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Technical Line

FASB — final guidance

How discontinued operations are changing

In this issue:

What you need to know

- The FASB's final guidance raises the threshold for disposals to qualify as discontinued operations.
- Continuing cash flows and continuing involvement with disposed components are no longer considered in determining whether a transaction qualifies as a discontinued operation.
- The standard expands the disclosures for discontinued operations and requires new disclosures for disposals of individually significant components that do not meet the new definition of a discontinued operation.
- For calendar-year public business entities and certain not-for-profit entities, the guidance is effective in 2015 and interim periods within that year. For other calendar-year entities, it is effective in 2015 and interim periods thereafter. Early adoption is permitted. Adoption is on a prospective basis.

Overview

The new guidance grew out of a joint project the Financial Accounting Standards Board (FASB or Board) and the International Accounting Standards Board (IASB) launched in 2008 to develop an improved definition of a discontinued operation. The FASB's goal was to converge US GAAP with IFRS and to respond to criticism that too many disposals are reported as discontinued operations under existing US GAAP, resulting in information that financial statement users do not find useful and that is costly for preparers to provide.

Building a better working world

Accounting Standards Update (ASU) 2014-08, *Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity*, raises the threshold for a disposal to qualify as a discontinued operation and requires new disclosures about disposals of both discontinued operations and certain other disposals that do not meet the new definition. It also allows an entity to present a discontinued operation even when it has continuing cash flows and significant continuing involvement with the disposed component.

In addition, the ASU eliminates most scope exceptions that currently exist. As a result, equity method investments and other asset groups that previously would not have been eligible to be treated as discontinued operations may now qualify (if the related criteria are met). Only oil and gas properties accounted for using the full cost method of accounting remain out of the scope of the revised standard.

Criteria for reporting discontinued operations

Prior to the issuance of ASU 2014-08, a discontinued operation was defined as a component of an entity that had either been disposed of or was classified as held for sale, provided the ongoing entity did not have significant continuing involvement in or continuing cash flows with the disposed component following the disposal date. A newly acquired asset group that meets certain criteria for classification as an asset held for sale on the acquisition date but not all of the criteria also could have met the definition of a discontinued operation.

Under the revised standard, a discontinued operation is defined as (1) a component of an entity or group of components that has been disposed of by sale, disposed of other than by sale or is classified as held for sale that represents a strategic shift that has or will have a major effect on an entity's operations and financial results or (2) an acquired business or nonprofit activity (the entity to be sold) that is classified as held for sale on the date of the acquisition.

ASU 2014-08 incorporates the held-for-sale criteria in ASC 360-10-45-9 to determine whether a component of an entity or a group of components of an entity, a business or a nonprofit activity is classified as held for sale. Those criteria are:

- Management, having the authority to approve the action, commits to a plan to sell the entity to be sold
- The entity to be sold is available for immediate sale in its present condition, subject only to terms that are usual and customary for sales of such entities to be sold
- An active program to locate a buyer or buyers and other actions required to complete the plan to sell the entity to be sold have been initiated
- The sale of the entity to be sold is probable, and transfer of the entity to be sold is expected to qualify for recognition as a completed sale within one year (some exceptions may apply)
- The entity to be sold is being actively marketed for sale at a price that is reasonable in relation to its current fair value
- Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn

The raised threshold

The new guidance defines a component of an entity the same way as existing guidance. That is, a component comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. However, the new guidance requires that a disposal of a component represent a strategic shift that has or will have a major effect on an entity's operations and financial results. A strategic shift could include the disposal of (1) a major line of business, (2) a major geographical area, (3) a major equity method investment or (4) other major parts of an entity.

Consider the following illustrations of the application of the definition of a discontinued operation under ASU 2014-08.

The new guidance adds the concept of a strategic shift to the definition of a discontinued operation.

Illustration 1 — Disposal of a major line of business

A company manufactures and sells 10 brands of consumer products that are grouped into five major product lines — beauty care, health care, food, pet care and baby care. Each brand comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, each brand is a component of the entity. Each product line (i.e., a group of components) represents a major line of business that comprises a major part of the entity's operations and financial results. The company decides to exit the beauty care market and disposes of its related product line. The continuing entity will have no ongoing cash flows or involvement with the product line following the disposal and reflects the operations of the beauty care product line as a discontinued operation in its statement of net income.

Analysis

Under the new guidance, this disposal qualifies as a discontinued operation because the beauty care product line is a group of components of the entity that represents a major line of business that comprises a major part of an entity's operations and financial results (i.e., a strategic shift).

Under existing guidance, this disposal also qualifies as a discontinued operation because the beauty care product line is a group of components of the entity and the entity does not have significant cash flows or continuing involvement in the discontinued operation following the disposal.

