

Dynamic Divestitures: A Codification Exercise on the Reporting of Discontinued Operations

Casey J. McNellis
Gonzaga University

ABSTRACT: This instructional case discusses a hypothetical scenario of a global conglomerate that has recently divested operations for three different subsidiaries. Students are required to determine the appropriate general financial statement presentation of the different subsidiaries in the consolidated income statement of the conglomerate. The case expands students' understanding of the accounting for discontinued operations, a financial accounting topic that has recently changed, and develops their research skills within the Financial Accounting Standards Board's (FASB) Accounting Standards Codification®. Furthermore, the case allows students to practice applying judgment to unique and complex situations within the accounting environment.

Keywords: FASB codification; financial reporting; discontinued operations; restructuring.

THE CASE

In a meeting with shareholders in Q1 of 2017, Dynamic Inc. CEO Austin Cruz discussed the company's 2016 performance and then shifted to a discussion about the future of the company:

Dynamic Inc. has routinely set the standards of excellence in the business world, and this year, we will make a bold move that I believe will have a positive impact on our shareholders and promote sustainable practices that will set a new standard for global conglomerates. Growing carbon emissions present a major problem for the sustainability of global communities, and we at Dynamic have a responsibility to be at the forefront of this issue. This year, we will begin focusing our business portfolio on companies that offer sustainable products and services. To make this strategic transition a success, it is important that we “walk the walk” and include companies in our portfolio that run responsible and sustainable business operations, and set high standards for the usage of natural resources. We have the most qualified team of experts who regularly eye the equity markets for profitable investments. I have asked them to seek out “win-win” opportunities that enhance our growth and accomplish our shift in focus. We will also be reviewing our existing subsidiaries on similar standards to ensure that Dynamic is the global leader in sustainable business operations as well as sustainable products and services.

Dynamic Inc. Background

Dynamic Inc. is a global conglomerate headquartered in the United States. The company operates subsidiary companies throughout the world in a wide array of industries. While the company originally started operations in the oil/gas industry back in 1978, the company has shifted its focus over the years to managing a large portfolio of companies within the oil/gas industry, as well as in other sectors. Dynamic has a team of experienced business valuation experts who have specializations in several industries. These professionals serve the company by (1) keeping close tabs on the public and private equity markets for key acquisition opportunities that could potentially result in significant revenue and earnings growth for Dynamic and (2) reviewing the performance and direction of currently owned subsidiaries to determine whether the companies are meeting the performance standards set forth by Dynamic. As such, Dynamic regularly acquires other companies that are judged to be profitable investments. However, the company has a strict policy of owning 100 percent of the stock in these companies, as management is not interested in working with non-controlling interests. Furthermore, the company has spun off several

The author thanks the Accounting students at the University of Montana who completed the case requirements and provided valuable feedback. The author also acknowledges the helpful comments offered by Walter Teets from Gonzaga University.

Editor's note: Accepted by Valaria P. Vandrzyk.

Submitted: March 2017
Accepted: July 2017
Published Online: August 2017

subsidiaries in the past, because management considered them to be underperforming. The following table illustrates the acquisition and disposal activity of the company in the ten years prior to 2017.

<u>Segment</u>	<u># of Subsidiaries as of 12/31/06</u>	<u>Acquisitions from 12/31/06–12/31/16</u>	<u>Divestures from 12/31/06–12/31/16</u>	<u># of Subsidiaries as of 1/1/17</u>
Natural Resource Production	3	2	1	4
Consulting	1	1	0	2
Consumer Products	4	4	2	6
Industrial Products	2	3	3	2
Logistics	1	1	0	2
Totals	11	11	6	16

Additionally, the 2016 total revenues, year-end assets, and Scope 1 and 2 carbon emissions¹ for each segment are:

<u>Segment</u>	<u>Revenues (\$millions)</u>	<u>Assets (\$millions)</u>	<u>Scope 1 and 2 Carbon Emissions (metric tons)</u>
Natural Resource Production	\$30,801	\$43,197	17,926,328
Consulting	22,515	11,246	990,660
Consumer Products	36,079	25,990	6,097,309
Industrial Products	11,821	32,982	3,168,095
Logistics	4,978	12,988	1,732,170
Totals	106,194	126,403	29,914,562

During 2017, Dynamic had a very active year in the equity markets, particularly focusing on divestures. The company disposed of, or put forth plans to dispose of, some or all of the assets of three subsidiaries. Information about these subsidiaries follows.

