
ORGANIC FOODS: THE FINANCIAL REPORTING OF DISCONTINUED OPERATIONS

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CASE DESCRIPTION

The primary subject matter of this case concerns the proper financial reporting of gains or losses on discontinued operations per Generally Accepted Accounting Principles (GAAP). This case has a difficulty level of three, appropriate for junior level courses. The case is designed to be taught in a one class hour and is expected to require three to four hours of outside preparation by students. The case would be appropriate for an undergraduate intermediate accounting course or graduate courses in either financial accounting theory or applied financial accounting research. Students will need access to Statement of Financial Accounting Standard No. 144, "Accounting for the Impairment or Disposal of Long-Lived Asset" and APB #30. These standards can be downloaded from the Financial Accounting Standards Board (FASB) web site at www.fasb.org or can be found on the Financial Accounting Research System disk that may be packaged with Intermediate Accounting or other advanced financial accounting textbooks.

CASE SYNOPSIS

This case provides students the opportunity to apply a financial reporting standard to a real-world situation where there is uncertainty about the proper reporting of restructuring costs. Specifically, Organic Foods, a publicly owned organic food retailing chain, is restructuring parts of its business and management is hoping to report all the related costs in a discontinued operations section at the bottom of their Income Statement. Financial analysts often spend very little time evaluating the discontinued operations section since it is not considered part of income from operations and usually includes only non-recurring disposal costs. For this reason, company managements have been known to pressure their accountants to include inappropriate costs in discontinued operations rather than reporting them as operations related expenses.

The case requirements have been separated into two parts -- Part A and Part B. Instructors can choose to have students complete Part A only or both Part A and Part B. In Part A, students: 1) read and interpret FAS #144 to determine the GAAP requirements for discontinued operations, and 2) apply those requirements to Organic Food's restructuring costs. However, Part A does not require the actual completion of any financial statements. Instead, Part A focuses on understanding

the appropriate accounting for Organic's restructuring costs without getting into the computational details of preparing Comparative Income Statements.

Part B provides financial information and requires students to complete Comparative Income Statements based on the decisions they made in Part A. In addition, Part B requires students to discuss the impact of the required financial reporting on management and shareholder decision making. Overall, the case provides students the ability to develop skills they will need to understand and apply FASB based financial reporting standards to uncertain situations.

INSTRUCTORS' NOTES

This case examines the financial reporting requirements for discontinued operations. The case is designed primarily for intermediate accounting or graduate accounting students. For intermediate accounting classes, the case would best be used as a supplement to the property, plant, and equipment chapter. Prior to beginning the case, students will need to acquire FAS #144, "Accounting for the Impairment or Disposal of Long-Lived Assets" and APB #30 from the FASB web site (www.fasb.org) or from other sources. In addition, students should be told to concentrate on the FAS #144 sections that relate to discontinued operations (i.e., FAS #144, para. 41 - 44 and FAS #144, Appendix A, para. A24 - A31).

The case requirements are divided into two parts -- Part A and Part B. Instructors may assign Part A only or both Part A and Part B, depending on the depth of analysis desired.

Part A: The Financial Reporting Research Issue, may be assigned without Part B if instructors want students to apply the discontinued operations reporting requirements to the case situation without actually preparing the related Comparative Income Statements.

Part B: Preparation of Comparative Income Statements and Analysis, may be added to the assignment if instructors wish to extend the case to include the preparation of the Comparative Income Statements. Students are also asked to discuss the likely impact of the required financial reporting on management and stockholder decision-making.

Prior to beginning the in-class discussion of the case, instructors should emphasize that financial analysts often give discontinued operations less scrutiny because it is believed that the section only includes special, nonrecurring gains or losses. For this reason, company managements often try to pressure their accountants to place a variety of losses in the discontinued operations section with the hope that analysts will not focus on those losses. As such, the ethical responsibilities of the accountants in the case can also be discussed.

CASE OVERVIEW

This case can be used for the following primary purposes:

- ◆ to develop students' technical knowledge of the FAS #144 requirements for reporting gains/losses on discontinued operations,
- ◆ to develop analytical thinking skills by requiring students to apply the FAS #144 reporting requirements to a set of business activities where it is uncertain whether those activities qualify for discontinued operations treatment,
- ◆ to use FAS #144's discontinued operations reporting requirements to prepare Comparative Income Statements for Organic Foods,
- ◆ to develop an understanding of how FAS #144 reporting requirements differ from those that were in place under the superseded APB #30, and
- ◆ to develop an understanding of the potential impact of discontinued operations on management and stockholder decision-making.

