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Preface

The purpose of this book is to set out the principles and conceptual issues of South African Generally Accepted Accounting Practice (GAAP). The book summarises by topic the disclosure requirements of both the accounting statements and Schedule 4 to the Companies Act. Sample accounting policy notes are included where appropriate. In addition, complete sets of specimen financial statements for a group, a private company and a close corporation are included in the appendix.

The book is aimed at both the undergraduate and graduate student, practising accountants, financial analysts, credit providers and the wider business community. Each chapter is conceptually based and includes worked examples, with journal entries where appropriate, that demonstrate the more important principles. The underlying concepts of AC 000 are incorporated into the topics and taxation issues are addressed to the extent that deferred taxation is applicable to certain accounting areas. The text should be useful to:

- university and technikon students studying accounting courses in financial accounting;
- members and students of professional bodies such as the South African Institute of Chartered Accountants (SAICA), the Institute of Commercial and Financial Accountants (CFA), the Chartered Institute of Secretaries (CIS) and the Institute of Bankers (IOB); and
- preparers of financial statements.

The book incorporates the recently revised statements on Net profit or loss for the period, fundamental errors and changes in accounting policies (AC 103); Inventories (AC 108); Construction contracts (AC 109); Revenue (AC 111); Borrowing costs (AC 114) and Property, plant and equipment (AC 123). ED 101 on Cash flow statements is also discussed. Where appropriate, the content and disclosure requirements of International Accounting Standards are considered.

Pretoria
December 1995

The authors

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1 The Accounting Framework

1.1 Introduction

The Accounting Framework (often referred to as the Conceptual Framework) can be regarded in general terms as a constitution for financial reporting. A framework could be viewed as a statement of inter-related objectives and theoretical principles which forms a reference for the underlying discipline. In the case of financial reporting, it concerns the provision of information that is useful in making economic decisions. The accounting framework, therefore, should establish the basis for determining which events should be reported, how they should be measured and the format in which they should be communicated to users.

1.1.1 The Need for a Framework

Historically, accounting standard setting bodies around the world have attempted to resolve accounting problems through the development of accounting standards. These standards were developed without an accepted theoretical frame of reference as the starting point. This gave rise to haphazard development (often related to the immediate needs of the financial reporting community) and inconsistencies in standards. In addition, certain key issues (e.g. off balance sheet financing) are sometimes addressed in more than one standard. The framework is an attempt to provide a foundation that sets out the concepts that underlie the preparation and presentation of financial statements. More specifically, the framework should:

- assist standard setters with the development of an accounting standard. Standard setters should be able to issue more useful and consistent standards that are built on an established set of concepts and objectives;
- assist preparers in applying accounting standards and dealing with topics not forming the subject of an accounting standard;
- assist auditors in assessing whether financial statements conform with accounting standards;
- assist users in interpreting the information contained in financial statements.

Various efforts have been made to develop an accounting framework. The most ambitious project was that of the Financial Accounting Standards Board (FASB) in the United States. The FASB have issued six concept statements

("SFAC") that deal with the objective of financial reporting and financial statements, the qualitative characteristics of accounting information, the elements of financial statements and recognition and measurement issues. Other bodies have developed similar statements, including the International Accounting Standards Committee (IASC) which issued its document in 1989. This document was adopted by the Accounting Practices Board in South Africa in November 1990 and is known as AC 000, Framework for the Preparation and Presentation of Financial Statements.

1.1.2 The South African Framework (AC 000)

AC 000 is neither a statement of generally accepted accounting practice nor an accounting guideline, but a framework that sets out the objectives and concepts which underlie the preparation and presentation of financial statements. The framework should be distinguished from the other AC series of statements, namely the:

- AC 100 series – Statements of GAAP.
- AC 200 series – Guidelines.
- AC 300 series – Opinions.

AC 000 does not override any of the AC 100 series statements, but does provide an overriding requirement for information that is useful in making economic decisions. It should be noted that the Accounting Practices Board will be guided by the framework when developing future standards and reviewing existing statements. This is evident in the recent spate of exposure drafts issued by the Accounting Practices Committee of the South African Institute of Chartered Accountants.

The framework applies to the public and private sector (paragraph 8) and deals with general purpose financial statements and not with special purpose financial reports such as a prospectus (paragraph 6). Financial statements would usually include a balance sheet, income statement, cashflow statement and notes and other explanatory material. The framework deals with:

- (a) the objective of financial statements;
- (b) the qualitative characteristics that determine the usefulness of information in financial statements;
- (c) the definition, recognition and measurement of the elements from which financial statements are constructed; and
- (d) the concepts of capital and capital maintenance.

Each of these topics will be dealt with in the remainder of this chapter.

1.2 The Objective of Financial Statements

AC 000 states (paragraph 12) that the objective of financial statements is to provide information about the:

- financial position
- performance and
- changes in financial position

of an enterprise that is useful to a wide range of users in making economic decisions.

Prior to examining these components of financial statements in more detail (section 1.2.2), it is necessary to consider further the 'wide range of users' referred to in AC 000.

1.2.1 Users and their Information Needs

There are seven categories of users listed in AC 000. These users, together with a summary of their information needs is set out below.

(a) Investors	Assessment of risk and return.
(b) Employees	Assessment of ability of employer to provide remuneration, retirement benefits and employment opportunities (concerned with stability and profitability of employer).
(c) Lenders	Assessment of repayment of loans and related interest.
(d) Suppliers and other trade creditors	Assessment of payment of balances owing.
(e) Customers	Assessment of enterprise's ability to continue.
(f) Government	Regulate activities of enterprise, determine national resource allocation and tax policies, and compile statistics.
(g) Public	Assessment of contribution to local economy and range of activities.

AC 000 acknowledges that financial statements cannot meet the needs of all these users, but argues (paragraph 10) that the provision of financial statements that meet the needs of investors will also meet most of the needs

of other users. AC 000 also stresses that financial statements do not necessarily supply all of the information needs that users require to make economic decisions since financial statements concentrate on past events and do not necessarily provide non financial information.

1.2.2 Components of Financial Statements

The economic decisions that are taken by users of financial statements are assumed to be based on assessments of future cashflows. Such assessments require information about the financial position, performance and changes in financial position of an enterprise. Information about financial position is primarily provided in a balance sheet. Information about performance is primarily provided in an income statement and information about changes in financial position is provided in the cashflow statement. These components should indicate the following:

- Balance Sheet
 - Shows the resources available to generate future cash flows.
 - Shows an assessment of management of resources in the past.
 - Indicates where future cashflows will be distributed (for example, interest, dividends).
 - Shows liquidity position.
 - Shows solvency position.
- Income Statement
 - Allows assessment for potential changes in resources.
 - Permits assessment of potential effective use of resources.
 - Shows potential to generate cashflows.
- Cashflow Statement
 - Allows an assessment of the investing, financing and operating activities of an enterprise and its ability to generate and use cashflows.

The financial statements should also include notes and supplementary statements that contain relevant additional explanatory information about the risks and uncertainties facing the enterprise.

1.2.3 Underlying Assumptions

AC 000 states that financial statements should be prepared on the **accrual**

basis of accounting. It is argued that financial statements prepared on the accrual basis inform users not only of past transactions involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Therefore, they provide the type of information about past transactions and other events that is most useful to users in making economic decisions.

AC 000 also states that financial statements should be prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future. If this is not the case, then the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

1.3 The Qualitative Characteristics of Financial Statements

The qualitative characteristics of financial statements are those characteristics that make accounting information useful to the users of that information. The attributes that determine the usefulness of accounting information have been the subject of many studies. These studies have generally concluded that the primary attributes of useful information are:

- understandability
- relevance
- reliability and
- comparability.

AC 000 considers these qualitative characteristics of financial statements as well as the constraints attached to the provision of information. Each of these qualitative characteristics and the constraints will be considered in the following sections.

1.3.1 Understandability

Understandability is the key quality for accounting information to achieve decision usefulness. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence. It is important that financial reporting should not exclude relevant information merely on the grounds that it may be too difficult for certain users to understand. It should also be noted that accounting standards are established for general

purpose reporting in financial statements and financial reporting should therefore provide information that can be used by all users who are willing to learn to use it properly.

1.3.2 Relevance

Information must be relevant to the decision making needs of users. Information has the quality of relevance when it is useful to the formulation of predictions by users and useful for the assessment of past predictions by users. These predictive and confirmatory roles of information are interrelated. For example, information about the capital structure of an enterprise provides users with information to assist them in predicting the ability of the enterprise to take advantage of future opportunities. The same information plays a confirmatory role in respect of past predictions.

The relevance of information is affected by its nature and materiality. Information is relevant when it is capable of making a difference to a decision. By definition, therefore, information can only be relevant when it is material. AC 000 states that information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of financial statements (paragraph 30). The assessment of materiality is, by nature, subjective. Nevertheless, accounting standards make frequent reference to materiality; usually only material items require separate disclosure.

1.3.3 Reliability

According to AC 000, information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome. It is recognised by AC 000 that preparers of financial statements have to contend with the uncertainties that inevitably surround many events and circumstances, for example the probable useful life of plant and equipment. This factor may detract from neutrality but it is a necessary component of financial reporting.

AC 000 notes that prudence may have to be exercised in the preparation of the financial statements but emphasises that the exercise of prudence does not allow the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of

liabilities or expenses, because the financial statements would not be neutral if excessive prudence was applied.

In order to be free from bias, information in financial statements must also be complete. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of relevance. AC 000 recognises the potential trade off between relevance and reliability. It is often necessary to provide information early in order to increase its relevance. However, the reliability of the information may be reduced as a result of uncertainties if the information is provided too early.

Faithful representation essentially means that information included in financial statements should represent what it purports to represent. For example, if an enterprise's balance sheet discloses finished inventory, users would be justified in assuming that the financial statements were truthful and the inventory represented goods freely available for sale by the enterprise.

AC 000 recognises that there are inherent difficulties either in identifying transactions or in devising and applying measurement and presentation techniques that can convey messages that correspond with those transactions. Therefore, most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray.

AC 000 stresses that transactions are not necessarily accounted for and presented in accordance with their legal form but rather with their substance and economic reality. For example, a finance lease may not provide for the passing of ownership in its legal form from the lessor to the lessee at the conclusion of the lease. However, often the substance of the finance lease is that the lessee exercises control over the risks and rewards of ownership of the leased asset. It is appropriate, therefore, for the lessees to capitalise the leased asset on its balance sheet.

In summary, the reliability characteristic of information implies that:

- information is free from material error and bias;
- information represents faithfully what it purports to represent, i.e. a valid description;
- information complies with the substance over form concept;
- the information is neutral; i.e. it does not influence decision making;
- the information is prepared exercising prudence (this should be balanced with the neutrality requirement);
- the information includes all relevant aspects.

1.3.4 Comparability

The fourth primary qualitative characteristic of accounting information recognised by AC 000 is comparability. Information about a company is useful if it can be compared with similar information from other companies or with similar information from past periods from the same company. Therefore, the measurement and display of the financial effect of like transactions should be carried out in a consistent way throughout an enterprise and over time for that enterprise and in a consistent way for different enterprises.

In order to provide comparable information, enterprises should disclose information about adopted accounting policies. These accounting policies should be consistent with those adopted in prior years unless it is more appropriate for the enterprise to adopt a new accounting policy. If accounting policies are changed then the effect of those changes should be clearly disclosed so that users are able to identify differences between accounting policies for like transactions used by the same enterprise from period to period and by different enterprises.

The need for comparability should not be confused with uniformity and should not be allowed to become an impediment to the introduction of improved accounting standards. That is, unnecessary emphasis on uniformity should not impede relevance and reliability.

To enhance comparability, it is also important that financial statements show corresponding information for the preceding periods, i.e. comparatives.

1.3.5 Constraints

AC 000 identifies two main constraints on relevant and reliable information.

Firstly, information must be timely. If there is undue delay in the reporting of information it may lose its relevance. In order to provide information on a timely basis, it may often be necessary to report before all aspects of a transaction are known, thereby impairing reliability. On the other hand, if reporting is delayed until all aspects are known, the information may be highly reliable but of little relevance to users who have had to make decisions in the interim. Therefore, management needs to balance the relative merit of timely reporting and the provision of reliable information.

Secondly, the benefits derived from information should always exceed the cost of providing it. Even when information is both relevant and reliable it should not always be reported. Useful information should only be reported when the benefits to be derived from the information exceed the cost of providing it. Evaluating the benefits and costs of information is a demanding

and subjective task. It is therefore difficult to apply a cost benefit test in any particular case, but standard setters should be aware of this constraint.

1.4 The Elements of Financial Statements

Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the elements of financial statements. AC 000 identifies five main classes of transactions relating to the balance sheet and income statement. The elements identified are assets, liabilities, equity, income and expenses.

1.4.1 Assets

Assets are defined as being “resources controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise” (paragraph 49). For example, an item of inventory on hand is a resource controlled by the enterprise as a result of a past event (the purchase thereof) and from which future economic benefits are expected (the intention is to sell the item of inventory at a profit).

Assets are the economic resources used to carry out an enterprise’s economic activities. The primary characteristic of all assets is the future economic benefit (or service potential) which eventually results in net cash inflows to the enterprise. In terms of the above definition, an economic resource must have three characteristics prior to being considered as an asset:

1. The resource should provide future economic benefits, which will usually be in the form of future receipts of cash, although economic benefits may also be only indirectly related to the generation of cash. For example, use of a factory to produce goods; the future cash flows relate to the sale of the goods but the factory is indirectly generating those cash flows.
2. The future economic benefit should be within the control of the enterprise. This includes the ability to restrict access of the benefit to other parties. Control implies that the enterprise generally can deny or regulate the ability of others to utilise the resource.
3. The event giving rise to the company’s right to the resource and control over the future benefits must already have occurred (i.e. past event). The recognition of an asset is restricted to the position where the transaction resulting in the right to the economic benefit has passed.

The future economic benefits embodied in an asset may flow to the enterprise in a number of ways. For example, an asset may be used in the production of goods or services, exchanged for other assets, used to settle a liability, or distributed to owners (paragraph 55).

There is a close association between incurring expenditure and generating assets but the two do not necessarily coincide. For example, an enterprise may make a donation to a political party with the intention of obtaining future economic benefits but the donation may not satisfy the definition of an asset.

It should be noted that legal ownership of an item is not essential for its recognition as an asset; the right to future economic benefits is a requirement for asset recognition and providing the enterprise controls these benefits then a right to use an item is classified as an asset. An example of this occurs when companies capitalise finance-leased assets.

1.4.2 Liabilities

Liabilities are defined as “present obligations of an enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits” (paragraph 49). A liability, therefore, has three essential characteristics:

1. It embodies a present responsibility to one or more other entities that entails settlement by probable future transfer of economic benefits. These economic benefits could be transferred either through use of the enterprise's assets at a specified or determinable date, on occurrence of a specified event, or on demand. Settlement of a liability may occur by the payment of cash, the transfer of assets, the provision of services, the waiving of the creditor's rights, the replacement of that obligation with another obligation, or the conversion of the obligation to equity.
2. The responsibility obligates the enterprise, leaving it little or no discretion to avoid the future sacrifice of economic benefits.
3. The transaction or other event obligating the entity has already happened.

It should be noted that although a liability is recognised only when the enterprise is obliged to give up economic benefits, the obligation need not be a legally enforceable one. Liabilities arise primarily from deferring payment for goods or services received and from borrowing monies. Liabilities also result from collecting economic resources in advance of providing goods or service to customers and from selling goods subject to warranties.

Assets and liabilities could be considered mirror images of each other and are in many ways complimentary. Assets and liabilities, however, are normally reported gross and should only be netted off under special circumstances.

A distinction should be drawn between an obligation and a future commitment. A decision by the management of an enterprise to acquire assets in the future does not, of itself, give rise to a present obligation. An obligation normally arises only when the asset is delivered or the enterprise enters into an irrevocable agreement to acquire the asset.

Some liabilities can be measured only by using a substantial degree of estimation. For example, a provision for future warranty expenditure is a liability requiring estimation based on past warranty claims. Provided that the provision involves a present obligation (i.e. relates to sales already made) and satisfies the remainder of the definition of a liability, then it is a liability even if the amount has to be estimated.

1.4.3 Equity

Equity is defined as the “residual interest in the assets of an enterprise after deducting all of its liabilities” (paragraph 49). Equity is usually sub classified in the balance sheet. For example, companies often distinguish share capital, retained earnings, non-distributable reserves and capital maintenance reserves separately. These classifications are usually relevant to users of financial statements when they indicate legal or other restrictions on the ability of the enterprise to distribute or otherwise apply its equity.

The amount at which equity is shown in the balance sheet is dependent on the measurement of assets and liabilities and not the value of the enterprise as a whole on the going concern basis.

1.4.4 Income

Income is defined as “increases in economic benefits in the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants” (paragraph 70).

As a result of the articulation between the components of financial statements, changes in the net assets of an entity depicted in the statement of financial position (the balance sheet) are also reflected in its performance (the income statement). Income encompasses both revenue and gains. Revenue arises in the course of the ordinary activities of an enterprise and

is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent. Chapter 8, Revenue Recognition, deals further with the appropriate accounting treatment for revenue. Gains represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an enterprise. Gains include, for example, those arising on the disposal of non current assets.

The definition of income also includes unrealised gains. For example, the surplus arising on the revaluation of listed investments and increases in the carrying amount of long term assets constitute gains.

1.4.5 Expenses

Expenses are defined as “decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants” (paragraph 70).

The definition of expenses encompasses losses as well as those expenses that arise in the course of the ordinary activities of the enterprise, for example, cost of sales, wages and depreciation. Losses represent other items that meet the definition of expenses and may, or may not, arise in the course of the ordinary activities of the enterprise. Losses include, for example, those resulting from disasters such as fire and flood as well as those arising on the disposal of non current assets. The definition of expenses also includes unrealised losses, for example, those arising from the effects of increases in the rate of exchange for a foreign currency in respect of an enterprise’s borrowings.

1.5 Recognition Issues

Recognition is the process of incorporating a transaction or event into one of the elements of the financial statements. It involves depiction of the transaction or event in words and in monetary amount and the inclusion of that amount in the financial statement totals.

Generally, a transaction or event should be recognised in financial statements if:

- it meets the definition of an element of financial statements (considered in section 1.4); and
- it is **probable** that a future economic benefit associated with the transaction or event will flow to or from the enterprise; and
- it can be measured at a monetary amount with sufficient reliability.

AC 000 notes that when assessing whether a transaction or event meets the above criteria, and therefore qualifies for recognition in the financial statements, regard needs to be given to the materiality constraint discussed when examining the qualitative characteristics of financial statement information. It also notes that the inter-relationship between the elements means that an item that meets the definition and recognition criteria for a particular element, for example an asset, automatically requires the recognition of another element, for example income or a liability.

1.5.1 Probability of Future Economic Benefits

The environment in which an enterprise operates is inherently uncertain and for many past events there is either a lack of certainty that there has been a change in the enterprises assets or liabilities or uncertainty as to the monetary amount of the change. It is this lack of certainty that gives rise to recognition problems. Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence available when the financial statements are prepared. AC 000 gives the example of when it is probable that a receivable owned by an enterprise will be paid, it is then justifiable, in the absence of any evidence to the contrary, to recognise the receivable as an asset. For a large population of receivables, however, some degree of non-payment is normally considered probable; hence an expense representing the expected reduction in economic benefits is recognised.

The exercise of prudence means that the recognition of assets and gains should be more persuasive than that relating to liabilities and losses.

1.5.2 Reliability of Measurement

Before a transaction or event is recognised as an element in financial statements, it must possess a cost or value that can be measured with reliability. In many cases, the cost or value is estimated and the use of reasonable estimates is an essential part of the preparation of financial statements. As noted in section 1.3.3 above, the use of estimates does not undermine the reliability of financial statements. However, when a reasonable estimate cannot be made then a transaction or event is not recognised in the balance sheet or income statement. The existence of the transaction or event, however, should be disclosed in the notes, explanatory material or supplementary schedules of the financial statements.

The use of estimates implies an element of uncertainty about the underlying measurement of a transaction or event. Uncertainty is usually countered

by evidence; the more evidence there is about a transaction or event and the better the quality of that evidence, the less uncertainty there will be over its existence, nature and measurement.

1.6 Measurement Issues

Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the balance sheet and income statement.

There are a number of different measurement bases which are employed to different degrees and in varying combinations in financial statements. Traditionally, the historical cost basis has been used for the measurement of the various elements of financial statements. However other bases are sometimes encountered. These are current cost, realisable value and present value.

1.6.1 Historical Cost

Under the historical cost basis of accounting, assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalent expected to be paid to satisfy the liability in the normal course of business.

1.6.2 Current Cost

Under the current cost basis of accounting, assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

1.6.3 Realisable Value

Under the realisable (or settlement) value basis of accounting, assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values; that is, the undiscounted amount of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.

1.6.4 Present Value

Under the present value basis of accounting, assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liability in the normal course of business.

1.7 Concepts of Capital Maintenance

The selection of an appropriate concept of capital by an enterprise should be based on the needs of the users of its financial statements. Most enterprises adopt a financial concept of capital (see section 1.7.1) but where the main concern of users is with the operating capability of the enterprise then a physical concept of capital should be used (refer section 1.7.2). The concept chosen indicates the goal to be attained in determining profit even though there may be some measurement difficulties in making the concept operational.

1.7.1 Financial Capital

Under this concept of capital maintenance, a profit is earned only if the financial (or money) amount of the net asset at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to and contributions from, owners during the period.

For example, if an enterprise started trading on 1 January 1901 with capital of R1 000 in the bank and bought and sold widgets during the year and assuming no payment of dividends or injections of fresh capital, the company will not have earned a profit unless it has net assets (or equity) of more than R1 000 at the end of 1901. Assuming that the trading of widgets for one year results in the company having R1 500 in the bank at the end of the year, which is represented by share capital of R1 000 and profit of R500; i.e. the company has increased its financial capital by R500. Notice that this increase in financial capital is measured in terms of nominal monetary units, i.e. without taking into account inflation.

The above profit, measured on the financial capital maintenance basis, could be measured in units of constant purchasing power. In this case, general inflation for the year 1901 would have to be taken into account. Assuming inflation of 10%, this would require that the R1 000 injected at the beginning of the year in constant purchasing power terms is equivalent to R1 100

at the end of the year. In order to maintain financial capital using constant purchasing power units, therefore, profit of only R400 should be recognised; i.e. the capital at the end of the period of R1 500 is in essence R400 of profit and R1 100 of capital. The R1 100 of capital equates to the original injection of R1 000 at the beginning of the year.

1.7.2 Physical Capital

Under the physical capital maintenance concept, a profit is earned only if the physical productive capacity (or operating capability) of the enterprise at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from owners during the period.

The physical capital maintenance concept requires the adoption of the current cost basis of measurement in that a profit is only recognised when the physical capacity of the enterprise has increased. In our example above, if we assume that the R1 000 injected into the company at the start of 1901 was able to purchase two widgets then the company has only made a profit at the end of 1901 to the extent that the R1 500 of cash available at the year end can buy in excess of two widgets. Assuming, therefore, that the purchase price of a widget has risen from R500 at the start of 1901 to R700 at the end of 1901, the company has made a profit of only R100 under the physical capital maintenance concept. This is because R1 400 ($R700 \times 2$) would be required in order to purchase two widgets and to be in an identical position to that achieved at the start of the year, i.e. at the beginning of 1901, R1 000 purchased two widgets.

Under this concept of capital maintenance, therefore, capital is looked at from a physical point of view, that is, the ability to buy assets. This should be distinguished from the financial capital maintenance concept, where capital is looked at from a monetary point of view. It is argued that a major disadvantage of the historic cost concept is that it follows the financial capital maintenance concept (in nominal monetary units only) and as such overstates profit in a period of rising prices which could lead to an erosion of capital.

1.8 Conclusion

The framework seeks to provide a basis for financial reporting. To achieve this goal, the objective and qualitative characteristics of financial statements are established. Thereafter, the framework identifies the elements of financial statements and the related measurement issues. In this way, the basis

for determining which events should be reported, how they should be measured and the format in which they should be communicated to users is established.

The framework should not be viewed as the last word on the basis for financial reporting. Financial accounting and reporting is an evolving discipline that needs to be responsive to ever-increasing user demands. This evolution may require a future paradigm shift away from the traditional accounting model. Even within this traditional model, the present framework can be criticised for precluding the recognition of deferrals on the balance sheet and for side-stepping revaluation (of assets) issues within the historical cost framework. These limitations aside, the current framework provides a useful foundation for the continuing evolution of financial reporting practice.

2 Deferred Taxation

2.1 Introduction

2.1.1 The Need for Deferred Taxation

Enterprises may be subject to a number of taxes; for example, income tax and secondary tax on companies. This chapter is concerned primarily with accounting for income tax, and more specifically with the appropriate accounting treatment for differences that arise between the timing of income recognition for accounting purposes and the timing of income recognition for taxation purposes.

A simple example should illustrate the timing differences that arise between accounting and taxation income recognition. Harry Hotfoot (HH) purchased a hotdog stand for R2 000 on 1 January 1901. The stand is expected to last four years and the residual value is negligible. Depreciation is provided on the straight line basis. HH rents out the stand for R100 per month. The rate of taxation is 40% but the Receiver of Revenue considers that the hotdog stand has only a two year useful life and grants wear and tear (i.e. depreciation) on the straight line basis over two years.

If HH ceased his business operation after four years. If HH reported on his financial performance only after four years then net income before tax would be calculated as follows:

Rental Income (48 months $\times$ R100 per month)	4 800
Less: Depreciation (R2 000 $\times$ 25%) $\times$ 4 years	<u>(2 000)</u>
Net Income before taxation	<u>2 800</u>

The Receiver of Revenue would calculate taxable income as follows:

Gross Income (Rentals received 48 $\times$ 100)	4 800
Less: Wear and Tear (R2 000 $\times$ 50%) $\times$ 2 years	<u>(2 000)</u>
Taxable Income	<u>2 800</u>

Notice that although wear and tear allowances were only allowed in 1901 and 1902 (in years three (1903) and four (1904) wear and tear is nil as the asset is fully "depreciated" for tax purposes), the taxable income and net income before taxation are identical over the four year period, i.e. R2 800.

HH therefore pays tax of $R2\,800 \times 40\% = R1\,120$ for the four years of his business operations. If HH only produced an income statement after four years then the following extract to the four year income statement would apply:

Profit on ordinary activities before taxation	2 800
SA Normal Taxation – current	<u>(1 120)</u>
Profit on ordinary activities after taxation	<u>1 680</u>

Note that the tax charge is 40% of profit on ordinary activities before taxation and, as expected, profit on ordinary activities after taxation is 60% of profit on ordinary activities before taxation.

Over the four year business life, therefore, there was no timing difference between income recognition for accounting purposes and for taxation purposes. When one considers individual years, however, there are significant differences between accounting income and taxable income. Accounting income will be constant at R700 (R1 200 rent less R500 depreciation) for each year whereas taxable income and tax payable will vary as follows:

	1901 R	1902 R	1903 R	1904 R	TOTAL R
Gross Income					
(Rentals received)	1 200	1 200	1 200	1 200	4 800
Less: Wear & Tear	<u>(1 000)</u>	<u>(1 000)</u>	<u>–</u>	<u>–</u>	<u>(2 000)</u>
Taxable Income	200	200	1 200	1 200	2 800
Tax Payable (40%)	80	80	480	480	1 120

If the taxation payable for each year to HH's income statement is applied, the following result is obtained:

	1901 R	1902 R	1903 R	1904 R	TOTAL R
Profit on ordinary activities before taxation	700	700	700	700	2 800
SA Normal Taxation – Current	<u>(80)</u>	<u>(80)</u>	<u>(480)</u>	<u>(480)</u>	<u>(1 120)</u>
Profit on ordinary activities after taxation	620	620	220	220	1 680
Tax charge as a percentage of Profit on ordinary activities before taxation	11,4%	11,4%	68,6%	68,6%	40%

Thus the granting of accelerated capital allowances (wear and tear) by the Receiver of Revenue results in a widely fluctuating tax charge from year to year, but the tax rate over the full four year period is 40% – giving rise to tax payable of R1 120.

Reporting on an annual basis has introduced distortions to the tax charge as a result of timing differences between accounting income and taxable income. These distortions impair the value of the reported information to users

as the underlying reality is that 40% is the actual tax rate applicable to the accounting income of R700 recognised in each year, i.e. tax of R280 ($R700 \times 40\%$) is the actual amount of tax that will ultimately be paid in respect of the R700 of accounting income recognised in 1901 and 1902. The reality is that the payment of this tax has been deferred (from a cash flow perspective) to future periods – 1903 and 1904.

Accounting for deferred tax takes into consideration the distortions caused by timing differences and recognises a deferred tax charge (or credit) which is considered in more detail in the next section.

2.1.2 Example

The presence of timing differences between income recognition for accounting purposes and taxation purposes gives rise to distortions in after tax income. These “distortions” cancel each other out over time so as to produce a constant tax charge that is equivalent to the statutory tax rate. As stated in AC 101, financial statements are prepared on the basis of the matching (or accruals) concept which implies:

- costs be matched with the revenue to which they have given rise; and
- costs or revenues that relate to a specific period should be included in the accounts for that period, regardless of when payment or receipt takes place.

