FASB Emerging Issues Task Force

Issue No: 03-13
Title: Applying the Conditions in Paragraph 42 of FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, in Determining Whether to Report Discontinued Operations

Document: Issue Summary 1, Supplement No. 3*
Date Prepared: September 13, 2004
FASB Staff: Sogoloff (ext. 376)/Larson (ext. 229)
Dates Issue Previously Discussed: November 12–13, 2003; March 17–18, 2004; June 30–July 1, 2004

References:
APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock (APB 18)
FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (FAS 144)
EITF Issue No. 87-24, "Allocation of Interest to Discontinued Operations" (Issue 87-24)
EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease" (Issue 01-8)
EITF Abstracts, Topic No. D-104, "Clarification of Transition Guidance in Paragraph 51 of FASB Statement No. 144" (Topic D-144)

* The alternative views presented in this Issue Summary are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination.
Background

1. The proposed approach for assessing whether cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity focuses on whether continuing cash flows are direct or indirect cash flows. Cash flows of the component would not be eliminated if the continuing cash flows to the entity are considered direct cash flows. The determination of whether continuing cash flows are direct or indirect depends on the nature and significance of the cash flows and requires judgment. Direct cash flows include gross cash flows (cash inflows and cash outflows) that are directly associated with the revenue-producing and cost-generating activities of an entity. The revenue-producing activities (cash inflows) of a component have been continued and therefore are considered direct cash flows if (a) significant cash inflows are expected to be recognized by the remaining entity as a result of a migration of revenues from the disposed component after the disposal transaction or (b) significant cash inflows are expected to be received by the remaining entity as a result of the continuation of activities between the remaining entity and the disposed component after the disposal transaction. The cost-generating activities (cash outflows) of the component have been continued and therefore considered direct cash flows if (c) significant cash outflows are expected to be recognized by the remaining entity as a result of a migration of costs from the disposed component after the disposal transaction or (d) significant cash outflows are expected to be recognized by the remaining entity as a result of the continuation of activities between the remaining entity and the disposed component after the disposal transaction.

2. The proposed approach for assessing whether the remaining entity will have any significant continuing involvement in the operations of the component after the disposal transaction focuses on whether the entity has (a) the ability to influence the operating and/or financial policies of the disposed component, (b) retained risk associated with the operations of the disposed component, or (c) the ability to obtain benefits associated with the ongoing operations of the disposed component. The determination as to whether the remaining entity has significant continuing involvement is based on a quantitative and qualitative assessment from the perspective of the disposed component and should take into consideration all types of continuing involvement, individually and in the aggregate. The proposed approach provides two categories of relationships that should be considered in determining whether an entity has significant
continuing involvement in the operations of the component. Those categories are: (a) the entity retains an interest in the disposed component sufficient to enable it to exert significant influence over the component's operating and financial policies and (b) the entity and the buyer (or disposed component) are parties to a contract or agreement that, based on a consideration of several factors, constitutes significant continuing involvement.

3. The Task Force discussed and expressed general support for the scope and direction of the Working Group's proposed approach; however, the Task Force did not support specifying a threshold (that is, a specific percentage) in the evaluation of whether continuing cash flows are significant. The Task Force asked the FASB staff to further refine and articulate how an entity should evaluate the nature of the cash flows to determine whether the cash flows need to be evaluated for significance in the proposed approach. Additionally, the Task Force asked the FASB staff to further articulate the basis for the conclusions that were reached in the examples in Issue Summary No. 1 for this Issue and to apply the proposed approach to the examples in FAS 144. The FASB staff agreed to propose disclosures for disposed components that are presented as discontinued operations for the Task Force's consideration.

4. The FASB staff prepared a draft abstract which is included in the appendix to this Issue Summary. In order to achieve the staff’s objective of reaching a consensus on this Issue, the staff believes the Task Force must address the following issues at the September 29-30, 2004 meeting:

a. Whether an assessment period is necessary in evaluating whether a disposal meets the criteria outlined in the draft abstract. The assessment language was originally included to alleviate concerns regarding short-term agreements that provide the ongoing entity significant continuing involvement in the operations of the disposed component (the paragraph 42(b) criterion). However, there were concerns regarding the assessment of the paragraph 42(a) criterion. Some believe that having direct cash flows for any amount of time following the disposal should preclude discontinued operation classification. Additionally, others believe that it will be very difficult for companies to determine whether a reassessment is necessary and that it will be difficult to audit any conclusions during the
assessment period. In an effort to address those concerns, the FASB staff has removed the assessment language from the draft abstract and incorporated language into the paragraph 42(b) guidance that effectively allows companies to disregard agreements with terms of one year or less in their assessment of whether a disposal is a discontinued operation.

b. Whether the sale of a product or service into an open market should be considered a migration of customers. The FASB staff developed two examples in the draft abstract relating to the disposal of an oil well. In those examples, the oil is being sold to specific customers under contract as opposed to an open market. The Task Force should discuss whether those examples should be modified to include the sale of oil on the open market (assuming a conclusion can be reached on whether the sale to an open market should be considered a migration).

c. Whether the determination of significant should be based on operating measures such as gross profit or net income or whether it should be limited to gross cash inflows (revenues) and cash outflows (costs).

d. Whether the retention of risk associated with the ongoing operations of the disposed component or the ability to obtain benefits associated with the ongoing operations of the disposed component should be considered continuing involvement (paragraph 9 of the draft abstract).

