

## Seller beware: danger and difficulty lurk in discontinued operations

*Companies routinely sell off poorer-performing or non-core businesses in order to enhance the value of their remaining operations. Many such companies prefer to present themselves to the capital markets on a “with and without” basis even before the sale occurs. Discontinued operations, a reporting mechanism, allows companies to separate the performance of a business to be sold from the rest of their operations.*

*Historically, companies had to clear a high hurdle to qualify for discontinued operations reporting. Then, in 2001, the FASB issued FAS 144 in response to input from investors interested in valuing companies apart from their soon-to-be-sold operations, and with the intent of easing the requirements for discontinued operations reporting.*

*Unfortunately, because of its intricacies, this rule actually resulted in fewer sales being reported as discontinued operations. In their latest guidance, the rule makers require a seller to walk through a four-step process in order to determine whether a divestiture qualifies for discontinued operations reporting. This Deal Flash!™ traces recent rules on this accounting treatment, and suggests some steps companies can take to minimize the risk of encountering accounting “surprises” when they attempt to qualify for discontinued operations reporting.*

Reporting divestitures as discontinued operations is desirable for several reasons, including:

- Results for the business being sold are reported “below the line” and not included in operating income for the rest of the company
- It allows companies to clearly communicate their strategy to the financial markets

Before FAS 144, only business “segments” could qualify for discontinued operations reporting. Typically, a segment is a major line of business or customer class, such as the financing arm of a large manufacturer. Under FAS 144, business “components” are also candidates for discontinued operations reporting. Components are typically part of a segment; a reporting unit, subsidiary, or group of assets such as the credit card or auto lending operations of a manufacturer’s financial arm.

In order to qualify for discontinued operations reporting under FAS 144, a business component to be sold must first be deemed “held for sale”, a criterion that is not hard to meet so long as the seller is serious about disposing of an operation; that is, management has developed a

formal plan or has begun the sales process. In addition to being “held for sale”, a business segment or component must meet two other requirements:

- The divestiture must completely separate the operations and cash flows of the business being sold from the ongoing operations of the seller
- The seller must have no **significant** continuing involvement with the business being sold once the transaction closes

While these requirements may seem straightforward, sellers encountered many difficulties when they tried to apply them. The problem is that in many transactions, it is customary for sellers to retain some involvement in a business being sold, be it simple administrative functions during the post-deal transition, or more complex connections such as sublease arrangements, seller financing, retained equity stakes, royalties from licensed intellectual property, or service agreements (e.g., contract manufacturing, shipping/logistics, customer support, etc.).

Such arrangements could potentially disqualify a seller from using discontinued operations reporting because

they allow the company to either receive some cash flow or retain some continuing involvement in the operation it is selling. Unfortunately, GAAP has not clearly defined the line between immaterial and significant involvement or elimination with respect to operations and cash flows.

### WHAT'S NEW

The FASB issued EITF 03-13 to guide sellers in determining whether a seller retains involvement in or receives cash flow from a business segment or component after it is sold. This rule requires a seller to go through a complex four-step process illustrated in Figure 1. If the seller can clear all four hurdles, it should be able to report a divestiture as a discontinued operation.

