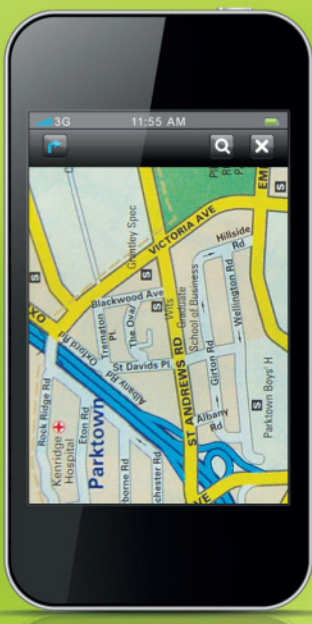
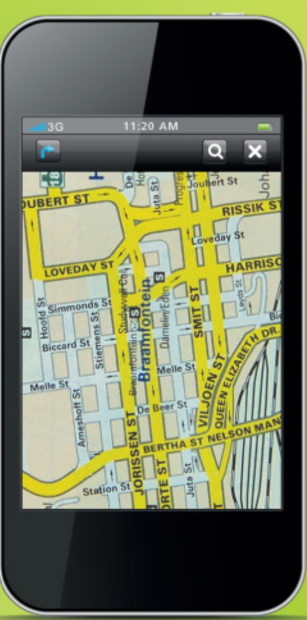
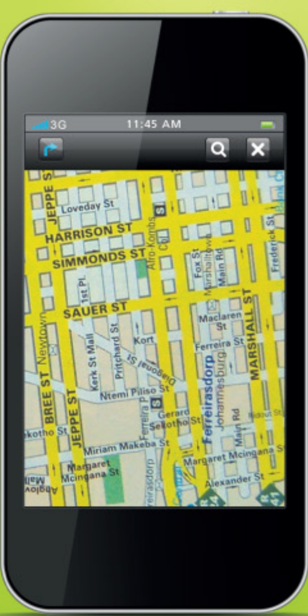
financial accounting:

GAAP PRINCIPLES

LUBBE • MODACK • WATSON







THIRD EDITION

LUBBE • MODACK • WATSON

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each segment item reported is based on how that information is presented to the chief operating decision-maker for the purposes of resource allocation and assessing performance), and
- Reconciliations of the totals of segment revenues, reported segment profit or loss, segment assets, and segment liabilities.

9 Interim financial reporting

The basic purpose of interim financial statements is to provide users with relevant and decision-useful information on a more regular basis than when financial statements are provided on an annual basis. Reporting financial information at an interim period (that is, for a period covering less than a full financial year) makes the information timely and relevant, thereby improving the ability of investors, creditors and others to understand the entity's capacity to generate earnings and cash flows and to understand its financial condition and liquidity. IAS34, *Interim Financial Reporting*, does not mandate which entities should report interim financial information. Its objective is to prescribe the minimum content of an interim financial report and the principles that should be applied for the recognition and measurement in financial statements for an interim period.

An **interim period** is defined in IAS34 as 'a financial reporting period shorter than a full financial year. An interim financial report means a financial report containing either a complete set of financial statements (as described in IAS1) or a set of condensed financial statements (as described in IAS34) for an interim period'.

Legal requirements for presenting an interim report

The new Companies Act, 2008 does not specifically require the preparation of an interim report (as was the case with the Companies Act of 1973). The overriding requirement in the Companies Act, 2008 that a company must prepare financial statements in compliance with International Financial Reporting Standards includes the presentation of an interim report, where applicable.

In South Africa, interim reports are normally prepared on a **half-yearly basis**, that is, for a period of six months. Listed companies are required, as part of the JSE Limited listing requirements, to present interim results six months after their previous reporting date. When the next annual report is prepared, it includes the interim results, as it then covers the annual period of 12 months. Interim results normally include three columns of results, disclosing comparative amounts relating to the immediately preceding corresponding interim period and the audited amounts in respect of the most recent completed financial period. For example, a company with a financial year ended 31 December 20x9 should report its interim figures for the six months ending 30 June 20x9, and when these interim figures are reported, the interim report should include the interim figures for the corresponding period to 30 June 20x8 and the audited figures for the year ended 31 December 20x8.

