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The Last Days of Disco Ops

Consider this scenario: Staying Alive, Inc., a publicly traded clothing company based in South Beach, Florida, is planning to offer additional shares to the public in a registered securities offering. Several weeks before launching the offering, Staying Alive's board of directors decides to put the company's leisure suit division up for sale. Management intends to sell the division within the next few months and has already started talking to potential buyers.

Staying Alive is already working with its auditors to sort out the accounting issues surrounding the sale. But the company and its underwriters have turned to you to ask how the planned sale will affect the upcoming offering. In particular, they want to know whether (and when) Staying Alive will have to revise its historical financial statements and narrative disclosure to show the leisure suit division as a discontinued operation, which could have timing implications for the deal.

Where Do We Go From Here?

This *Client Alert* will answer the following questions:

- What is a “discontinued operation”?
- What is an “asset held for sale”?
- When are retrospective revisions to historical financial statements and/or *pro formas* required?
- When must retrospective revisions to historical financial statements and/or *pro formas* be filed with the SEC?
- Does MD&A need to be revised if the historical financials are revised?
- Are there any other things to worry about here?

Although this *Client Alert* provides a summary of the relevant accounting literature and SEC guidance relating to discontinued operations to help you answer these questions, the presentation here is only a summary. It should not be used as a replacement for the more detailed literature and guidance.

Don't Leave Me This Way

If Staying Alive determines that the leisure suit division is a discontinued operation, it will need to report that determination in the upcoming Form 10-Q or 10-K filing for the period during which the applicable criteria are met and will need to revise its pre-event financial statements to retroactively separate the leisure suit division's operations from the ongoing operations in Staying Alive's historical financial statements. The exact timing of that retroactive revision will depend on a number of factors, which we discuss below.

What Is a "Discontinued Operation"?

A "discontinued operation" is a line item on the income statement in which the results of operations for a portion of a business that has already been disposed of or is up for sale are reported. Under the currently applicable accounting literature, discontinued operations treatment is appropriate when:¹

- a "**component** of an entity . . . either has been **disposed of** or is classified as **held for sale**,"
- "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" and
- "the entity **will not have any significant continuing involvement** in the operations of the component after the disposal transaction."

A Component of an Entity . . .

Companies dispose of portions of businesses all the time, but only the disposal of a sufficiently distinguishable component of a business merits discontinued operations treatment. This principle is reflected in the accounting literature's requirement that only a "component of an entity" that is held for sale (or has been sold) may qualify as a discontinued operation. The accounting literature states 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." A component of an entity "may be a reportable segment or an operating segment, a reporting unit, a subsidiary, or an asset group."

The key takeaway here is that *only a distinct operating unit* will be eligible for discontinued operations treatment. If, for example, rather than selling the entire leisure suit segment, Staying Alive was proposing to sell only one leisure suit brand, that brand might not be classified as a discontinued operation, even though it could be classified as an asset held for sale (assuming that Staying Alive does not have any involvement with the brand after the sale). Given that the leisure suit division is a distinct operating unit with its own, clearly identifiable operating results, it is safe to say that it constitutes a "component" for these purposes.

Disposed of or "Held for Sale" . . .

A component of an entity can only be a discontinued operation if it has already been disposed of or if it is classified as "held for sale." Staying Alive has not yet disposed of the leisure suit division, so the question here is whether the leisure suit division should be properly classified as held for sale.

In general, an asset is considered held for sale once two things have occurred: (1) management, with proper authorization, has committed to selling the asset within one year *and* (2) the company has taken one or more definitive steps towards consummating the sale. The accounting literature lays out the formal requirements for a determination that an asset is held for sale:

- "Management, having the authority to approve the action, commits to a plan to sell the asset . . . ;

- the asset . . . is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets . . . ;
- an active program to locate a buyer and other actions required to complete the plan to sell the asset . . . have been initiated;
- the sale of the asset . . . is probable, and transfer of the asset . . . is expected to qualify for recognition as a completed sale, within one year . . . ;
- the asset . . . is being actively marketed for sale at a price that is reasonable in relation to its current fair value . . . ; [and]
- actions required to complete the plan of sale indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.”

Given that Staying Alive’s board of directors has instructed management to proceed with the sale process and management is already actively marketing the leisure suit division, it is reasonable to conclude that the leisure suit division should properly be classified as held for sale.

