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FASB Amends Guidance on Derecognition and Partial Sales of Nonfinancial Assets

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Introduction

On February 22, 2017, the FASB issued ASU 2017-05,[1] which clarifies the scope of the Board's recently established guidance on nonfinancial asset derecognition (ASC 610-20[2]) as well as the accounting for partial sales of nonfinancial assets. The ASU conforms the derecognition guidance on nonfinancial assets with the model for transactions in the new revenue standard[3] (ASC 606, as amended).

The FASB issued the ASU in response to stakeholder feedback indicating that (1) the meaning of the term "in-substance nonfinancial asset" is unclear because the Board's new revenue standard does not define it and (2) the scope of the guidance on nonfinancial assets is confusing and complex and does not specify how a partial sales transaction should be accounted for or which model entities should apply.

[1] FASB Accounting Standard Update No. 2017-05, *Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets*.

[2] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

[3] FASB Accounting Standards Update No. 2014-09, *Revenue From Contracts With Customers (Topic 606)*.

Key Provisions of the ASU

Scope

The ASU clarifies that ASC 610-20 applies to the derecognition of all nonfinancial assets and in-substance nonfinancial assets. While the guidance in ASC 360-20[4] contained references to in-substance assets (e.g., in-substance real estate), it would not have applied to transactions outside of real estate. The FASB therefore added the definition of an in-substance nonfinancial asset to the ASC master glossary. The definition states, in part:

> An in substance nonfinancial asset is a financial asset (for example, a receivable) promised to a counterparty in a contract if substantially all of the fair value of the assets (recognized and unrecognized) that are promised to the counterparty in the contract is concentrated in nonfinancial assets. If substantially all of the fair value of the assets that are promised to a counterparty in a contract is concentrated in nonfinancial assets, then all of the financial assets promised to the counterparty in the contract are in substance nonfinancial assets. For purposes of this evaluation, when a contract includes the transfer of ownership interests in one or more consolidated subsidiaries that is not a business, an entity shall evaluate the underlying assets in those subsidiaries.

Accordingly, all business or nonprofit activities are excluded from the scope of ASC 610-20 and should be accounted for under the consolidation guidance in ASC 810-10. Further, all investments should be accounted for under the guidance in ASC 860 on transfers and servicing transactions, regardless of whether they are business or nonprofit activities or are in-substance nonfinancial assets.

Editor's Note

In January 2017, the FASB issued ASU 2017-01,[5] which clarifies and narrows the definition of a business. An entity should apply that definition when adopting the guidance in ASU 2017-05. Under the revised definition, an entity is likely to consider fewer real estate transactions to be businesses than it does in current practice, and therefore more transactions will be accounted for in accordance with ASC 610-20. For additional information about ASU 2017-01, see Deloitte's January 13, 2017, *Heads Up*.

ASU 2017-05 also clarifies that if a transaction (not involving a subsidiary) is partially within the scope of ASC 610-20 and partially within the scope of other guidance, an entity should apply the separation and allocation guidance in ASC 606. However, the entity should not separate the transferred assets of an individual subsidiary. That is, a transaction involving a subsidiary that does not have in-substance nonfinancial assets is excluded from the scope of ASC 610-20 in its entirety. The example below, which is reproduced from the ASU, illustrates the application of this guidance.

ASC 610-20

Case B — Nonfinancial Assets and Financial Assets

55-6 Entity X enters into a contract to transfer machinery and financial assets, both of which have significant fair value. Entity X concludes that the assets promised in the contract are not a business within the scope of Topic 810 and are not an output of the entity's ordinary activities within the scope of Topic 606. Entity X also concludes that substantially all of the fair value of the assets promised in the contract is not concentrated in nonfinancial assets. Therefore, the financial assets promised in the contract are not in substance nonfinancial assets.

55-7 In accordance with the guidance in paragraph 610-20-15-9, Entity X should derecognize only the machinery in accordance with this Subtopic. Entity X should apply the guidance in paragraph 606-10-15-4 to separate and measure the financial assets.

[4] ASC 360-20, which provides guidance on real estate sale transactions, was partially superseded by ASC 606 and ASC 610-20. However, ASC 360-20 continues to apply to sale-leaseback transactions involving real estate assets until the amendments in ASU 2016-02, *Leases*, become effective.

[5] FASB Accounting Standards Update No. 2017-01, *Clarifying the Definition of a Business.*

ASC 610-20 (continued)

55-8 If Entity X transfers the machinery and financial assets by transferring ownership interests in a consolidated subsidiary, it would still conclude that the financial assets are not in substance nonfinancial assets. As described in paragraph 610-20-15-8, if all of the assets promised to the counterparty in an individual consolidated subsidiary within a contract are not nonfinancial assets and/or in substance nonfinancial assets, those assets should not be derecognized in accordance with this Subtopic. Instead, Entity X should apply the guidance in paragraph 810-10-40-3A(c) or 810-10-45-21A(b)(2) to determine the guidance applicable to that subsidiary.