e. Whether the guidance for determining significant continuing involvement is adequate. Some believe more specific guidance is necessary while others would like to retain the facts and circumstances approach.

f. Whether disclosure requirements in the draft abstract are adequate.
APPENDIX 03-13A

EITF Abstracts (DRAFT\textsuperscript{1})

Issue No: 03-13

Title: Applying the Conditions in Paragraph 42 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, in Determining Whether to Report Discontinued Operations

Dates Discussed: November 12–13, 2003; March 17–18, 2004; June 30–July 1, 2004; September 29–30, 2004

References: APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*

FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*

EITF Issue No. 87-24, "Allocation of Interest to Discontinued Operations"

EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease"

EITF Topic No. D-104, "Clarification of Transition Guidance in Paragraph 51 of FASB Statement No. 144"

ISSUE

1. Paragraph 42 of Statement 144 states that:

   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.

2. Consideration of the guidance in paragraph 42 of Statement 144, has generated questions about how to apply the criterion that the operations and cash flows be *eliminated* from the ongoing operations of the reporting entity. Specifically, which cash flows of the disposed

\textsuperscript{1} This draft abstract was prepared to facilitate discussion of the guidance on which the Task Force reached its consensus and contains all substantive aspects of the consensus. The final abstract, which will be included in the next update for *EITF Abstracts*, may contain nonsubstantive editorial revisions.
component have to be eliminated from the ongoing operations of the entity? Additionally, questions have been raised about the types of continuing involvement that constitute significant continuing involvement. A working group was formed to address those issues.

3. The issues are:

Issue 1— How an ongoing entity should evaluate whether the operations and cash flows of a disposed component have been or will be eliminated from the ongoing operations of the entity

Issue 2— The types of continuing involvement that constitute significant continuing involvement in the operations of the disposed component.

EITF DISCUSSION

4. The Task Force reached a consensus on Issue 1 that the evaluation of whether the operations and cash flows of a disposed component have been or will be eliminated from the ongoing operations of the entity depends on whether continuing cash flows have been or are expected to be generated and, if so, whether those continuing cash flows are direct or indirect. Continuing cash flows are cash inflows or outflows that are generated by the ongoing entity and are associated with activities involving a disposed component. If continuing cash flows are generated, the determination as to whether those continuing cash flows are direct or indirect should be based on their nature and significance. If any continuing cash flows are direct, the cash flows have not been eliminated and the operations of the component should not be presented as a discontinued operation. Conversely, if all continuing cash flows are indirect, the cash flows are considered to be eliminated and the disposed component meets the paragraph 42(a) criterion to be considered a discontinued operation. The assessment as to whether continuing cash flows are direct cash flows should be based on management’s expectations using the best information available.
5. Cash flows\(^2\) of a component include gross cash flows (cash inflows and cash outflows) that are associated with the revenue-producing and cost-generating activities of that component (that is, "direct" cash flows). The intention of the criterion in paragraph 42(a) is to determine whether, in substance, the ongoing entity continues either the revenue-producing activities (cash inflows) or the cost-generating activities (cash outflows) of the disposed component after the disposal transaction.

6. The revenue-producing activities (cash inflows) of the component have been continued and therefore considered direct cash flows if:

a. Significant cash inflows are expected to be recognized by the ongoing entity as a result of a migration\(^3\) of revenues from the disposed component after the disposal transaction; or

b. Significant cash inflows are expected to be received by the ongoing entity as a result of the continuation of activities\(^4\) between the ongoing entity and the disposed component after the disposal transaction.

The cost-generating activities (cash outflows) of the component have been continued and therefore considered direct cash flows if:

c. Significant cash outflows are expected to be recognized by the ongoing entity as a result of a migration\(^5\) of costs from the disposed component after the disposal transaction; or

\(^2\) The cash flows that are associated with the revenue-producing and cost-generating activities are the same cash flows utilized in the Statement 144 impairment analysis under the "held and used" model.

\(^3\) The term "migration" means the ongoing entity is expected to recognize revenues or costs that likely would have been recognized by the disposed component absent the disposal transaction. A migration occurs when the ongoing entity continues to generate revenues and cost of sales from the sale of similar products or services to specific customers of the disposed component.

\(^4\) The term "continuation of activities" means the continuation of any revenue-producing or cost-generating activity through active involvement with the disposed component. For example, the ongoing entity sold products or services to the disposed component before its disposal (recognized as intercompany sales) and it continues to sell similar products or services to the disposed component or a related party to the disposed component after its disposal (recognized as sales). After the disposal transaction, the former intercompany sales are no longer eliminated in consolidation, which will result in continuing cash inflows to the ongoing entity. Similarly, for cost-generating activities, the ongoing entity purchased products or services from the disposed component before its disposal (recognized as intercompany cost of sales) and it continues to purchase similar products or services from the disposed component after its disposal (recognized as cost of sales). After the disposal transaction, the former intercompany cost of sales are no longer eliminated in consolidation, which will result in continuing cash outflows from the ongoing entity.
d. Significant cash outflows are expected to be recognized by the ongoing entity as a result of the continuation of activities\(^6\) between the ongoing entity and the disposed component after the disposal transaction.

