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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**25 January 2007, London**
Project:	**Financial Statement Presentation (Phase B)**
Subject:	**Definition of Discontinued Operations (Agenda paper 13A)**

INTRODUCTION

1. The purpose of the January meeting is to discuss the definition of a discontinued operation with a goal of reaching a converged definition to be included in the initial discussion document. At a future meeting, the staff will ask the Boards to revisit its leanings on the presentation of discontinued operations in the financial statements based on their decisions regarding the definition. Statement 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* and IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*, have a common definition of a *component of an entity;* however, those standards have different criteria for determining when an entity should report a component of an entity as a discontinued operation. Rather than starting with a clean sheet of paper, the staff chose to focus on those criteria in developing a definition on which both Boards could agree. In the basis for conclusions of IFRS 5, the IASB indicated a willingness to work towards a converged definition. The staff believes that because the financial reporting communities have more experience with reporting discontinued operations, the Boards may be able to

leverage that additional experience to reach a converged definition. Before addressing those criteria, the following background information is provided.

a. Existing Guidance [sentence omitted from Observer Notes]
b. Input from Analysts [sentence omitted from Observer Notes]
c. FASB Agenda Request.

EXISTING GUIDANCE

Statement 144

2. Statement 144 provides the accounting guidance for reporting long-lived assets to be disposed of. Specifically, if a held for sale long-lived asset meets the criteria in paragraphs 41–44 of Statement 144, then the results from operations and any gain or loss on the disposal is to be reclassified and included in discontinued operations. One of the criteria is that the long-lived asset is a component of an entity. Paragraph 41 of Statement 144 provides the following guidance on a component of an entity:

> For purposes of this Statement, a *component of an entity* comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. A component of an entity may be a reportable segment or an operating segment (as those terms are defined in paragraph 10 of Statement 131), a reporting unit (as that term is defined in Statement 142), a subsidiary, or an asset group (as that term is defined in paragraph 4).

Paragraph 4 defines an asset group as:

> For a long-lived asset or assets to be held and used, that group (hereinafter referred to as an *asset group*) represents the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities.

3. Paragraph 42 of Statement 144 includes the following additional guidance for determining whether a component of an entity should be reported in discontinued operations:

> The results of operations of a component of an entity that either has been disposed of or is classified as held for sale shall be reported in discontinued operations in accordance with paragraph 43 if both of the following conditions are met: (a) the operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal

transaction and (b) the entity will not have any significant continuing involvement in the operations of the component after the disposal transaction.

4. The application of paragraph 42 proved difficult for some preparers and auditors and, as a result, the Emerging Issues Task Force (the Task Force) issued interpretive guidance in EITF Issue 03-13 (Issue 03-13). The Task Force provided guidance on determining when the cash flows have been (or will be) eliminated from the ongoing operations and how to determine what constitutes significant continuing involvement. The Task Force discussed the issue at five EITF meetings beginning in November 2003; a final consensus was reached in November 2004. [Sentence omitted from Observer Notes].

5. Statement 144 does not include a significance concept (other than an overall materiality considerations) for determining when to report the disposal of a component as a discontinued operation. The Exposure Draft that preceded Statement 144 contained a significance qualifier in the definition of a component of an entity. Paragraph 42 of the Exposure Draft provided the following guidance:

> For purposes of this Statement, *discontinued operations* refers to the operations of a <u>significant</u> component of an entity (a) that either has been disposed of by sale or otherwise (paragraph 27) or is classified as held for sale and (b) whose activities, operations, and assets have been or will be eliminated in the disposal transaction. In assessing whether a component of an entity is significant, an entity shall consider all relevant facts and circumstances, quantitative and qualitative. The disposal of a significant component of an entity shall be distinguished from the disposal of other assets (groups) and other activities incident to the evolution of the entity's business or other activities, such as the shifting of production or marketing activities for a particular line of business from one location to another, the phasing out of a product line or class of service, and other changes occasioned by technological improvements.