Change Is Gonna Come

The FASB recently issued a proposed Accounting Standards Update (ASU) that will change the definition of “discontinued operation.”² In particular, the new ASU will:

- limit components eligible for discontinued operations treatment to those “that represent a separate major line of business or geographical area of operations;” and
- remove the “no continuing involvement” requirement from the definition of discontinued operations.

As a result of these changes, fewer dispositions will qualify for discontinued operations presentation. But don’t put on your Boogie Shoes just yet – even though the new standard will result in fewer reclassifications, it will also create additional disclosure requirements about discontinued operations and the disposal of significant components that do not qualify for discontinued operations treatment, including information about a company’s continuing involvement with the component disposed of.

The final ASU is expected to be issued in the first half of 2014.

You Make Me Feel (Mighty Real)

Once Staying Alive has determined that the leisure suit division is a discontinued operation, it will need to report this determination *in the period during which the applicable criteria are met*. For example, if Staying Alive concludes that the leisure suit division became a discontinued operation during its first fiscal quarter, it will be required to show the leisure suit division as a discontinued operation in the financial statements included in its next (first quarter) Form 10-Q filing.

And what about retroactively revising financial statements for prior periods? In general, the financial statements for all prior periods in a Form 10-Q or Form 10-K filing must be retroactively revised to report the

Practice Point – Form 8-K issues

Separate from the question of revising prior period financials, Staying Alive may have an obligation to file a Form 8-K once the sale of a “significant amount of assets” has been completed. The 8-K would report the sale under Item 2.01.

There are some traps for the unwary here:

- Unlike the “component” test used for discontinued operations disclosure, the Form 8-K requirement is tied to a disposition of a “significant amount of assets” with the

assets, cash flows and results of operations of the discontinued operations as discontinued so that all of the periods presented are comparable. The idea here is to present comparable periods on an apples-to-apples basis in order to facilitate an analysis of the performance of the continuing business from period to period.

Let's recap what this all means for Staying Alive's periodic reporting requirements:

- Starting with the Form 10-Q for the quarter in which the leisure suit division satisfies all of the criteria for treatment as a discontinued operation, Staying Alive will need to present results for the current interim period showing the leisure suit division as a discontinued operation and will need to revise the comparable interim period of its prior year to present it on a comparable basis (i.e., retroactively revise the earlier period to show the leisure suit division as a discontinued operation) and this will continue on a quarter-by-quarter basis until Staying Alive's next Form 10-K is filed.
- When Staying Alive files its next Form 10-K, it will need to present the results for its current fiscal year showing the leisure suit division as a discontinued operation and will need to provide retrospectively revised audited annual financial statements for all prior fiscal years included in the 10-K filing so that investors can compare the current year to the prior year on an apples-to-apples basis.
- Whenever prior period financials are retroactively revised, Staying Alive will need to consider revising the related MD&A for that prior period.
- This whole timetable can get accelerated in the context of a securities offering, as we will explore below.

Take Your Time, Do It Right

In the context of a securities offering, the need for retroactively revised historical financial statements may be accelerated. If Staying Alive needs to include or incorporate by reference in a registration statement (1) financial statements for periods prior to the time the discontinued operation is first reported *and* (2)

significance level set at 10 percent. To be more precise, a Form 8-K is required if either:

(i) Staying Alive's (and its other subsidiaries') equity in the net book value of disposed assets or the amount received for the assets upon disposition exceeds 10 percent of the total assets of Staying Alive as of the end of its most recently completed fiscal year or

(ii) the disposed business would exceed the 10 percent (not the 20 percent) threshold under any of the three significance tests under Regulation S-X Rule 1-02(w).

- No Form 8-K is required based on a "held for sale" determination. Instead, the Form 8-K is due four business days after completion of the sale.
- If, at the time of the 8-K filing, prior year financial statements have not been retrospectively revised to reflect the discontinued operation, then Regulation S-X Article 11 *pro forma* financial information should be included under Item 9.01(b)(1). Those *pro formas* would cover the latest balance sheet and income statements for the latest year-to-date interim period and the three most recent fiscal years (or such shorter period for which audited financials are presented).³ Note that there is no additional 71-day grace period for asset sales (like there is for material acquisitions) so the *pro formas* are due within four business days of the asset sale closing. Note also that if the disposition had not qualified as a discontinued operation, the *pro forma* income statement would be limited to the latest year-to-date interim period and the most recent fiscal year.

financial statements for any subsequent period, Staying Alive will be required to retrospectively revise the pre-event financial statements in connection with the offering to effect a consistent presentation.⁴ However, as with most rules, there are exceptions. The application of these rules depends on the type of offering.