DISCUSSION QUESTIONS FOR PART A: THE FINANCIAL REPORTING RESEARCH ISSUE

1. **Based on FAS #144, "Accounting for the Impairment or Disposal of Long-Lived Assets" where are gains and losses associated with discontinued operations shown on an Income Statement? Where are gains and losses on the disposal of long-lived assets that do not qualify as discontinued operations usually shown?**

FAS #144, para. 43 requires that the results of discontinued operations, less applicable income taxes (benefits), shall be reported as a separate component of income before extraordinary items and the cumulative effect of accounting changes (if applicable).

FAS #144, para. 45 requires gains and losses on disposal of long-lived assets that do not qualify as discontinued operations to be shown in the income from operations section of an Income Statement.

FAS #144, para. 43 also provides an Income Statement format that may be used when discontinued operations are included. Students that will not be completing the Part B requirements of the case should be asked to review this format to ensure they understand how an Income Statement would be presented when a company incurs discontinued operations.

2. Based on FAS #144, “Accounting for the Impairment or Disposal of Long-Lived Assets” what criteria are used to determine if a gain or loss qualifies for discontinued operations treatment?

Answering this question is critical in the process of determining the proper financial reporting for Organic Foods. Students must be able to correctly extract the appropriate discontinued operations criteria from FAS #144 prior to assessing the facts in the Organic Foods case. FAS #144 does not have the criteria well laid out so students will need to use their analytical thinking skills to summarize the required criteria.

The answers to this question are buried in FAS #144, para. 41 - 43. Some of the criteria are explicit that students will identify quickly, while some are more implicit and students are likely to miss them. **A summary of the four key criteria students should identify include:**

1. The PPE assets being disposed of must be classifiable as a “component of an entity.”

The standard indicates that 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 (FAS #144, para. 41). A component may be a reportable segment, an operating segment (as per FAS #131), a reporting segment (as per FAS #142), a subsidiary, or even just an “asset group” (as per FAS #144, para. 4).

Students do not need to get into the specifics of the different ways a component can be defined. They should understand that 1) more than one asset is being disposed of, 2) there is a logical argument for calling that set of disposed assets a component of the entity, and 3) those assets must have distinct operations and cash flows.

2. The component has been disposed of or is classified as held-for -sale.

This is noted in FAS #144, para. 43, but it is not highlighted and students may easily miss this requirement. This criteria will be important in classifying some of Organic Food’s gains/losses. Specifically, students should understand that impairments of PPE assets being held-for-use do not qualify as discontinued operations gains/losses.

3. 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 (FAS #144, para. 42).

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4. **The entity will not have any significant continuing involvement in the operations of the component after the disposal transaction (FAS #144, para. 42).**
 3. **Identify what you believe are appropriate components of the entity for Organic Foods. Identify any related costs discussed at the February 1 meeting that you believe will qualify for the discontinued operations section of the Income Statement.**

This is the core question for Part A of the case. If students have completed the prior discussion questions they should be able to apply the criteria summarized in discussion question 2 to Organic Foods. If desired, this question can be segmented into the components shown in the answer below to help provide students a more focused way to respond.

Arizona Segment. Most students will classify all the Arizona stores into one operating component of Organic Foods. Some students may argue that each of the Arizona stores should be viewed as a separate component of Organic Foods. However, the reporting of the related gains/losses will not be affected by that distinction and it is recommended the discussion include all of the Arizona stores as a component.

Clearly, the Arizona stores are a component of the company and the first criteria noted under discussion question 2 is met. Further, the existing five stores will be sold under the proposed restructuring plan so the second criteria noted in discussion question 2 is also met. However, criteria three and four from discussion question 2 above are not met and the restructuring of the Arizona operations DOES NOT qualify as discontinued operations. Overall, the company will continue to service the Arizona segment with the new megastores so the company will not be eliminating the component from continuing operations and they will have continuing interest in the Arizona segment operations. Therefore, any gains or losses on this restructuring cannot be included in the discontinued operations section and must be shown as income from operations.

