TBH Consulting LLC

Discontinued Operations

Executive Summary

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I. Discontinued Operations Overview

Discontinued operations presentation refers to the specific accounting and reporting requirements for a component that meets distinct criteria. If discontinued operations criteria are met for a divestiture, an entity will present financial information using ASC 205 guidance.

ASC 205 requires the results of the discontinued operation and the assets and liabilities of the discontinued operation be presented separately in the financial statements. The underlying objective is to provide users of the financial statements with comparable financial information. This way users have the data to determine the impact of the disposal on the entity's ongoing business activities.

This document addresses discontinued operations presentation guidance as well as other relevant guidance when accounting for a divestiture.

II. Criteria for Reporting Discontinued Operations

To be reported as a discontinued operation, the disposal must meet all of the following criteria outlined within ASC 205-20-45:

1 Must represent a strategic shift that has (or will have) a major effect on an entity's operations and financial results.

While the terms "strategic shift" and "major effect" are not defined in ASC 205, the guidance provides the following examples of disposals that represent a strategic shift that has (or will have) a major effect on an entity's operations: selling a major geographical area, a major line of business, or a major equity method investment.

ASC 205-20-55-83 through 101 includes five examples of dispositions that would qualify as a strategic shift –

1. The sale of a product line that represents 15 percent of the entity's total revenues.
2. The sale of a geographical area that represents 20 percent of the entity's total assets.
3. The sale of all the entity's mall stores (which historically have provided 30 to 40 percent of the entity's total net income and 15 percent of its current total net income) so that the entity can focus solely on its supercenter stores.
4. The sale of a component that is an equity method investment that represents 20 percent of the entity's total assets.
5. The sale of an 80 percent interest in one of two product lines that account for 40 percent of total revenue.

If the disposal is determined to not represent a strategic shift, the entity should consider if the disposal falls within ASC 420.

2 The disposal must be a component or a group of components.

A component of an entity consists of operations and cash flows that are clearly identifiable and distinguished. A component may be a segment, division, business unit, or asset group that is reported individually for operational and financial reporting purposes.

ASC does not provide bright lines in the definition of a component of an entity, management will need to use judgement when determining if a disposal group meets the criteria of a component.

3 Meets the criteria to be classified as held for sale, is disposed of by sale, or is disposed of other than by sale.

Under 205-20-45-1E a component of an entity or a group of components of an entity, or a business or nonprofit activity, shall be classified as held for sale in the period in which all of the following criteria are met:

i. The sale has been approved. Management, having the authority to approve the action, commits to a plan to sell the entity to be sold.

ii. No major changes need to be made prior to the sale. The entity to be sold is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such entity to be sold.

iii. The seller is searching for a buyer. An active program to locate a buyer(s) and other actions required to complete the plan to sell the entity to be sold have been initiated.

iv. The sale is likely to occur soon. The sale of the entity to be sold is probable, and transfer of the entity to be sold is expected to qualify for recognition as a completed sale, within one year, except as permitted by paragraph 205-20-45-1G.

v. The sale price is fair. The entity to be sold is being actively marketed for sale at a price that is reasonable in relation to its current fair value. The price at which an entity to be sold is being marketed is indicative of whether the entity currently has the intent and ability to sell the entity to be sold. A market price that is reasonable in relation to fair value indicates that the entity to be sold is available for immediate sale, whereas a market price more than fair value indicates that the entity to be sold is not available for immediate sale.

vi. The plan is developed. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

To qualify as a discontinued operation, a divestiture must meet the criteria to be classified as held for sale. As such, ASC 360-10 held for sale guidance should be applied to all long-term assets within the disposal group.

If a component of an entity is disposed of or classified as held for sale and does NOT meet the criteria to be reported as discontinued operations, utilize ASC 360-10-45 for presentation matters.

III. What to Classify as Discontinued Operations

Discontinued operations presentation requires the results of the discontinued operation and the assets and liabilities of the discontinued operation be presented separately in the financial statements. As a result, an entity must evaluate which balances and activities should be included in discontinued operations for financial statement presentation.

Assets and liabilities

Assets and liabilities directly attributable to the disposal should be presented as discontinued operations.

These assets and liabilities should be expected to be transferred on the disposal date. Typically, these amounts are outlined within the transaction agreement. This makes it clear to all parties involved which assets and liabilities will be included as a part of the disposal. As debt obligations are generally held at the parent level, they are typically not included as part of the disposal group. However, if it is explicitly stated that the obligation will be assumed by the buyer these obligations should be presented as discontinued operations.

