

Interpretive Response: No. The circumstances are such that the risks of the business have not, in substance, been transferred to Company Y or its owners. In assessing whether the legal transfer of ownership of one or more business operations has resulted in a divestiture for accounting purposes, the principal consideration must be an assessment of whether the risks and other incidents of ownership have been transferred to the buyer with sufficient certainty.

When the facts and circumstances are such that there is a continuing involvement by the seller in the business, recognition of the transaction as a divestiture for accounting purposes is questionable. Such continuing involvement may take the form of effective veto power over major contracts or customers, significant voting power on the board of directors, or other involvement in the continuing operations of the business entailing risks or managerial authority similar to that of ownership.

Other circumstances may also raise questions concerning whether the incidents of ownership have, in substance, been transferred to the buyer. These include:

- Absence of significant financial investment in the business by the buyer, as evidenced, for instance, by a token down payment;
- Repayment of debt which constitutes the principal consideration in the transaction is dependent on future successful operations of the business; or
- The continued necessity for debt or contract performance guarantees on behalf of the business by the seller.

In the above transaction, the seller's continuing involvement in the business and the presence of certain of the other factors cited evidence the fact that the seller has not been divorced from the risks of ownership. Accounting for this proposed transaction as a divestiture—even with deferral of the “gain”—does not reflect its economic substance and therefore is not appropriate.

Further, Company X may need to consider whether it should consolidate Company Y by way of its variable interests pursuant to the provisions of FASB Interpretation 46.

Question 2: If the transaction is not to be treated as a divestiture for accounting purposes, what is the proper accounting treatment?

Interpretive Response: If, in the circumstances surrounding a particular transaction, a determination is made that a legal transfer of business ownership should not be recognized as a divestiture for accounting purposes,

an accounting treatment consistent with that determination is required. In this instance, if Company Y is not consolidated by Company X, the assets and liabilities of the business which were the subject of the transaction should be segregated in the balance sheet of the selling entity under captions such as: “Assets of business transferred under contractual arrangements (notes receivable),” and “Liabilities of business transferred” or similar captions which appropriately convey the distinction between the legal form of the transaction and its accounting treatment.

A note to the financial statements should describe the nature of the legal arrangements, relevant financing and other details and the accounting treatment.

Where, as in this instance, realization of the sale price is wholly or principally dependent on the operating results of the business operations which were the subject of the transaction, the uncertainty associated with such realization should be reflected in the financial statements of the seller. Thus, absent a deterioration in the business, any operating losses of the divested business should be considered the best evidence of a change in valuation of the business in a manner somewhat analogous to equity accounting for an investment in common stock.¹ If the business suffered a loss during its initial period of operations after the transaction, that loss should be reflected in the financial statements of the seller by recording a valuation allowance and a corresponding charge to income. The amount of the valuation allowance (absent unusual circumstances) would be at least the amount of the loss attributable to the business. Other evidence, however (such as a question as to the ability of the business to continue as a going concern), might require that a higher valuation allowance be established.

This accounting treatment should be continued for each period until either:

1. The net assets of the business have been written down to zero (or a net liability recognized in accordance with GAAP); or

¹ The staff recognizes that APB Opinion 18 is specifically applicable only to the use of the equity method of accounting for investments in common stock. The principles enunciated in Opinion 18 are also relevant in these particular circumstances, however, notably paragraph 12, which states, in pertinent part: “The equity method tends to be most appropriate if an investment enables the investor to influence the operating of financial decisions of the investee. The investor then has a degree of responsibility for the return on its investment, and it is appropriate to include in the results of operations of the investor its share of the earnings or losses of the investee.”

2. Circumstances have changed sufficiently that it has become appropriate to recognize the transaction as a divestiture.

In the latter instance, it would normally also be appropriate to recapture any asset balance remaining on the balance sheet of the seller in keeping with the changed circumstances, e.g., “Notes receivable.”

In the case where the business reports net income, such net income should not be recorded by the former owner, because the rewards of ownership (but not the risks) have been passed to Company Y. Any payments received on obligations of the buyer arising out of the transaction should be treated as a reduction of the carrying value of the segregated assets of the business.

Question 3: Should Company X recognize interim (quarterly) losses of the business even if it is projected that it will have a profit for the full year?

Interpretive Response: Yes. However, for quarters for which the business has net income, such net income may be recognized by Company X to the extent of any cumulative quarterly losses within the same fiscal year. Similarly, quarterly losses of the business need not be recognized by Company X except to the extent that they exceed any cumulative quarterly net income within the same fiscal year. Disclosure of this accounting treatment should be made in the notes to Company X's interim financial statements.

Question 4: If the accounting treatment described above is applied to the transaction, when should a gain or loss on the transaction be recognized?

Interpretive Response: Whether or not the transaction is treated as a divestiture for accounting purposes, GAAP require that losses on such transactions be recognized. When it is determined that no divestiture should be recognized for accounting purposes, it follows that gain should not be recognized until:

1. The circumstances precluding treatment of the transaction as a divestiture have changed sufficiently to permit such recognition; and,

2. Any major uncertainties as to ultimate realization of profit have been removed, that is, the consideration received in the transaction can be reasonably evaluated.

The authoritative literature indicates that:

Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured.²

² ARB 43, Chapter 1, Section A. This passage is also quoted in paragraph 12 of APB Opinion 10,