6. In redeliberations, the FASB removed the significance qualifier because it concluded that the determination of when to report a component of an entity as a discontinued operation should not focus on whether a component of an entity is significant or incorporate other quantitative criteria. Rather, it should focus on whether a component of an entity has operations and cash flows that can be clearly distinguished from the rest of the entity.

IFRS 5

7. IFRS 5 provides the guidance on the presentation and disclosure of assets classified as held for sale under IFRS 5. Specifically paragraphs 31–35 provide the criteria an entity uses to evaluate when the entity is required to report a disposal transaction as a discontinued operation. Paragraph 31 of IFRS 5 states:

> A component of an entity comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. In other words, a component of an entity will have been a cash-generating unit or a group of cash-generating units while being held for use.

8. IFRS 5 includes additional criteria to determine whether a component of an entity should be reported in discontinued operations. Paragraph 32 of IFRS 5 states:

> A discontinued operation is a component of an entity that either has been disposed of, or is classified as held for sale, and
>
> (a) represents a separate major line of business or geographical area of operations,
>
> (b) is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations or
>
> (c) is a subsidiary acquired exclusively with a view to resale.

9. When IFRS 5 was issued as an exposure document it was intended to fully converge with Statement 144. However, the IASB decided to retain the IAS 35 criteria for reporting discontinued operations based on the comment letters received (95 in total). Respondents were concerned that the proposed definition was at such a low level that it would result in too many disposal transactions being reported as discontinued operations. In fact, it was believed that some entities would perpetually report discontinued operations. Respondents to the Exposure Draft also noted that the requirements from paragraph 42 of Statement 144 (see paragraphs above) would be difficult to implement, as evidenced by the ongoing EITF discussion of Issue 03-13. As stated in paragraph BC71 of IFRS 5, the IASB viewed this as an interim approach and intended to work with the FASB to arrive at a converged definition within a relatively short time.

INPUT FROM ANALYSTS

10. In order to understand the needs of users, the staff conducted interviews with users to understand how they use financial information to analyze an entity and how the discontinued operation reporting is considered in this analysis. The staff spoke with analysts that analyze financial statements of entities that apply Statement 144 and with analysts that analyze financial statements of entities that apply IFRS 5. Those analysts were drawn from the FASB's User Advisory Council and the IASB's Analysts Representative Group.

Summary of Discussion with Analysts regarding Statement 144

11. The FASB staff asked the following questions of the analysts with Statement 144 experience:

    a. Are the current criteria for classifying the disposal of long-lived assets as discontinued operations resulting in too few, too many, or just the right number of long-lived asset disposals being classified as discontinued operations?

    b. Is the use of the discontinued operations presentation useful for decision-making? If so, why? If not, why not? What type of presentation would be more useful?

    c. Where should additional information be presented–the face of the financial statements or note disclosures?

12. The staff discussed these questions with 14 analysts. On question (a), the majority view was that the Statement 144 definition was appropriate and an appropriate number of components were being reported as discontinued operations. On question (b), the majority stated that, generally, the discontinued operation presentation is useful for decision-making purposes because it enhances the predictive value of the information to future periods. On question (c), the majority of the analysts indicated that additional summarized financial information regarding the balance sheet, income statement, and cash flow amounts would be useful in evaluating the results of an entity and improving the predicative nature of the reported information. [Sentence omitted from Observer Notes].

Summary of Disclosures with Analysts Regarding IFRS 5

13. The FASB staff asked the following questions of the analysts regarding IFRS 5:

a. Are the current criteria for classifying the disposal of long-lived assets as discontinued operations under IFRS 5 resulting in too few, too many, or just the right number of long-lived asset disposals being classified as discontinued operations?

b. Are you aware that U.S. accounting standards have a less restrictive definition that does NOT require that a discontinued operation "represent a separate major line of business or geographical area of operation"? As a result, more items would qualify for classification as a Discontinued Operation under Statement 144 than under IFRS 5.

c. Do you believe a less restrictive definition would prove more or less useful and why?