Illustration 2 — Disposal that does not qualify for presentation as a discontinued operation under ASC 2014-08

Assume the same facts as in Illustration 1, except the company decides to dispose of one of its brands within the beauty care product line. Following the disposal, the company will not have significant continuing involvement or continuing cash flows with the disposed component.

Analysis

Under existing guidance, this disposal would qualify for as a discontinued operation because the brand being disposed of is a component of the entity and the ongoing entity does not have significant continuing involvement or continuing cash flows following the disposal.

Under ASU 2014-08, however, this disposal does not meet the definition of a discontinued operation because the disposed brand does not represent a major part of an entity's operations and financial results (i.e., disposing of it is not considered a strategic shift).

Illustration 3 — Disposal of a major geographical area

An entity is a general merchandise retailer and operates 300 retail stores throughout the US. The entity divides its stores into five major geographical regions — the Northwest, Southwest, Midwest, Northeast and Southeast. Each retail store is a component of the entity. Due to its declining market share in the Southeast, the entity decides to close all of its stores in the Southeast region. The Southeast region accounts for approximately 20% of the entity's total revenues. The entity does not expect a significant amount of sales to migrate to other locations given the distance customers would have to travel, and it does not have and does not plan to have any online capability.

Analysis

Under the new guidance, this disposal meets the definition of a discontinued operation because the group of retail stores in the Southeast region that were disposed of represent a major geographical area that comprises a major part of an entity's operations and financial results (i.e., strategic shift).

Under existing guidance, this disposal also qualifies as a discontinued operation because the stores in the Southeast region that were disposed of represent a group of components of the entity, and the entity does not have significant continuing involvement in the components following the disposal.

The ASU raises the threshold for reporting newly acquired asset groups as discontinued operations.

Illustration 4 — Disposal of a component that does not qualify for presentation as a discontinued operation under ASU 2014-08

Assume the same facts as in Illustration 3, except that the entity decides to close one of its retail stores in the Southeast region, and there will be no migration of sales given its location.

Analysis

Under existing guidance, this transaction would meet the criteria for reporting as a discontinued operation because the one store that was closed is a component of the entity, there is no migration of sales and the entity does not have significant continuing involvement in the discontinued operation following the disposal.

Under the new guidance, however, this disposal does not meet the definition of a discontinued operation because closing one store does not have a major impact on the entity's operations and financial results and therefore does not represent a strategic shift.

Newly acquired businesses and nonprofit activities

Under the new guidance, newly acquired businesses or nonprofit activities that meet all of the criteria to be accounted for as held for sale at the date of acquisition are reflected in discontinued operations. A newly acquired business (or nonprofit activity) that qualifies as held for sale at the date of acquisition does not have to meet the strategic shift requirement.

The new guidance differs from current guidance in two ways. First, the unit of measure under the revised guidance is a business or nonprofit activity rather than an asset group (as defined in ASC 360-10-20), as is the case under current guidance. The new guidance requires that the newly acquired component meet the definition of a business in ASC 805-10 or a nonprofit activity in ASC 958-805 as follows:

> *A business is 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.*

> *A nonprofit activity is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing benefits, other than goods or services at a profit or profit equivalent, as a fulfillment of an entity's purpose or mission (for example, goods or services to beneficiaries, customers, or members). As with a not-for-profit entity, a nonprofit activity possesses characteristics that distinguish it from a business or a for-profit business entity.*

The second change is that under the new guidance, the newly acquired business or nonprofit activity must meet all of the held-for-sale criteria to be classified as held for sale at the date of acquisition. In contrast, existing guidance requires that the sale of the newly acquired asset group is expected to occur within one year from the date of acquisition and it is probable that the other held-for-sale criteria will be met within a short period (i.e., three months) after the date of acquisition.

Continuing involvement

The current criteria for reporting discontinued operations require that a continuing entity not have any significant ongoing cash flows or involvement with the disposed component. The ASU eliminates these criteria and allows companies to have continuing cash flows and significant continuing involvement with operations following the disposal date, while presenting those operations as discontinued in the period of disposal and prior periods. Examples of continuing involvement include supply and distribution agreements, financial guarantees, options to repurchase a discontinued operation and an equity investment in the disposed operations.

Consider the following examples of disposal transactions in which the ongoing entities have continuing cash flows or significant continuing involvement with the disposed components following the disposal date.

