LETTER OF COMMENT NO. /4

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Financial Accounting and Reporting Section
of the American Accounting Association

Financial Reporting Policy Committee

Response to the FASB Invitation to Comment:
AMENDING THE CRITERIA FOR REPORTING A DISCONTINUED OPERATION

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The Financial Reporting Policy Committee (the Committee) of the Financial Accounting and Reporting Section of the American Accounting Association is charged with responding to discussion papers and exposure drafts related to financial accounting and reporting issues. The Committee is pleased to provide the Financial Accounting Standards Board (FASB, the Board) comments on the Proposed FASB Staff Position FAS144-d, “Amending the Criteria for Reporting a Discontinued Operation.” The comments in this letter reflect the views of the individuals on the Committee and do not represent an official position of the American Accounting Association or the Financial Accounting and Reporting Section.¹

The document, Notice for Recipients of This Proposed FASB Staff Position, poses six questions. This letter includes the Committee’s response to these questions; each question posed is stated in bold and our response follows each of the questions.

¹ The Committee is independent of the Financial Accountings Standards Committee (FASC) of the American Accounting Association.
1. The proposed FSP would amend the definition of a discontinued operation so that a discontinued operation is a component of an entity that is (a) an operating segment (as that term is defined in FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*) and either has been disposed of or is classified as held for sale or (b) a business (as that term is defined in FASB Statement No. 141 [revised 2007], *Business Combinations*) or a nonprofit activity that meets the criteria to be classified as held for sale on acquisition. Do you agree with the proposed definition of a discontinued operation? Why or why not? If not, what definition would you propose and why?

The Committee agrees that the Board should revise the definition and scope of discontinued operations. The current scope appears to be too broad. Real Estate Investment Trusts (REITs), among others, complain that the current rule reports as discontinued operations transactions that should be characterized as income from continuing operations (such as the sale of real estate for a firm in the business of selling real estate). Preliminary research in the area (Curtis et al., 2009) suggests that the reporting of discontinued operations is less associated with economic factors following SFAS 144, and that the persistence of this component of income has increased dramatically. Specifically, both firm and industry performance are less associated with reported discontinued operations following SFAS 144, and that the amounts reported for discontinued operations are systematically associated with income from continuing operations in future periods, consistent with this line item including recurring items.

While the Committee is concerned with the representational faithfulness of reported discontinued operations under SFAS 144, we also conclude that the newly proposed definition is
too restrictive; that it will allow too few transactions to be appropriately classified as discontinued operations. The underlying intent of reporting discontinued operations is to partition sales and related costs generated from assets that the firm does not intend to keep, and classify these as discontinued operations to improve the predictive capabilities of income from continuing operations.

Conceptually, SFAS 144’s scope is appropriate—as asset groups are identified for disposal, relatively unambiguous and seemingly measureable changes to future sales and related expenses (i.e., reductions) will occur. For example, if a retail firm sells or closes all of its stores in California, the classification of discontinued operations should allow them to remove from income from continuing operations and separately report the sales and related expenses of these stores. The resulting reported amounts should provide a more informative representation of the discontinued and the continuing operations than combining these types of stores in the determination of income from continuing operations.

The broader scope of SFAS 144 also follows the recommendations made by the Jenkins Committee 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” (AICPA 1994). The Board, when issuing SFAS 144, concluded that “[b]roadening the presentation of discontinued operations to include more disposal transactions provides investors, creditors, and others with decision-useful information that is relevant in assessing the effects of disposal transactions on the ongoing operations of an entity” (FASB 2001). Restricting discontinued operations to operating segments under SFAS 131 is even more restrictive than the original criteria under APB Opinion No. 30, and seems contrary to the goals of the Jenkins Committee and the Board.
The Committee identified three reasons that the Board should consider a narrower scope than that of SFAS 144, where managers are forced to treat, as discontinued, items that should be included within income from continuing operations; however, the scope should not be as narrow as the SFAS 131 definition of operating segments. First, the Jenkins Committee recommendation leads us to conclude that the operating-segment-level is too coarse, and that separate reporting of sub-segment-level divestitures will be informative to financial statement users. Second, only 40 percent of publicly-traded firms in the U.S. disclose more than one reportable segment (Berger and Hann, 2003). Assuming that many of these firms also have only one operating segment, separate reporting of discontinued operations would not occur for these firms. Third, we note that the definition of a SFAS 131 operating segment is subjective, and the application of this rule varies widely among firms (Schiff et al., 2006). Because of the heterogeneity among firms in their application of SFAS 131, the Committee is concerned that the informativeness of discontinued operations will be diminished. In conclusion, by narrowing the scope of discontinued operations to SFAS 131 operating segments, the Committee concludes that performance reporting will not meaningfully convey companies’ economic activity, diminishing the overall usefulness of financial statements.

