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November 3, 2004

TO: MEMBERS OF THE FASB EMERGING ISSUES TASK FORCE

Attached is the Issue Summary Supplement for EITF Issue No. 03-13, "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." Included in the appendix to this Supplement is a marked draft abstract that incorporates many of the comments from Task Force members and constituents on the draft abstract that was posted to the FASB website on October 15, 2004. Additionally, included in the Supplement is a list of issues that the FASB staff believes should be addressed by the Task Force at the November 17–18, 2004 meeting. The objective of this meeting is to (1) discuss the issues outlined in the Supplement, (2) discuss any other comments Task Force members may have on the draft abstract, and (3) determine whether a consensus can be reached by the Task Force.

If you have any questions or comments, please call me at (203) 956-5376.

Sincerely,

Randall Sogoloff
Practice Fellow

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. 4*

Date Prepared: September 1, 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

Previously Distributed EITF Materials: Working Group Report No. 1 (Issue Summary No. 1), dated September 29, 2003; Working Group Report No. 2 (Issue Supplement No. 1), dated March 4, 2004; Working Group Report No. 3 (Issue Supplement No. 2), dated June 14, 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)

FASB Statement No. 57, *Related Party Disclosures* (FAS 57)

International Financial Reporting Standard No. 5, *Non-current Asset Held for Sale and Discontinued Operations* (IFRS 5)

* **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 and it is ratified by the Board.**

Background

1. At the September 29–30, 2004 EITF meeting, the Task Force reached a tentative conclusion on an approach for evaluating whether the criteria in paragraph 42 of FAS 144 have been met for purposes of classifying the results of operations of a component of an entity that either has been disposed of or is classified as held for sale as discontinued operations. Additionally, the Task Force requested that the FASB staff incorporate into that approach six other tentative conclusions reached at the September EITF meeting. The revised approach, which incorporates all of those tentative conclusions, is included in the attached draft abstract as Appendix 03-13A. That draft abstract also incorporates comments from Task Force members and constituents and has been marked for changes.

2. The Task Force also reached a tentative conclusion that the consensus would be applied to a component of an enterprise that is either disposed of or classified as held for sale in fiscal periods beginning after December 15, 2004. Previously reported operating results related to disposal transactions initiated within an enterprise's fiscal year that includes the date that this consensus is ratified may be reclassified to reflect the consensus.

3. Based on the Task Force's request, the FASB staff posted the draft abstract to the FASB website on October 15, 2004, for a 15-day comment period. The FASB staff received comment letters from the National Association of Real Estate Investment Trusts (NAREIT) and Pfizer, Inc.

4. The comment letter from NAREIT states that "the cash inflows and/or outflows eliminated by dispositions of many investment properties are replaced through the acquisition of like-kind properties and, therefore, reporting these regular dispositions as discontinued operations does not faithfully represent the financial impact of the business transaction on the reporting entity." This constituent believes that the Task Force should consider broadening its evaluation of issues created by reporting regular, insignificant dispositions as discontinued operations—especially when cash flows from disposed properties are replaced through the acquisition of similar properties. This constituent also requests that the Task Force consider expanding the discussion to clarify that the guidance may be applicable to components whose cash flows are replaced by

cash flows from similar components—regardless of the similarity of customers and geographic region. The constituent points out that the International Accounting Standards Board recently issued IFRS 5 in which it concluded that discontinued operations should be a major line of business or geographical area of operations.

5. The comment letter from Pfizer states that "the Assessment Period guidance should be modified to allow treatment as discontinued operations when the entity has the intent and ability to eliminate the operations and cash flows within a timeframe that is appropriate in consideration of the facts and circumstances of the transaction." The constituent believes this modification is necessary in order to address industries, such the pharmaceutical industry, that have strict regulations governing the manufacture of products, which has implications for how quickly manufacturing operations may be transitioned from the buyer to the seller. Additionally, the constituent believes an additional example should be included in the draft abstract that illustrates application of the proposed changes to the assessment period language. The constituent also suggests editorial changes to certain paragraphs in the draft abstract.