The Task Force reached a consensus that the guidance below should be used to evaluate whether continuing cash flows are direct cash flows:

*Nature of Activities that Generate Continuing Cash Flows*

7. In evaluating whether continuing cash flows are direct cash flows, the ongoing entity must first consider the nature of the activities that generate those continuing cash flows. A disposal transaction may result in the ongoing entity (a) recognizing revenues or costs that likely would have been recognized by the disposed component absent the disposal transaction (a "migration") or (b) continuing any of the revenue-producing or cost-generating activities through active involvement with the disposed component (a "continuation of activities"). In situations in which continuing cash flows are being generated from either a migration or continuation of activities, the ongoing entity must then determine whether the cash flows are significant. If continuing cash flows are not generated from either a migration or a continuation of activities, the ongoing entity would not need to determine whether the cash flows are significant but must perform an evaluation to assess whether it has significant continuing involvement in the operations of the disposed component. Examples of continuing cash flows that would likely result from activities other than a migration or continuation of activities include, but are not limited to: (a) interest income generated from seller-provided financing, (b) contingent consideration in a business combination, (c) dividends on a cost method investment, and (d) a passive royalty interest in the disposed component’s future cash flows.

*Significance of Continuing Cash Flows*

---

\(^5\) Refer to footnote 3.  
\(^6\) Refer to footnote 4.
8. If expected continuing cash inflows or outflows are the result of a migration of revenues or costs to the ongoing entity or a continuation of activities between the disposed component and the ongoing entity, the ongoing entity should consider whether the continuing cash flows are significant. The evaluation as to whether continuing cash flows will be significant is a matter of judgment and should be based on a comparison between the expected continuing cash flows to be recognized by the ongoing entity after the disposal transaction and the cash flows that would have been expected to be recognized by the disposed component absent the disposal transaction. The cash flows that would have been expected to be recognized by the disposed component should include cash flows from both third party and intercompany transactions (the amount of cash flows attributed to intercompany transactions should be determined based on a consideration of the transactions as if they had been between unrelated third parties). Continuing cash inflows should be evaluated separately from continuing cash outflows in evaluating significance, regardless of whether financial statement presentation is on a gross or net basis. If a determination is made that continuing cash inflows represent direct cash flows, an evaluation of cash outflows is not necessary. If a determination is made that continuing cash flows are indirect (cash inflows and cash outflows), the ongoing entity must perform an evaluation under the criterion in paragraph 42(b) to assess whether it has significant continuing involvement in the operations of the disposed component.

Significant Continuing Involvement

9. If the operations and cash flows of a disposed component have been (or will be) eliminated from the ongoing operations of an entity as a result of a disposal transaction (see Issue 1 for guidance on making this determination), an entity should evaluate whether the ongoing entity will have significant continuing involvement in the operations of the component after the disposal transaction. The Task Force reached a consensus on Issue 2 that continuing involvement in the operations of the disposed component provides the ongoing entity with (a) the ability to influence the operating and (or) financial policies of the disposed component, (b) the retention of risk associated with the ongoing operations of the disposed component, or (c) the ability to obtain benefits associated with the ongoing operations of the disposed component. Continuing involvement may be provided to the ongoing entity through an interest in the
disposed component or through the existence of a contractual arrangement or other type of arrangement with the disposed component.

10. The determination as to whether the continuing involvement is significant should be based on an assessment that is both quantitative and qualitative from the perspective of the disposed component. The assessment should consider all types of continuing involvement, individually and in the aggregate.

11. The following factors, among others, should be considered in evaluating whether continuing involvement constitutes significant continuing involvement:7

a. The ongoing entity retains an interest8 in the disposed component sufficient to enable it to exert significant influence over the disposed component's operating and financial policies. An interest that provides the ongoing entity significant influence may or may not be accounted for under the equity method of accounting since an entity would only consider those interests that are common stock or in-substance common stock in evaluating whether the equity method of accounting is appropriate. However, interests other than common stock or in-substance common stock may provide the ongoing entity significant influence over the disposed component's operating and financial policies. A cost method investment individually would not be considered significant continuing involvement.

b. The ongoing entity and the buyer (or the disposed component) are parties to a contract or otherwise parties to an arrangement, such as the relationship between a customer and a supplier or when one entity provides management services to another entity. The determination as to whether that constitutes significant continuing involvement in the operations of the disposed component should be based on the following factors:

---

7 This guidance should be used only to evaluate the criterion in paragraph 42(b) of Statement 144 and should not be used to evaluate the criterion in paragraph 42(a) of Statement 144 or whether an entity meets the criteria for sale accounting or gain recognition set forth in other applicable accounting literature.

8 An entity holding a call option to acquire an interest in the disposed component is a form of continuing involvement; however, whether that continuing involvement is significant depends on a number of factors, including whether the call option is at fair value, when the call option becomes exercisable and the percentage ownership underlying the call option. Additionally, a call option to acquire an interest in the disposed component that is exercisable at fair value generally would not be a form of continuing involvement.
i. Significance of the contract or arrangement to the overall operations of the disposed component

ii. The extent to which the ongoing entity is involved in the operations of the disposed component

iii. The rights conveyed by the contract to each party

iv. The pricing terms of the contract or arrangement.

The assessment should focus on those arrangements whose terms are for a period of time greater than one year from the disposal date. Arrangements between the ongoing entity and the disposed component whose terms are for a period of one year or less will likely not provide the ongoing entity with the retention of significant risk associated with the ongoing operations of the disposed component or the ability to obtain significant benefits associated with the ongoing operations of the disposed component.

The circumstances discussed in paragraph 44 of Statement 144 would not constitute continuing cash flows or continuing involvement.