Assets can also be transferred to a counterparty under a contract with one or more subsidiaries. To determine the accounting, an entity should first assess whether substantially all of the fair value of all assets under the contract is concentrated in nonfinancial assets. If it is not, the entity should evaluate whether substantially all of the fair value of the assets in any individual subsidiary under the contract is concentrated in nonfinancial assets, in which case the financial assets of that subsidiary are, in substance, nonfinancial assets that are within the scope of ASC 610-20. The example below, which is reproduced from the ASU, illustrates the application of this guidance.

ASC 610-20

Case C — One Subsidiary That Holds Nonfinancial Assets and One Subsidiary That Holds Financial Assets

55-9 Entity A enters into a contract to transfer ownership interests in two consolidated subsidiaries to a single counterparty. Subsidiary 1 consists entirely of nonfinancial assets, and Subsidiary 2 consists entirely of financial assets. Assume that the assets in Subsidiary 1 and Subsidiary 2 have an equal amount of fair value. Entity A concludes that the transaction is not the transfer of a business within the scope of Topic 810 and that the subsidiaries are not outputs of the entity's ordinary activities within the scope of Topic 606.

55-10 Entity A first considers whether substantially all of the fair value of the assets promised to the counterparty in the contract is concentrated in nonfinancial assets. Because the contract includes the transfer of ownership interests in one or more consolidated subsidiaries, Entity A evaluates the underlying assets in those subsidiaries. Entity A concludes that because both the financial assets and nonfinancial assets have an equal amount of fair value, substantially all of the fair value of the assets promised to the counterparty in the contract is not concentrated in nonfinancial assets. Entity A next considers whether substantially all of the fair value of the assets within Subsidiary 1 or Subsidiary 2 is concentrated in nonfinancial assets. Because the assets transferred within Subsidiary 1 are entirely nonfinancial assets, Entity A concludes that those assets are within the scope of this Subtopic. Entity A also concludes that the financial assets in Subsidiary 2 are not in substance nonfinancial assets and, therefore, are not within the scope of this Subtopic. Entity A should apply the guidance in paragraph 606-10-15-4 to separate and measure the financial assets in Subsidiary 2 from the nonfinancial assets in Subsidiary 1 that are derecognized within the scope of this Subtopic.

The ASU provides a decision tree (reproduced in the appendix of this *Heads Up*) for entities to use in determining whether assets promised to a counterparty are within the scope of ASC 610-20.

Distinct Nonfinancial Assets

The ASU clarifies that the unit of account is defined as a distinct nonfinancial asset. At the inception of a contract, an entity should therefore identify each distinct nonfinancial and in-substance nonfinancial asset in accordance with the guidance on identifying distinct performance obligations in ASC 606. The entity should then, in a manner consistent with the approach outlined in ASC 606, allocate consideration to each distinct asset and derecognize the asset when a counterparty obtains control of it.

Partial Sales

Partial sales are sales or transfers of a nonfinancial asset to another entity in exchange for a noncontrolling ownership interest in that entity. Such sales are common in the real estate industry (e.g., a seller transfers a building (or an asset) to a buyer but either retains an interest in the building (or the asset) or has an interest in the buyer).

Before adopting the new revenue standard, entities account for partial sales principally under the transaction-specific guidance in ASC 360-20 on real estate sales, the industry-specific guidance in ASC 970-323, and (sometimes) ASC 845-10-30. The ASU amends the guidance in ASC 970-323 to align it with the requirements in ASC 606 and ASC 610-20. It also eliminates ASC 360-20 as well as the initial-measurement guidance on nonmonetary transactions in ASC 845-10-30 to simplify the accounting treatment for partial sales (i.e., entities would use the same guidance to account for similar transactions) and to remove inconsistencies between ASC 610-20 and the noncash consideration guidance in the new revenue standard. As a result of these changes, any transfer of a nonfinancial asset in exchange for the noncontrolling ownership interest in another entity (including a noncontrolling ownership interest in a joint venture or other equity method investment) should be accounted for in accordance with ASC 610-20.

To determine when to derecognize a nonfinancial asset or in-substance nonfinancial asset, an entity should first assess whether it has transferred control of it. If the entity retains a controlling financial interest in a subsidiary (e.g., because the entity sold a noncontrolling ownership interest in a consolidated subsidiary), the entity should account for the transaction as an equity transaction in accordance with ASC 810 and should not recognize a gain or loss on the derecognition of nonfinancial assets.