Illustration 5 — Disposal of a component with significant continuing involvement

An entity that manufactures and sells sports equipment has two major lines of business that serve the football and baseball markets. Each line of business is a component of the entity. The entity decides to shift its strategy of trying to sell products to the baseball equipment market, which accounts for 40% of the entity's total revenues, and focus more on serving its customers in the football equipment market. The entity decides to retain some exposure to the baseball equipment market by selling an 80% controlling interest in its baseball equipment line of business to another entity. The entity reflects the disposal of its baseball equipment line of business as a discontinued operation.

Analysis

The disposal of 80% of the baseball equipment line qualifies for presentation as a discontinued operation under the new guidance because the line is a component and disposing of it represents a strategic shift (i.e., major line of business) that has a major effect on the entity's operations and financial results. Retaining a 20% interest (i.e., equity investment) in the baseball line does not preclude the parent from presenting the business as a discontinued operation.

Illustration 6 — Disposal of a component with continuing cash flows

An entity manufactures and sells furniture through company-owned and dealer-owned retail stores. Each company-owned retail store is a component of the entity. The entity has experienced losses in its company-owned store division resulting from an increase in costs associated with operating its retail stores. The entity decides to remain in the furniture manufacturing business but sells all of its company-owned retail stores to one of its dealers. The entity determines the disposal represents a strategic shift that has a major effect on the entity's operations and financial results. The entity enters into a supply arrangement to supply furniture to the dealer-owned stores, including the stores that were previously owned by the company.

Analysis

The disposal of the company-owned retail stores qualifies for presentation as a discontinued operation under ASU 2014-08 because the disposal group (i.e., company-owned retail stores) is a group of components and disposing of it represents a strategic shift that has a major effect on the entity's operations and financial results (i.e., major part of an entity). The continuing cash flow from the supply arrangement does not preclude discontinued operations presentation under the ASU. However, the entity will have to make additional disclosures about the arrangement (see discussion of disclosures on page 10).

Reporting and disclosure

Presentation

The ASU does not change the presentation requirements for discontinued operations in the statement where net income is presented or the statement of activities for a not-for-profit entity. It does, however, require an entity to reclassify the assets and liabilities of a discontinued operation to separate line items for the assets held for sale and liabilities held for sale in the statement of financial position for all periods presented.

The following illustration provides one example of how to present the results of operations of a discontinued operation on the face of the statement where net income is presented. This presentation is consistent with existing guidance[1].

Illustration 7 — Reporting discontinued operations on the face of the statement where net income is presented

A general merchandise retailer operates 1,000 retail stores throughout the US. The entity divides its stores into five major geographic regions — the Northwest, Southwest, Midwest, Northeast and Southeast — that each have 200 stores. Each geographic region comprises a major part of the entity's operations and financial results. Each retail store is a component of the entity.

The entity has experienced declining sales at some of its stores in the Southwest and Midwest regions and, in November 20X4, commits to a plan to sell 100 stores from the Southwest region and 100 stores from the Midwest region (total of 200 stores). These 200 stores account for approximately 15% of the company's total assets. The disposal is expected to occur in 20X5, and the entity expects a $3,000 loss on the disposal.

The planned disposal of the 200 stores meets the criteria to be classified as an asset held for sale at 31 December 20X4. Also, because the 200 stores are a major part of the entity's operations and financial results, the disposal represents a strategic shift and qualifies for presentation as a discontinued operation. The entity presents the discontinued operation in its consolidated statements of income as follows:

Consolidated Statements of Income

	Year Ended 31 December		
	20X4	20X3	20X2
Income from continuing operations, before tax	$ 320,000	$ 300,000	$ 270,000
Income taxes	(112,000)	(105,000)	(94,500)
Income from continuing operations	208,000	195,000	175,500
Discontinued operations (Note X)			
Loss from operations of discontinued stores	(37,000)	(35,000)	(31,000)
Loss on classification as held for sale [1]	(3,000)	–	–
Income tax benefit[2]	15,400	14,000	12,400
Loss on discontinued operations	(24,600)	(21,000)	(18,600)
Net income	183,400	174,000	156,900

(1) A gain or loss recognized on the disposal (or loss recognized on classification as held for sale) must be presented separately on the face of the statement where net income is reported or disclosed in the notes to the financial statements.

(2) Follows the application of ASC 740-20, *Income Taxes — Intraperiod Tax Allocation*. Refer to our FRD, *Income Taxes*, (section I1.1.15) for additional guidance.