14. The staff discussed these questions with 7 analysts. Overall, there was a greater diversity in views among this group of analysts than there was with the analysts that have experience with Statement 144. On question (a), the majority of the analysts believe that IFRS 5 results in the appropriate number of entities being classified as discontinued operations. On question (b), there was no clear consensus. On question (c), the majority favored a more restrictive definition, but their comments noted that improved disclosure at the component level in the notes would be most beneficial to the users. [Sentence omitted from Observer Notes].

FASB AGENDA REQUEST

15. In July 2006, the FASB staff received an agenda request from the National Association of Real Estate Investment Trusts (NAREIT) to address whether the current discontinued operations reporting requirements were fulfilling the needs of the users of financial statements or whether they were, in fact, providing misleading financial information. In August 2006, the FASB staff received a letter from the European Public Real Estate Association (EPREA) urging the Board to consider adding a project to reconsider discontinued operations reporting. The EPREA reviewed the letter from NAREIT and fully supports their efforts on this matter.

16. When a REIT sells a property, it typically is required to classify the operating results for that entity into discontinued operations. This has concerned some analysts that follow the REIT industry because they believe the cash flows from the property disposed of are a good predictor of future cash flows and the generation of gains or losses is part of the operating activities of the REIT. Those analysts believe that the

lack of clarity in financial reporting is not enabling analysts to obtain the information they need to analyze and forecast the results of the REIT. According to the analysts, the lack of clarity occurs because the results of operations and the gain or loss on disposal are all reported on one line on the income statement. In order to understand how other analysts perceive this issue, the staff followed up with several analysts that follow the REIT industry to obtain their perspective. Those analysts agree that conceptually, the current reporting is not the most appropriate reporting; however, there is diversity in views on whether the FASB should address the issue and what represents the most conceptually superior reporting model.

17. On November 15, 2006, the FASB considered whether to add a project to its agenda to address the issues raised by NAREIT. The FASB decided not to add a project to its agenda, but rather preferred to address the issues as part of the Financial Statement Presentation project. The FASB asked the staff to consider whether, from a timing perspective, it would be possible to accelerate this portion of the project.

ISSUE 1: CRITERIA FOR DETERMINING WHEN A COMPONENT SHOULD BE REPORTED AS A DISCONTINUED OPERATION

18. As noted in paragraph 1, the definition of *discontinued operations* in both Statement 144 and IFRS 5 begins with the concept of a component of an entity. A component of an entity is defined in Statement 144 as "comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity." IFRS 5 has a definition that has the same meaning. Preparers, users, auditors and regulators have been applying this concept since Statement 144 and IFRS 5 were first issued, thus any implementation issues should have already been vetted by the financial reporting community. The staff is not asking the Boards to reconsider their definitions of a *component of an entity*, but rather reconsider what criteria, if any, should be required for determining when an entity should report a component as a discontinued operation. Three possible criteria based on the existing guidance and input from analysts and preparers are addressed below.

Separate Major Line of Business Criteria

19. The Boards should consider whether the guidance for determining when a component of an entity is reported as a discontinued operation should include the criteria in paragraph 32 of IFRS 5 (collectively referred to as the separate major line of business criteria). The reasons for and against including the separate major line of business criteria are described below.