However, if the entity has not retained a controlling financial interest in the nonfinancial asset or in-substance nonfinancial asset, it should derecognize it when it transferred control of the asset in a manner consistent with the principles in ASC 606. Further, the entity should measure any retained noncontrolling ownership interest (and resulting gain or loss to be recognized) at fair value in a manner consistent with the guidance on noncash consideration in ASC 606-20-32-21 through 32-24.

The following example, which is reproduced from the ASU, illustrates the application of this guidance:

ASC 610-20

Case A — Control Transfers Under Topics 810 and 606

55-11 Entity A owns 100 percent of Entity B, a consolidated subsidiary. Entity B holds title to land with a carrying amount of $5 million. Entity A concludes that the land is not an output of its ordinary activities within the scope of Topic 606 and that Entity B does not meet the definition of a business within the scope of Topic 810.

55-12 Entity A enters into a contract to transfer 60 percent of Entity B to Entity X for $6 million cash due at contract inception. For ease of illustration, assume that at contract inception the fair value of the 40 percent interest retained by Entity A is $4 million. Because all of the assets (the land) promised to Entity X in the contract are nonfinancial assets, Entity A concludes that it should derecognize the land in accordance with this Subtopic.

ASC 610-20 (continued)

55-13 As described in paragraphs 610-20-25-2 through 25-7, Entity A first considers the guidance in Topic 810 and concludes that it no longer has a controlling financial interest in Entity B or in Entity X (the buyer). Entity A then determines that the contract meets the criteria in paragraph 606-10-25-1 and that control of the land has been transferred in accordance with the guidance in paragraph 606-10-25-30. Because Entity A continues to have a noncontrolling interest in Entity B, it evaluates the point in time at which Entity B, its former subsidiary, has control of the distinct nonfinancial asset as described in paragraph 610-20-25-7. Entity A concludes that it has transferred control of the distinct nonfinancial asset because Entity B controls the distinct nonfinancial asset. When evaluating the indicators of control in paragraph 606-10-25-30, Entity A concludes the following:

a. It has the present right to payment.
b. Entity B has legal title to the land.
c. It does not have physical possession of the asset because it cannot restrict or prevent other entities from accessing the land.
d. Entity B has the significant risks and rewards of ownership.
e. There is no acceptance clause (assumption).

55-14 Entity A derecognizes the land and calculates the gain or loss as the difference between the amount of consideration measured in accordance with the guidance in paragraphs 610-20-32-2 and 610-20-32-6 and the carrying amount of the land. The amount of the consideration is $10 million, which includes $6 million in cash plus $4 million for the fair value of the noncontrolling interest in Entity B. Entity A recognizes a gain of $5 million ($10 million consideration – $5 million carrying amount of the assets) and presents the gain in the income statement in accordance with the guidance in paragraph 360-10-45-5. In accordance with the guidance in paragraph 610-20-32-4, Entity A records the noncontrolling interest in Entity B at $4 million and subsequently accounts for that interest in accordance with other Topics.

Editor's Note

The ASU requires an entity to derecognize the nonfinancial asset or in-substance nonfinancial asset in a partial sale transaction when (1) the entity ceases to have a controlling financial interest in a subsidiary pursuant to ASC 810 and (2) control of the asset is transferred in accordance with ASC 606. The entity therefore has to consider repurchase agreements (e.g., a call option to repurchase the ownership interest in a subsidiary) in its assessment and may not be able to derecognize the nonfinancial assets, even though it no longer has a controlling financial interest in a subsidiary in accordance with ASC 810. The ASU illustrates the application of this guidance in ASC 610-20-55-15 and 55-16.

Effective Date and Transition

The effective date of the new guidance is aligned with the requirements in the new revenue standard, which is effective for public companies for annual reporting periods (including interim reporting periods within those periods) beginning after December 15, 2017, and for nonpublic companies for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019.[6] If the entity decides to early adopt the ASU's guidance, it must also early adopt ASC 606 (and vice versa).