Preparing an interim report

Interim financial information can be presented either as a complete set of financial statements, or as a set of **condensed financial statements**. In South Africa, companies normally prepare a set of condensed financial statements. The minimum content of an interim financial report consists of:
- A condensed statement of financial position
- A condensed statement of comprehensive income
- A condensed statement of cash flows
- A condensed statement of changes in equity, and
- Selected explanatory notes.

An entity should include, as a minimum, each of the headings and sub-totals that were included in its most recent annual financial statements and the selected explanatory notes as required by IAS34. Additional line items or notes should be included if their omission would make the condensed interim financial statements misleading. When you prepare interim financial reports, you should prepare them on a consolidated basis if the entity's most recent financial statements were consolidated statements. (Refer to Chapter 22, *Business combinations* and Chapter 23, *Consolidation and separate financial statements* for a discussion on the preparation of consolidated financial statements).

An entity should **recognise and measure** its assets and liabilities at the interim period in the same way as would apply if it were a full financial year. In other words, the usual recognition and

measurement criteria must be applied at the interim reporting date as if this were a stand-alone period. For example, a cost that does not meet the definition of an asset at the end of an interim period is expensed at that time, and not deferred to await further information as to whether or not it has met the definition of an asset, or to smooth earnings over interim periods within a financial year. In addition, an income tax expense should be calculated and recognised at each interim period based on the best estimate of the weighted average annual tax rate expected for the year. Similarly, where revenues are received seasonally or cyclically, these revenues may not be anticipated or deferred at an interim date if anticipation or deferral would not be appropriate at the financial year-end.

An entity should apply the **same accounting policies** in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes that are made after the most recent annual financial statements.

Examples of information to be included in interim reports are:

- Disclosures about changes in accounting policies
- Nature and amount of any unusual items affecting assets, liabilities, equity, income or cash flows
- Issues, repurchases, and repayments of debt and equity
- Dividends
- Revenue and results for each primary segment
- Changes in composition of the business during the interim period, and
- Changes in contingent assets or contingent liabilities.

QUESTIONS

Discussion questions

1 IAS1 requires an entity to include a detailed explanation of the accounting policies used when preparing financial statements. Why is it important for entities to disclose the measurement bases used in preparing the financial statements?

2 What is the general principle for disclosure of information in financial statements?

3 What is meant by the consistency and comparability of information in financial statements?

4 Companies listed on the JSE Limited have had to comply with IFRS since 2005. List the additional disclosure requirements for companies listed on the JSE Limited.

5 Explain the following potential threats to the quality of information presented in financial statements:
- Offsetting
- Aggregation.

6 Discuss when and how you would decide on the materiality of an amount.

7 IAS1 requires that an entity should include the balances of the prior reporting period when preparing financial statements. Why is the presentation of comparative amounts and information in financial statements important?

8 The use of accounting estimates is an essential part of the preparation of financial statements and does not undermine their reliability. Discuss how you would determine the amount of an estimate and its disclosure requirements.

9 What is a related party, and why is disclosure of related-party transactions important?

10 IFRS8 requires that an entity provides information relating it its operating segments. What is meant by an operating segment, and what information should be presented for such an operating segment in the financial statements?

11 What is an interim report, and when will an entity prepare an interim financial report?

Exercise question

Question 1

You invested R50 000 of your hard-earned spare cash five years ago when you bought shares in Lochlin Limited, a company listed on the JSE Limited. You have recently read the following extract in a financial magazine relating to Lochlin Limited:

‘ The directors of Lochlin have announced that the financial results for the year ended 31 December 20x8, which were published on 14 January 20x9, have subsequently been restated. The reason for the restatement was a failure to recognise certain write-downs in the carrying amount of inventories. The effect of the error indicated a decrease of R25m in reported earnings for the current year. ’

Learning objectives

By the end of this chapter, you should be able to:

- ✓ Identify non-current assets and disposal groups that meet the criteria for classification as held for sale
- ✓ Measure non-current assets held for sale prior to classification as held for sale, on classification as held for sale and subsequent thereto
- ✓ Present non-current assets that are held for sale separately in the statement of financial position and the related profit or loss implications, and
- ✓ Identify and present information regarding discontinued operations.