The matching concept implies, therefore, that HH’s tax expense of R1 120 should be matched to the period in which the related revenue of R2 800 is recognised. In addition, AC 000 requires that in the interests of relevance and understandability to users of financial information, the tax charge be matched to the recognition of the underlying income. This is achieved through a provision for future tax payments being raised and is illustrated (using the information relating to HH’s hotdog stand) as follows:

	1901 R	1902 R	1903 R	1904 R	TOTAL R
Profit on ordinary activities before taxation	700	700	700	700	2 800
Taxable Income	<u>200</u>	<u>200</u>	<u>1 200</u>	<u>1 200</u>	<u>2 800</u>
Timing Difference	<u>500</u>	<u>500</u>	<u>(500)</u>	<u>(500)</u>	<u>NIL</u>

The timing differences of R500 at 31 December 1901 and 1902 represent the amount of accounting income not yet taxed (i.e. R1 000) but which will be taxed in 1903 and 1904. The accruals concept requires that the taxation payable on these timing differences be deferred by making provision as follows:

	1901	1902
	R	R
Timing Difference	500	500
Provision for deferred taxation (40%)	200	200

and then released as follows:

	1903	1904
	R	R
Timing Difference	(500)	(500)
Release of deferred taxation (40%)	(200)	(200)

The provision for deferred taxation is credited to a balance sheet account ("deferred taxation") which in this case gives rise to a liability (i.e. credit balance) on the balance sheet. (Accounting for deferred taxation could also give rise to an asset (i.e. debit balance) on the balance sheet. This is considered in further detail below.)

The journal entries to record the deferred taxation implications for HH would be as follows:

	DR	CR
31-12-01 Deferred Taxation (I/S expense)	200	
Deferred Taxation (B/S provision)		200
Being recognition of provision for deferred taxation on timing differences arising in the current year.		
31-12-02 Deferred Taxation (I/S expense)	200	
Deferred Taxation (B/S provision)		200
Being recognition of provision for deferred taxation on timing differences arising in the current year.		

Note that at 31 December 1902, the deferred taxation liability on the balance sheet is now R400, representing the tax effect (40%) of **cumulative** timing differences of R1 000 (R500 + R500).

	DR	CR
31-12-03 Deferred Taxation (B/S provision)	200	
Deferred Taxation (I/S credit)		200
Being recognition of a reduction in the tax charge for the year as a result of provisions made previously.		
31-12-04 Deferred Taxation (B/S provision)	200	
Deferred Taxation (I/S credit)		200
Being recognition of a reduction in the tax charge for the year as a result of provisions made previously.		

The above entries may be summarised as follows:

INCOME STATEMENT	1901 R	1902 R	1903 R	1904 R	TOTAL R
Profit on ordinary activities before taxation	700	700	700	700	2 800
SA Normal taxation					
– Current	80	80	480	480	1 120
– Deferred	<u>200</u>	<u>200</u>	<u>(200)</u>	<u>(200)</u>	<u>NIL</u>
	280	280	280	280	1 120
 BALANCE SHEET (31 December)					
Deferred Taxation	200	400	200	NIL	

The provision of deferred taxation has removed the distortions that arise in the annual current tax charge from timing differences and a constant tax rate of 40% ($R700 \times 40\% = R280$) is evident in HH's income statement for each year in the four year period.

At this stage, it is important to note two things:

- (i) the deferred taxation in the income statement may be calculated by applying the tax rate to the timing differences that arise in a particular year:

	TIMING DIFFERENCE	DEFERRED TAXATION (I/S)
1901	500	200 Dr
1902	500	200 Dr
1903	(500)	200 Cr
1904	(500)	200 Cr

Deferred taxation on the balance sheet may be calculated either

- (a) by applying the tax rate to the **cumulative** timing differences at any point in time, i.e. at 31 December 1903, cumulative timing differences are R500 (R500 + R500 – R500) which gives rise to a deferred tax balance (credit) of R200 on the balance sheet.

or

- (b) by using the differences between the book values and tax values of assets.

The book values and tax values of HH's asset may be summarised as follows:

	BOOK VALUE R	TAX VALUE R	DIFFER- ENCE R	DEFERRED TAX R
01–01–1901 Purchase	2 000	2 000	–	–
1901 Deprec/Wear & Tear	<u>(500)</u>	<u>(1 000)</u>	<u>500</u>	200 (I/S)
31–12–1901 Balance	1 500	1 000	500	200 (B/S)
1902 Deprec/Wear & Tear	<u>(500)</u>	<u>(1 000)</u>	<u>500</u>	<u>200</u> (I/S)
31–12–1902 Balance	1 000	NIL	1 000	400 (B/S)
1903 Depreciation	<u>(500)</u>	<u>–</u>	<u>(500)</u>	<u>(200)</u> (I/S)
31–12–1903 Balance	500	NIL	500	200 (B/S)
1904 Depreciation	<u>(500)</u>	<u>–</u>	<u>(500)</u>	<u>(200)</u> (I/S)
31–12–1904 Balance	<u>NIL</u>	<u>NIL</u>	<u>NIL</u>	<u>NIL</u>

Deferred taxation balances may therefore be derived either by an analysis of timing differences arising in the current year (in conjunction with cumulative timing differences or opening balances) or by using a comparison of tax values and book values of assets (or liabilities) that give rise to timing differences.

- (ii) Accounting for deferred tax may also give rise to deferred taxation **assets** (debits) on the balance sheet; i.e. if the facts relating to wear and tear allowances in HH's example were reversed, the following pattern might emerge:

	TAXABLE INCOME	NET INCOME BEFORE TAX	DIFFERENCE	DEFERRED TAX (I/S)
1901	1 200	700	(500)	(200) Cr
1902	1 200	700	(500)	(200) Cr
1903	200	700	500	200 Dr
1904	<u>1 200</u>	<u>1 700</u>	<u>500</u>	<u>200</u> Dr
	<u>2 800</u>	<u>2 800</u>	<u>NIL</u>	<u>NIL</u>

The tax effect of the cumulative timing differences is R400 at 31 December 1902, giving rise to a debit deferred tax balance (i.e. asset) on the balance sheet. This debit is then released during 1903 and 1904 by debiting the income statement and crediting the balance sheet with R200 each year. A debit (asset) balance is acceptable provided that the asset recognition criteria of AC 000 and AC 102 are met. Refer to sections 2.2.2 & 2.3.2 for further discussion.

2.2 Conceptual Issues

2.2.1 Definitions

AC 102, *Taxation in Financial Statements*, deals with the appropriate accounting treatment for deferred taxation.

As we have seen above, the objective in accounting for deferred taxation is to determine the appropriate amount of tax to be recognised in the financial statements of an enterprise for the period.

AC 102 contains a number of definitions. Three of these definitions are considered below.

Taxable income is defined as “the amount of income for a period, determined in accordance with tax legislation, upon which income tax payable for the period is computed” (AC 102 paragraph 5). Taxable income may therefore be different to accounting or reported income because of the presence of either timing differences or permanent differences.

Timing differences are the differences between taxable income and accounting or reported income that arise because certain items of income and expense are included in taxable income in periods different from those in which they are reported in accounting income (AC 102 paragraph 7). The example used in section 2.1.2 above incorporated the effects of a timing difference that arose as a result of the Receiver of Revenue granting different capital allowances to those recognised for accounting purposes. Common sources of timing differences are as follows:

- interest receivable accrued in the accounting period, but taxed when received;
- interest or royalties payable accrued in the accounting period, but allowed for tax purposes only when paid;
- pension costs accrued in the financial statements but allowed for taxation purposes when paid or contributed at some later date;

- provisions for repairs and maintenance made in the financial statements but not allowed for tax purposes until the expenditure is incurred;
- bad debt provisions not allowed for tax purposes;
- revenue expenditure deferred in the financial statements, such as development or advertising expenditure if it is allowed for tax purposes as it is incurred; and
- accelerated capital allowances granted for taxation purposes.

When an item first appears in either the income statement or the taxation computation, but not the other, the timing difference is said to originate. The timing difference is said to reverse when it filters through and appears in a tax computation when it first appeared in the income statement or in the income statement when it first appeared in the tax computation, i.e. when the accounting treatment and the tax treatment, taking all periods together, have become the same.

Permanent differences are the differences between taxable income and accounting income for the period that originate in the current period and will not reverse in subsequent periods (AC 102 paragraph 9). Permanent differences are an inevitable consequence of the differences between tax and accounting rules and deferred tax is not concerned with permanent differences. Permanent differences may arise when:

- revenue or gains are exempt from tax;
- expenses or losses are not allowed as deductions in determining taxable income;
- certain incentive allowances are allowed as a deduction for tax purposes but are not taken into account when arriving at reported income.

The tax effects of permanent differences are recognised in the income statement of the period in which they arise, i.e. in the example used earlier, if Harry Hotfoot (HH) received dividend income in each year of operation of R200 per annum then in terms of current legislation this dividend income would not have been taxable. Therefore, profit on ordinary activities before tax would have increased by R200 per annum to R900 per annum, giving total income over the four year period of R3 600. The taxable income, however, would be unchanged at R2 800 and the tax charge over four years would remain at R1 120 ($R2\ 800 \times 40\%$). The effective tax rate therefore for HH over four years is only 31,1% ($R1\ 120 \div R3\ 600$). The presence of permanent differences has reduced the effective tax rate for HH from 40% of his accounting income to 31,1%.

2.2.2 Comprehensive Basis

The comprehensive basis was illustrated in the example used in section 2.1.2. Under the comprehensive basis of providing for deferred tax, the tax effects of all timing differences are recognised in the financial statement in the period in which they arise. The approach is supported on the premise that the incidence of taxation on all transactions should be recorded in the period in which the transactions are recognised for accounting purposes. Therefore, timing differences may result in either a postponement of taxation on current accounting income or a prepayment of taxation on future accounting income.

Where timing differences have the effect of postponing the payment of current taxation, an accrual for deferred taxation is made which results in both the matching of expense with revenue and the recognition of the liability for taxes payable in the future. This liability, known as a deferred tax liability, meets the AC 000 criteria for the recognition of a liability. There is a present obligation which arose as a result of a past event (earning income) and there will be a future flow of economic benefits out of the business enterprise (when the liability for tax is settled). The recognition criteria are also met in that the future flows can be measured reliably and are probable.

Timing differences which result in the prepayment of tax are also recognised in order to avoid understating profit on ordinary activities after taxation in the period in which the timing differences originate, and overstating profit on ordinary activities after taxation in the period in which these differences reverse. This prepayment of tax may give rise to a deferred tax asset being recognised in the financial statements. The recognition of an asset in terms of the conceptual framework (AC 000) should involve a resource controlled by the enterprise as a result of the past event which will give rise to a future inflow of economic benefits. The inflow of economic benefits occurs when income accrues in future time periods and as long as the recognition criteria (i.e. probability of future economic benefits and reliable measurement) are met then a deferred tax asset should be recognised in the financial statements.

One of the problems of the comprehensive basis is that liabilities may be recorded that will almost certainly never actually arise or assets may be recorded that will never actually be realised. This may happen because new timing differences arise which will constantly replace some or all of the timing differences that are reversing. In such cases part or all of the net effect of the timing differences may be permanently deferred. Therefore, although individual timing differences must reverse and give rise to an actual liability

(or asset), the net effect of collective timing differences is that the total liability for deferred tax may be permanently deferred. It is argued against the comprehensive basis that there is little point in placing assets or liabilities in a balance sheet if they will never give rise to a receipt or payment.

The partial basis attempts to avoid the problems of an ever increasing liability or asset that may arise in using the comprehensive basis by focusing on what is defined as "recurring timing differences". This definition describes timing differences which, when they reverse, are replaced by similar originating timing differences on an ongoing basis (AC 102 paragraph 8).

The following example illustrates a situation where the comprehensive basis gives rise to liabilities that will almost certainly never actually be settled.

Using the example in section 2.1.2, one further assumption is made: HH decides to expand his business each year and purchases a new hotdog stand on January 1 of each year. The price of hotdog stands increases by R400 each year. Taxation and depreciation allowances are unchanged, i.e. 50% wear and tear per annum and 25% depreciation per annum.

Depreciation and wear and tear allowances may be calculated as follows for the period 1901 to 1904:

DEPRECIATION	1901 R	1902 R	1903 R	1904 R
Stand 1 (Cost R2 000)	500	500	500	500
Stand 2 (Cost R2 400)	—	600	600	600
Stand 3 (Cost R2 800)	—	—	700	700
Stand 4 (Cost R3 200)	—	—	—	800
	<u>500</u>	<u>1 100</u>	<u>1 800</u>	<u>2 600</u>
WEAR & TEAR	1901 R	1902 R	1903 R	1904 R
Stand 1 (Cost R2 000)	1 000	1 000	—	—
Stand 2 (Cost R2 400)	—	1 200	1 200	—
Stand 3 (Cost R2 800)	—	—	1 400	1 400
Stand 4 (Cost R3 200)	—	—	—	1 600
	<u>1 000</u>	<u>2 200</u>	<u>2 600</u>	<u>3 000</u>
Net difference between depreciation and wear & tear allowances (i.e. timing differences)	500	1 100	800	400
Cumulative Timing Differences	500	1 600	2 400	2 800

Based on these timing differences, deferred taxation on the comprehensive basis would be as follows:

DEPRECIATION	1901 R	1902 R	1903 R	1904 R
INCOME STATEMENT	1901 R	1902 R	1903 R	1904 R
Deferred Tax charge (timing differences × tax rate of 40%)	200	440	320	160
BALANCE SHEET (31 December)				
Deferred Tax liability	200	640	960	1 120

It can be shown that if HH continues to **maintain** his present operation (which consists of four hot dog stands) by purchasing one hotdog stand on January 1 of each year (note that the stands have a useful life of only four years) and the price of the stands continues to increase by R400 then the deferred tax liability of R1 120 will never actually become payable as new originating timing differences will always be larger than the reversals of previous timing differences. This is illustrated by extending the above example:

DEPRECIATION	1905 R	1906 R	1907 R	1908 R
Stand 2	600	—	—	—
Stand 3	700	700	—	—
Stand 4	800	800	800	—
Stand 5 (Cost R3 600)	900	900	900	900
Stand 6 (Cost R4 000)	—	1 000	1 000	1 000
Stand 7 (Cost R4 400)	—	—	1 100	1 100
Stand 8 (Cost R4 800)	—	—	—	1 200
	<u>3 000</u>	<u>3 400</u>	<u>3 800</u>	<u>4 200</u>
WEAR & TEAR	1905 R	1906 R	1907 R	1908 R
Stand 4	1 600	—	—	—
Stand 5 (Cost R3 600)	1 800	1 800	—	—
Stand 6 (Cost R4 000)	—	2 000	2 000	—
Stand 7 (Cost R4 400)	—	—	2 200	2 200
Stand 8 (Cost R4 800)	—	—	—	2 400
	<u>3 400</u>	<u>3 800</u>	<u>4 200</u>	<u>4 600</u>
Timing Differences	400	400	400	400
Cumulative Timing Diffs (1904 = 2 800)	3 200	3 600	4 000	4 400
Deferred Tax liability (x 40%)	1 280	1 440	1 600	1 760

Hence, the deferred tax balance continues to increase as long as HH maintains his current level of operations. Only if HH decided to curtail operations

or adjust the timing of asset replacement would the deferred tax balance decrease. The partial basis of accounting for deferred tax ensures that only that portion of the deferred tax liability (under the comprehensive basis) that gives rise to payment within the next three years is provided for. The partial basis is considered below.

2.2.3 Partial Basis

Under the partial basis deferred taxation is accounted for in respect of the net amount by which it is probable that any payment of tax will be temporarily deferred or accelerated by timing differences which will reverse in the foreseeable future without being replaced.

The partial basis may only be used when all of the following criteria are met (AC 102 paragraph 28):

- the enterprise is a going concern; and
- management is able to make a reasonable estimate of the taxation that will become payable in respect of reversing timing differences which will not be replaced by recurring timing differences, for some considerable period (at least three years ahead); and
- it is not probable that after this period the situation is likely to change so as to crystallise further tax liabilities.

The partial basis recognises that, if an enterprise is not expected to reduce the scale of its operations significantly, it will often have what amounts to a hard core of recurring timing differences that result in the permanent deferral of the payment of tax thereon. This was illustrated in section 2.2.2 in the example of Harry Hotfoot where the deferred tax liability increased from year to year, i.e. none of the deferred tax liability actually crystallised into a payment.

The partial basis would require that deferred tax only be provided when it is probable that tax will become payable as a result of a future reversal of existing timing differences. A future reversal arises where future reversing timing differences are forecast to exceed future originating timing differences. This situation can be illustrated if we assume that on 1 January 1905 HH decided that he only wanted three hotdog stands in his operation so did not purchase a new stand on 1 January 1905. On 1 January 1906 he would once again purchase a new stand in order to ensure that he always had three stands in operation. The following depreciation and wear and tear allowances can be derived from this information:

DEPRECIATION	1905 R	1906 R	1907 R	1908 R
Stand 2	600	—	—	—
Stand 3	700	700	—	—
Stand 4	800	800	800	—
Stand 5 (not purchased)	—	—	—	—
Stand 6	—	1 000	1 000	1 000
Stand 7	—	—	1 100	1 100
Stand 8	—	—	—	1 200
	<u>2 100</u>	<u>2 500</u>	<u>2 900</u>	<u>3 300</u>
WEAR & TEAR	1905 R	1906 R	1907 R	1908 R
Stand 4	1 600	—	—	—
Stand 5 (not purchased)	—	—	—	—
Stand 6	—	2 000	2 000	—
Stand 7	—	—	2 200	2 200
Stand 8	—	—	—	2 400
	<u>1 600</u>	<u>2 000</u>	<u>4 200</u>	<u>4 600</u>
Timing Differences	(500)	(500)	1 300	1 300
Cumulative Timing Diffs (1904 = 2 800)	2 300	1 800	3 100	4 400

Deferred Tax liability (Cumulative timing differences × 40%):

	1901 R	1902 R	1903 R	1904 R	1905 R	1906 R	1907 R	1908 R
Situation (i)								
Deferred Tax Liability	200	640	960	1 120	1 280	1 440	1 600	1 760
Situation (ii)								
Deferred Tax Liability	200	640	960	1 120	920	720	1 600	1 760

Situation (i) = A new hot dog stand purchased every year.

Situation (ii) = A new hot dog stand purchased every year **except** for 1905.

Notice that in situation (i) there are net originating timing differences arising in each and every year (i.e. the deferred tax liability is constantly increasing). Under the partial basis, therefore, no provision would be made in any year from 1901 to 1905 because there are no net reversing timing differences expected in the three year "window" period applicable to each year; the comprehensive balance is not forecast to decrease.

Situation (ii), however, results in a decrease in the balance of deferred tax under the comprehensive basis in 1905 and 1906. This arises because of the net reversal of R500 of timing differences in both 1905 and 1906. The implication is that a portion of the comprehensive basis deferred tax liability

“crystallises”, i.e. becomes payable in 1905 and 1906. Under the partial basis, provision should be made for this as soon as it is anticipated; in practice the anticipated period is limited to three years. The following table illustrates the relevant calculation for the years 1901 to 1905:

ANTICIPATED TIMING DIFFERENCES (3 year horizon)							
() = Reversing differencesc							
YEAR	1902 R	1903 R	1904 R	1905 R	1906 R	1907 R	1908 R
1901	1 100	800	400				
1902		800	400	(500)			
1903			400	(500)	(500)		
1904				(500)	(500)	1 300	
1905					(500)	1 300	1 300

Applying a three year window in 1901, the deferred tax balance on the comprehensive basis is expected to increase in each of the next three years (the originating timing differences increase the balance, as evidenced by the deferred tax balances shown earlier under situation (ii)).

In 1902, the three year window indicates that the anticipated originating timing differences in the next two years (i.e. 1903 and 1904) will increase the comprehensive basis deferred tax balance in those years by $(800 + 400) \times 40\% = 480$. This is evidenced in the deferred tax balances under situation (ii); the balance increased from R640 to R1 120 between 1902 and 1904. In the third year of the three year window, a reversing timing difference of R500 results in a decrease of $R500 \times 40\% (= R200)$ in the deferred tax balance on the comprehensive basis. Therefore, the *net* movement anticipated in the comprehensive basis deferred tax balance is an *increase* of $R480 - R200 = R280$ over the three years. No provision is therefore necessary under the partial basis.

In 1903, the comprehensive basis deferred tax balance is expected to increase by R160 in 1904 (originating timing differences of $R400 \times 40\%$), decrease by R200 in 1905 (reversing timing differences of $R500 \times 40\%$), and decrease by R200 in 1906 (reversing timing differences of $R500 \times 40\%$). The **net decrease** anticipated is $R200 + R200 - R160 = R240$. Therefore, the amount of the comprehensive basis deferred taxation liability expected to crystallise over the next three years is R240 which is the provision required under the partial basis.

In 1904, the comprehensive basis deferred tax balance is expected to decrease by R400 in 1905 and 1906 ($R500 \times 40\%$ in each year) and then increase by R520 in 1907 ($R1 300 \times 40\%$). Although the *net* movement anticipated is an

increase of R120 (R520 – R400), it is important to note that an amount of R400 will actually crystallise (i.e. become payable) before the anticipated increase. Therefore, under the partial basis, it is appropriate to provide for the amount that will become payable of R400. The total provision required is therefore R400, of which R240 was provided in 1903; i.e. charge to the income statement is R160 in 1904.

In 1905, the comprehensive basis deferred tax balance is expected to decrease by R200 ($R500 \times 40\%$) and thereafter increase by R1 040 ($R1\ 300 \times 40\%$ for each of years 1907 and 1908), giving a net increase of R840 ($R1\ 040 - R200$). However, because the decrease will occur before the increase, a liability of R200 will crystallise and the partial basis requires a provision of R200. R400 was provided in 1904, therefore R200 of that provision may be released in 1905.

The effects of the partial basis may be summarised as follows:

	PROVISION REQUIRED (B/S) R	INCOME STATEMENT MOVEMENT R
1901	NIL	NIL
1902	NIL	NIL
1903	240	240 Dr
1904	400	160 Dr
1905	200	200 Cr

The relevant journal entries would be as follows:

1901 & 1902	No deferred tax entries; disclosure in notes about the full potential liability if comprehensive basis was used		
1903	Deferred Taxation Expense (I/S)	240	
	Deferred Taxation (B/S)		240
1904	Deferred Taxation Expense (I/S)	160	
	Deferred Taxation (B/S)		160
1905	Deferred Taxation (B/S)	200	
	Deferred Taxation Credit (I/S)		200

The following schedule summarises the accounting implications of the comprehensive basis and the partial basis for the two situations considered.

Situation (i) A new hotdog stand purchased every year

(A) Comprehensive Basis

INCOME STATEMENT	1901	1902	1903	1904	1905
	R	R	R	R	R
SA Normal Taxation – deferred	200	440	320	160	160
BALANCE SHEET					
Deferred Tax liability	200	640	960	1 120	1 280

(B) Partial Basis

No entries in either income statement or balance sheet (as evidenced by ever increasing comprehensive basis deferred tax balance). Some disclosures necessary – see section 2.4.

Situation (ii) A new hotdog stand purchased every year except 1905**(A) Comprehensive Basis**

INCOME STATEMENT	1901	1902	1903	1904	1905
	R	R	R	R	R
SA Normal Taxation – deferred	200	440	320	160	(200)
BALANCE SHEET					
Deferred Tax liability	200	640	960	1 120	920

(B) Partial Basis

INCOME STATEMENT	1901	1902	1903	1904	1905
	R	R	R	R	R
SA Normal Taxation – deferred	—	—	240	160	(200)
BALANCE SHEET					
Deferred Tax liability	—	—	240	400	200

Note that even if an enterprise adopts the partial basis, the balance that would have been provided on the comprehensive basis is the total potential deferred tax liability for that enterprise. This contingent liability, equal to the difference between the potential balance and what has actually been provided, should be disclosed in the notes to the financial statements of enterprises using the partial method. Refer to section 2.4.3.

2.3 Specific Issues

2.3.1 Changes in Tax Rate

The deferred tax liability (or asset) should be calculated using the best estimate of future rates of taxation. In practice, the current tax rate is normally

used as the best estimate, unless other information indicates that another rate may be more appropriate, for example where a change in the standard tax rate has been announced. This means that where there is a change in the rate of taxation then the whole balance is recalculated.

In the example of Harry Hotfoot, if the rate of taxation had changed from 40% to 45% in 1902 then HH, using the comprehensive basis, would restate the deferred tax balance at the start of 1902 to reflect a liability of $45\% \times$ cumulative timing differences of 500, i.e. 225 instead of the carried forward balance of 200. This adjustment to HH's liability is "merely a change in estimate and so forms part of the tax charge in the income statement" (AC 102 paragraph 39). This is in line with the definition of extraordinary items in the new AC 103 (revised and issued March 1995). Paragraph 39 of AC 102 (July 1989) reads as follows: "However, where the change in the standard tax rate is associated with a fundamental change in the basis of taxation, the adjustment is treated as an extraordinary item." It would be difficult to argue that such a change is "clearly distinct from the ordinary activities of the enterprise and therefore are not expected to recur frequently or regularly" (AC 103.05). It is also not clear what the precise meaning is of "a fundamental change in the basis of taxation". Therefore no change in tax rate should be treated as extraordinary.

Disclosure of the effect of the change in tax rate would then have to be given in terms of AC 102 paragraph 63. This is considered in more detail in section 4, Financial Statement Presentation.

It should be obvious that there can be a considerable distortion in the tax charge in the year in which there is a change in the applicable rate of tax. This occurred recently when the rate of tax was reduced to 35% as a result of the increase in the rate of secondary tax on companies. The distortion arising from a change in tax rate, however, is a necessary consequence of ensuring that the amount appearing in the balance sheet is a reasonable estimate of the amount of tax that would eventually be paid or received. Note that the secondary tax on companies is considered in more detail in chapter 20.

The effect of changes in the tax rate apply equally whether accounting for deferred tax on the comprehensive basis or on the partial basis, i.e. an adjustment is made to the opening deferred tax balance to ensure that deferred tax has been provided on timing differences at the revised standard rate of taxation.

2.3.2 Debit Balances

In our example relating to HH we have examined only one category of timing difference in isolation. In practice, an enterprise would normally have more than one category of timing difference. Some categories of timing differences would give rise to liabilities while others may give rise to assets. These timing differences can normally be offset to arrive at a net balance. For example, there may be accelerated capital allowances (giving rise to a liability) and short term timing differences such as a doubtful debt provision which give rise to an asset. The short term timing differences should be deducted from the accelerated capital allowances and the net figure provided for in the income statement.

In practice, most companies would have a liability for deferred taxation as a result of generous taxation allowances. However, many items may give rise to debit balances on deferred tax. For example, interest receivable that is accrued before receipt, depreciation in excess of capital allowances, and the write off of costs prior to their recognition by the Receiver of Revenue.

There may be situations where a net debit balance arises as a result of the debit balances exceeding credit balances for deferred tax. AC 102 (paragraph 60) recognises that the asset should be recognised only if there is assurance beyond reasonable doubt that future taxable income will be sufficient to allow the tax effect of the timing differences to be realised. This assurance is similar to the asset recognition criteria of AC 000.

2.3.3 Assessed (or Tax) Losses

An assessed loss (or tax loss) for taxation purposes does not give rise to a receipt of tax from the Receiver of Revenue! Instead, the Receiver allows the tax loss to be carried forward to future periods and set-off future taxable income.

Where an assessed loss is being carried forward, it can be regarded as an asset in the sense that future economic benefits (in the form of less tax) will flow to the enterprise when the tax loss is utilised. The realisation of the potential tax saving related to a tax loss is dependent upon the earning of taxable income in future periods and AC 102 (paragraph 42) states that "it is normal that a prudent approach is taken before recognising such losses as deferred tax assets in the balance sheet". In AC 000 jargon, the asset should only be recognised when the future economic benefits are **probable**.

It is important to note that the tax saving related to a tax loss only arises where future taxable income is sufficient to allow the tax benefit of the loss

to be realised. Therefore, AC 102 only allows the tax effects of a tax loss to be recognised where there is "assurance beyond reasonable doubt that future taxable income will be sufficient to allow the tax benefit of the loss to be realised" (AC 102 paragraph 43). This "assurance beyond reasonable doubt" implies that the future economic benefits associated with the tax loss are probable.

The existence of a tax loss, therefore, gives rise to an asset where its future utilisation is probable. A tax loss of R1m at the end of 1904 would give rise to a tax saving of R350 000 (35% tax rate) in 1905, provided that sufficient taxable income (i.e. at least R1m) was earned during 1905. If the earning of future taxable income was assessed as probable then the enterprise can recognise an asset of R350 000 at 31 December 1904.

Where there is an existing deferred tax liability then the tax effect of that tax loss (R350 000) can be set off against the deferred tax liability. When profits are earned in future the loss is used to reduce the tax that will be paid on those profits. The utilisation of the loss effectively offsets the reversal of the timing differences relating to the deferred tax liability that existed prior to any set-off of the tax effects of a tax loss.