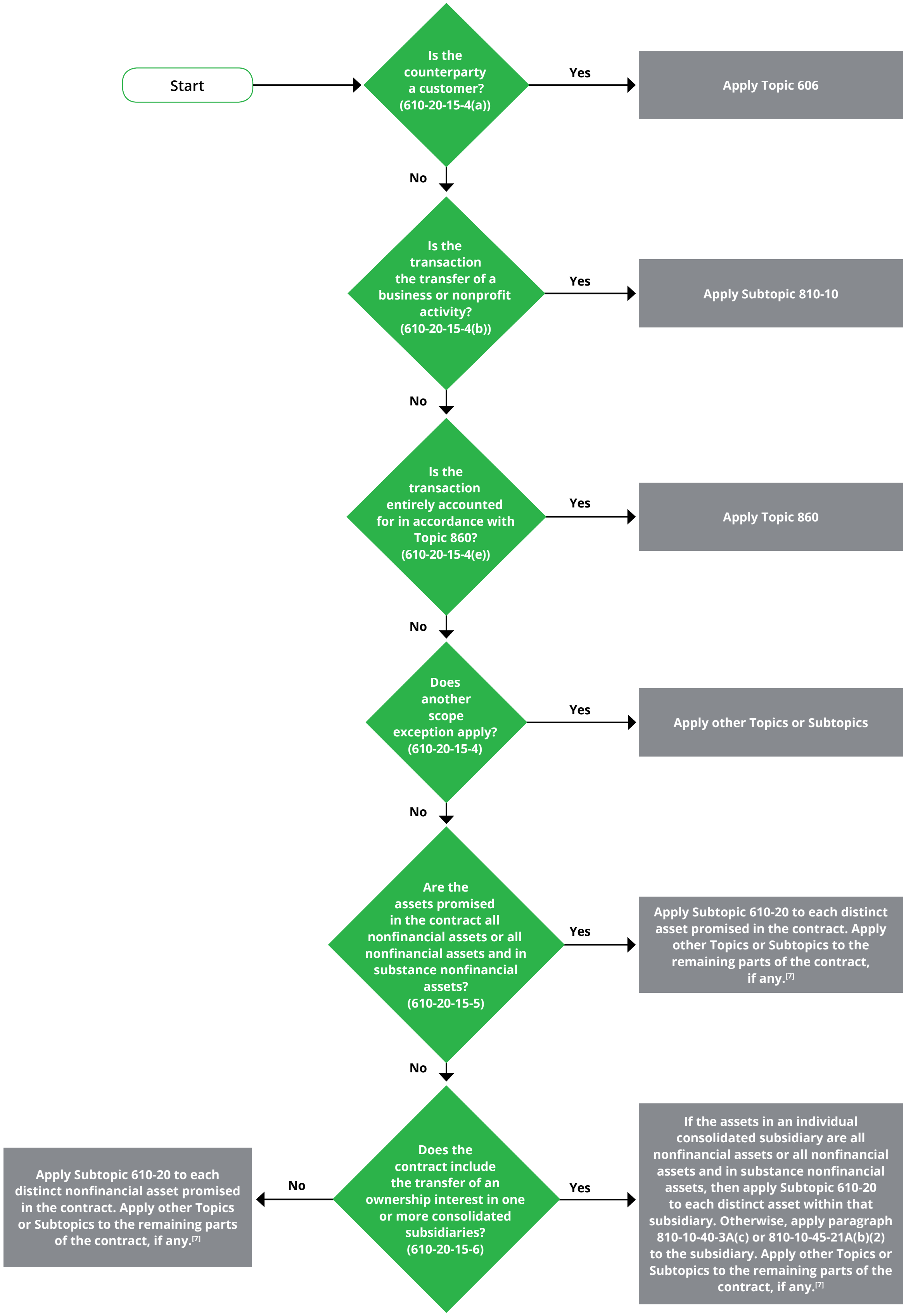
Like the new revenue standard, the ASU allows an entity to use a full or modified retrospective adoption approach. The entity can also elect to apply (1) different adoption approaches for ASC 610-20 and ASC 606 (e.g., modified retrospective for ASC 610-20 and full retrospective for ASC 606) and (2) practical expedients for contracts within the scope of ASC 610-20 that are different from those for contracts within the scope of ASC 606.

[6] FASB Accounting Standards Update No. 2015-14, *Revenue From Contracts With Customers (Topic 606): Deferral of the Effective Date*, delayed the effective date of the new revenue standard by one year and permits early adoption on a limited basis.

If the entity uses different transition methods, it would need to provide the transition-method disclosures required by ASC 606 for each transition method elected and indicate the method it used to adopt ASC 610-20. Regardless of the transition method the entity elects, it should apply the definition of a business as amended by ASU 2017-01 (see discussion in the Editor's Note above), under which a transaction that was previously considered a disposal of a business may be considered a disposal of an asset. The ASU clarifies that in such instances, the amounts previously allocated to goodwill associated with the disposal should not be reinstated.

Appendix — Decision Tree: Determining Whether ASC 610-20 Applies to Assets Promised to a Counterparty

An entity can use the decision tree below, reproduced from the ASU, to determine whether assets promised to a counterparty are within the scope of ASC 610-20.



[7] If the transfer includes other contractual arrangements that are not assets of the seller to be derecognized (for example, guarantees), those contracts are separated and accounted for in accordance with other Topics or Subtopics.

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