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ACCOUNTING ALERT

JUNE 2016

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COMMON ERRORS IN ACCOUNTING FOR DISCONTINUED OPERATIONS

For Tier 1 and Tier 2 entities disclosure requirements in relation to discontinued operations are contained in NZ IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* (PBE IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* is the equivalent standard for public benefit entities).

Background

The aim of NZ IFRS 5 is to enable users to understand the performance of the continuing business. In reality, the thrust of the standard is intended to restrict which assets can be classified as held for sale, and which operations can be shown as being discontinued.

There is obviously a great incentive for entities with loss making businesses to classify them as discontinued operations and to present a much better set of results from continuing operations. Similarly, showing an asset as held for sale can give an unrealistically positive view of an entity's liquidity position if the asset is presented as current when it is not highly probable that it will be disposed of in the next 12 months.

Some of the major accounting errors that occur under NZ IFRS 5, discussed further below, include:

- Classification as held for sale when the asset fails to meet the 'held for sale' criteria
- Classification of disposals of interests in subsidiaries
- Measurement of a non-current asset (or disposal group) classified as held for sale
- Presentation and disclosure of results from continuing and discontinuing operations.

'An entity shall classify a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use.'

NZ IFRS 5, paragraph 6

'For this to be the case, the asset (or disposal group) must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups) and its sale must be highly probable.'

NZ IFRS 5, paragraph 7

'For the sale to be highly probable, the appropriate level of management must be committed to a plan to sell the asset (or disposal group), and an active programme to locate a buyer and complete the plan must have been initiated. Further, the asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value. In addition, the sale should be expected to qualify for recognition as a completed sale within one year from the date of classification, except as permitted by paragraph 9….'

NZ IFRS 5, paragraph 8

Classification as held for sale

There are a number of accounting errors that can result in an entity incorrectly classifying an asset or a business as held for sale. These include:

- The asset is not saleable in its current state
- The asset is not being actively marketed
- It is not highly probable that the asset will be disposed of within the next 12 months because, for example:
  - The asking price is unrealistically high and it is not highly probable that a buyer will be found at that price, or
  - There simply is not a market for that asset/business in the current economic cycle
- The asset is to be abandoned rather than sold (NZ IFRS 5, paragraph 13)
- The asset(s) or disposal group is to be used and then closed down.

Disposal of an interest in subsidary

'An entity that is committed to a sale plan involving loss of control of a subsidiary shall classify all the assets and liabilities of that subsidiary as held for sale when the criteria set out in paragraphs 6–8 are met, regardless of whether the entity will retain a non-controlling interest in its former subsidiary after the sale.'

NZ IFRS 5, paragraph 8A

Accounting errors that can occur here include:

- Showing a partial disposal in a subsidiary (but still having control of the subsidiary) as an asset held for sale
- When an entity is to dispose of a controlling stake in a subsidiary, but will continue to hold a non-controlling interest in the entity, only showing the holding in the subsidiary to be disposed of as an asset held for sale, rather than the entire holding.

Measurement of a non-current asset (or disposal group)

'An entity shall measure a non-current asset (or disposal group) classified as held for sale at the lower of its carrying amount and fair value less costs to sell.'

NZ IFRS 5, paragraph 15

'An entity shall not depreciate (or amortise) a non-current asset while it is classified as held for sale or while it is part of a disposal group classified as held for sale…'

NZ IFRS 5, paragraph 25

Accounting measurement errors of non-current assets and disposal groups held for sale include:

- Entities incorrectly revaluing (upwards) an asset held for sale to its expected fair value less costs to sell (FVLCTS)
- Being over-optimistic in determining the fair value less cost to sell (FVLCTS)
- Continuing to depreciate/amortise the asset after it has been classified as held for sale.

NZ IFRS 5, paragraph 15's requirements are clear that measurement is at the ***lower of*** carrying amount and FVLCTS. Therefore upward revaluations cannot be made unless a revaluation policy is being applied to the asset class.

Presentation and disclosure

'An entity shall present and disclose information that enables users of the financial statements to evaluate the financial effects of discontinued operations and disposals of non-current assets (or disposal groups).'

NZ IFRS 5, paragraph 30

'A discontinued operation is a component of an entity that either has been disposed of, or is classified as held for sale, and: **a** represents a separate major line of business or geographical area of operations, **b** is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations or **c** is a subsidiary acquired exclusively with a view to resale.'

NZ IFRS 5, paragraph 32

The basic aim of NZ IFRS 5 is to restrict discontinued operations to a major component that represents a major line of business.