1 Introduction

The objective of financial reporting is to provide users of financial statements with information that is decision useful, that is, it allows users to evaluate the future cash flows (and their associated risks) of an entity. Assets are recognised as such, as they are expected to give rise to future economic benefits. Those benefits could arise from using the asset, selling the asset or a combination of the two. However, the cash flows and risks associated with those cash flows can differ depending on how future economic benefits are expected to be derived from the asset, especially when an asset that was previously expected to derive future economic benefits through use is now expected to be recovered through sale.

Therefore, to provide users of financial statements with more information about assets that are to be sold, the International Accounting Standards Board (IASB) introduced a classification in the statement of financial position of **held for sale**. The accounting treatment of assets held for sale and the presentation and disclosure of discontinued operations is covered under IFRS5, *Non-current Assets Held for Sale and Discontinued Operations.*

The main requirements of the standard are:[1]

- Assets that meet the criteria of held for sale are to be measured at the lower of their carrying amount and fair value less costs to sell
- Depreciation on such assets cease when classified as held for sale
- Assets that meet the criteria for classification as held for sale are to be presented separately in the statement of financial position, and
- Separate presentation is required of the results of discontinued operations (essentially a significant disposal group).

IFRS for SMEs update

IFRS for SMEs does not include a separate section on assets held for sale and discontinued operations. However, Section 4, *Statement of Financial Position* requires an entity preparing financial statements in compliance with IFRS for SMEs, and which has entered into a **binding sale agreement** for the disposal of its major assets (or its assets and liabilities), to disclose the following information:

- Description of the asset or group of assets and liabilities
- Description of the facts and circumstances of the sale or plan, and
- Carrying amount of the assets or, if the disposal involves a group of assets and liabilities, the carrying amounts of those assets and liabilities.

2 Non-current assets and disposal groups

IFRS5 deals with the measurement, presentation and disclosure requirements of **non-current assets** (with exceptions) and **disposal groups** of an entity. Non-current assets are all assets other than current assets, where current assets are assets that satisfy any of the following criteria:

- They are expected to be realised in, or intended for sale or consumption in, the entity's normal operating cycle.
- They are held primarily for the purpose of being traded.
- They are expected to be realised within twelve months after the reporting date.
- They are cash or cash equivalents (unless they are restricted from being exchanged or used to

settle a liability for at least twelve months after the reporting date).

Refer to Chapter 3, *Presentation of financial statements* for a discussion of assets classified as non-current and current.

Assets that are normally classified as non-current assets in terms of IAS1 can be reclassified as current assets only if they meet the criteria for classification as 'held for sale' in accordance with IFRS5. For example, machinery used in the manufacturing process is generally a non-current asset. Generally, if it is expected to be sold within the following 12 months, it will be classified as held for sale. If it does not meet those criteria, it cannot be presented as a current asset.

In addition, assets that would normally be regarded as non-current that are exclusively acquired with a view to resale shall only be classified as current if they meet the criteria for classification as held for sale in accordance with IFRS5. For example, a property company that leases space to tenants on a short-term basis would normally classify the property as non-current assets (as in most cases the property does not meet the definition of a current asset). If that company acquires a property that it intends to sell, it can classify it as a current asset only if it meets the criteria for classification as held for sale.