As previously stated, treatment of long-lived assets within the disposal group are valued in accordance with ASC 360-10. Other assets such as accounts receivable, inventory and all liabilities attributable to discontinued operations do not fall within the ASC 360-10 long-term assets guidance and should be separately evaluated. These assets and liabilities should be adjusted for impairment in accordance with applicable GAAP standards prior to the entity measuring fair value less cost to sale of the disposal group.

Long-lived assets should be measured at the lower of the carrying amount or fair value less costs to sell. If the carrying value exceeds the asset's fair value less costs to sell, the asset should be written down and a loss upon classification to held for sale should be recognized. If the carrying value is below the fair value less costs to sell, no adjustment is required.

If the assets written down upon classification to held for sale have a subsequent increase in fair value, a gain should be recognized. However, this gain cannot be more than the original loss recognized. Gain or loss on classification is reported on the income statement during the period incurred.

When evaluating the fair value of goodwill and other intangible assets classified as held for sale, consider specific criteria within ASC 350-20-40-1 through 40-7.

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The term "moving with the deal" is commonly used to describe the assets and liabilities that should be allocated to discontinued operations. Post separation, these assets and liabilities will no longer belong to the entity.

Revenues and expenses

Revenues and expenses that are directly attributable to the discontinued operation and that the entity will not continue to recognize after the disposal should be allocated to discontinued operations.

Per ASC 205-20-45-9, general corporate overhead should not be allocated to discontinued operations. Below are common areas to consider when presenting discontinued operations net income.

Depreciation and amortization should not be recognized on long-term assets classified as held for sale.

If applicable, a gain or loss on classification to held for sale should be presented in the discontinued operations section of the income statement in the period the entity meets the held for sale criteria. The gain or loss should continue to be presented in subsequent reporting periods until the reporting period in which the disposal occurs. In the period of disposal, the entity should recognize only a gain or loss on disposal.

Incremental direct costs incurred to complete the exit or disposal should be included within discontinued operations in accordance with ASC 420-20-45-10.

Per ASC 205-20-45-6, interest on debt that is to be assumed by the buyer or debt that is required to be repaid because of the transaction should be presented as discontinued operations. If the debt is specific to the disposed component (not corporate level), the entity should allocate amortization of discounts, premiums, or debt issuance costs, prepayment penalties, and gain or loss on extinguishment to discontinued operations. If the debt is not a corporate level obligation the entity must allocate the amortization of discounts, premiums, or debt issuance costs, and the gain or loss on extinguishment related to the prepayment to discontinued operations.

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It is important to consider early on if the disposition will trigger a mandatory debt repayment. This repayment must be calculated prior to the transaction's close date in order to allocate interest expense to discontinued operations.

Allocating consolidated interest that is not directly attributable to other operations of the entity to discontinued operations is allowed but not required under ASC 205-20-45-7.

If sales between an entity and its discontinued operation were historically eliminated in consolidation (related party), these sales and associated expenses should be grossed up for the purposes of presenting continuing and discontinued operations. However, if these sales are not expected to continue following the disposal or if the inventory has never been sold to a third-party customer, such presentation would not be appropriate.

IV. Financial Statement Presentation and Disclosure (GAAP)

Balance sheet presentation

Per ASC 205-20-45, in the period in which the discontinued operation criteria is met, the assets and liabilities of the disposal should be presented as separate financial statement line items within the asset and liability sections of the balance sheet for all periods presented. The major classes of assets and liabilities of discontinued operations must be disclosed on the face of the balance sheet or within the accompanying notes.

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Assets and liabilities cannot be offset and presented as a single amount on the balance sheet.

The guidance does not specify if the assets and liabilities of discontinued operations should be further disaggregated into current or noncurrent line items. However, disaggregation between current and noncurrent is typical practice. To ensure proper classification between current and non-current, a reporting entity should consider whether it expects to use the proceeds of the sale to pay down long-term borrowings. If so, classifying the borrowings as current would be appropriate. Refer to **Exhibit A** for captions typically used to present assets and liabilities of discontinued operations.

If a discontinued operation is disposed of in the period in which it meets the discontinued operations criteria, historical balance sheets presented in the financials must be retrospectively adjusted for comparative purposes. The historical periods should present assets and liabilities as if they were held for sale. As the operation has been disposed, no adjustments to the current period balance sheet are necessary.