Note that FAS #144, Appendix A, para. A-24 to A-31 provides specific examples of how to apply the discontinued operations criteria. The example in FAS #144, Appendix A, para. A-31 specifically addresses this exact situation where a company is combining individual stores into a “superstore.” That example indicates the gains/losses incurred when combining stores do not qualify as discontinued operations. Instructors should note that FASB often provides examples in appendixes that give guidance as to what was intended in the standard.

Nevada Segment. The Nevada stores and warehouse are to be closed and Organic Foods will exit doing business in the area. Students applying the four criteria shown in discussion question 2 should determine that all criteria are clearly met and any gains and losses from closing the Nevada operations do qualify as gains/losses on discontinued operations.

As part of this discussion, instructors should ask students how to report the regular operating losses the Nevada stores incurred in 2008 and 2009 and those they will incur until the stores are closed in 2010. FAS #144, para. 43 indicates that Income Statements for current and prior periods shall report results of operations of the component in discontinued operations. This indicates that the operating losses from 2008 and 2009 need to be reclassified into the discontinued operations section when preparing the financial statements for the 2009 Annual Report. In addition, the operating losses in 2010 until the stores are closed will be included in the discontinued operations section in the 2010 Income Statement. Students completing Part B of the case will need to apply these requirements in preparing the Comparative Income Statements.

Impairment Loss on Southern California Warehouse. The Southern California warehouse will likely have an impairment loss. The company believes the loss is primarily due to the closing of the Nevada segment. However, students will still need to use the criteria identified in discussion question 2 above to determine how the impairment loss should be reported.

Overall, the impairment loss does not meet any of the discontinued operations reporting criteria. Specifically, the first criteria does not appear to be met since the warehouse is part of the Southern California operations and it is not a component of the entity. Recall that a component is some type of grouping of assets which has “operations and cash flows that can clearly be distinguished, operationally and for financial reporting purposes, from the rest of the entity” (FAS #144, para. 41). Further, the second criteria is not met since the company appears to be leaning toward holding the warehouse for further use. Finally, the third and fourth criteria are not met since the warehouse is not being eliminated from on-going operations of the company. Overall, the company will need to show any impairment loss as part of income from operations.

- 4. Be prepared to discuss in-class how you and the Controller might want to communicate your financial reporting recommendations to the CEO given the reporting preferences he voiced at the February 1 restructuring meeting.**

This discussion question gives instructors the opportunity to discuss how to best communicate your financial reporting recommendations to a supervisor who desires a specific financial presentation of the restructuring costs. In this case, it would be best that

the Controller accept your findings and have a willingness to carry them to upper management. Some of the key things that could be done to help the CEO understand your financial reporting recommendations include:

- a. The discontinued operations requirements of FAS #144 should be clearly summarized in writing for the CEO and objectively applied to the components of Organic Foods.
- b. The documentation provided to the CEO should clearly indicate that the company's auditor would not accept a financial presentation of the costs that would violate FAS #144 requirements.
- c. The Controller might ask the company auditors (or other CPAs) to provide additional guidance as to how they believe the restructuring or disposal costs should be presented. The response of the CPAs can be forwarded to the CEO.

Overall, any discussion with the CEO should rely on the FAS #144 requirements as the basis to show costs in a discontinued operations section of an Income Statement.

**DISCUSSION QUESTIONS FOR PART B:
PREPARATION OF COMPARATIVE INCOME STATEMENTS AND ANALYSIS**

- 5. Prepare the Comparative Income Statements for 2008 and 2009 using the format provided by the Controller. Use the decisions you made in Part A of the case when completing the Other Operating Expenses and the Discontinued Operations sections.**

The appropriate Comparative Income Statements are shown below. All costs (both operating and disposal) for the Nevada operations are shown in the discontinued operations section. Restructuring costs for the Arizona segment and the impairment of the Southern California warehouse are shown as Other Operating Expenses.