Accounting errors might therefore include:

- Treating a closure of a single store as a discontinued operation (closing a single store is unlikely to be a major line of business)
- Treating the disposal of a single tenement or exploration area as a discontinued operation
- Treating the closure of a particular facility (factory, warehouse, data centre, etc.) as a discontinued operation, when the entity is still involved in that line of business
- Treating a disposal of an operation in an outsourcing arrangement as a discontinued business.

Closing a single store is unlikely to be a major line of business because the entity is likely to still be operating in that particular sector.

When an entity closes a single facility, e.g. a factory or a warehouse, again this most likely represents a simple reorganisation of the entity's continuing business, rather than discontinuing a major component of its business.

Also, where an entity disposes of assets or a business to an outsourcing business, e.g. an entity disposes of its servers and data storage facilities to an outsourcing operation, but will then engage that outsourcer to provide data storage services, this type of arrangement would most likely not represent a discontinued operation.

Example

An entity manufacturing sporting goods has a bicycle division that designs, manufactures, markets, and distributes bicycles. For the entity, the bicycle division is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, the bicycle division is a component of the entity. The entity has experienced losses in its bicycle division resulting from an increase in manufacturing costs (principally labor costs).

a. The entity decides to exit the bicycle business and commits to a plan to sell the division with its operations. The bicycle division is classified as held for sale at that date. The operations and cash flows of the division will be eliminated from the ongoing operations of the entity as a result of the sale transaction, and the entity will not have any continuing involvement in the operations of the division after it is sold. In that situation, the conditions for reporting in discontinued operations the operations of the division while it is classified as held for sale would be met.

b. The entity decides to remain in the bicycle business but will outsource the manufacturing operations and commits to a plan to sell the related manufacturing facility. The facility is classified as held for sale at that date. Because the manufacturing facility is part of a larger cash-flow-generating group (the bicycle division), and on its own is not a component of the entity, the conditions for reporting in discontinued operations the operations (losses) of the manufacturing facility **would not be met**. (Those conditions also would not be met if the manufacturing facility on its own was a component of the entity because the decision to outsource the manufacturing operations of the division will not eliminate the operations and cash flows of the division [and its bicycle business] from the ongoing operations of the entity.)

Typically these accounting errors involve a discontinued loss-making operation. Therefore the entity has incorrectly separated out from its income statement the results of this loss making operation, completely distorting the reported performance of the continuing operation, including gross margin, operating expenses, impairment, etc.

Other errors

There is a tendency to put all losses and costs to the discontinued operation, and to take all profits and credits to continued operations.

A simple example of such an error would be instances where an entity disposes of a business on contingent/deferred payment terms.

Example

In the 2016 financial year, Entity A disposes of Business B on deferred payment terms, whereby based on a 3 year post disposal EBIT calculation, Entity A will receive somewhere between $0 and $5 million in 2019.

When preparing its 2016 financial statements, Entity A takes a very 'conservative' view and recognises no receivable in respect of the deferred consideration, therefore recording a significant loss from **discontinued operations**.

Subsequently in 2017, Entity A reassesses the likelihood of the EBIT target being met and determines that it is likely to be $1 million. It credits this revised estimate to **continuing operations**.

In 2019 Entity A actually receives the full $5 million. It then makes three accounting errors:

- Continues to recognise all of the $5 million gain as a **gain from continuing operations**
- Shows the $5 million cash inflow as an **operating cash flow**, or fails to disclose this as a discontinued operation, and
- Includes the $5 million gain in its segment note as a profit from a **continuing segment**

For more on the above, please contact your local BDO representative.

DISCLOSURE OF SEASONAL DEBT

The Financial Markets Authority has recently stated that companies reporting under New Zealand equivalents to International Financial Reporting Standards ("NZ IFRS") should consider the most appropriate manner in which to disclose high seasonal debt in circumstances where debt at balance date is considerably less than peak debt.