Given that the Board is moving toward principles-based standards in their convergence with the IASB, the Committee recommends a more principles-based definition be considered. Starting with the current SFAS 144 definition (which encompasses SFAS 131 operating segments), we propose the following amendment. If the divestiture or asset held for sale satisfies the SFAS 144 definition, and removal of the related operations from income from continuing operations best characterizes the transaction, then discontinued operations reporting applies. This amendment should allow the managers and auditors to make the appropriate determination.
given their knowledge of their ongoing operations and their disposal transactions. Namely, discontinued operations reporting would be the default unless the managers were able to logically argue that the disposal should be included in income from continuing operations (for example the sale of investment properties by REITs).

2. Based on the proposed definition of a discontinued operation, an operating segment is the general level of aggregation for determining whether a component of an entity would be reported in the discontinued operation section of the income statement (or statement of activities for not-for-profit entities). The definition would no longer include certain subsidiaries and asset groups that do not meet the definition of an operating segment. Is it feasible for an entity that is not required to apply Statement 131 (that is, a nonpublic business entity and a not-for-profit entity) to determine whether the component of an entity meets the definition of an operating segment? Why or why not? If not, what definition would you propose for an entity that is not required to apply Statement 131 and why?

As noted in our response to Question 1, the Committee concluded that the scope of discontinued operations should be broader than that stated in the proposal, for all firms, and as such, the application of the rule should become less onerous for those not applying SFAS 131. However, if the SFAS 131 criteria are upheld in the final rule, the Committee agrees that the determination of operating segments for nonpublic business entities or not-for-profit entities would be feasible. First, the definition of operating segment under SFAS 131 is based on the structure of a given enterprise's internal organization and the flow of information to one of the
enterprise’s chief operating decision makers. Thus, the necessary data should be readily available if the entity has more than one set of potentially qualifying operations and this data should be available at a reasonable cost. Second, if these enterprises fail the basic qualitative test based on internal information flow, then these entities likely have one economically relevant operating segment; thus, discontinued operations reporting is not likely meaningful.

3. Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes would you propose and why?

The Committee agrees with the new disclosure requirements. Additional detailed disclosure requirements for all divestitures, regardless of whether they meet the threshold of discontinued operations, partially mitigate our concerns regarding the final scope of the rule. Investors and analysts should be able to use the disclosed information to infer changes in future sales and expenses related to the divestiture.

The Committee cautions that defining a component of an entity as distinguishable for cash flow and reporting purposes is subjective. Managers may use the discretion to decide to disclose only those components which indicate losses to highlight the effect to financial statement users. Under similar circumstances, Rapaccioli and Schiff (1991) found that discretion under APB 30 in classifying discontinued operations resulted in profitable disposals above the line, and losses below the line.

4. Under the disclosure requirements, income tax expense or benefit does not have to be calculated and disclosed for components of an entity that are reported within
continuing operations and that have been disposed of or are classified as held for sale. Do you agree or do you believe it would be beneficial to require income tax expense or benefit to be calculated and disclosed for discontinued components of an entity within continuing operations? If so, how would you calculate and disclose the income tax expense or benefit?

The Committee agrees that the costs of such a disclosure would outweigh the benefits. Requiring determination of the tax expense or benefit and the related disclosure would be inconsistent with disclosures of other items included in continuing operations (for example, restructuring charges or unusual items). This inconsistency may cause confusion among users. However, consideration should be given to requiring a disclosure if the disposal is expected to have a material impact on future income tax provisions (i.e., more of a qualitative statement than a quantitative number).

5. Do you agree with the disclosure exemptions for a business or a nonprofit activity that meets the criteria to be classified as held for sale on acquisition? Why or why not? If not, what changes would you propose and why?

The Committee agrees with the disclosure exemptions as long as the reconciliations required in paragraphs 15 and 16 of the proposal remain. The reconciliations would incorporate the information for the exempted activities and provide (1) transparency and (2) a link between the balance sheet and income statement.
6. Are the effective date and transition provisions sufficient for compiling the information needed? Why or why not? If not, what would you propose and why?

The Committee agrees that the effective date and transition provisions are sufficient.
References


