

# Dataline

## A look at current financial reporting issues



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### What's inside:

Overview .....	1
Background .....	1
Key provisions .....	2
Definition of a discontinued operation .....	2
Ongoing operations and cash flows and continuing involvement .....	4
Scope .....	4
Presentation and disclosure .....	5
What's next .....	9

## Discontinued operations

### *Revised standard significantly changes criteria for discontinued operations and disclosures for disposals*

#### Overview

- On April 10, 2014, the FASB issued [Accounting Standards Update No. 2014-08, Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity](#) (the revised standard). The revised standard changes today's guidance and, in many cases, is expected to result in fewer disposals being presented as discontinued operations. These changes will impact entities across all industries, particularly those that actively divest components.
- To be a discontinued operation, a component or group of components must represent a strategic shift that has (or will have) a major effect on an entity's operations and financial results. Companies should be prepared to exercise judgment to determine which disposals meet the new definition.
- Failure to eliminate significant continuing cash flows of or involvement with a disposed component from an entity's ongoing operations after a disposal no longer precludes presentation as a discontinued operation.
- Expanded disclosures for discontinued operations include more details about earnings and balance sheet accounts, total operating and investing cash flows, and cash flows resulting from continuing involvement. While elective currently, comparative balance sheet presentation of discontinued operations is also required. New disclosures are also required for disposals of individually significant components that do not qualify as discontinued operations.
- The guidance is to be applied prospectively to all new disposals of components and new classifications as held for sale beginning in 2015 for most entities, with early adoption allowed in 2014.

#### Background

.1 The issuance in 2001 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (now codified in ASC 205, *Presentation of Financial Statements*, and ASC 360, *Property, Plant, and Equipment*), broadened the reporting of discontinued operations to a component of an entity that has operations and cash flows that can be clearly distinguished from the rest of an entity.

\* The PwC observation related to paragraph .37 has been updated as of June 3, 2014 to reflect clarification of the revised standard's early adoption provisions.

.2 Some users of financial statements suggested that financial statements are less decision-useful because too many disposals that do not represent a strategic shift in operations are included in discontinued operations. This is particularly challenging in certain industries, such as real estate, that regularly engage in dispositions that are not strategic shifts. Some preparers indicated that the volume of discontinued operations makes financial statements more costly to prepare under current guidance and that it was often challenging to assess the significance of ongoing cash flows or other continuing involvement when evaluating whether a disposal qualified as a discontinued operation.

.3 The revised standard is intended to respond to stakeholder concerns. The FASB believes the revised standard strikes the right balance by reducing the number of disposals that will be presented as discontinued operations, while, through expanded disclosures, still providing decision-useful information.

## **Key provisions**

### ***Definition of a discontinued operation***

.4 Under the revised standard, “a disposal of a component of an entity or a group of components of an entity shall be reported in discontinued operations if the disposal represents a strategic shift that has (or will have) a major effect on an entity’s operations and financial results” as determined when the component or group of components: (i) meets the criteria to be classified as held for sale; (ii) is disposed of by sale; or (iii) is disposed of other than by sale.

.5 The revised standard does not change the six criteria required to qualify for held for sale presentation as currently described in ASC 360-10-45-9. Disposals of components other than by sale include abandonments and spin off transactions as currently described in ASC 360-10-45-15.

.6 The revised standard includes examples of strategic shifts that have (or will have) a major effect on an entity’s operations and financial results and states that a strategic shift could include the “disposal of a major geographical area, a major line of business, a major equity method investment, or other major parts of an entity.” The concept of strategic shifts is intended to be entity specific. For example, an entity that only operates in the Northeast region of the U.S. may conclude that each state represents a major geographical area. In contrast, a large multinational entity may conclude that each continent represents a major geographical area.

.7 Evaluating whether a disposal constitutes a discontinued operation begins with qualitatively assessing whether a strategic shift has occurred. The revised standard does not define what constitutes a strategic shift. Such decisions will be entity specific based on qualitative facts and circumstances. Once it is determined that a strategic shift has occurred, it must have had or will have a major effect on the entity’s operations and financial results to be considered a discontinued operation. Therefore, the disposal of a business may represent a strategic shift, but if its disposal does not or will not have a major effect on the entity’s operations and financial results, it would not be treated as a discontinued operation.

#### **PwC observation:**

Metrics to consider when evaluating the quantitative impact of a disposal may include a combination of total assets and liabilities, revenues, operating income, pretax income, EBITDA, net income, and operating cash flows. In terms of the evaluation period, we believe the greatest emphasis should be placed on the most recently completed, current and next annual reporting periods.

