Financial reporting developments
A comprehensive guide

Discontinued operations

Accounting Standards Codification 205-20
(prior to the adoption of ASU 2014-08, Reporting Discontinued Operations and Disclosure of Disposals of Components of an Entity)

Revised May 2017
To our clients and other friends

ASC 205-20, *Presentation of Financial Statements – Discontinued Operations*, provides guidance on the presentation and disclosure of discontinued operations, including criteria for determining when the presentation of discontinued operations is appropriate. Separate reporting of discontinued operations is important in providing users of financial statements the information necessary to determine the effects of a disposal transaction on the ongoing operations of an entity.

This publication is designed to assist professionals in understanding the accounting for discontinued operations prior to the adoption of Accounting Standards Update 2014-08, *Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity*. The publication reflects our current understanding of the existing guidance based on our experience with financial statement preparers and related discussions with the staff of the FASB and SEC. Ernst & Young professionals are prepared to help you identify and understand the issues related to the accounting for discontinued operations.

Ernst & Young LLP

May 2017
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Notice to readers:

This publication includes excerpts from and references to the FASB Accounting Standards Codification (the Codification or ASC). The Codification uses a hierarchy that includes Topics, Subtopics, Sections and Paragraphs. Each Topic includes an Overall Subtopic that generally includes pervasive guidance for the topic and additional Subtopics, as needed, with incremental or unique guidance. Each Subtopic includes Sections that in turn include numbered Paragraphs. Thus, a Codification reference includes the Topic (XXX), Subtopic (YY), Section (ZZ) and Paragraph (PP).

Throughout this publication references to guidance in the codification are shown using these reference numbers. References are also made to certain pre-codification standards (and specific sections or paragraphs of pre-Codification standards) in situations in which the content being discussed is excluded from the Codification.

This publication has been carefully prepared but it necessarily contains information in summary form and is therefore intended for general guidance only; it is not intended to be a substitute for detailed research or the exercise of professional judgment. The information presented in this publication should not be construed as legal, tax, accounting, or any other professional advice or service. Ernst & Young LLP can accept no responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. You should consult with Ernst & Young LLP or other professional advisors familiar with your particular factual situation for advice concerning specific audit, tax or other matters before making any decisions.
1 Overview and scope

Note: In April 2014, the FASB issued Accounting Standards Update (ASU) 2014-08, Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity, which raises the threshold for a disposal to qualify as a discontinued operation and requires new disclosures of both discontinued operations and certain other disposals that do not meet the definition of a discontinued operation. The new definition of a discontinued operation under ASU 2014-08 more closely aligns US GAAP with IFRS.

For public business entities and not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or an over-the-counter market, ASU 2014-08 is effective for annual periods beginning on or after 15 December 2014 and interim periods within those years. For other entities, it is effective for annual periods beginning on or after 15 December 2014 and interim periods within annual periods beginning on or after 15 December 2015. The ASU is applied prospectively. Early adoption is permitted but only for disposals (or classifications as held for sale) that have not been reported in financial statements previously issued or available for issue.

Refer to our FRD on Discontinued Operations — Accounting Standards Codification 205-20 (following the adoption of ASU 2014-08, Reporting Discontinued Operations and Disclosure of Disposals of Components of an Entity) for further guidance.

1.1 Overview

Excerpt from Accounting Standards Codification

Presentation of Financial Statements — Discontinued Operations

Overview and Background

205-20-05-1

This Subtopic provides guidance on when the results of operations of a component of an entity that either has been disposed of or is classified as held for sale would be reported as a discontinued operation in the financial statements of the entity. It also addresses the allocation of interest and overhead to discontinued operations. Subtopic 360-10 establishes held for sale criteria in paragraphs 360-10-45-9 through 45-14.

Reporting discontinued operations separately from continuing operations is intended to provide investors, creditors and others with information to help assess the effects of disposal transactions on the ongoing operations of an entity.

In order to qualify as a discontinued operation, the disposal group must meet all of the following criteria:

- The disposal group must qualify as a component of an entity (see Section 2, Component of an entity)
- Both of the following conditions are met or expected to be met by the end of the assessment period (see Section 3.6, Assessment period):
  - The operations and cash flows of the component have been or will be eliminated from the ongoing operations of the entity in the disposal transaction (see Sections 3.1, 3.2 and 3.3)
  - The entity will not have any significant continuing involvement in the operations of the component after the disposal transaction (see Section 3.4, Step 4: Significant continuing involvement)
Under ASC 205-20, the results of operations of a component of an entity to be disposed of by sale may not be classified as discontinued until the held for sale criteria are met. For disposals other than by sale (e.g., abandonment, distribution or exchange for similar productive assets), the results of operations of a component of an entity would not be recorded as a discontinued operation until the period in which the long-lived asset or disposal group is either abandoned, distributed or exchanged, depending on the manner of disposal.

**Illustration 1-1: Disposals other than by sale**

Assume on 1 June 20X9, the management of LSJU, Inc. commits to a plan to abandon certain long-lived assets that constitute a component of an entity, but the long-lived assets will continue to be used until 30 September 20X9. Because the long-lived assets are to be abandoned (and not sold), LSJU is not subject to the held for sale criteria and is restricted from reclassifying its operations as discontinued as long as the assets are being used. If the long-lived assets cease to be used on 30 September 20X9 (i.e., are abandoned) and the other discontinued operations criteria are met, the operations of the component may be reclassified as discontinued for all periods presented in the financial statements, encompassing the 30 September 20X9 abandonment.

The assets and liabilities of a discontinued operation that is held for sale are to be measured in the same manner as other asset groups that are held for sale (i.e., lower of carrying value or fair value less cost to sell – refer to our FRD, *Impairment or disposal of long-lived assets*, for further details on measurement of asset groups classified as held for sale). However, all initial or subsequent adjustments to the carrying value of the discontinued operation as a result of such measurement, so long as they continue to meet the requirements of a discontinued operation, should be classified in discontinued operations. Future operating losses are not recognized before they occur, even if a gain is expected on disposal.

### 1.2 Scope

**Excerpt from Accounting Standards Codification**

**Presentation of Financial Statements – Discontinued Operations**

**Scope and Scope Exceptions**

205-20-15-1

This Subtopic follows the same Scope and Scope Exceptions as outlined in both the Overall Subtopic; see Section 205-10-15, and paragraph 360-10-15-5, with specific transaction qualifications noted below.

205-20-15-2

The guidance in this Subtopic applies to the following transactions and activities:

a. **Components of an entity** that have been disposed of, or alternatively, have been classified as held for sale under the requirements of paragraph 360-10-45-9.

**Presentation of Financial Statements – Overall**

**Scope and Scope Exceptions**

205-10-15-1

The Scope Section of the Overall Subtopic establishes the pervasive scope for all Subtopics of the Presentation of Financial Statements Topic. Unless explicitly addressed within specific Subtopics, the following scope guidance applies to all Subtopics of the Presentation of Financial Statements Topic.

205-10-15-2

The guidance in the Presentation of Financial Statements Topic applies to business entities and not-for-profit entities (NFPs).
The guidance in ASC 205-20 and the impairment guidance in ASC 360-10 were originally issued as one statement, Statement 144, so both Topics have the same scope exceptions as detailed below.

### Excerpt from Accounting Standards Codification

**Property, Plant, and Equipment – Overall**

**Scope and Scope Exceptions**

**360-10-15-5**

The guidance in the Impairment or Disposal of Long-Lived Assets Subsections does not apply to the following transactions and activities:

a. Goodwill
b. Intangible assets not being amortized that are to be held and used
c. Servicing assets
d. Financial instruments, including investments in equity securities accounted for under the cost or equity method
e. Deferred policy acquisition costs
f. Deferred tax assets
g. Unproved oil and gas properties that are being accounted for using the successful-efforts method of accounting

h. Oil and gas properties that are accounted for using the full-cost method of accounting as prescribed by the Securities and Exchange Commission (SEC) (see Regulation S-X, Rule 4-10, Financial Accounting and Reporting for Oil and Gas Producing Activities Pursuant to the Federal Securities Laws and the Energy Policy and Conservation Act of 1975)

i. Certain other long-lived assets for which the accounting is prescribed elsewhere in the standards:

1. For guidance on financial reporting in the record and music industry, see Topic 928.
2. For guidance on financial reporting in the broadcasting industry, see Topic 920.
3. For guidance on accounting for the costs of computer software to be sold, leased, or otherwise marketed, see Subtopic 985-20.
4. For guidance on accounting for abandonments and disallowances of plant costs for regulated entities, see Subtopic 980-360.

