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# An analysis of the implications of discontinued operations for continuing income



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## ABSTRACT

We examine the extent to which changes in the accounting for discontinued operations affects the usefulness of disaggregated income components in predicting an entity's future continuing income. Our study is motivated by the joint FASB/IASB convergence project which seeks to define the scope of transactions reported in discontinued operations. To examine our question, we compare the properties of continuing income and discontinued operations reported under SFAS 144 and APB 30, where APB 30 closely parallels IFRS 5. We find that the broader scope of the rule under SFAS 144 results in more persistent continuing income among firms reporting discontinued operations, and that this is concentrated among single-segment firms, which previously were less likely to fall within the scope of APB 30. Because we find no evidence of increased opportunism, we conclude that the broader scope of the rule results in a finer partitioning of recurring and nonrecurring income. Overall, our results support the broader scope of discontinued operations.

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## 1. Introduction

We examine the extent to which changes in the accounting for discontinued operations affect the usefulness of disaggregated income components in predicting an entity's continuing income. The disaggregation of income aids in its usefulness in predicting an entity's future performance (Lipe, 1986; Fairfield et al., 1996). The usefulness of disaggregated information is crucially linked to the classification of transactions into reasonably homogenous groups. The discontinued operations line item is

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unique in that it aggregates income from a subset of the operations of the firm that have been identified for disposal and presents this subtotal after tax below income from continuing operations. The line item includes sales, expenses, and, if the disposal has transpired, the gain or loss from the sale of the sub-set of the business.<sup>1</sup> Essentially, the aggregation of this information into a single line item near the bottom of the income statement communicates to investors that the transactions included in this line item are nonrecurring. We contribute new empirical evidence on how changes in the accounting for discontinued operations changes the persistence of continuing income.

Our study is motivated by the joint FASB/IASB convergence project, which seeks to define the scope of transactions reported in discontinued operations, and the current consensus that the scope of discontinued operations should be limited to only large transactions such as the divestiture of an entire operating segment.<sup>2</sup> Currently, the FASB and IASB are undertaking a joint project to develop a converged definition of discontinued operations, which is especially important given the prominence with which discontinued operations are displayed in the proposed financial statement presentation project. Specifically, the Boards propose to have the transactions associated with discontinued operations presented separately in each of the financial statements. The key difference between the current rules (SFAS 144 and IFRS 5) is the scope of discontinued operations. Under SFAS 144, effective in 2002, a component of the entity held for sale falls under discontinued operations presentation if it has operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the ongoing operations of the entity. The scope under IFRS 5 is much narrower (and very similar to the scope of discontinued operations under APB 30). Separate presentation of discontinued operations is only allowed if the asset to be divested represents a separate major line of business or geographical area of operations.

We first provide evidence on how many firms report discontinued operations across the two reporting regimes (SFAS 144 and APB 30) to shed light on the economic importance of the differing scope of the two regimes facing convergence (SFAS 144 and IFRS 5). The number of firms reporting discontinued operations under the broader scope of the rule nearly doubles, suggesting that the outcome of the convergence project has important consequences for the number of transactions reported within discontinued operations. The number of smaller transactions included in discontinued operations drives the overall increase in the frequency of discontinued observations.

To examine whether the scope of accounting for discontinued operations affects the properties of continuing income, we test whether the persistence of continuing income changes following the change in scope. We find evidence that continuing income is more persistent under the broader scope (SFAS 144) than the narrower scope (APB 30). Moreover, this difference in persistence is only present among firms reporting discontinued operations, and thus is unlikely to be a result of other confounding events. Upon further examination, we find that this increase is concentrated among single-segment firms. These findings are consistent with single-segment firms having less latitude to report discontinued operations under the narrower scope of the rule, even when doing so would improve the informativeness of their income statement. Thus, our results have implications for the narrowing of the rule. Specifically, our results suggest that the broader scope of the rule results in higher quality continuing income. Although it is also possible that the broader scope of the rule allows for greater latitude to classify items as “discontinued” (e.g., Athanasakou et al., 2007; Barua et al., 2010; Choi et al., 2007), we find no evidence of increased opportunism.

<sup>1</sup> Under APB 30 (*Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*) any anticipated losses on the sale of the asset are recognized at the time the subset of the business was identified for disposal; under SFAS 144 (*Accounting for the Impairment or Disposal of Long-Lived Assets*), losses are recognized when incurred, consistent with SFAS 121, though assets in place must be reviewed for impairment regularly. The scope of discontinued operations was also affected by SFAS 144; under APB 30, only disposals of lines of business qualified as discontinued operations, while pursuant to SFAS 144, lower-level groups of assets could qualify if they are separable for financial reporting and cash flow purposes. We discuss SFAS 144 in greater detail in Section 2.

<sup>2</sup> At the time of writing, the scope of the IASB/FASB joint proposal is similar to APB 30 and IFRS 5. In particular, the current exposure draft states: “Only those components of an entity that represent a separate major line of business or major geographic area of operations would be eligible for discontinued operations presentation in the financial statements. Currently, a component of an entity that is a reportable segment, an operating segment, a reporting unit, a subsidiary, or an asset group is eligible for discontinued operations presentation” (FASB, 2013, p. 3).

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