.8 While the revised standard provides no “bright line” guidance, it includes five examples of strategic shifts that have or will have a major effect on an entity’s operations and financial results and therefore result in reporting a disposed component or group of components as a discontinued operation. These examples, included in paragraphs 205-20-55-83 through 102 in the revised standard, relate to the following:

- The sale of a product line that represents 15 percent of an entity’s total revenues
- The sale of a geographical area that represents 20 percent of an entity’s total assets
- The sale of all of an entity’s stores in one of its two types of store formats that historically provided 30 to 40 percent of an entity’s net income and 15 percent of current period net income
- The sale of a component that is an equity method investment that represents 20 percent of the entity’s total assets
- The sale of 80 percent of a product line that accounts for 40 percent of total revenue, but the seller retains 20 percent of its ownership interest

**PwC observation:**

Along with the examples in the revised standard that reflect fairly high thresholds, we believe that disposing of a reportable segment will in most cases be the type of strategic shift that qualifies as a discontinued operation. An entity should carefully consider whether disposing of an operating segment or reporting unit represents a strategic shift in operations.

In assessing what constitutes a strategic shift, we believe SEC registrants should also consider the extent to which the component’s performance was previously presented or discussed in MD&A, earnings releases, and other communications.

.9 The references to major lines of business and geographical areas incorporated into the new definition are consistent with those used to evaluate discontinued operations presentation under IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*.

**PwC observation:**

Although converging U.S. GAAP with IFRS was not the primary objective of this project, the FASB aligned certain concepts (the removal of ongoing cash flows and continuing involvement guidance) and terminology within IFRS 5 (major lines of business and geographical areas of operations) into its revised standard, which enhances convergence in this area of financial reporting.

.10 Entities that prepare parent-only or subsidiary level financial statements should separately evaluate whether a strategic shift has occurred and whether it has (or will have) a major effect on an entity’s operations and financial results at each level. A subsidiary may reach a different conclusion than its parent.

.11 Any business or nonprofit activity that upon acquisition meets the held for sale criteria is required to be presented as a discontinued operation regardless of whether it represents a strategic shift that has (or will have) a major effect on an entity’s operations and financial results. The board’s objective was to include in discontinued operations those businesses that will never be considered part of an entity’s continuing operations.

**PwC observation:**

The unit of account for making this assessment is a business, as defined in ASC 805, which may be different than a component of an entity, as defined in ASC 205, which is the level otherwise required to qualify as a discontinued operation.

***Ongoing operations and cash flows and continuing involvement***

.12 Failure to eliminate the significant operations and cash flows of a disposed component from an entity's ongoing operations after a disposal or having significant continuing involvement with a disposed component no longer precludes a disposal from being presented as a discontinued operation. As a result, more disposals may become eligible for discontinued operations. The revised standard requires expanded disclosures about significant continuing involvement with a discontinued operation (see paragraphs .28-.30).

**PwC observation:**

While no longer a gating criteria, we believe that entities should still consider the nature and extent of continuing involvement in order to evaluate whether there has been a strategic shift that has (or will have) a major effect on their operations and financial results. This assessment should incorporate qualitative and quantitative factors including consideration of how the disposal and continuing involvement will affect the comparison of an entity's financial statements before and after a disposal.

.13 Examples of arrangements that historically may have precluded discontinued operations, but will not necessarily do so under the new guidance, include retaining an equity method investment, engaging in supply or distribution agreements, executing transition service agreements or leases, providing certain indemnifications or guarantees, and establishing repurchase options.

**PwC observation:**

For example, assume an entity that both manufactures electronics and sells them through its retail stores disposes of its retail operations but continues to supply the sold component with electronics for resale. Even if the entity determines that the sale of its retail stores represents a strategic shift, it should determine whether the net effect of selling to a third party rather than operating its own stores has or will have a major effect on its overall operations and financial results. Although the entity has eliminated all of its retail store revenues, it will have a new partially offsetting revenue stream from sales to its former retail stores. Additionally, it would need to consider the impact that the disposal has on its balance sheet and statement of cash flows.

***Scope***

.14 The revised standard eliminates certain exceptions from reporting discontinued operations that exist under current guidance. In particular, disposals of a major equity method investment were precluded from being reported as discontinued operations, but will now be reported as such if they represent a strategic shift that has (or will have) a major effect on an entity's operations and financial results.