### 1.2.1 Sales of equity method investments

While the scope exceptions in ASC 360-10-15-5 primarily related to the impairment model in ASC 360-10, they also apply to discontinued operations. One practice issue that arose from the interaction of the scope of ASC 205-20 and the scope of the Impairment and Disposal of Long-lived Assets Subsection of ASC 360-10 relates to the classification of sales of equity method investments. At the 14 November 2001 board meeting, the FASB discussed an issue related to the disposal of an investment in equity securities accounted for by the equity method. The FASB clarified that the disposal of an equity method investment, by itself, should not be reported as a discontinued operation. Financial instruments, including investments in equity securities accounted for by the equity or cost method, are excluded from the scope of ASC 205-20. Further, the FASB concluded that the operations related to an equity method
investment (i.e., the investor entity’s share of the earnings or losses of the investee entity) are not sufficient to establish a component of an entity. However, the FASB further clarified that if a component of an entity has operations that included but are not limited to, operations related to an equity method investment or other assets that are excluded from the scope of ASC 205-20, and the conditions for reporting discontinued operations are met, all of the operations of the component should be reported in discontinued operations.

Although the guidance in ASC 205-20 does not apply to sales of non-controlling interests in a consolidated subsidiary, it does apply to sales of controlling interests in a consolidated subsidiary. An issue arises when a parent entity sells its controlling interest in a consolidated subsidiary that is a component of an entity in two separate transactions. This issue is highlighted in Illustration 1-2 below.

<table>
<thead>
<tr>
<th>Illustration 1-2: Sales of equity method investments</th>
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</table>
| A parent entity that owns 100% of a subsidiary and initially disposes of a controlling (e.g., 60%) interest in the common stock of the component in one period and then disposes of the remaining non-controlling (e.g., 40%) interest two years later (after the assessment period closes) to the same (or different) buyer. Because the parent will have significant continuing involvement in the operations of the component after the initial 60% disposal that continues through the assessment period, the entity is prohibited from classifying the operations of the subsidiary as discontinued. When the entity sells the remaining non-controlling interest of the subsidiary in the subsequent year, the entity is still unable to record the operations as discontinued because the FASB staff expressly stated that the disposal of an equity method investment, by itself, should not be reported as a discontinued operation (as discussed above).

Alternatively, if the parent entity initially disposes a non-controlling (e.g., 40%) interest in the common stock of a subsidiary that is a component of an entity and then disposes its remaining controlling (e.g., 60%) interest, the entity could classify the operations of the component as discontinued when the second disposal transaction meets the held for sale criteria (for a sale) or is disposed of (for a disposal other than by sale).
2 Component of an entity

2.1 Definition

Excerpt from Accounting Standards Codification

Master Glossary

Component of an Entity

A component of an entity comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. A component of an entity may be a reportable segment or an operating segment, a reporting unit, a subsidiary, or an asset group.

ASC 205-20 requires the reporting of discontinued operations for all components of an entity. A component of an entity is defined as comprising operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Hence, the legal form of the discontinued component (e.g., subsidiary, division or investee) is not important. Because the operations and cash flows of the component should be clearly distinguished, the financial information should be available or obtainable. Financial information would be considered obtainable even if effort, including analysis, and allocation of expenses would be required to produce such information. The significance of allocation would be considered in evaluating whether or not a component exists.

Because there are no criteria that require a component of an entity to be a certain minimum size or significance, components of an entity could be as small as one retail store in a national chain. The definition of a component of an entity does not include any bright lines; therefore, judgment in determining whether a disposal group constitutes a component of an entity likely will be needed.

ASC 205-20-55-28 through 32 provides the following examples of the judgment used in determining whether a disposal group constitutes a component of an entity, along with the effect of that determination on classification as discontinued operations.

Illustration 2-1: Component of an entity

Case A: Disposed brand is not a component of the entity

An entity that manufactures and sells consumer products has several product groups, each with different product lines and brands. For that entity, a product group 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 product group is a component of the entity.

The entity has experienced losses associated with certain brands in its beauty care products group. The entity decides to remain in the beauty care business but will discontinue the brands with which the losses are associated. Because the brands are part of a larger cash-flow-generating product group and, in the aggregate, do not represent a group that on its own is a component of the entity, the conditions in paragraph 205-20-45-1 for reporting in discontinued operations the losses associated with the brands that are discontinued would not be met.
**Case B: Elimination of cash flows and no continuing involvement**

This Case has the same assumptions as Case A except that the entity decides to exit the beauty care business and commits to a plan to sell the product group with its operations. The product group is classified as held for sale at that date. The operations and cash flows of the product group will be eliminated from the ongoing operations of the entity as a result of the sale transaction, and the entity will not have any continuing involvement in the operations of the product group after it is sold. In that situation, the conditions in paragraph 205-20-45-1 for reporting in discontinued operations the operations of the product group while it is classified as held for sale would be met.

2.2 **Measurement of a component of an entity**

The assets and liabilities of a component of an entity that are held for sale are to be measured in the same manner as other asset groups that are held for sale as prescribed by ASC 360-10-35-43 (i.e., the lower of carrying value or fair value less cost to sell); however, all initial or subsequent adjustments to the carrying value of a component as a result of such measurement should be classified in discontinued operations, if the component otherwise meets the definition of a discontinued operation (refer to our FRD, Impairment or disposal of long-lived assets, for further details on measurement of assets groups classified as held for sale). Entities are not permitted to accrue future operating losses of a discontinued operation as of the measurement date. Instead, operating losses are to be recorded, in all cases, in the period in which they occur – even in instances in which a gain is expected on disposal. Operating losses of a discontinued operation are also included in discontinued operations.

The guidance in ASC 205-20 provides that if a component of an entity that otherwise meets the definition of a discontinued operation is being reclassified from held for sale to held and used, the component’s operations should be reclassified from discontinued operations to continuing operations.
3 Criteria for reporting discontinued operations

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<th>Excerpt from Accounting Standards Codification</th>
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<tr>
<td><strong>Presentation of Financial Statements – Discontinued Operations</strong></td>
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<tr>
<td><strong>Other Presentation Matters</strong></td>
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<td><strong>205-20-45-1</strong></td>
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<tr>
<td>The results of operations of a component of an entity that either has been disposed of or is classified as held for sale under the requirements of paragraph 360-10-45-9, shall be reported in discontinued operations in accordance with paragraph 205-20-45-3 if both of the following conditions are met:</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>b. The entity will not have any significant continuing involvement in the operations of the component after the disposal transaction.</td>
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The implementation guidance in ASC 205-20-55 provides a model for evaluating the two criteria in ASC 205-20-45-1 and describes this approach as a four-step process, as follows:

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<tbody>
<tr>
<td><strong>Presentation of Financial Statements – Discontinued Operations</strong></td>
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<tr>
<td><strong>Implementation Guidance and Illustrations</strong></td>
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<tr>
<td><strong>205-20-55-3</strong></td>
</tr>
<tr>
<td>The following steps, presented as questions, may be used to evaluate whether the two conditions of paragraph 205-20-45-1 are met. These steps are also depicted in a flow chart (see paragraph 205-20-55-25 [not included in this publication]). The steps are as follows:</td>
</tr>
<tr>
<td>Step 1: Are continuing cash flows expected to be generated by the ongoing entity?</td>
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<tr>
<td>Step 2: Do the continuing cash flows result from a migration or continuation of activities?</td>
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<tr>
<td>Step 3: Are the continuing cash flows significant?</td>
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<tr>
<td>Step 4: Does the ongoing entity have significant continuing involvement in the operations of the disposed component?</td>
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<tr>
<td>Note that if the answer to Step 1, 2, or 3 is no, then evaluate Step 4.</td>
</tr>
</tbody>
</table>