Income statement presentation

Under ASC 205-20-45-3, in the period the discontinued operations criteria is met, the results of operations of all discontinued operations, less applicable income taxes, should be presented separately from continuing operations on the income statement. Income taxes from discontinued operations should be presented on a separate line to arrive at total income (loss) from discontinued operations. The loss or (gain) recognized on classification to held for sale should be disclosed on the face of the financials or within the accompanying notes.

In the period of disposal, the results of operations of the disposal up until the disposal date should be presented in accordance with the previously outlined criteria above. The entity should disclose on the face of the financials or within the accompany notes the loss or (gain) on disposal. Refer to **Exhibit B** for captions typically used to present income (loss) from discontinued operations.

Notes to the financial statements

The entity should disclose the following in the notes of the financials under ASC 360-10-50-3.

- A description of the facts and circumstances that lead to the disposal.
- The expected manner and timing of the disposal.
- The gain or loss recognized on long-term assets under ASC 360-10-35-27, 35-45, 260-10-40-5 and the caption of the income statement where it is reported if not disclosed separately on the face.
- The segment in which the long-lived asset (disposal group) is reported under, if applicable.
- A detailed presentation of the major classes of assets and liabilities classified as held for sale if not disclosed separately on the face.

The entity should disclose the following in the notes of the financials under ASC 205-20-50-5:

- A detailed presentation of the major classes of income statement line items that make up pretax income (loss).
- A presentation of (1) the total operating and investing cash flows of discontinued operations OR (2) depreciation, amortization, capital expenditures, and significant noncash operating and investing activities related to discontinued operations if not disclosed on the face of the financials.
- Information about its significant continuing involvement, if any, with a discontinued operation after the disposal date.
- Any changes to the plan for selling the discontinued operation. If the change results in changes to the amounts previously included in discontinued operations, the nature and amount of the adjustments should be disclosed.

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An additional footnote is typically added to the financials to include all the required disclosures. This footnote describes the transaction and includes the balance sheet, income statement, and cash flows of the disposal.

V. SEC Disclosure requirements

Filing requirements

SEC Regulation (S-X) Article 11 outlines the SEC requirements for pro forma reporting. Effective January 1, 2021, the SEC issued final ruling release number 33-10786 “Amendments to Financial Disclosures About Acquired and Disposed Businesses” which amended the rules related to acquired and disposed businesses.

This update amended S-X Rule 1-02(w), Rule 3-05, Rule 3-14, and the pro forma financial statements requirements under Article 11 Rule 11-01 (CRF 210.11-01), 11-02 (CRF 210.11-02) and 11-03 (CRF 210.11-03).

Public entities must consider the information necessary to disclose to investors when a disposition occurs. The entity should first consider if the disposition is significant. A disposition is considered significant if it meets the definition of a significant subsidiary outlined S-X Rule 1-02(w). Certain aspects of the significance test under S-X Rule 1-02(w) were modified under release 33-10786 and should be considered.

If significant, pro forma financial information must be filed under S-X Article 11 if the effect of the disposition is not reflected in the historical filings. The purpose of pro forma financials is to provide investors with the effect on operations as if the disposition had occurred in an earlier reporting period. Even if the disposition does not meet the discontinued operation criteria outlined within ASC 205-20, pro forma financials may still be required if the transaction is significant.

Upon signing an agreement for the disposition, an entity should file Form 8-K announcing their plan to complete the sale, spinoff, or disposal by other means. Within **four days** of the disposition being finalized, the entity is required to file Form 8-K describing the closing of the transaction. This filing should include pro forma financial information under Item 9.01 (b).

For acquisition transactions, a 71-day extension to file pro forma financial information is granted under 9.01(a)(4). However, this extension period is not granted for a significant disposal.

Periods presented

In accordance with S-X Rule 3-01, a pro forma balance sheet should be presented for the most recent reporting period (annual OR interim), unless the transaction was already reflected in the most recent filing. If already reflected or if the effect of the disposal on historical results is minimal, a pro forma balance sheet is not required.

Pro forma income statements should be presented for the most recent fiscal year AND the most recent year-to-date interim period. If the transaction is already reflected in all presented historical income statements for the full periods or when the effect of the disposal on historical results is minimal, pro forma presentation is not required. In accordance with S-X Rule 11-02(c)(2)(ii), there could be circumstances in which additional pro forma statements are required due to a significant disposition. If the discontinued operations have not yet been reflected for ALL years presented in the most recent Form 10-K, additional pro forma income statement(s) for the prior comparative annual period(s) must be presented. If required, this would result in the presentation of **three** (small reporting or emerging growth company) or **four** (large accelerated filer) total pro forma income statements. For pro forma financial information, only income for continuing operations should be presented. Income from discontinued operations should be excluded from the results.