ZD Consulting Services

<u>Segment</u>	<u>Consulting</u>
2016 Revenues (\$millions)	\$21,558
12/31/2016 Assets (\$millions)	\$7,641
2016 Scope 1 and 2 Carbon Emissions (metric tons)	819,185

ZD offers a variety of services for a broad base of clients in the areas of valuation, market research, and business plan implementation. ZD professionals spend significant time at client sites performing these services. The following table provides a breakdown of ZD's clients by industry:

<u>Industry</u>	<u>Percentage of Total Revenues</u>
Acrospace	5%
Retail services	14%
Oil/gas	41%
Financial services	10%
Food service	4%
Professional services	9%
Healthcare	17%

ZD operates out of a small office that includes professionals from a wide variety of fields and a staff that is competent in all major business functions. Apart from the company's payroll costs, the major expense incurred by ZD is for the travel activities

¹ According to the Environmental Protection Agency, Scope 1 emissions are "direct emissions from sources that are owned or controlled" by the organization. Scope 2 emissions are "indirect emissions from sources that are owned or controlled" by the organization. Accordingly, an example of Scope 1 emissions would be on-site fuel usage of company vehicles and equipment. Scope 2 emissions include electricity or natural gas generated by a utility company and purchased by the organization. These definitions and examples are at: <https://www.epa.gov/greeningepa/greenhouse-gases-epa>

(i.e., transportation, lodging, meals, etc.) of the professionals as they carry out their commitments for clients. Although ZD's revenue growth has been sluggish in recent years, the company is responsible for approximately 20 percent of Dynamic's total revenues. Furthermore, ZD's earnings represent 10 percent of Dynamic's bottom line, and this relationship has not changed for the past five years.

During the first quarter of 2017, Dynamic became aware of market curiosity in ZD. In particular, a market competitor displayed considerable interest in purchasing the company. Intrigued by the level of attention, Dynamic management consented to initial due diligence, and in the process, it was revealed that the potential purchaser was especially drawn to the oil/gas services offered by ZD. Furthermore, the competitor informally indicated that this aspect of the business would fit well with its existing portfolio of clients within traditional oil/gas operations and channels. Ultimately, Dynamic received a very strong offer from the competitor for 100 percent of the shares of ZD, and on October 17, 2017, the sales transaction was completed.

With the sale of ZD, the Consulting segment of Dynamic consisted of only one company as of the end of 2017. This one remaining firm specializes in financial consulting for educational product companies. Specifically, professionals from this firm advise clients on a number of financial issues including intangible asset valuations, financial reporting compliance, and XBRL reporting.

Hope Industries

Segment	Consumer Products
2016 Revenues (\$millions)	\$5,766
12/31/2016 Assets (\$millions)	\$4,495
2016 Scope 1 and 2 Carbon Emissions (metric tons)	3,707,698

Hope Industries operates within Dynamic's Consumer Products segment, which includes five other subsidiaries. Two of the other five companies offer different types of travel products, with one manufacturing and selling deluxe luggage and the other specializing in travel food and beverage containers. Another company in the segment offers sporting goods and apparel, while a different entity within the same niche sells athletic supplies and equipment used by athletic trainers. Finally, another company serves the market for home products, producing and selling home décor items such as scented candles and authentic picture frames. Overall, this sector has reported relatively slow growth during the past two years across all companies. Thus far, Dynamic management has no plans to dispose of these other five companies within the Consumer Products segment.

Hope Industries primarily manufactures and sells a variety of residential home products. Most notably, the company makes high-end home-improvement necessities such as painting trays, paint brushes, and other home maintenance goods. The synthetic materials used in these products are highly durable and can withstand very high temperatures resulting from the sanitation process, thus allowing consumers to maintain these products for an extensive period and through many projects. In order to produce such goods that pass durability tests and meet consumer expectations for design, the company uses a complicated and extensive injection-molding process. As such, the production environment requires large machinery along the assembly line and the molding process demands extreme temperatures in order to achieve the end result. Because of the elaborate design of many of the products, the company follows a complex, yet disciplined distribution process that includes extensive use of protective packaging materials (i.e., Styrofoam). In doing so, the company streamlined the distribution process so that there is very little spoilage of products as they move through the supply chain.

