

FASB Emerging Issues Task Force

Issue No: 03-13

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

Document: Working Group Report No. 3*

Date Prepared: June 14, 2004

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Dates Issue Previously Discussed: November 12–13, 2003; March 17–18, 2004

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

References:

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

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

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

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

Background

1. Paragraph 42 of FAS 144 states:

The results of operations of a component of an entity that either has been disposed of or is classified as held for sale shall be reported in discontinued operations in accordance with paragraph 43 if both of the following conditions are met: (a) the operations and cash flows of the component have been (or will be) *eliminated* from the ongoing operations of the entity as a result of the disposal transaction and (b) the entity will not have any significant continuing involvement in the operations of the component after the disposal transaction. [Emphasis added.]

2. At its April 29, 2003 meeting, the EITF Agenda Committee considered whether to add an issue to the EITF agenda that would provide additional guidance regarding the application of criterion (a) in paragraph 42 of FAS 144. Specifically, that issue addressed whether, in connection with a disposal transaction, the presence of *any* cash flows of a disposed component that continue through another component of the same reporting entity precludes the entity from reporting the disposal transaction as a discontinued operation.

3. The Agenda Committee decided not to add that issue to the EITF's agenda at that time. However, the Agenda Committee agreed that a number of issues have arisen in practice in applying the criteria in paragraph 42 and requested that the FASB staff solicit input from Task Force members and others to identify key issues related to the application of both criteria in that paragraph.

4. Based on discussions with a number of constituents, the FASB staff has identified the following broad categories of issues as the more frequent and/or troublesome types of issues that have arisen in applying the criteria in paragraph 42:

- Whether the criterion in paragraph 42(a) requires all operations and cash flows of the disposed component to be eliminated from the ongoing operations of the entity or whether some minor level of operations or cash flows may remain.

- If under the criterion in paragraph 42(a) some minor level of operations or cash flows of the disposed component can continue without precluding discontinued operations reporting, the level at which "minor" should be measured.
- In the context of applying the criterion in paragraph 42(b), factors to consider in determining whether the selling entity has retained "significant continuing involvement" in the disposed component based on the structure of the disposal transaction.

5. The FASB staff has considered and responded to certain questions regarding the application of paragraph 42. In general, the staff has emphasized that judgment, based on specific facts and circumstances, is required in applying the criteria in paragraph 42.

6. At its June 18, 2003 meeting, the Agenda Committee decided to add Issue 03-13 to the EITF's agenda and suggested that the scope of the Issue should, initially, be based on a broad interpretation of the paragraph 42 criteria. At the Agenda Committee's request, the FASB staff established the Issue 03-13 Working Group to, in particular, assist in the development of a model for evaluating (a) which cash flows are to be considered in determining whether cash flows have been or will be eliminated and (b) what types of continuing involvement constitute significant continuing involvement. Therefore, this Working Group was not asked to consider whether paragraph 42 requires all operations and cash flows of the disposed component to be eliminated from the ongoing operations of the entity or whether some minor level of operations or cash flows may remain.

7. At its first meeting, the Working Group generally agreed that current practice with respect to applying the criteria in paragraph 42 of FAS 144 does not coincide with what appears to be the Board's intent in broadening the reporting of discontinued operations. The requirement to eliminate all cash flows of the component from the ongoing operations of the entity has been interpreted in a very restrictive fashion, which is primarily due to a lack of guidance to assist in the determination of what constitutes "cash flows of the component." The difficulty in determining what cash flows constitute the cash flows of the component arises when the seller engages in activities with the component after its disposal. Often, those activities generate continuing cash flows to the seller, which may or may not be considered cash flows of the

component. The Working Group agreed that the evaluation of what cash flows are to be considered in determining whether cash flows have been or will be eliminated and what types of continuing involvement constitute significant continuing involvement should be based on many factors.

8. With respect to significant continuing involvement, the Working Group generally believes that the criterion in paragraph 42(b) is intended to address situations in which the seller continues to have significant involvement in the operations of a component after it is sold, and is not intended to apply to other types of involvement in the disposed component. The Working Group generally agreed that the evaluation of whether an entity has significant continuing involvement in the operations of the disposed component should be based on both significance from the perspective of that component and facts and circumstances.

Prior Task Force Discussion

9. At the November 12–13, 2003 EITF meeting, the Task Force discussed the Working Group's proposed approach for assessing whether the criteria in paragraph 42 of FAS 144 have been met for purposes of classifying the results of operations of a component of an entity that either has been disposed of or is classified as held for sale as discontinued operations. That proposed guidance focuses on (a) the cash flows that constitute "cash flows of the component" and (b) the type of continuing involvement that constitutes significant continuing involvement.