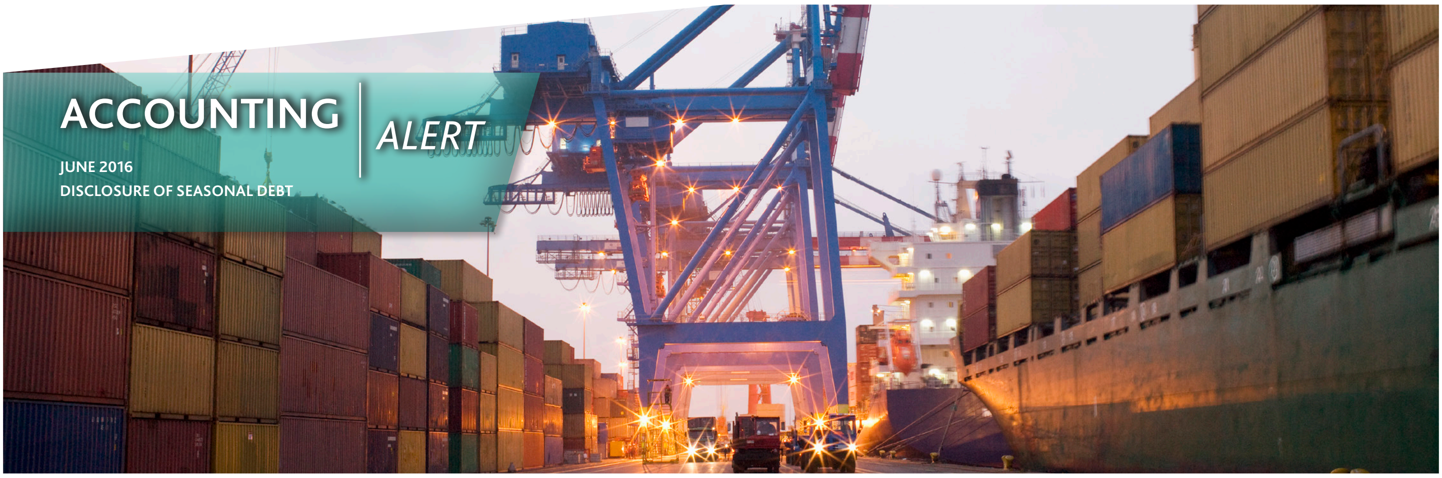
Where debt is lower at balance date than at other times during the financial year, users of the financial statements gain a more complete understanding of the entity's borrowing behaviour and exposure by being provided with information about the variability of the entity's indebtedness.

In developing appropriate disclosure, we consider that entities reporting under NZ IFRS should provide information such as the following:

- Debt at balance date and the terms and conditions of that debt (such as the lender(s), the total debt facility, the amount drawn down on that facility, interest rate charged and repayment terms)
- The fact that debt is seasonal and the reasons for that seasonality
- The pattern in which debt is drawn down against the facility (such as the months in which it is increasing, when it peaks and the months in which it is decreasing) – useful disclosure might include a table showing monthly indebtedness
- Peak debt, when it occurs, how long the peak lasts for and the terms and conditions of that debt (such as the lender(s), the total debt facility, the amount drawn down on that facility, interest rate charged and repayment terms)
- Any other required NZ IFRS disclosures (such as those required if there has been a breach of covenants or default on payments).

For entities with high seasonal debt that do not report under NZ IFRS, we consider that disclosure of the matters outlined above is likely to be relevant to users of the financial statements and that it would be best practice to make such disclosures.

For more on the above, please contact your local BDO representative.



SEMINARS FOR NOT-FOR-PROFITS ON THE NEW FINANCIAL REPORTING REQUIREMENTS

BDO has teamed up with CCH Learning to present a series of three seminars on the new financial reporting requirements for not-for profits. Those interested in attending can attend one, two or all three webinars. The registration fee for each webinar is per connection, so several people watching on the one connection will pay only the one connection fee between them.

The three webinars are:

Webinar 1: This session provides:

- An overview of the requirements of the new framework (including the tier structure) that applies to not-for-profits for balance dates from 31 March 2016 onwards
- An overview of the accounting requirements that apply to Tier 4 not-for-profits (registered charities with less than $125,000 of annual expenses) for balance dates from 31 March 2016 onwards.

The webinar is being held on Wednesday 1 June, from 2:30pm to 3:45pm. **Register here for webinar 1**.

Webinar 2: This session provides an overview of the accounting requirements that apply to Tier 3 not-for-profits (registered charities with between $125,000 and $2 million of annual expenses) for balance dates from 31 March 2016 onwards.

The webinar is being held on Thursday 9 June, from 10:30am to 11:45am. **Register here for webinar 2**.

Webinar 3: This session provides an overview of the accounting requirements that apply to Tier 1 and Tier 2 not-for-profits (registered charities that are either publicly accountable, or have in excess of $2 million of annual expenses) for balance dates from 31 March 2016 onwards.