Including a Separate Major Line of Business Criteria

20. Reasons to require the separate major line of business criteria are as follows:

    a. Only a strategic shift in an entity's operations should be reported as a discontinued operation. An entity will frequently purchase and sell assets that meet the definition of a component of an entity; however, those transactions do not fundamentally change an entity's current business model. The normal churning of assets should **not** be the basis for requiring an entity to restate its financial statements and report a disposal as a discontinued operation.

    b. Without the separate major line of business criteria, some entities or industries (for example, REITs) would be perpetually restating their financial results to report discontinued operations. Since part of the operating activities of those entities involves the continual purchasing and selling of assets, classifying those disposal activities as discontinued operations is misleading because it includes activities that are part of the ongoing operations within discontinued operations (see related discussion in paragraphs 25–27). (The staff notes that the majority of the disposal transactions in these fact patterns would not meet the criteria in paragraph 32 of IFRS 5. Thus, under IFRS 5, the results of those disposal activities would be included within the operating results of the entity.) In addition, when an entity has a significant number of restatements it is often difficult to analyze its results period over period. According to one study prepared by NAREIT, 77 percent of the accounting quarters between the first quarter of 2003 and the second quarter of 2005 included a discontinued operation for a sample of companies in the REIT industry.

    c. In some industries (for example, REITs and Oil and Gas Industries), analysts will add back the discontinued operation amounts to continuing operations because the analysts believe it is relevant to predicting results of future operations. However, because the amounts reported in discontinued operations are not broken down by financial statement line item, analysts expend a significant amount of effort to recast financial statements to include the discontinued operations in continuing operations. If the separate major line of business criteria is included in the definition, analysts will have to recast the financial statements less often.

d. From a cost-benefit perspective, the incremental benefit obtained from including more components in discontinued operations does not outweigh the effort it takes an entity to restate its financial statements for each discontinued operation. Restating financial statements is a difficult task for some entities because not only are the income statement and cash flow statement restated (the balance sheet is reclassified when the held-for-sale criteria is satisfied) but many note disclosures need to be restated as well. Additionally, entities need to consider intra-period tax allocations, interest allocation, and other allocation issues when reporting discontinued operations.

e. When the definition of *discontinued operations* was exposed in connection with IFRS 5, the respondents (the majority were preparers) overwhelmingly supported including the separate major line of business criteria for reporting a component as a discontinued operation for the reasons listed above. The respondents stated that preparers and users know how to apply the then-existing literature to discontinued operations and are not of the opinion that the change would provide an incremental benefit to financial reporting. In recent conversations with analysts who have experience with IFRS 5, they indicated a preference for retaining these criteria.

Excluding the Separate Major Line of Business Criteria

21. Reasons to **not** require the separate major line of business criteria are as follows:

a. One of the working principles of the project states that the financial statements should help investors, creditors, and others assess an entity's ability to generate future cash flows. Reporting a component of entity that has been separately disposed of from the continuing operations of an entity provides better predictive information to the users of the financial statements because it separately reports revenue and cash flows that are not expected to incur in the future. This separate presentation provides a user with information that can be used to evaluate an entity's performance by comparing similar operating metrics period over period. Some analysts are concerned that the inclusion of gains and losses in operating results will potentially improve an entity's operating performance and provide an entity with an incentive to sell a component when its operating results are not going to meet expectations.

b. Segregating the results of a discontinued operation ensures that a gain or loss from the sale of a component is excluded from the continuing operations results (as it is not part of the operating activities of the entity).

c. Analysts are of the view that additional components included in discontinued operations would result in more information being segregated and would enable financial statement users to better understand the financial effect of asset impairments, and assess the disposal activities on both the affected business segment and the entity as a whole.

d. The IFRS 5 definition of a discontinued operation has been effective in distinguishing disposal transactions that are likely to have a significant effect on the ongoing operations of the entity. However, the disposal of other components that do not represent a separate major line of business or geographical area also might have a significant effect on the ongoing operations of the entity. This view is consistent with the recommendation made by the AICPA Special Committee on Financial Reporting in its 1994 report, *Improving Business Reporting*—A Customer Focus, which states:

> Discontinued operations is defined in current practice as a component of a company whose activities represent a separate major line of business or class of customer. That definition should be broadened to include all significant discontinued operations whose assets and results of operations and activities can be distinguished physically and operationally and for business-reporting purposes. [page 138]

Continuing Involvement Criteria

22. The second criteria for the Boards to consider is the criteria in paragraph 42 of Statement 144, that (a) the operations and cash flows of the component has been (or will be) eliminated from the ongoing operations of the entity and (b) the entity will not have any significant continuing involvement in the operations of the component after the disposal transaction (collectively referred to as the continuing involvement criteria).

