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New Developments Summary

Amendments clarify nonfinancial asset derecognition guidance and add partial sales guidance

FASB issues ASU 2017-05

Summary

In response to questions on implementing the new revenue standard for transfers of certain nonfinancial assets to noncustomers, the FASB recently issued ASU 2017-05, *Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets*, which clarifies the guidance in ASC 610-20, *Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets,* and adds new guidance for partial sales of nonfinancial assets.

The effective dates for the amendments in ASU 2017-05 are the same as those for the new revenue guidance in ASC 606, which means for public entities, the guidance is effective in annual periods beginning after December 15, 2017, including interim periods therein. Early adoption is permitted in annual periods beginning after December 15, 2016, including interim periods therein.

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A. Overview

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606),* which primarily focuses on revenue recognition for contracts that require an entity to provide goods and services to customers. ASU 2014-09 also added to the Codification ASC 610-20, *Other Income: Gains and Losses from the Derecognition of Nonfinancial Assets,* to provide guidance on how an entity should account for the derecognition of a nonfinancial asset or an in substance nonfinancial asset. ASC 610-20 requires an entity to apply the guidance in ASC 606 on the existence of a contract, the transfer of control of goods or services, and the measurement of contract consideration, to the accounting for transfers of nonfinancial assets (and in substance nonfinancial assets) that are not an output of the entity's ordinary activities.

Since ASU 2014-09 was issued, the Board has received stakeholder questions related to applying several areas of guidance in ASC 610-20, including the scope of the guidance and how to account for a partial sale of nonfinancial assets. ASU 2017-05 addresses many of these stakeholder questions by

- Defining an "in substance nonfinancial asset"
- Excluding the transfer of all businesses and nonprofit activities from the scope of ASC 610-20
- Clarifying that the unit of account for applying the guidance in ASC 610-20 is the *distinct nonfinancial asset* or *in substance nonfinancial asset*
- Stipulating when an entity should derecognize each distinct asset and how it should allocate consideration to each distinct asset
- Providing criteria for derecognizing a distinct nonfinancial asset or a distinct in substance nonfinancial asset in a partial sale transaction
- Requiring an entity to measure at fair value any noncontrolling interest it receives (or retains) in a transaction that transfers control of a distinct nonfinancial asset or a distinct in substance nonfinancial asset

The amendments in ASU 2017-05 will affect any entity that enters into a contract with a noncustomer to transfer a nonfinancial asset, a group of nonfinancial assets, or an ownership interest in a consolidated subsidiary that is not a business or nonprofit activity. Further, the new guidance will affect entities that enter into transactions that would have been within the scope of the superseded real estate–specific derecognition guidance in ASC 360-20, *Property, Plant, and Equipment: Real Estate Sales*, as well as those that contribute nonfinancial assets that are neither a business nor a nonprofit activity to a joint venture or other noncontrolled investee.

B. Clarified scope of ASC 610-20

General

ASC 610-20 provides guidance on the recognition of gains and losses on transfers of nonfinancial assets and in substance nonfinancial assets to counterparties that are not customers. Although the guidance in ASC 610-20 does not apply to transfers of nonfinancial assets or in substance nonfinancial assets in a contract with a customer, it does refer to the new revenue recognition principles related to the existence of a contract, the transfer of control of goods or services, and the measurement of contract consideration in transactions with noncustomers.

Under ASC 610-20, transfers can include sales and other circumstances that result in the derecognition of nonfinancial assets or in substance nonfinancial assets that do not constitute a business or a not-for-profit activity. Examples of transfers within the scope of ASC 610-20 include losing control of nonfinancial assets or in substance nonfinancial assets because of the expiration or termination of a contractual arrangement, a dilution event, a government action, or default of a subsidiary's nonrecourse debt, as well as contributing assets to a joint venture or other noncontrolled investee.