Disposal groups are groups of assets that are disposed of together with their associated liabilities. Where a disposal group is classified as held for sale, the assets and liabilities in that group should be measured in terms of the relevant standards applicable to those assets and liabilities immediately before the date of being classified as held for sale. After the measurement is done in terms of the standards, the assets and liabilities are classified as held for sale by transferring them to assets held for sale under current assets, and liabilities held for sale under current liabilities. The entire group of net assets is re-measured to the lower of the group's carrying amount and the group's fair value less costs to sell. In other words, the fair value less costs to sell of the entire group is determined and compared to the total carrying amounts of all assets and liabilities in the group. For example, a textile company is intending to sell one of its divisions, which produces men's shoes. The division is likely to be a disposal group, as the entity is selling the factory that produces the men's shoes, the related land, inventory (raw materials, finished goods), and the related receivables from customers, as well as transferring the obligation to suppliers and other creditors to the purchaser. The presentation requirements for disposal groups held for sale are outlined in section 4.

There are certain non-current assets that are excluded from the measurement scope of IFRS5, which means that they cannot be measured in terms of IFRS5, but could be presented as held for sale if they meet the criteria (individually or as part of a disposal group). They have been excluded from the measurement criteria as they may already have been measured at fair value, or it may be difficult to determine their fair value. These non-current assets include:

- Deferred tax assets
- Financial assets within the scope of IFRS9, and
- Investment property accounted for on the fair value model.

3 Classification and measurement of non-current assets classified as held for sale

3.1 Criteria for classification as held for sale

An entity classifies a non-current asset as held for sale if its carrying amount is expected to be recovered principally through **sale** (including barter transactions, which are exchanges of non-monetary assets that have commercial substance) rather than continuing use.[2]

A non-current asset that is abandoned is not classified as held for sale, as abandoned non-current assets are expected to be recovered principally through continuing use.[3]

The non-current asset is expected to be recovered through sale if:

- It is **available for immediate sale in its present condition** subject only to terms that are usual and customary for the sales of such assets, and
- The sale is **highly probable**, that is, significantly more likely than probable. As management intention is not sufficient, the standard gives guidance on when the sale is highly probable:
  - The appropriate level of management must be committed to the plan to sell the asset

- An active programme to locate a buyer and complete the plan must have been initiated
- The asset must be actively marketed for sale at a price that is reasonable in relation to its fair value, and
- The sale must be completed within one year from the date of classification, except in those instances where the cause of the delay in sale beyond one year is caused by events beyond the entity's control, and there is sufficient evidence that the entity remains committed to its plan to sell the asset.

If the abovementioned criteria are met only after the reporting date, but before the financial statements are authorised for issue, it results in a **non-adjusting event after the reporting period** (see Chapter 14, *Events after the reporting period*).

3.2 Measurement of non-current assets classified as held for sale

3.2.1 Immediately before classification as held for sale

Immediately prior to classification as held for sale, the non-current asset must be accounted for in accordance with the applicable standard(s) which govern that non-current asset. For example, if an item of machinery is to be classified as held for sale, immediately prior to such classification, it must be depreciated in accordance with IAS16 (see Chapter 4, *Property, plant and equipment*), and revalued in accordance with IAS16 (if the entity has selected the revaluation model and its policy is to revalue at that time). It must also be tested for impairment with reference to its recoverable amount, in accordance with IAS36 (see Chapter 9, *Impairment of assets*).

3.2.2 On classification as held for sale

On classification as held for sale, the non-current asset is re-measured to the lower of its carrying amount (as calculated in section 3.2.1) and its **fair value less costs to sell**, which is the amount that the asset could be exchanged for in an arm's-length transaction between knowledgeable and willing parties, less those incremental costs directly attributable to the disposal of the non-current asset, excluding finance costs and income taxes. Where the sale is expected to be concluded more than one year later (see section 3.1), the costs to sell are measured at their present value. Any increase in the present value of the costs to sell as a result of the unwinding of the discount factor is recognised in profit or loss as a finance expense.