AC 102 (paragraph 44) states that "irrespective of the basis of deferred taxation adopted by the enterprise, the potential tax saving relating to a tax loss is recognised only to the extent that the tax loss exceeds the existing net reversing timing differences". A simple rule of thumb that ensures compliance with this paragraph under both the comprehensive and the partial basis is to calculate:

$(\text{Tax loss} - \text{existing cumulative timing differences}) \times \text{tax rate}$

Where this calculation gives rise to a negative figure then that figure is the deferred tax liability. Where the calculation gives rise to a positive figure then the asset recognition criteria need to be assessed, i.e. if there is assurance beyond reasonable doubt that future taxable income will be sufficient to allow the tax benefit of the loss to be realised then a deferred tax asset for that amount is recognised otherwise neither an asset nor a liability is recognised.

In summary, the potential asset relating to tax losses is recognised to the extent of existing deferred tax credit balances and any excess is only recognised where there is assurance beyond reasonable doubt that future taxable income will be sufficient to allow the tax benefit of the loss to be realised. Where the asset relating to a tax loss is not recognised then a reconciling item will arise in the tax rate reconciliation. This is illustrated in the following example.

Example

Media Publications (MP) made a net loss before tax of R100 000 during the year ended 31 December 1904. The tax loss for the same period was assessed at R120 000 and the deferred tax balance at 1 January 1904 was R25 000 (credit). Assume that there were no permanent differences during 1904 and a tax rate of 40%.

The first step is to calculate deferred tax in the normal way. The timing differences that arise during the year amount to R20 000 (R120 000 – R100 000) and the deferred tax entry is:

Dr Deferred Tax Expense (I/S)	8 000	
Cr Deferred Taxation (B/S)		8 000

The deferred taxation liability on the balance sheet is now stated at R33 000 – the opening balance of R25 000 and current year timing differences of R8 000. The potential asset relating to the tax loss is R48 000 ($120\,000 \times 40\%$) and this may be set off against the deferred tax liability of R33 000. After applying the set-off, there will still be R15 000 of the tax loss unprovided. This balance will be raised as an asset only if there is “assurance beyond reasonable doubt that future taxable income will be sufficient to allow the tax benefit of the loss to be realised”. The example is completed based on two different assumptions:

(i) Asset created for the tax loss

Assuming that the tax benefit of the loss is expected to be realised, then an asset is raised in respect of the tax loss by the following entry:

Dr Deferred Taxation (B/S)	48 000	
Cr Deferred Taxation Credit (I/S)		48 000

This results in a deferred tax asset of R15 000 ($48\,000 - 8\,000 - 25\,000$) on the balance sheet and an income statement credit for deferred tax of R40 000 ($R48\,000 - R8\,000$). The effective tax rate (or “tax shield”) on the income statement is, therefore, 40%; i.e. net loss before taxation of R100 000 and a tax credit of R40 000. In 1905, if accounting and taxable income was R100 000, there would be no current tax payable as the taxable income of R100 000 would be reduced by the tax loss carried forward of R120 000. However, the effect of the utilisation of R100 000 of the tax loss will result in R40 000 of the R48 000 original tax asset from the tax loss being realised; i.e. only R8 000 remains. The deferred tax balance will be the original liability arising from cumulative timing differences of R33 000 less the asset of

R8 000 from the tax loss carried forward, i.e. R25 000. The opening balance was R15 000 (asset) and the utilisation of the assessed loss gives rise to the following entry:

Dr Deferred Tax Expense (I/S)	40 000	
Cr Deferred Tax (B/S)		40 000

The resultant balance on the balance sheet is, as expected, R25 000 credit and the income statement reflects a tax charge of 40% – accounting income of R100 000 and deferred tax charge of R40 000.

(ii) No asset created for the tax loss

Assuming that the recovery of the tax loss was not assured beyond reasonable doubt then the tax benefit of the tax loss is only recognised to the extent of the existing deferred tax liability. In the above example, only R33 000 of the tax effect of R48 000 could be recognised – this would leave R15 000 unprovided for.

The following entry would apply:

Dr Deferred Tax (B/S)	33 000	
Cr Deferred Tax Credit (I/S)		33 000

There would be no balance for deferred taxation on the balance sheet and the effective tax shield is now only 25% in 1904 (net loss before taxation of R100 000 and a tax credit R25 000 (R33 000 – R8 000)). It is necessary, therefore, to note the 15% reconciling item in the tax note as a result of not recognising the full tax benefit of a tax loss. In addition, it is necessary to disclose a tax loss of R120 000 before reducing the deferred tax balance and R37 500 (15 000/40%) after having reduced the deferred tax balance (see the final disclosure bullet under section 2.4.3 and paragraph 48(a) of Schedule 4).

In the following year, R100 000 of the assessed loss is utilised, leaving R20 000 available for future years. This amounts to an asset of R8 000 which can be set off against the existing liability from cumulative timing differences of R33 000, i.e. a net deferred tax liability of R25 000 arises.

Therefore, the entry in 1905 is:

Dr Deferred Tax Expense (I/S)	25 000	
Cr Deferred Tax (B/S)		25 000

The income statement reflects accounting income of R100 000 and a tax charge of R25 000 – an effective tax rate of 25%. Once again, the tax note should

indicate a reconciling item of 15% arising from the utilisation of a tax loss which had not been provided for in the previous year. As the tax loss carried forward (R20 000) at the end of 1905 is fully provided for (the deferred tax liability has been reduced by R8 000), proper matching should be achieved during 1906 and future years.

2.3.4 Consolidated Financial Statements

When preparing consolidated financial statements, a deferred tax asset recognised in the financial statements of one taxable entity in the group should not be set off against a deferred tax liability of another tax entity in the group (AC 102 paragraph 61).

2.3.5 Asset Revaluations

The revaluation of an asset does not in itself give rise to a tax liability. The revaluation is, in effect, a permanent difference and there are no deferred tax implications. However, a recoupment of tax allowances may arise if a sale occurs in the case of a revalued asset. (A recoupment of tax allowances is similar in nature to the profit recognised on sale of an asset, i.e. the difference between the proceeds, usually limited to the original cost of the asset, and the tax value of an asset is the profit or recoupment recognised as taxable for taxation purposes.) The possible recoupment of tax allowances is a contingent liability in the case of a revalued asset and is treated in accordance with the accounting statement dealing with contingencies (see chapter 18). If it is probable that the revalued asset will be sold and a tax recoupment will arise then the tax payable on the recoupment of previous allowances is recognised in the computation of the deferred tax liability.

2.4 Financial Statement Presentation

2.4.1 Accounting Policy

An example of an accounting policy for the comprehensive basis of taxation is:

Deferred taxation is provided at the standard tax rate in respect of all material timing differences between the accounting results and taxable income.

An example of an accounting policy for the partial basis is:

Deferred taxation is provided at the standard rate of taxation in respect of all material timing differences to the extent that such timing differences will result in a liability that crystallises in the foreseeable future.

2.4.2 Companies Act

Schedule 4 to the Companies Act defines current taxation, deferred taxation, effective tax rate, standard tax rate and timing differences in paragraph 4. The disclosure requirements of Schedule 4 in relation to taxation are as follows:

- Paragraph 16 (b) the liability for income tax payable;
- Paragraph 16 (c) the liability for deferred taxation analysed by major category of timing difference;
- Paragraph 41 (d) the amount provided or paid for taxation (specifying, where material the origin and different classes of taxes) in respect of the financial year concerned and the amount, if any, so provided or paid in respect of any other financial year;
- Paragraph 42 (e) the amount provided for current and deferred taxation, significant adjustments to prior period provisions and adjustments to deferred taxation arising from changes in the standard tax rate;
- Paragraph 45 if no provision for taxation has been made, that fact and the reason therefore shall be stated;
- Paragraph 46 the nature and amount of taxation relating to extraordinary items;
- Paragraph 48 there shall be stated –
 - (a) the estimated tax effect of tax losses available for set off against future taxable income, before and after they have been applied to reduce deferred taxation; and
 - (b) the total unprovided net timing differences separately stating those relating to the current year.

2.4.3 AC 102

AC 102 incorporates the Schedule 4 disclosure requirements as well as some additional details, in particular details about the partial basis.

The requirements of AC 102 are as follows:

- an accounting policy;
- information relating to the income statement:
 - amounts provided for current taxation,
 - amounts provided for deferred taxation,

- significant adjustments to prior period tax provisions,
 - adjustments to deferred taxation arising from changes in the standard tax rate, and
 - any significant amount for other categories of income tax;
- where the partial basis is used, the effect on the amounts provided for taxation for the period, had the comprehensive basis been used, should also be disclosed;
- if a change in the standard tax rate is associated with a fundamental change to the basis of taxation then any related adjustment should be treated as an extraordinary item. (This is contrary to the definition of an extraordinary item – refer to section 2.3.1);
- a reconciliation between the standard tax rate and the effective tax rate, separately disclosing and quantifying the significant reconciling items; and
- the information relating to the balance sheet:
 - the liability for income tax payable,
 - the liability for deferred taxation or the deferred tax asset, analysed by major category of timing difference,
 - the amount of the contingent liability relating to deferred taxation, analysed by major category of timing difference, and
 - the estimated tax effect of tax losses available for set off against future taxable income before and after they have been applied to reduce the deferred taxation balance.

3 Earnings and Dividends per Share

3.1 Introduction

3.1.1 Use of Earnings Per Share (EPS)

Earnings per share is a widely used ratio by most user groups, in particular financial analysts and the financial press. In addition, earnings per share is used extensively to calculate earnings yields (EY) and price earnings ratios (PE) by the Johannesburg Stock Exchange (JSE) and other users. The continued use of the EY and PE ratios by users requires that EPS be calculated on a comparable basis between companies and accounting periods. AC 104, Earnings and Dividends Per Share, therefore details a standard definition and calculation method for both earnings per share and dividends per share. There has been much debate recently about the standard definition of earnings for EPS calculation purposes. The debate centres around the appropriate treatment of extraordinary items. This issue is examined in more detail in chapter 9 and sections 3.1.2 and 3.1.3 of this chapter.

AC 104 applies to listed companies and "other companies whose shares are publicly traded" (AC 104 paragraph 2). Although any company may elect to disclose EPS, the ratio is usually of little relevance to owner-managed private companies as the presence of shareholder loan accounts, that essentially constitute capital funding, gives rise to a meaningless EPS figure. Mining companies that use the appropriation method of accounting (most South African mining companies use this method) are exempt from EPS disclosures.

AC 104 requires disclosure of both EPS and DPS (dividend per share) on the face of the income statement, the latter disclosure arising from a 1992 revision to the statement. Where consolidated financial statements are prepared, EPS should not be disclosed for the holding company.

3.1.2 Basic Calculation

EPS is no more than the expression of a ratio:

Earnings/Number of shares in Issue.

In its simplest form, the calculation is straightforward. However, earnings may fluctuate considerably from year to year as a result of unusual or non-recurring events. For example, the sale of a non-depreciable fixed asset carried at a ten year old historical cost usually gives rise to a healthy profit on sale. This profit inflates the usual operating earnings of the company

artificially in the year that the asset is sold. Users, in particular investors, are more concerned with future *sustainable* earnings growth than with one-off artificially high profits. For this reason, AC 104 requires that the earnings figure used for the EPS calculation be taken before extraordinary items. In the past, the profit on sale of the non-depreciable asset would be classified as extraordinary and therefore excluded from the EPS calculation.

The rules governing extraordinary items changed with the issue of the new AC 103 (see chapter 9) and it is likely that in future very few events will give rise to extraordinary items. This will result in pressure, similar to that experienced in the United Kingdom, from analysts for a different definition of earnings for EPS calculation purposes. This may result in the amendment of AC 104 in the near future. Refer to section 3.1.3 for further discussion.

At present AC 104 refers to "net income" and not "profit on ordinary activities" as is now required by AC 103. In terms of AC 104, earnings is "the net income for the period after tax, outside shareholders' interest and preference dividends but before extraordinary items and transfers to or from reserves and includes the retained equity income or deficit for the period which has been equity accounted" (AC 104 paragraph 5). In simple terms, earnings is the net profit attributable to ordinary shareholders before extraordinary items. For example, EPS (and DPS) can be calculated from the following extract from an income statement:

	R000's
Profit on ordinary activities after tax	9 123
Retained Equity Income – Associate (Refer Ch 13)	345
Outside shareholders' Interest	<u>(1 946)</u>
Profit before extraordinary items	7 522
Extraordinary item	<u>(522)</u>
Net profit	7 000
Dividends – Ordinary	2 000
Dividends – Preference	500
Retained profit for the year	<u>4 500</u>

Assuming that there are 10m ordinary shares in issue, EPS is calculated based on earnings of 7 022 (7 522 – 500 (Pref Div)):

$$\begin{aligned}\text{EPS} &= 7\,022 / 10\,000 \\ &= 70.22 \text{ cents per share}\end{aligned}$$

Dividends per share is calculated based on the actual dividend paid:

$$\begin{aligned}\text{DPS} &= 2\,000 / 10\,000 \\ &= 20 \text{ cents per share.}\end{aligned}$$

Both EPS and DPS are disclosed on the face of the income statement, in cents.

Nearly all EPS calculations are as simple as the above example. However, the presence of convertible instruments and changes in the capital structure of companies sometimes complicates the calculation. These issues are considered in further detail in sections 3.3 and 3.4 but first it is necessary to consider the framework (AC 000) and its objective of financial statements in relation to the disclosure of EPS.

3.1.3 Objective of Financial Statements

Paragraph 12 of AC 000 states that the “objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions”. The disclosure of EPS provides information about the financial performance of a company and is a useful indicator of the capacity of a company to generate cash flows from its existing resource base. However, AC 000 warns of placing too much reliance on only income statement information when assessing financial performance; paragraph 20 indicates that unless income statement information is used in conjunction with the balance sheet, an “incomplete picture of performance” is presented. This warning is not heeded by most users of EPS; as stated above in section 3.1.1, the EPS figure is widely used for PE and EY ratios and is thus heavily relied upon.

The heavy reliance on EPS has led to much abuse of creative accounting techniques. The most common abuse involves extraordinary items because these are excluded from the EPS calculation. Companies appear to have treated normal operating losses as “extraordinary” in order to artificially inflate EPS. This has led to criticism of EPS and a number of standard setting bodies have addressed the issue by changing the rules regarding extraordinary items.

The changes to the rules regarding extraordinary items by the IASC and in the UK and South Africa has led to an EPS figure which is based on *net* profit for the period (see chapter 9). In the UK, companies are permitted to disclose an alternative EPS (which would usually exclude “extraordinary” items) provided that a full reconciliation is given between the two EPS figures. While there has been some criticism of the UK approach, user groups are responding by defining their own EPS figures. This is a positive move as it reduces the reliance on a single, headline measure of performance and encourages users to make their own assessment of sustainable earnings based on *all* the information included in the financial statements.

The revision to the South African statement on extraordinary items (see chapter 9) is likely to result in a similar change to EPS disclosures. The Accounting Practices Committee is presently researching this issue and it is likely that an exposure draft to revise AC 104 will be issued in the near future.

3.2 Determination of Earnings

3.2.1 Preference Shares

In section 3.1.2 it is illustrated that the basic calculation of EPS is straightforward, involving the determination of earnings and the number of shares in issue. The determination of earnings is always calculated after taking into account dividends attributable to preference shareholders, since this amount is not available for distribution to the ordinary shareholders. If the dividend due to preference shareholders has been charged in the income statement then this is a relatively simple calculation, as shown in the example above (section 3.1.2). However, situations may arise where the dividend is not charged in the income statement but does accrue to the preference shareholders because the preference shares are cumulative in nature.

It is safe to assume that all preference shares are cumulative unless specifically expressed otherwise. Therefore, the full net amount of any dividend attributable to preference shares should be deducted in the year in which it is earned, regardless of whether or not it has been declared (see paragraph 29 of AC 104). This means that when the dividend is actually charged against income, care should be exercised to ensure that the preference dividend is not taken into account twice for EPS purposes. This is illustrated using the following information:

	1902	1901
	R000's	R000's
Net profit	7 000	(1 000)
Dividends – Ordinary	3 000	–
– Preference	1 000	–

The company has 5m 10% R1 preference shares and 10m ordinary shares in issue.

Earnings per share will be based on a net loss of R1 500 000 in 1901 (loss of R1 000 000 less preference dividend accrued of R500 000) and net profit of R6 500 000 in 1902 (profit of R7 000 000 less preference dividend attributable to 1902 of R500 000. Note that the other R500 000 of the preference dividend of R1m actually paid in 1902 relates to the 1901 period). EPS is, therefore, 65 cents in 1902.

If the preference shares were non-cumulative then EPS would be based on earnings after the actual preference dividend paid (R6 000 000 in 1902 and a loss of R1 000 000 in 1901).

3.2.2 Participating Preference Shares

Participating preference shares normally fall into the definition of equity shares because they “carry a right to participate in a distribution of earnings” (AC 104 paragraph 07). As such, EPS must be calculated for participating preference shares (AC 104 requires disclosure of EPS for each class of equity share) and is disclosed separately on the face of the income statement together with EPS for ordinary shares and DPS.

Participating preference shares usually rank for dividends in two parts, a fixed (cumulative) element that is a percentage of their nominal value and a variable element that is dependent on the profits generated by the company. The fixed element is treated in exactly the same way as for non-participating preference shares while the variable element is calculated separately based on the stated allocation of profits between ordinary shareholders and participating preference shareholders. To illustrate, assume that a company has 500 000 R10 participating preference shares that are subject to the following conditions:

- a fixed 12% dividend; and
- an additional right of 12,5% of total dividends declared to ordinary shareholders.

If the company made net income of R10,5m during the year then the earnings may be split between the ordinary and preference shareholders as follows:

	R000's
Net profit	10 500
Fixed Pref Dividend R5m x 12%	<u>(600)</u>
	9 900
Variable Pref Share (R9,9m x 12,5/112,5)	<u>(1 100)</u>
Income attributable to ordinary shareholders	<u>8 800</u>

The EPS for participating preference shares is, therefore, based on earnings of R1 700 000 (R600 000 + R1 100 000) and 500 000 shares in issue, i.e. EPS = 340 cents while EPS for ordinary shares is based on earnings of R8 800 000 and, say, 10m shares in issue, i.e. EPS = 88 cents.

Note that if a dividend of 20 cents was declared to ordinary shareholders

then the participating preference shareholders would be due 12,5% of the **total** dividend of R2m (10m shares $\times$ 20 cents), i.e. R250 000. This amounts to 50 cents per share (250 000/500 000). The total dividend received by the participating preference shareholders amounts to 170 cents (120 cents fixed portion and 50 cents variable portion). The net result on the income statement can be summarised as follows:

	R000's
Net profit for the year	10 500
Ordinary Dividend	2 000
Participating Preference Dividend (R600 + R250)	<u>850</u>
Retained income for the year	7 650
EPS – ordinary shares in cents	88
– participating preference shares in cents	340
DPS – ordinary shares in cents	20
– participating preference shares in cents	170

3.2.3 Losses

If a company makes a net loss for a period then there is no change to the method for calculating EPS – a net loss per share is calculated in the same way as earnings per share. In terms of AC 104 (paragraph 31), a loss per share, described as such, is disclosed on the face of the income statement.

3.2.4 Restatement of Comparative Figures

Changes in accounting policies and corrections of fundamental errors usually result in a restatement of comparative figures (refer chapter 9). In addition, historic information in ten year summaries is often restated as a result of changes in accounting policies. In these circumstances, comparative EPS figures should be restated to take into account the adjusted information from prior periods.

3.3 Determination of the Number of Shares

3.3.1 Share Issues

Section 3.1.2 demonstrates that most EPS calculations are relatively straightforward. Section 3.2 explores situations where the earnings part of the equation may require adjustment. Complications may also arise about the determination of the number of shares to be used in the equation. The issue of shares during an accounting period is the first complication examined.

AC 104 (paragraph 6) requires EPS to be calculated using the weighted

average number of shares which is "the number of shares determined by relating the portion of time within a reporting period that a particular number of shares has been entitled to share in earnings to the total time in that period" (AC 104 paragraph 08). In simple terms, this paragraph is an extension of logical common sense; if shares are issued part of the way through the year then it would be incorrect to assume that they had been in issue throughout the year when calculating EPS.

A fresh issue of shares that are fully paid up results in an inflow of capital to a company that is used to generate a return. As the return will only accrue to the company after the injection of capital (i.e. the new issue), it is logical to weight the number of shares issued over the time period of the increased capital. It is not appropriate to use the total number of shares in issue at the end of the year as the cash obtained from the issue would not have been available to generate earnings prior to the issue date.

For example, assume that a company earned R8m during the year and had 10m ordinary shares in issue at 1 January. On 30 September a further 8 million shares were issued.

The weighted average number of shares is:

10 million for 12 months ($\times 12/12$)	10 000 000
8 million for 3 months ($\times 3/12$)	<u>2 000 000</u>
	<u>12 000 000</u>

EPS = R8m/12m = 66,67 cents

Note that the weighted average number of shares could also be calculated as follows:

10 million for 9 months ($\times 9/12$)	7 500 000
18 million for 3 months ($\times 3/12$)	<u>4 500 000</u>
	<u>12 000 000</u>

The net result of either approach is, as expected, identical but the logic is slightly different.

3.3.2 Capitalisation or Bonus Issues

A capitalisation issue or a bonus issue will result in an increased number of shares in issue without generating new earnings. For the reporting period in which the capitalisation or bonus issue occurs, the total number of shares after the issue is used in the calculation of EPS and the comparative periods are proportionally adjusted. In effect, the capitalisation shares are treated as if they had always been in issue.

For example, a company had issued share capital of 10m R1 shares at 1 January 1902. During 1902, a one for four capitalisation issue out of retained earnings was held. Earnings in 1902 amounts to R5m while EPS in 1901 was 45 cents.

EPS for 1902 would be calculated as $R5m/12,5m = 40$ cents (note that 2,5m shares were issued by way of the 1-in-4 capitalisation issue). The comparative EPS (i.e. 1901) requires restatement in proportion to the revised number of shares in issue, i.e. $45 \text{ cents} \times 10m/12,5m = 36$ cents (note that this can be checked by taking earnings of R4,5m in 1901 ($EPS 45c \times 10m \text{ shares}$) and shares of 12,5m, i.e. $R4,5m/12,5 = 36$ cents). The comparatives are adjusted to provide a more meaningful comparison between the current year's EPS which, despite there being no increase in total equity, is based on the increased shares in issue. Therefore, the increased number of shares in issue are also taken into account for the comparative period. This is in contrast to a fresh issue where the increased number of shares in issue are expected to generate increased earnings in the current year. Therefore, current year EPS is based on the increased number of shares in issue but the comparative EPS is not adjusted.

Note that where a new issue (or a rights issue) takes place in the same year as and prior to a capitalisation issue then the effect of the new issue which has been included in the capitalisation issue should also be weighted for purposes of calculating the weighted average number of shares in the EPS equation. This is illustrated in example 2 of the appendix to AC 104.

Note that if the capitalisation issue takes place prior to the new issue then no complications arise and both issues are treated in the usual way.

3.3.3 Share Splits

Where shares are split into shares of a smaller nominal value (or consolidated into shares of a higher nominal value) then there is no effect on the company's overall capital. Therefore, the treatment is identical to that applied to capitalisation or bonus issues.

3.3.4 Share Reductions

Share capital is sometimes reduced by companies without refunding any capital to shareholders. For example, accumulated losses are set off against share capital with a corresponding number of shares being cancelled, thereby reducing the share capital (effectively the reverse of a capitalisation issue out of general reserves). The treatment is identical to that applied to capitalisation issues, EPS is based on the decreased number of equity shares after the reduction scheme and comparatives are proportionately adjusted.

3.3.5 Share Exchanges

If shares are issued in exchange for assets or to acquire another business then it is treated like a new issue. However, for EPS calculation purposes, the shares are assumed to be issued on the date from which income from the assets or investment in shares is included in earnings; i.e. the actual date of issue of the shares is irrelevant to the EPS calculation. This is a logical application of the EPS equation as the weighting of the shares issued should coincide with the increased earning capacity of a company as a result of acquiring assets or shares in another company. Example 4 of the appendix to AC 104 illustrates this principle.

3.3.6 Rights Issues

Although rights issues can take place at or below market price, they usually are below market price. Where a rights issue takes place at market price then it is treated in the same way as a new issue. Where a rights issue takes place below market price then it involves two components; an issue of shares for full value and a bonus issue.

The problem when calculating EPS is to determine the extent to which a rights issue is an issue at full value and the extent to which it is a bonus issue. AC 104 states that "the determination of the fair value for the purpose of arriving at the bonus element in a rights issue requires the use of judgement and is based on factors such as the share price history before the rights issue, the liquidity of the market and the amount of funds to be raised" (AC 104 paragraph 15).

The following example shows how identification of a fair value at the time of a rights issue enables EPS to be calculated.

A company had 10m shares in issue at 1 January 1902. On 30 June the company had a rights issue of one share for every five held for 40 cents. The market price of the shares prior to the announcement was 170 cents but a fair value of shares is estimated at 160 cents.

In order to calculate the weighted average number of shares, it is necessary to calculate the effective number of shares issued at full value. The cash which the company will receive amounts to 2 million shares at 40 cents per share or R800 000. Based on a fair value of 160 cents, the company would have to issue 500 000 shares ($R800\,000/1,60$) in order to raise R800 000. Therefore, of the 2 million new shares, 500 000 are theoretically issued at full value and 1 500 000 are bonus shares. The weighted average number of shares can be calculated as follows:

	TOTAL	WEIGHTED 1902	
Original issue	10 000 000	10 000 000	
Issued for value	<u>500 000</u>	<u>250 000</u>	$(500\,000 \times 6/12)$
	10 500 000	10 250 000	
Bonus element	1 500 000	1 464 286	$(\frac{1\,500\,000}{10\,250\,000} \times 10\,250\,000)^*$
	<u>12 000 000</u>	<u>11 714 286</u>	

*Note that this is weighted in the same proportion to the total, i.e. the proportion of 1 500 000 to 10 500 000 is used to determine the weighting of the bonus element for calculation of the weighted average number of shares in 1902. The same proportion would be used for the comparative year of 1901.

EPS for the year ended 31 December 1902 would, therefore, be calculated using the earnings of the company divided by 11 714 286 shares while DPS would be calculated using the actual dividend paid (i.e. if a dividend was paid on 30 November then DPS would be the total dividend paid divided by the 12 000 000 shares in issue at 30 November). Note that the comparative figure for DPS would be adjusted for the bonus element of the increased shares in issue by the ratio 10 500 000/12 000 000. This is illustrated in the comprehensive example 3 that is included in the appendix to AC 104.

3.3.7 Seasonal Variations

Situations may arise where shares are issued during an accounting period over which earnings do not accrue evenly. In this case, to avoid misrepresentation of the effect of the new issue, it is necessary to calculate EPS for the period prior to and for the period subsequent to the effective date of issue and to aggregate the two EPS figures to accrue an EPS for the full period (AC 104 paragraph 32). For example, assuming that a company earned only R100 000 in the first six months of its financial year and R600 000 in the remaining six months and a share issue took place at the start of the tenth month of the financial year. EPS should be calculated by aggregating the EPS for the first six months (based on R100 000 of earnings) and the EPS for the second six months (based on R600 000 of earnings and a weighted average number of shares that takes into account the fresh issue). It would not be meaningful to calculate EPS over the entire year in one calculation as this would assume that R700 000 was earned evenly over the period and that the fresh issue of shares had a lesser effect than it actually did.

Example 8 in the appendix to AC 104 illustrates the calculation of EPS where there is a new issue and seasonal variations.

3.4 Dilutions

3.4.1 Fully Diluted Earnings Per Share

In most cases the calculation of EPS is relatively straightforward. Adjustments that need to be made to earnings (section 3.2) and the number of shares (section 3.3) involve amendments to the amounts in the income statement or balance sheet, but the figures used are still fundamentally the current figures. Circumstances sometimes arise where changes to the capital structure of a company are anticipated and those changes will have an effect on EPS in future accounting periods. Usually this effect involves a dilution in earnings per share. Examples listed in AC 104 (paragraph 22) are:

- options to subscribe for equity shares of the company or its subsidiaries; or
- other issues of shares contingent upon future events; or
- debentures, loan stock or preference shares convertible into equity shares of the company or its subsidiaries; or
- separate classes of equity shares in the company or its subsidiaries which do not rank for dividend in the period but will do so in the future.

AC 104 applies a prudent approach in paragraph 23 in that expected **increases** in earnings per share are not calculated and disclosed “unless there is a compulsory obligation to issue equity that would result in an increase in earnings per share or would reduce a loss per share”.

The disclosure of fully diluted earnings per share is only required where the dilutive factor becomes effective within five years. Also, if the dilution is not material then the effect does not necessarily have to be disclosed, but the fact of potential dilution should always be disclosed.