Section 3.7, Illustrations, includes examples from the implementation guidance in ASC 205-20-55 illustrating disposal transactions that do or do not qualify for reporting as discontinued operations based on the two criteria in ASC 205-20-45-1 and whether the disposal group is a component of an entity.
3.1 **Step 1: Continuing cash flows**

When an entity either has disposed of a component of an entity or met the held-for-sale criteria, it will need to evaluate whether continuing cash flows are expected to be generated. Continuing cash flows are either *direct* or *indirect* and, based on their identification as such (see Section 3.3, *Step 3: Significance of the continuing cash flows*), are determinative in assessing whether the operations and cash flows of a disposed component have been or will be eliminated. That is, direct cash flows are viewed as continuing cash flows which, depending on how long they continue (see Section 3.6, *Assessment period*), preclude discontinued operations presentation, whereas indirect cash flows do not preclude discontinued operations presentation.

The implementation guidance in ASC 205-20-55 discusses the concept of continuing cash flows as follows:

**Excerpt from Accounting Standards Codification**

**Presentation of Financial Statements – Discontinued Operations**

**Implementation Guidance and Illustrations**

**205-20-55-4**

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.

**205-20-55-5**

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 (that is, not direct), the cash flows are considered to be eliminated and the disposed component meets the paragraph 205-20-45-1(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.

**205-20-55-6**

Cash flows 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 205-20-45-1(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. The cash flows that are associated with the revenue-producing and cost generating activities are the same cash flows utilized in the impairment analysis under the held and used model (see paragraphs 360-10-35-16 through 35-36).
3.2 **Step 2: Migration or continuation of activities**

In order to be a direct cash flow, the cash flow must result from either a migration or continuation of activities and must be significant. If a continuing cash flow is not a result of a migration or continuation of activities, it would be an indirect cash flow. In addition, if the ongoing cash flow is not significant, it is automatically indirect.

**Migration** – Continuing cash flows are considered to be direct if significant cash inflows (revenue-producing activities) or significant cash outflows (cost-generating activities) are expected to be recognized by the ongoing entity as a result of a migration of revenues or costs, respectively, from the disposed component.

**Continuation of Activities** – Continuing cash flows are also considered to be direct if significant cash inflows (revenue producing activities) or significant cash outflows (cost-generating activities) are expected to be received or paid, respectively, by the ongoing entity as a result of the continuation of activities between the ongoing entity and the disposed component.

The implementation guidance in ASC 205-20-55 discusses the concepts of migration and continuation of activities as follows:

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**Excerpt from Accounting Standards Codification**

**Presentation of Financial Statements – Discontinued Operations**

**Implementation Guidance and Illustrations**

**205-20-55-7**

The revenue-producing activities (cash inflows) of the component have been continued and therefore are considered direct cash flows if either of the following two conditions is met:

a. Significant cash inflows are expected to be recognized by the ongoing entity as a result of a migration of revenues from the disposed component after the disposal transaction. An entity is not required to track the identity of the individual customers who are expected to migrate to conclude a migration has occurred (for example, an entity that closes [or sells] several smaller retail stores and opens a superstore in the immediate area would likely conclude 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 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 or whether the sale of the commodity after the disposal transaction occurs in a different geographic region as compared with the sale of the commodity before the disposal transaction.

b. Significant cash inflows are expected to be received by the ongoing entity as a result of the **continuation of activities** between the ongoing entity and the disposed component after the disposal transaction. For example, the ongoing entity sold products or services to or purchased products or services from the disposed component before its disposal (recognized as intra-entity sales or cost of sales) and it continues to sell similar products or services to or purchase similar products or services from the disposed component or a related party, as defined in Topic 850 to the disposed component after its disposal (recognized as sales or cost of sales). After the disposal transaction, the former intra-entity sales or cost of sales are no longer eliminated in consolidation, which will result in continuing cash inflows or outflows to the ongoing entity.
The cost-generating activities (cash outflows) of the component have been continued and therefore are considered direct cash flows if either of the following conditions is met:

a. Significant cash outflows are expected to be recognized by the ongoing entity as a result of a migration of costs from the disposed component after the disposal transaction.

b. Significant cash outflows are expected to be recognized by the ongoing entity as a result of the continuation of activities between the ongoing entity and the disposed component after the disposal transaction.

The following guidance shall be used to evaluate whether continuing cash flows are direct cash flows.

When 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 performing either of the following:

a. Recognizing revenues or costs that likely would have been generated by the disposed component absent the disposal transaction (a migration)

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 of the criteria in paragraph 205-20-45-1(b) to assess whether it has significant continuing involvement in the operations of the disposed component.

Examples of continuing cash flows that would likely not be direct include, but are not limited to, the following:

a. Interest income recognized from seller-provided financing

b. Contingent consideration in a business combination

c. Dividends on an investment

d. Passive royalty interests in the disposed component's operations.

Section 3.7, Illustrations, includes examples from the implementation guidance in ASC 205-20-55 illustrating direct versus indirect cash flows.
3.3 **Step 3: Significance of the continuing cash flows**

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. In order for cash flows to be direct, they must be significant. An evaluation of significance is not necessary if the continuing cash flows are not as a result of a migration or continuation of activities; however, the ongoing entity would still need to evaluate whether there is significant continuing involvement in the operations of the disposed component (ASC 205-20-45-1(b) criterion).

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 transaction. Additional guidance for determining the significance of continuing cash flows is presented below.

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**Excerpt from Accounting Standards Codification**

**Presentation of Financial Statements – Discontinued Operations**

**Implementation Guidance and Illustrations**

**205-20-55-14**

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 intra-entity transactions (the amount of cash flows attributed to intra-entity 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 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 205-20-45-1(b) to assess whether it has significant continuing involvement in the operations of the disposed component.

While the guidance in ASC 205-20 does not provide any quantitative bright lines to assess the significance of cash flows, it is noteworthy that in the facts certain examples conclude that continuing cash flows of 20% are significant, while other examples conclude that continuing cash flows of 5% are not significant. (These examples may be found in Section 3.7, Illustrations.) We believe that entities should establish an accounting policy for determining the level of continuing cash flows (i.e., a single amount between 5% and 20%) that would be significant and should apply that accounting policy consistently in its evaluation of components that have been disposed of or are held for sale.
Illustration 3-1: Evaluation of significant cash flows

An entity owns a commercial building that is being leased to third-party lessees. For that entity, the building is considered a component of an entity. The entity commits to a plan to sell the building and the building is classified as held for sale at that date. The entity expects to enter into a long-term management agreement with the buyer under which the entity will continue to manage the building’s operations in exchange for a market-based management fee.

The management fee constitutes continuing cash flows because the cash flows are expected to be generated by the ongoing entity after the disposal transaction as a result of a continuation of activities. In order to determine whether the continuing cash flows are significant, the ongoing entity would need to compare the cash flows expected to be received under the management agreement (revenue-producing activity) to the cash flows the entity would have received through its rental revenue absent the disposal transaction. In addition, the ongoing entity would need to compare the estimated continuing cash outflows as a result of providing services under the management agreement (cost-generating activity) to the total cash outflows that the disposed component would have generated associated with owning and managing the building absent the disposal transaction.