The company includes the assets and liabilities of the discontinued operation in its statements of financial position as follows:

Consolidated Statements of Financial Position

	31 December	
	20X4	20X3
Current assets held for sale	$ 1,450	$ 380
Long-term assets held for sale	0	1,100
Current liabilities held for sale	980	250
Long-term liabilities held for sale	0	700

The ASU requires the reclassification of assets and liabilities of a discontinued operation in the statement of financial position for all periods presented (prior guidance did not address this issue). Therefore, the 20X3 amounts of the discontinued operation were reclassified. The new guidance does not address the current and long-term classification of assets and liabilities held for sale. We believe that assets and liabilities to be sold should be classified as current or long-term, depending on the anticipated disposal date. However, for prior periods being reclassified as required by the new guidance, the current and long-term classification of those assets and liabilities should not change because they did not meet the held-for-sale criteria in the prior period.

If the assets and liabilities classified as held for sale consist of both a disposal group that meets the criteria to qualify as a discontinued operation and a disposal group that does not meet these criteria, an entity may elect to present the assets and liabilities of the discontinued operations separately in the statement of financial position. In addition, if a discontinued operation is disposed of before it meets the held-for-sale criteria (e.g., disposed of other than by sale), the assets and liabilities of the discontinued operation are required to be presented separately in the asset and liability sections, respectively, for all periods prior to the period that includes the disposal (i.e., comparative periods).

Disclosure

The ASU expands the disclosure requirements for discontinued operations and requires new disclosures for individually significant disposals that do not meet the definition of discontinued operations. New disclosures are also required for an entity's continuing involvement with a discontinued operation following the disposal date.

Discontinued operations

The ASU retains the existing disclosure requirements for discontinued operations and adds new requirements.

Under the new guidance, entities must provide all of the following disclosures for disposals meeting the definition of a discontinued operation in the period in which a discontinued operation has either been disposed of or classified as held for sale:

- A description of the facts and circumstances leading to the disposal and the expected manner and timing of that disposal
- The gain or loss recognized on the disposal (if not separately presented on the face)
- The segment in which the discontinued operation is reported

The ASU requires new disclosures for discontinued operations and certain disposals that don't meet the new definition of a discontinued operation.

For discontinued operations that are not (1) equity method investments or (2) businesses or nonprofit activities held for sale at acquisition, entities must provide the following disclosures in the period in which the operations were disposed of or classified as held for sale and all prior periods presented (to the extent not included on the face of the financial statements):

- Pretax profit or loss (or change in net assets for a not-for-profit entity)
- Major assets and liabilities and a reconciliation to the amounts reported on the face of the financial statements
- Major components of pretax profit or loss (or change in net assets for a not-for-profit entity) and a reconciliation to the amounts reported on the face of the financial statements
- Operating and investing cash flows or the amounts of depreciation, amortization, capital expenditures, and significant operating and investing noncash items of the discontinued operation
- If the discontinued operation includes a noncontrolling interest, the pretax profit or loss (or change in net assets for a not-for-profit entity) attributable to the parent

For equity method investments meeting the criteria of discontinued operations, entities are required to disclose summarized information about the assets, liabilities and results of operations of the equity method investment if that information was disclosed in the financial statements in periods prior to the disposal.

If an entity changes its plan for selling a discontinued operation, it must disclose the following in the period the decision is made to change the plan of sale:

- Description of the facts and circumstances leading to the decision to change that plan
- Change's effects on the results of operations for the period and any prior periods presented

Entities are also required to disclose the nature and amount of any adjustments to a discontinued operation disposed of in a prior period.

The following illustration demonstrates the presentation in the notes to the financial statements of the reconciliation of the major assets and liabilities of a discontinued operation to the amounts reported in the statement of financial position.

Illustration 8 — Major assets and liabilities of a discontinued operation and the reconciliation to the amounts reported in the statement of financial position

Reconciliation of the Carrying Amounts of Major Classes of Assets and Liabilities of the Discontinued Operation That Are Disclosed in the Notes to Financial Statements to Total Assets and Liabilities of the Disposal Group Classified as Held for Sale That Are Presented Separately in the Statement of Financial Position

	31 December 20X4	31 December 20X3
Carrying amounts of major classes of assets included as part of discontinued operations		
Cash	$ 200	$ 250
Trade receivables	120	100
Inventories	60	30
Property, plant, and equipment	980	950
Other assets	90	150
Total assets of the discontinued operation	1,450	1,480
Total assets of the disposal group classified as held for sale in the statement of financial position	$ 1,450	$ 1,480*
Carrying amounts of major classes of liabilities included as part of discontinued operations		
Trade payables	$ 200	$ 140
Short-term borrowings	110	110
Long-term borrowings	390	500
Other liabilities	280	200
Total liabilities of the discontinued operation	980	950
Total liabilities of the disposal group classified as held for sale in the statement of financial position	$ 980	$ 950*

* Amounts in the comparative period will be broken out between current and long-term on the statement of financial position.