The disclosure of fully diluted earnings per share attempts to show the impact of new equity shares on EPS. For example, the conversion of debentures into ordinary shares will increase the number of shares used to calculate EPS while earnings will increase as a result of no longer paying interest to the debenture holders. The net effect of this conversion is usually a dilution in EPS (the interest rate on the debentures is lower than the earnings return to shareholders) and fully diluted EPS is a pro forma calculation that assumes that the conversion had taken place on the first day of the financial year, i.e. “where securities have been converted or options taken up

during the period, unless this occurred on the first day of the period, it is necessary to include the shares so issued in the calculation of fully diluted earnings per share as if they had been issued on the first day of the period'' (AC 104 paragraph 24).

The reason for disclosing fully diluted EPS is to emphasise to shareholders the effect that the dilution will have on earnings per share. This is important as most convertibles have a low rate of interest as a result of the attraction of their conversion rights.

The next three sections consider examples of dilutions.

3.4.2 Options

If options are in issue then fully diluted EPS should be calculated on the basis that all of the options were exercised on the first day of the financial year. The effect of an option is that increased earnings will arise from increased capital, but the number of shares will also increase.

For example, during 1902 a company issues 500 000 share options to a number of directors to subscribe for shares at R1 each. The company expects to earn 10% after tax on funds invested in the company. EPS for 1902 was 60 cents, based on earnings of R1,8m.

Fully diluted earnings is calculated as follows:

	R000's
Earnings	1 800
Add: Notional earnings from issue of shares in terms of options, net of tax (500 000 × 10%)	50
	<u>1 850</u>

The number of shares in issue after the exercise of the options is calculated as follows:

Shares presently in issue (R1,8m/60 cents)	3 000 000
Options	<u>500 000</u>
	3 500 000

Therefore, fully diluted EPS = R1 850 000/3 500 000 = 52,86 cents.

Fully diluted earnings per share illustrates that if all the options outstanding had been exercised on 1 January then EPS would have been 52,86 cents and not 60 cents.

Disclosure of fully diluted EPS is given on the face of the income statement

together with EPS and DPS. Refer to example 5 of the appendix to AC 104 for a further illustration of the calculation of fully diluted earnings per share as a result of options outstanding.

3.4.3 Convertible Instruments

Where debentures, loan stock or preference shares that are convertible into ordinary shares of the company are in issue then fully diluted EPS should be calculated under the assumption that the conversion took place at the start of the financial year. The effect of the conversion of preference shares will reduce the preference dividends payable, thereby increasing the earnings figure for the EPS calculation while the number of ordinary shares will increase. In the case of the conversion of debentures or loan stock, the number of ordinary shares will also increase and an adjustment to earnings is made for the after tax cost of interest expensed relating to the convertible debentures and loan stock.

For example, on 1 January 1902 a company issues 500 000 R10 12% preference shares which are convertible in 1904 to four ordinary NPV shares for each convertible preference share held. EPS for 1902 was 60 cents, based on earnings of R1,8m. Fully diluted earnings is calculated as follows:

	R000's
Earnings	1 800
Add: Reduced preference dividend assuming conversion of shares (500 000 × R10 × 12%)	<u>600</u>
	2 400

The number of shares in issue after the conversion into ordinary shares is calculated as follows:

Shares presently in issue (R1,8m/60 cents)	3 000 000
Conversion (500 000 × 4)	<u>2 000 000</u>
	<u>5 000 000</u>

Therefore, fully diluted EPS = R2 400 000/5 000 000 = 48 cents.

Fully diluted earnings per share illustrates that if all the preference shares had been converted on 1 January then EPS would have been 48 cents and not 60 cents. Example 6 of the appendix to AC 104 gives an illustration of the calculation of fully diluted earnings per share where convertible debentures are in issue.

3.4.4 Equity Shares Ranking for Future Dividend

Where equity shares ranking for future dividend (usually known as deferred shares) are in issue then a dilution in earnings per share arises when the shares become eligible for dividend. The earnings of the company will be unaffected, but the number of shares will change. Fully diluted earnings per share is calculated on the basis of identical earnings, but on the assumption that the shares ranked for dividend from the beginning of the financial period.

For example, on 01 January 1902 a company issues 500 000 ordinary “A” class shares which will rank for dividend only in 1906. EPS for 1902 was 60 cents, based on earnings of R1,8m. A dividend of 20 cents per ordinary share was paid on 30 November 1902.

Fully diluted earnings per share is calculated as follows:

Ordinary Shares (R1,8m/60 cents)	3 000 000
Deferred ordinary shares (“A” class shares)	500 000
	<u>3 500 000</u>

Therefore, fully diluted EPS = $R1\,800\,000 / 3\,500\,000 = 51,43$ cents.

Note that in addition to EPS of 60 cents and fully diluted EPS of 51,43 cents, AC 104 requires disclosure of EPS for *each* class of equity, i.e. EPS for the “A” class shares must also be disclosed. This may be calculated as follows:

	R
Earnings for 1902	1 800 000
Less: Dividend paid (3m × 20c)	<u>600 000</u>
Retained earnings for 1902	<u>1 200 000</u>

Effectively, both the ordinary shares and the deferred ordinary shares will share in the retained earnings and earnings per share for the deferred shares is, therefore: $R1\,200\,000 / 3\,500\,000 = 34,29$ cents.

The disclosure on the face of the income statement may be summarised as follows:

	CENTS
EPS – ordinary shares	60
– deferred “A” class ordinary shares	34,29
DPS – ordinary shares	20
Fully diluted EPS	51,43

Refer to example 7 of the appendix to AC 104 for a further illustration.

3.5 Financial Statement Presentation

3.5.1 Companies Act

Schedule 4 to the Companies Act defines EPS in paragraph 4 (k) as “the earnings attributable to each equity share, based on the consolidated net income for the period after tax, and after deducting outside shareholders’ interest and preference dividends, but before extraordinary items, divided by the weighted average number of that class of share in issue”.

The only disclosure requirement of Schedule 4 relating to EPS is paragraph 42 (l) which requires disclosure of earnings per share and dividends per share in respect of listed companies for each class of equity share.

3.5.2 AC 104

The disclosure requirements of AC 104 expand on Schedule 4 and may be summarised as follows:

- Paragraph 33 On the face of the income statement:
- EPS (or loss per share)
 - DPS
- for each class of share, including comparatives. In the case of consolidated income statements, EPS is not given for the holding company.
- Paragraph 34 The earnings and weighted average number of shares used in the calculation of each EPS figure disclosed. (This detail is usually given in a note to the income statement.)
- Paragraph 35 Details of rights attached to the different classes of equity share.
- Paragraph 38 Fully diluted earnings per share for each class of equity share (or the percentage dilution on EPS).
- Paragraph 39 The earnings and weighted average number of shares used in the calculation of fully diluted EPS.
- Paragraph 40 Description of dilutive instrument.
- Paragraph 41 Dilutive factors which will not be effective within five years and have not been taken into account in the disclosure of fully diluted earnings per share.
- Paragraph 42 Pro forma EPS (and, if applicable, fully diluted earnings per share) that takes into account capitalisation issues, bonus issues as part of a rights issue, share splits, share consolidations or reductions in capital that affect the number of shares in issue without a refund of capital that occur between the balance sheet date and the date of approval of the financial statements.

4 Inventories

4.1 Introduction

4.1.1 Stock vs Inventories

ED 94 has introduced the North American terminology of “inventories” to replace the traditional Anglo-Saxon word “stock”. This change is in line with the South African harmonisation programme and is consistent with IAS 2 (revised). AC 108 (revised and issued August 1995) therefore also refers to “inventories” and not to stock.

Inventory is often an important component of an enterprise’s balance sheet, particularly in manufacturing concerns. The accounting treatment adopted for the recognition and valuation of inventory has a direct effect on the profit that an enterprise reports for a period. The accounting rules regarding the recognition and valuation of inventory appear relatively straightforward. However, a number of subjective and judgemental areas arise and, more often than not, taxation considerations play a role in the valuation of inventory. The valuation of inventory provides the creative accountant with opportunities to manipulate both profits and the balance sheet.

Inventories are defined by AC 108 as assets:

- held for sale in the ordinary course of business,
- in the process of production for such sale, or
- in the form of materials or supplies to be consumed in the production process or in the rendering of services.

(AC 108 paragraph 4)

It should be noted that it is not necessary that an item be intended for sale for it to be included in the definition of inventory. Consumable stores, for example, are not sold on, but they can still be treated as part of inventories.

Inventories are generally recognised at historical cost which is the aggregate of cost of purchase, cost of conversion, and other costs incurred in bringing the inventory to its present location and condition. Calculating the cost of inventory is often an extremely complicated exercise.

4.1.2 Exclusions and Definitions

AC 108 does not apply to the valuation of long term construction contracts

(see chapter 7) in progress, inventories of mining products, financial instruments, nor to agricultural inventories.

Agriculture and mining inventories are normally measured according to the industry specific practice. This usually involves measurement at net realisable value at certain stages of production.

“Net realisable value” is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale (AC 108 paragraph 4).

4.1.3 Cost of Purchase

Cost of purchase comprises the purchase price, including import duties and other purchase taxes, transport and handling costs, and any other directly attributable costs of acquisition less discounts, rebates and subsidies on purchases (AC 108 paragraph 8).

4.1.4 Costs of Conversion

Cost of conversion is the manufacturing or processing cost that relates to bringing the inventory to its present location and condition. The cost of conversion includes costs directly related to the units of production such as direct material and direct labour. In addition, the cost of conversion includes an allocation of fixed and variable production overheads. Variable production overheads are those indirect costs that vary directly, or nearly directly, with the volume of production, whereas fixed production are those indirect costs that remain relatively constant regardless of the volume of production. The determination of the amount of overheads that should be included in the valuation of inventory is an important issue and is considered in more detail in section 4.3.1, Inclusion of Overheads.

Inventory is normally disclosed in financial statements broken down into its various components, i.e. raw materials, work-in-progress, finished goods and consumable stores.

4.1.5 Other Costs

Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. Examples of costs excluded from the cost of inventories include abnormal wastage costs, storage costs (unless necessary for production), certain administrative overheads and selling costs (AC 108 paragraph 14).

4.2 Conceptual Issues

4.2.1 Asset Recognition

The primary issue in accounting for inventory is the amount of cost to be recognised as an asset and carried forward until related revenues are recognised. AC 108 uses the matching concept (AC 101) to justify the deferral of the cost of inventory; the cost of unsold or unconsumed inventory has been incurred in the expectation of future sales and when these sales will only arise in a later period, it is appropriate to carry forward the costs to match them to the revenue (AC 108 paragraph 30).

The framework, AC 000, justifies the deferral of the recognition of the cost of unsold inventory to future periods in that the costs incurred meet the definition of an asset. Inventory on hand, therefore, is recognised as an asset where:

- it is controlled by the enterprise;
 - as a result of a past event (acquisition or production thereof);
 - from which **probable** future benefits will flow; and
 - has a cost which can be measured reliably
- (AC 000 paragraphs 49 (a) and 83).

The framework approach, therefore, confirms the application of the matching concept in that unsold inventory at year end is carried as an asset provided that it is probable that future revenue will flow to the enterprise. In addition, that future revenue should exceed the cost of the inventory and subsequent selling expenditure. The key issue in the accounting treatment of inventory centres around the measurement of the cost of inventory. This is considered in more detail in section 4.3.

4.2.2 Write-downs to Net Realisable Value

The recognition of an asset (AC 000) is dependent on future economic benefits being probable. It follows that those future economic benefits should amount to at least the recorded value of the asset, otherwise the asset is not capable of recovery through future revenue. If the future net revenue expected to be generated by the sale of inventory on hand is less than the cost of that inventory then the inventory should be written down. The measurement of expected future revenue should also take into account the costs of selling the inventory.

The cost of inventory may not be recoverable if the inventory is damaged,

if it is wholly or partially obsolete, if selling prices have declined, or (in the case of manufactured goods) the estimated cost of completion or the estimated costs to be incurred in making the sale have increased. In these circumstances, inventory is written down to “net realisable value” or the amount of the expected net revenue to be generated.

Ideally inventory should be written down to net realisable value on an item by item basis, but it is often appropriate to group similar items together. It is not acceptable, however, to write inventory down on the basis of an entire classification, for example, finished goods.

The estimates of net realisable value are based on the most reliable evidence available and take into account fluctuations in price after the balance sheet date, to the extent that such events confirm conditions existing at the end of the period (see chapter 19 on post balance sheet events).

Raw materials are written down only where it is estimated that the cost of the finished product will exceed net realisable value. A new assessment of net realisable value is made in each accounting period. In terms of AC 108, write downs to net realisable value may be reversed if circumstances which previously caused the inventory to be written down below cost no longer exist.

4.3 Valuation Issues

4.3.1 Inclusion of Overheads

For a manufacturing company, the costs of converting raw materials into a finished product include direct costs (labour and material) and indirect production overheads. The allocation of indirect production overheads to the cost of work-in-progress and finished goods is a complicated process. Production overheads usually consist of fixed and variable portions.

Variable production overheads are the indirect costs of production that vary directly, or nearly directly, with the volume of production, for example indirect materials and indirect labour. The allocation of variable production overhead is relatively straightforward; variable overheads are allocated to each unit of production on the basis of the actual use of the production facility.

Fixed production overheads are the indirect costs of production such as depreciation and administration costs that remain relatively constant regardless of the volume of production. The allocation of fixed production overheads to the cost of conversion is usually based on the normal capacity of

the production facility. For example, annual administration costs of R1 million may be allocated to the costs of conversion based on normal production of 100 000 units. Therefore, the cost of each unit of finished product will include R10 of administration costs. The normal capacity of 100 000 units is the estimated production for the next year, based on an average production over the previous few years.

Note that in this example, if 120 000 units are produced, then R1,2 million of administration overhead would be allocated to costs of conversion while if actual production is 80 000 units then only R800 000 of administration overhead will be allocated to the costs of conversion. The net result is that in a period of abnormally high production (120 000 units), the administration cost allocation to costs of conversion is greater than the **actual** administration cost incurred. The reverse occurs in a period of abnormally low production (80 000 units) in that unallocated administration costs of R200 000 remain. AC 108 provides specific guidance for this situation; in times of low production or idle plant, the amount of fixed overhead allocated to each unit of production is not increased. The unallocated overhead (R200 000 in the example) is recognised as an expense in the period incurred.

In contrast, however, in times of abnormally high production, the amount of fixed overhead allocated to each unit of production is decreased so that inventory is not measured above cost. (The administration costs of R1 million/120 000 units would result in a redefined allocation of R8,33 per unit instead of R10.)

In the case of more than one product being produced simultaneously, for example, joint products or by-products, fixed production overheads should be allocated to each product on a rational and consistent basis.

AC 108 makes the inclusion of fixed production overheads in the cost of conversion mandatory. It is sometimes argued that the omission of fixed production overheads from the cost of inventory is prudent. The counter argument is that prudence should be applied through the net realisable value test and not through the somewhat arbitrary omission of relevant costs.

Excess amounts of waste incurred in the production process (for example, material, labour and other expenses) which do not relate to bringing the inventory to its present location and condition are excluded from the cost of conversion (AC 108 paragraph 14).

In terms of AC 108, selling expenses, general administrative overheads and storage costs (of finished goods) do not relate to putting inventory in its present location and condition and these costs would not therefore be allocated to the cost of inventory.

4.3.2 First-In-First-Out

First-in-first-out (FIFO) is one of several different formulas that are used for the purpose of assigning costs to items of inventory. The underlying assumption of FIFO is that the goods that are produced or purchased first are sold first. Under this method, items remaining in inventory at the end of the period are those items that have been produced or purchased at the most recent level of cost. An example is considered in section 4.3.4 below.

Under FIFO, the income statement should provide a close approximation to the actual costs incurred in the production or purchase of each unit of sales.

4.3.3 Weighted Average

Under the weighted average cost formula, the cost of each item is determined from the weighted average of the cost of similar items at the start of the period and the cost of similar items purchased or produced during the period. The total costs of production over a period are, therefore, divided equally between all of the goods produced in that period. The average is calculated either on a periodic basis (i.e. annually, monthly) or as each additional shipment of inventory is received, depending upon the circumstances of the enterprise. An example is considered in section 4.3.4 below.

The weighted average formula is unlikely to reflect the actual costs incurred in the production or purchase of each actual unit of sales. However, in times of moderate inflation, the difference is not material and this method is fairly widely used.

4.3.4 Last-In-First-Out

Last-in-first-out (LIFO) uses the opposite assumption to FIFO in that the latest goods to be produced or purchased are assumed to be the first ones to be sold. This ensures that the profit on each item is calculated by comparing a current sales value with a current level of cost. This cost, however, is unlikely to be the actual cost of the goods sold and as a general rule the profits shown using LIFO will be lower than those shown using FIFO. Note, however, that where there is a considerable decrease in the level of inventory held then the cost of inventory released to the income statement will be an "old" cost that is related to a current sales level thereby giving rise to a high level of profit being reported (this is known as erosion of a LIFO layer).

The use of LIFO can result in the reporting of current assets at amounts that bear little relationship to actual recent costs. The LIFO formula is not

recognised in many countries in the world and is permitted only as an allowed alternative under the IAS 2 (revised) standard. For this reason it is perhaps not surprising that few companies in South Africa adopt this method of valuing their inventory. In addition, it is not recognised for taxation purposes so enterprises that use LIFO have to maintain their inventory records on two bases, one for the financial statements and one for the Receiver of Revenue. AC 108, although based on IAS 2 (revised), disallows the LIFO method of inventory valuation.

The following example will illustrate the principal difference between the three different cost flow assumptions.

Example

Assume that a company has no inventory at 1 January. During the year, the following transactions took place:

Date	Purchased/ (sold)	Price R	Total R	Units on hand
1 January	150	100	15 000P	150
5 February	300	110	33 000P	450
31 March	(250)	200	50 000S	200
7 May	450	120	54 000P	650
11 June	(375)	220	82 500S	275
14 July	300	120	36 000P	575
17 August	(300)	220	66 000S	275
6 November	300	130	39 000P	575
17 December	(375)	230	86 250S	200
			ΣP = 177 000	
			ΣS = 284 750	

Note that sales and purchases amount to R284 750 and R177 000 respectively. These values are not affected by the cost flow assumption; the value of closing inventories, however, is greatly affected by the cost flow assumption. Cost of sales and closing inventories is calculated according to three different cost flow assumptions, namely FIFO, weighted average and LIFO.

FIFO

200 units are on hand at the year end. FIFO assumes that it is inventory from the most recent purchase and these units are valued at R46 000 (200 @ R230).

Gross Profit is:		R
Revenue (i.e. Turnover)		284 750
Purchases	177 000	
Less: Closing inventory	<u>(46 000)</u>	<u>131 000</u>
Gross Profit		<u>153 750</u>

Weighted Average

Weighted average assumes that the closing inventory is valued at the average price of purchases during the period. Total units purchased during the year amount to 1 500 at a cost of R177 000. Therefore, the average price is R118 (177 000/1 500). Closing inventory is valued at R23 600 (200 @ R118).

Gross Profit is:		R
Revenue (i.e. Turnover)		284 750
Purchases	177 000	
Less: Closing inventory	<u>(23 600)</u>	<u>153 400</u>
Gross Profit		<u>131 350</u>

LIFO

LIFO assumes that closing inventory is from the earliest purchases. The cost is calculated, therefore, on the price of units purchased (150) on 1 January and 5 February (50 units of the 300 purchased on that date). The value of closing inventory is, therefore, R20 500 ((150 @ R100) + (50 @ R110)).

Gross Profit is:		R
Revenue (i.e. Turnover)		284 750
Purchases	177 000	
Less: Closing inventory	<u>(20 500)</u>	<u>156 500</u>
Gross Profit		<u>128 250</u>

4.3.5 Base Inventory

The base inventory method is not sanctioned by AC 108. This method involves stating a fixed quantity of inventory at a fixed price. This base inventory is effectively a fixed asset of the enterprise in that the valuation is fixed; any amounts of inventory over and above the base level must be valued using a separate cost flow assumption. The base inventory method is rarely used in South Africa but may be appropriate where the inventory comprises raw materials and consumables, or the overall value of the inventory is not material to the company. In addition, it is submitted that the quantity, value and composition of the inventory should not be subject to material variation.

4.3.6 Specific Identification

The specific identification formula attributes specific costs to identified items of inventory and is the most accurate method of costing, since the cost of each stock item is based on the actual costs that have been incurred in its purchase or production. AC 108 (paragraph 19) states that the specific identification formula is an appropriate treatment for goods that have been

bought or manufactured and are segregated for a specific project. It is only in these circumstances that the specific identification formula is practicable as, where there is a high volume of production, it may be impossible to determine the individual costs to be attributed to each unit of production. The specific identification method is most useful where the only costs to be included in inventory are those of purchase and transportation and possibly storage costs.

4.3.7 Latest Purchase Price

The latest purchase price or replacement cost formula for valuing inventory is not appropriate under the historical cost convention as it does not recognise the actual cost that has been incurred and is likely to overstate the profits recognised in the period. The latest purchase price formula is not sanctioned by AC 108.

4.3.8 Standard Cost

The standard cost method involves valuing inventory by some form of cost standard which is normally set prior to production, by reference to product specifications, expected costs, operating volumes and efficiencies. Under the standard cost method, inventory is valued based on the standard cost established by management's estimates of the expected costs, level of operations and operational efficiency. Standards are often altered as experience of actual production grows. The alteration of a standard does not necessarily imply that the original standard was incorrect, rather it may reflect the improved experience and expertise of the production staff that led to reductions in cost.

Differences between the standard cost of an item and its actual cost are known as variances and give rise to useful management control techniques. The use of standard costing for valuing inventory is acceptable under AC 108 (paragraph 17) if the standards approximate consistently the results that would be obtained if inventory was valued at historical cost. Care should be taken therefore to review standard costs frequently to ensure that they bear a reasonable relationship to actual cost.

4.3.9 Retail Method

AC 108 allows the use of the retail method for valuing merchandise. Under this method, the average profit margin is deducted from the selling price of inventory to arrive at a reasonable estimate of cost. This method may be used if it approximates actual historical cost. The method is often used by

organisations with fixed margins (usually retailers, hence the name retail method) where it may be the only practical method to adopt.

AC 108 requires that the percentage used takes into consideration inventory which has been marked down to below its original selling price, i.e. the inventory would not be marked down to below its historical cost and its net realisable value.

4.4 Financial Statement Presentation

4.4.1 Accounting Policy

Appropriate wording for an accounting policy on inventories is as follows:

Inventories are stated at the lower of cost and net realisable value. Cost is determined on a First In First Out (FIFO) basis and includes transport and handling costs. Direct costs of conversion and production overhead allocated on the basis of normal operating capacity are included in the cost of manufactured goods. Provision is made for slow moving and obsolete inventory.

4.4.2 Companies Act

The disclosure requirements of Schedule 4 to the Companies Act that are applicable to inventory (Schedule 4 uses the term stock) are as follows:

- Paragraph 4(aa) Stock is defined as any tangible property which the company buys, or manufactures, or processes, or develops or sells in the ordinary course of business.
- Paragraph 29(1) There shall be stated the amount in respect of the following categories of stock:
- (a) Raw materials.
 - (b) Finished goods.
 - (c) Merchandise.
 - (d) Consumable stores (including maintenance spares).
 - (e) Work-in-progress (including standing crops).
 - (f) Contracts in progress. (Refer chapter 6.)
- Paragraph 29(2) There shall be stated for contracts in progress, whether profits or losses have been taken into account and, if so, on what basis.

4.4.3 AC 108

The disclosure requirements of AC 108 are as follows:

- The financial statements should disclose:
 - the accounting policies adopted in measuring inventories, including the cost formula used;
 - the total carrying amount of inventories and the carrying amount in classifications appropriate to the enterprise;
 - the carrying amount of inventories carried at net realisable value;
 - the amount of any reversal of any write-down which is recognised as income in the period in accordance with paragraph 29;
 - the circumstances or events that led to the reversal of a write-down of inventories in accordance with paragraph 29; and
 - the carrying amount of inventories pledged as security for liabilities.
- The financial statements should disclose either:
 - the cost of inventories recognised as an expense during the period; or
 - the operating costs, applicable to revenues, recognised as an expense during the period, classified by their nature.

5 Property, Plant and Equipment

5.1 Introduction

5.1.1 Objective

Fixed assets are usually a major portion of an enterprise's total assets and therefore are significant in relation to its financial position. In the past, AC 106 and AC 202 dealt specifically with the appropriate accounting treatment for fixed assets. However, in line with South Africa's harmonisation project which involves the adoption of International Accounting Standards, ED 90 was released in December 1993 with the ultimate intention of replacing AC 106 and AC 202.

ED 96 was issued as AC 123 in December 1994. AC 202 was withdrawn with the release of AC 123. However, AC 106 is still applicable to assets not defined as property, plant and equipment, for example intangible assets. According to AC 123 paragraph 8, investment properties may be treated as property in accordance with AC 123 or as long-term investments in accordance with a statement on accounting for investment properties. A statement on accounting for investment properties has not been issued to date and until such a statement comes into effect, investment properties may be accounted for as investment properties in accordance with AC 106 (refer section 5.8).

The remainder of this chapter considers the content of AC 123 and, in respect of investment properties, AC 106.

AC 123, closely based on IAS 16 (revised), adopts the international terminology of "property, plant and equipment" as opposed to the fairly loose term of fixed assets.

AC 123 is closely based on the framework (AC 000) and is concerned with three principal issues in accounting for property, plant and equipment. These issues are:

- (a) the timing of recognition of items of property, plant and equipment;
- (b) the determination of carrying amounts and related depreciation charges;
and
- (c) the determination and accounting treatment of impairments in the carrying amounts.

These are important criteria as an item of expenditure is either an asset or an expense and the classification thereof can have a significant effect on an enterprise's results. AC 123 requires an item of property, plant and equipment to be recognised as an asset when it satisfies the definition and recognition criteria for assets as set down in AC 000.

5.1.2 Definitions

AC 123 (paragraph 9) includes a number of definitions, the more important of which are:

Property, plant and equipment are tangible assets that:

- are held by an enterprise for use in the production or supply of goods or services, for rental to others or for administrative purposes; and
- are expected to be used during more than one period.

Useful life is either:

- the period of time over which an asset is expected to be used by the enterprise; or
- the number of production or similar units expected to be obtained from the asset by the enterprise.

Cost is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction.

Fair value is the amount for which an asset could be exchanged between knowledgeable willing parties in an arm's length transaction.

Carrying amount is the amount at which an asset is included in the balance sheet after deducting any accumulated depreciation thereon.

Recoverable amount is the amount that the enterprise expects to recover from the future use of an asset, including its residual value on disposal.

The distinguishing feature apparent from the above definitions between an item of property, plant and equipment and a current asset is that the former is expected to be used during more than one period, i.e. a current asset would be expected to be used or realised within the next accounting period. In addition, an important distinction, needs to be made between carrying amount and recoverable amount. The carrying amount represents the net book value of property, plant and equipment at the balance sheet date whereas the recoverable amount is the expected future economic benefits

that the enterprise should recover from that asset. A decline in the recoverable amount, therefore, may require the carrying amount to be reduced to the level of expected economic benefits, i.e. the recoverable amount.

5.1.3 Exclusions

AC 123, unlike AC 106, does not deal specifically with investment properties but recognises that investment properties may be treated either as property in accordance with AC 123, or as long-term investments and therefore carried at cost or revalued amounts, without depreciation. Section 5.8 considers the appropriate accounting treatment, in terms of AC 106, of investment properties that are not depreciated.

AC 123 does not apply to forests and similar regenerative natural resources and mineral rights, the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources.

Note that the principles of AC 123 apply equally to property, plant and equipment that has been acquired under a financial lease arrangement (see chapter 11).

5.2 Recognition Issues

5.2.1 Recognition of Property, Plant and Equipment

In keeping with AC 000, an item of expenditure is recognised as an asset when it satisfies the definition and recognition criteria of the framework. Therefore, in terms of paragraph 10 of AC 123, an “item of property, plant and equipment should be recognised as an asset when:

- it is probable that future economic benefits associated with the asset will flow to the enterprise, and
- the cost of the asset to the enterprise can be measured reliably”.

The probability of future economic benefits is dependent on the degree of certainty attached to estimates of the expected flow of benefits at the time of the acquisition of the asset. Evidence of certainty is usually provided where there is assurance that the risks and rewards of ownership of the asset have passed, i.e. the enterprise will receive the rewards attaching to the asset and will undertake the associated risks.

In most cases, the reliable measurement of the cost of an item of property, plant and equipment is straightforward; i.e. usually invoiced cost exclusive of VAT. In certain circumstances, however, the reliable measurement of the cost of property, plant and equipment may be difficult:

- where the asset is self constructed
- where the asset is exchanged for another asset
- where the asset is paid for in a foreign currency.

These possibilities are considered further in section 5.3.

5.2.2 Maintenance Spares

Most companies carry spare parts and servicing equipment as inventory items (i.e. current assets) and the expenditure is recognised as an expense when the spare part is used. Due to their nature, the spares do not normally meet the definition of property, plant and equipment. However, when an enterprise expects to use them during more than one accounting period or where they can be used only in connection with an item of property, plant and equipment and their use is expected to be irregular, then they are accounted for as fixed assets and depreciated over a time period not exceeding the useful life of a related asset.