The webinar is being held on Tuesday 26 July, from 2:30pm to 3:45pm. **Register here for webinar 3**.

Those wanting to attend all three seminars should **register here for the package price**.

For more on the above, please contact your local BDO representative.

STANDARD CONDITIONS ISSUED FOR MANAGED INVESTMENT SCHEME MANAGER LICENCES

Late in 2015 the Financial Markets Authority ("FMA") consulted on proposed variations to standard conditions for market service licences. The FMA has now completed the consultation process and issued updated information on standard licence conditions for managed investment scheme ("MIS") managers. The new conditions are effective from 31 March 2016, which means that the new audit procedures and financial resource requirements apply to licensees for accounting periods ending on or after 31 March 2016.

The standard licence conditions are:

Condition 1: **Skills and expertise**	A MIS manager, or any authorised body covered by its licence, must inform the FMA whenever there is a change in its key people and managers (these are the people responsible for the main activities required for the MIS manager to deliver the licensed service; the FMA would have been told about these people during the licence application process and this requirement means that the relevant information is kept up to date).
Condition 2: **Investing**	A MIS manager must maintain adequate and effective procedures to monitor any dealings with scheme assets to ensure the limits and asset allocations set out in the statement of investment policy and objectives ("SIPO") are adhered to at all times. This requires the MIS manager to ensure that its SIPO monitoring procedures and controls continue to enable it to identify material breaches of certain SIPO limits ("limit breaks") and effectively minimise, and manage, the risks of limit breaks occurring.
Condition 3: **Outsourcing**	A MIS manager that outsources a process/system necessary to the effective and proper running of its market service (or any other market services licensee obligation) must: ▶ Be satisfied that the provider is capable of performing the service to the standard required to enable the MIS manager to meet its market services licensee obligations ▶ Have a legally binding agreement with the provider ▶ Ensure that records pertaining to the market service are available for inspection when requested by the FMA.
Condition 4: **Records**	A MIS manager must: ▶ Have systems and procedures to maintain relevant records pertaining to its market service ▶ Provide the FMA with the records its needs to monitor the MIS manager's on-going capability to effectively perform the market service in accordance with the applicable eligibility criteria in the Financial Markets Conduct Act 2013 ("FMC Act").
Condition 5: **Regulatory returns**	A MIS manager must provide the FMA with the information it needs to monitor the MIS manager's on-going capability to effectively perform the market service in accordance with the applicable eligibility criteria in the FMC Act. Information that will be required will include updated information on the nature, size and complexity of the MIS manager's market service. Information must be provided in accordance with any requirements issued under the FMC Act.

Condition 6: **Compliance**	A MIS manager must, at all times, have adequate and effective systems, policies, processes and controls that are likely to ensure that it will meet its market services licensee obligations in an effective manner.
Condition 7: **Governance arrangements**	A MIS manager's governance and compliance arrangements must be substantially the same as, or better than, those in place, or which the FMA was advised of, at the time the MIS manager applied for its licence (or any subsequent change advised to the FMA). A MIS manager must notify the FMA of material changes to its governance and compliance arrangements (including material changes to its outsourcing arrangements) as soon as practicable (which the FMA would ordinarily consider to be within five working days of the change taking effect).
Condition 8: **Financial resources**	***Calculation of net tangible assets ("NTA")*** A MIS manager must calculate its NTA (note that the manner in which NTA must be calculated is explained in an appendix to the standard licence conditions): ▶ At least monthly, including as at its balance date each year on the basis of its audited financial statements ▶ On any other date on which there is a reason to suspect that its NTA is not positive. If the calculation shows that the MIS manager did not have positive NTA, the MIS manager must notify its supervisor or, if you does not have a supervisor, the FMA, as soon as practicable and explain: ▶ The circumstances that cause it to have NTA that is not positive, including the nature of any significant intangible assets or related party receivables ▶ Whether the MIS manager considers that having NTA that is not positive adversely impacts on its ability to carry out the market service effectively on an ongoing basis and why. The MIS manager is not required to make this notification if: ▶ It has previously notified its supervisor or the FMA (as applicable) that its NTA was not positive and provided an explanation ▶ Its supervisor or the FMA (as applicable) has advised in writing that it does not need to provide further notifications in respect of having NTA that is not positive arising from those circumstances ▶ There has been no material change from the position and circumstances described to its supervisor or the FMA (as applicable) in its most recent previous notification. ***NTA Report*** A MIS manager that does not have a supervisor must: ▶ Engage a qualified auditor to perform agreed upon procedures ("AUP") and provide the MIS manager with a report in respect of the calculation of its NTA during its accounting period, including the calculation of its NTA as at its balance date performed on the basis of its audited annual financial statements ▶ Send the FMA a copy of the report, including a copy of the MIS manager's NTA calculation as at its balance date, by the earlier of (1) five working days after the audit report on its annual financial statements is signed and (2) four months and five working days after the end of its accounting period. A MIS manager that has a supervisor must: ▶ Engage a qualified auditor to perform AUP and provide the MIS manager with a report in respect of the calculation of its NTA as at its balance date performed on the basis of its audited annual financial statements ▶ Send the MIS manager's supervisor or, if requested by the FMA, the FMA, a copy of the report, including a copy of the MIS manager's NTA calculation as at its balance date, by the earlier of (1) five working days after the audit report on its annual financial statements is signed and (2) four months and five working days after the end of its accounting period. The AUP must include the following procedures (or procedures to achieve the same outcome): ▶ Re-perform the MIS manager's NTA calculation ▶ Check that each component of the NTA calculation agrees with the relevant information in the MIS manager's audited annual financial statements (or, where the information is not included in those financial statements, agree it to appropriate accounting records or other relevant documentation)