**PwC observation:**

A registrant's conclusion about whether an equity method investment is major or individually significant for purposes of assessing discontinued operations may not always align with its conclusion about determining the quantitative significance of equity method investments under the SEC's reporting rules (e.g., Regulation S-X 3-09).

.15 The revised standard continues to exclude from its scope oil and gas properties that are accounted for using the full-cost method of accounting as prescribed by the SEC.

***Presentation and disclosure***

.16 The revised standard requires several new disclosures about disposals that qualify as discontinued operations. Because the higher threshold is expected to result in fewer disposals being presented as discontinued operations, the revised standard includes new disclosures about individually significant components of an entity that are disposed of or classified as held for sale, but that do not rise to the level of discontinued operations. The new disclosures expand on those already required under existing guidance for all disposal transactions.

**Discontinued operations**

.17 The revised standard includes several new disclosures about the earnings, assets and liabilities, cash flows, and continuing involvement relating to discontinued operations. Discontinued operations that are businesses held for sale upon acquisition are exempt from most of these disclosures, except those relating to continuing involvement. In many cases, businesses held for sale upon acquisition do not have a significant effect on an entity's results of operations given their disposal shortly after acquisition.

.18 Consistent with current guidance, in the period during which a discontinued operation has been disposed of or is classified as held for sale, entities must disclose (i) the facts and circumstances leading to the disposal or expected disposal, (ii) the expected manner and timing of the disposal, (iii) the gain or loss recognized (if not presented separately on the face of the statement where net income is reported), and (iv) the segment in which the discontinued operation is reported, if applicable.

.19 For all discontinued operations other than equity method investments, the expanded disclosures include the following, if not already presented on the face of the financial statements: (i) pretax profit or loss of the discontinued operation, (ii) major line items constituting pretax profit or loss, (iii) if the discontinued operation includes a noncontrolling interest, the pretax profit or loss attributable to the parent, and (iv) either total operating and total investing cash flows or depreciation, amortization, capital expenditures, and significant non-cash operating and investing items. These disclosures must be provided for all periods in which the results of the discontinued operation are reported in the statement where net income is reported.

.20 Entities must reconcile both (i) pretax profit or loss and (ii) the major line items constituting pretax profit or loss to the after-tax profit or loss from discontinued operations that is presented on the face of the statement where net income is reported. The reconciliation must be provided for all periods in which the results of the discontinued operation are presented. The FASB provided an example in paragraph 205-20-55-103 that includes the line items of revenue, cost of sales, selling, general and administrative expenses, and interest expense.

**PwC observation:**

Today, entities must disclose the revenue and pretax profit or loss related to discontinued operations. The revised standard requires additional “major” line items to be disclosed, but does not provide specific guidance about how to determine which pretax line items are major. Entities will need to evaluate which line items they consider to be major and tailor their reconciliations accordingly.

.21 If a discontinued operation was an equity method investment before its disposal, the disclosures should include summarized information about the assets, liabilities and results of operations of the investee only if the entity disclosed this information about its investee before the disposal under ASC 323-10-50-3. The FASB’s intent is for financial statement users to continue to receive the same level of detail that they had before an equity method investment was classified as held for sale or disposed of.

.22 Existing guidance provides flexibility when presenting cash flows related to discontinued operations. After evaluating the costs and benefits of potentially requiring separate presentation or disclosure of all categories of cash flows from discontinued operations, the board decided to allow entities an option to disclose total operating and total investing cash flows or, alternatively, only depreciation, amortization, capital expenditures, and significant non-cash operating and investing items related to discontinued operations. The FASB decided not to require any disclosures of financing cash flows related to discontinued operations since financing transactions are typically conducted at the parent level rather than at the component level. The new cash flow disclosures can either be presented on the face of the statement of cash flows or in the notes to the financial statements.

**Assets held for sale**

.23 Consistent with existing guidance, the assets and liabilities of a disposal group classified as held for sale must continue to be presented separately in the respective asset and liability sections of the statement of financial position, and cannot be offset and presented as a single amount. Current guidance does not address reclassification of the prior period statement of financial position. The revised standard now requires that the assets and liabilities of a disposal group that is held for sale and qualifies as a discontinued operation be presented separately for all prior periods. If a discontinued operation is disposed of by sale before ever meeting the criteria to be classified as held for sale, the assets and liabilities of the discontinued operation for prior periods must be presented separately in the asset and liability sections of the statement of financial position. Entities are not required to reclassify prior period assets and liabilities for disposal groups classified as held for sale that do not qualify as discontinued operations.