Nonfinancial assets within the scope of ASC 610-20 include intangible assets, land, buildings, or materials and supplies, even if the carrying value of these assets is zero.

In substance nonfinancial assets

Under the amendments in ASU 2017-05, an entity should apply the nonfinancial asset derecognition guidance in ASC 610-20 both to nonfinancial assets and to "in substance nonfinancial assets." The new guidance defines an "in substance nonfinancial asset" as a financial asset, such as a receivable, that is included in a contract with a counterparty if *substantially all* of the fair value of the promised assets in the contract is concentrated in nonfinancial assets (see shaded box, "Determining *substantially all*," below). If substantially all of the fair value of the promised assets in the contract is concentrated in nonfinancial assets, then all of the financial assets in the contract are considered in substance nonfinancial assets.

For determining whether substantially all of the fair value of the promised assets in a contract (or a consolidated subsidiary within a contract) is concentrated in nonfinancial assets, any cash or cash equivalents that are included within the promised assets should be excluded. Liabilities assumed or relieved by the counterparty also do not affect the determination. ASC 610-20 does not change when an entity can derecognize a liability.

In the Basis for Conclusions of ASU 2017-05, the Board stated that cash or cash equivalents should be excluded from this analysis because it did not want an entity to achieve a particular accounting outcome simply by contributing cash to a counterparty and increasing the consideration the entity would receive by the same amount.

Determining *substantially all*

The clarified definition of "in substance nonfinancial assets" may result in an entity applying the nonfinancial asset derecognition guidance in ASC 610-20 to a greater number of transactions that include both nonfinancial assets and financial assets.

In the Basis for Conclusions, the Board stated that it had considered other alternatives to assess whether the substance of a transaction is the transfer of nonfinancial assets, including the use of terms other than *substantially all.* The Board decided to retain the term *substantially all* because it is a higher threshold than other measures of significance and is more likely to result in an appropriate assessment of the substance of a transaction. Further, *substantially all* is a term that is well understood by stakeholders because it is used frequently throughout the Codification.

The consideration of *substantially all* of the fair value implies a quantitative approach to that determination. However, in the Basis for Conclusions, the Board stated that an entity may qualitatively determine whether substantially all of the fair value of the assets that are promised to a counterparty in a contract is concentrated in nonfinancial assets. There could be some qualitative considerations in making the determination when evaluating a transaction that is not a business or nonprofit activity because, typically, this type of transaction does not include a significant amount of financial assets.

Transfers of nonfinancial assets within a legal entity and other transfers

The amendments also clarify that transfers of nonfinancial assets within a legal entity may be within the scope of ASC 610-20. For example, a consolidated subsidiary (that is not a business or nonprofit activity) for which substantially all of the fair value of its assets consists of nonfinancial assets should be considered an in substance nonfinancial asset within the scope of ASC 610-20.

However, if a contract includes one or more consolidated subsidiaries that do not individually or together constitute a business or nonprofit activity, and substantially all of the fair value of the promised assets in the contract is not concentrated in nonfinancial assets, an entity should then evaluate whether substantially all of the fair value of the promised assets in an individual consolidated subsidiary is concentrated in nonfinancial assets.

The following example from Case C in ASU 2017-05 illustrates how an entity applies the guidance in ASU 2017-05 when the promised assets include (1) a consolidated subsidiary that holds nonfinancial assets, and (2) another consolidated subsidiary that holds financial assets.

A tale of two consolidated subsidiaries

In this example, an entity enters into a contract to transfer to a counterparty ownership interests in two consolidated subsidiaries that individually or together do not constitute a business and are not outputs of the entity's ordinary business activities. Subsidiary 1 consists entirely of nonfinancial assets, the fair value of which closely approximates one-half of the fair value of the combined assets of both subsidiaries, and Subsidiary 2 consists entirely of financial assets.