When the effects of the disposal are minimal, a narrative description of the pro forma adjustments could be included in Item 9.01(b) in lieu of pro forma financials. Management should work with SEC counsel to ensure compliance with applicable regulations.

Pro forma adjustments

Specific pro forma adjustment requirements for acquisitions and disposals are found within S-X Article 11 Rule 11-02(a)(6). There are three types of pro forma adjustments –

1) Transaction Accounting Adjustments

2) Autonomous Entity Adjustments

3) Management's Adjustments

Transaction accounting adjustments demonstrate the effect of accounting for the transaction under US GAAP. The adjustments are required and must be presented in columnar format on the face of the pro forma statement.

Autonomous entity adjustments reflect the financial position and results of operations as if the entity were a separate stand-alone entity. The adjustments are required to be presented in a columnar format if the entity was previously a part of another entity.

Management's adjustments depict synergies and dis-synergies of the acquisition or disposition. The adjustments are optional.

When a significant disposal occurs, generally only transaction accounting adjustments are presented on the face of the pro forma financials. This is because autonomous entity adjustments typically do not apply to a company completing a disposal. These adjustments are generally applicable to entities being spun off in a spinoff transaction. However, if applicable the adjustments should be in a column (separate from transaction accounting adjustments) on the pro forma financials. As management's adjustments are optional, they are only described in the pro forma notes and NOT presented on the face of the pro forma financials. Refer to **Exhibit C** for an example of pro forma financials presentation.

The pro forma balance sheet should present the transaction accounting adjustments and autonomous entity adjustments (if applicable) as if the transaction occurred on the balance sheet date. The pro forma income statement should present the transaction accounting adjustments and autonomous entity adjustments (if applicable) as if the transaction occurred at the beginning of the fiscal year presented and carried forward through the subsequent interim period. The same rules apply for management's adjustments; however, the adjustments are described only within the notes.

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The guidance does not provide bright lines on how transaction accounting adjustments should be presented when more than one fiscal year income statement is required to be presented under Rule 11-02(c)(2)(ii). This has led to variations in practice with adjustments being presented as if the transaction occurred at the beginning of the most recent fiscal year OR at the beginning of the earliest fiscal year presented.

Refer to the scenario outlined below for an example of suggested filing requirements –

A registrant finalized a significant disposal on 7/14/23. The most recent reporting period was Q2 2023 reported on Form 10-Q. The company would be required to report pro forma financial information four days following the close of the transaction on 7/18/23. A pro forma balance sheet should be presented as of 6/30/23 (the most recent reporting period). A pro forma income statement should be presented for the six months ended 6/30/23 (the most recent year-to-date interim period), the twelve months ended 12/31/22 (the most recent fiscal year), and the twelve months ended 12/31/21 (the additional period required to be presented on per Rule 11-02(c)(2)(ii).).

Balance sheet accounting adjustments should be applied as if the transaction occurred 6/30/2023 (the balance sheet date). The income statement adjustments should be applied as if the transaction occurred 1/1/2022 (the beginning of the most recent fiscal year reported or ended).

Pro forma explanatory notes

All pro forma adjustments should be clearly explained in the explanatory notes of the pro forma financial statements. Any assumptions made should be included in the explanation. Common pro forma adjustments for a significant disposal include the following –

1. *Amounts reclassified to discontinued operations*
2. *Cash proceeds received at closing*
3. *Debt required to be repaid as a result of the transaction*
4. *Transactions costs that were required to complete the sale ti have not been expensed and accrued*
5. *Tax effects*

For the transaction adjustment that shows the consideration transferred (cash proceeds received at closing), a table should be included to outline each piece of consideration.

VI. Key Takeaways

When an entity plans to dispose of a portion of their business they should evaluate if the disposal meets the discontinued operations criteria. Once the criteria is met, the entity will present discontinued operations in the applicable reporting period. ASC 205, ASC 360 and other applicable guidance under US GAAP provide guidance on what amounts should be allocated to discontinued operations as well as disclosure requirements. If the entity is public and the disposal is determined to be significant, pro forma financial information is required. The pro forma financials should be presented in accordance Regulation S-X Article 11, Pro Forma Financial Information, as amended by the final rule, Amendments to Financial Disclosures About Acquired and Disposed Businesses, as adopted by the SEC on May 20, 2020.