(continued from previous page) **Condition 8:** **Financial resources**	▶ If the MIS manager has intangible assets or related-party receivables in its audited annual financial statements, determine whether an adjustment has been made for those in the NTA calculation ▶ For any adjustment for subordinated debt made when calculating adjusted liabilities, check that (1) an executed deed of subordination exists and (2) the amount that has been classified as subordinated debt is not repayable within one year from the date of the NTA calculation and enquire of the MIS manager whether it has provided any guarantees during the accounting period and note any that have not been included in the NTA calculation. ▶ If the MIS manager does not have a supervisor, obtain all NTA calculations performed by the MIS manager during the accounting period and, for each calculation include in the report (1) the date that the calculation relates to, (2) the date the calculation is recorded as having been prepared and (3) the value of the NTA calculated.

Note that condition 8 does not apply to a MIS manager that is a registered bank, a non-bank deposit taker (as defined in the FMC Act), or a licensed insurer.

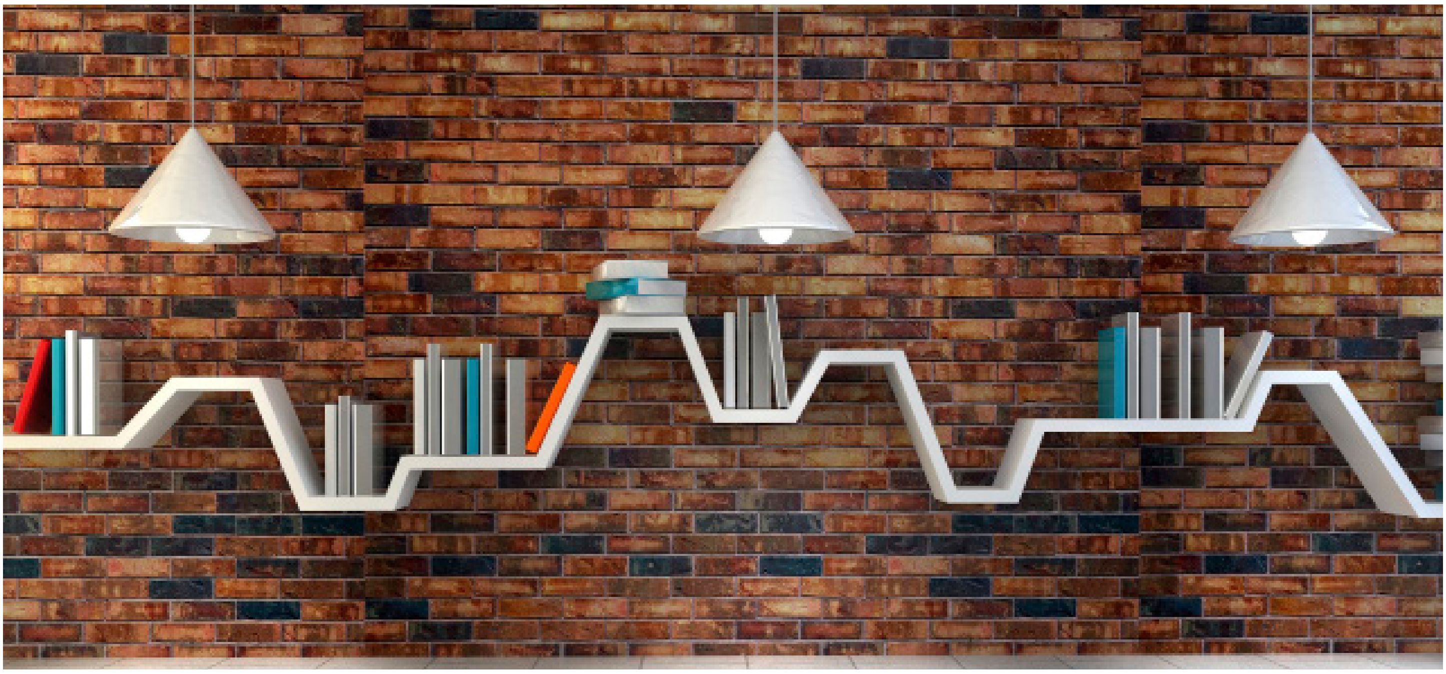
Condition 8 also does not apply to a MIS manager that is a market participant requiring capital under the NZX Participant Rules ("NZX Rules"), provided that the MIS manager:

