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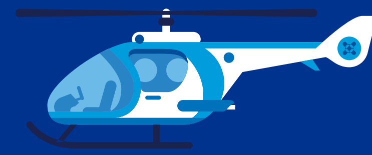


Defining Issues®

FASB clarifies scope of derecognition of nonfinancial assets

February 23, 2017

KPMG reports on ASU 2017-05[1], which defines in-substance nonfinancial assets and includes guidance on partial sales of nonfinancial assets.

Applicability

Companies that sell/transfer nonfinancial assets.

Key facts and impacts

The ASU clarifies that the guidance in ASC 610-20 on accounting for derecognition of a nonfinancial asset and an in-substance nonfinancial asset applies only when the asset (or asset group):

- does **not** meet the definition of a business; and
- is **not** a not-for-profit activity.

Definition of in-substance nonfinancial asset

Nonfinancial assets include intangible assets, land, buildings, and materials and supplies, and may have a zero carrying value.

The FASB has defined an in-substance nonfinancial asset as a financial asset (e.g. receivable) included in a contract, or consolidated subsidiary, in which substantially all of the fair value (excluding cash and cash equivalents) is concentrated in nonfinancial assets.

When the definition is met, the seller applies the guidance in ASC 610-20 to all of the assets in the group or subsidiary, even if individual assets would be considered financial assets if they were sold independently.

Noncontrolling interest in transferred assets

When a seller receives a noncontrolling interest in the nonfinancial assets (and in-substance nonfinancial assets, if any) transferred or exchanged (e.g. in a partial sale of real estate), it accounts for that interest as noncash consideration and measures it at fair value.

The new guidance eliminates the partial profit recognition models in real estate and nonmonetary transactions guidance when a seller retains a noncontrolling interest in the transferred asset(s).[2]

A seller recognizes its full gain in earnings when it loses its controlling financial interest in the subsidiary and transfers control of the underlying assets. A seller does not recognize a gain in earnings if it retains a controlling financial interest.

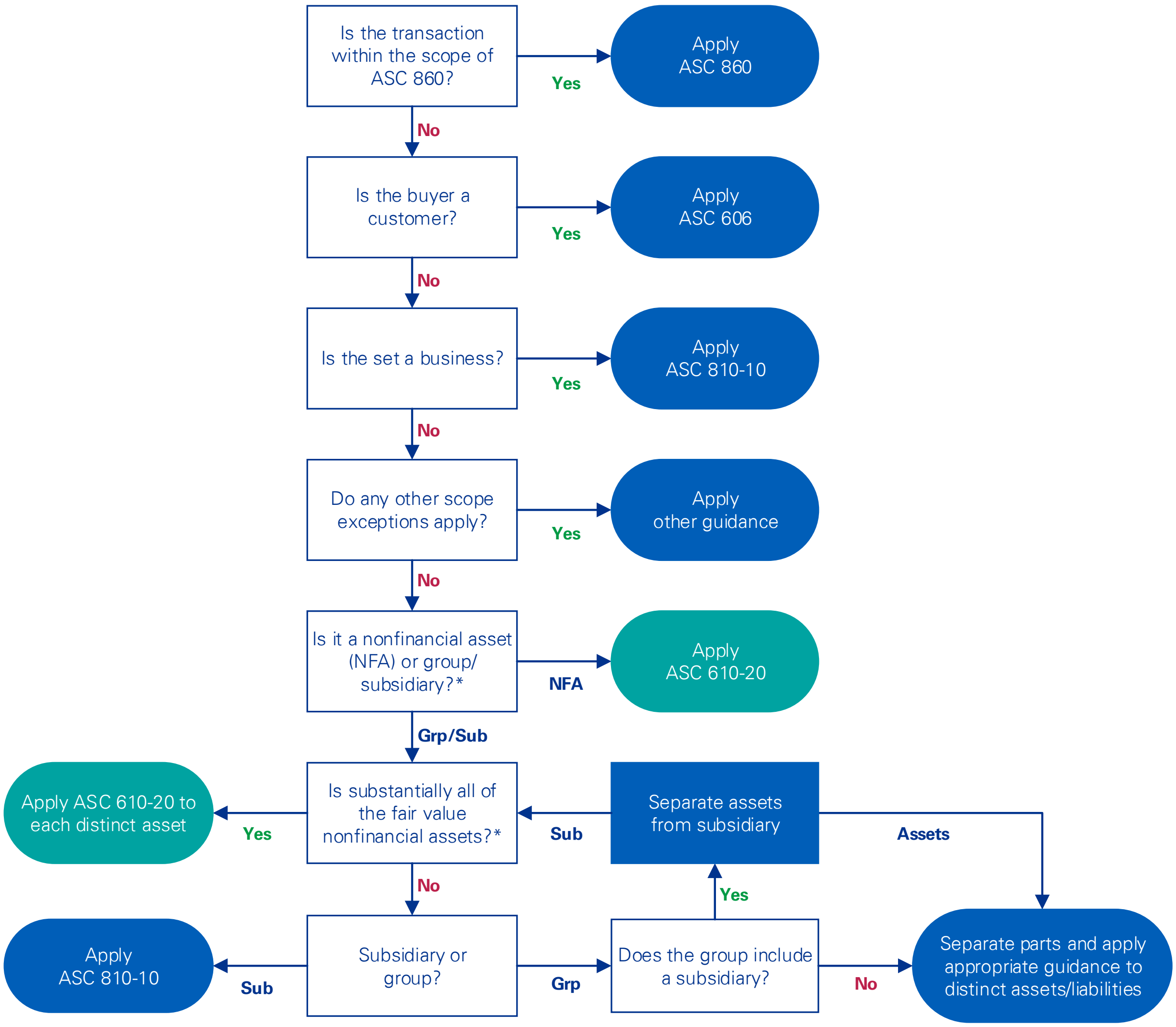
ASC 610-20 does **not** apply to transfers of investments (e.g. equity method investments) even if the underlying assets are nonfinancial assets.