5.2.3 Separate Components

In some circumstances, it is necessary to account separately for the various components of an asset. AC 123 gives the example of an airplane and its engines; the engines may have a different useful life to the airplane and care should be exercised in allocating the total cost of the airplane between the engines and the rest of the craft. The two components of the cost of the airplane are then depreciated over their respective useful lives.

5.2.4 Safety Equipment

Safety equipment and other equipment acquired to meet environmental regulations qualify for recognition as assets if the resulting carrying amount of the equipment and its related assets does not exceed the total recoverable amount from those assets.

5.3 Carrying Amount

5.3.1 Determining the Cost

Property, plant and equipment are initially measured at cost. The cost of an item of property, plant and equipment includes all expenses necessary in bringing it to its working condition or its intended use and may include:

- import duties

- non refundable purchase taxes
- site preparation costs
- delivery and handling costs
- installation costs, and
- professional fees (e.g. architects/engineers).

Trade discounts or rebates are excluded from the cost of property, plant and equipment while administrative and general overheads are not normally included in the cost of property, plant and equipment. In addition, start up and pre-production costs are only included in the cost of an asset if they are necessary to bring the item of property, plant and equipment to its working condition.

5.3.2 Construction of Property, Plant and Equipment

When property, plant and equipment are produced or constructed rather than purchased, then all directly attributable costs should be included in the production cost. The production cost should be determined in the same way as inventory (see chapter 4), i.e. abnormal wastage of materials or labour and internal profit is excluded from the production cost. Note that AC 114 allows financing costs to be included in the cost of a fixed asset that has been produced or constructed (see chapter 6).

5.3.3 Exchange Transactions

Assets are sometimes acquired through an exchange transaction; i.e. an item of property, plant and equipment is acquired in exchange for another item of property, plant and equipment. The appropriate accounting treatment depends on whether or not the exchange includes similar or dissimilar assets.

Where the exchange involves dissimilar assets, then the cost of such an asset is equivalent to the **fair value** of the asset given up, adjusted by the amount of any cash or cash equivalents transferred. In effect, the exchange is accounted for as though a disposal of the asset given up took place.

In the case of an exchange involving similar assets, then the cost of the new asset is the carrying amount of the asset given up unless the fair value of the asset received provides evidence of an impairment in the carrying amount of the asset given up. In this case, the asset given up should firstly be written down and then assigned to the new asset.

5.3.4 Improvements and Repairs

Where subsequent expenditure is incurred on existing property, plant and equipment, it is necessary to identify whether the expenditure will give rise to future economic benefits that are in excess of the originally assessed standard of performance of the existing items of property, plant and equipment (AC 123 paragraph 25). This test ensures that if the expenditure is an enhancement, then it is added to the carrying amount of the asset whereas if the expenditure is a repair then it is expensed.

The classification of an expenditure between a repair and an improvement is often subjective. AC 123 (paragraph 26) provides specific guidance about improvements by listing the following examples:

- modification of an item of plant to extend its useful life, including an increase in its capacity;
- upgrading machine parts to achieve a substantial improvement in the quality of output; and
- adoption of new production processes enabling a substantial reduction in previously assessed operating costs.

Expenditure on repairs and maintenance is usually expensed since it restores, rather than increases, the originally assessed standard of performance.

In certain circumstances, costs incurred subsequent to acquisition are capitalised because the purchase price reflected the enterprise's obligation to incur future expenditure. AC 123 (paragraph 28) gives an example of the acquisition of a building that requires renovation. In this case, the renovation costs are added to the carrying amount of the asset to the extent that they can be recovered from future use.

5.4 Depreciation

5.4.1 Economic Benefits Consumed

An item of property, plant and equipment is capitalised as an asset when its cost can be measured reliably and it is probable that future economic benefits associated with that asset will flow to the enterprise. It follows, therefore, that the carrying amount of the asset should be reduced to reflect the consumption of economic benefits embodied in the asset. This is achieved through a depreciation charge.

The amount of an item of property, plant and equipment that is subject to depreciation is known as the depreciable amount. This is the cost (or

valuation) of the asset less any estimated residual value. The depreciable amount should be allocated on a systematic basis over its useful life. This allocation should, as far as possible, match the consumption of economic benefits.

Economic benefits are consumed when an asset is used. In addition, obsolescence may result in a diminution of the originally estimated economic benefits. The following factors, therefore, need to be considered when assessing an asset's useful life:

- expected usage of the asset
- expected physical wear and tear of the asset
- technical obsolescence
- legal or other limits on the use of the asset.

The estimate of the useful life is a subjective exercise based on judgement. The useful life is not necessarily as long as an asset's economic life, i.e. the useful life is assessed in terms of the asset's expected utility to the enterprise. For example, a motor vehicle may be expected to have a five year useful life for an enterprise even though its economic life may be seven or more years. Useful lives should be reviewed regularly. The significant use by an enterprise of assets with a net total value of nil is often indicative of inappropriate depreciation policies, since the enterprise is not estimating useful lives properly.

It should be noted that depreciation arises from the consumption of economic benefits which bear a close relationship to the **cost** of an asset; i.e. depreciation is no more than the allocation of a historical cost to a period in which economic benefits are consumed. An increase in the value of an item of property, plant and equipment does not, therefore, negate the need for depreciation.

With the exception of land, which is usually assumed to have an indefinite useful life, all items of property, plant and equipment are depreciated. Although land and buildings are often combined by enterprises, AC 123 points out that land and buildings are separable assets and should be dealt with separately for accounting purposes. Buildings have a limited life and are therefore depreciable assets and an increase in the value of land on which a building stands should not affect the determination of the useful life of a building. (In certain circumstances, land and buildings may be treated as long term investments and not depreciated. Refer to section 5.8 for further discussion of investment properties.)

The revaluation of an asset (see section 5.5) does not eliminate the requirement that it should be depreciated, if it has a limited useful life.

Circumstances sometimes arise where the purchase of an asset results in the enterprise incurring dismantling, removal or restoration costs at the end of the asset's useful life. In terms of AC 123, these costs are recognised as an expense over the life of the asset, either by reducing the anticipated residual value by the expected cost or by providing for the costs as a separate expense over the life of the asset.

5.4.2 Depreciation Method

As noted above, depreciation should be allocated on a systematic basis that matches the expected pattern of economic benefits. There are, therefore, a number of different methods of providing depreciation. AC 123 does not provide an exhaustive list of possible methods of depreciation but highlights the three more common methods, namely the straight line method, the diminishing (or reducing) balance method and the sum of the units (or unit of production) method. These three methods and the sum of the digits method are illustrated below:

- (a) **Straight line.** This is the simplest and easiest method to apply. The cost, less residual value, is written off in equal parts over the asset's life. For example, if an asset is purchased for R99 000 and is expected to last for six years with a residual value of R9 000 then the depreciable amount is $R99\,000 - R9\,000 = R90\,000$, giving an annual depreciation charge of R15 000 ($R90\,000/6$).
- (b) **Diminishing balance.** This method, more commonly known in SA as reducing balance, is based on the argument that the total costs associated with an asset should be spread fairly over the asset's life. In order to achieve this, less depreciation is charged in later years because a higher cost for repairs and maintenance usually arises in the later years. The method is usually applied by using a simple percentage that is multiplied by the current carrying amount of an asset. For example, an asset costing R90 000 is to be depreciated at 25% using the diminishing balance method. The depreciation in year 1 is $R90\,000 \times 25\% = R22\,500$. This leaves a carrying amount of R67 500 and the depreciation charge in the second year is $R67\,500 \times 25\%$ which equals R16 875. The process continues in a similar way each year. Notice that the carrying amount of the asset will never reach zero as the depreciation charge is a constant proportion of the carrying amount and becomes less and less each year.
- (c) **Sum of the units.** This method ensures that the asset is written off in

line with its total estimated output. The formula applied is the original value of the asset multiplied by the value of the annual output divided by the total expected value of output from that asset. For example, if an asset is estimated to have an output of 100 000 units and in the first year the actual output is 15 000 then the depreciation percentage will be $15/100$ i.e. 15% and the depreciation charge will be $15\% \times$ the original value.

- (d) **Sum of the digits.** This method is a variation of the diminishing balance method in that the depreciation charge falls by a fixed amount each year. The method is calculated by summing the digits of the number of years over which an asset is to be depreciated and applying a proportion each year of the amount of the total sum of the digits. For example, if an asset costing R50 000 is depreciated over five years using the sum of the digits method, then the depreciation is calculated on a proportion of $5 + 4 + 3 + 2 + 1 = 15$. Therefore, the depreciation charge each year is:

Year 1	=	5	÷	15	×	50 000	=	16 667
Year 2	=	4	÷	15	×	50 000	=	13 333
Year 3	=	3	÷	15	×	50 000	=	10 000
Year 4	=	2	÷	15	×	50 000	=	6 667
Year 5	=	1	÷	15	×	50 000	=	3 333
Total								<u>50 000</u>

The depreciation method for an asset should be selected based on the expected pattern of economic benefits and should be consistently applied from period to period unless there is a change in the expected pattern of economic benefits from that asset.

5.4.3 Review of Useful Life

During the life of an asset it may be necessary to review the useful life because the original estimate of useful life becomes inappropriate. Technological factors or improvements to an asset may result in an increased or reduced useful life of the asset. The adjustment to the useful life of an asset should never be treated as giving rise to a prior year adjustment. Such an adjustment is deemed to be a change in estimate and in terms of AC 123 "the depreciation charge for the current and future periods should be adjusted". For example, if a company purchased an asset for R450 000 three years ago and the original expected useful life was six years and the asset has been depreciated on the straight line basis for the previous two years and it has now been decided that the asset will only last five years, then the depreciation charge is adjusted as follows:

Carrying amount before review of useful life = 300 000 ($450\,000 \times 2/6$)

Remaining useful life = 3 years

Therefore, annual depreciation charge = 100 000.

The asset is therefore depreciated on the following basis over the five year useful life:

Year 1	75 000
Year 2	75 000
Year 3	100 000
Year 4	100 000
Year 5	100 000
Total	<u>450 000</u>

Alternatively, "catch-up" depreciation could be accounted for in year 3:

Year 1	75 000
Year 2	75 000
Year 3	120 000
Year 4	90 000
Year 5	90 000
	<u>450 000</u>

The depreciation in year 3 is calculated as follows:

$R450\,000 \div 5 = R90\,000$ of depreciation assuming a five year useful life, plus $2 \times (90\,000 - 75\,000)$, being "catch-up" depreciation for years 1 and 2 where depreciation of R75 000 and not R90 000 (based on the revised estimated useful life) was charged.

Either of these two approaches appear to be sanctioned by AC 123 in that the depreciation for the current and future periods is adjusted in both cases.

5.4.4 Review of Depreciation Method

Method A change in the depreciation method is allowed by AC 123 if there has been a significant change in the expected pattern of economic benefits relating to an asset. "When such a change in depreciation method is necessary the change should be accounted for as a change in accounting estimate and the depreciation charge for the current and future periods should be adjusted" (AC 123 paragraph 56). As with a change in the useful life of an asset, note that a change in depreciation method is not a change in accounting policy and therefore cannot be treated as a prior year adjustment. The carrying amount should be written off over the remaining useful life starting with the year in which the depreciation method is changed.

For example, assume that a company purchased an item of plant three years ago at a cost of R90 000. Previously, the company depreciated the plant at 15% on the diminishing balance method but in the current period (i.e. the third year of ownership) decided that it should be written off on the straight line basis over the four remaining years of its useful life of seven years. The carrying amount of the asset will be determined as follows:

	R
Cost	90 000
Year 1 Depreciation	(13 500)
Year 2 Depreciation (76 500 × 15%)	<u>(11 475)</u>
Net book value at start of Year 3	<u>65 025</u>

Therefore, the depreciation charge on the straight line basis in years 3 to 7 will be R13 005 (65 025 ÷ 5).

Alternatively, “catch-up” depreciation could be accounted for in the same way as shown in section 5.4.3 above.

5.4.5 Diminution in Value

Where an asset has fallen in value then it should be written down to its new value. For example, the usefulness of an item of property, plant and equipment may be impaired by damage or technological obsolescence or other economic factors. This impairment may result in the recoverable amount (see section 5.1.2 on Definitions) being less than the carrying amount of the asset. In this case a write down of the asset is necessary.

AC 123 requires the amount of the reduction in the carrying amount to “be recognised as an expense immediately, unless it reverses a previous revaluation in which case it should be charged to equity”, i.e. the revaluation surplus (see section 5.5.3) (AC 123 paragraph 57).

Note that the recoverable amount of individual assets, or groups of identical assets, is determined separately and the carrying amount reduced to recoverable amount on an individual asset, or group of identical assets, basis.

Where there is a subsequent increase in the recoverable amount of an asset that has been written down, then the previous write down can be written back when the circumstances and events that led to the write down or write off cease to exist, and there is persuasive evidence that the new circumstances and events will persist for the foreseeable future. The amount written back is reduced by the amount that would have been recognised as depreciation had the write down or write off not occurred.

For example, if an asset purchased three years ago for R100 000 and depreciated on the straight line basis over ten years was **written down** by R10 000 in year 3 then the carrying value at the end of year 3 is R60 000 (depreciation of $R10\,000 \times 3 + R10\,000$ write down). The depreciation charge in year 4 will be based on the carrying amount of R60 000 over the remaining useful life of seven years, i.e. R8 571. If at the end of year 6 the circumstances that gave rise to the write down in year 3 no longer exist then that write down may be reversed but must be reduced by the depreciation that would have been recognised, i.e. R10 000 p.a. had the write down not occurred. Note that in years 4, 5 and 6 depreciation of R8 571 was charged whereas R10 000 would have been charged had the write down not occurred, i.e. the effect of the write down on depreciation charged in years 4, 5 and 6 is R4 287 ($(R10\,000 - R8\,571) \times 3$). Therefore, the write back at the end of year 6 is R5 713 ($R10\,000 - R4\,287$) and the net book value of the asset is as originally anticipated at the end of year 6, i.e. R40 000 ($60\,000 - 8\,571 - 8\,571 + 5\,713$).

5.5 Revaluations

5.5.1 Fair Value

The revaluation of property, plant and equipment is allowed by the alternative accounting treatment envisaged by AC 123. An overriding criteria is that an item of property, plant and equipment may only be revalued when the **entire class** relating to that item of property, plant and equipment is revalued. A class of property, plant and equipment is a grouping of assets of a similar nature and use in an enterprise's operations. AC 123 (paragraph 39) lists the following examples of separate classes:

- land
- land and buildings
- machinery
- ships; aircraft
- motor vehicles
- furniture and fixtures
- office equipment.

Where an item of property, plant and equipment is revalued then the asset is carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation. AC 123 notes that

revaluations should be made with sufficient regularity such that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date.

The fair value of land and buildings is normally determined by external valuers and is based on its market value for existing use, which presupposes continued use of the asset in the same or a similar business. Sometimes internal valuers are used where there is an internal property department that has a large number of qualified valuers.

The fair value of items of plant and equipment is usually the market value determined by appraisal. If the market value is not easily determinable then property, plant and equipment can be valued at depreciated replacement cost. In all cases property, plant and equipment is valued on the basis of its existing use.

5.5.2 Frequency of Revaluations

Usually, revaluations are only required every three to five years, but the frequency of revaluations depends upon the level of movements in fair value of items of property, plant and equipment. When the fair value of a revalued asset differs materially from its carrying amount then a further revaluation is necessary.

5.5.3 Revaluation Surplus

When an item of property, plant and equipment is revalued, the amount of the revaluation is credited to a revaluation surplus which is a non distributable reserve included in an enterprise's equity. The amount of the revaluation surplus is the net increase in the net book value of the asset that has been revalued. AC 123 allows two possible treatments for the accumulated depreciation at the revaluation date. The accumulated depreciation may either be restated to reflect the change in the gross carrying amount of the asset or may be eliminated against the gross carrying amount of the asset. The following example illustrates the two possible approaches.

Assume that a company purchased an asset four years ago for R100 000. The asset was being depreciated on the straight line basis over ten years. The company decided to revalue the asset at the end of the fourth year and the fair value of the plant was considered to be R75 000 at that date. If the company wishes to show the asset at its gross carrying amount and to proportionately restate the accumulated depreciation then the revaluation journal entry would be as follows:

Dr	Asset	25 000	
	Cr Accumulated Depreciation		10 000
	Cr Revaluation Surplus (NDR)		15 000

Notice that the asset is now stated at "cost" of R125 000 ($100 + 25$) less accumulated depreciation of R50 000 ($40 + 10$), i.e. a carrying amount or net book value of R75 000. The net increase in the carrying amount is R15 000.

Alternatively, the company may elect to eliminate the accumulated depreciation at the date of the revaluation and to show the asset at the net revalued amount of R75 000. This is achieved by the following entry.

Dr	Accumulated Depreciation	40 000	
	Cr Asset		25 000
	Cr Revaluation Surplus (NDR)		15 000

The increased carrying amount of R15 000 will be depreciated over the remaining useful life of the asset, i.e. 6 years. Annual depreciation will, therefore, amount to R12 500 (R10 000 historical cost depreciation and R2 500 revaluation depreciation). Paragraph 43 of AC 123 allows the revaluation surplus (R15 000) to be transferred to retained earnings as the asset is depreciated, i.e. R2 500 p.a. will be transferred from NDR to retained earnings each year. Alternatively, the revaluation surplus is left intact as a capital maintenance reserve and not transferred to retained earnings as the asset is depreciated.

If there is a subsequent impairment in the value of the revalued asset then the amount of the decrease in value should be taken from the revaluation surplus. If the amount of the impairment exceeds the original amount of the revaluation then the excess would be charged as an expense in the income statement. Similarly, "a revaluation increase should be recognised as income to the extent that it reverses a revaluation decrease of the same asset previously recognised as an expense" (AC 123 paragraph 41).

AC 123 states that the revaluation surplus may be transferred directly to retained earnings when the surplus is realised. The surplus is realised on the disposal of the asset or as the asset is used by the enterprise. Therefore, the difference between profit on sale based on the revalued carrying amount of an asset and profit on sale based on the asset's original cost could be transferred from the revaluation surplus directly to retained earnings when a revalued asset is sold.

5.6 Financial Statement Presentation

5.6.1 Accounting Policy

Suitable wording for an accounting policy on property, plant and equipment may be as follows:

Land and buildings are valued on an open market basis every three years. The revaluation surplus is credited to non distributable reserves. On disposal, the net revaluation surplus is transferred to retained earnings while profits or losses on disposal based on current values, are credited or charged to income.

Plant, equipment and vehicles are stated at historical cost less accumulated depreciation. Depreciation is calculated to write off the cost on a straight line basis over the expected useful life of the assets.

Note that rates of depreciation or useful lives should be disclosed as part of the accounting policy where these are considered to be meaningful. Disclosure of the rates and useful lives is usually only meaningful when there is not a large range of rates or useful lives.

5.6.2 Companies Act

Schedule 4 to the Companies Act has the following requirements relating to property, plant and equipment:

- | | |
|-----------------|--|
| Paragraph 20 | Fixed assets, capitalised leased assets, current assets and assets that are neither fixed nor current should be separately identified |
| Paragraph 21 | The method used to arrive at the amount of fixed assets should be stated |
| Paragraph 22(1) | <p>The method of arriving at the amount of any fixed asset whether tangible or intangible shall be to take the difference between –</p> <ul style="list-style-type: none"> (a) its cost, or if it has been revalued, the amount of the valuation; and (b) the aggregate amounts provided or written off since the date of acquisition or valuation, as the case may be, for depreciation or diminution in value. |
| Paragraph 22(2) | <p>In respect of the assets referred to in paragraph 22(1), the following should be shown –</p> <ul style="list-style-type: none"> • the aggregate of cost or valuation; and • the aggregate of accumulated depreciation and provisions for diminution in value. |

- Paragraph 22(3) In respect of land and buildings:
- description and situation
 - date of acquisition
 - purchase price
 - cost of additions or improvements since acquisition or valuation.

If there are more than five different items of land and buildings then the information may be included in a separate register or schedule.

- Paragraph 22(4) In the case of revalued land and buildings:
- description and situation
 - most recent year of valuation
 - names and qualifications of valuers in respect of valuations carried out in the current year
 - basis of valuation
 - policy regarding frequency of valuation.

If there are more than five different items of land and buildings then the information may be included in a separate register or schedule.

- Paragraph 42(o) Amount charged to income by way of provisions, specifying the nature (e.g. diminution in value).

- Paragraph 44 If depreciation is not provided for or some other method than depreciation is used then the fact of not providing depreciation or the other method used should be disclosed.

5.6.3 AC 123

AC 123 incorporates the disclosure requirements of Schedule 4 in addition to certain other requirements:

- in respect of each class of property, plant and equipment:
 - measurement basis;
 - depreciation method;
 - useful lives or depreciation rates;
 - gross carrying amount and accumulated depreciation at the beginning and end of the period;
 - reconciliation of carrying amount at the beginning and end of the period showing (where applicable):

- ★ additions,
 - ★ disposals,
 - ★ acquisitions through business combinations,
 - ★ revaluation movements,
 - ★ provisions for write downs/write backs in value,
 - ★ depreciation,
 - ★ exchange differences arising on translation, and
 - ★ other movements;
- details of any restrictions on title or pledges of property, plant and equipment;
 - accounting policy for restoration costs (where applicable);
 - expenditure on property, plant and equipment under construction;
 - commitments for the acquisition of property, plant and equipment;
 - whether discounting techniques have been used to determine recoverable amount; and
 - in respect of property, plant and equipment that is revalued:
 - basis of valuation,
 - effective date of valuation,
 - whether valuer was independent,
 - nature of indices used (where applicable),
 - the carrying amount of each class of revalued property, plant and equipment at cost less accumulated depreciation, and
 - revaluation surplus and the movement thereon for the period.

5.7 Taxation

5.7.1 Deferred Taxation

The accounting treatment for property, plant and equipment often gives rise to deferred taxation because of the timing difference between the recognition of depreciation for accounting purposes and wear and tear allowances granted by the Receiver of Revenue. These timing differences are accounted for in the normal way (see chapter 2).

Where an item of property, plant and equipment is revalued, then a permanent difference arises between accounting income and taxable income because the revaluation is not recognised by the Receiver of Revenue. A revaluation of an item of plant, for example, would give rise to depreciation charges that are in excess of the historical cost based depreciation. This extra depreciation is not recognised for tax purposes and therefore represents a permanent difference. This permanent difference would be identified in the tax reconciliation disclosure that is required by AC 102 (refer chapter 2).

5.8 Investment Properties

Investment properties may be accounted for as property in accordance with AC 123 or in accordance with the relevant paragraphs in AC 106 (refer section 5.1.1).

AC 106 defines investment properties as those “which, based on intention and the particular circumstances, are classified as such by management” (paragraph 07). The key determinant, therefore, is one of management intention. In contrast, IAS 25 defines an investment property as “an investment in land or buildings that are not occupied substantially for use by, or in the operations of the investee enterprise or another enterprise in the same group as the investing enterprise” (paragraph 04). The international accounting standard’s definition centres around two issues:

- the land or buildings must be held for investment purposes; and
- the land or buildings should not be substantially owner-occupied.

In terms of both AC 106 and IAS 25, investment properties may either be treated as depreciable assets and accounted for in accordance with AC 123 (or IAS 16 (revised)), or classified as investments and not depreciated. Where an investment property is treated as an investment, in terms of AC 106, it is stated at cost and disclosure is made of the most recently determined open market value. IAS 25 allows the investment to be carried in the balance sheet at either cost or revalued amounts. Similar disclosure about open market value is required.

The definition of investment properties in AC 106, because it is based on management intention, provides preparers of financial statements with considerable scope to avoid the depreciation of buildings. In addition, the definition makes no mention of owner-occupied properties.

5.8.1 Depreciation of Properties

There is a general assumption that items of property, plant and equipment

should be depreciated. These assets all have limited useful lives and economic benefits are consumed when they are used. It is, however, generally accepted that land has an indefinite useful life and does not, except for specialised circumstances, consume economic benefits when used. Thus, land should not be depreciated but buildings, plant and equipment should be depreciated by a systematic allocation of the costs thereof to match against related revenues. This depreciation arises from the consumption of economic benefits and is no more than the allocation of a historical cost to the period in which economic benefits are consumed, presumably in an effort to generate further benefits, i.e. profits.

The overriding presumption of the depreciation argument is that assets are held for **use** in the generation of economic benefits. In contrast, if an asset is held for investment purposes then it is the **current value** of such an asset that is important, not its depreciated historical cost. It is therefore also the current value that needs to be included in the financial statements in order to provide a proper understanding of the position of the enterprise. It is argued that the calculation of a depreciation charge would not be useful to the user of such financial statements. Therefore, an item of property held for investment purposes need not be depreciated; the change in its fair value is considered more significant than its depreciation.

Most South African companies that hold investment properties do not depreciate them; instead they are carried at cost and the open market value is disclosed. This allows users to assess the current value of the investment properties.

5.8.2 Specialised Buildings

AC 106 defines a specialised property as “that kind of property which is rarely, if ever, sold except by way of a sale of the business in occupation due to the specialised nature of the buildings, their construction, arrangement, size, location or otherwise” (paragraph 21). A specialised property is not classified as an investment property unless it can be bought and sold or leased in the open market and can be valued by reference to its trading potential, for example a hotel or a cinema. Non-specialised properties are those for which there is general demand and which can generally be bought and sold or leased in the open market with vacant possession.

IAS 25 does not address the issue of specialised versus non-specialised properties.

5.8.3 Disclosure

Where investment properties are treated as depreciable assets then the disclosure requirements of AC 123 (refer section 5.6.3) apply.

Where investment properties are not treated as depreciable assets then in terms of AC 106 the following should be disclosed:

- the carrying values;
- the most recently established open market values;
- the effective date of valuation;
- whether the valuation was independent or internal; and
- any provision made to recognise permanent declines in value.

In addition, if management considers that factors have occurred since the most recent valuation to render its use and disclosure misleading then these factors should be disclosed.

5.8.4 Owner-occupied Properties

Properties AC 106 makes no reference to owner-occupied properties in the definition of investment properties. This is in contrast to IAS 25, SSAP 19 (UK), and SSAP 17 (New Zealand) where owner-occupied properties are excluded from the definition of investment properties. This exclusion is consistent with the arguments considered briefly above (section 5.8.1) relating to the *use* of an asset versus an *investment* therein. It is difficult to argue that an owner-occupied building is not consuming economic benefits and that it is available for re-sale in the ordinary investment sense. Therefore, it seems appropriate that owner-occupied properties be excluded from classification as investment properties. AC 106, however, allows owner-occupied buildings to be classified as investment properties, based on the intention of management. A number of South African companies follow this view and the implication of adopting IAS 25 in the future is therefore significant.

6 Borrowing Costs

6.1 Introduction

6.1.1 Borrowing Costs

Borrowings costs are regularly incurred by enterprises during the normal course of their business operations. Where borrowing costs are incurred in order to finance the acquisition, construction or production of assets, it is often argued that these costs form part of the historical cost of the asset. Therefore, AC 114, Capitalisation of Borrowing Costs (revised March 1995), allows borrowing costs to be capitalised to the historical cost of qualifying assets provided that certain criteria are met. These criteria are considered, together with an example, in section 6.3.2.

As part of the South African Institute of Chartered Accountants' international harmonisation programme, ED 92, Borrowing Costs, was issued during February 1994. The revised AC 114 was issued in March 1995. AC 114 (revised) is based on IAS 23 (revised). The only difference in principle between ED 92 and AC 114 (revised) is that AC 114 (revised) requires borrowing costs to be expensed in the period incurred, but allows an alternative policy of capitalisation providing certain criteria are met, whereas ED 92 permits the alternative treatment only.

Usually, capitalised borrowing costs are those costs incurred that theoretically could have been avoided during the period if expenditures for certain qualifying assets had not been made. Borrowing costs need not arise from borrowings specifically made to acquire the qualifying assets. The amount of borrowing costs to be capitalised may be determined using the borrowing costs incurred on specific borrowings, using the weighted average cost of borrowings or a combination of the two.

Borrowing costs are capitalised to the historical cost of assets only when expenditures have been incurred and activities necessary to bring the asset to its intended use are in progress. Borrowing costs are not usually capitalised to the cost of inventory that is routinely manufactured or otherwise produced in large quantities on a repetitive basis.

6.1.2 Cost of Equity

The construction or acquisition of assets may be funded by both debt and equity. However, AC 114 does not deal with the imputed cost of equity,

including preference capital that is not classified as a liability. Therefore, where equity is used to finance the acquisition of a qualifying asset then the cost of that equity may not be capitalised to the historical cost of that asset. This is in contrast to where debt is used and borrowing costs may be capitalised to the cost of the asset.

6.2 Conceptual Issues

6.2.1 Definitions

AC 114 defines borrowing costs as interest and other costs incurred by an enterprise in connection with the borrowing of funds. Examples of borrowing costs are:

- interest on bank overdrafts and short term and long term borrowings;
- amortisation of discounts or premiums relating to borrowings;
- amortisation of ancillary costs incurred in connection with the arrangement of borrowings;
- finance charges in respect of finance leases recognised in accordance with the statement on accounting for leases in the financial statements of lessees;
- exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs; and
- hedging costs, including premiums on forward exchange contracts and interest rate and currency options.