The entity concludes that substantially all of the fair value of the promised assets is not concentrated in nonfinancial assets because the nonfinancial assets in Subsidiary 1 and the financial assets in Subsidiary 2 have an equal amount of fair value. The assets transferred within Subsidiary 1 are entirely nonfinancial assets, which means that the entity can apply the guidance in ASC 610-20 when derecognizing these assets. But it cannot apply this guidance when derecognizing the assets transferred within Subsidiary 2 because the financial assets in Subsidiary 2 are not in substance nonfinancial assets.

Transfers of equity method investments and certain other investments (such as debt securities and equity securities) are accounted for under the guidance in ASC 860, *Transfers and Servicing*, regardless of whether the underlying assets are in substance nonfinancial assets. As previously discussed, the derecognition of businesses and nonprofit activities should not be accounted for under ASC 610-20 and should instead be accounted for under ASC 810-10, *Consolidation – Overall*.

Additional transactions excluded from the scope of ASC 610-20

The guidance in ASC 610-20 does not apply to certain transactions or circumstances that are within the scope of other Codification guidance, some of which include

- Real estate or non-real-estate sale-leaseback transactions within the scope of ASC 360-20 or ASC 840-40, *Leases: Sale-Leaseback Transactions,* respectively
- Other transactions entirely accounted for under ASC 860, such as transfers of certain investments
- Transfers of nonfinancial assets that are part of the consideration in a business combination transaction pursuant to ASC 805, *Business Combinations*

- Nonmonetary transactions within the scope of ASC 845, *Nonmonetary Transactions*
- Lease contracts under ASC 840
- Contributions of cash and other assets, including promises to give cash, that are either made by certain entities or received by not-for-profit entities within the scope of ASC 720-25, *Other Expenses: Contributions Made*, or ASC 958-605, *Not-for-Profit Entities: Revenue Recognition*, respectively
- Transfers of investments that are accounted for under the proportionate consolidation guidance within ASC 810
- Transfers between entities or persons under common control

Contracts partially within scope of ASC 610-20 and other guidance

Certain contracts may be partially within the scope of ASC 610-20 and partially within the scope of other Codification guidance, such as when the promises to a counterparty in a contract are not all nonfinancial assets or all nonfinancial assets and in substance nonfinancial assets. For example, in transferring nonfinancial assets to a counterparty, an entity may also issue that counterparty a guarantee that is within the scope of ASC 460, *Guarantees.* In this circumstance, an entity should apply the guidance in ASC 606 when determining how to separate and measure one or more parts of a contract that are within the scope of other Codification guidance.

Appendix A includes a decision tree from ASU 2017-05 that summarizes the guidance in ASC 610-20 by depicting the process for evaluating whether assets promised to a counterparty in a contract (or parts of a contract) should be recognized within the scope of ASC 610-20.

C. Partial sales of nonfinancial assets

Partial sales are common in the real estate industry and include transactions in which the seller can retain either an interest in the property or an interest in the buyer. ASU 2014-09 supersedes the guidance in ASC 360-20 that includes detailed real estate–specific guidance on partial sales transactions. The guidance in ASC 610-20, as originally issued, did not address partial sales transactions.

To determine whether the entity has, or continues to have, a controlling financial interest in the legal entity that holds the nonfinancial assets or in substance nonfinancial assets, an entity should apply the guidance in ASC 610-20-25-2, which requires that this evaluation be made by applying the consolidation guidance in ASC 810.

ASU 2017-05 states further that a decrease in an entity's ownership interest in a subsidiary in which the entity retains a controlling financial interest should be accounted for as an equity transaction, and that the nonfinancial assets or in substance nonfinancial assets should not be derecognized. In other words, there is no gain or loss recognized in this situation. However, if a parent transfers its ownership interests in a consolidated subsidiary that contains a nonfinancial asset and retains a noncontrolling interest in the subsidiary, it should derecognize a distinct nonfinancial asset or distinct in substance nonfinancial asset if both of the following conditions exist:

- The entity does not have (or ceases to have) a controlling financial interest in the legal entity that holds the asset in accordance with ASC 810.
- Control of the nonfinancial asset has been transferred in accordance with ASC 606.