The following chart illustrates some common scenarios,⁵ assuming that:

- a component of the business met the criteria for treatment as a discontinued operation during the first fiscal quarter; and
- pre-event financial statements have not yet been revised to reflect the discontinued operation.

Scenario	Requirement
IPO/initial registration statement on Form S-1, S-4 or S-11	Revision of all pre-event financial statements is required if post-event financial statements are needed for the offering. In our example, if the offering takes place at a time when Q1 interim financial statements are required for the registration statement, retrospective revision of financial statements for all prior periods would be required. ⁶
New/follow-on registration statement on Form S-3, S-1, S-4 or S-11 (including post-effective amendments to those forms) or proxy statement	• If post-event financial statements have already been filed, then the answer here is the same as in the first box above. Both pre-event and post-event financial statements are needed for the offering, so revision of all pre-event financial statements is required.⁷ • If post-event financial statements have <i>not</i> yet been filed, then filing audited revised pre-event financials is not allowed (although unaudited supplementary information or <i>pro forma</i> financial statements reflecting the discontinued operation may be a good idea in order to tell the complete story).
Takedown from an effective shelf registration statement	Effective shelf registration statements get special treatment. Pre-event financial statements in a shelf registration statement that was declared effective prior to the date on which the component became a discontinued operation are not required to be retrospectively revised, <i>whether or not post-event financial statements have been filed</i> , unless there has been a “fundamental change.” ⁸ This policy position is consistent with other SEC Staff positions showing added deference in the context of an already effective shelf.
New registration statement on Form S-8	Revision of pre-event financial statements is typically not required. ⁹

Can't Get Enough of Your Love

Let's review a few of the more common scenarios in a little bit greater detail. This is tricky stuff.

Form S-3 Registration Statements – Don't Stop 'Til You Get Enough

For a Form S-3 filer, the answer to the question “How much is enough?” depends on the timing of the discontinued operations determination and the effective date of the registration statement:

- If Staying Alive has not yet filed a post-event Form 10-Q at the time that the Form S-3 is declared effective, then it will *not* need to retroactively revise the previous full year financial statements until Staying Alive's next 10-K is filed.
- By contrast, if Staying Alive files a Form 10-Q with financial statements reporting the discontinued operation prior to the Form S-3 being declared effective, it *will* have to retrospectively revise its financial statements in connection with the offering.

To illustrate this, imagine two different scenarios. In each, Staying Alive determines that the leisure suit division is a discontinued operation on March 1, during its first fiscal quarter. Staying Alive has also not yet filed a Form 8-K with *pro forma* financial information to report the discontinued operation because the sale has not yet occurred.

- In **Scenario A**, Staying Alive plans to file a Form 10-Q on May 10 with unaudited interim financial statements for the first quarter of the current year and the prior year, each reflecting discontinued operations, and to file the Form S-3 after that.
- In **Scenario B**, Staying Alive intends to file the Form S-3 on April 30, prior to filing the first quarter Form 10-Q reflecting discontinued operations.

Let's look at how this sequencing decision will impact Staying Alive's offering plans.

- In **Scenario A**, Staying Alive will incorporate by reference both pre-event financial statements and post-event financial statements into the registration statement. As a result, all of Staying Alive's pre-event financial statements will have to be retrospectively revised before its registration statement is filed.
- In **Scenario B**, however, Staying Alive will incorporate by reference pre-event financial statements only, since it will not yet have filed its Form 10-Q for the first quarter. As a result, its previous year's audited financial statements will *not* need to be retrospectively revised.¹⁰ Note that even if Staying Alive's Form 10-K for the previous fiscal year was filed after the date of the event (March 1), the financial statements for that year would not reflect the discontinued operations presentation.

All of the above discussion assumes that it is possible to produce full and fair disclosure about Staying Alive without showing how the continuing business (*i.e.*, the components other than the leisure suit division) have been doing over the recent periods on a stand-alone basis. Depending on the materiality of the leisure suit division to Staying Alive's overall business, it might be more prudent to postpone the offering or include *pro formas* until retrospectively revised financials are available. That will be an all-facts-and-circumstances analysis for the deal team at the time of the offering.