10. The Task Force agreed with the general direction of the Working Group's proposed approach but asked the Working Group to further refine and articulate the principles set forth in the proposed approach and to provide examples of the application of those principles to specific fact patterns.

11. With respect to the appropriate (re)assessment period, the Task Force reached a tentative conclusion that the appropriate (re)assessment period should include the point at which the component initially meets the criteria to be classified as held for sale and one year after the date the component is actually disposed of. The (re)assessment should be based on all facts and circumstances, including management's intent and ability to eliminate the cash flows of the

disposed component from its operations and management's intent and ability not to have significant continuing involvement in the operations of the disposed component. If at any time during that (re)assessment period the criteria in paragraph 42 are not expected to be met within one year after the disposal date, the component's operations should be reclassified from discontinued operations. If at any time during the (re)assessment period the criteria in paragraph 42 are met or are expected to be met within one year after the disposal date, the component's operations should be classified as discontinued operations. The Task Force observed that events or circumstances beyond an entity's control may extend the period in which cash flows of the disposed component continue or in which significant continuing involvement in the disposed component remains. Therefore, the Task Force also agreed that an exception to the one-year period shall apply in situations described in paragraph 31 of FAS 144.

12. At the March 17–18, 2004 EITF meeting, the Task Force discussed the Working Group's proposed approach for assessing whether the criteria in paragraph 42 of FAS 144 have been met for purposes of classifying the results of operations of a component of an entity that either has been disposed of or is classified as held for sale under discontinued operations.

13. The proposed approach for assessing whether cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity focuses on whether continuing cash flows are direct or indirect cash flows. Cash flows of the component would not be eliminated if the continuing cash flows are considered direct cash flows. The determination as to whether the continuing cash flows are direct or indirect is based on an evaluation of a set of indicators. That set of indicators focuses on the characteristics of the cash inflows and cash outflows to (from) the entity following the disposal. The indicators specifically address (a) the customers that purchase products or services of the entity that are similar to products or services of the disposed component, (b) the costs associated with the similar products or services sold, and (c) the nature of the products or services sold to or purchased from the disposed component. The relative strength of each indicator is considered in relation to the other indicators to determine whether the cash flows are direct or indirect cash flows of the disposed component.

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

15. The Task Force discussed and expressed general support for the direction of the Working Group's proposed approach. The Task Force asked the FASB staff to further refine and articulate the principles set forth in the proposed approach and provide more guidance on the application of the proposed approach to the specific examples. Additionally, the Task Force requested that the FASB staff develop additional examples for specific fact patterns raised by some Task Force members.

16. The FASB staff, with direction from the Working Group, refined the approach for determining whether continuing cash flows are cash flows of the disposed component. The approach focuses on whether significant continuing cash inflows or cash outflows are expected to be recognized by the remaining entity as a result of a migration of revenues or costs or a continuation of transactions with the disposed component after the disposal transaction.

17. The Working Group discussed whether a threshold should be included in the evaluation of the criterion in paragraph 42(a). Although the Working Group generally believes that "significant" should be based on facts and circumstances, they also believe a threshold is

necessary in order to assist resolution of the practice issue of determining which cash flows must be eliminated. The FASB staff believes the Task Force should further discuss this particular issue.

18. The Working Group was unable to agree as to what the appropriate threshold should be for determining whether continuing cash flows are "significant." Some members believe that continuing cash flows in excess of 10 percent should be deemed significant. These members believe that a 10 percent threshold would accomplish the objective of broadening the use of discontinued operations while reducing the potential financial statement impact of displaying "instant growth" in the remaining business. Other members believe that continuing cash flows in excess of 20 percent should be deemed significant. These members believe that a 20 percent threshold is consistent with the proposed criteria for determining significant continuing involvement and will likely broaden the use of discontinued operations classification for vertically-integrated companies since these companies typically continue activities with a disposed component after its disposal. The FASB staff has used 10 percent as the threshold for purposes of this Working Group Report; however, the staff believes the Task Force should further discuss this particular issue. The Working Group did agree that there should be a presumption that continuing cash flows in excess of the established threshold should be considered direct cash flows and therefore discontinued operations presentation would not be appropriate.