AC 114 describes expenditures on a qualifying asset as those expenditures that have resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities (paragraph 21).

Qualifying assets are defined as assets that necessarily take a substantial period of time to get ready for their intended use or sale (AC 114 paragraph 4). Examples of qualifying assets are inventory that requires a substantial period of time to bring it to a saleable condition, manufacturing plants, power generation facilities and investment properties. AC 114 does not elaborate on what is meant by “a substantial period of time”. This permits borrowing costs to be capitalised to inventory which has a long maturation period before it can be sold as an end product, for example wine or whisky. Assets that are ready for their intended use or sale when acquired are not qualifying assets.

6.2.2 Asset Recognition

AC 000 defines an asset as a resource controlled by the enterprise as a result of a past event and from which future economic benefits are expected to flow to the enterprise (paragraph 49(a)). The relevant test, therefore, for the capitalisation of borrowing costs is whether or not the borrowing cost will give rise to future economic benefits flowing to the enterprise. This implies that the historical cost of the asset combined with borrowing costs capitalised must be capable of recovery through future economic benefits. (This has implications when assessing the recoverable amount or the net realisable value of an asset and is considered further in section 6.3.4.) Therefore, borrowing costs that are directly attributable to the acquisition, construction or production of an asset may be included in the cost of that asset when it is probable that such borrowing costs will result in future economic benefits to the enterprise and the cost can be measured reliably. Otherwise, borrowing costs meet the definition of an expense and should be recognised as an expense in the period in which they are incurred.

6.3 Specific Issues

6.3.1 Capitalisation in Group Situations

Borrowings costs may only be capitalised if they are being incurred. Therefore, if a qualifying asset is financed by interest free borrowings from the holding company then a subsidiary may not capitalise any interest assuming it has no other borrowings. In this situation, capitalisation will take place at the consolidated level since at this level both a qualifying asset and borrowing costs exist. The holding company may capitalise interest on its investment in a subsidiary or in an associate when the activities preparatory to the commencement of the investee's planned operations are in progress. The investee's preparatory activities would usually include the use of funds to acquire qualifying assets for its operations. The capitalisation of borrowing costs would stop when the investee commences its planned operations.

6.3.2 Borrowing Costs Eligible for Capitalisation

Where an enterprise has adopted a policy of capitalisation then the borrowing costs that may be capitalised are those costs that are directly attributable to the acquisition, construction or production of a qualifying asset. The amounts of borrowing costs that are directly attributable are usually determined by considering those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. The amount

of borrowing costs capitalised should be before taking account of taxation, as this is consistent with all other capitalised costs. The tax effects of capitalising are then dealt with through the deferred tax account (see section 6.5.1).

Borrowing costs may only be capitalised when:

- expenditures on the asset are being incurred;
- borrowing costs are being incurred;
- activities that are necessary to prepare the asset for its sale or intended use are in progress.

As noted in section 6.2.1, expenditures should include only those expenditures that have resulted in payments of cash, transfers of other assets or the assumption of interest bearing liabilities. The average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the expenditures to which the capitalisation rate is applied in that period.

The activities necessary to prepare the asset for its intended use or sale include more than merely the physical construction of the asset. For example, technical and administrative work during the pre-construction stage and activities undertaken after construction has begun in order to overcome unforeseen obstacles are included in the ambit of activities. However, activities that relate to the holding of an asset when no production or development that changes the asset's condition is taking place are excluded. For example, "borrowing costs incurred while land is under development are capitalised during the period in which activities related to the development are being undertaken". However, borrowing costs do not qualify for capitalisation if incurred "while land acquired for building purposes is held without any associated development activity" (AC 114 paragraph 22).

Where an enterprise borrows specific funds for the purpose of obtaining a particular qualifying asset then it is usually a simple process to identify the borrowing costs incurred that directly relate to that qualifying asset. However, it is often difficult to identify a direct relationship between particular borrowings and a qualifying asset when, for example, the financing activity of an enterprise is co-ordinated centrally. In addition, in a group situation, the group may use a range of debt instruments to borrow funds at different interest rates and then lend those funds on various bases to other enterprises in the group. The net result is that the determination of the amount of borrowing costs that are directly attributable to the acquisition of a qualifying asset is difficult and the exercise of judgement is required.

Where there are no directly associated borrowings, then the capitalisation rate, where possible, should be based on the additional borrowings incurred as a result of the expenditure on the qualifying asset. Where this is not possible, the total average borrowing cost is acceptable. For example, if a company has average borrowings during 1901 of R10 million and the interest paid during the year amounted to R1,8 million, then the capitalisation rate should be 18% ($1,8 \div 10 \times 100/1$). This rate is then applied to the expenditure incurred on qualifying assets. The expenditure could have occurred on the following basis:

1 January	R400 000
1 March	R700 000
1 July	R1 000 000
1 November	R2 100 000

Assuming that the qualifying asset is still being constructed at year end (31 December) then the interest to be capitalised may be calculated as follows:

400 000 × 18% × 12/12 =	72 000
700 000 × 18% × 10/12 =	105 000
1 000 000 × 18% × 6/12 =	90 000
2 100 000 × 18% × 2/12 =	63 000
Total =	<u>330 000</u>

Note that the above calculation could have been performed by calculating the average expenditure during the period and then applying the average cost of borrowings of 18% i.e.

400 000 × 12/12 =	400 000
700 000 × 10/12 =	583 333
1 000 000 × 6/12 =	500 000
2 100 000 × 2/12 =	<u>350 000</u>
Total average expenditure =	<u>1 833 333</u> × 18% = R330 000

It is important to identify costs that are incurred at a specific point of time (i.e. in the above example) versus costs that are incurred over a period of time. For example, assume the same costs as the previous situation except that the expenditure of R400 000 on 1 January was actually incurred evenly over the two month period of January and February 1901. Because the costs of R400 000 were therefore accumulated over a two month period and not incurred at a specific point in time (i.e. on 1 January) it is necessary to average the expenditure in order to obtain a weighted average total of expenditure incurred. This weighted average expenditure may be calculated as follows:

400 000 × ½ (incurred evenly) × 2/12 (Jan and Feb) =	33 333
400 000 × 10/12 =	333 333
700 000 × 10/12 =	583 333
1 000 000 × 6/12 =	500 000
2 100 000 × 2/12 =	<u>350 000</u>
Total weighted average expenditure =	<u>1 800 000</u>
∴ Interest that may be capitalised is 1,8m × 18% =	R324 000

Notice that when the expenditure of R400 000 is assumed to have incurred evenly over the period January and February then the amount of borrowing costs capitalised is reduced when compared to the amount of costs capitalised when it is assumed that the expenditure was incurred in total on 1 January.

The amount of borrowing costs capitalised during a period should not exceed the total of borrowing costs incurred during that period (see section 6.3.4).

The above example considered the use of general borrowings to finance a qualifying asset. Where an enterprise borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified.

The financing arrangements may result in an enterprise incurring borrowing costs before some or all of the funds are used for expenditures on the qualifying asset. In these circumstances, the funds are often temporarily invested pending their use. In this case, it is necessary to offset any investment income against the borrowing costs incurred when determining the "amount of borrowing costs eligible for capitalisation during a period" (paragraph 15). Consider the following example:

A specific loan of R1m was raised on 1 January at 15%. R0,5m was spent on a qualifying asset immediately but the other R0,5m was spent only on 1 February. Interest at 13% was earned on the temporary investment of funds in January. The qualifying asset is still being constructed at 31 December.

In terms of AC 114, the borrowing costs eligible for capitalisation amount to R144 583 [(15% × 1 000 000) – (500 000 × 13% × ½)]; that is total borrowing costs incurred less interest income. On the basis that the general principle of AC 114 is that "those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made" should be capitalised (paragraph 13), it is submitted that the entire R144 583 be capitalised. AC 114 does not require the use of a capitalisation rate for specific borrowings, rather the borrowing costs capitalised are those incurred

less related investment income. This means that AC 114 capitalises the deficit arising from investing funds at a lower rate than the cost of obtaining such funds. To illustrate, in the above example, R500 000 was invested at 13% in January while those funds cost 15%. The net cost of this is $2\% \times 500\,000 \times \frac{1}{12} = R833$. AC 114 allows this cost to be capitalised to the qualifying asset.

6.3.3 Capitalisation Period

Where the criteria for capitalising borrowing costs are met then the capitalisation continues until substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete, unless active development has been interrupted.

Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted. These borrowing costs are holding costs of partially completed assets and therefore do not qualify for capitalisation. However, capitalisation should not cease for brief interruptions in activities, interruptions that are caused by external factors, and delays that are inherent in the asset acquisition process. For example, a strike action by workers for a brief period would not result in the suspension of the capitalisation of borrowing costs.

Capitalisation of borrowing costs cease when the asset is ready for its sale or intended use. An asset is normally ready for its sale or intended use when the physical construction of the asset is complete even though routine administrative work may still continue. This point in time is somewhat subjective but the judgement is similar to that required where fixed assets are constructed and the recognition of depreciation and other expenses commences. The important issue is that interest should not be capitalised in situations where final completion is intentionally delayed.

When the construction of an asset is completed in parts and each part is capable of being used or sold while construction continues on other parts then capitalisation of borrowing costs should cease on each part as it is completed (AC 114 paragraph 27).

For example, a business park comprising several buildings, each of which can be used individually, is an example of an asset for which each part is capable of being sold or used separately while construction continues on other parts.

6.3.4 Limit to Capitalisation

The amount of borrowing costs capitalised during a period should not exceed the total amount of borrowing costs incurred by the enterprise in the

period (AC 114 paragraph 17). Where the capitalisation of borrowing costs results in the carrying amount of the qualifying asset exceeding the net realisable value or the amount recoverable from its future use, the capitalisation of borrowing costs continues but a provision is made against the accumulated cost of the asset. The important issue is that net realisable value or the expected recovery of future economic benefits (recoverable amount) is not a factor that should limit the amount of borrowing costs capitalised. Rather, borrowing costs are capitalised if the criteria are met and the carrying value of an asset is assessed periodically against its net realisable value or recoverable amount and, if necessary, a provision for write down is made (which may subsequently reverse if no longer required).

6.3.5 IAS 23 and AC 114

As noted earlier, IAS 23 (revised) takes the view that borrowing costs should be expensed but allows the alternative of capitalisation provided that the criteria relating to qualifying assets are met. AC 114 (revised) adopts the same approach.

6.4 Financial Statement Presentation

6.4.1 Accounting Policy

Appropriate wording for an accounting policy may be as follows:

Borrowing costs are capitalised in relation to items of plant requiring a substantial period of time for preparation for sale or for intended use. If the capitalised cost of assets where borrowing costs have been capitalised exceeds the estimated recoverable amount then provision is made for such excess.

6.4.2 Companies Act

Schedule 4 to the Companies Act requires, in terms of paragraph 42 (f), "the amount of interest (or other consideration) on any loans, including debentures and bank overdrafts made to the company identifying the portion, if any, capitalised during the period" to be disclosed.

6.4.3 AC 114

The disclosure requirements of AC 114 are as follows:

- the accounting policy adopted for borrowing costs;

- the amount of borrowing costs incurred during the period, distinguishing between amounts capitalised and expensed; and
- the capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation.

6.5 Taxation

6.5.1 Deferred Taxation

Deferred taxation may arise where borrowing costs are capitalised as the Receiver of Revenue would normally allow the borrowing costs to be deducted in full in the year in which they arise (in terms of s11(a) or s11(bA)). This would give rise to timing differences between the recognition of borrowing costs for accounting purposes and taxation purposes. These timing differences should be treated in the normal way and would give rise to a deferred tax liability.

7 Construction Contracts

7.1 Introduction

The allocation of contract revenue and related expenses to accounting periods over the duration of a contract is the primary issue in accounting for construction contracts. The nature of construction activity is such that the date at which a contract is entered into and the date when a contract is completed often fall into different accounting periods.

AC 109, Construction Contracts, issued in August 1995 and based on IAS 11 (revised), defines a construction contract as “a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use”. Projects involving the construction of bridges, buildings, dams, pipelines, roads, ships and tunnels would therefore be classified as construction contracts. Contracts for the provision of services are regarded as construction contracts to the extent that they are directly related to a long term construction contract, for example project managers’ and architects’ services.

7.1.1 Types of Construction Contracts

There are a number of different types of construction contracts, for example lump sum (fixed price) contracts, schedule of rates contracts, cost plus contracts and guaranteed maximum price contracts. It is generally accepted that contracts can be separated into two classifications. Firstly, fixed price contracts in which the contractor agrees to a fixed contract price or a fixed rate per unit of output. Secondly, a cost plus contract in which the contractor is reimbursed for allowable or otherwise defined costs plus a percentage of those costs or a fixed fee.

Escalation clauses built in to fixed price contracts usually allow the amounts payable under a contract to be adjusted for increases or decreases in such items as wage rates, charges amended by statutory authorities, the ruling market price of material, freight, insurance premiums, import duties, rates of exchange and delivery charges.

7.2 Conceptual Issues

Long term construction contracts extend over more than one accounting period. The basic problem therefore is determining the period or periods in

which income should be recognised. Conceptually, elements of financial statements should be recognised (AC 000 paragraph 83) if:

- (a) it is probable that any future economic benefit associated with the item will flow to or from the enterprise; and
- (b) the item has a cost or value that can be measured with reliability.

The recognition of revenue and expenses relating to construction contracts, therefore, needs to be determined according to the above recognition criteria. Contract revenue and expenses should only be recognised when it is probable that future economic benefits associated with the revenue and expense will flow to or from the enterprise and the amount of expenses and revenue can be measured with reliability.

The probability associated with the reliable measurement of contract revenue and expenses becomes easier to assess as contract activity progresses.

7.2.1 Future Economic Benefits

The probability that future economic benefits will flow to an enterprise engaged in construction contract activity is dependent on the outcome of that activity. Only once that probability has been established can there be any degree of certainty about the future economic benefits associated with the contract. Once there is sufficient certainty about future economic benefits (i.e. revenue) that will flow to the enterprise then expenses associated with the contract may be capitalised and recognised as an asset, provided the expenses can be measured reliably.

7.2.2 Reliability

During the first stages of the contract it is often the case that the contract outcome cannot be estimated with any degree of reliability. However, when contract revenue can be measured reliably and the costs to complete a contract and the stage of contract completion at the accounting period date can be measured reliably then income (i.e. contract revenue less contract expense) should be recognised by reference to the stage of completion of the contract activity. The reliability of current estimates of future revenue and expenses is therefore a key factor when assessing the extent to which income associated with partial completion of a contract should be recognised.

7.2.3 Accounting Treatment

The accounting treatment of a construction contract depends therefore on whether or not the outcome of the contract can be measured reliably.

Where the outcome cannot be measured reliably then no income should be recognised. However, in order to correctly reflect the level of activity undertaken by the construction company, revenue should be recognised to the extent of costs incurred that are recoverable and contract costs should be recognised as expenses in the period when incurred. The recognition of such revenue and related costs provides useful information about the extent of contract activity in the period.

When the outcome of a construction contract can be estimated reliably then the revenue and expenses associated with the construction contract should be recognised by reference to the stage of completion at the balance sheet date. This implies recognition of a portion of the total anticipated contract income (i.e. revenue less expenses).

Where it is probable that total contract costs will exceed total contract revenues then the excess contract costs should be recognised immediately as an expense (see also section 7.4.3 below).

7.3 Recording

Revenue and costs are recognised during the period of the contract whereas, formerly, according to the previous AC 109, costs and contract profits/losses were accumulated in work in progress until the completion of the contract.

7.3.1 Completed Contract Method

The completed contract method has its origin in the prudence concept. This method recognises income only after all work on a contract is complete. (Minor costs which may occur at the end of a contract may be ignored when deciding whether or not a contract is complete.) The prudence concept has become dated and is not endorsed specifically by the framework (AC 000). In addition, AC 109 (revised and issued August 1995) does not sanction the use of the completed contract method.

An advantage of the completed contract method is that it does not depend upon estimates for income recognition and therefore eliminates any risk of recognising income that may not eventuate or is subject to subsequent adjustment. This method however does not conform with the framework in that revenue and any associated costs are not recognised even when the related economic benefits can be reliably measured. In addition, the completed contract method does not fairly report operating results in each accounting period. It often results in wide fluctuations in income between accounting periods.

7.3.2 Stage of Completion Method

The stage of completion method recognises income on the basis of the stage of completion of the contract activity at the end of each accounting period. The advantage of this method is that it reflects contract revenue and expenses in the accounting period during which the related activity was undertaken, i.e. the costs incurred in reaching the stage of completion are matched with the revenue, resulting in the reporting of income which can be attributed to the proportion of work completed.

The stage of completion of a contract can be determined in a number of ways. For example, the proportion that costs incurred for work performed to date bear to the estimated total costs of the contract would indicate activity based on costs incurred to date over total anticipated costs. Further examples of measuring the stage of completion of a contract may be surveys of work performed and completion of a physical proportion of the contract work or any combination of these methods.

The method adopted by a construction company should be the one that most closely approximates the stage of completion.

It should be noted that progress payments and advances received from customers do not necessarily reflect the stage of completion.

The following example illustrates the use of the stage of completion method:

Example

The XYZ Construction Company signs a contract on 1 August 1901 to construct a bridge. The contract price (fixed) is R17m and expected total costs are R15,2m. The bridge was completed in June of 1903.

Details of costs incurred and receipts are as follows:

		R000's		
31 DECEMBER	1901	1902	1903	
Costs to date	3 750	14 000	15 500	
Estimated additional costs to complete	11 450	1 500	NIL	
Progress billings	3 300	11 100	2 600	
Payments received from customers	3 000	10 500	3 500	

The estimated contract income (revenue) to be recognised each year can be calculated on the basis of the proportion that costs incurred to date bear to the estimated total costs as follows:

	(R000's)	
1901	Contract Price	<u>17 000</u>
	∴ Income recognised in 1901	
	= 3 750/15 200 × 17 000 =	<u>4 194</u>
	The contract is 24,67% complete	
1902	Contract Price	<u>17 000</u>
	∴ Estimated total income to year 1902	
	= 14 000/15 500 × 17 000 =	15 355
	Less: Recognised in year 1901	<u>4 194</u>
	Income recognised in 1902	<u>11 161</u>
	The contract is 90,32% complete	
1903	Total income (contract complete)	17 000
	Less: Recognised in previous years	<u>15 355</u>
	Income recognised in 1903	<u>1 645</u>

Note that the change in estimated costs (from 15 200 to 15 500) is taken into account when using the stage of completion method because the most recent estimate of expenses (and revenues if changed in terms of claims, incentives or variations) is used to calculate **cumulative** income to date. This is adjusted by income previously recognised (i.e. on the previous cost estimates) to ensure that total income recognised to date is accurate.

Note that in the above example, income in 1901 is based on the current estimates of costs (i.e. 1901 estimates). Had income in 1901 been recognised on the basis of 1902 cost estimates then it would have been calculated as $3\,750/15\,500 \times 1\,500 = 363$; and income in 1902 would have been $1\,355 - 363 = 992$ which is equivalent to the expected proportion of income relating to the costs actually incurred during 1902, i.e. $(14\,000 - 3\,750)/15\,500 \times 1\,500 = 992$. The income recognised in 1902 of 911 is, therefore, 992 relating to current year (1902) activity and 81 relating to a correction of the assessment of income in 1901.

The following summarises the stage of completion method:

	1901	R000's 1902	1903
Contract income (revenue)	4 194	11 161	1 645
Costs	<u>(3 750)</u>	<u>(10 250)</u>	<u>(1 500)</u>
∴ Net profit recognised	444	911	145
Amounts due to/from customers	894	955	NIL
Debtors	300	900	NIL

Note that the amounts due to/from customers account can be viewed as the net investment in the contract; that is the gross amount due to/from customers for contract work. This balance is the net amount of costs incurred plus recognised profits, less the sum of recognised losses and progress billings (refer AC 109 paragraphs 43 and 44). This is illustrated for the above contract:

1901: $4\,194\text{ (a)} - 3\,300 = 894$
 1902: $894 + 11\,161\text{ (b)} - 11\,100 = 955$
 1903: $955 + 1\,645\text{ (c)} - 2\,600 = \text{NIL}$

(a) $3\,750 + 444 = 4\,194$
 (b) $10\,250 + 911 = 11\,161$
 (c) $1\,500 + 145 = 1\,645$

The accounting entries may be recorded as follows:

1901			
(i) Dr	Contract expenses	3 750	
	Cr Creditors/Cash		3 750
	Recognition of costs incurred.		
(ii) Dr	Debtors	3 300	
	Cr Amounts due to/from customers		3 300
	Accumulation of amounts billed during the year.		
(iii) Dr	Cash	3 000	
	Cr Debtors		3 000
	Recognition of cash received.		
(iv) Dr	Amounts due to/from customers	4 194	
	Cr Contract revenue		4 194
	Recognition of current year's revenue.		
1902			
(i) Dr	Contract expenses	10 250	
	Cr Creditors/Cash		10 250
	Recognition of costs incurred.		
(ii) Dr	Debtors	11 100	
	Cr Amounts due to/from customers		11 100
	Accumulation of amounts billed during the year.		
(iii) Dr	Cash	10 500	
	Cr Debtors		10 500
	Recognition of cash received.		
(iv) Dr	Amounts due to/from customers	11 161	
	Cr Contract revenue		11 161
	Recognition of current year's revenue.		

1903			
(i)	Dr Contract expenses	1 500	
	Cr Creditors/Cash		1 500
	Recognition of costs incurred.		
(ii)	Dr Debtors	2 600	
	Cr Amounts due to/from customers		2 600
	Accumulation of amounts billed during the year.		
(iii)	Dr Cash	3 500	
	Cr Debtors		3 500
	Recognition of cash received.		
(iv)	Dr Amounts due to/from customers	1 645	
	Cr Contract revenue		1 645
	Recognition of current year's revenue.		

The balances of amounts due to/from customers would, therefore, be as follows for each respective year:

1901: 4 194 – 3 300 = 894
1902: 894 + 11 161 – 11 100 = 955
1903: 955 + 1 645 – 2 600 = NIL

7.4 Specific Issues

7.4.1 Conservative Use of Stage of Completion Method

Some companies who use the stage of completion method have a policy that no profits should be recognised on a contract until it has reached a given stage of completion. For example, XYZ Construction Company might have a policy that states “profit is only recognised under the stage of completion method in long term construction contracts which are at least 60% complete”.

This conservative use of the stage of completion method exists as a result of the uncertainty inherent in estimating costs to complete construction contracts, particularly during the early stages of the construction period. A problem with this practice is that reported income can be distorted because income is not recognised proportional to the work carried out during any accounting period. This is particularly the case where the higher the minimum percentage becomes, the closer this method comes to the completed contract method. A further problem is where companies are allowed to vary this minimum percentage from year to year and from contract to contract. In this way net income can be increased or decreased at management’s discretion.

AC 109 gives guidance about the conservative use of the stage of completion method. The statement requires the use of the stage of completion method unless the outcome of a construction contract cannot be measured reliably. Where reliable measurement is not possible then revenue should be recognised only to the extent of costs incurred that are recoverable and contract costs should be recognised as an expense in the period when incurred. This approach sanctions use of the completed contract method only until reliable measurement of future revenue and costs is possible. From that period on, construction contracts would be recognised using the stage of completion method. This is a logical extension of the principles examined above under conceptual issues.

The advantage of the IAS approach (i.e. AC 109) is that a company is not fixed to a particular (and somewhat arbitrary) stage of completion prior to recognising profits. This makes it more difficult to manipulate profits by continually changing the minimum percentage from year to year or conservatively applying a set minimum percentage to construction contracts. Furthermore, this approach recognises that in certain cases the reliability of future revenue and expenses is so uncertain that income might well not be recognised until a contract is, say, 80% complete whereas income might be recognised on other contracts which are only, say, 10% complete but future revenue and expenses can be reliably measured.

7.4.2 Accumulation of Costs

AC 109 identifies three different groups of costs relating to construction contracts. These three groups are:

- (1) costs that relate directly to a specific contract;
- (2) costs that are attributable to the contract activity in general and can be allocated to a contract;
- (3) costs that are specifically chargeable to the customer under the terms of the contract.

Costs that relate directly to a specific contract would include:

- (a) labour costs (including supervision);
- (b) materials used;
- (c) depreciation of plant and equipment used on the contract;
- (d) costs of moving plant and equipment to or from the contract site;
- (e) costs of hiring plant and equipment;

- (f) costs of design and technical assistance that is directly related to the contract;
- (g) expected warranty costs and claims from third parties (for example, sub-contractors or penalties against the contractor arising from delays in the completion of the contract or from other causes).

Costs that relate to the contract activity in general and can be allocated to specific contracts include:

- (a) insurance;
- (b) design and technical assistance;
- (c) construction overheads;
- (d) borrowing costs (capitalised in terms of AC 114/IAS 23).

These costs are allocated using methods that are systematic and rational and are applied consistently to all costs having similar characteristics. Construction overheads would include costs such as the preparation and processing of construction personnel payroll.

Costs which are specifically chargeable to the customer under the terms of the contract may include some general administration costs and development costs for which reimbursement is specified in the terms of the contract. General costs which cannot be attributed to the contract activity or cannot be allocated to a contract are excluded from the accumulated contract costs. These costs would include:

- (a) general administration and selling costs;
- (b) research and development costs;
- (c) depreciation of idle plant and equipment that is not used on a specific contract.

AC 109 gives guidance as to the correct treatment of the costs incurred in securing the contract (e.g. tendering costs). Generally, only costs attributable to a contract for the period from the date of securing the contract to the completion of the contract may be accumulated in contract costs. Costs incurred in securing the contract may also be included in accumulated contract costs if they can be separately identified and measured reliably and it is probable that the contract will be obtained.

7.4.3 Recognition of Losses

AC 109 states that when it is probable that total contract costs will exceed

total contract revenue, the expected loss should be recognised as an expense immediately.

If a provision for loss is required, the amount of such loss is provided for irrespective of:

- (a) whether or not work has commenced on the contract;
- (b) the stage of completion of contract activity; or
- (c) the amount of profits expected to arise on other contracts.

In providing for expected losses on construction contracts, the future income tax benefits that will accrue should be taken into account, subject to there being a reasonable likelihood of future taxable income to offset those losses against.

A practical issue not considered by AC 109 is circumstances where contracts are accepted with anticipated future losses so as to avoid larger losses in future years caused by a sub-optimal use of capacity. It is submitted that if there is sufficient certainty about the avoidance of losses in future years then the losses anticipated in the short term should be attributed to those future periods in proportion to the activities performed, i.e. the losses (or expenses incurred) meet the definition of an asset as the probability of future economic benefits is reasonably assured. Such losses carried forward would have to be fully disclosed.

7.4.4 Claims and Variations

Claims arise in construction contracts where the contractor claims additional compensation above the contract price because of occurrences such as customer caused delays, errors in specifications and designs, and other unforeseen reasons which caused additional costs to the contractor. The contractor seeks to collect from his client or other parties reimbursement for costs not included in the contract price.

Variations are instructions from the contractor's client for a change in the scope of the work to be performed in terms of the contract. For example, increases or decreases of any proportion of the work under the contract; changes in the quality of any material, equipment or work; varying the contract programme or the order of the work under the contract; execution of any part of the work under the contract outside normal or agreed upon working hours; and the execution of additional work not agreed upon in the terms of the original contract.

The concepts of AC 000 would hold that claims and variations in contract

work should only be recognised to the extent that it is probable they will result in future revenue and the claims or variations are capable of being reliably measured.

According to AC 109, a variable is included in contract revenue when:

- (a) it is probable that the customer will approve the variation and the amount of revenue arising from the variation, and
- (b) the amount of revenue can be reliably measured.

According to AC 109, claims are only included in contract revenue when:

- (a) negotiations have reached an advance stage such that it is probable that the customer will accept the claim, and
- (b) the amount that will probably be accepted by the customer, can be measured reliably.

In the example above, if it was demonstrated that the increase in estimated total costs in 1902 was attributable to a claim or variation then the contract price would have increased by a similar (or larger) amount. The income recognised in 1902 would have been based on not only the revised estimate of total costs but also the revised total contract price.

7.4.5 Retentions

Retentions are portions of progress billings which are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified.

AC 109 requires separate disclosure of the amount of retentions at the end of an accounting period.

In the above example, debtors of R300 in 1901 and R900 in 1902 may have included retention amounts due of, say, R200 and R800. These would be separately disclosed as retention debtors under current assets in the balance sheet.

7.4.6 Contingency Provisions

Contracts sometimes contain provision for rewards or penalties that exceed or fall short of various performance standards. For example, a contract may allow for an additional payment to the contractor for early completion of the contract. Such incentives are more common than penalty provisions for late completion.

Contingent gains and losses are disclosed in accordance with the statement on contingencies and events occurring after the balance sheet date, i.e. AC 107 (refer chapter 18).

7.5 Financial Statement Presentation

7.5.1 Accounting Policy

Paragraph 6 of Schedule 4 to the Companies Act requires disclosure of the accounting policies adopted by a company in determining the carrying amounts of assets and liabilities and the resulting net income. Following are two examples of accounting policy disclosures:

“Revenue from fixed price construction contracts is recognised on the stage of completion method, measured by reference to the percentage of labour hours incurred to date to estimated total labour hours for each contract.