Including a Continuing Involvement Criteria

23. A reason to require a continuing involvement criteria in determining when to report a component as a discontinued operation is that it provides guidance to assist entities in determining what represents a discontinued operation. Conceptually, when the entity continues to be involved in the component after its disposal or the cash flows have not been (or will not be) eliminated, the component has not been disposed of economically and therefore should remain as part of continuing operations. Some would argue that a change in the legal structure, without a similar change in the economics of the arrangement, should be the basis for reporting a disposal as a discontinued operation.

Excluding a Continuing Involvement Criteria

24. Reasons not to require a continuing involvement criteria are as follows:

    a. The application of these additional criteria in practice is difficult and does not result in consistent application of Statement 144. The difficulty in applying these criteria is evidenced by the fact that the EITF had to issue guidance (Issue 03-13). While this guidance is helpful, some preparers continue to have difficulty in applying the 03-13 guidance to individual fact patterns.

b. The additional criteria do not reflect the substance of the transaction because while an entity may have continuing involvement, the seller has transferred control, along with the risk and rewards, to another entity. The inclusion of financial results in continuing operations should be based on the consolidation model of control and not the economic relationship that exists between two parties.

Capital Appreciation Criterion

25. The third criterion for the Boards to consider is whether an entity engages in the purchase and sale of a component for capital appreciation purposes as part of normal operations. This potential criterion was developed based on conversations with analysts and preparers of financial statements.

Including a Capital Appreciation Criterion

26. Reasons for including a Capital Appreciation Criterion are as follows:

a. The results from disposal activities of an entity that engages in the business of purchasing and selling components represent operating activities of the entity and should be reported in continuing operations. These results should also include gains and losses on the disposal activities because the entity's purchase and sale determination are based on maximizing capital appreciation. An entity will typically sell a component and reinvest the proceeds in a similar type of component.

b. Several of the users who commented on the appropriateness of the existing discontinued operations reporting noted that this type of disposal transaction should not be reported as a discontinued operation because it represents the operating activities of an entity.

Excluding a Capital Appreciation Criterion

27. A reason for not including a Capital Appreciation Criterion is that the business justification for an entity disposing of a component should not be the basis for whether the disposal is reported as a discontinued operation. Including the results of a component that has been disposed of in continuing operations detracts from the predictive value of the financial statements because it is difficult to assert that an entity will have consistent disposal activities and gains and losses period over period.

Staff Recommendation

28. The staff is of the opinion that both of the alternatives have conceptual merit and are supported by the information needs of different constituents. In making its recommendation on Issue 1, the staff was also evaluating Issue 2 to determine what alternatives would provide the most useful information to the users of the financial statements. The staff recommends that the definition of a discontinued operation include **the separate major line of business criteria** (see below) because a disposal of a component should be reported on the face of the financial statements as a discontinued operation only when the disposal represents a strategic shift in an entity's business strategy. Thus, a discontinued operation would be defined as follows:

> A discontinued operation is a component of an entity that either has been disposed of, or is classified as held for sale, and
>
> (a) represents a separate major line of business or geographical area of operations,
>
> (b) is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations or
>
> (c) is a subsidiary acquired exclusively with a view to resale.

29. The staff did not find the reasons for including the other two possible criteria compelling, and thus is of the view that if **the separate major line of business criteria** is included, there is no need for a continuing involvement or a capital appreciation criterion.

30. The staff acknowledges that a disposal of a component that does not represent a separate major line of business or geographic area may be a significant event to an entity. Thus, the staff is of the view that there should be disclosure requirements related to those disposals so that users have the information they need to predict future operating results.

