ensure that the relaxed comparability factors do not undermine the arm's-length standard due to lack of data:

> [I]n order to be considered comparable to a controlled transaction, an uncontrolled transaction need not be identical to the controlled transaction, but must be sufficiently similar that it provides a reliable measure of an arm's length result. If there are material differences between the controlled and uncontrolled transactions, adjustments must be made if the

[1] Regs. § 1.482-1(b)(1).

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> effect of such difference on prices or profits can be ascertained with sufficient accuracy to improve the reliability of the results. . . A material difference is one that would materially affect the measure of an arm's length result under the method being applied.[2]

Accordingly, comparability adjustments are required when:

- there are material differences between the controlled and the uncontrolled transactions that can adversely impact the reliability of an arm's-length assessment, and
- differences in terms of impacts on prices or profits can be accounted for with sufficient accuracy.

Comparability requirements are more stringent for some transfer pricing methods, such as the resale price and cost plus methods, making the use of segment data much more relevant. Reportable operating segments that are not comparable to the tested transactions can have a significant impact on the comparable entity's consolidated group returns, even if they are small relative to the rest of the company's businesses. This impact is pronounced when the profitability of the non-comparable segments deviates significantly from those of the comparable segments. In such cases, relying on consolidated profitability as a benchmark for the tested transactions may not be in compliance with the comparability standards under the applicable Section 482 regulations, especially if the company provides segment financial data sufficiently detailed to account reasonably for material differences in profits between the comparable and uncontrolled transactions.

The Internal Revenue Service's APA study guide, published as part of the APA training materials, recognizes that determining comparability can be difficult, and often is at the heart of the APA team's work:

> Companies sometimes have financial data broken down by business line or geographic units. Sometimes omitting one or more business or geographic segments can make a company more comparable to the tested party. Thus, through the use of segmented data, an otherwise unacceptable potential comparable might become acceptable. While such segmented comparables might be used in some cases, segment data is sometimes unreliable; the reliability must be examined on a case-by-case basis.[3]

While the study guide acknowledges the need for relying on segment financial data under some circumstances, in practice the IRS often rejects segmented comparables, citing concerns about the reliability of segment data. Moreover, consolidated data are more readily accessible in available electronic databases. A preference often is stated for using consolidated data because they are not affected by intercompany pricing—a valid concern especially if the segmentation is based on geographic data, which may reflect transfer prices between related parties operating in different countries or regions.

In cases where segment data are based on different business or product lines, there still may be intersegment transfers affecting sales and cost of sales of the segment that is of interest. Public companies typically provide such intersegment eliminations as part of their segment reporting. Nonetheless, stated objections to using segment data seem to apply categorically to the whole universe of available comparables without regard to whether it might improve comparability and reliability of financial data for a given comparable in the set when there are companies with reportable segments that are not materially affected by intersegment transactions.

In addition, unallocated corporate expenses and assets are cited as a concern affecting the reliability of segmented data. A breakdown of unallocated corporate accounts sometimes is provided and can be used to identify accounts that may not be associated with the business segment in question. Otherwise, such accounts typically can be allocated to reported business segments based on respective segment sales or assets.

These allocations do not necessarily have an adverse impact on the reliability of segmented data. It is not uncommon to allocate these types of expenses to specific business or product lines in a similar fashion in the case of tested-party data for which business or product line data typically are available for direct sales and expenses, but not necessarily for general and administrative expenses, which usually are allocated by sales or other bases as appropriate. Therefore, allocating unallocated corporate expenses does not necessarily impair the reliability of benchmark financial data based on segment information when certain tested-party data may need to be allocated using a similar method.

Like the U.S. Section 482 regulations, the Organization for Economic Cooperation and Development transfer pricing guidelines require the determination of comparability adjustments where appropriate:

> Where segmented data are available, they can provide better comparables than company-wide, non-segmented data, because of a more transactional focus, although it is recognized that segmented data can raise issues in relation to the allocation of expenses to various segments. Similarly, company-wide third party data may provide better comparables than third party segmented data in certain circumstances, such as where the activities reflected in the comparables correspond to the set of controlled transactions of the taxpayer.[4]
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> Examples of comparability adjustments include adjustments for accounting consistency designed to eliminate differences that may arise from differing accounting practices between the controlled and uncontrolled transactions; segmentation of financial data to eliminate significant non-comparable transactions; adjustments for differences in capital, functions, assets, risks.[5]

The use of segmented data as a comparability adjustment may be warranted depending on case-specific facts and circumstances. Sufficiently detailed segment-level data may be unavailable in some jurisdictions, however, limiting the use of segment data as a comparability adjustment. Further, private companies are not

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[2] Regs. §1.482-1(d)(2).