3.4 Step 4: Significant continuing involvement

If the ongoing entity does not have continuing operations and cash flows related to the disposed component, as evaluated under Steps 1 through 3 above, it will still need to evaluate whether there is significant continuing involvement in the operations of the disposed component after the disposal transaction, as discussed in ASC 205-20-45-1(b). Significant continuing involvement that extends or is expected to extend beyond the assessment period precludes discontinued operations (see Section 3.6, Assessment period). 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. The ongoing entity should make quantitative and qualitative assessments (individually and in the aggregate) from the perspective of the disposed component to determine whether continuing involvement is significant. ASC 205-20 provides the following guidance:

Excerpt from Accounting Standards Codification
Presentation of Financial Statements – Discontinued Operations

Implementation Guidance and Illustrations

205-20-55-15

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 paragraphs 205-20-55-4 through 55-14 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. Continuing involvement in the operations of the disposed component provides the ongoing entity with the ability to influence the operating 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 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 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.
The determination as to whether the continuing involvement is significant should be based on 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.

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

a. The ongoing entity retains an interest in the disposed component sufficient to enable the ongoing entity to exert significant influence over the disposed component's operating and financial policies. 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. 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:

1. Significance of the contract or arrangement to the overall operations of the disposed component
2. The extent to which the ongoing entity is involved in the operations of the disposed component
3. The rights conveyed by the contract to each party
4. The pricing terms of the contract or arrangement.

The guidance in the preceding paragraph should be used only to evaluate the criterion in paragraph 205-20-45-1(b) and should not be used to evaluate the criterion in paragraph 205-20-45-1(a) or to determine whether an entity meets the criteria for sale accounting or gain recognition set forth in other applicable accounting literature.

Since an investment accounted for under the equity method gives the investor the ability to exercise significant influence over operating and financial policies of an investee, the retention by the ongoing entity of an equity-method investment in the disposed component would constitute significant continuing involvement, precluding presentation of the disposed component as a discontinued operation, assuming it holds the investment through the assessment period. A cost-method investment in the disposed component retained by the ongoing entity, in all cases, would not constitute significant continuing involvement and would not, in and of itself, preclude presentation of the disposed component as a discontinued operation.
An entity holding a call option to acquire an interest in the disposed component may be a form of continuing involvement that may be significant; however, such evaluation will require the use of judgment. Factors to consider in evaluating an option are as follows:

<table>
<thead>
<tr>
<th>Indicator – Not significant</th>
<th>Indicator – Significant</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pricing</td>
<td>Fair value</td>
</tr>
<tr>
<td>Exercisable</td>
<td>Not currently exercisable and/or contingent</td>
</tr>
<tr>
<td>Percentage ownership that would be obtained</td>
<td>Cost method investment</td>
</tr>
<tr>
<td></td>
<td>Equity method investment</td>
</tr>
</tbody>
</table>

Contractual arrangements (e.g., royalty agreements, franchise agreements) between the ongoing entity and disposed component must be evaluated using all available information in order to determine if the arrangement represents significant continuing involvement. If the contractual arrangement is determined to be significant, the arrangement would preclude the ongoing entity from presenting the disposed component as a discontinued operation. The following factors should be considered in the evaluation; however, no one factor should be considered presumptive or determinative:

- Significance of the contractual arrangement to the overall operations of the disposed component
- The extent to which the ongoing entity is involved in the operations of the disposed component
- The rights conveyed by the contract to each party
- The pricing terms of the contractual arrangement

### 3.4.1 SEC staff view on retained interests

In SAB Topic 5.Z.4, the SEC staff gives its view on the classification in the statement of operations when an entity disposes of a controlling interest in a component of an entity. Their view is consistent with the guidance in ASC 205-20-55-17.

**Excerpt from SAB Topic 5.Z.4**

**Presentation of Financial Statements – Discontinued Operations**

**SAB Topic 5.Z.4, Disposal of Operation with Significant Interest Retained**

**205-20-S99-1**

The following is the text of SAB Topic 5.Z.4, Disposal of Operation with Significant Interest Retained.

**Facts:** A Company disposes of its controlling interest in a component of an entity as defined by FASB ASC Master Glossary. The Company retains a minority voting interest directly in the component or it holds a minority voting interest in the buyer of the component. Controlling interest includes those controlling interests established through other means, such as variable interests. Because the Company's voting interest enables it to exert significant influence over the operating and financial policies of the investee, the Company is required by FASB ASC Subtopic 323-10, Investments – Equity Method and Joint Ventures – Overall, to account for its residual investment using the equity method. FN54

**FN54** In some circumstances, the seller's continuing interest may be so great that divestiture accounting is inappropriate.

**Question:** May the historical operating results of the component and the gain or loss on the sale of the majority interest in the component be classified in the Company's statement of operations as "discontinued operations" pursuant to FASB ASC Subtopic 205-20, Presentation of Financial Statements – Discontinued Operations?

**Interpretive Response:** No. A condition necessary for discontinued operations reporting, as indicated in FASB ASC paragraph 205-20-45-1 is that an entity "not have any significant continuing involvement in the operations of the component after the disposal transaction." In these circumstances, the
transaction should be accounted for as the disposal of a group of assets that is not a component of an entity and classified within continuing operations pursuant to FASB ASC paragraph 360-10-45-5 (Property, Plant and Equipment Topic). FN55

However, a plan of disposal that contemplates the transfer of assets to a limited-life entity created for the single purpose of liquidating the assets of a component of an entity would not necessitate classification within continuing operations solely because the registrant retains control or significant influence over the liquidating entity.

### 3.5 Circumstances that would not represent continuing cash flows or involvement

**Excerpt from Accounting Standards Codification**

Presentation of Financial Statements – Discontinued Operations  
Implementation Guidance and Illustrations  
205-20-55-19

The circumstances discussed in paragraph 205-20-45-5 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.

### 3.6 Assessment period

The guidance in ASC 205-20-55-20 through 55-23 relates to the appropriate assessment period in evaluating the elimination of cash flows of the disposed component and significant continuing involvement.

**Excerpt from Accounting Standards Codification**

Presentation of Financial Statements – Discontinued Operations  
Implementation Guidance and Illustrations  
205-20-55-20

The appropriate assessment period for evaluating the criteria of paragraph 205-20-45-1 should include the point at which the component initially meets the criteria to be classified as held for sale or is disposed of through one year after the date the component is actually disposed of.

205-20-55-21

The assessment should be based on all facts and circumstances, including management’s intent and ability to both:

- **a.** Eliminate the cash flows of the disposed component from its operations

- **b.** Not have significant continuing involvement in the operations of the disposed component.
205-20-55-22
For one year after a component has been disposed of, an entity should reassess whether the criteria in paragraph 205-20-45-1 are expected to be met only when 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 that paragraph 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 the paragraph 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.

205-20-55-23
The assessment period may extend beyond one year after the component is actually disposed of in situations in which events or circumstances beyond an entity's control extend the period required to eliminate the direct cash flows of the disposed component or eliminate significant continuing involvement in the ongoing operations of the disposed component provided that the entity both:

a. Takes the actions necessary to respond to those situations
b. Expects to eliminate the direct cash flows and the significant continuing involvement.

When a component meets the held for sale criteria or is disposed of, management must assess whether (a) the operations and cash flows of the disposed component will be eliminated from its operations and (b) the ongoing entity will not have any significant continuing involvement in the operations of the component at the end of the assessment period. As a result, reclassification into and out of discontinued operations for all periods presented may be required during the assessment period.

Illustration 3-2: Plans to eliminate continuing involvement before end of assessment period
An ongoing entity that owns 100% of a component of an entity disposes of a controlling (e.g., 75%) interest in the common stock of that component as of 31 December 20X0. If management has the intent and ability to dispose of the remaining noncontrolling (e.g., 25%) interest in the component before 31 December 20X1 (i.e., one year after the disposal date), the component would be reported as a discontinued operation as of 31 December 20X0, assuming the entity has no other significant continuing involvement in the disposed component. If the entity does not dispose of its remaining noncontrolling interest by 31 December 20X1, the entity would have to reclassify the component into continuing operations (for the current and comparative prior periods) when management no longer has the intent or ability to dispose of the remaining noncontrolling interest.