6. The FASB staff believes that the Task Force should consider the following four issues raised by constituents:

a. Should the consensus permit entities to report insignificant dispositions that meet the criteria in paragraph 42 of FAS 144 in continuing operations as opposed to discontinued operations?

The FASB staff believes the consensus should not include an exception that would permit entities to report insignificant dispositions in continuing operations that otherwise qualify as discontinued operations. FAS 144 does not include an exception for insignificant components and, accordingly, the question is outside the scope of this project and therefore should not be addressed in the final consensus.

b. Should the definition of migration in footnote 3 be changed to include components whose cash flows are replaced by cash flows from similar components—regardless of the similarity of customers and geographic region?

The FASB staff believes the definition of migration in footnote 3 should not be changed to include components whose cash flows are replaced by cash flows from similar components. This proposed modification is not consistent with the underlying principal with respect to a migration. As discussed in paragraph 7 of the draft abstract, a migration relates to instances in which the ongoing entity is expected to recognize revenues or costs that likely would have been generated by the disposed component absent the disposal transaction. An ongoing entity would not necessarily be recognizing revenues or costs that would have been generated by the disposed component if the cash flows are replaced by cash flows of similar components. For example, an entity owns a retail store and decides to build another retail store in a different geographic area. The entity sells the existing retail store and continues to sell similar goods to similar customers as the sold retail store (not specific customers of the sold retail store) through the new retail store location. If the definition of migration was changed, this situation would meet the definition of a migration even though a migration of specific customers from the sold retail store to the new retail store has not occurred. Therefore, the FASB staff recommends the Task Force retain the current definition of migration.

c. Should the assessment period guidance be modified to allow treatment as discontinued operations when the entity has the intent and ability to eliminate the operations and cash flows within a timeframe that is appropriate in consideration of the facts and circumstances of the transaction?

The FASB staff believes the Task Force should consider whether to include language that would allow an assessment period of greater than one year if events or circumstances beyond an entity's control extend the period required to eliminate the direct cash flows or significant continuing involvement beyond one year.

d. Should the evaluation of whether the conditions for a component that is either disposed of or classified as held for sale at the balance sheet date include significant events or circumstances that occur after the balance sheet date but before the issuance of the financial statements? For example, assume a company with a September 30 fiscal year end determined at March 31, 2004, that a component met the criteria in FAS 144 for recognition (classification) and measurement as held for sale. Company management, at March 31, 2004, June 30, 2004, and September 30, 2004, based on an assessment of all then available information, determined that the criteria in paragraph 42 of FAS 144 would not be met. After the balance sheet date of September 30, 2004, but before issuance of the financial statements, the company determined, based on developments subsequent to September 30, 2004, that the criteria in paragraph 42 would now be met in connection with the disposal. Should the company report the component's operations as discontinued operations in the September 30, 2004 financial statements?

The FASB staff considered the practicability issues resulting from a continuous assessment up to the date of the issuance of the financial statements but believes the evaluation of whether the conditions for a component that is either disposed of or classified as held for sale at the balance sheet date should include significant events or circumstances that occur after the balance sheet date but before the issuance of the financial statements. This provides the most meaningful presentation to the user of the financial statements. The staff has incorporated language consistent with this view into paragraph 13 of the draft abstract.

Appendix 03-13A

***EITF Abstracts* (DRAFT[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; November 17–18, 2004

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

FASB Statement No. 57, *Related Party Disclosures*

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

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 (the "ongoing entity"). Specifically, which cash flows of the disposed component have to be eliminated from the ongoing operations of the entity? Additionally, questions have been raised about the types of continuing involvement that

[1] This draft abstract was prepared to facilitate discussion of the guidance on which the Task Force reached its tentative conclusions and contains all substantive aspects of the tentative conclusions. The final abstract, which will be included in the next update for *EITF Abstracts,* may contain nonsubstantive editorial revisions.

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* <u>(that is, not direct)</u>, 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

[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.