[1] ASU 2017-05, Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets; issued February 22, 2017

[2] ASC 360-20, Property, Plant, and Equipment – Real Estate Sales; ASC 845, Nonmonetary Transactions

Scope

The following flowchart highlights the transactions to which the new guidance applies.



* If the transfer includes other contractual arrangements that are not the assets of the seller that will be derecognized (e.g. guarantees), those contracts are separated and accounted for under the applicable guidance.

What is outside the scope of the ASU?

ASC 606, Revenue from Contracts with Customers

If an entity transfers assets to a customer, it accounts for the transaction under ASC 606.

Investments

If the transferred asset is an investment (e.g. an equity method investment), an entity accounts for the transaction under the guidance on transfers of financial assets under ASC 860.

Business

If the group or subsidiary is a business and is sold to a noncustomer, an entity accounts for the transaction under the derecognition guidance in ASC 810.[3]

Subsidiary

If substantially all of the fair value of a transferred subsidiary (that is not a business) is *not* concentrated in nonfinancial assets, an entity accounts for the transaction under the derecognition guidance in ASC 810.

Business combination

If a nonfinancial asset is transferred as consideration in a business combination, an entity accounts for the transfer under ASC 805.

Nonmonetary exchanges

If there are nonreciprocal transfers or nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers, an entity accounts for the transactions under ASC 845.

Other

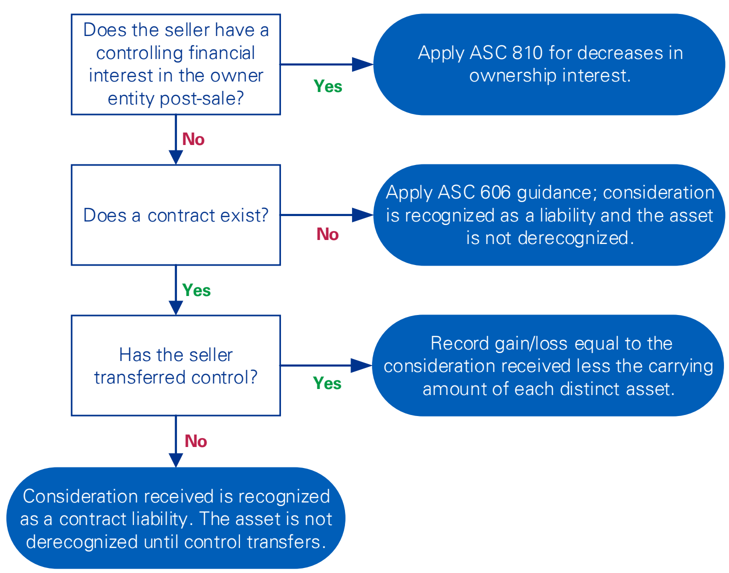
ASC 610-20 does not apply to a lease contract, a sale-leaseback transaction, a contribution in the scope of ASC 720-25 or ASC 958-605, an investment in a venture accounted for using proportionate consolidation, a conveyance of oil and gas mineral rights, a common control transaction or the exchange of an airline take-off and landing slot.

Derecognition

An entity uses the guidance in the new revenue recognition standard to determine whether it is transferring multiple, distinct assets and recognizes a gain or loss for each distinct asset transferred.