[3] IRS APA Study Guide, note 27. See 11 *Transfer Pricing Report* 478, 10/2/02.

[4] Review of Comparability and of Profit Methods: Revision of Chapters I-3 of the Transfer Pricing Guidelines, 7/22/10, Chapter 3, para. 3.37.

[5] *Id.*, para. 3.47.

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required to disclose segment-level financial data and so the use of segment data for private companies may not be feasible at all.

Accepting a segment of a company as a comparable can be appropriate when the company as a whole fails to meet the applicable comparability criteria. Being able to include the segment as a comparable is especially helpful when there are only a few good comparables to begin with. If a potential comparable company does not satisfy the screening criteria, but has a business segment that is determined to be sufficiently comparable based on available data, and if the financial performance of the segment can be determined reliably, then the comparable should not be rejected solely on the basis that it is a segment.

Tax authorities' concerns regarding the use of segment data are warranted when the use of segment data requires subjective assumptions and substantial allocations or adjustments. In most cases, however, segment data from audited financial statements include third-party sales, operating profit and asset data, and this financial information easily can be used to derive profit-level indicators such as the operating margin, return on assets and return on total costs without any major adjustments or allocations. In such cases, the categorical rejection of using segment data results in elimination of otherwise comparable benchmarks and a less precise benchmarking analysis.

Accounting Standards Codification 280

Financial Accounting Standards Board Accounting Standards Codification Topic 280 (ASC 280) instructs public companies on how to report certain financial information for operating segments in the audited financial statements of the company. ASC 280 also requires public entities to report similar segment information on products and services as well as geographic areas.

The main reason for segment disclosures is to provide information about the different types of business activities in which a public entity engages and the different economic conditions in which it operates.

ASC 280 defines a public entity as a business entity that meets at least one of three conditions:

- it has issued debt or equity securities or is a conduit bond obligator for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market including local or regional markets),
- it is required to file financial statements with the SEC, and
- it provides financial statements for the purpose of issuing any class of securities in a public market.

The segment reporting provides relevant segment information to better understand the public entity's financial performance, to better assess different business lines' viability and to better understand the public entity as a whole. To this end, ASC 280 requires public companies to disclose specific financial information about reportable operating segments that meet any of the following quantitative thresholds:

- its reported revenue, including both sales to external customers and intersegment sales or transfers, is 10 percent or more of the combined revenue, internal and external, of all operating segments;
- the absolute amount of its reported profit or loss is 10 percent or more of the greater, in absolute amount, of (a) the combined reported profit of all operating segments that did not report a loss or (b) the combined reported loss of all operating segments that reported a loss; or
- its assets are 10 percent or more of the combined assets of all operating segments.

Operating segment financial data reported in a public entity's Form 10-K include disclosures of revenue, profits and losses, and assets. A public entity shall disclose information on revenue from external customers, intercompany segment revenue, interest revenue and expenses, depreciation and amortization and extraordinary and unusual items if the associated figures for these accounts are included in the measure of segment profit or loss that is reviewed by the public entity's management.

Thus, segment disclosure requirements are comprehensive, and reportable segment data in general are sufficiently detailed to determine the financial performance of a business segment for purposes of a transfer pricing benchmarking analysis; however, there still may be cases where other factors may preclude the use of this segment data. For instance, thresholds can be introduced to identify whether:

- the relevant segment is not an integral part of the comparable's core business line and revenue generated from this segment constitutes a small portion of consolidated revenue (for example, less than one-third of consolidated revenue) and
- segment revenue generated from intercompany transactions constitutes a significant portion of total segment revenue.

Potential Impact of Using Segment Data

The following examples illustrate the potential impact of using segmented data in comparables' benchmarking analyses. The first two examples illustrate the impact of using segment data vis-à-vis the company's consolidated data in benchmarking analyses for routine distribution and manufacturing functions, respectively. The third example illustrates a situation where relying on segment data might actually undermine the reliability of benchmark results.