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 are 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 are considered direct cash flows if:

c. Significant cash outflows are expected to be recognized by the ongoing entity as a result of a

[3] The term *migration* means the ongoing entity expects to continue to generate revenues and (or) incur expenses from the sale of similar products or services to specific customers of the disposed component. An entity is not required to track the identity of the individual customers who are expected to migrate in order to conclude a migration has occurred ~~perform a quantitative assessment to conclude that a migration has occurred~~ (for example, an entity that closes several smaller retail stores and opens a superstore in the immediate area would likely conclude ~~based on a qualitative assessment~~ that a migration of specific retail customers is expected, even if the entity has not tracked the identity of all its individual customers). There is a presumption that if the ongoing entity continues to sell a similar commodity on an active market after the disposal transaction, the revenues and (or) costs would be considered a "migration." This presumption may be overcome based on facts and circumstances, such as the lack of similarity of the commodities ~~and~~or whether the sale of the commodity after the disposal transaction occurs in a different geographic region as compared to the sale of the commodity before the disposal transaction. For purposes of this Issue, the term *commodity* means products whose units are interchangeable and are traded on a commodity exchange and therefore have an immediate marketability at quoted prices.

[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 or purchased products or services ~~to (~~from~~)~~ the disposed component before its disposal (recognized as intercompany sales or cost of sales) and it continues to sell ~~or purchase~~ similar products or services to or purchase similar products or services ~~(~~from~~)~~ the disposed component or a related party, as defined in Statement 57, to the disposed component after its disposal (recognized as sales or cost of sales). After the disposal transaction, the former intercompany sales or cost of sales are no longer eliminated in consolidation, which will result in continuing cash inflows or outflows to the ongoing entity.

migration[5] of costs from the disposed component after the disposal transaction; or

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 should 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 generated 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 by the ongoing entity from either a migration or a continuation of activities, the ongoing entity should 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 should 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 recognized from seller-provided financing, (b) contingent consideration in a business combination, (c) dividends on an investment, and (d) a passive royalty interest in the disposed component's operations.

[5] Refer to footnote 3.
[6] Refer to footnote 4.

Significance of Continuing Cash Flows

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 will be significant. The evaluation as to whether continuing cash flows would be significant is a matter of judgment and should be based on a comparison between the expected continuing cash flows to be generated by the ongoing entity after the disposal transaction and the cash flows that would have been expected to be generated by the disposed component absent the disposal transaction. The cash flows that would have been expected to be generated 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~~income 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 should 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 that 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 the ability to influence the operating and (or) financial policies of the disposed component. The retention of risk or the ability to obtain benefits should be considered in the overall evaluation of

whether the ongoing entity has the ability to influence the operating and (or) financial policies of the disposed component. However, the retention of risk or the ability to obtain benefits associated with the ongoing operations of the disposed component does not indicate by itself that the ongoing entity has the ability to influence the operating and (or) financial policies of the disposed component resulting in continuing involvement. An interest in the disposed component or the existence of a contractual arrangement or other type of arrangement with the disposed component should be evaluated to determine whether the ongoing entity has continuing involvement with the disposed component.

10. The determination as to whether the continuing involvement is significant should be based on ~~a~~ quantitative and qualitative assessments 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 interest[8] in the disposed component sufficient to enable the ongoing entity to exert significant influence over the disposed component's operating and financial policies. An interest that provides the ongoing entity with 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 with significant influence over the disposed component's operating and financial policies. A cost method investment in common stock or in-substance common stock alone would not be considered significant continuing involvement.

[7] The guidance in this paragraph 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's holding of a call option to acquire an interest in the disposed component may be a form of continuing involvement. If the call option represents a form of continuing involvement, the determination of 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.

b. The ongoing entity and the buyer (or the disposed component) are parties to a contract or otherwise parties to an arrangement that in substance enables the ongoing entity to exert significant influence over the disposed component's operating and financial policies. Judgment is required in evaluating whether a contract or an arrangement constitutes significant continuing involvement, and all available information should be considered in performing the related analysis. The following factors should be considered in that regard; however, no one factor should be considered presumptive or determinative:
   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.