Any loss on re-measurement of the non-current asset to its fair value less cost to sell (if lower than its carrying amount immediately prior to classification as held for sale) is recognised in the profit or loss from continuing operations (unless it relates to a discontinued operation – see section 5). This implies that even if the asset were previously revalued, any loss on re-measurement on classification as held for sale is recognised in profit or loss. This differs from the impairment loss associated with an item of machinery that is not classified as held for sale and had been revalued, in that the impairment loss is recognised in other comprehensive income and/or in profit or loss. IFRS5 tries to simulate what would happen when an entity actually sells the non-current asset at a loss. If an asset that has previously been revalued is sold at a loss, the loss is recognised in profit or loss and not in other comprehensive income.

A non-current asset could be classified as held for sale at acquisition (see section 2). This means that an entity could incur a loss on the initial recognition of a non-current asset. This is because

Example of identifying an asset as 'held for sale'

An entity intends selling a nuclear plant and has entered into negotiations with a potential buyer. The purchaser will perform a due diligence (that is, a check of the condition and other important aspects of the nuclear plant). The due diligence is customary for purchases and sales of nuclear plants, given the risks associated with such assets. Even though the asset is not sold immediately as a result of the time taken to complete the due diligence, it is still available for immediate sale, as the sale is subject to the completion of the due diligence, which is customary for such transactions.

Alternatively, if an entity wishes to sell a building but the sale will be concluded only once its new building is complete, the existing building will not be available for immediate sale.

GAAP principle: Measurement of assets

Assets that meet the criteria of held for sale should be measured at the lower of carrying amount and fair value less costs to sell, and depreciation on such assets should cease.

assets are recognised initially at cost (being the fair value of the consideration paid or payable). If it is classified as held for sale, it must be re-measured immediately to its fair value less costs to sell. This will result in a loss at acquisition, unless the cost of the asset was below its fair value less costs to sell.

3.2.3 Treatment of non-current asset subsequent to classification as held for sale

Subsequent to classification as held for sale, one of three events can occur, and the measurement of the non-current asset held for sale is therefore dependent on these events:

- The non-current asset is sold.
- The non-current asset is not yet sold, but classification as held for sale is still appropriate.
- There is a change in the plan to sell the non-current asset.

Example of measurement and recording of non-current assets held for sale

A Ltd acquires an item of machinery on 1 January 20x8 at a cost of R1 million. The machine is expected to have a useful life of 10 years and no residual value. On 1 July 20x9, the machine met the criteria to be classified as held for sale. At that date, the machine had a fair value less costs to sell of R750 000. This amount also reflected the recoverable amount of the machine immediately prior to classification as held for sale.

The journal entries for the financial year ended 31 December 20x9 are as follows:

1. The machine will be depreciated prior to classification as held for sale. As depreciation ceases once the machine is classified as held for sale, depreciation is recognised for only six months during the 20x9 financial year. The depreciation is therefore $R1m \times 10\% \times \frac{1}{2} = R50\ 000$ for the period 1 January 20x9 to 30 June 20x9.
2. The machine will be tested for impairment immediately prior to classification as held for sale by comparing its carrying amount of R850 000 $\left(\frac{R1m \times 8,5}{10}\right)$ on 30 June 20x9 to its recoverable amount of R750 000. As the recoverable amount is less than the carrying amount, the machine is impaired by R100 000.
3. The machine will be reclassified as a non-current asset held for sale. As the machine's fair value less costs to sell is R750 000, no re-measurement is required on classification as held for sale.

30 June 20x9

Dr		Depreciation	50 000	
	Cr	Machine: Accumulated depreciation		50 000

Depreciation for 6 months to 30 June 20x9 (see section 3.2.3)

Dr		Impairment loss (P&L)	100 000	
	Cr	Machine: Accumulated depreciation and impairment		100 000

Impairment to recoverable amount immediately prior to classification as held for sale

Dr		Non-current asset held for sale	750 000	
Dr		Machine: Accumulated depreciation and impairment	250 000	
	Cr	Machine: Cost		1 000 000

Reclassification as held for sale (see section 4)