A Routine Distribution Benchmark

Kaman Corp., a publicly traded company, has two reportable segments: distribution and aerospace. The distribution segment is engaged in wholesale distribution of power transmission and motion control products in North America, whereas the Aerospace segment is engaged in manufacture of aircraft bearings and components for commercial, military and general aviation fixed and rotary wing aircraft.

Kaman typically is included in a distribution comparables search universe due to its primary Standard Industry Classification code: 5080 (wholesale distribution of machinery, equipment and supplies). However, using Kaman's consolidated returns to test routine distribution functions of a tested party would yield distorted results. Table 1 shows revenue and profit as well as segment-level profitability measures for each operating segment for the fiscal year ended Dec. 31, 2013.

Kaman's distribution segment had an operating margin of 1.36 percent, while the operating margin earned by the aerospace segment was significantly higher at 14.35 percent in FY 2013. Despite constituting about one-third of consolidated revenue only, the aerospace segment profit had a material and positive impact on the consolidated operating margin, which was 4.75 percentage points higher than that of the distribution segment. As this example illustrates, relying on the consolidated operating margin as a comparable arm's-length benchmark for wholesale distribution functions would be flawed due to material difference in profitability between the distribution segment and the consolidated results. Thus, using segment data for the distribution segment is justified and in compliance with the Section 482 regulations.

Table 1: Kaman's Operating Segment Financials in FY 2013

In USD Thousands	Distribution	Aerospace	Corporate	Consolidated
Net Sales, per Form 10-K	1,067,839	613,967	—	1,681,806
% of Consolidated Sales	*63.49%*	*36.51%*	—	*100.0%*
Operating Profit, per Form 10-K[6]	43,326	104,644	(45,291)	102,679
Allocations of Corporate based on Segment Sales Ratio[7]	(28,757)	(16,534)	45,291	102,679
Adjusted Operating Profit after Corporate allocations	14,569	88,110	—	102,679
% of Consolidated Profit	*14.19%*	*85.81%*	—	*100.0%*
Operating Margin[8]	**1.36%**	**14.35%**	**—**	**6.11%**

Source: Kaman's FY 2013 Form 10-K.

[6] Goodwill impairment and net loss on sale of assets are reclassified to non-operating for this illustrative purpose.
[7] Unallocated Corporate operating loss, after below-the-line reclassification of net loss on sale of assets, is allocated to the operating segments based on respective sales ratio.
[8] Operating margin is defined as operating profit, as defined above, divided by net sales.

A Routine Manufacturing Benchmark

CTS Corp., a publicly traded company manufacturing electronic components, has two reportable business segments: components and sensors and electronic manufacturing services (EMS). The components and sensors segment manufactures electronic components for original equipment manufacturers (OEMs), whereas the EMS segment assembles electronic and mechanical components into a finished subassembly for OEMs. CTS appears to be a good candidate for a manufacturing comparable in the electronics industry. However, relying on profitability for the entire company is misguided and leads to unreliable results.

Even though both segments of CTS are engaged in manufacturing or assembly of electronic components for OEMs, the components and sensors segment invests in research and development and incurs a substantial amount of R&D expense. For the fiscal year ended Dec. 31, 2012, CTS incurred $20.9 million in R&D, a substantial part of which were incurred by the components and sensors segment. The company's Form 10-K states that ''R&D expenditures in the EMS segment are typically very low.'' Assuming that the components and sensors segment incurred the total $20.9 million of R&D, the segment R&D-to-sales ratio would be 6.9 percent.

With such a substantial investment in R&D, one can conclude that the components and sensors segment takes entrepreneurial risks and owns valuable proprietary technology intangibles. Further, the components and sensors segment's operations are much more capital-intensive than those of the EMS segment.

As presented in Table 2, the components and sensors segment's assets-to-sales ratio is 1.34, while that of the EMS segment is merely 0.43. The difference in the assets-to-sales ratio indicates functional differences between the two segments: components manufacture versus light assembly. Due to these material differences in functions performed and risks assumed between the two segments, the use of the EMS segment provides a more accurate and reliable measure to benchmark a routine manufacturing and assembly return.

Although CTS's two segments are approximately the same size in revenue, the components and sensors segment derives nearly 70 percent of the consolidated operating income and employs more than 77 percent of the consolidated assets. As a result, there are material differences in both income statement-based and asset-based PLIs. An interesting observation is that, due to the substantial difference in asset intensity relative to sales between the two segments, the EMS segment's operating margin is lower than the components and sensors segment; however, return on assets for the EMS segment is higher than that for the components and sensors segment.