12. The circumstances discussed in paragraph 44 of Statement 144 would not constitute continuing cash flows or continuing involvement. Examples include the following:

a. The resolution of contingencies that arise pursuant to the terms of the disposal transaction, such as the resolution of purchase price adjustments and indemnification issues with the purchaser
b. The resolution of contingencies that arise from and that are directly related to the operations of the component prior to its disposal, such as environmental and product warranty obligations retained by the seller
c. The settlement of employee benefit plan obligations (pension, postemployment benefits other than pensions, and other postemployment benefits), provided that the settlement is directly related to the disposal transaction.

Assessment Period

13. The Task Force reached a consensus that the appropriate assessment period should include the point at which the component initially meets the criteria to be classified as held for sale <u>or is</u>

disposed of through one year after the date the component is actually disposed of. The assessment should be based on all facts and circumstances, including management's intent and ability to (a) eliminate the cash flows of the disposed component from its operations and (b) not have significant continuing involvement in the operations of the disposed component. For one year after a component has been disposed of, an entity ~~is required to~~ should reassess whether the criteria in paragraph 42 are expected to be met only when ~~only~~ significant events or circumstances occur that may change its current assessment. If the occurrence of a significant event or circumstance at any time during the assessment period results in an expectation that the criteria in paragraph 42 will not be met by the end of the assessment period, the component's operations should not be presented as discontinued operations. If the occurrence of a significant event or circumstance at any time during the assessment period results in an expectation that the criteria in paragraph 42 will be met by the end of the assessment period, the component's operations should be presented as discontinued operations. Reclassification into and out of discontinued operations for all periods presented may be required during the assessment period. The evaluation of whether the criteria in paragraph 42 are expected to be met for a component that is either disposed of or classified as held for sale at the balance sheet date should include significant events or circumstances that occur after the balance sheet date but before the issuance of the financial statements.

14. 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

15. The following information should 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, for each discontinued operation ~~in situations~~ in which the ongoing entity will engage in a "continuation of activities" with the disposed component after its disposal and the amounts presented in continuing

operations after the disposal transaction include a continuation of revenues and expenses that were intercompany transactions (eliminated in consolidated financial statements) before the disposal transaction, those amounts should be disclosed for all periods presented for comparability purposes. The types of continuing involvement, if any, that the entity will have after the disposal transaction should be disclosed. That information should be disclosed in the period in which operations are initially classified as discontinued.

Transition

16. The consensus should be applied to a component of an enterprise that is either disposed of or classified as held for sale in fiscal periods beginning after December 15, 2004. Previously reported operating results related to disposal transactions initiated within an enterprise's fiscal year that includes the date that this consensus is ratified may be reclassified to reflect the consensus.