3.6.1
Subsequent events

Excerpt from Accounting Standards Codification
Presentation of Financial Statements – Discontinued Operations
Implementation Guidance and Illustrations
205-20-55-24
The evaluation of whether the criteria in paragraph 205-20-45-1 are expected to be met for a component that is either disposed of or classified as held for sale at the statement of financial position date should include significant events or circumstances that occur after the statement of financial position date but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25). This evaluation is solely for the purposes of determining the presentation of discontinued operations pursuant to that paragraph and does not apply to any other guidance in this Subtopic.
The evaluation of whether or not the disposal of a component of an entity qualifies for discontinued operations presentation in accordance with ASC 205-20-45-1 (i.e., whether the entity has, or expects to have, continuing operations and cash flows or has significant continuing involvement with the disposed component) should include significant events or circumstances that occur after the balance sheet date but before the financial statements are issued or available to be issued. **Note that this evaluation is inconsistent with the evaluation necessary to determine whether a component has met the held-for-sale criteria under the Impairment or Disposal of Long-Lived Assets Subsections of ASC 360-10, which requires that all the criteria be met as of the balance sheet date (i.e., the evaluation of whether or not the component meets the held for sale criteria is not affected by events that occur after the balance sheet date but before the financial statements are issued or available to be issued).**

3.7 Illustrations

The examples in this section illustrate disposal activities that do or do not qualify for reporting as discontinued operations by applying the steps outlined in ASC 205-20-55-3 included in Section 3, *Criteria for reporting discontinued operations*, above.

The following examples from ASC 205-20-55-33 through 55-41 illustrate the guidance related to continuing cash flows and significant continuing involvement when a company-owned restaurant is sold and the ongoing entity enters into a franchise agreement.

<table>
<thead>
<tr>
<th>Illustration 3-3: Quick-service restaurant franchisor</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cases A, B, and C share the following assumptions.</strong></td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td><strong>Case A: Continuing direct cash flows</strong></td>
</tr>
<tr>
<td>In this Case, 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.</td>
</tr>
<tr>
<td>The following describes the evaluation, using the step-by-step process, to determine whether the conditions of paragraph 205-20-45-1 are met:</td>
</tr>
<tr>
<td><strong>Step 1:</strong> Yes. Continuing cash flows would be generated by the ongoing entity from the sale of product and the franchise fee.</td>
</tr>
</tbody>
</table>
Step 2: 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: 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.

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. Because 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.

Case B: Significant continuing involvement

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.

The following describes the evaluation, using the step-by-step process, to determine whether the conditions of paragraph 205-20-45-1 are met:

Step 1: Yes. Continuing cash flows are being generated by the ongoing entity from the franchise agreement.

Step 2: 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: 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: 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.

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.
Case C: Elimination of cash flows and no continuing involvement

The entity has experienced losses on its company-owned restaurants in one region. The entity decides to exit the quick-service restaurant business in that region and commits to a plan to sell the restaurants in that region. The restaurants are classified as held for sale at that date. The operations and cash flows of the restaurants in that region will be eliminated from the ongoing operations of the entity as a result of the sale transaction, and the entity will not have any continuing involvement in the operations of the restaurants after they are sold. In that situation, the conditions in paragraph 205-20-45-1 for reporting in discontinued operations the operations of the restaurants while they are classified as held for sale would be met.

The following examples from ASC 205-20-55-42 through 55-52 illustrate the guidance in ASC 205-20 related to a component of an entity, continuing cash flows and significant continuing involvement in a manufacturing environment when there will be an ongoing outsourcing arrangement.

Illustration 3-4: Sporting goods manufacturer

Cases A and B share the following assumptions.

An entity that manufactures sporting goods has a bicycle division that designs, manufactures, markets, and distributes bicycles. For that entity, the bicycle division 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 bicycle division 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).

Case A: Cash flows eliminated and no continuing involvement

The entity decides to exit the bicycle business and commits to a plan to sell the division with its operations. The bicycle division is classified as held for sale at that date. The operations and cash flows of the division will be eliminated from the ongoing operations of the entity as a result of the sale transaction, and the entity will not have any continuing involvement in the operations of the division after it is sold. In that situation, the conditions in paragraph 205-20-45-1 for reporting in discontinued operations the operations of the division while it is classified as held for sale would be met.

Case B: Disposed facility not a component of the entity

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. Because the manufacturing facility is part of a larger cash-flow-generating group (the bicycle division), and on its own is not a component of the entity, the conditions in paragraph 205-20-45-1 for reporting in discontinued operations the operations (losses) of the manufacturing facility would not be met. (Those conditions also would not be met if the manufacturing facility on its own was a component of the entity because the decision to outsource the manufacturing operations of the division will not eliminate the operations and cash flows of the division [and its bicycle business] from the ongoing operations of the entity.)

Case C: Indirect cash flows and no continuing involvement

Case C utilizes the assumptions below.

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 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 Subtopic 840-10.

There are no continuing cash inflows as a result of the continuation of activities because 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 $50,000 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.

The following describes the evaluation, using the step-by-step process, to determine whether the conditions of paragraphs 205-20-45-1 are met:

Step 1: Yes. Continuing cash flows are being generated by the ongoing entity resulting from the purchasing of manufactured product from the disposed component.

Step 2: Yes. The continuing cash flows are the result of a continuation of activities between the ongoing entity and the disposed component because 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: 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: 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:

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

2. 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.

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

4. The outsourcing agreement is at market.

Because 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.
Illustration 3-5: Furniture manufacturer and retailer

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.

The following describes the evaluation, using the step-by-step process, to determine whether the conditions of paragraph 205-20-45-1 are met:

- **Step 1:** Yes. Continuing cash flows are being generated by the ongoing entity resulting from the sale of product to the disposed component.
- **Step 2:** Yes. The continuing cash flows are the result of a continuation of activities between the ongoing entity and the disposed component because 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:** 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. Ninety-one percent is significant.

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. Because 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.

ASC 205-20-55-57 through 55-58 provide the following example of significant continuing direct cash flows as a result of migration of activities for a crude oil producer.
Illustration 3-6: Crude oil producer

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.

The following describes the evaluation, using the step-by-step process, to determine whether the conditions of paragraph 205-20-45-1 are met:

Step 1: Yes. Continuing cash flows are expected to be generated from the sale of oil because the ongoing entity will continue to sell a similar type of oil to the same market.

Step 2: Yes. The continuing cash flows are the result of a migration because 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: 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. One hundred percent is significant.

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.

The following examples from ASC 205-20-55-59 through 55-65 related to the sale of a commercial building illustrate (a) the evaluation of continuing cash flows when there is a long-term management agreement with the buyer and (b) the evaluation of continuing involvement when the seller provides the buyer financing.

Illustration 3-7: Commercial building lessor

Case A: Continuing direct cash flows

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 $250,000 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 $200,000 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.

The following describes the evaluation, using the step-by-step process, to determine whether the conditions of paragraph 205-20-45-1 are met:

**Step 1:** Yes. Continuing cash flows are being generated by the ongoing entity resulting from the management agreement.

**Step 2:** Yes. The continuing cash flows are the result of a continuation of activities because 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:** 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.

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. Because 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.

**Case B: Indirect cash flows and no continuing involvement**

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.
The following describes the evaluation, using the step-by-step process, to determine whether the conditions of paragraph 205-20-45-1 are met:

Step 1: Yes. Cash flows associated with the disposed component are being generated by the ongoing entity resulting from both of the following:

1. Leasing space in the new building to some of the same lessees of the old building
2. Interest income from the seller-provided financing.

Step 2: 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 because 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, Step 3, an evaluation of the significance of the continuing cash flows is not necessary. An evaluation of continuing involvement should be performed.

Step 4: 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:

1. The agreement is not significant to the overall operations of the disposed component because 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.
2. The extent to which the ongoing entity is involved in the operations of the disposed component is limited to the loan agreement.
3. The rights conveyed by the loan agreement do not enable the ongoing entity to exert significant influence over the disposed component.

Because 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.

The following examples from ASC 205-20-55-66 through 55-71 illustrate the evaluation of migrating activities for a retailer.