12. Refer to the flowchart in Exhibit 03-13A for an illustration of the above guidance. Examples illustrating the application of the above guidance are included in Exhibit 03-13B.

**Disclosures**

13. The following information shall be disclosed in the notes to the financial statements for each discontinued operation that generates continuing cash flows: (a) the nature of the activities that give rise to continuing cash flows, (b) the period of time continuing cash flows are expected to be generated, and (c) the principal factors used to conclude that the expected continuing cash flows are not direct cash flows of the disposed component. Additionally, a description of the types of continuing involvement, if any, that the entity will have subsequent to the disposal transaction should be disclosed. That information shall be disclosed in the year that a disposal transaction is initially classified as a discontinued operation.
Transition

14. The consensus reached by the Task Force at the September 29–30, 2004 EITF meeting should be applied to a component of an entity that has been either disposed of or classified as held for sale after October 13, 2004 (date of Board ratification). Previously reported operating results related to disposal transactions initiated within an enterprise's fiscal year that includes the date of the ratification may be reclassified to reflect the consensus.

Board Ratification

15. At its October 13, 2004 meeting, the Board ratified the consensus reached by the Task Force in this Issue.

STATUS

16. No further EITF discussion is planned.
DETERMINING WHEN A COMPONENT SHOULD BE CLASSIFIED AS A DISCONTINUED OPERATION

A Component of an Entity Either has Been Disposed of or is Classified as Held For Sale

Are Continuing Cash Flows Expected to be Generated?

Yes

Do the Continuing Cash Flows Result From a Migration or a Continuation of Activities?

No

Yes

Are the Continuing Cash Inflows or Outflows Significant?

No

Is There Significant Continuing Involvement in the Operations of the Disposed Component?

No

Yes

Classification as a Discontinued Operation is not Appropriate

Classification as a Discontinued Operation is Appropriate

---

9 This diagram represents an overview of the provisions of this Issue with respect to determining when a component should be classified as a discontinued operation.
EXAMPLES OF THE APPLICATION OF THE EITF CONSENSUS ON ISSUE 03-13

Example 1

An entity owns and operates retail stores that sell household goods. For that entity, each store is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, each store is a component of the entity.

To expand its retail store operations in one region, the entity decides to close two of its retail stores and open a new "superstore" within 10 miles of the retail stores to be closed. The new superstore will continue to sell the household goods previously sold through the two retail stores along with other types of goods. The ongoing entity purchased and will continue to purchase the household goods from an unrelated wholesale distributor. The ongoing entity estimates that a migration of customers from the closed retail stores after the disposal transaction will result in the ongoing entity recognizing $400 thousand of sales ($200 thousand from each store). The ongoing entity estimates that each of the disposed components would have recognized $250 thousand of sales absent the disposal transaction.

Evaluation:

Step 1: Are continuing cash flows expected to be generated by the ongoing entity? Yes. Continuing cash flows are being generated from the customers of the disposed component.

Step 2: Do the continuing cash flows result from a migration or continuation of activities? Yes. The continuing cash flows are the result of a migration since customers are migrating from the closed retail stores to the superstore which is selling similar products as the closed retail stores. Therefore, an evaluation of the significance of the continuing cash flows must be performed.

Step 3: Are the continuing cash flows significant? Yes. The ongoing entity estimates that the continuing cash inflows will approximate 80 percent of the cash inflows that would have been recognized by the components absent the disposal transaction. The ongoing entity believes that 80 percent is significant.
Conclusion: The continuing cash flows should be considered direct cash flows of the disposed component due to the significant cash inflows that are expected to be recognized by the ongoing entity as a result of a migration of customers from the closed retail stores to the superstore. An evaluation of cash outflows is not necessary. Since the continuing cash flows are considered direct cash flows, classification as a discontinued operation would not be appropriate. An evaluation of continuing involvement is not necessary.

Example 2
An entity owns and operates retail stores and has internet operations (website), all of which sell household goods. For that entity, each store is a component of the entity and the internet operation is a component of the entity.

The entity closes a retail store which is expected to result in a migration of customers to the website operations. The website sells the household goods previously sold through the closed retail store in addition to other products. The ongoing entity purchased and will continue to purchase the household goods from an unrelated wholesale distributor. The ongoing entity estimates that a migration of customers from the closed retail store to the website after the disposal transaction will result in the ongoing entity recognizing $50 thousand of sales related to such migration. The ongoing entity estimates that the component would have recognized $250 thousand of sales absent the disposal transaction.

Evaluation:
Step 1: Are continuing cash flows expected to be generated by the ongoing entity? Yes. Continuing cash flows are being generated from the customers of the disposed component.
Step 2: Do the continuing cash flows result from a migration or continuation of activities? Yes. The continuing cash flows are the result of a migration since customers are migrating from the closed retail store to the website which is selling similar products as the closed retail store. Therefore, an evaluation of the significance of the continuing cash flows must be performed.
Step 3: Are the continuing cash flows significant? Yes. The ongoing entity estimates that the continuing cash inflows will approximate 20 percent of the cash inflows that would have been
incurred absent the disposal transaction. The ongoing entity believes that 20 percent is significant.

Conclusion: The continuing cash flows should be considered direct cash flows of the disposed component due to significant cash inflows that are expected to be recognized by the ongoing entity as a result of a migration of customers from the closed retail store to the website. An evaluation of cash outflows is not necessary. Since the continuing cash flows are considered direct cash flows, classification as a discontinued operation would not be appropriate. An evaluation of continuing involvement is not necessary.