Shelf Takedowns —That's the Way (uh-huh, uh-huh) I Like It

What if, instead of filing a new registration statement, Staying Alive wants to do a takedown from an existing shelf that was declared effective prior to filing post-event financial statements? The SEC Staff takes the position that retrospectively revised

Practice Point

When a registrant files retrospectively revised financial statements, it needs a new auditor's report on the financial statements.¹¹

financial statements need not be included in a prospectus supplement, whether or not post-event financial statements have been filed, unless management determines there has been a “fundamental change.” That is a high standard to meet. As a result, in practice, pre-event financial statements are typically not revised for prospectus supplements, except where the discontinued operation was of sufficient size that it’s not possible to tell the issuer’s whole story in all material respects without retrospectively revised financial statements.

Rule 144A Offerings – That’s Where the Happy People Go

What if Staying Alive wants to do a Rule 144A offering instead of a registered offering? Deal teams likely will analyze retrospective revision in this context in the same way as a new shelf offering, particularly if the company is already a public reporting company. While it may be possible to conclude that the discontinued operation is sufficiently immaterial such that retrospectively revised financial statements are not required in a Rule 144A offering memorandum even though they would be required in a public offering, omission of retrospectively revised financial statements may have an impact on the comfort letter provided by the company’s auditors.

Retrospective Revision – Got to Give It Up

In general, retrospectively revised audited annual financial statements should *not* be filed on a Form 10-K/A.¹³ As discussed above, a registrant that will not be reissuing its pre-event financial statements in connection with an offering (or, in some circumstances, a proxy solicitation) is not required to retrospectively revise the previous year’s financial statements until those financial statements are included in the next Form 10-K.¹⁴ Nevertheless, many registrants choose to file retrospectively revised audited annual financial statements under cover of a Form 8-K (Item 8.01) once the registrant has filed a periodic report that includes post-event financial statements.¹⁵ And there are good reasons for doing so, both from a marketing perspective and a disclosure perspective. Filing an 8-K with revised financial statements shows the market what the company will look like without the discontinued operation and positions the registrant to conduct an offering (either by incorporating the 8-K by reference or including the revised financials in the registration statement) without scrambling to revise its financial statements. The SEC Staff generally expects a company to file a Form 8-K with revised audited historical financial statements in connection with the filing of a new registration statement.¹⁶

Practice Point

What happens if a public company has included in, or incorporated into, a registration statement its annual financial statements giving retrospective effect to a discontinued operation and also consummates a significant business combination? In those circumstances, the SEC Staff has interpreted the guidance in Regulation S-X Rule 3-05 to require that the significance tests be based on the company’s retrospectively revised financial statements that give effect to the discontinued operations in the case of:

- individual businesses acquired after the date the retrospectively revised financial statements are filed;
- probable acquisitions; and
- the aggregate impact of all individually insignificant businesses that have occurred since the end of the most recently completed fiscal year.

For individual acquisitions consummated on or before the annual financial statements giving retrospective effect to the discontinued operation are filed, the SEC Staff allows a registrant to use *either* the annual audited financial statements filed prior to the discontinued operation or the annual financial statements filed that give retrospective effect to the discontinued operation.¹²

Revising MD&A – Do It ‘Til You’re Satisfied

When Staying Alive revises its pre-event financial statements, it will also need to revise its MD&A.

- The SEC Staff requires that Staying Alive describe “the events or circumstances that led to the discontinued operation, the material terms of that termination, and the impact on the issuer’s operating results and business.”¹⁷
- Staying Alive should also discuss “any contingent obligations, financial commitments, or continuing relationship with the discontinued operation, and any impact on the company’s liquidity and capital resources.”¹⁸
- Finally, Staying Alive should “describe the likely effect the discontinued operation will have on the registrant’s continuing business and financial health.”

If Staying Alive files its retrospectively revised financial statements with a registration statement, then it should include the above disclosure in the registration statement’s MD&A. Alternatively, if Staying Alive files the revised financial statements on Form 8-K, then it may include the revised MD&A disclosure in the body of the Form 8-K.