**Illustration 3-8: Retail stores – Owner and operator**

**Case A: Continuing direct cash flows from website**

An entity owns and operates retail stores and has a website, all of which sell household goods. For that entity, each store is a component of the entity and the website 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 $50,000 of sales related to such migration. The ongoing entity estimates that the component would have generated $250,000 of sales absent the disposal transaction.
The following describes the evaluation, using the step-by-step process, to determine whether the conditions of paragraph 205-20-45-1 are met:

**Step 1:** Yes. Continuing cash flows are being generated by the ongoing entity from transactions with customers of the disposed component.

**Step 2:** Yes. The continuing cash flows are the result of a migration because 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:** 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.

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. Because 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.

**Case B: Continuing direct cash flows from superstore**

To expand its retail store operations in one region, an 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 $400,000 of sales ($200,000 from each store). The ongoing entity estimates that each of the disposed components would have generated $250,000 of sales absent the disposal transaction.

The following describes the evaluation, using the step-by-step process, to determine whether the conditions of paragraph 205-20-45-1 are met:

**Step 1:** Yes. Continuing cash flows are being generated by the ongoing entity from transactions with customers of the disposed component.

**Step 2:** Yes. The continuing cash flows are the result of a migration because 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:** 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.

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. Because 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.
The following example from ASC 205-20-55-72 through 55-74 illustrates the application of ASC 205-20 to a transaction in which the ongoing entity and buyer enter into a royalty agreement.

**Illustration 3-9: Medical devices manufacturer and distributor**

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.

The following describes the evaluation, using the step-by-step process, to determine whether the conditions of paragraph 205-20-45-1 are met:

1. **Step 1:** Yes. Continuing cash flows are being generated resulting from the royalty arrangement.

2. **Step 2:** 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, Step 3, an evaluation of the significance of the continuing cash flows, is not necessary. An evaluation of continuing involvement shall be performed.

3. **Step 4:** The royalty arrangement would likely not provide the ongoing entity with the ability to significantly influence the operating or financial policies of the disposed component based on the following:
   1. The royalty agreement is not significant to the overall operations of the disposed component.
   2. 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 five years.
   3. The rights conveyed by the agreement do not enable the ongoing entity to exert significant influence over the disposed component.

Because 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.
The following example from ASC 205-20-55-75 through 55-79 illustrates the guidance in ASC 205-20 related to the sale of a component of an entity by a manufacturer when there will be a continuing supply arrangement.

**Illustration 3-10: Mining, refining, and smelting operator**

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 $300,000 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 $250,000 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.

The following describes the evaluation, using the step-by-step process, to determine whether the conditions of paragraph 205-20-45-1 are met:

**Step 1:** Yes. Continuing cash flows are being generated by the ongoing entity resulting from the sale of product to the disposed component.

**Step 2:** Yes. The continuing cash flows are the result of a continuation of activities between the ongoing entity and the disposed component because the ongoing entity will sell raw materials to the disposed component. Therefore, an evaluation of the significance of the continuing cash flows should be performed.

**Step 3:** 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: The supply agreement likely will not result in the ongoing entity having the ability to significantly influence the operating or financial policies of the disposed component after it is sold, based on the following:

1. The agreement is not significant to the overall operations of the disposed component because the ongoing entity will be selling 10 percent of the disposed component's aluminum requirements.

2. 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.

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

4. The agreement is at market.

Because 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.
4 Reporting and disclosure

4.1 Reporting disposal gains or losses in continuing operations

Excerpt from Accounting Standards Codification

Presentation of Financial Statements – Discontinued Operations

Other Presentation Matters

205-20-45-3
In a period in which a component of an entity either has been disposed of or is classified as held for sale, the income statement of a business entity or statement of activities of a not-for-profit entity (NFP) for current and prior periods shall report the results of operations of the component, including any gain or loss recognized in accordance with paragraphs 360-10-35-40 and 360-10-40-5, in discontinued operations. The results of operations of a component classified as held for sale shall be reported in discontinued operations in the period(s) in which they occur. The results of discontinued operations, less applicable income taxes (benefit), shall be reported as a separate component of income before extraordinary items (if applicable). For example, the results of discontinued operations may be reported in the income statement of a business entity as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from continuing operations before income taxes</td>
<td>$ XXXX</td>
</tr>
<tr>
<td>Income taxes</td>
<td>XXX</td>
</tr>
<tr>
<td>Income from continuing operations (^{(a)})</td>
<td>$ XXXX</td>
</tr>
<tr>
<td>Discontinued operations (Note X)</td>
<td></td>
</tr>
<tr>
<td>Loss from operations of discontinued Component X (including loss on disposal of $XXX)</td>
<td>XXXX</td>
</tr>
<tr>
<td>Income tax benefit</td>
<td>XXXX</td>
</tr>
<tr>
<td>Loss on discontinued operations</td>
<td>XXXX</td>
</tr>
<tr>
<td>Net income</td>
<td>$ XXXX</td>
</tr>
</tbody>
</table>

\(^{(a)}\) This caption shall be modified appropriately when an entity reports an extraordinary item. If applicable, the presentation of per-share data will need similar modification.

A gain or loss recognized on the disposal shall be disclosed either on the face of the income statement or in the notes to financial statements (see paragraph 205-20-50-1(b)).

205-20-45-4
Adjustments to amounts previously reported in discontinued operations that are directly related to the disposal of a component of an entity in a prior period shall be classified separately in the current period in discontinued operations.
Examples of circumstances in which those types of adjustments may arise 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. A settlement is directly related to the disposal transaction if there is a demonstrated direct cause-and-effect relationship and the settlement occurs no later than one year following the disposal transaction, unless it is delayed by events or circumstances beyond an entity’s control (see paragraph 360-10-45-11).

The illustration in ASC 205-20-45-5 above is a single year presentation only. Current and prior periods should report the results of operations of the component in discontinued operations when comparative income statements are presented.

Although the income tax benefit in the example above is shown as a separate line item, we would expect that most entities would display discontinued operations net of tax, with the tax benefit stated parenthetically.

Adjustments to amounts previously reported in discontinued operations that are directly related to the disposal of a component of an entity in a prior period (e.g., 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) should be classified separately in the current period discontinued operations.

### Assessing the Materiality of Discontinued Operations

The guidance in ASC 205-20 does not address the manner in which an entity should assess the materiality of a component of an entity’s operations to determine whether they must be classified as discontinued in the statement of operations. Specifically, questions have emerged as to whether entities must consider the materiality of 1) the gain or loss on disposal of the component, 2) the component’s operations (e.g., revenues, expenses, income or loss) or 3) both.

For example, should the operations of a component of an entity that has been disposed of resulting in a material gain or loss on disposal be classified as discontinued if its operations are clearly immaterial to the entity? Although SAB Topic 1.M.1 currently provides general guidance on assessing materiality, certain existing standards discuss specific guidance on assessing materiality for purposes of applying its provisions. For example, ASC 225-20-45-3 describes how an entity should assess materiality for purposes of classifying an extraordinary gain or loss (that is, items should be considered individually and not in the aggregate when assessing materiality).