Example 3
An entity owns a commercial building that is being leased to third-party lessees. For that entity, the building is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, the building is a component of the entity. The entity commits to a plan to sell the building. The building is classified as held for sale at that date. The ongoing entity will enter into a long-term management agreement with the buyer under which the ongoing entity will continue to manage the day-to-day operations of the building in exchange for a management fee at market rates.

The ongoing entity estimates that continuing cash inflows as a result of a continuation of activities (providing management services) will result in the ongoing entity recognizing $250 thousand of revenue. The ongoing entity estimates that the disposed component would have recognized $5 million of rental revenue absent the disposal transaction. The ongoing entity estimates that after the disposal transaction, continuing cash outflows as a result of a continuation of activities (providing management services) between the ongoing entity and the disposed component will result in the ongoing entity recognizing $200 thousand of cash outflows. The ongoing entity estimates that the disposed component would have recognized $1 million of cash outflows associated with owning and managing the building absent the disposal transaction.
Evaluation:

Step 1: Are continuing cash flows expected to be generated by the ongoing entity? Yes. Continuing cash flows are being generated from the management agreement between the ongoing entity and the disposed component.

Step 2: Do the continuing cash flows result from a migration or continuation of activities? Yes. The continuing cash flows are the result of a continuation of activities since the ongoing entity provided management services, along with other services such as providing rental space, prior to the disposal transaction and will continue to provide management services to the disposed component after the disposal transaction. Therefore, an evaluation of the significance of the continuing cash flows must be performed.

Step 3: Are the continuing cash flows significant? Yes. The ongoing entity estimates that the continuing cash inflows will approximate 5 percent of the cash inflows that would have been recognized by the disposed component. The ongoing entity does not believe this is significant. However the continuing cash outflows will approximate 20 percent of the cash outflows that would have been recognized by the disposed component. The ongoing entity believes that this is significant.

Conclusion: The continuing cash flows should be considered direct cash flows of the disposed component due to significant cash outflows that are expected to be recognized by the ongoing entity as a result of a continuation of management activities between the ongoing entity and the disposed component after disposal. Since the continuing cash flows are considered direct cash flows, classification as a discontinued operation would not be appropriate. An evaluation of continuing involvement is not necessary.

Example 4

An entity owns an oil field that produces crude oil that is sold to specific customers through supply contracts at market prices. For that entity, a field is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, the field is a component of the entity. The entity commits to a plan to sell the oil field to a third-party buyer. The oil field is classified as held for sale at that date. The entity will bring another oil field online shortly after the sale and expects to sell the same type of crude oil extracted from this new field as it did from the sold oil field to all
the same customers. The sold oil field will continue to operate at capacity after the sale; however, the customers of the sold oil field will all be different. The ongoing entity will not have any involvement in the operations of the sold oil field subsequent to its disposal.

**Evaluation:**

Step 1: Are continuing cash flows expected to be generated by the ongoing entity? Yes. Continuing cash flows are expected to be generated from the sale of oil to the customers of the sold oil field since the ongoing entity will retain the supply contracts of the sold oil field.

Step 2: Do the continuing cash flows result from a migration or continuation of activities? Yes. The continuing cash flows are the result of a migration since customers are migrating from the sold oil field to the new oil field, which is selling similar product as the sold oil field. The new oil field will generate revenues and costs that would have been generated by the sold oil field absent the disposal transaction since customers are migrating from the sold oil field to the new oil field. Therefore, an evaluation of the significance of the continuing cash flows must be performed.

Step 3: Are the continuing cash flows significant? Yes. The ongoing entity estimates that the continuing cash inflows will approximate 100 percent of the cash inflows that would have been incurred absent the disposal transaction since all customers will be migrating. The ongoing entity believes that 100 percent is significant.

Conclusion: The continuing cash flows should be considered direct cash flows of the disposed component due to the significant cash inflows that are expected to be recognized by the ongoing entity as a result of a migration of customers from the sold oil field to the new oil field. An evaluation of cash outflows is not necessary. Since the continuing cash flows are considered direct cash flows, classification as a discontinued operation would not be appropriate. An evaluation of continuing involvement is not necessary.

**Example 5**

An entity owns an oil field that produces crude oil that is sold to specific customers through supply contracts at market prices. For that entity, a field is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, the field is a component of the entity. The entity
commits to a plan to sell the oil field to a third-party buyer. The oil field is classified as held for sale at that date. The ongoing entity will bring another oil field online shortly after the sale and expects to sell the same type of crude oil extracted from this new field as it did from the sold oil field. The sold oil field will continue to operate at capacity after the sale and will continue to sell oil to the same customers. The ongoing entity will not have any involvement in the operations of the sold oil field subsequent to its disposal.

**Evaluation:**

Step 1: Are continuing cash flows expected to be generated by the ongoing entity? No. Continuing cash flows are not expected to be generated since there are no activities involving the disposed component that are generating cash flows to the ongoing entity after the disposal transaction. The ongoing entity is not retaining any of the supply contracts from the sold oil field and there will be no activities that will continue between the ongoing entity and the disposed component.

Step 2: Does the ongoing entity have significant continuing involvement in the operations of the disposed component? No. The ongoing entity will not have any involvement in the operations of the sold oil field subsequent to its disposal.