ABOUT US

TBH Consulting provides accounting and financial reporting services. We deliver Big 4 level of experience to our clients at competitive rates. We can mobilize the right resources at the right time to meet our clients' needs, whether such clients are Fortune 500, middle-market public companies or pre-IPO companies.

CONTACT US

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Exhibit A

Company A
Consolidated Balance Sheet

	December 31, 2023	December 31, 2022
Assets		
Current assets:		
Cash	$ 50,000	$ 42,000
Accounts receivable	30,000	32,000
Inventory	7,000	6,000
Current assets of discontinued operations	12,000	13,000
Total current assets	99,000	93,000
Property and equipment, net	9,000	10,000
Intangible assets, net	7,000	8,000
Noncurrent assets of discontinued operations	3,000	4,000
Total assets	**$ 118,000**	**$ 115,000**
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 8,000	$ 9,000
Accrued expenses	9,000	10,000
Current portion of long-term debt	3,000	2,000
Current liabilities of discontinued operations	6,000	7,000
Total current liabilities	26,000	28,000
Long-term debt	41,000	38,000
Other long-term liabilities	1,000	2,000
Noncurrent liabilities of discontinued operations	2,000	1,000
Total liabilities	70,000	69,000
Stockholders' equity:		
Common Stock	10,000	10,000
Additional paid-in capital	5,000	5,000
Retained Earnings	33,000	31,000
Total stockholders' equity	48,000	46,000
Total liabilities and stockholders' equity	**$ 118,000**	**$ 115,000**

Exhibit B

Company A
Consolidated Statement of Income

	Year Ended December 31,		
	2023	**2022**	**2021**
Net sales	$ 42,000	$ 40,000	$ 38,000
Cost of sales	22,000	21,000	20,000
Gross profit	20,000	19,000	18,000
Sales, general, and administrative expenses	8,000	7,000	6,000
Operating income	12,000	12,000	12,000
Interest expense	2,000	3,000	2,000
Other income	3,000	3,000	1,000
Income before income taxes	7,000	6,000	9,000
Income tax provision	1,000	2,000	2,000
Net income from continuing operations	6,000	4,000	7,000
Loss from discontinued operations, net of tax (including loss on disposal of $527)	(4,000)	(3,000)	(4,000)
Net income	$ 2,000	$ 1,000	$ 3,000
Earnings per common share:			
Earnings from continuing operations per common share - basic	$ 0.60	$ 0.40	$ 0.70
Earnings per from continuing operations per common share - diluted	$ 0.50	$ 0.33	$ 0.58
Loss from discontinued operations per common share - basic	$ (0.40)	$ (0.30)	$ (0.40)
Loss from discontinued operations per common share - diluted	$ (0.33)	$ (0.25)	$ (0.33)
Earnings per common share - basic	$ 0.20	$ 0.10	$ 0.30
Earnings per common share - diluted	$ 0.17	$ 0.08	$ 0.25
Weighted average common shares outstanding - basic	10,000,000	10,000,000	10,000,000
Weighted average common shares outstanding - diluted	12,000,000	12,000,000	12,000,000

Exhibit C

Company A
Unaudited Pro Forma Condensed Consolidated Statement of Income
For the Twelve Months Ended December 31, 2023

	Historical	Transaction Accounting Adjustments: Discontinued Operations (Note a)	Transaction Accounting Adjustments: Continuing Operations	Transaction Accounting Adjustments: Other Adjustments	Pro Forma
Net sales	$ 46,000	$ (4,000)	$ 42,000	$ -	$ 42,000
Cost of sales	24,000	(2,000)	22,000	-	22,000
Gross profit	22,000	(2,000)	20,000	-	20,000
Sales, general, and administrative expenses	11,000	(3,000)	8,000	400 (b)	8,400
Operating income	11,000	1,000	12,000	(400)	11,600
Interest expense	3,000	(1,000)	2,000	100 (c)	2,100
Other income (loss)	3,000	-	3,000	-	3,000
Income before income taxes	5,000	2,000	7,000	(500)	6,500
Income tax provision	1,000	-	1,000	-	-
Net Income from continuing operations	4,000	2,000	6,000	(500)	6,500
Earnings per common share:					
Earnings from continuing operations per common share - basic	$ 0.40				
Earnings from continuing operations per common share - diluted	$ 0.33				
Weighted average common shares outstanding - basic	10,000,000				
Weighted average common shares outstanding - diluted	12,000,000				