- Is not exempt from the capital adequacy requirements in the NZX Rules
- Complies with the capital adequacy requirements in the NZX Rules
- Provides the FMA with copies of any notification given by it to the NZX if its net tangible current assets (as defined in the NZX Rules) is at any time less than 120% of its prescribed minimum capital adequacy (this information must be provided at the same time as it is provided to the NZX)
- Provides the FMA with copies of the final version of any reports from the NZX relating to its compliance or non-compliance with the capital adequacy requirements in the NZX Rules
- Notifies the FMA if it ceases to be subject to regulation by the NZX as soon as reasonably practicable.

The full standard licence conditions for MIS managers are **available here**.

In addition to these standard licence conditions, the FMA may impose additional specific licence conditions on individual MIS managers on a case by case basis.

For more on the above, please contact your local BDO representative.



BDO PUBLICATIONS

The **Audit** section of our website (**www.bdo.nz/en-nz/services/audit-assurance**) includes a range of publications on accounting standards issues. For example:

- **Summaries on a Page (SOAPs)** contain summaries of NZ IFRS Standards for for-profit entities and PBE Standards for public sector and not-for profit entities currently in effect in New Zealand.

The **BDO International** site includes resources such as:

- **IFRS at a glance** – 'one page' and short summaries of all IFRS standards.
- **IFRS News at a glance** – provides high-level headlines of newly released documents by the IASB and IFRS related announcements by securities regulators.
- **Need to Knows** – updates on major IASB projects and highlights practical implications of forthcoming changes to accounting standards. Recent Need to Knows include IFRS 9 *Financial Instruments – Classification and Measurement* (April 2015), IFRS 9 *Financial Instruments - Impairment of Financial Assets* (Dec 2014), IFRS 15 *Revenue from Contracts with Customers* (Aug 2014), IFRS 9 *Financial Instruments* (May 2014), *Hedge Accounting* (IFRS 9 *Financial Instruments*) (Jan 2014).
- **IFRS in Practice** – practical information about the application of key aspects of IFRS, including industry specific guidance. Recent IFRS in Practice include IFRS 11 *Joint Arrangements* (Feb 2016), IFRS 9 *Financial Instruments*, IFRS 15 *Revenue from Contracts with Customers – Transition*; IFRS 15 *Revenue from Contracts with Customers* (Oct 2014), IAS 7 *Statement of Cash Flows*, *Distinguishing between a business combination and an asset purchase in the extractives industry* (March 2014), IAS 36 *Impairment of Assets* (Dec 2013) and *Common Errors in Financial Statements – Share-based Payment* (Dec 2013).
- **Comment letters on IFRS standard setting** – includes BDO comments on various projects of international standard setters, including Exposure Drafts and other Discussion Papers, when it is considered that the issue is significant to the BDO network and its clients. Latest comment letters include IASB ED 2015-08 *IFRS Practice Statement: Application of Materiality to Financial Statements*, IASB ED 2015-11 *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts – Proposed amendments to IFRS 4*, IASB ED 2015-3 *Conceptual Framework for Financial Reporting*, ED *Proposed amendments to IAS 19* and IFRIC 14, IASB 2015-6 *Clarifications to IFRS 15*, IASB ED 2015-1 *Classification of Liabilities* and Basel Committee on Banking Supervision – Guidance on accounting for expected credit losses.

For more on the above, please contact your local BDO representative.

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