Conclusion: Since there are no continuing cash flows and the ongoing entity will not have significant continuing involvement in the operations of the disposed component, classification as a discontinued operation would be appropriate.

**Example 6**

An entity owns several commercial buildings that are being leased to third-party lessees. The buildings are of the same type and are located in the same geographic region. For that entity, the building is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, each building is a component of the entity. The entity commits to a plan to sell one of the buildings. The building is classified as held for sale at that date.

The ongoing entity will purchase another commercial building in the same geographic region as the sold building. The ongoing entity does not anticipate that any lessees from the sold building
will terminate their leases and migrate to the new building, however, the ongoing entity believes that certain lessees from the sold building will also be lessees in the new building. The seller provides the buyer financing in the form of a 5-year recourse loan equal to 20 percent of the purchase price. The loan bears a market rate of interest, the rights conveyed are customary for these types of loan agreements, and the buyer is considered to have high credit quality. The ongoing entity will not otherwise be involved in the operations of the disposed component.

**Evaluation:**
Step 1: Are continuing cash flows expected to be generated by the ongoing entity? Yes. Cash flows associated with the disposed component are being generated by the ongoing entity resulting from (1) leasing space in the new building to some of the same lessees of the old building and (2) interest income from the seller provided financing.

Step 2: Do the continuing cash flows result from a migration or continuation of activities? No. The continuing cash flows do not result in a migration nor do they provide for a continuation of activities. Although the ongoing entity will lease space to some of the same lessees as the old building, the new building will not generate any revenues or costs that would have been generated by the sold building absent the disposal transaction since there is no migration of customers and there will not be any continuation of activities between the ongoing entity and the sold building. Accordingly, an evaluation of the significance of the continuing cash flows is not necessary. An evaluation of continuing involvement must be performed.

Step 3: Does the ongoing entity have significant continuing involvement in the operations of the disposed component? No. The seller-provided financing likely will not result in the ongoing entity having significant continuing involvement in the operation of the building after it is sold based on the following:

a. The agreement is not significant to the overall operations of the disposed component since the loan amount is equal to 20 percent of the purchase price, the loan is recourse, and the buyer is considered to have high credit quality

b. The extent to which ongoing entity is involved in the operations of the disposed component is limited to the loan agreement

c. The rights conveyed by the loan agreement are customary

d. The loan bears a market rate of interest.
Conclusion: Since the continuing cash flows are considered indirect cash flows and the ongoing entity will not have significant continuing involvement in the operations of the disposed component, classification as a discontinued operation would be appropriate.

Example 7
An entity that manufactures sporting goods has a bicycle division that designs, manufactures, markets, and distributes bicycles to its company-owned retail stores as well as third party retailers. For that entity, the bicycle manufacturing operation is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, the manufacturing of the bicycles is a component of the entity.

The entity has experienced losses in its bicycle division resulting from an increase in manufacturing costs (principally, labor costs). The entity decides to remain in the bicycle business but will outsource the manufacturing operations and commits to a plan to sell the related manufacturing facility. The facility is classified as held for sale at that date. The entity will sell the manufacturing facility along with the third-party customer contracts and will enter into an outsourcing agreement with the buyer of that facility. The outsourcing agreement will allow the ongoing entity to purchase 5 percent of the output from the facility at market for a period of 10 years, which will then be sold through the company-owned store locations. The outsourcing agreement includes customary terms and does not permit the ongoing entity to be otherwise involved in the operations of the disposed component. The revenues generated by sales to company-owned store locations approximated 5 percent of the total revenues generated by the disposed component. The outsourcing agreement does not meet the definition of a lease based on an evaluation of the guidance in Issue 01-8.

There are no continuing cash inflows as a result of the continuation of activities since no revenue will be recognized by the ongoing entity as a direct result of the disposal transaction. The ongoing entity estimates that the continuing cash outflows as a result of a continuation of activities (the outsourcing arrangement) will result in the ongoing entity recognizing $50 thousand in costs to provide product for the company-owned retail stores. The ongoing entity
estimates that the disposed component would have recognized $1 million of costs to manufacture product for the third-party customers and the company-owned retail stores.

**Evaluation:**

Step 1: Are continuing cash flows expected to be generated by the ongoing entity? Yes. Continuing cash flows are being generated from the purchasing of manufactured product from the disposed component.

Step 2: Do the continuing cash flows result from a migration or continuation of activities? Yes. The continuing cash flows are the result of a continuation of activities between the ongoing entity and the disposed component since the ongoing entity will purchase manufactured product from the disposed component. Therefore, an evaluation of the significance of the continuing cash flows must be performed.

Step 3: Are the continuing cash flows significant? No. The ongoing entity estimates that the continuing cash outflows will approximate 5 percent of the cash outflows that would have been recognized by the disposed component. The ongoing entity believes that 5 percent is not significant.

Step 4: Does the ongoing entity have significant continuing involvement in the operations of the disposed component? No. The outsourcing agreement likely will not result in the ongoing entity having significant continuing involvement in the operation of the manufacturing facility after it is sold based on the following:

a. The agreement is not significant to the overall operations of the disposed component since the ongoing entity will be purchasing only 5 percent of the output from the facility

b. The extent to which the ongoing entity is involved in the operations of the disposed component is limited to its ability to purchase bicycles for a period of 10 years

c. The rights conveyed by the agreement are customary

d. The outsourcing agreement is at market.