19. Certain Working Group members expressed concern that there are many other implementation issues surrounding the accounting for discontinued operations. These implementation issues include: (a) determining what constitutes a component when intercompany transactions exist, (b) how to perform an allocation of costs when costs are shared between the remaining entity and the disposed component before its disposal, and (c) how to perform an allocation of revenues when revenues migrate from the disposed component to the remaining entity resulting in "instant growth" to the remaining entity. Certain Working Group members believe that all implementation guidance relating to the accounting for discontinued operations should be part of a comprehensive Board project and the Task Force should not continue deliberating the issues set forth in this Issue Summary. Other members believe the

implementation guidance relating to the accounting for discontinued operations should be part of a comprehensive Board project but also believe Task Force should continue deliberating the issues set forth in this Issue Summary since a consensus would be beneficial to current practice in the short term.

20. Working Group members expressed concern over the tentative conclusion on reassessment, which is discussed in paragraph 11 of this Working Group Report. Certain Working Group members believe that specific language should be included that requires an entity to reassess during the one year period only when events or circumstances make it likely that the criteria in paragraph 42 will or will no longer be met within one year after the disposal date. These Working Group members believe that without such language, an entity will be required to reassess whether continuing cash flows are significant on an ongoing basis during the one year period which may not be practicable.

Current Working Group Discussion

Issue 1: The cash flows of the component that should be considered in the determination of whether cash flows have been or will be eliminated from the ongoing operations of the entity.

21. Based on the Working Group's discussion, the FASB staff has further refined and articulated the principle and proposed approach with respect to applying the criterion in paragraph 42(a) of FAS 144, as follows:

Principle: The evaluation of whether the operations and cash flows of a disposed component have or will be eliminated (paragraph 42(a) criterion) depends on whether any continuing cash flows are *direct* or *indirect*. If any 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 any cash flows are *indirect*, the cash flows are considered to be eliminated and the disposed component meets the paragraph 42(a) criterion to be considered a discontinued operation.

The determination of whether cash flows are *direct* or *indirect* depends on the nature and significance of the cash flows and requires judgment. For the purposes of this Issue, cash flows of a component¹ include gross cash flows (cash inflows and cash outflows) that are directly associated with the revenue producing and cost generating activities of that component (that is, "direct" cash flows).

The intention of the criterion in paragraph 42(a) is to determine whether, in substance, the remaining entity continues either the revenue generating activities (cash inflows) of the disposed component after the disposal transaction or the cost generating activities (cash outflows) of the disposed component after the disposal transaction.

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

- a. Significant cash inflows are expected to be recognized by the remaining entity as a result of a migration² of revenues from the disposed component after the disposal transaction; or
- b. Significant cash inflows are expected to be received by the remaining entity as a result of the continuation of activities³ between the remaining entity and the disposed component after the disposal transaction.

¹ The cash flows that are directly associated with the revenue producing and cost generating activities are the same cash flows utilized in the FAS 144 impairment analysis under the "held and used" model.

² A migration results in the remaining entity recognizing revenues or costs as a direct result of the disposal transaction that would have been recognized by the disposed component absent the disposal transaction. For example, a migration occurs when customers of the disposed component generate revenues and cost of sales for the remaining entity as a direct result of the disposal transaction. Revenues or costs that continue to be generated by the remaining entity through transactions on an open market would be considered a migration since the customer base of the disposed component would be considered the same market.

³ The term "continuation of activities" means the continuation of any revenue producing or cost generating activity through active involvement with the disposed component. For example, the remaining entity sold products or services to the disposed component before its disposal (recognized as intercompany sales) and it continues to sell products or services to the disposed component after its disposal (recognized as sales). After the disposal transaction, the former intercompany sales are no longer eliminated in consolidation, which will result in continuing cash inflows to the remaining entity. Similarly, for cost generating activities, the remaining entity purchased products or services from the disposed component before its disposal (recognized as intercompany cost of sales) and it continues to purchase products or services from the disposed component after its disposal (recognized as cost of sales). After the disposal transaction, the former intercompany cost of sales are no longer eliminated in consolidation, which will result in continuing cash outflows from the remaining entity.

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

- c. Significant cash outflows are expected to be recognized by the remaining entity as a result of a migration⁴ of costs from the disposed component after the disposal transaction; or
- d. Significant cash outflows are expected to be recognized by the remaining entity as a result of the continuation of activities⁵ between the remaining entity and the disposed component after the disposal transaction.