When assessing the materiality of a disposed component, generally we believe that an entity should consider the magnitude of the gain or loss on disposal in addition to the operations of the component and the other qualitative factors as discussed in SAB Topic 1.M.1.
4.3 Allocation of interest and overhead to discontinued operations

**Excerpt from Accounting Standards Codification**

<table>
<thead>
<tr>
<th>Presentation of Financial Statements – Discontinued Operations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Other Presentation Matters</strong></td>
</tr>
<tr>
<td><strong>205-20-45-6</strong></td>
</tr>
<tr>
<td>Interest on debt that is to be assumed by the buyer and interest on debt that is required to be repaid as a result of a disposal transaction shall be allocated to discontinued operations.</td>
</tr>
<tr>
<td><strong>205-20-45-7</strong></td>
</tr>
<tr>
<td>The allocation to discontinued operations of other consolidated interest that is not directly attributable to or related to other operations of the entity is permitted but not required. Other consolidated interest that cannot be attributed to other operations of the entity is allocated based on the ratio of net assets to be sold or discontinued less debt that is required to be paid as a result of the disposal transaction to the sum of total net assets of the consolidated entity plus consolidated debt other than the following:</td>
</tr>
<tr>
<td>a. Debt of the discontinued operation that will be assumed by the buyer</td>
</tr>
<tr>
<td>b. Debt that is required to be paid as a result of the disposal transaction</td>
</tr>
<tr>
<td>c. Debt that can be directly attributed to other operations of the entity.</td>
</tr>
<tr>
<td><strong>205-20-45-8</strong></td>
</tr>
<tr>
<td>This allocation assumes a uniform ratio of consolidated debt to equity for all operations (unless the assets to be sold are atypical—for example, a finance company—in which case a normal debt-equity ratio for that type of business may be used). If allocation based on net assets would not provide meaningful results, then the entity shall allocate interest to the discontinued operations based on debt that can be identified as specifically attributed to those operations. This guidance applies to income statement presentation of both continuing and discontinued operations (including the presentation of the gain or loss on disposal of a component of an entity). A decision as to interest allocation shall be applied consistently to all discontinued operations.</td>
</tr>
<tr>
<td><strong>205-20-45-9</strong></td>
</tr>
<tr>
<td>General corporate overhead shall not be allocated to discontinued operations.</td>
</tr>
</tbody>
</table>

The SEC staff indicated that it expects entities to disclose their accounting policy regarding the allocation of interest, as noted below:

**Excerpt from SEC Observer Comment**

<table>
<thead>
<tr>
<th>Presentation of Financial Statements – Discontinued Operations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>SEC Materials</strong></td>
</tr>
<tr>
<td><strong>205-20-S99-3</strong></td>
</tr>
<tr>
<td>The following is the text of SEC Observer Comment: Allocation of Interest to Discontinued Operations.</td>
</tr>
</tbody>
</table>

The SEC staff will expect registrants electing to allocate interest in accordance with paragraph 205-20-45-6 to clearly disclose the accounting policy (including the method of allocation) and the amount allocated to and included in discontinued operations for all periods presented.
Classification and disclosure of contingencies relating to discontinued operations

In SAB Topic 5.Z.5, the staff provides the following guidance regarding the classification and disclosure of contingencies relating to discontinued operations.

Excerpt from SAB Topic 5.Z.5
Presentation of Financial Statements – Discontinued Operations

SAB Topic 5.Z.5, Classification and Disclosure of Contingencies Relating to Discontinued Operations
205-20-S99-2

The following is the text of SAB Topic 5.Z.5, Classification and Disclosure of Contingencies Relating to Discontinued Operations.

Facts: A company disposed of a component of an entity in a previous accounting period. The Company received debt and/or equity securities of the buyer of the component or of the disposed component as consideration in the sale, but this financial interest is not sufficient to enable the Company to apply the equity method with respect to its investment in the buyer. The Company made certain warranties to the buyer with respect to the discontinued business, or remains liable under environmental or other laws with respect to certain facilities or operations transferred to the buyer. The disposition satisfied the criteria of FASB ASC Subtopic 205-20 for presentation as "discontinued operations." The Company estimated the fair value of the securities received in the transaction for purposes of calculating the gain or loss on disposal that was recognized in its financial statements. The results of discontinued operations prior to the date of disposal or classification as held for sale included provisions for the Company's existing obligations under environmental laws, product warranties, or other contingencies. The calculation of gain or loss on disposal included estimates of the Company's obligations arising as a direct result of its decision to dispose of the component, under its warranties to the buyer, and under environmental or other laws. In a period subsequent to the disposal date, the Company records a charge to income with respect to the securities because their fair value declined materially and the Company determined that the decline was other than temporary. The Company also records adjustments of its previously estimated liabilities arising under the warranties and under environmental or other laws.

Question 1: Should the writedown of the carrying value of the securities and the adjustments of the contingent liabilities be classified in the current period's statement of operations within continuing operations or as an element of discontinued operations?

Interpretive Response: Adjustments of estimates of contingent liabilities or contingent assets that remain after disposal of a component of an entity or that arose pursuant to the terms of the disposal generally should be classified within discontinued operations. FN56 However, the staff believes that changes in the carrying value of assets received as consideration in the disposal or of residual interests in the business should be classified within continuing operations.

FN56 Registrants are reminded that FASB ASC Topic 460, Guarantees requires recognition and disclosure of certain guarantees which may impose accounting and disclosure requirements in addition to those discussed in this SAB Topic.
FASB ASC paragraph 205-20-45-4 requires that "adjustments to amounts previously reported in discontinued operations that are directly related to the disposal of a component of an entity in a prior period shall be classified separately in the current period in discontinued operations." The staff believes that the provisions of FASB ASC paragraph 205-20-45-4 apply only to adjustments that are necessary to reflect new information about events that have occurred that becomes available prior to disposal of the component of the entity, to reflect the actual timing and terms of the disposal when it is consummated, and to reflect the resolution of contingencies associated with that component, such as warranties and environmental liabilities retained by the seller.

Developments subsequent to the disposal date that are not directly related to the disposal of the component or the operations of the component prior to disposal are not "directly related to the disposal" as contemplated by FASB ASC paragraph 205-20-45-4. Subsequent changes in the carrying value of assets received upon disposition of a component do not affect the determination of gain or loss at the disposal date, but represent the consequences of management's subsequent decisions to hold or sell those assets. Gains and losses, dividend and interest income, and portfolio management expenses associated with assets received as consideration for discontinued operations should be reported within continuing operations.

Question 2: What disclosures would the staff expect regarding discontinued operations prior to the disposal date and with respect to risks retained subsequent to the disposal date?

Interpretive Response: MD&A FN57 should include disclosure of known trends, events, and uncertainties involving discontinued operations that may materially affect the Company's liquidity, financial condition, and results of operations (including net income) between the date when a component of an entity is classified as discontinued and the date when the risks of those operations will be transferred or otherwise terminated. Disclosure should include discussion of the impact on the Company's liquidity, financial condition, and results of operations of changes in the plan of disposal or changes in circumstances related to the plan. Material contingent liabilities, FN58 such as product or environmental liabilities or litigation, that may remain with the Company notwithstanding disposal of the underlying business should be identified in notes to the financial statements and any reasonably likely range of possible loss should be disclosed pursuant to FASB ASC Topic 450, Contingencies. MD&A should include discussion of the reasonably likely effects of these contingencies on reported results and liquidity. If the Company retains a financial interest in the discontinued component or in the buyer of that component that is material to the Company, MD&A should include discussion of known trends, events, and uncertainties, such as the financial condition and operating results of the issuer of the security, that may be reasonably expected to affect the amounts ultimately realized on the investments.

FN57 Item 303 of Regulation S-K.

FN58 Registrants also should consider the disclosure requirements of FASB ASC Topic 460.

### 4.5 Recognition of outside basis differences of subsidiaries classified as discontinued operations

The guidance in ASC 740-30-25-10 states that the tax benefit for the excess of the tax basis over the financial reporting basis (or the tax liability when the financial reporting basis exceeds the tax basis) of an investment in a subsidiary (outside basis difference) should be recognized when it is apparent that the temporary differences will reverse in the foreseeable future. See section 14.7 (Limitations on deferred tax assets) of our Income Taxes FRD for further details.
4.6 Entities with frequent disposals

At the 20 February 2002 meeting, the FASB focused the discussion on constituents’ concerns that for entities such as real estate investment trusts (REITs), the reporting requirements of ASC 205-20 will result in frequent reclassification of amounts reported in prior periods, potentially causing confusion among users of financial statements. The FASB concluded that those concerns did not raise new issues sufficient to reconsider the requirements of ASC 205-20.

The FASB clarified that one of the principal objectives of ASC 205-20 is to improve the usefulness of reported financial information by broadening the reporting of discontinued operations to include more disposal transactions. The transactions that qualify for reporting in discontinued operations include the disposal of a component of an entity’s operations that comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Those transactions are no longer limited to the disposal of a component of an entity’s operations that comprises a separate major line of business and that results from a change in business strategy. However, the Board reiterated that the requirements for reporting discontinued operations need not apply to immaterial items.