The following illustration demonstrates the required reconciliation of the major components of pretax profit or loss of a discontinued operation to the amounts reported in the statement where net income is presented.

Illustration 9 — Major components of pretax profit or loss and a reconciliation to the amounts reported in the statement where net income is presented

Reconciliation of the Major Line Items Constituting Pretax Profit (Loss) of Discontinued Operations That Are Disclosed in the Notes to Financial Statements to the After-Tax Profit or Loss of Discontinued Operations That Are Presented in the Statement Where Net Income is Presented

	Year Ended 31 December 20X4	20X3	20X2
Major line items constituting pretax profit (loss) of discontinued operations			
Revenue	$ 450,000	$ 420,000	$ 400,000
Cost of sales	(350,000)	(330,000)	(320,000)
Selling, general, and administrative expenses	(100,000)	(90,000)	(78,000)
Interest expense	(30,000)	(28,000)	(27,000)
Other (1)	(7,000)	(7,000)	(6,000)
Pretax loss of discontinued operations	(37,000)	(35,000)	(31,000)

Pretax gain or loss on disposal of the discontinued operation	(3,000)	-	-
Total pretax loss on discontinued operations	(40,000)	(35,000)	(31,000)
Income tax benefit	15,400	14,000	12,400
Loss on discontinued operations	(24,600)	(21,000)	(18,600)

(1) An entity may aggregate amounts that are not considered major and present them as one line item in the reconciliation.

Continuing involvement

When an entity has continuing involvement with a discontinued operation following the disposal date, the ASU requires the following disclosures in the notes to the financial statements until the results of operations of the discontinued operation in which the entity retains continuing involvement are no longer presented separately as discontinued operations on the face of the financial statements:

- Description of the activities giving rise to continuing involvement
- Period of time that the continuing involvement is expected to continue
- For all periods presented, the amount of cash flows with the discontinued operation following the disposal
- For all periods presented, the revenues or expenses presented in continuing operations after the disposal that before the disposal were eliminated in consolidated financial statements as intra-entity transactions

When an equity method investment is retained in a discontinued operation, the ASU requires additional disclosures regarding (1) the pretax income of the investee in which an entity has retained an equity method investment, (2) the share of income or loss of the investee recognized following the disposal, including the line item in the statement where net income is presented that includes the income or loss, and (3) an entity's ownership interest before and after the disposal. This information is required to enable financial statement users to compare the financial performance of the entity from period to period as if the entity held the same equity method investment for all periods presented.

The ASU does not provide guidance on reporting discontinued operations for prior periods when an entity has continuing involvement following the date of disposal.

Individually significant disposals

The ASU requires new disclosures for the disposal of individually significant components that do not qualify for presentation as discontinued operations. These disclosures are required for individually significant components that have either been disposed of or are classified as held for sale. There is no requirement to evaluate materiality of disposals in the aggregate (i.e., these disclosures do not apply to multiple disposals in a period that are individually insignificant but significant in the aggregate). The new guidance does not define individually significant disposals.

The following new disclosures are required in the notes to the financial statements for individually significant components that have been disposed of or are classified as held for sale and do not qualify for presentation as discontinued operations:

- Pretax profit or loss (or change in net assets for a not-for-profit entity) of the individually significant component
- If the individually significant component includes a noncontrolling interest, the pretax profit or loss (or change in net assets for a not-for-profit entity) attributable to the parent

For public business entities and not-for-profit entities that have issued or are conduit bond obligors for securities that are traded, listed or quoted on an exchange or an over-the-counter market, these disclosures are required for the period in which the individually significant component is disposed of or is classified as held for sale and for all periods presented in the statement where net income is presented (or statement of activities for a not-for-profit entity). For other entities, these disclosures are required only for the period in which the component is disposed of or is classified as held for sale.

Effective date and transition

For public business entities and not-for-profit entities that have issued or are conduit bond obligors for securities that are traded, listed or quoted on an exchange or an over-the-counter market, the ASU is effective for annual periods beginning on or after 15 December 2014 and interim periods within those years. For other entities, it is effective for annual periods beginning on or after 15 December 2014 and interim periods within annual periods beginning on or after 15 December 2015. The ASU is applied prospectively. Early adoption is permitted but only for disposals (or classifications as held for sale) that have not been reported in financial statements previously issued or available for issue.

How we see it

Companies that frequently dispose of components and present these disposals in discontinued operations today (e.g., real estate investment trusts) may consider adopting the ASU early to take advantage of the higher threshold for reporting discontinued operations.

Endnotes:

[1] Regulation S-X Rule 3-15 includes specific requirements for the presentation of the income statement for real estate investment trusts.