If expected continuing cash flows are not the result of a migration of revenues or costs or a continuation of activities, an entity should not consider the cash flows for the purpose of evaluating the criteria in paragraph 42(a). For example, if the remaining entity provides financing to the buyer of the disposed component, interest income from the financing should not be considered in an evaluation of whether the continuing cash flows are significant. That is, the interest income does not result from a migration of revenues or costs or a continuation of activities and, therefore, it should be considered an indirect cash flow. However, the entity should evaluate under the criterion in paragraph 42(b) whether it has significant continuing involvement in the operations of the disposed component through the retention of significant risks associated with the disposed component through its seller-provided financing.

The evaluation as to whether continuing cash flows will be significant is a matter of judgment and should be based on the expected continuing cash flows to be recognized by the entity after the disposal transaction as compared to the cash flows expected to have been recognized by the disposed component absent the disposal transaction. The cash flows expected to have been recognized by the disposed component should include both third party and intercompany transactions (the amount of cash flows attributed to

⁴ Refer to footnote 2.

⁵ Refer to footnote 3.

intercompany transactions should be based on transactions as if they had been between unrelated third parties). An entity shall presume that continuing cash flows in excess of 10 percent of the expected cash flows of one disposed component is significant. This presumption may be overcome if the relevant facts and circumstances, such as the length of time the cash flows will continue, clearly indicate that continuing cash flows in excess of 10 percent is not significant. If a determination is made that cash inflows represent direct cash flows, an evaluation of cash outflows is not necessary. However, if a determination is made that continuing cash flows are indirect, an entity should evaluate the paragraph 42(b) criterion.

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

22. Based on the Working Group's discussion, the FASB staff has further refined and articulated the principle and proposed approach with respect to applying the criterion in paragraph 42(b) of FAS 144, as follows:

Definition: Continuing involvement in the operations of the disposed component provides the entity with (1) the ability to influence the operating and (or) financial policies of the disposed component, (2) the retention of risk associated with the ongoing operations of the disposed component, or (3) the ability to obtain benefits associated with the ongoing operations of the disposed component. Continuing involvement may be provided to the entity through an interest in the disposed component or through the existence of a contractual arrangement or other type of arrangement with the disposed component.

The criterion in paragraph 42(b) precludes discontinued operations reporting in situations in which the entity continues to have significant involvement in the operations of a component after its disposal. The Working Group believes that the determination as to whether the entity has significant continuing involvement in the operations of the component after the disposal transaction should be based on both a quantitative and a qualitative assessment

from the perspective of the disposed component. The assessment should consider all types of continuing involvement, individually and in the aggregate.

The following indicators should be considered in evaluating whether continuing involvement constitutes, in substance, significant continuing involvement⁶:

- a. The entity retains an interest⁷ in the disposed component sufficient to enable it to exert significant influence over the disposed component's operating and financial policies. A cost method investment individually would therefore not be considered significant continuing involvement.
- b. The entity and the buyer are parties to a contract or otherwise to an arrangement, such as the relationship between a customer and a supplier or when one entity provides management services to another entity. The determination as to whether this constitutes significant continuing involvement in the operations of the disposed component should be based on the following factors:
 - i. Significance of the contract or arrangement to the overall operations of the disposed component
 - ii. The extent to which the entity is involved in the operations of the disposed component
 - iii. The length of the term of involvement in the operations of the disposed component
 - iv. The rights conveyed by the contract to each party
 - v. The pricing terms of the contract or arrangement.

⁶ This guidance should be used only to evaluate the criterion in paragraph 42(b) of FAS 144 and should not be used to evaluate whether an entity meets the criteria for sale accounting or gain recognition set forth in other applicable accounting literature.

⁷ An entity holding a call option to acquire an interest in the disposed component is a form of continuing involvement; however, whether that continuing involvement is significant depends on a number of factors, including the fair market value of the call option, the exercisability of the call option, and the percentage ownership underlying the call option.

23. The FASB staff, with assistance from the Working Group, has developed the following eight examples to illustrate the application of the proposed approach.

Example 1

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

To expand its retail store operations in one region, the entity decides to close two of its retail stores and open a new "superstore" within 10 miles of the other retail stores. The new superstore will continue to sell the household goods previously sold through the two retail stores along with other types of goods. The entity purchased and will continue to purchase the household goods from a wholesale distributor. The entity believes that a migration of customers from the closed retail stores after the disposal transaction will result in the entity recognizing \$400 thousand of sales. The entity believes the components would have recognized \$500 thousand of sales absent the disposal transaction.