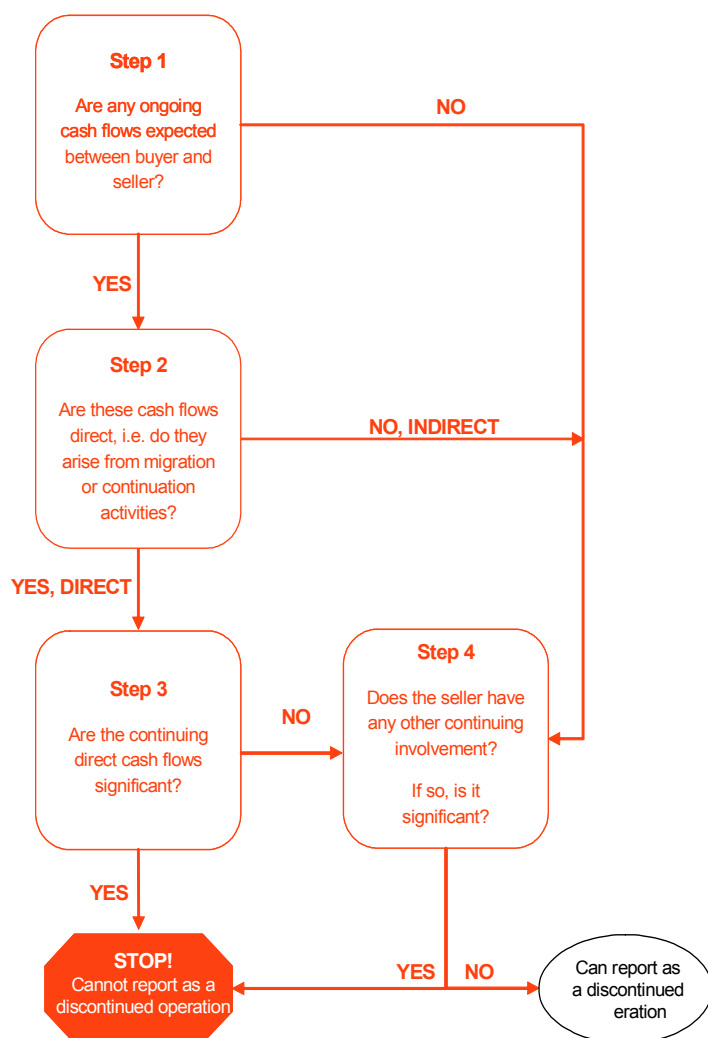
### INSIGHTS

Although the process may seem daunting, it is possible for a company to qualify for discontinued operations reporting. This will require carefully balancing transaction and financial reporting objectives. In assessing these objectives, dealmakers should consider the following:

**Know the buyer**—Financial and strategic buyers are likely to have different needs, and these differences can collide with the seller's goal of achieving discontinued operations reporting. Strategic buyers may be less likely to require transition or ongoing service arrangements, as their plan may be to integrate the target's operations with their own in order to capture synergies. By contrast, a financial buyer that plans to use the target as a "platform" for entering a new industry may require ongoing contributions of intellectual property and shared services.

Figure 1

#### Four key questions determine whether a divestiture qualifies for discontinued operations reporting



#### Considerations

##### Step 1

Understand the economics of the transaction and the cash flows exchanged. Keep it simple.

##### Step 2

Direct cash flows arise from the migration or continuation of activities. Examples:

- Migration: a retailer closes a store and transitions customers to its website.
- Continuation: seller has ongoing sales or purchases, or outsources some operations to the unit sold.

Indirect cash flows include interest on seller-financed debt, and potential earn-out payments.

##### Step 3

GAAP does not define "significance" for ongoing direct cash flows. Seller should compare cash flow before and after divestiture.

##### Step 4

Continuing involvement can exist when a seller retains an equity stake or other contractual arrangement that enables it to exert influence over the divested operation.

**Know yourself**—Sellers should weigh the benefits of discontinued operations reporting against those of remaining involved in a divested business. For example, the seller of a troubled business may have to retain a significant equity stake or provide financing just to get the deal done. Conversely, the seller of a non-core business that could perform better with a more efficient owner may want to retain an economic stake in order to share in the business’s upside potential. Finally, some sellers may not be willing to walk away from important intellectual property, such as source code, but may be willing to provide access through a license.

**Know each link in the supply chain**—Besides understanding its own situation and that of the prospective buyer, a seller must also carefully consider the supply chains and sales channels of its ongoing business and the one being sold. If the divested operation is an important link in the seller’s supply or distribution chain either because the seller continues to use it as a source for critical items, or because it constitutes one of the seller’s critical distribution channels, it is more likely to create the appearance of significant continuing involvement.

**Creating carve-out financials can be difficult**—Many companies don’t realize how hard it can be to create separate financial information for a business component that does not currently have separate financial information. By taking the time to create the information for discontinued operations reporting, the seller may be

telling the market that it has made the investment necessary to present the business separately for diligence purposes.

**Remember, continuing involvement can pose other accounting risks**—While failure to qualify for discontinued operations treatment does not, by itself, bar a company from recognizing a sale, companies that also maintain a significant stake in a business after they have sold it may find themselves on the wrong side of other accounting guidance. In certain cases, continuing arrangements can preclude a seller from recognizing a gain on the sale of assets, or can put the deconsolidation of a divested business in jeopardy. This can possibly occur when continuing involvement exposes the seller to a majority of the economic upside or downside of the unit being sold.

We do not believe the new accounting guidance will erase the difficulty in accounting for the sale of smaller business units or assets. To uncover accounting surprises before they occur, companies planning such divestitures should define their objectives early in the transaction process and gain a thorough understanding of the accounting implications of maintaining certain arrangements with the unit being sold. By weighing its accounting and financial reporting objectives against its other strategic and business goals, a seller stands a better chance of achieving the appropriate balance among all its transaction objectives.

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