Any retained noncontrolling interest in that former subsidiary should be measured at fair value.

The nonmonetary transaction guidance in ASC 845-10-05 on exchanges of a nonfinancial asset for a noncontrolling interest is superseded by the amendments in the ASU. The guidance in ASC 610-20 on partial sale transactions also applies to contributions of nonfinancial assets in exchange for a noncontrolling interest in a joint venture or other investee. In addition, a full gain or loss should be recognized on the partial sale of nonfinancial assets to equity method investees. In other words, there will be no intra-entity profit elimination for assets remaining on the investee's books.

D. Unit of account for applying ASC 610-20

The guidance in ASC 610-20, as originally issued in ASU 2014-09, did not specify how an entity should identify each performance obligation and allocate the transaction price to each of those performance obligations.

The unit of account for applying the clarified nonfinancial asset derecognition guidance in ASC 610-20 is the *distinct nonfinancial asset*. At contract inception, and once a contract meets all of the criteria in ASC 606-10-25-1, an entity should first identify the nonfinancial assets and in substance nonfinancial assets promised in the contract under ASC 610-20, and then determine whether the contract contains distinct nonfinancial assets by applying the guidance in ASC 606 on distinct goods and services.

Each distinct asset is derecognized when the entity transfers control of the asset under the new revenue guidance related to performance obligations satisfied at a point in time. In some cases, an entity may not be required to separate and allocate consideration to each distinct nonfinancial asset and in substance nonfinancial asset, because control of each asset may have transferred at the same time. However, when control of each asset does not transfer at the same time, such as when a parent has not transferred control of some of the assets because the seller retains a repurchase option, an entity is required to separate and allocate consideration to each distinct nonfinancial asset.

When an entity meets the derecognition criteria for a distinct nonfinancial asset or a distinct in substance nonfinancial asset, it recognizes a gain or loss based on the difference between the contract consideration and the carrying amount of the distinct asset. Contract consideration, which includes both the transaction price and the carrying amount of liabilities assumed or relieved by the counterparty, is measured based on the guidance on determining the transaction price in ASC 606. Contract consideration should then be allocated to each identified distinct nonfinancial asset or in substance nonfinancial asset based on the relevant guidance in ASC 606.

E. Effective date and transition

The effective dates for the amendments are the same as those for the new revenue guidance in ASC 606:

- *For public entities (public business entities, certain not-for-profit entities, and certain employee benefit plans):* Annual periods, including interim periods therein, beginning after December 15, 2017
- *For all other entities:* Annual periods beginning after December 15, 2018 and interim periods in annual periods beginning after December 15, 2019

Early adoption is permitted in annual reporting periods, including interim periods therein, beginning after December 15, 2016.

ASC 606 and ASC 610-20 must be adopted at the same time. Entities are required to adopt the new guidance either (1) retrospectively by restating all prior periods presented, or (2) retrospectively, with a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption.