31. If the Boards are unable to reach agreement on a definition, the staff proposes that a "clean sheet of paper" approach be used to develop a new definition of a discontinued operation. However, because issuance of the discussion document would most likely be delayed if it needed to include the Boards' preliminary views on that new

definition, the staff proposes that the discussion document include alternative definitions for *discontinued operations* and request feedback on what would be an appropriate definition of *discontinued operations*. In other words, the Boards would not discuss the merits of those definitions prior to issuance of the discussion document**.**

Question for the Boards: (Issue 1)

- **What criteria, if any, should be required for determining when an entity should report a component as a discontinued operation?**

ISSUE 2: DISCLOSURE OF FINANCIAL INFORMATION FOR DISCONTINUED OPERATIONS

32. The second issue for the Boards to consider is whether an entity should be required to disclose financial information for all components that have been (or will be) disposed of regardless of whether the component is reported as a discontinued operation. The staff suggests that the following information could be required to be disclosed:

    a. Statement of Operations–Revenue, operating expenses, operating margin, other expenses, impairments, interest, depreciation and amortization expense, taxes, comprehensive income and minority interest.

    b. Statement of Cash Flows–Operating cash flows, investing cash flows, and financing cash flows.

    c. The notes should also include a discussion about the nature of the disposal activities and the use of the proceeds from the disposal activities.

    The majority of these disclosures are incremental to the existing disclosure requirements of Statement 144 and IFRS 5. Statement 144 and IFRS 5 already require the disclosure, on either the face of the statement of financial position or in the notes, of the major classes of asset and liabilities classified as held for sale. The statement of operations and cash flows disclosures would be recommended captions, but the standard would allow for each entity to tailor it to their particular industry or fact pattern.

33. Requiring additional disaggregated financial information will enable users to better assess the impact a disposal of a component might have on an entity. In the staff's discussions with users of the financial statements [sentence omitted from Observer

Notes], most users stated that this additional information would be decision-useful in evaluating an entity's performance. Many of the users interviewed by the staff utilize non-GAAP measures (for example, EBITDA and FFO (funds from operations)) in evaluating the financial results of an entity or industry. Additional information about the disposed component will enable users to better refine those measures and forecast future financial results. Some analysts also noted that in some cases, entities are already providing this type of supplement disclosure either in the notes to or in their MD&A (management commentary) and this requirement would ensure consistent disclosure of this information.

34. An alternative view is that the additional information is not appropriate from a cost-benefit perspective for the following reasons:

    a. This additional disclosure requirement will entail a significant amount of incremental work for preparers of financial statements who are already addressing a number of other complex disclosure requirements.

    b. The effect the disposal of a component has on the continuing entity is sufficiently communicated in the reporting of a discontinued operation on the face of the financial statements.

Staff Recommendation

35. If the FASB agrees to include one or more criterion for narrowing the number of components that are reported as a discontinued operation under Statement 144, and the IASB agrees to retain the definition in IFRS 5 (or to further narrow the definition), the staff recommends that an entity be required to disclose information about any component that has been (or will be) disposed of that is not reported as a discontinued operation. The staff believes that providing additional information (a) will be useful to users of the financial statements, (b) is consistent with the working principles of the Financial Statement Presentation project, and (c) will alleviate many of the concerns about reporting disposals as discontinuing operations.

36. Information that could be disclosed includes the following:

    a. Statement of Operations–Revenue, operating expenses, operating margin, other expenses, impairments, interest, depreciation and amortization expense, taxes, comprehensive income and minority interest.

b. Statement of Cash Flows–Operating cash flows, investing cash flows, and financing cash flows.

c. The notes should also include a discussion about the nature of the disposal activities and the use of the proceeds from the disposal activities.

Question for the Boards: (Issue 2)

- **Should there be additional disclosure requirements for all components that have been (or will be) disposed of regardless of whether the component is reported as a discontinued operation? If so, is the information suggested by the staff the appropriate?**