Revenue from cost plus contracts is recognised by reference to the recoverable costs incurred during the period plus the fee earned, measured by the proportion that costs incurred to date bear to the estimated total costs of the contract.”

In addition, IAS 11 (revised) gives further examples of possible accounting policy wording for incentives and contract costs:

“Incentives are included in revenue when it is probable that they will be received. An amount equal to contract costs attributable to claims is included in revenue when realisation is probable and the amount can be reliably estimated.

Contract costs include all direct material and labour costs and those indirect costs that are attributable to contract activity, including indirect labour, supplies, repairs and depreciation. Selling, general and administrative costs are recognised as an expense as incurred. Estimated losses on uncompleted contracts are recognised as an expense in the year in which such losses are determined. Changes in job performance, job conditions and estimated profitability, including those arising from contract penalty provisions, and final contract settlements may result in revisions to costs and are recognised in the year in which the costs are incurred.”

7.5.2 Companies Act Requirements

In addition to paragraph 6 requiring disclosure of the accounting policy, Schedule 4, paragraph 29(1)(f) requires disclosure of contracts in progress as a specific category of stock. In addition, paragraph 29(2) requires that profits or losses taken into account for contracts in progress be stated as well as the basis on which such profits or losses have been calculated.

7.5.3 Accounting Standards

AC 109 requires disclosure in the financial statements of:

- the amount of contract revenue recognised as revenue in the period;
- the methods used to determine the contract revenue recognised in the period; and
- the methods used to determine the stage of completion of contracts in progress.

The following should be disclosed for contracts in progress at the balance sheet date:

- the aggregate amount of costs incurred and recognised profits (less recognised losses) to date;
- the amount of retentions.

An enterprise should present:

- the gross amount due from customers for contract work as an asset; and
- the gross amount due to customers for contract work as a liability.

The relevant disclosures (AC 109) for the foregoing example on the stage of completion method would be as follows:

Income statement

	Notes	1901 R'000	1902 R'000	1903 R'000
Gross revenue		4 194	11 161	1 645
Cost of sales		<u>(3 750)</u>	<u>(10 250)</u>	<u>(1 500)</u>
Gross profit		444	911	145

Balance sheet

	Notes	1901 R'000	1902 R'000	1903 (Contract complete)
<i>Employment of capital</i>				
<i>Current assets</i>				
Debtors		300	900	—
Amount due from customers	2	894	955	—

Notes to the financial statements

1. Accounting policy – Contracts in progress

Contract revenue is recognised on the stage of completion method. The stage of completion is determined on the basis of the proportion of costs incurred for work performed to date, to the estimated total costs of the contract.

2. Amounts due from customers

	1901 R'000	1902 R'000	1903 R'000
Contract costs to date	3 750	14 000	15 500
Profit recognised to date	444	1 355	1 500
	<u>4 194</u>	<u>15 355</u>	<u>17 000</u>
Progress billings charged	<u>(3 300)</u>	<u>(14 400)</u>	<u>(17 000)</u>
	<u>894</u>	<u>955</u>	<u>NIL</u>

7.6 Taxation

7.6.1 Contract Revenue

In terms of the gross income definition the total amount received by or accrued to a contractor shall be included in gross income. In the case of contractors, therefore, the amount included in gross income would normally be progress billings net of retentions.

Where contract revenue is earned in advance of costs incurred in terms of the contract then a Section 24C allowance may be claimable in respect of future expenditure which will be incurred by the contractor in performing his obligations under the contract.

The allowance granted is calculated on the basis of the budgeted gross profit expected in terms of the contract. The effect of a Section 24C allowance is to effectively increase expenditure to the expected proportion of total revenue against the current year gross income shown for a particular contract. The allowance is then added back in the next period.

Timing differences between accounting and taxable income that arise in respect of the recognition of contract revenue give rise to deferred taxation balances which should be accounted for in the usual way (see chapter 2).

7.6.2 Construction Work-In-Progress

Construction work-in-progress had to be included in a contractor's closing stock for the first time in years ending on or after 1 January 1991. The value

of construction work-in-progress is determined by Section 22 (3A) of the Income Tax Act. Essentially closing stock is calculated on the basis of costs incurred in terms of generally accepted accounting practice, less progress billings (these billings would include retentions). The costs incurred would exclude costs that are irrecoverable in terms of the contract. Closing stock arises therefore when costs incurred are greater than progress billings in any year of assessment.

The inclusion of construction work-in-progress as closing stock in the taxable income of a contractor is subject to a ten year phasing in provision in terms of Section 22 (3B). The phase in provision allows a deduction of the following percentages of construction work-in-progress included in a taxpayer's closing stock for the first time in any year of assessment ending on or after 1 January 1991:

YEAR	1	2	3	4	5	6	7	8	9
	97,5%	95%	90%	85%	75%	65%	50%	35%	20%

For nine years, therefore, after the first inclusion of closing construction work-in-progress in a contractor's closing stock on or after 1 January 1991, the contractor may deduct the above percentages of that first closing stock in the respective years. The phasing in deduction cannot be more than the value of the closing stock it is deducted from.

Timing differences that arise in respect of the recognition of construction work-in-progress give rise to deferred taxation balances which should be accounted for in the usual way (see chapter 2).

8 Revenue

8.1 Introduction

8.1.1 Recognition Criteria

Revenue is income that arises in the course of ordinary activities of an enterprise and is referred to by a variety of different names including turnover, sales, fees, interest, dividends and royalties. For most companies, particularly those trading in goods, accounting for revenue is a fairly straightforward process. However, there are a number of exceptions to the general rule of revenue recognition. Some of these exceptions are dealt with by specific accounting statements, for example, AC 110 dealing with income from associated undertakings and AC 113 dealing with the recognition of income on leases.

The general rules for revenue recognition were originally incorporated in AC 111, Revenue Recognition, which was issued in July 1984. ED 89, Revenue, was issued during 1994 as part of the harmonisation project of the South African Institute of Chartered Accountants. ED 89 is closely based on IAS 18 (revised).

ED 89 had been approved for issue as AC 111 (revised) by the Accounting Practices Board. AC 111 (revised) was issued during December 1994 and applies to periods commencing on or after 1 January 1995. AC 111 links the principles of AC 000 to the revenue recognition criteria. Essentially, "Revenue is recognised when it is probable that future economic benefits will flow to the enterprise and these benefits can be measured reliably" (AC 111 paragraph 3). AC 111 applies this principle to specific circumstances identified in the document and provides practical guidance on the application of the revenue recognition criteria.

AC 111 defines revenue as "the gross inflows of economic benefits during the period arising in the course of the ordinary activities of an enterprise when those inflows result in increases in equity, other than increases relating to contributions from equity participants" (AC 111 paragraph 9). Revenue is therefore a subset of income which is defined in AC 000 as increases in economic benefits in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants. The only difference between the definition of revenue and the definition of income is that revenue is more specific in relating to ordinary activities of an enterprise and revenue

encompasses gross inflows rather than net inflows which are envisaged by the definition of income.

AC 111 applies to all enterprises in the recognition of revenue arising from:

- the sale of goods;
- the rendering of services; and
- the use by others of enterprise assets yielding interest, royalties and dividends.

Assets yielding interest would normally be cash or cash equivalents for amounts due to the enterprise, while assets yielding royalties would normally be patents, trademarks, copyrights or computer software that are used by another enterprise.

8.1.2 Exclusions

AC 111 does not deal with revenue arising from:

- lease agreements (see chapter 11);
- dividends from investments that are equity accounted (see chapter 13);
- insurance contracts of insurance companies;
- natural increases in herds, and agricultural and forest products;
- the extraction of mineral ores; and
- construction contracts (see chapter 7).

Revenue excludes amounts collected on behalf of third parties, such as Value Added Taxes or goods and service taxes as those amounts are not economic benefits that flow to the enterprise and do not result in increases in equity. Similarly, amounts collected by an agent on behalf of the principal do not result in increases in equity for the agent and are not recognised as revenue. Revenue for an agent would be the commission received as a result of acting on behalf of the principal.

8.2 Measurement

8.2.1 Fair Value

Revenue should be measured at fair value which is defined as “the amount for which an asset could be exchanged, or a liability settled, between knowledgeable willing parties in an arm’s length transaction” (AC 111 paragraph 9).

Further guidance given about the measurement of revenue is as follows:

- Revenue should be net of trade discounts and volume rebates.
- Where a transaction in effect constitutes a financing element (i.e. interest free credit is given for an extended period) then the fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest. The difference between the fair value and the nominal amount of the consideration is recognised as interest revenue. For example, an enterprise might grant two years interest free credit on its sales of R2 million. If the prevailing rate of interest that is normally charged by the enterprise is 10% then the R2 million in reality reflects a cash selling price plus interest over the two year period. The cash sales price can be determined by calculating the net present value of R2 million in 24 months at 10%, i.e. the cash selling price is R1 652 893 and the interest is R347 107. Therefore, the enterprise should recognise sales immediately for the cash selling price and the interest over a two year period. If the prevailing interest rate is not determinable, then the cash selling price is determined by reference to the normal selling price of the goods that are sold, i.e. in this example if the enterprise's normal selling price for cash on delivery was R1,6 million then R400 000 would be recognised as interest revenue over the two year period while R1,6 million would be recognised as sales revenue.
- The exchange or swap of goods or services which are of a similar nature and value is not considered to be a revenue transaction. However, the exchange of dissimilar goods or services constitutes revenue. For example, an exchange of goods bought at a retailer would not be recognised as revenue by the retailer. The revenue was recognised on the initial transaction and the exchange or swap is merely an exchange of goods of a similar nature. A barter transaction, however, where dissimilar goods are exchanged would give rise to revenue.

8.2.2 Identification of Transactions

Some transactions may include two or more separate components that are not usually easily identifiable. For example, the selling price of a product may include an amount for subsequent servicing. This transaction is often used by the motor industry when selling vehicles for a "cash price" that includes free maintenance for, say, three years. This case should be distinguished from a sales transaction that includes a warranty provision as the warranty is concerned with the original condition of the product at the time of sale. A service contract, however, is concerned with the ongoing maintenance of the product after sale.

When the selling price of a product includes an identifiable amount for subsequent servicing then that amount is deferred and recognised as revenue over the period during which the service is performed. This is in accordance with the framework as the revenue “received” is in fact a liability for future services and meets the definition of a liability in that there will be an outflow of future economic benefits when those services arise. Therefore, when a car manufacturer sells a vehicle at a “cash price” of R100 000 but includes a three year free maintenance contract then the manufacturer should recognise the revenue of R100 000 according to its separate components, i.e. R12 000 may be revenue relating to the free servicing and should be recognised over the three year period on an appropriate basis while the remaining R88 000 should be recognised as sales revenue.

8.3 Transactions and Events

8.3.1 Sale of Goods

The recognition of revenue where goods are sold takes place when all of the following conditions have been satisfied (AC 111 paragraph 16):

- (a) the enterprise has transferred to the buyer significant risks and rewards of ownership of the goods;
- (b) the enterprise retains neither continuing managerial involvement to the degree usually associated with ownership nor the effective control over the goods sold;
- (c) the amount of revenue can be measured reliably;
- (d) it is probable that the economic benefits associated with the transaction will flow to the enterprise; and
- (e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.

These conditions are little different in substance to the general recognition criteria as set out in AC 000.

The conditions for the recognition of revenue from the sale of goods are primarily concerned about any material uncertainties that affect the underlying transaction. Uncertainties about the selling price, the underlying costs of the transaction, the extent of returns or the collectability of the amounts due may preclude revenue recognition. The reliable measurement of revenue does not necessarily imply one hundred per cent accuracy of measurement. For example, there may be a stated formula for the determination of selling

price and the actual selling price is determined only after the end of the accounting period. In this case, provided the risks and rewards of ownership have passed, it would be appropriate to recognise the revenue. Where there are significant uncertainties concerning costs, for example costs cannot be precisely determined, then revenue is not normally recognised.

In order to recognise revenue, it must be clear that the risks and rewards of ownership of goods have passed from the seller to the buyer. A number of examples are given in AC 111 in which an enterprise may retain the significant risks and rewards of ownership and revenue should not be recognised. These are:

- (a) when the enterprise retains an obligation for unsatisfactory performance not covered by normal warranty provisions;
- (b) when the receipt of the revenue from a particular sale is contingent on the derivation of revenue by the buyer from its sale of the goods (e.g. consignment inventories);
- (c) when the goods are shipped subject to installation and the installation is a significant part of the contract which has not yet been completed by the enterprise;
- (d) when the buyer has the right to rescind the purchase for the reasons specified in the sales contract and the enterprise is uncertain about the probability of return.

(AC 111 paragraph 18)

It should be noted that in order for revenue to be recognised, it is essential that it is probable that the economic benefits associated with the transaction will flow to the enterprise. In certain cases this may not be probable until the consideration is received or until an uncertainty is removed. For example, it may be uncertain that a foreign government authority will grant permission to remit the consideration from a sale in a foreign country. Until that permission is granted, revenue should not be recognised. However, when an uncertainty arises about the collectability of an amount already included in revenue, the uncollectable amount "is recognised as an expense rather than as an adjustment of the amount of revenue originally recognised" (AC 111 paragraph 20).

8.3.2 Rendering of Services

Revenue associated with a transaction involving the rendering of services is recognised by reference to the stage of completion of the transaction at the balance sheet date when the revenue can be estimated reliably. Revenue

in connection with rendering of services can be estimated reliably when all of the following conditions are satisfied (AC 111 paragraph 22):

- (a) the amount of revenue can be measured reliably;
- (b) it is probable that the economic benefits associated with the transaction will flow to the enterprise;
- (c) the stage of completion of the transaction at the balance sheet date can be measured reliably; and
- (d) the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

Revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the enterprise. This probability is closely linked to the enterprise's ability to make reliable estimates. Reliable estimates can usually be determined when the following have been agreed to with the other parties to the transaction (AC 111 paragraph 25):

- (a) each party's enforceable rights regarding the service to be provided and received by the parties;
- (b) the consideration to be exchanged; and
- (c) the manner and terms of settlement.

When the outcome of a transaction involving the rendering of services cannot be estimated reliably, revenue should be recognised only to the extent of the expenses recognised that are recoverable. This frequently occurs during the early stages of a transaction where the outcome of the transaction cannot be estimated reliably.

Recognition of revenue by reference to the stage of completion of a transaction is commonly known as the percentage of completion method. This method ensures that revenue is recognised in the accounting period in which the service is rendered by reference to the stage of completion of a transaction. Depending on the nature of the transaction, a number of methods are available to measure the stage of completion of a transaction. These methods include:

- (a) surveys of work performed;
- (b) services performed to date as a percentage of total services to be performed; or
- (c) the proportion that costs incurred to date bear to the estimated total costs of the transaction. Only costs that reflect services performed to date are included in costs incurred to date.

The application of the percentage of completion method is considered in detail in chapter 7 dealing with construction contracts. The principles of the percentage of completion method dealt with in that chapter are equally applicable to the measurement of revenue of transactions that involve the rendering of services.

8.3.3 Interest, Royalties and Dividends

Revenue arising from the use by others of enterprise assets yielding interest, royalties and dividends should be recognised on the bases set out below when (AC 111 paragraph 32):

- (a) it is probable that the economic benefits associated with the transaction will flow to the enterprise; and
- (b) the amount of the revenue can be measured reliably.

Revenue arising from the use by others of enterprise assets is recognised on the following bases (AC 111 paragraph 33):

- (a) interest should be recognised on a time proportion basis that takes into account the effective yield on the asset;
- (b) royalties should be recognised on the accrual basis in accordance with the substance of the relevant agreement; and
- (c) dividends should be recognised when the shareholder's right to receive payment is established.

Interest and dividends that accrue prior to acquisition or out of pre-acquisition net income should not be recognised as revenue but rather taken to the cost of the asset. This takes into account that such interest or dividend is, in fact, a return of the capital investment and not a return on the investment.

As with the sale of goods or the rendering of services, revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the enterprise. For example, royalty payments that are withheld by a government authority due to exchange control regulations in another country should not be recognised when they accrue if it is probable that they will not be received in the near future. When an uncertainty arises about the collectability of an amount already included in revenue, the uncollectable amount, or the amount in respect of which recovery has ceased to be probable, is recognised as an expense, rather than as an adjustment to the amount of revenue originally recognised. This treatment is consistent with uncertainties that arise relating to revenue from the sale of goods or revenue from the rendering of services.

8.3.4 Examples

AC 111 includes an appendix which details the specific revenue recognition principles surrounding certain transactions. These transactions are not considered here as the appendix to AC 111 includes a detailed explanation and discussion of the examples. The examples include:

- **Sale of Goods**
 - “bill and hold” sales
 - goods shipped subject to conditions
 - lay-by sales
 - payments received in advance
 - sale and repurchase agreements
 - sales to intermediaries
 - publications and subscriptions
 - instalment sales
 - real estate sales.
- **Rendering of Services**
 - installation fees
 - servicing fees included in the price of the product
 - advertising commissions
 - insurance agency commissions
 - financial service fees
 - admission fees
 - tuition fees
 - entrance and membership fees
 - franchise fees
 - customised software development fees.
- **Interest, Royalties and Dividends**
 - licence fees and royalties.

The appendix to AC 111 is very detailed and readers should carefully study the examples listed; comprehensive guidance and a full explanation of specific revenue recognition issues are given in the appendix.

8.4 Financial Statement Presentation

8.4.1 Accounting Policy

An appropriate accounting policy note for a group that has revenue arising from the sale of goods, the rendering of services and from royalties is as follows:

Group revenue from the sale of goods consists of wholesale and retail sales to customers, excluding Value Added Taxation and agency commissions. Revenue from the rendering of services represents the value of work performed to date and royalty revenue is recognised on an accrual basis according to the underlying royalty agreement.

8.4.2 Companies Act

The requirement of Schedule 4 to the Companies Act is as follows:

Paragraph 43 There shall be stated the aggregate amount of turnover for the accounting period concerned and the basis upon which turnover had been determined.

There is no requirement in Schedule 4 to distinguish between turnover that arises from the sale of goods, the rendering of services and the use of enterprise assets. However, Schedule 4 requires separate disclosure of income from investments, distinguishing between listed and unlisted investments and between interest, dividends, and other specified income (paragraph 42(a)). It should be noted that Schedule 4 does not use the term revenue, rather turnover is used to express revenue or sales recognised from the sale of goods or rendering of services while revenue from the use of enterprise assets is described as income by Schedule 4.

It is likely that Schedule 4 will either be amended or scrapped once the international harmonisation project is complete and legal backing for accounting standards is obtained. Any amendment to Schedule 4 would incorporate the requirements of AC 111 which are considered in section 8.4.3.

8.4.3 AC 111

AC 111 requires disclosure of the following (paragraph 39):

- (a) the accounting policies adopted for the recognition of revenue including the methods adopted to determine the stage of completion of transactions involving the rendering of services;
- (b) the amount of each significant category of revenue recognised during the period. These categories include the sale of goods, the rendering of services, interest, royalties, and dividends; and
- (c) the amount of revenue arising from exchanges of goods or services analysed by each category.

The requirements of AC 111 extend the disclosure requirements of Schedule 4 in that revenue arising from exchange transactions should be disclosed by category of revenue. In addition, AC 111 requires a different classification of disclosure to Schedule 4 in that revenue is the term used to describe that which Schedule 4 refers to as turnover and income from investments. If Schedule 4 falls away as a result of legal backing for accounting standards being obtained then the requirements of AC 111 would become statutory.

9 Net Profit for the Period

9.1 Introduction

9.1.1 International Harmonisation

AC 103, Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies, was issued in March 1995 as part of the harmonisation project that has as its objective the adoption of international accounting standards. The new AC 103 is closely based on IAS 8 (revised) which was issued towards the end of 1993. The impact of AC 103 is significant; the use and abuse of extraordinary items by South African companies is curtailed by the new statement and a two tiered income statement that distinguishes between continuing operations and discontinued operations was introduced. AC 103 also superseded AC 117, Accounting for Discontinued Operations.

The introduction of a statement that precludes the use of extraordinary items is likely to be met with some resistance by both preparers and users of financial statements. In particular, users will be concerned about EPS disclosures that do not reflect sustainable earnings because they include items that are of an "extraordinary" nature. (EPS is based on earnings before extraordinary items. Refer chapter 3.) However, a similar move in the United Kingdom has resulted in a compromise between preparers of the two tiered income statement and users in that more than one EPS figure is presented and disclosed.

In the UK, the Institute of Investment and Management Research developed a definition of earnings for a "Headline" EPS figure. This figure is enjoying support from both the investment analyst community and the preparers of financial statements. Essentially, preparers disclose two EPS figures: a "GAAP EPS" which is based on net profit for the period and a "Headline EPS" which is a reflection of sustainable earnings. A full reconciliation between the two EPS disclosures is given thereby allowing users to interpret the "Headline EPS" more fully. The preparers, in the main, quote the "Headline EPS" in their press releases and profit announcements. AC 103 is essentially proposing the same approach, except that no "Headline EPS" is defined. It is expected that an opinion (AC 306), dealing with "Headline Earnings", will be issued soon.

AC 103 justifies its approach of precluding extraordinary items, other than in very rare cases, on the grounds of consistency. AC 103 argues that it is necessary to prescribe the classification, disclosure and accounting treatment of certain items in the income statement so that "all enterprises prepare and present an income statement on a consistent basis" (AC 103 paragraph 1). It is important in terms of AC 000 that an enterprise's financial statements are comparable not only with previous periods but also with the financial statements of other enterprises. Therefore, it is appropriate that guidance is given about the classification and disclosure of income statement items, in particular extraordinary items. AC 103, as its title suggests, deals with changes in accounting policies, fundamental errors, and the determinants of net profit or loss for the period. The main change from the previous AC 103 is that extraordinary items are by definition very rare and therefore unlikely to arise during a company's normal operations.

AC 103 is closely based on IAS 8 (revised) except for a change to the requirements regarding changes in accounting policy and corrections of fundamental errors. IAS 8 (revised) allows enterprises to treat the correction of a fundamental error and a change in accounting policy either by restating comparative information and processing a prior year adjustment or by making the correction in the current period only. This alternative treatment is included in IAS 8 (revised) because in some countries it is not permissible to adjust comparative information for statutory reasons. However, in South Africa this does not apply and it is appropriate that AC 103 has adopted a treatment for fundamental error correction and changes in accounting policy that is consistent with our existing approach, i.e. adjustment of comparative information and a prior year adjustment against opening retained earnings.

9.1.2 Definitions

A key aspect of AC 103 is the definitions included in paragraph 5 which are reproduced below.

Extraordinary items are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and therefore are not expected to recur frequently or regularly.

Ordinary activities are any activities that are undertaken by an enterprise as part of its business and such related activities in which the enterprise engages in furtherance of, incidental to, or arising from these activities.

A **discontinued operation** results from the sale or abandonment of an operation that represents a separate, major line of business of an enterprise and of which the assets, net profit or loss and activities can be distinguished physically, operationally and for financial reporting purposes.

Fundamental errors are errors discovered in the current period that are of such significance that the financial statements of one or more prior periods can no longer be considered to have been reliable at the date of their issue.

Accounting policies are the specific principles, bases, conventions, rules and practices adopted by an enterprise in preparing and presenting financial statements.

The key definition above is that of ordinary activities in that only activities outside of this definition would give rise to an extraordinary item. The definition of ordinary activities is very broad and encompasses items that previously would have been regarded as extraordinary, for example, the profit or loss on sale of non-depreciable fixed assets.

9.2 Net Profit or Loss for the Period

AC 103 splits the income statement between profit or loss from ordinary activities and extraordinary items:

	R
Net profit from ordinary activities	XX
Extraordinary item	<u>XX</u>
Net profit for the period	<u>XX</u>

Extraordinary items will seldom occur. There may, however, be items such as discontinued operations, changes in accounting estimates and material transactions that are included in profit from ordinary activities. In this case, separate supporting disclosure is appropriate. For example, the following format may arise (see also section 9.2.2):

	R'000	
	1902	1901
Gross revenue	3 000	2 500
Continuing operations	2 400	1 900
Acquisitions	400	—
Discontinued operations*	200	600
Cost of sales	(1 500)	(1 300)
	1 500	1 200
Operating costs	(900)	(800)
Operating profit	600	400
Continuing operations	400	300
Acquisitions	150	—
Discontinued operations*	50	100
Loss on sale of discontinued operation*	(100)	—
Profit on ordinary activities before interest	500	400
Interest paid	(100)	(50)
Profit on ordinary activities before taxation	400	350
Taxation	(160)	(140)
Profit on ordinary activities†	240	210
Dividends paid	(60)	(45)
Retained profit for the year	180	165

*A note to these line items would provide additional disclosures in terms of AC 103 – see section 9.2.3.

†A note to net profit on ordinary activities would highlight separate disclosures (see section 9.2.2), together with the taxation effect and outside shareholders (if applicable).

Profit per share would be based on this line item and would be disclosed on the face of the income statement. This figure could be reconciled to the company's assessment of a sustainable earnings per share figure.

9.2.1 Extraordinary Items

AC 103 requires that all items of income and expense recognised in a period by an enterprise be included in the determination of net profit or loss for the period. The net profit or loss for the period, therefore, includes extraordinary items. However, due to their nature, extraordinary items warrant separate disclosure. It follows that net profit or loss for the period comprises firstly, profit or loss from ordinary activities and secondly, extraordinary items.

AC 103 emphasises that extraordinary items should be clearly distinct from the ordinary activities of an enterprise and that the event giving rise to the extraordinary item should be rare. Note that the frequency with which such

a rare event is expected to occur should be examined from the viewpoint of the enterprise and not from the frequency of the event. For example, the losses sustained as a result of a hailstorm may qualify as an extraordinary item for many enterprises, but for an insurance enterprise that insures against hail damage, the claims paid out would not qualify as extraordinary items, despite the fact that the occurrence of hailstorms may be rare.

AC 103 gives only two examples of an extraordinary item, namely the expropriation of assets, or an earthquake or other natural disaster.

The nature and amount of each extraordinary item should be separately disclosed detailing, in the notes to the financial statements, the taxation effect and any amount attributable to outside shareholders (AC 103 paragraph 10).

9.2.2 Separate Disclosures

AC 103 does not preclude the disclosure of items considered by virtue of their size, nature or incidence to be separately disclosed in order to explain the performance of the enterprise for the period. However, such items must be included in the profit or loss from ordinary activities and not with extraordinary items. For example, the following items may give rise to separate disclosure, together with the taxation effect and the amount attributable to outside shareholders:

- the write-down of inventories to net realisable value;
- the write-down of property, plant and equipment to recoverable amount;
- a restructuring of the activities of an enterprise;
- disposals of items of property, plant and equipment;
- disposals of long-term investments;
- discontinued operations;
- litigation settlements; and
- reversals of provisions.

Separate disclosure of items such as these should be encouraged as it enables users to assess the sustainable earnings of an enterprise and to adjust reported EPS which is based on net profit or loss for the period accordingly. These separate disclosures could either be presented on the face of the income statement or in a note to the line item "Profit from ordinary activities", as illustrated in section 9.2 above.

9.2.3 Discontinued Operations

Previously AC 117 dealt with discontinued operations. AC 117 has been superseded by the new AC 103. The requirement of AC 103 that all discontinued operation results be excluded from extraordinary items makes the determination of the discontinuance date (defined in AC 117) less relevant. The requirements of AC 103 are for separate disclosure of discontinued operations but for the inclusion of the results of a discontinued operation in profit or loss from ordinary activities. Note, however, that if the discontinuance is the result of events or transactions that are clearly distinct from the ordinary activities of the enterprise and therefore are not expected to recur frequently or regularly, then the income or expense that arises from the discontinuance is treated as an extraordinary item. In these circumstances, the income or expense arising from the discontinuance should be determined by reference to AC 117. The results of operations prior to the discontinuance date would be regarded as not extraordinary while the results from the discontinuance date would be classified as extraordinary. AC 117 defines the discontinuance date as the date from which management has reasonable assurance as to the eventual conclusion of a formal plan of discontinuance.

The disclosure requirements of AC 103 in respect of discontinued operations are as follows:

- the nature of the discontinued operation;
- the industry and geographical segments in which it is reported;
- the effective date of discontinuance for accounting purposes;
- the manner of discontinuance, i.e. whether by sale or abandonment;
- the gain or loss on discontinuance, detailing in the notes to the financial statements, the taxation effect and any amount attributable to outside shareholders and the accounting policy used to measure that gain or loss; and
- the revenue and profit or loss from the ordinary activities of the operation for the period, with the corresponding amounts for each prior period presented, detailing the taxation effect and any amount attributable to outside shareholders.

For example, the following information may be presented in respect of the suggested format set out in section 9.2:

Discontinued Operation

On 1 July 1902, the company sold its security gate manufacturing plant. The results of this operation had previously been reported in the home security

industry segment and the domestic geographic segment. The results relating to this operation are as follows:

	R'000	
	1902	1901
Operating profit	50	100
Taxation – current	<u>(20)</u>	<u>(40)</u>
	30	60
Loss on sale of operation	100	–
Taxation – current	<u>(40)</u>	<u>–</u>
	60	–

(Note that, where applicable, the outside shareholders' interest should also be given.)