.24 Entities must continue to disclose separately, either in the statement of financial position or in the notes, the major classes of assets and liabilities classified as held for sale for all periods presented as such in the statement of financial position.

.25 While the revised standard does not specify how to determine which classes of assets and liabilities held for sale should be considered major, the FASB provided an example in paragraph 205-20-55-102, which includes cash, trade receivables, inventories, plant, property and equipment, trade payables and short-term borrowings.

.26 If the major classes of assets and liabilities of a discontinued operation classified as held for sale are disclosed in the notes, entities must reconcile such disclosure to the total assets and total liabilities of the disposal group classified as held for sale presented on the face of the statement of financial position. This reconciliation must be provided for all periods presented. If the disposal group includes assets and liabilities that are not part of the discontinued operation, the reconciliation should show them separate from the assets



and liabilities of the discontinued operation. Paragraph 205-20-55-102 of the revised standard includes an example of this reconciliation.

**PwC observation:**

Although the example in the revised standard does not include sub-totals for current assets and liabilities included in assets held for sale, we do not believe it was the FASB's intent to change existing practice in which some entities classified assets and liabilities that are held for sale as current and noncurrent. Generally, we believe it is acceptable for entities to continue to classify assets and liabilities held for sale as current and noncurrent based on their presentation prior to being classified as held for sale. However, entities may classify all assets and liabilities held for sale as current when i) the disposal is expected to be consummated within one year of the balance sheet date, and ii) the entity expects to receive cash or other current assets upon disposal and the sale proceeds will not be used to reduce long-term borrowings.

SEC registrants should also consider the impact of the new reclassification requirement when preparing their selected financial data table.

.27 The revised standard states that any loss recognized on a disposal group classified as held for sale, whether or not the disposal group qualifies as a discontinued operation, is not to be allocated to the major classes of assets of the disposal group when disclosing the major assets and liabilities within assets held for sale.

**PwC observation:**

Under existing guidance, it can be challenging to allocate an impairment loss that results from remeasuring the carrying amount of assets held for sale to their fair value, less costs to sell. To reduce costs and complexity, the board decided to remove this existing disclosure requirement and instead require entities to present an impairment loss in total, akin to an allowance against the carrying amount of total assets held for sale before the effect of the impairment loss.

**Continuing involvement**

.28 Although engaging in significant continuing involvement with a disposed component no longer precludes presentation as a discontinued operation, the revised standard requires entities to disclose all significant continuing involvement with a discontinued operation after its disposal. The disclosures must be provided until the results of operations of the discontinued operation in which the entity has significant continuing involvement are no longer presented separately as discontinued operations in the statement where net income is reported.

**PwC observation:**

Entities must still evaluate the significance of continuing involvement with a disposed component that is presented as a discontinued operation to determine if the disclosures are necessary. Because the existing implementation guidance for assessing significance has been removed from the revised standard, entities will need to apply judgment when determining what level of continuing involvement warrants disclosure.

.29 Consistent with existing disclosure requirements, the revised standard requires a description of the nature of the activities that give rise to significant continuing involvement and the period during which the involvement is expected to continue. However, the revised standard goes further by requiring entities to disclose the amount of any cash inflows or outflows to or from the discontinued operation after a disposal

when there is significant continuing involvement. Entities also need to disclose the amount of revenues or expenses, if any, presented in continuing operations after the disposal transaction that prior to the disposal transaction were eliminated in the consolidated financial statements as an intra-entity transaction.

**PwC observation:**

The revised standard does not specify whether entities should provide the new disclosures about cash inflows from and outflows to a discontinued operation on a gross or net basis. We believe that separately disclosing cash inflows and outflows on a gross basis will generally provide more useful information and will better supplement the qualitative disclosure describing the nature of continuing involvement with a discontinued operation.

It may require additional effort to track the cash movements to and from a discontinued operation during all periods until the discontinued operation is no longer presented. Accordingly, entities will need to implement the necessary processes and controls to gather this information each period.