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

Example 2

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

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

Evaluation of Continuing Cash Flows: The continuing cash flows should be considered direct cash flows of the disposed component due to significant cash inflows that are expected to be recognized by the remaining entity as a result of a migration of customers from the closed retail store to the website. The entity believes that the continuing cash inflows will approximate 20 percent of the cash inflows that would have been incurred absent the disposal transaction. An evaluation of cash outflows is not necessary. Since the continuing cash inflows are considered direct cash flows, classification as a discontinued operation would not be appropriate. An evaluation of continuing involvement is not necessary.

Example 3

An entity owns a commercial building that is being leased to third-party lessees. For that entity, the building is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, the building is a component of the entity. The entity commits to a plan to sell the building. The building is classified as held for sale at that date. The entity will enter into a

long-term management agreement with the buyer under which the entity will manage the day-to-day operations of the building in exchange for a management fee at market.

The entity believes that continuing cash inflows as a result of a continuation of activities (providing management services) will result in the entity recognizing \$500 thousand of revenue. The entity believes the disposed component would have recognized \$5 million of rental revenue absent the disposal transaction.

The entity believes that continuing cash outflows as a result of a continuation of activities (providing management services) between the entity and the disposed component after the disposal transaction will result in the entity recognizing \$200 thousand of cash outflows. The entity believes the disposed component would have recognized \$1 million of cash outflows associated with owning and managing the building absent the disposal transaction.

Evaluation of Continuing Cash Flows: The continuing cash flows should be considered direct cash flows of the disposed component due to significant cash outflows that are expected to be recognized by the remaining entity as a result of a continuation of activities between the entity and the disposed component after disposal. The continuing cash inflows will approximate 10 percent of the cash inflows that would have been recognized by the disposed component and therefore not considered significant. However, since the continuing cash outflows will approximate 20 percent of the cash outflows that would have been recognized by the disposed component, they are considered significant. Since the continuing cash outflows are considered direct cash flows, classification as a discontinued operation would not be appropriate. An evaluation of continuing involvement is not necessary.

Example 4

An entity owns an oil field that produces crude oil that is sold on the open market at market prices. For that entity, a field is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, the field is a component of the entity. The entity commits to a plan to

sell the oil field to a third-party buyer. The oil field is classified as held for sale at that date. The entity will bring another oil field online shortly after the sale and expects to sell a similar quantity of oil extracted from this new field as it did from the sold oil field and to the same market.

Evaluation of Continuing Cash Flows: The entity concludes that the continuing cash flows should be considered direct cash flows of the disposed component due to significant cash inflows that are expected to be recognized by the remaining entity as a result of a migration of revenues from the sold oil field to the new oil field. The new oil field will produce a similar quantity of crude oil that will be sold on the same market as the sold oil field. An evaluation of cash outflows is not necessary. Since the continuing cash inflows are considered direct cash flows, classification as a discontinued operation would not be appropriate. An evaluation of continuing involvement is not necessary.

Example 5

An entity 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. The bicycles manufactured are not specialized brand-name bicycles. For that entity, the bicycle manufacturing operation is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, the manufacturing of the bicycles is a component of the entity.

The entity has experienced losses in its bicycle division resulting from an increase in manufacturing costs (principally, labor costs). The entity decides to remain in the bicycle business but will outsource the manufacturing operations and commits to a plan to sell the related manufacturing facility. The facility is classified as held for sale at that date. The entity will sell the manufacturing facility along with the third-party customer contracts and will enter into an outsourcing agreement with the buyer of that facility. The outsourcing agreement will allow the entity to purchase 10 percent of the output from the facility at market, which will then be sold through the company-owned store locations. The

outsourcing agreement includes customary terms and does not permit the entity to be otherwise involved in the operations of the disposed component. The revenues generated by sales to company-owned store locations approximated 10 percent of the total revenues generated by the disposed component. The outsourcing agreement does not meet the definition of a lease based on an evaluation of the guidance in Issue 01-8.

There are no continuing cash inflows as a result of the continuation of activities since no revenue will be recognized by the entity as a direct result of the disposal transaction. Therefore, an evaluation of continuing cash inflows is not necessary.

The entity believes the continuing cash outflows as a result of a continuation of activities (the outsourcing arrangement) will result in the entity recognizing \$100 thousand in costs to provide product for the company-owned retail stores. The entity believes the disposed component would have recognized \$1 million of costs to manufacture product for the third-party customers and the company-owned retail stores.

Evaluation of Continuing Cash Flows: The continuing cash flows should not be considered direct cash flows of the disposed component since continuing cash outflows will approximate 10 percent of cash outflows that would have been incurred absent the disposal transaction and therefore not considered significant. An evaluation of continuing involvement must be performed.