Item 303(b) of Regulation S-K requires disclosure in the MD&A that will “enable the reader to assess material changes in the financial condition and results of operations between the periods” presented in the report, including information about prior periods provided for comparative purposes. As a result, Staying Alive will have to provide an appropriate discussion of material changes to its financial condition and results of operations on a period-to-period basis. Depending on the magnitude of the discontinued operation, it may not be possible to have an apples-to-apples comparison in MD&A without revising the financial statements for the prior period. This will be an all-facts-and-circumstances discussion among the members of the deal team at the time.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Senet S. Bischoff

senet.bischoff@lw.com
+1.212.906.1834
New York

Jessica R. Munitz

jessica.munitz@lw.com
+1.202.637.3337
Washington, D.C.

Alexander F. Cohen

alexander.cohen@lw.com
+1.202.637.2284
Washington, D.C.

Joel H. Trotter

joel.trotter@lw.com
+1.202.637.2165
Washington, D.C.

Kirk A. Davenport II

kirk.davenport@lw.com
+1.212.906.1284
New York

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Endnotes

- ¹ See Accounting Standard Codification (ASC) 205-20-45-1. The FASB recently issued for exposure a proposed Accounting Standards Update (ASU), *Presentation of Financial Statements (Topic 205), Reporting Discontinued Operations*. The ASU proposes a revised definition of discontinued operations and additional financial statement disclosures. In the proposed ASU, a discontinued operation would be either: (1) a component of an entity or a group of components of an entity that represents a separate major line of business or major geographical area of operations that either has been disposed of or is part of a single coordinated plan to be classified as held for sale or (2) a business that, on acquisition, meets all of the criteria to be classified as held for sale.
- ² A business that, on acquisition, meets the criteria in paragraph 360-10-45-9 to be classified as held for sale will also qualify as a discontinued operation.
- ³ See SEC Division of Corporation Finance, *Financial Reporting Manual* (FRM) Sections 3120 and 3230.2(b).
- ⁴ In the absence of a securities offering, once post-event financial statements have been filed, a registrant can elect to file a Form 8-K with retrospectively revised audited financial statements for the pre-event period.
- ⁵ We cover this topic in our *Words of Wisdom* blog entry, "The Last Days of Disco Ops," <http://www.wowlw.com/financial-statement-requirements/dispositions/>.
- ⁶ See FRM Section 13110.1.
- ⁷ See FRM Section 13110.2; Form S-3 Item 11(b)(ii).
- ⁸ See FRM Section 13110.2; Item 512(a) of Regulation S-K.
- ⁹ See Securities Act Forms Compliance & Disclosure Interpretations (C&DIs), Question 126.40 ("The fact that financial statements eventually will be retroactively restated does not necessarily mean that there are 'material changes in the registrant's affairs,' thereby requiring the financial statements to be restated for inclusion, or incorporation by reference, in a Form S-8.").
- ¹⁰ This question was addressed in the Center for Audit Quality SEC Regulations Committee's Highlights from the June 14, 2005 meeting. In that meeting, the committee recommended, and the SEC Staff concurred, the view that retrospective revision of financial statements is not required when "the change to discontinued operations treatment has not yet been reflected in the period for which historical financial statements are included or incorporated by reference" See Center for Audit Quality SEC Regulations Committee Highlights (June 14, 2005).
- ¹¹ The auditor's report must be reissued "when a previously filed 1934 Act filing is amended to include restated financial statements or retrospectively adjusted financial statements." FRM Section 4810.4(d).
- ¹² See FRM Section 2025.1 and related notes.
- ¹³ FRM Section 13110.6. The one exception to this rule is when the registrant files a Form 10-K/A to correct a material error. In that case, the SEC Staff will not object if the registrant also files retroactively revised financial statements with that Form 10-K/A, provided that the effects of material error corrections are clearly distinguished from the revisions required by the discontinued operations.
- ¹⁴ FRM Section 13110.3.
- ¹⁵ FRM Section 13110.5.
- ¹⁶ In addition, the SEC Staff confirmed that, where a company has retrospectively revised prior period information in interim financial statements (e.g., a Form 10-Q reporting discontinued operations and revising the previous year's comparable information) and those revisions will also be reflected in comparative annual financial statements in its next 10-K, the SEC would generally expect the company to file revised audited annual financial statements before filing a new or amended registration statement, assuming the effect of the revisions is material. See Center for Audit Quality SEC Regulations Committee Highlights (June 27, 2012).
- ¹⁷ FRM Section 9830.1.
- ¹⁸ *Id.* See also SEC Accounting Rules, Topic 5, Miscellaneous Accounting, Subtopic Z.5.