Conclusion: Since the continuing cash flows are considered indirect cash flows and the ongoing entity will not have significant continuing involvement in the operations of the disposed component, classification as a discontinued operation would be appropriate.
Example 8
An entity manufactures and sells specialized brand-name furniture through its company-owned and dealer-owned retail stores. For that entity, each of the company-owned retail stores is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, each 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 (principally, labor and rental costs). The entity decides to remain in the furniture manufacturing business but will sell its retail operations to its dealers and commits to a plan to sell those retail stores. The retail stores are classified as held for sale at that date. The entity will sell the retail stores and will enter into a supply arrangement to supply all of the specialized brand-name furniture to the dealers which include the stores that were previously company-owned stores.

The entity estimates that continuing cash inflows as a result of a continuation of activities (selling furniture) will result in the ongoing entity recognizing $10 million of revenue from the sale of furniture to dealers. The entity estimates that the disposed component would have recognized $11 million from the sale of furniture to the individual customers through the company owned retail stores.

*Evaluation:*
Step 1: Are continuing cash flows expected to be generated by the ongoing entity? Yes. Continuing cash flows are being generated from the sale of product to the disposed component.
Step 2: Do the continuing cash flows result from a migration or continuation of activities? Yes. The continuing cash flows are the result of a continuation of activities between the ongoing entity and the disposed component since the ongoing entity will sell manufactured product to the disposed component. Therefore, an evaluation of the significance of the continuing cash flows must be performed.
Step 3: Are the continuing cash flows significant? Yes. The entity estimates that the continuing cash inflows will approximate 91 percent of the cash inflows that would have been recognized.
by the component absent the disposal transaction. The entity believes that 91 percent is significant.

Conclusion: The continuing cash flows should be considered direct cash flows of the disposed component due to the significant cash inflows that are expected to be recognized by the ongoing entity as a result of the sale of manufactured product to the disposed component. An evaluation of cash outflows is not necessary. Since the continuing cash flows are considered direct cash flows, classification as a discontinued operation would not be appropriate. An evaluation of continuing involvement is not necessary.

Example 9
An entity mines, refines, and smelts aluminum that is sold to third-party customers and is used in the entity's fabrication business. For that entity, the manufacturing (which includes the mining, refining, and smelting operations) and fabrication businesses are the lowest levels at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, the manufacturing and fabrication businesses each represent components of the entity.

The entity has experienced losses in its fabrication operation resulting from an increase in costs (principally, labor costs). The entity decides to remain in the aluminum manufacturing business but will sell its fabrication operation. The fabrication operation is classified as held for sale at that date. The entity will sell the fabrication business and will enter into a 5 year supply arrangement with the buyer to supply all of the aluminum requirements to the disposed component at market rates, which is expected to be approximately 3 percent of the output of the manufacturing business. The terms of the supply agreement are customary and it does not provide the ongoing entity with the ability to otherwise be involved in the operations of the disposed component.

The entity estimates that continuing cash inflows as a result of a continuation of activities (selling aluminum) will result in the ongoing entity recognizing $300 thousand of revenue from the sale of aluminum to the disposed component. The entity estimates that the disposed
component would have recognized $10 million of revenue from the sale of fabricated aluminum to third-party customers absent the disposal transaction.

The entity estimates that continuing cash outflows as a result of a continuation of activities (selling aluminum) will result in the ongoing entity recognizing $150 thousand of costs associated with the production of the aluminum to be sold to the disposed component. The entity estimates that the disposed component would have recognized $12 million of costs associated with the fabrication of aluminum to be sold to third-party customers absent the disposal transaction.

**Evaluation:**
Step 1: Are continuing cash flows expected to be generated by the ongoing entity? Yes. Continuing cash flows are being generated as a result of the selling of product to the disposed component.
Step 2: Do the continuing cash flows result from a migration or continuation of activities? Yes. The continuing cash flows are the result of a continuation of activities between the ongoing entity and the disposed component since the ongoing entity will sell raw materials to the disposed component. Therefore, an evaluation of the significance of the continuing cash flows must be performed.
Step 3: Are the continuing cash flows significant? No. The entity estimates that the continuing cash inflows will approximate 3 percent of the cash inflows and 1 percent of the cash outflows that would have been recognized by the disposed component absent the disposal transaction. The entity believes that 3 percent and 1 percent are not significant.
Step 4: Does the ongoing entity have significant continuing involvement in the operations of the disposed component? The supply agreement likely will not result in the ongoing entity having significant continuing involvement in the operation of the fabrication business after it is sold based on the following:
  a. The agreement is not significant to the overall operations of the disposed component since the ongoing entity will be selling only 3 percent of the output from the facility
  b. The extent to which the ongoing entity is involved in the operations of the disposed component is limited to the ability to sell aluminum for a period of 5 years
c. The rights conveyed by the agreement are customary
d. The outsourcing agreement is at market.

Conclusion: Since the continuing cash flows are considered indirect cash flows and the ongoing entity will not have significant continuing involvement in the operations of the disposed component, classification as a discontinued operation would be appropriate.

**Example 10**

An entity is a manufacturer and distributor of medical devices. For that entity, the medical device operation is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, the medical device operation is a component of the entity.

The entity sells the medical device operations to a third party buyer. In conjunction with the sale, the ongoing entity and the buyer enter into a 5 year royalty agreement that provides the ongoing entity with the right to receive a royalty fee from the buyer equal to 10 percent of net income generated from the sale of medical devices that were sold previously by the entity. The terms of the royalty agreement are customary and it does not provide the ongoing entity with the ability to be otherwise involved in the operations of the disposed component.