Ultimately, though, Hope Industries reports one of the five largest Scope 1 and 2 carbon emissions levels of all the companies included in Dynamic's portfolio of subsidiaries. These carbon levels also surpass the other five companies within the Consumer Products segment, as those companies emit carbon in relatively similar amounts. Hope operates in a very competitive market, which includes many other companies that offer such products. In addition, Hope faces threats from companies that manufacture similar products that are of a less-durable nature, but are sold at a lower price. During the last five years, consumers have indicated a preference for these less-durable products in order to allocate their disposable income to other products and activities. As such, Hope, which has always operated on tight margins, has seen its profits diminish. During 2016, the company reported an overall loss on its income statement, joining the other home products company as the only two within the Consumer Products segment to post net losses.

In January 2017, Dynamic management became interested in a budding phenomenon: disposable kitchenware products. In conducting market research, Dynamic professionals concluded that consumers desired products such as spatulas, mixing bowls, etc., that are designed for one-time use. Meetings with a local research and development (R&D) firm that was currently working on a process to produce similar types of goods that are eco-friendly confirmed this decision. Such convenience would allow consumers to accomplish their personal culinary goals without the hassle of cleaning kitchenware. Consistent with CEO Cruz's focus outlined in the shareholder meeting, Dynamic set out to acquire the necessary technology from the R&D firm,

tailor it specifically to kitchenware products, and produce those goods in an eco-friendly fashion. Ultimately, the company made the decision to move forward with plans to produce these products with recycled and biodegradable materials. A lingering issue, however, was the location of this new manufacturing operation.

Upon further review, Dynamic management determined that it possessed the infrastructure (manufacturing facilities) within Hope Industries to support this venture. However, in order to produce the new products, management was aware that it must (1) suspend all manufacturing of Hope's current product mix and (2) completely replace the machinery currently used at Hope. Additionally, the new manufacturing process would require a certain type of skilled labor that the Hope employees do not presently possess. One of the hallmarks of Dynamic, within the sphere of conglomerate organizations, is the fair treatment of its personnel across all subsidiaries. Along those lines, Dynamic management determined that the termination of current employees to facilitate the required skills was not an option. Rather, Dynamic proposed a large-scale investment in Hope by establishing a comprehensive training program for all of its current employees. The program provided the necessary education for the laborers to acquire the appropriate skills for the manufacturing process. Additionally, the company supplied training to support staff (i.e., accounting, HR, IT, etc.).

In order to make this switch to kitchenware products a reality, Dynamic's management approached a neighboring competitor that manufactures the less-durable version of the home improvement products. The competitor expressed an interest in expanding to the highly durable products currently offered by Hope. On May 14, 2017, the competitor agreed to a layered purchase of Hope's inventory, fixed assets (including machinery, equipment, and patents), information about manufacturing processes, and limited support information (including the purchasing and sales modules of the accounting system), according to the following schedule:

May 14, 2017	Transfer of machinery, equipment, and patents
June 30, 2017	Transfer of manufacturing process and support information
August 30, 2017	Transfer of remaining inventory

Hope suspended its production of residential products on May 14, 2017. In the midst of the transaction with the competitor, Hope continued to sell the remaining inventory, per the agreement, until August 30, 2017, at which time the competitor assumed the remaining inventory. During this process, Hope purchased plans from the local R&D firm, instituted training programs for personnel, and purchased machinery/equipment that was conducive to the manufacture of the new kitchenware products. Manufacturing of the kitchenware products commenced in the middle of July 2017. Due to the overlap between the suspension of activities related to the residential products and the commencement of kitchenware production, Hope accounting personnel were unable to efficiently separate the specific support operations (aside from the sale of the inventory) of the two activities for the second half of 2017 within the accounting system. However, the staff was able to estimate the costs of these separate operations based upon trends from prior years.

According to Dynamic's global responsibility report for 2017, carbon emissions for Hope dropped slightly in Q4. While Dynamic believes that the new focus on kitchenware will prove a wise investment, the company expects a return to profitability to be a multi-year process. During the next year, Dynamic plans to change Hope Industries' name to Hope Home Products, Inc.