Board Ratification

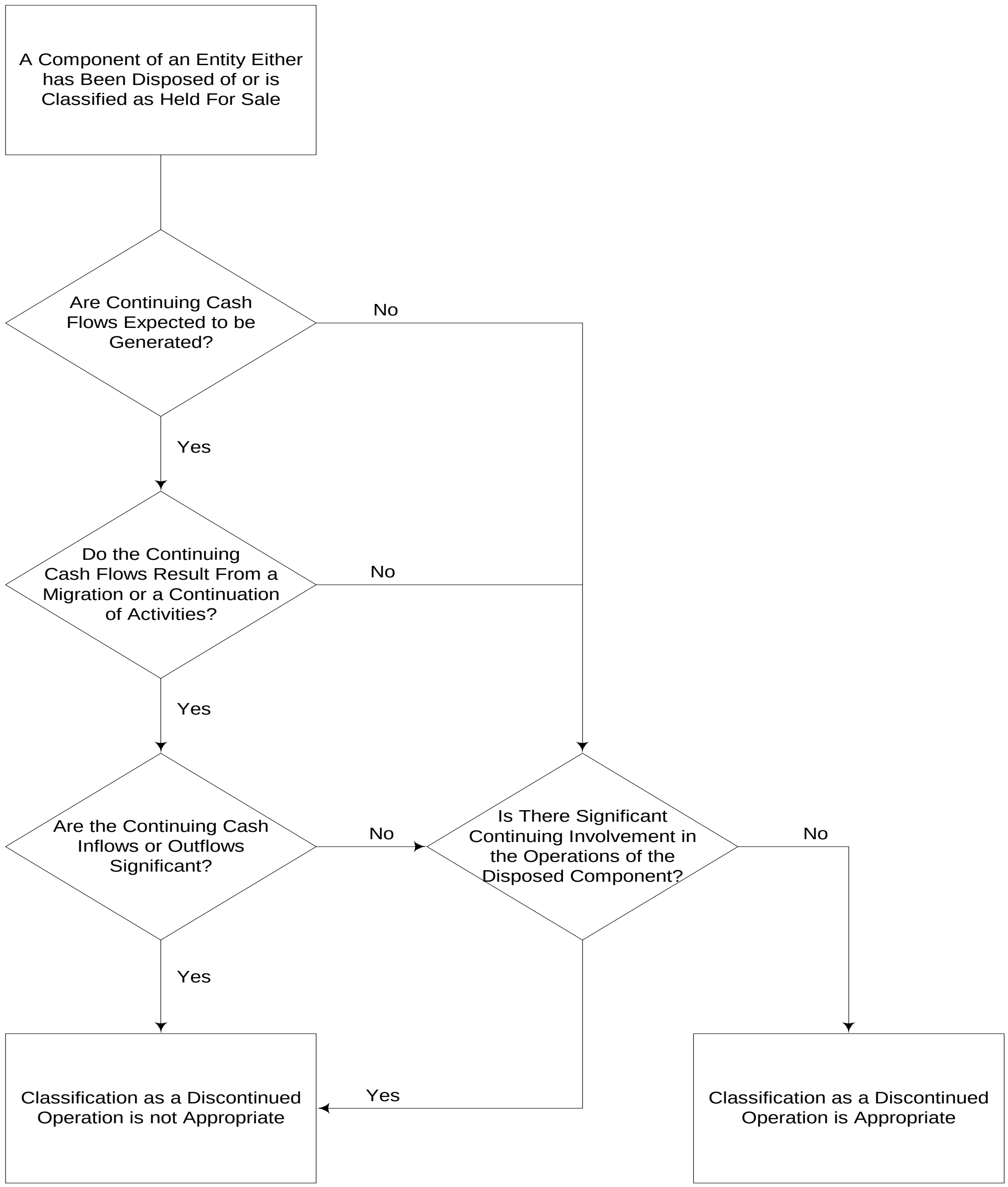
17. At its November 30, 2004 meeting, the Board ratified the consensus reached by the Task Force in this Issue.

STATUS

18. No further EITF discussion is planned.

Exhibit 03-13A

DETERMINING WHEN A COMPONENT SHOULD BE CLASSIFIED AS A DISCONTINUED OPERATION[9]



[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. The diagram is a visual supplement to the written consensus. It should be neither interpreted to alter any requirements of the consensus nor considered a substitute for its requirements.

Exhibit 03-13B

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 2 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 generated $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 by the ongoing entity from transactions with 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 sells products similar to those sold in 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 generated by each of 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 components due to the significant cash inflows that are expected to be generated 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 generated $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 by the ongoing entity from transactions with 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 sells products similar to those sold in 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 generated 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 generated $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 generated $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 by the ongoing entity resulting from the management agreement.

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, before 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 generated 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 generated 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 generated 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 in an active market. 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 in the same geographic region and expects to sell the same amount and type of crude oil extracted from this new field as it did from the sold oil field to the same market. The ongoing entity will not have any involvement in the operations of the sold oil field after 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, since the ongoing entity will continue to sell a similar type of oil to the same market.

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 there is a presumption that the ongoing entity continuing to sell a similar commodity in an active market after the disposal transaction would be considered a migration. This presumption may be overcome based on facts and circumstances. The new oil field is located in the same geographic region as the sold oil field and will be selling a similar type of crude oil to the same market. Therefore, the presumption that a migration has occurred cannot be overcome, and 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 will be selling the same amount of crude oil from the new oil field and therefore estimates that the continuing cash inflows will approximate 100 percent of the cash inflows that would have been generated absent the disposal transaction. 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 generated 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 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, which provides the seller with recourse to the buyer's assets. 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 revenues or incur costs from specific customers who have migrated from the disposed component, since the lessees of the disposed component are not expected to terminate their leases and migrate to the new building. Additionally, there will not be any continuation of activities between the ongoing entity and the sold building. That is, the interest income recognized is from an activity that is different in nature from the activities of leasing and managing space in a building. Accordingly, an evaluation of the significance of the continuing cash flows is not necessary. An evaluation of continuing involvement should 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 the ability to significantly influence the operating and (or) financial policies of the disposed component 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 to the buyer's assets, and the buyer is considered to have high-credit quality.
b. The extent to which the 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 do not enable the ongoing entity to exert significant influence over the disposed component.