**Evaluation:**

Step 1: Are continuing cash flows expected to be generated by the ongoing entity? Yes. Continuing cash flows are being generated as a result of the royalty arrangement.

Step 2: Do the continuing cash flows result from a migration or continuation of activities? No. The royalty agreement does not provide for a migration nor does it provide for a continuation of activities. The revenue producing-activities and cost-generating activities of the component before the disposal transaction were the manufacturing and sale of medical devices. The ongoing entity will not continue any of these activities after the disposal transaction and, therefore, the cash flows associated with the royalty fee are indirect cash flows. Accordingly, an evaluation of the significance of the continuing cash flows is not necessary. An evaluation of continuing involvement must be performed.
Step 3: Does the ongoing entity have significant continuing involvement in the operations of the disposed component? The royalty arrangement would likely not constitute significant continuing involvement based on the following:

a. The royalty agreement is not significant to the overall operations of the disposed component since the royalty is only 10 percent of net income
b. The extent to which the ongoing entity is involved in the operations of the disposed component is limited to the ability to receive a royalty for a period of 5 years
c. The rights conveyed by the agreement are customary for these types of agreements.

Conclusion: Since the continuing cash flows are considered indirect cash flows and the ongoing entity will not have significant continuing involvement in the operations of the disposed component, classification as a discontinued operation would be appropriate.

**Example 11**

An entity that is a franchisor in the quick-service restaurant business also operates company-owned restaurants. For that entity, an individual company-owned restaurant is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, each company-owned restaurant is a component of the entity.

Based on its evaluation of the ownership mix of its system-wide restaurants in certain markets, the entity commits to a plan to sell its company-owned restaurants in one region to an existing franchisee. The restaurants are classified as held for sale at that date. The ongoing entity will enter into a franchise agreement that will provide them the right to sell product to the restaurants in addition to receiving franchise fees determined, in part, based on the future revenues of the restaurants. The entity estimates that the continuing cash inflows from the sale of product will approximate 20 percent of the cash inflows while the franchise fee will approximate 5 percent of the cash inflows that would have been recognized by the disposed component absent the disposal transaction. The entity believes 25 percent is significant.
**Evaluation:**

Step 1:  Are continuing cash flows expected to be generated by the ongoing entity?  Yes. Continuing cash flows are being generated from the sale of product and the franchise fee.

Step 2:  Do the continuing cash flows result from a migration or continuation of activities?  Yes. The continuing cash flows are the result of a continuation of activities between the ongoing entity and the disposed component since the ongoing entity will sell product to the disposed component and will provide franchise services to the disposed component. The ongoing entity sold product prior to the disposal transaction and performed franchise services on its own behalf prior to the disposal transaction. Therefore, an evaluation of the significance of the continuing cash flows must be performed.

Step 3:  Are the continuing cash flows significant?  Yes. The entity estimates that the continuing cash inflows will approximate 25 percent of the cash inflows that would have been recognized by the disposed component absent the disposal transaction. The entity believes that 25 percent is significant.

Conclusion: The continuing cash flows should be considered direct cash flows of the disposed component due to the significant cash inflows that are expected to be recognized by the ongoing entity as a result of the sale of product to the disposed component and the franchise fee. An evaluation of cash outflows is not necessary. Since the continuing cash flows are considered direct cash flows, classification as a discontinued operation would not be appropriate. An evaluation of continuing involvement is not necessary.

**Example 12**

An entity that is a franchisor in the quick-service restaurant business also operates company-owned restaurants. For that entity, an individual company-owned restaurant is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, each company-owned restaurant is a component of the entity.

Based on its evaluation of the ownership mix of its system-wide restaurants in certain markets, the entity commits to a plan to sell its company-owned restaurants in one region to an existing franchisee. The restaurants are classified as held for sale at that date. The ongoing entity will
enter into a franchise agreement that will provide them the right to receive franchise fees determined, in part, based on the future revenues of the restaurants. The entity estimates that the continuing cash inflows from the franchise fee will approximate five percent of the cash inflows that would have been recognized by the disposed component absent the disposal transaction. The entity believes five percent is insignificant.

_Evaluation:_

Step 1: Are continuing cash flows expected to be generated by the ongoing entity? Yes. Continuing cash flows are being generated from the franchise fee.

Step 2: Do the continuing cash flows result from a migration or continuation of activities? Yes. The continuing cash flows are the result of a continuation of activities between the ongoing entity and the disposed component since the ongoing entity will provide franchise services to the disposed component. The ongoing entity performed franchise services on its own behalf prior to the disposal transaction. Therefore, an evaluation of the significance of the continuing cash flows must be performed.

Step 3: Are the continuing cash flows significant? No. The entity estimates that the continuing cash inflows will approximate five percent of the cash inflows that would have been recognized by the disposed component absent the disposal transaction. The entity believes that five percent is insignificant.

Step 4: Does the ongoing entity have significant continuing involvement in the operations of the disposed component? The franchise arrangement would likely constitute significant continuing involvement. Although the franchise agreement is only five percent of net sales, the ongoing entity is actively involved in the operations of the disposed component through the franchise agreement.

Conclusion: Although the continuing cash flows generated by the franchisee agreement are indirect cash flows, the franchise agreement provides the ongoing entity significant continuing involvement in the ongoing operations of the disposed component. Therefore, classification as a discontinued operation would not be appropriate.