As discussed in Section 1, Overview and scope, above, the FASB recently issued ASU 2014-08, Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity, which raises the threshold for a disposal to qualify as a discontinued operation. Entities with frequent disposals that currently report discontinued operations for each disposal transaction will most likely see a reduction in the number of disposals reported as discontinued operations following the adoption of the ASU.

4.7 Disclosure

Excerpt from Accounting Standards Codification

Presentation of Financial Statements – Discontinued Operations

Disclosure

General Note: The Disclosure Section provides guidance regarding the disclosure in the notes to financial statements. In some cases, disclosure may relate to disclosure on the face of the financial statements.

205-20-50-1

The following shall be disclosed in the notes to financial statements that cover the period in which a long-lived asset (disposal group) either has been sold or is classified as held for sale under the requirements of paragraph 360-10-45-9:

a. A description of the facts and circumstances leading to the expected disposal, the expected manner and timing of that disposal, and, if not separately presented on the face of the statement, the carrying amount(s) of the major classes of assets and liabilities included as part of a disposal group

b. The gain or loss recognized in accordance with paragraphs 360-10-35-40 and 360-10-40-5 and if not separately presented on the face of the income statement, the caption in the income statement or the statement of activities that includes that gain or loss

c. If applicable, amounts of revenue and pretax profit or loss reported in discontinued operations

d. If applicable, the segment in which the long-lived asset (disposal group) is reported under Topic 280.
As indicated in paragraph 205-20-45-10, the major classes of assets and liabilities classified as held for sale shall be separately disclosed either on the face of the statement of financial position or in the notes to financial statements (see item a in paragraph 205-20-50-1(a)).

If either paragraphs 360-10-35-44 or 360-10-35-45 applies, a description of the facts and circumstances leading to the decision to change the plan to sell the long-lived asset (disposal group) and its effect on the results of operations for the period and any prior periods presented shall be disclosed in the notes to financial statements that include the period of that decision.

The following information shall be disclosed in the notes to 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
c. The principal factors used to conclude that the expected continuing cash flows are not direct cash flows of the disposed component.

The nature and amount of adjustments to amounts previously reported in discontinued operations that are directly related to the disposal of a component of an entity in a prior period shall be disclosed.

For each discontinued operation in which the ongoing entity will engage in a continuation of activities with the disposed component after its disposal and for which the amounts presented in continuing operations after the disposal transaction include a continuation of revenues and expenses that were intra-entity transactions (eliminated in consolidated financial statements) before the disposal transaction, intra-entity amounts before the disposal transaction shall be disclosed for all periods presented. The types of continuing involvement, if any, that the entity will have after the disposal transaction shall be disclosed. That information shall be disclosed in the period in which operations are initially classified as discontinued.

Run-offs of operations

The transition guidance in Statement 144, required that if a disposal activity accounted for under APB 30 was initiated prior to the issuance of Statement 144 and did not meet the held for sale criteria by the end of the fiscal year in which Statement 144 was initially applied, the related long-lived assets shall be reclassified as held and used. SAB 93 permitted the operations of a segment that will be abandoned through the run-off of operations to be reported as a discontinued operation (in accordance with APB 30) at the plan date, if the entity was obligated by regulation or contract to provide services after it ceased accepting new business, and the entity planned to cease accepting all new business within one year. However, Statement 144 (codified in ASC 205-20) does not permit such treatment. The operations of a component of an entity that will be abandoned through the liquidation or run-offs of operations should not be reported as a discontinued operation until all operations, including run-offs of operations, cease.
Subsequent to the issuance of Statement 144, the FASB staff issued a staff announcement in EITF Topic No. D-104 stating that a segment of a business that was being reported as a discontinued operation in accordance with APB 30 when Statement 144 was initially applied that will be abandoned through the liquidation or run-off of operations because the entity is obligated by regulation or contract to provide services after it ceases accepting all new business, should continue to be accounted for under APB 30 for the remaining run-off period. Although the below guidance from EITF D-104 was not codified, we believe it continues to apply.

**Excerpt from EITF Topic D-104**

An FASB representative announced that the staff has received inquiries about the application of the transition guidance in paragraph 51 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Paragraph 51 states:

> Except as provided in the following sentence, long-lived assets (disposal groups) classified as held for disposal as a result of disposal activities that were initiated prior to this Statement's initial application shall continue to be accounted for in accordance with the prior pronouncement (Statement 121 or Opinion 30) applicable for that disposal. If the [plan-of-sale] criteria in paragraph 30 of this Statement are not met by the end of the fiscal year in which this Statement is initially applied, the related long-lived assets shall be reclassified as held and used in accordance with paragraph 38 of this Statement.

The inquiries relate to a segment that will be abandoned through the liquidation or "run-off" of operations because the entity is obligated by regulation or contract to provide services after it ceases accepting all new business. In that situation, SEC Staff Accounting Bulletin No. 93, *Accounting and Disclosure Relating to Discontinued Operations*, permits the segment to be reported as a discontinued operation at the plan date in accordance with APB Opinion No. 30, *Reporting the Results of Operations – Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, if the entity will cease accepting all new business within one year.

Q – Does the one-year limitation in paragraph 51 apply to a segment that (1) will be abandoned through the liquidation or run-off of operations because the entity is obligated by regulation or contract to provide services after it ceases accepting all new business and (2) is being reported as a discontinued operation in accordance with Opinion 30 when Statement 144 is initially applied?

A – The FASB staff believes that the one-year limitation in paragraph 51 is not intended to apply to a segment that (1) will be abandoned through the liquidation or run-off of operations because the entity is obligated by regulation or contract to provide services after it ceases accepting all new business and (2) is being reported as a discontinued operation in accordance with Opinion 30 when Statement 144 is initially applied. The accounting for such a segment should continue under Opinion 30 for the remaining run-off period. However, if, after Statement 144 is initially applied, a component of an entity will be abandoned through the liquidation or run-off of operations, that component should not be reported as a discontinued operation in accordance with Statement 144 until all operations, including run-off operations, cease.

### 4.9 Entities that file for bankruptcy

Entities that file for bankruptcy may be subject to specific considerations relating to the presentation of discontinued operations. See our FRD, *Bankruptcies, liquidations and quasi-reorganizations*, for additional guidance.
### Abbreviations used in this publication

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Glossary

Excerpt from Accounting Standards Codification

**Asset Group**
An asset group is the unit of accounting for a long-lived asset or assets to be held and used, which represents the lowest level for which identifiable cash flows are largely independent of the cash flows of other group of assets and liabilities.

**Commodity**
Commodity means products whose units are interchangeable, are traded on an active market where customers are not readily identifiable, and are immediately marketable at quoted prices.

**Component of an Entity**
A component of an entity comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. A component of an entity may be a reportable segment or an operating segment, a reporting unit, a subsidiary, or an asset group.

**Continuation of Activities**
Continuation of activities means the continuation of any revenue-producing or cost-generating activity through active involvement with the disposed component.

**Continuing Cash Flows**
Continuing cash flows are cash inflows or outflows that are generated by the ongoing entity and are associated with activities involving a disposed component.

**Disposal Group**
A disposal group for a long-lived asset or assets to be disposed of by sale or otherwise represents assets to be disposed of together as a group in a single transaction and liabilities directly associated with those assets that will be transferred in the transaction.

**Migration**
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.

**Operating Segment**
A component of a public entity. See section 280-10-50 for additional guidance on the definition of an operating segment.

**Reporting Unit**
The level of reporting at which goodwill is tested for impairment. A reporting unit is an operating segment or one level below an operating segment (also known as a component).

**Settlement of a Pension or Postretirement Benefit Obligation**
A transaction that is an irrevocable action, relieves the employer (or the plan) of primary responsibility for a pension or postretirement benefit obligation, and eliminates significant risks related to the obligation and the assets used to effect the settlement.
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