When an entity transfers nonfinancial assets (and in-substance nonfinancial assets, if any) included in a subsidiary and retains (or receives) an equity interest, it first determines whether it has retained a controlling financial interest in the subsidiary. If so, the entity does not derecognize the assets and accounts for the sale of the noncontrolling interest in the subsidiary under the consolidation guidance covering decreases in ownership. That guidance requires recognizing the gain or loss in equity.

If the entity does not retain a controlling financial interest, it applies the new revenue recognition standard to evaluate whether a contract exists and whether it has transferred control of the underlying assets to their owner (i.e. the subsidiary holding the assets post-sale).



[3] KPMG's Defining Issues: FASB Clarifies the Definition of a Business

Measurement

An entity measures its gain or loss on derecognition of each distinct asset as the difference between the amount of consideration received and the carrying amount of the distinct asset.

The consideration received is (1) the transaction price as determined using the new revenue recognition standard and (2) the carrying amount of liabilities assumed by the other party. If there is more than one distinct asset, the entity allocates the total consideration received under the contract to each one using the allocation guidance in the new revenue recognition standard.

If the entity retains (or receives) a noncontrolling interest in the entity that owns the asset post-sale, that noncontrolling interest is considered noncash consideration and is included in the transaction price at its fair value.

Including the retained noncontrolling interest in the transaction price at its fair value results in the entity recognizing a 100 percent gain on the sale of the asset. This contrasts with partial gain recognition under current US GAAP for partial sales of real estate. An entity also would recognize the full gain or loss on transfers of nonfinancial assets within the scope of ASC 610-20 to equity method investees.

Example: Implementation

Background

Company X owns 100% of Entity A, which is a consolidated subsidiary that holds land, a building subject to operating leases and rent receivables.

Entity A does not meet the definition of a business under the FASB's new guidance, and the assets held by Entity A are not an output of Company X's ordinary activities.

Substantially all of Entity A's fair value is attributable to nonfinancial assets.

Company X concludes that all of Entity A's assets, including the rent receivables, are either nonfinancial or in-substance nonfinancial assets.

The total carrying amount of Company X's investment in Entity A is $7 million.

Transaction

Company X transfers a 60% ownership interest in Entity A to Company Z for $9 million. The fair value of Company X's 40% retained interest is $6 million.

Company X concludes that it no longer has a controlling financial interest in Entity A. The criteria for a contract are met, and Entity A has control of all of its assets.

Analysis

Company X derecognizes each of Entity A's assets and recognizes a total gain of $8 million – the fair value of the retained interest of $6 million plus cash of $9 million less the carrying amount of $7 million.

Company X does not need to determine whether each of Entity A's assets is distinct (nor does it allocate the total consideration to each one), because control of all the individual assets transfers at the same time.

However, the ASU defines the unit of account as each distinct asset included in the subsidiary when substantially all of the fair value of the subsidiary's assets is concentrated in nonfinancial assets.

Real estate entities

The FASB recently issued guidance that clarified the definition of a business, which will result in characterizing more real estate properties as nonfinancial assets and not businesses.

Because ASC 610-20 applies when real estate does not meet the definition of a business, we believe most noncustomer real estate sales will fall within its scope.

Additionally, sales of noncontrolling ownership interests accounted for under the equity method that are considered in-substance real estate under US GAAP now will be accounted for under ASC 860 on transfers and servicing regardless of whether the buyer is a customer or a noncustomer.

Effective date and transition

The new ASU is effective at the same time as the new revenue recognition standard. An entity applies the guidance using a full retrospective or modified retrospective approach regardless of which approach it chooses for adopting the new revenue recognition standard. At adoption, an entity must apply the new definition of a business to determine which transactions are in the scope of the new ASU, regardless of the entity's transition method.[4] However, an entity does not need to revisit its existing allocation to goodwill if it changes its conclusion about whether a transferred group of assets is a business.

Effective dates:	Public business entities and certain other entities*	All other entities
Annual periods – In fiscal years beginning after	December 15, 2017	December 15, 2018
Interim periods – In fiscal years beginning after	December 15, 2017	December 15, 2019
Early adoption allowed?	An entity is required to apply the amendments in this ASU at the same time that it applies the new revenue recognition standard. However, the earliest an entity may apply this ASU or the new revenue recognition standard is for annual and interim periods in fiscal years beginning after December 15, 2016.	
*(1) public business entities; (2) not-for-profits that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or an over-the-counter market; and (3) employee benefit plans that file financial statements with the SEC.		

[4] ASU 2017-01, Clarifying the Definition of a Business

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KPMG's Financial Reporting View

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