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Table 2: CTS's Operating Segment Financials in FY 2012

In USD Thousands	Components and Sensors	EMS	Consolidated
Income Statement			
Net Sales, per Form 10-K	304,481	272,437	576,918
% of Consolidated Sales	*52.78%*	*47.22%*	*100.00%*
Operating Profit, per Form 10-K[9]	11,293	5,061	16,354
% of Consolidated Operating Profit	*69.05%*	*30.95%*	*100.00%*
Balance Sheet			
Total Assets, per Form 10-K	443,271	117,905	561,176
Less: Goodwill, per Form 10-K[10]	(35,900)	(500)	(36,350)
Equals: Total Assets excluding Goodwill	407,371	117,405	524,826
% of Consolidated Assets excl. Goodwill	*77.62%*	*22.37%*	*100.00%*
Financial Ratios			
Asset-to-Sales Ratio	**1.34**	**0.43**	**0.91**
Return on Assets	**2.77%**	**4.31%**	**3.12%**
Operating Margin	**3.71%**	**1.86%**	**2.83%**

Source: CTS's FY 2012 Form 10-K. CTS sold the EMS segment to Benchmark Electronics Inc. in October 2013. Thus, FY 2012 data are used for illustrative purposes.

[9] Segment reporting on Form 10-K (Note L) includes a gain on sales-leaseback and restructuring charges, which are reclassified below-the-line in this example.

[10] Segment goodwill information is rounded to the nearest $100,000, and thus a sum of segment goodwill figures does not perfectly add up to the consolidated goodwill balance.

Possibility of Distorted Results

The use of segment data does not always enhance comparability or produce reliable results. When there are substantial intersegment transactions, the use of segment data may distort arm's-length results. Significant intersegment transactions often are observed in a company whose operations are segmented by geographic region or include complementary product lines or businesses.

For example, Bel Fuse Inc., a manufacturer of components used in networking and telecommunications, data transmission and consumer electronics products, discloses three geographic segments in its Form 10-K: North America, Asia and Europe. All three geographic segments are engaged in both manufacturing and distribution of products to final customers. There are substantial intersegment sales among the three. The sum of sales for the three segments was $394 million for the fiscal year ended December 2013, more than 10 percent of which were intersegment sales. Table 3 presents each segment's net sales to external customers and net sales including intersegment sales as well as consolidated sales.

Due to the materiality of intersegment transactions, use of geographic segment data (for example, the North America segment to benchmark a routine U.S. manufacturing return) might undermine the reliability of arm's-length results because intersegment transactions are controlled transactions, and thus, there is no assurance that they were transacted at arm's-length prices. Segment returns inevitably include controlled transactions, and thus, the use of segment profitability as an arm's-length benchmark is flawed.

Table 3: Bel Fuse's Operating Segment Financials in FY 2013

In USD Thousands	North America	Asia	Europe	Inter-geographic	Consolidated
Income Statement					
Net Sales to External Customers, per Form 10-K	116,548	193,647	38,994	—	349,189
Net Sales, per Form 10-K	128,472	225,151	40,742	(45,176)	349,189
Intersegment Sales, per Form 10-K	11,924	31,504	1,748	45,176	n/a
Intersegment Sales as % of Segment Net Sales	*9.28%*	*13.99%*	*4.29%*		

Source: Bel Fuse's FY 2013 Form 10-K.

Conclusion

The Section 482 regulations and the OECD guidelines require making comparability adjustments to account for material differences between the controlled and uncontrolled transactions. As illustrated in the examples above, failure to use segment data when appropriate leads not only to eliminating comparables that are otherwise reliable benchmarks, but also to distorted arm's-length benchmarks. Segment data from audited financial statements typically provide operating-level data that can be used as benchmarks without additional adjustments or allocations. They generally are reliable and improve reliability and comparability as well as precision of the comparables analysis.

Tax authorities' concerns regarding the use of segment data can be minimized by assessing the suitability of each potential comparable's relevant operating-level segment data after applicable adjustments and allocations as a reliable arm's-length benchmark. Rather than categorically rejecting the use of comparable company segment data, the authors recommend evaluating each potential comparable's available segment data as a worthwhile practice in identifying and quantifying the most reliable benchmarks.

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