AM Mining Operations

<u>Segment</u>	<u>Natural Resource Production</u>
2016 Revenues (\$millions)	\$9,904
12/31/2016 Assets (\$millions)	\$17,693
2016 Stage 1 and 2 Carbon Emissions (metric tons)	10,022,595

Dynamic owns a copper mining operation in the southwestern region of the United States. The operation includes several properties that are actively mining and producing copper, and the most lucrative of them all is one that accounts for 80 percent of the production. The name of this mine is Abby Marie (AM), the source of the company's formal name. While the company is very profitable, it also has a substantial impact on the environment, and in the past several years, AM has reported one of the five largest Scope 1 and 2 carbon emissions among Dynamic companies. Furthermore, AM is subject to significant regulations that are related to environmental and safety issues. As an example, AM is required to complete a round of regulatory audits at about the same time every five years. These audits focus on key issues such as the environmental impact of AM's mining activities, occupational hazard and safety accreditation, and hazardous waste certifications. AM management is committed to facilitating these regulatory activities, as these audits are a crucial piece of the company's business plan. In fact, the company

has received “clean” audit results on each audit since the company’s inception. The regulators have notified AM management that a new round of audits will commence during 2018. Normally, the regulators schedule their work toward the end of the year; however, they will schedule the audit earlier in the year if the company has scheduling issues or other extenuating circumstances exist. These regulatory activities are very extensive, often resulting in multiple site visits and significant costs. As such, the process of facilitating the government inspections to the receipt of the different agencies’ reports can take up to nine months, depending upon the level of complications that arise.

In Q2 of 2017, Dynamic made the decision to put the company up for sale. Management believes that AM has a sales value consistent with an earnings multiple² of 4.3. After obtaining approval to move forward with plans for AM’s disposal from the corporate governance functions of both Dynamic and AM, Dynamic management requested the services of XJ Equity Brokers, Inc. to find an interested buyer. While XJ has never brokered a transaction in the mining industry, the firm has represented Dynamic extensively in its merger and acquisition activities. XJ professionals indicate that since the mining operations are very unique, they will need to conduct a considerable search to find buyers in the market for such a company. Furthermore, they concluded that management’s valuation (i.e., the 4.3 multiple) was much too aggressive, given recent comparative analyses obtained by XJ from their network of resources. As a result, XJ plans to present the AM opportunity to investors with a 3.6 multiple, which the firm feels is a reasonable valuation. Given the nature of AM’s operations and the environment in which the company operates, the professionals at XJ believe the sale of AM will likely take several months to complete.

Dynamic believes that the management of AM has been very satisfactory, allowing an experienced industry participant to operate AM in its present condition without substantial alterations to the business plan. As of 12/31/17, XJ had found three potential buyers, and two of those interested parties have signed non-disclosure agreements in order to learn more about the possible acquisition. According to XJ, the potential buyers would normally need about 4–6 months for due diligence in order to make a purchase commitment. However, the interested parties also mentioned that the results of the regulatory activities would play a major role in their intentions to move forward, as their ability to get operating permits transferred would be contingent upon clean audit opinions. In response, management indicated it would promptly schedule the audits for Q1 2018 if either party provided a purchase/sale agreement contingent upon audit results.

Requirements

During the first week of 2018, Dynamic’s corporate controller, Anne Smith, prepares to initiate the closing activities for 2017. The closing process at Dynamic is very extensive, as it includes routine activities for consolidating the activities of several subsidiary companies for the creation of the consolidated financial statements. Furthermore, Dynamic’s reporting personnel must also address the unique complications of each acquisition and divesture. As Ms. Smith awaits the final financial statement numbers prepared by the reporting personnel at each subsidiary, she is anxious to determine the appropriate financial statement presentation of the three subsidiaries discussed above. Most specifically, she is curious as to whether the financial performance of each of the three subsidiaries qualifies for reporting under discontinued operations. Ms. Smith has asked you to review the intricacies of ZD Consulting, Hope Industries, and AM Mining Operations to determine which type of reporting (i.e., continuing operations versus discontinued operations) is appropriate for each subsidiary on Dynamic’s consolidated income statement.

To complete the task, you should perform the following functions:

1. Consider the facts presented for each company within the case.
2. Consult the FASB *Accounting Standards Codification*[®] for guidance on the specific income statement presentation issue that the controller has requested.
3. Prepare a memo that clearly addresses the issue, discusses each company’s facts, and provides a clear conclusion regarding the appropriate presentation of each company’s financial information on Dynamic’s consolidated income statement. In constructing this memo, you should expect to incorporate *Accounting Standards Codification*[®] references. Please include any basic calculations used in your analysis from the data provided.

² An earnings multiple provides a method to state the proposed value of a company. In this example, a multiple of 4.3 indicates a valuation of 4.3 times the dollar amount of company earnings.