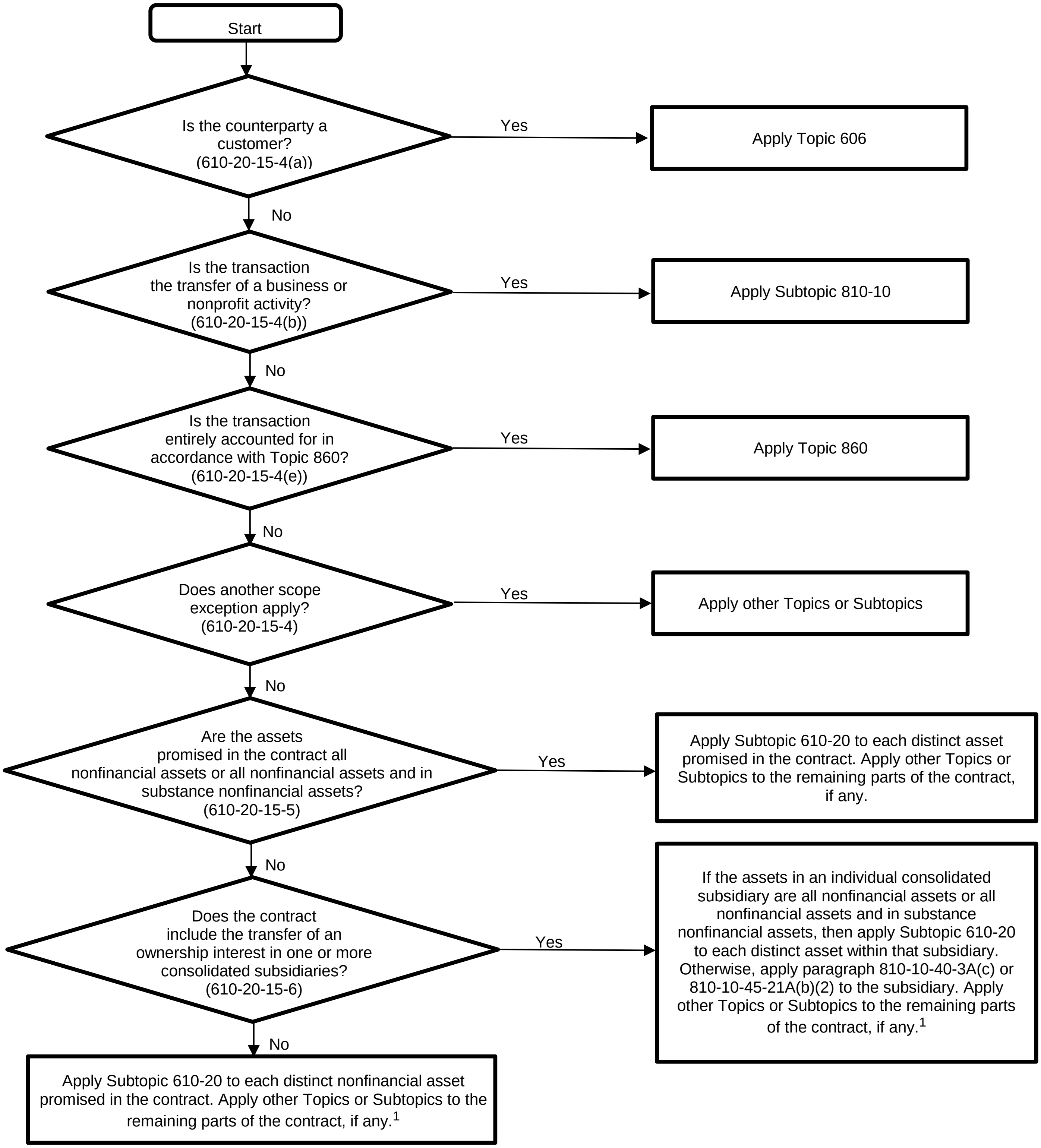
Under both transition methods, an entity adopting the guidance will be required to apply to contracts with noncustomers the revised definition of a “business” in ASU 2017-01, *Clarifying the Definition of a Business.* However, if an entity concludes that a transaction previously recognized as the disposal of a business does not meet the revised definition in ASU 2017-01, the entity should not reinstate amounts previously allocated to goodwill associated with that disposal.

An entity does not need to apply the same transition method for ASC 606 and ASC 610-20. If an entity applies a different transition approach to ASC 610-20 than to ASC 606, it must comply with the disclosure requirements for the transition approach selected, including disclosure of which method of transition is applied for each ASC 610-20 and ASC 606.

Appendix

Evaluating whether promised assets should be derecognized under ASC 610-20

The following decision tree is included in ASC 610-20-15-10.



[1] 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.