Evaluation of Continuing Involvement: The outsourcing agreement likely will not result in the entity having significant continuing involvement in the operation of the manufacturing facility after it is sold since (a) the entity will be purchasing only 10 percent of the output from the facility, (b) the outsourcing agreement is at market, (c) the other terms of the outsourcing agreement are customary, and (d) the entity is not otherwise involved in the operations of the disposed component. Therefore, classification as a discontinued operation is appropriate.

Example 6

An entity manufactures and sells specialized brand-name furniture through its company-owned and dealer-owned retail stores. For that entity, each of the company-owned retail stores is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, the retail stores are components 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 with the buyer to supply all of the specialized brand-name furniture to the dealers.

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

Evaluation of Continuing Cash Flows: The continuing cash flows should be considered direct cash flows of the disposed component since the continuing cash inflows will approximate 91 percent of the cash inflows that would have been recognized by the disposed component absent the disposal transaction. An evaluation of cash outflows is not necessary. Since the continuing cash inflows are considered direct cash flows, classification as a discontinued operation would not be appropriate. An evaluation of continuing involvement is not necessary.

Example 7

An entity mines, refines, and smelts aluminum that is sold to third-party customers and is used in the entity's fabrication business. For that entity, the manufacturing and fabrication businesses are 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 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). 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 long-term supply arrangement with the buyer to supply all of the aluminum requirements to the disposed component at market, which is expected to be approximately 10 percent of the output. The terms of the supply agreement are customary and it does not provide the entity with the ability to otherwise be involved in the operations of the disposed component.

The entity believes that continuing cash inflows as a result of a continuation of activities (selling aluminum) will result in the entity recognizing \$1 million of revenue from the sale of aluminum to the disposed component. The entity believes the disposed component would have recognized \$10 million of revenue from the sale of fabricated aluminum to third-party customers absent the disposal transaction.

The entity believes that continuing cash outflows as a result of a continuation of activities (selling aluminum) will result in the entity recognizing \$500 thousand of costs associated with the production of the aluminum to be sold to the disposed component. The entity believes the disposed component would have recognized \$5 million of costs associated with the fabrication of aluminum to be sold to third-party customers absent the disposal transaction.

Evaluation of Continuing Cash Flows: The entity concludes that the continuing cash flows should not be considered direct cash flows of the disposed component since insignificant cash inflows and outflows are expected to be recognized by the remaining entity after the disposal transaction. An evaluation of continuing involvement is required.

Evaluation of Continuing Involvement: Although the supply agreement provides the disposed component with the ability to purchase all of its aluminum requirements, (a) the supply agreement is at market, (b) aluminum is a commodity and readily available from other suppliers, (c) the other terms of the outsourcing agreement are customary, and (d) the entity is not otherwise involved in the operations of the disposed component. Therefore, classification as a discontinued operation is appropriate.

Example 8

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 entity and the buyer enter into a royalty agreement that provides the entity with the right to receive a royalty fee from the buyer equal to 10 percent of net sales of medical devices. The terms of the royalty agreement are customary and it does not provide the entity with the ability to be otherwise involved in the operations of the disposed component.

Evaluation of Continuing Cash Flows: The entity concludes that the continuing cash flows should not be considered direct cash flows of the disposed component since the royalty agreement does not provide for a migration of revenues or costs nor does it provide for a continuation of activities between the entity and the disposed component. The revenue producing activities and cost generating activities of the component before the disposal transaction were the manufacturing and sale of medical devices. The remaining entity will

not continue these activities after the disposal transaction. An evaluation of continuing involvement must be performed.

Evaluation of Continuing Involvement: The royalty arrangement would not constitute significant continuing involvement since (a) the royalty is not significant to the disposed component (based on 10 percent of the sales), (b) the terms of the agreement are customary, and (c) the entity is otherwise not involved in the operations of the disposed component. In that situation, the criterion in paragraph 42(b) for reporting in discontinued operations the operations of the business would be met.

Transition

24. The FASB staff believes the transition guidance for this Issue should be as follows:

The consensus reached by the Task Force at the June 30–July 1, 2004 EITF meeting should be applied to disposal transactions initiated after July 14, 2004 (date of Board ratification). Previously reported operating results related to disposal transactions initiated within an enterprise's fiscal year that includes the date of the consensus may be reclassified to reflect the consensus.

This transition guidance is consistent with the guidance in Issue 87-24.