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 6

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 agreement will allow the ongoing entity to purchase 5 percent of the output from the facility at market rates for a period of 10 years, which will 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 from 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 EITF Issue No. 01-8, "Determining Whether an Arrangement is a Lease."

There are no continuing cash inflows as a result of the continuation of activities, since no revenue will be generated 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 generated $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 by the ongoing entity resulting 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 should 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 generated 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 the ability to significantly influence the operating and (or) financial policies of the disposed component 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 do not enable the ongoing entity to exert significant influence over the disposed component.

d. The outsourcing agreement is priced at market rates.

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 manufactures and sells furniture through its company-owned and dealer-owned retail stores. These company-owned and dealer-owned stores also purchase furniture from third-parties. 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 furniture to the dealer-owned stores, 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 the dealers that have acquired the company-owned stores. The entity estimates that the disposed component would have generated $11 million from the sale of furniture 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 by the ongoing entity resulting 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 should 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 generated 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 generated 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 8

An entity mines, refines, and smelts aluminum that is sold to third-party customers and 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 approximately 10 percent of the aluminum requirements to the disposed component at market rates. The terms of the supply agreement are customary, and the agreement 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 generated $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 $250 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 generated $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 by the ongoing entity resulting 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 aluminum~~raw materials~~ to the disposed component. Although aluminum is considered a commodity, the continuing cash flows would not be considered a migration since the ongoing entity does not expect to continue to generate revenues and (or) incur expenses from the sale of aluminum to specific customers of the disposed component nor is it selling the aluminum on an active market. Rather, the ongoing entity will continue to sell aluminum to the disposed component resulting in a continuation of activities. Therefore, an evaluation of the significance of the continuing cash flows should 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 2 percent of the cash outflows that would have been generated by the disposed component absent the disposal transaction. The entity believes that 3 percent and 2 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 the ability to significantly influence the operating and (or) financial policies of the disposed component 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 10 percent of the disposed component's aluminum requirements.
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 five years.
c. The rights conveyed by the agreement do not enable the ongoing entity to exert significant influence over the disposed component.
d. The 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 9

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 revenues generated from the sale of medical devices that were sold previously by the entity. The terms of the royalty agreement do 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 resulting from 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 those activities after the disposal transaction; 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 should 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 provide the ongoing entity with the ability to significantly influence the operating and (or) financial policies of the disposed component based on the following:

a. The royalty agreement is not significant to the overall operations of the disposed component.

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 payment.~~for a period of 5 years.~~

c. The rights conveyed by the agreement do not enable the ongoing entity to exert significant influence over the disposed component.

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 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 it with 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 generated by the disposed component absent the disposal transaction.

Evaluation:

Step 1: Are continuing cash flows expected to be generated by the ongoing entity? Yes. Continuing cash flows would be generated by the ongoing entity 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 services similar to franchise services on its own behalf prior to the disposal transaction. Therefore, an evaluation of the significance of the continuing cash flows should 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 generated 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 generated 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 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 with 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 5 percent of the cash inflows that would have been generated by the disposed component 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 by the ongoing entity from the franchise agreement.

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 services similar to the franchise services on its own behalf prior to the disposal transaction. Therefore, an evaluation of the significance of the continuing cash flows should be performed.

Step 3: Are the continuing cash flows significant? No. The entity estimates that the continuing cash inflows will approximate 5 percent of the cash inflows that would have been generated by the disposed component absent the disposal transaction. The entity believes that 5 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 5 percent of net sales, the ongoing entity is actively involved in the operations of the disposed component through the franchise agreement and, therefore, would have the ability to significantly influence the operating and (or) financial policies of the disposed component.

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