Organic Foods				
Comparative Income Statements				
For the Years Ended 12/31/2009 and 12/31/2008				
(In Thousands)	2009		2008	
Revenues		\$186,000		\$155,000
- Costs of Goods Sold and Occupancy Costs		<u>- \$121,000</u>		<u>- \$99,000</u>
Gross Profit		\$65,000		\$ 56,000
Other Operating Expenses:				
General and administrative expenses	\$58,100		\$50,400	
Other items classified as operations related expenses:				
Restructuring Costs to Arizona Operating Segment	\$ 240		\$ 0	
Loss on Impairment of Southern California Warehouse	<u>\$ 60</u>		<u>\$ 0</u>	
Total Operating Expenses		<u>- \$58,400</u>		<u>- \$50,400</u>
Income From Continuing Operations (Before Taxes)		\$6,600		\$ 5,600
- Income Tax Expense (30%)		<u>- \$1,980</u>		<u>- \$ 1,680</u>
Income From Continuing Operations		\$4,620		\$ 3,920
Discontinued Operations:				
Loss from operations of discontinued component(s), less applicable income taxes of \$150 for 2009; \$180 for 2008.	\$350		\$420	
Loss from disposal of discontinued component(s), less applicable income taxes of \$123 for 2009; \$0 for 2008.	<u>\$287</u>		<u>\$ 0</u>	
Total Net Losses on Discontinued Operations		<u>- \$ 637</u>		<u>- \$ 420</u>
Net Income		<u>\$3,983</u>		<u>\$ 3,500</u>

Income Statement Preparation Related Notes for Instructor:

- (a) The revenue and cost of goods sold/occupancy costs are the combined Southern California and Arizona segment amounts from Exhibit 1 in the case. All related revenue and cost of goods sold/occupancy cost items for the Nevada segment have been restated to the discontinued operations section for both 2008 and 2009.
- (b) The other operating expense section includes the Arizona segment restructuring costs and the impairment loss on the Southern California warehouse. These items cannot be included in the discontinued operations section (as discussed in Part A of the case).
- (c) The discontinued operations subtotal for “loss from operations” includes all operations related losses for 2008 and 2009, respectively, that are shown in Exhibit 1 for the Nevada segment, net of the 30% tax rate. The \$20 thousand dollar expected 2010 operating loss for the Nevada Segment is excluded (see Exhibit 2). FAS #144 requires expected future operating losses to be reported when they are incurred (i.e., 2010 Income Statement). Finally, FAS #144 requires all operations related gains or losses to be reported in the “loss from operations” subtotal regardless of whether they were incurred before or after the date the segment was classified as held-for-sale. Therefore, the note provided to the students in Exhibit 1 that separates the operating losses into those that were incurred before and after the restructuring decision date is not relevant to the preparation of the Comparative Income Statements.
- (d) The discontinued operations subtotal for “loss on disposal” for 2009 is \$287 thousand dollars, net of the 30% tax. It consists of the actual Nevada segment disposal costs to date of \$400 thousand dollars plus the \$10 thousand dollar estimated future Nevada segment PPE losses (see Exhibit 2) times .70. Unlike estimated future losses on operations discussed in note 3 above, FAS #144 requires that estimated future losses on disposal be recognized in the period the component is classified as held-for-sale.
- (e) Prepare a memo to the Controller that provides in bullet points the critical differences between FAS #144 requirements for the discontinued operations section and those that were required by the superseded APB #30.

The student memos should include the following key differences between FAS #144 and APB #30:

- a. FAS #144 expanded the discontinued operation provisions so that more disposal situations would likely trigger the display of discontinued operations. Specifically, FAS #144 allows any “component of the entity” to be considered for discontinued operations treatment while APB #30 only allowed “segments of the entity” to be considered. A component of the entity can be a much smaller portion of a company than a segment of the entity was under APB #30.
- b. APB #30 required that both estimated future operating losses and future disposal losses be anticipated and recorded in the year the segment was classified as held-for-sale. However, under FAS #144 the treatment of operating losses of a component designated as held-for-sale has changed considerably from prior practice. In particular, FAS #144 requires that expected future operating losses be recorded in the period incurred. This change was made because the accrual of estimated future operating losses under APB #30 did not conform to the definition of liabilities as stated within the FASB’s Conceptual Framework. On the other hand, FAS #144 continues to require that estimated future losses on disposal be anticipated and recorded in the period the component is classified as held-for-sale.
- c. FAS #144 abandoned the APB #30 requirement of distinguishing between operating results that occurred before and after the date the disposal was announced (i.e, the “measurement date” under APB #30). Operating losses for a discontinued component that occur after the disposal announcement date are now included in the losses from operations subtotal in discontinued operations and not under the losses on disposal subtotal as required by APB #30.