.30 Retaining an equity method investment in a component no longer precludes presentation as a discontinued operation. However, when an entity retains an equity method investment in a discontinued operation, the revised standard requires new disclosures to enable financial statement users to compare financial performance assuming the entity held the same equity method investment in all periods presented. These new disclosures, which are required for all periods until the discontinued operation is no longer presented in the statement where net income is reported, include:

- Pretax income or loss of the discontinued operation in which the entity retains an equity method investment (i.e., the investee's pretax income or loss)
- The entity's ownership interest in the discontinued operation before and after the disposal transaction
- The entity's share of the investee's income or loss in the period(s) after the disposal transaction resulting from the entity's ongoing equity method investment in the discontinued operation, and the income statement line item that includes this income or loss

**Individually significant components**

.31 The revised standard requires new disclosures about pretax profit or loss for an individually significant component of an entity that has been disposed of or is classified as held for sale but does not qualify as a discontinued operation. If an individually significant component includes a noncontrolling interest, the pretax profit or loss attributable to the parent must be disclosed. These disclosures are less onerous than those required for discontinued operations.

.32 All entities must provide the disclosures for the initial period in which an individually significant component is sold or classified as held for sale. Public business entities and certain not-for-profit entities (see paragraph .35) must also include comparative disclosures for all prior periods presented in the statement where net income is reported.

.33 For an individually significant component that is classified as held for sale, all entities must continue to disclose, if not separately presented on the face of the statement of financial position, the carrying amounts of the major classes of assets and liabilities of the component. Entities must also continue to disclose the gain or loss recognized on a disposal group that is either classified as held for sale or disposed of.



.34 The FASB expects fewer disposals to be presented as discontinued operations under the new definition. Therefore, it intended the new disclosures to allow financial statement users to better understand the effect of disposals of individually significant components that are not included as discontinued operations.

**PwC observation:**

The revised standard does not provide guidance about how to evaluate whether an individual component is significant, or whether to consider the gain or loss on disposal when determining significance. Entities must exercise judgment in assessing significance and should consider both quantitative and qualitative factors about the effect of the disposal on their overall financial position, results of operations, and cash flows. Entities should also consider whether disclosure should be provided when multiple disposals of individually insignificant components occur in the same reporting period.

**What's next**

.35 All entities may early adopt the revised standard. For those that do not early adopt, the revised standard is effective for i) public business entities and ii) 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 for any new disposals and new classifications of assets held for sale in annual periods beginning on or after December 15, 2014, and interim periods within those annual periods. All other entities, including most private companies, are required to apply the guidance in annual periods beginning on or after December 15, 2014, and interim periods within annual periods that begin on or after December 15, 2015.

.36 Calendar year-end public entities and certain not-for-profit entities that do not early adopt must apply the revised standard in the interim and annual period beginning January 1, 2015. All other calendar year-end entities that do not early adopt must apply the guidance for the annual period ending December 31, 2015, followed by the interim period beginning January 1, 2016 if they prepare interim financial statements.

.37 Entities that early adopt the revised standard should apply the guidance to all new disposals and new classifications as held for sale provided they have not yet issued (or made available for issuance) their interim and annual financial statements that cover the period in which such disposals occur.

**PwC observation:**

We are aware that questions have been raised about whether, in the initial year of adoption, entities must consistently apply the same discontinued operations guidance to all new disposals and new classifications as held for sale that occur in the annual period. We understand that the FASB and SEC staffs believe it is acceptable for entities to apply the revised standard to all eligible disposals that occur after the adoption date, regardless of whether they applied the current standard to disposals that occurred earlier in the year. This may yield inconsistent treatment for disposals that occur within the initial year of adoption. For example, assume a calendar year-end entity applied existing guidance to a new disposal in the first quarter of 2014 and the seller's significant continuing involvement with the disposed component precluded presentation as a discontinued operation. An entity could, however, initially apply the revised standard to a comparably sized disposal occurring in the third quarter of 2014 and present discontinued operations despite the existence of significant continuing involvement.

Questions were also raised about whether, in the initial year of adoption, entities could retrospectively apply the revised standard to disposals that occurred earlier in the year and prior to adoption to achieve consistency for all disposal transactions within the annual period. We do not believe this would be acceptable because the revised standard must be applied prospectively.

.38 All entities are required to apply the revised standard prospectively to new disposals and new classifications as held for sale of components of an entity occurring after the effective date. The guidance may not be retroactively applied to a component of an entity that is classified as held for sale as of the effective date.

**PwC observation:**

Entities cannot apply the revised standard to a component that was previously disposed of but was initially precluded from discontinued operations because of significant continuing involvement or ongoing cash flows, even when there are subsequent changes in the activities with a disposed component that would no longer preclude discontinued operations.

**Questions?**

PwC clients who have questions about this *DataLine* should contact their engagement partner. Engagement teams who have questions should contact the Business Combinations team in the National Professional Services Group (1-973-236-7801).

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