9.2.4 Changes in Accounting Estimates

The estimation process inherent in financial reporting involves judgements based on the latest information available. The use of reasonable estimates, therefore, is an essential part of the preparation of the financial statements and it follows that estimates may have to be revised from time to time.

Estimates are often revised if changes occur regarding the circumstances on which the estimate was based or as a result of new information, more experience or subsequent developments. For example, a provision for inventory obsolescence might have to be revised as a result of developments in the market for a particular item of inventory. The nature of the estimate determines that any revision of an estimate does not fall under the definition of an extraordinary item or a fundamental error. Because a change in an accounting estimate may affect the results reported in the current period or in future periods, the change in accounting estimate warrants separate disclosure. Therefore, AC 103 requires that the effect of a change in an accounting estimate should be included in the same income statement classification as was used previously for the estimate. In addition, "the nature and amount of a change in an accounting estimate that has a material effect in the current period or which is expected to have a material effect in subsequent periods should be disclosed. The taxation effect, and any amount attributable to outside shareholders should be disclosed in the notes to the financial statements. If it is impracticable to quantify the amount, this fact should be disclosed" (AC 103 paragraph 29).

Note that if a change in an accounting estimate is related to an estimate which was previously included as an extraordinary item then the change in estimate is reported as an extraordinary item.

In terms of AC 103, paragraph 24, where it proves difficult to distinguish between a change in accounting policy and a change in an accounting estimate then the latter takes preference; that is if in doubt then account for the different circumstances as a change in estimate and not a change in policy. A change in an accounting estimate can affect either only the period of the change or both the period of the change and any future periods. For example, a change in the estimated useful life of a depreciable asset results in the current and future periods being affected by the change in estimate whereas a change in the estimate of the amount provided for inventory obsolescence affects only the period in which the change is made. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods is recognised in future periods.

For example, if an enterprise previously estimated that an obsolete inventory provision of 3% of slow moving inventory items was necessary but, in the current period, sales patterns indicate that an obsolescence provision of only 2% is required then the reduction in the estimate of 1% of the slow moving inventory is treated as income for the current period, arising from a change in accounting estimate.

In contrast, however, if an enterprise changes the expected useful life of an asset, acquired four years ago for R100 000, to eight years from the original ten years then the effect of the change in estimate is accounted for in the current period and future periods, i.e. at the start of the current period, the net book value of the depreciable asset, using the old estimate of useful life, was R70 000. In terms of the revised estimate, the remaining useful life is only five years and not the original seven years. Therefore, the remaining book value of R70 000 is depreciated over a five year period, i.e. R14 000 per annum. The net effect of the change in estimate (R20 000) has therefore been accounted for over the remaining useful life of five years, i.e. an extra R4 000 depreciation is charged each period.

Alternatively, the enterprise could "catch up" the prior years' under-depreciation in the current year. If the asset had originally been depreciated over 8 years then depreciation for the 3 years preceding the current year should have been R12 500 p.a. and not R10 000. In the current year, therefore, a "catch up" of R7 500 ($R2\,500 \times 3$) is made, in addition to the R12 500 depreciation for the year. The difference between these two approaches, either of which appears to be sanctioned by AC 103, is illustrated as follows:

	<i>Depreciation Pattern Without "Catch-up"</i>	<i>Depreciation Pattern With "Catch-up"</i>
Year 1	10 000	10 000
Year 2	10 000	10 000
Year 3	10 000	10 000
Year 4	14 000	20 000
Year 5	14 000	12 500
Year 6	14 000	12 500
Year 7	14 000	12 500
Year 8	14 000	12 500
	<u>100 000</u>	<u>100 000</u>

9.3 Changes in Accounting Policies

9.3.1 Criteria

"A change in accounting policy should be made only if required by statute, or by an accounting standard setting body, or if the change will result in a more appropriate presentation of events or transactions in the financial statements of the enterprise" (AC 103 paragraph 37). There are, therefore, three criteria for the change in accounting policy; statute, accounting standard, or more appropriate presentation of events or transactions. AC 103 discourages frequent changes in accounting policies and emphasises that often what is thought to be an accounting policy change is actually a change in accounting estimate (see section 9.2.4).

The statutory or accounting standard criteria for a change in an accounting policy are objective decisions to implement in practice. However, determining "more appropriate presentation" is a subjective decision. According to AC 103, more appropriate presentation occurs when "the new accounting policy results in more relevant or reliable information about the financial position, performance or cash flows of the enterprise" (paragraph 38).

The adoption of an accounting policy either for transactions that differ in substance from previously occurring transactions or for transactions that did not occur previously or were immaterial does not constitute a change in accounting policy.

A change in accounting policy is applied retrospectively or prospectively. Retrospective application results in a new accounting policy being applied to all events and transactions as if the new accounting policy had always been in use. Prospective application results in the new accounting policy being applied to the events and transactions that occur only after the date of the change in policy. No adjustments are made to prior periods or the

opening balance of retained earnings when an accounting policy is changed prospectively.

9.3.2 Retrospective Change

Changes in accounting policy should be accounted for retrospectively unless the amount of any resulting adjustment that relates to prior periods is not reasonably determinable. Most changes in accounting policy are accounted for retrospectively and this is the requirement of AC 103. A retrospective change requires the opening balance of retained earnings to be adjusted and comparative information to be restated unless it is impracticable to do so. The financial statements, including the comparative information for prior periods, are presented as if the new accounting policy has always been in use. The amount of the adjustment relating to periods prior to those included in the financial statements is adjusted against the opening balance of retained earnings of the earliest period presented. Historical summaries, i.e. five or ten year reviews, should be restated.

An example of a retrospective change in accounting policy is considered in section 9.3.5 below.

9.3.3 Prospective Change

A change in accounting policy should be applied prospectively when the adjustment to the opening balance of retained earnings cannot be reasonably determined. In this case, the financial statements are prepared on the basis of a new accounting policy from the time that the accounting policy is changed and no adjustments are made to the information reported in previous periods.

9.3.4 Disclosure

AC 103 requires the following disclosures when a change in accounting policy has a material effect on the current period or any prior period presented or may have a material effect in subsequent periods (AC 103 paragraph 48):

- the nature of and the reasons for the change;
- the amount of the adjustment for the current period and for each period presented detailing, in the notes to the financial statements, the taxation effect and any amount attributable to outside shareholders;
- the amount of the adjustment relating to periods prior to those included in the comparative information detailing, in the notes to the financial statements, the taxation effect and any amount attributable to outside shareholders; and

- the fact that comparative information has been restated or the reason for not restating comparative information.

9.3.5 Example

An example of a change in accounting policy, including related disclosures is considered below. Taxation implications have been excluded in order to illustrate the principles involved.

Zabol Ltd currently accounts for its inventory on the Last-In-First-Out (LIFO) basis. On 1 January 1904, Zabol Ltd changed its accounting policy for inventory to the FIFO method in order to comply with a new accounting standard that disallows use of the LIFO method of inventory valuation. The following information is available:

INCOME STATEMENT ON LIFO	1904 R'000	1903 R'000
Revenue	1 000	900
Profit on ordinary activities after taxation	250	220
Dividends paid	100	100
Retained profit for the year	150	120
Opening retained earnings	250	130
Closing retained earnings	400	250

INVENTORY VALUATIONS	FIFO R'000	LIFO R'000
31-12-01	55	45
31-12-02	65	53
31-12-03	78	62
31-12-04	95	80

Note that sufficient information is available to restate the comparatives for the new policy, i.e. the change in accounting policy can be applied retrospectively. The cumulative difference between the LIFO and FIFO valuation at the start of the comparative period (i.e. 1 January 1903) will be adjusted against the opening retained income of that period and the 1903 and 1904 periods will be restated on the new policy.

The differences between the new and old policy may be summarised as follows (R'000s):

	FIFO (new)	LIFO (old)	B/S DIFFERENCE	I/S DIFFERENCE
31-12-02	65	53	(12)	12 Cr = PYA
31-12-03	78	62	(16)	4 Cr (16 - 12)
31-12-04	95	80	(15)	1 Dr (15 - 16)

The above calculations give rise to the following summarised income statement:

	1904 R'000	1903 R'000
Revenue	<u>1 000</u>	<u>900</u>
Profit on ordinary activities after taxation	<u>249</u>	<u>224</u>
Dividends paid	<u>100</u>	<u>100</u>
Retained profit for the year	149	124
Opening retained earnings as restated	266	142
Opening retained earnings as previously reported	250	130
Effect of change in accounting policy	<u>16</u>	<u>12</u>
Closing retained earnings	<u>415</u>	<u>266</u>

Note that the net adjustment to retained profit at 31 December 1903 is R16 000 (266–250) which is the net difference between the LIFO and FIFO inventory valuation at that date; i.e. the **net** effect of the change in policy is an increase (debit) in inventory and an increase (credit) to retained profit of R16 000.

The following additional disclosures are required in order to comply with AC 103 (paragraph 48):

The accounting policy for inventory valuation was changed during the year from the LIFO to the FIFO basis in order to comply with the new accounting standard, AC 103.

The effect of the change was as follows:

Gross increase/(decrease) in net profit*	<u>(1)</u>	<u>4</u>
Restatement of opening retained earnings in respect of prior year adjustment:		
Increase/(decrease) in retained earnings†	<u>16</u>	<u>12</u>

*The taxation effect and amount attributable to outside shareholders (if applicable) should be disclosed separately after this line item.

†The taxation effect and amount attributable to outside shareholders (if applicable) should be disclosed separately after this line item. The net increase/(decrease) in retained earnings is disclosed as "change in accounting policy" on the face of the income statement.

9.4 Fundamental Errors

9.4.1 Criteria

Fundamental errors are errors discovered in the current period that are of such significance that the financial statements of one or more prior periods can no longer be considered to have been reliable at the date of their issue. Errors may occur as a result of mathematical mistakes, human mistakes in applying accounting policies, misinterpretation of facts, fraud or oversights.

A fundamental error should be clearly distinguished from a change in estimate. A change in estimate arises when different circumstances occur regarding a particular estimate whereas an error results when financial statements that are misleading are released and the financial statements would not have been issued if the errors had been recognised in time. A fundamental error may arise, for example, from the fraudulent actions of a director in prior periods that are only discovered in the current period. The director's fraudulent action has resulted in a significant understatement of liabilities in prior years and a discovery that the financial statements were misleading at the time of issue. The correction of this error should be treated in the same way as a change in accounting policy, i.e. "the amount of the correction of a fundamental error that relates to prior periods should be reported by adjusting the opening balance of retained earnings. Comparative information should be restated unless this is not permitted by regulatory authorities or it is impracticable to do so" (AC 103 paragraph 33).

The net result of correcting a fundamental error is that the financial statements are presented as if the fundamental error had been corrected in the period in which it was made. Therefore, the amount of the correction relating to each period presented is included within the net profit or loss for that period and the retained earnings of the earliest period presented are adjusted for the effect of the fundamental error in the years prior to that.

9.4.2 Disclosure

Where an enterprise has corrected a fundamental error then the following should be disclosed:

- the nature of the fundamental error;
- the amount of the correction for the current period and for each prior period presented detailing, in the notes to the financial statements, the taxation effect and any amount attributable to outside shareholders;
- the amount of the correction relating to periods prior to those included

- in the comparative information detailing, in the notes to the financial statements, the taxation effect and any amount attributable to outside shareholders; and
- the fact that comparative information has been restated or the reason for not restating comparative information.

(AC 103 paragraph 35).

9.5 Financial Statement Presentation

9.5.1 Companies Act

Schedule 4 to the Companies Act includes definitions relating to the previous AC 103 regarding extraordinary items. Because the new AC 103 considerably narrows the definition of extraordinary items, there is some conflict between the requirements of Schedule 4 and the accounting treatment prescribed by AC 103. It is envisaged that once international accounting standards have been adopted, legal backing will be obtained for all accounting statements and Schedule 4 disclosure requirements will fall away. Therefore, the present Schedule 4 requirements relating to extraordinary items are likely to be superseded by the principles of AC 103. Nevertheless, compliance with Schedule 4 is a statutory requirement and it is worth reproducing the relevant paragraphs of Schedule 4 below:

- Paragraph 4(m) Extraordinary items are defined as any material item of income and expense resulting from the occurrences, the underlying nature of which is not typical of the ordinary trading or operating activities of the company.
- Paragraph 46 There shall be stated the amount of extraordinary items including the nature and amount of taxation and the extent of outside owners' interest relating to these items.
- Paragraph 42(s) Items of income and expense which, in the accounting period, are abnormal in amount and result from occurrences the underlying nature of which is typical of the ordinary trading or operating activities of the enterprise should be disclosed.

9.5.2 AC 103

The disclosure requirements of AC 103 relate mostly to changes in accounting policy and the correction of fundamental errors. These were considered in sections 9.3.4, 9.3.5, and 9.4.2. The other requirement of AC 103 is that the income statement is split between two main categories, namely net profit

or loss from ordinary activities and extraordinary items. These two categories aggregate to net profit or loss for the period on the income statement. Within those categories additional disclosures may be required, for example, net profit or loss from ordinary activities should be distinguished, where appropriate, between discontinued operations, changes in accounting estimates, and separate disclosure for material or significant transactions. In all of these cases, and in the case of extraordinary items, AC 103 requires, where appropriate, that the taxation effect and any amount attributable to outside shareholders be disclosed.

10 Foreign Exchange

10.1 Introduction

10.1.1 Foreign Currency Accounting

Business enterprises may enter into transactions that are denominated in a different currency to their own. For example, a South African company may import raw materials from Botswana at a price quoted in Pula. Since financial statements are produced in one currency, known as the reporting currency, the transaction will need to be translated into the reporting currency for incorporation in the financial statements.

Alternatively, a South African company may establish a UK branch to handle the marketing and selling of its products in Europe. The UK branch would maintain its own accounting records in Pounds and could be a subsidiary or a division of the South African company. In order to consolidate or incorporate the results of the branch with the financial statements of the South African company, the results will need to be translated into the main reporting currency.

A South African company would generally report its results in Rand and the effects of paying for raw materials in Pula and incurring expenses in Pounds, need to be expressed in Rands. It is appropriate, therefore, that AC 112, Accounting for the Effects of Changes in Foreign Currency Exchange Rates, provides guidance for the appropriate treatment for the translation of foreign currency transactions and operations into the reporting currency (i.e. Rands). It is worth noting that the reporting currency need not be Rands. South African companies are not compelled to prepare their financial statements in Rands.

A foreign currency is any currency other than the reporting currency which is the currency used when presenting financial statements (for ease of understanding, the reporting currency can be regarded as Rands in all circumstances). The relative value of currencies fluctuates continuously and is determined by the market. Currencies are usually quoted by the market in terms of their relative worth on a buy and sell basis. Daily prices are quoted in newspapers as an indication of the relative closing price between currencies. For example, the price for US dollars may be quoted at close of trading as follows:

	09-12-03		10-12-03	
	SELL	BUY	SELL	BUY
US Dollars (1\$ = R)	3,38	3,36	3,39	3,365

These prices indicate that US dollars may be purchased from a bank for R3,38 for each dollar on 9 December 1903 but \$1 exchanged for Rands would only have netted R3,36 on 9 December 1903. Note that the prices have changed on 10 December. The difference between the "Buy" and "Sell" rates represents the return made by the market participant (i.e. the bank) for undertaking the transaction. Note that the bank always benefits; for example, \$1 exchanged for Rands on 9 December 1903 would have yielded R3,36 and an exchange of the latter would only have netted 99,41 US cents. The net cost of entering into the transaction would be 0,59 US cents which does not appear significant until applied to transactions involving millions of dollars (e.g. on \$1m, the cost amounts to approximately \$5 900 or R20 000).

Theoretically, accountants should distinguish between the "buy" and "sell" rate for purposes of expressing foreign currency denominated debtors ("buy" rate) and creditors ("sell" rate) in Rands, but for practical purposes an average rate is usually used.

Although the relative prices of currencies fluctuate constantly, it is possible to "lock-in" on a price in advance. This possibility ensures that an exchange rate is fixed for a particular transaction and the risk associated with currency fluctuations is avoided, in return for a premium. The mechanism that is often used to achieve this is known as a forward exchange contract.

There are two broad categories of foreign currency operations in which an enterprise engages.

Firstly, enterprises may directly undertake transactions which are denominated in foreign currencies. For example, an enterprise may "purchase or sell goods for which payment is made in a foreign currency or it may lend or borrow amounts denominated in a foreign currency" (AC 112 paragraph 23). Since financial statements are produced in one currency, the results of these **transactions** are translated into the reporting currency for incorporation into the financial statements.

Secondly, enterprises may conduct business through foreign operations which maintain their own accounting records in a foreign currency. In order to prepare the financial statements of such an enterprise, the financial statements of its **foreign operation** need to be translated into the reporting currency.

AC 112 distinguishes between the accounting treatment for foreign transactions and foreign operations.

10.1.2 Terminology

Proficiency with the accounting treatment of foreign currency transactions and operations requires mastery of the associated terminology. AC 112 incorporates no fewer than twenty definitions and some of the more important definitions are considered in this section.

The **spot rate** is the “exchange rate for immediate delivery of currencies to be exchanged at a particular time” (AC 112 paragraph 08). For example, the ruling price at close of the market on 9 December 1903 of R3,38 for US\$1,00 is indicative of the spot rate that would apply if you wanted “immediate delivery” of US Dollars. Similarly, the **closing rate** is the spot rate ruling at the close of business at the balance sheet date.

Forward exchange contracts are agreements to “exchange different currencies at a specified future date and at a specified rate (the forward rate)” (AC 112 paragraph 15). For example, a newspaper may quote a particular bank’s rates as follows:

	SPOT RATE	FORWARD RATE (at 09–12–03)	
	09–12–03	09–01–04	09–03–04
British Pounds (£1 = R)	5,02	5,06	5,14

These prices indicate that on 9 December 1903, the bank will exchange Pounds at a rate of R5,02 or on the same day will contract to exchange Pounds at a rate of R5,06 in one month’s time and R5,14 in three months’ time. Note that the forward rate is contractually fixed and even if the spot rate were actually R5,50 (or R4,80) on 9 March 1904, the bank would honour the agreement and exchange Pounds at R5,14 on that date. Entering into a forward exchange contract with a bank, therefore, eliminates the risks associated with foreign currency movements.

The difference between the spot rate on 9 December 1903 and the forward rates quoted on that day represents a premium on a forward exchange contract of 4 cents for every Pound in terms of the one month contract and 12 cents for every Pound in terms of the three month contract. The difference could also be a discount; if the one month forward contract rate was quoted at R4,96 then the discount would be 6 cents (R5,02 – R4,96) for every Pound.

Where an enterprise enters into a forward exchange contract it is said to have “covered forward”. Note that an enterprise can take forward cover

to minimise the risk of currency fluctuations (i.e. fix a currency rate of exchange) or to speculate. When speculating, the enterprise is not contractually fixing an amount of a foreign currency denominated debtor or creditor in Rands, rather the enterprise is "playing" the market. For example, if the one month forward rate is R5,06 for each Pound, the spot rate is R5,02 and it is considered that the rate will actually be R5,15 for each Pound in one month's time then it could be profitable to contractually agree to buy Pounds at R5,06 in one month's time. If the presumption proves to be right then in one month's time the Pounds purchased in terms of the contract can be sold for R5,15, thereby making a profit of 9 cents for every forward contract Pound purchased. The accounting treatment for speculative versus non-speculative forward cover differs (refer to sections 10.3.2 and 10.3.4).

A **foreign operation** is a "subsidiary, associate, joint venture or branch whose activities are based or conducted in a country other than the country of the reporting entity" (AC 112 paragraph 03). Foreign operations are either an integral part of the activities of the reporting enterprise (integrated foreign operation) or a separate **foreign entity**. Note that a foreign operation does not have to be an incorporated entity and that the definition includes branches within its scope.

10.2 Conceptual Issues

10.2.1 Risks and Rewards of Ownership

The general rule for recording a foreign currency transaction is that it should be translated using the actual rate at the date on which the transaction took place. For example, an enterprise importing an item of plant costing US\$100 000 would record the plant in Rands using the rate applicable on the date of the transaction. Consistent with revenue recognition principles (AC 111) and the framework (AC 000), the date of the transaction should be determined with reference to the transfer of the risks and rewards of ownership. For this reason, AC 112 defines the transaction date as "the date on which the significant risks and rewards of ownership of an asset have been transferred or a service has been performed" (AC 112 paragraph 16).

The transaction date is determined by reference to the contract; i.e. if the plant was shipped FOB (free on board) then the risks and rewards of ownership pass on the date of loading the ship whereas if the plant was shipped CIF (cost, insurance, freight) then the risks and rewards of ownership only pass upon arrival in the port of destination. Alternatively, ownership may only pass in terms of the contract when the plant is delivered and installed.

The transaction date is a key determinant of the appropriate accounting treatment for any foreign currency transaction and care should be exercised to ensure that the substance of an agreement is accounted for and not merely its legal form. It is worth noting, however, that in practice it is often not practicable to determine the transaction date for each and every transaction. For this reason, delivery date is often used as the effective transaction date. In the case of stock purchases, this approach has very little effect on the "bottom line" as any fluctuation in the exchange rate is either expensed through cost of sales or exchange differences. If the stock is unsold at year end, a temporary difference may arise but over time this difference is "smoothed". Alternatively, an appropriate average rate is often used in practice as an approximation of the transaction rate. Although this is not in keeping with AC 112, it is an approach sanctioned in the UK by SSAP 20, provided that rates do not fluctuate significantly.

10.2.2 Objectives of Translation

The objective of financial statements is to provide "information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions" (AC 000 paragraph 12). The translation of foreign currency transactions and financial statements should, therefore, produce results which are generally compatible with the effects of rate changes on an enterprise's cash flows and its equity and should ensure that the financial statements fairly present management's actions. It also follows that consolidated financial statements should incorporate the financial position, performance and changes in financial position of a foreign operation as measured in the foreign currency financial statements prior to translation.

10.3 Foreign Currency Transactions

10.3.1 Uncovered Transactions

The general principle for the recording of transactions is that the spot rate at the transaction date is used for translation purposes. A purchase of plant from the UK that was shipped FOB on 15 January 1903 and invoiced (£100 000) on 31 January 1903 should be recorded at the spot rate ruling on 15 January (the transaction date). The exchange rate ruling on either 31 January 1903 or the final delivery date is not relevant. The journal entry processed to record the acquisition of plant, assuming an exchange rate of R5,02 = £1,00 on 15 January 1903 and 90 days credit from invoice date, is:

Dr	Plant and Machinery	502 000	
	Cr Creditor		502 000
Being purchase of plant of £100 000			

Note that the creditor is payable on 30 April 1903 and that the amount in Rands needed to settle the creditor will depend on the spot rate on the date of payment. For example, if the spot rate is R5,15 on 30 April 1903 then R515 000 is required to settle the creditor of £100 000. On the other hand, if the spot rate is R4,90 on 30 April 1903 then only R490 000 is required to settle the creditor of 100 000. Because the spot rate is unlikely to be R5,02 on 30 April 1903, a difference will arise between the amount at which the initial liability was recorded and the amount paid in settlement of the liability. This difference is known as an exchange difference and may either be a loss or a gain, depending on the ruling spot rate at the date of settlement.

Assuming that the liability was settled on 30 April 1903 for R490 000 (i.e. exchange rate R4,90 = 1,00), then the journal entry is as follows:

Dr	Creditor	502 000	
	Cr Exchange gain		12 000
	Cr Cash		490 000

Similarly, if the exchange rate had been R5,15 then the credit to cash would have been R515 000 and a debit to exchange loss of R13 000 would have arisen.

The above example illustrates that the transaction is effectively recorded in "two legs", i.e. the cost of the non monetary asset is fixed based on the spot rate on the transaction date while the payment for the asset is accounted for separately, depending on the settlement rate. Note that the presence of a year end between the transaction date and the settlement rate poses a potential problem in that the exchange rate at the year end is likely to differ from the transaction rate and the settlement rate. However, the year end rate, known as the closing rate, is the best estimate of the liability at the year end. The liability is, therefore, restated at the closing rate for year end reporting purposes.

Assuming an exchange rate of R5,10 at 28 February 1903 (the year end), then a closing entry to restate the liability is recorded:

Dr	Exchange loss	8 000	
	Cr Creditor		8 000

The creditor is now reflected at R510 000 (502 000 + 8 000) which is the best estimate of the amount payable at year end. Note that the closing rate is that ruling at the actual year end date (i.e. balance sheet date) and not the reporting date. The movement in foreign currency exchange rates subsequent to the balance sheet date does not affect the condition of assets or liabilities at that date and is, therefore, a non-adjusting post balance sheet event (see chapter 19).

On 1 March 1903 (i.e. the first day of the financial year), the creditor is brought forward at R510 000 and the exchange difference that arises in the 1903/1904 financial year will be the difference between the amount actually paid to settle the liability and R510 000, i.e. if the exchange rate is R5,15 on 30 April 1903 then the journal entry to record the settlement of the liability is:

Dr	Creditor	510 000	
Dr	Exchange loss	5 000	
	Cr Cash		515 000

Note that the total exchange difference relating to this transaction remains at R13 000 (R8 000 in the period ended 28 February 1903 and R5 000 in the period ended 28 February 1904).

The above principles are equally applicable to any transaction involving foreign currency payments or receipts, for example, purchases of raw materials or stock and sales of fixed assets and stock. Note, however, that it is only foreign currency (denominated) items that give rise to exchange differences. If a company sells stock to an overseas buyer and invoices in Rands then there are no foreign exchange complications. However, if the same company invoices its sales in, say, French Francs, then the sale (and debtor) is recorded at the spot rate (between the Rand and the French Franc) on the transaction date and any subsequent movement in exchange rate between the transaction date and the debtor's settlement date gives rise to an exchange difference.

10.3.2 Forward Cover

The general principle that the spot rate ruling on the transaction date is used to record a transaction also applies where forward cover is taken out in order to provide protection from fluctuations in foreign exchange rates. However, in certain circumstances a transaction may be recorded at the forward cover rate. This is considered further below but firstly it is necessary

to consider the appropriate accounting treatment for recording the cost of forward cover where the general principle is applied.

A company may wish to take out forward cover as protection against currency fluctuations. This protection (often referred to as hedging) is usually obtained at a premium and the cost of the premium should be treated as a period cost. If a company imports an item of plant costing US\$1 000 000, payable in 90 days, and the transaction date is 15 September 1904 then it may wish to cover forward for the three month credit period. Relevant exchange rates on 15 September 1904 are as follows:

	US\$1,00 = R
Spot	3,36
3 month forward	3,44

Applying the general principle of recording the plant at the spot rate on the transaction date, the cost of the plant is fixed at R3 360 000. However, the related liability is contractually fixed at R3 440 000 and the difference between the cost of the plant and the amount of the liability is the forward exchange premium. The entry on 15 September 1904 to record this transaction is:

Dr	Plant and Machinery	3 360 000	
Dr	Forward Premium	80 000	
	Cr Creditor (Forward Exchange Contract)		3 440 000

The forward premium is expensed in the period to which it relates and the entry on 15 December 1904 when the creditor is paid is:

Dr	Creditor	3 440 000	
	Cr Cash		3 440 000

Because the forward premium is a period cost, care should be exercised when a financial year end occurs during the period of the forward exchange contract. If, for example, the company's year end was 30 November then only $\frac{1}{3}$ of the premium should be expensed in the year ended 30 November 1904 and the remaining $\frac{2}{3}$ is expensed in the subsequent period. The following entry therefore would be processed at 30 November 1904 ($80\,000 \times \frac{1}{3}$):

Dr	Unallocated Premium (B/S)	13 333	
	Cr Forward Premium		13 333

Note that for balance sheet presentation purposes, the unallocated premium is "disclosed as part of the related monetary item" (AC 112 paragraph 29), i.e. the creditor is included in the balance sheet at the net amount of R3 426 667 (R3 440 000 – R13 333). The amount of forward premium expensed in the year ended 30 November 1904 is R66 667 ($R80\,000 \times \frac{3}{4}\%$) while R13 333 ($R80\,000 \times \frac{1}{4}\%$) is expensed in the subsequent year.

There may be circumstances where a forward exchange contract is entered into in respect of a commitment to purchase or sell goods. For example, on 1 June 1905 a company may sign a contract to take delivery of US\$100 000 of stock in three months' time. In order to obtain protection from currency fluctuations, the company decides to cover forward on 1 June 1905 until the expected settlement date of 1 December 1905. The forward cover premium amounts to R6 000. In this case, "the premium or discount (on forward cover) up to the transaction date may be allocated to the value of the transaction as this premium or discount is not considered to be a financing cost" (AC 112 paragraph 30).

The application of paragraph 30 to this example allows the premium attributable to the period prior to the delivery date to be included in cost of stock, i.e. R3 000 of the forward cover premium ($R6\,000 \times \frac{3}{4}\%$) is capitalised to the cost of stock while the remaining R3 000 is treated in the normal way as a period cost. This approach results in stock being recorded at the approximate spot rate on the transaction date.

At the start of this section, it was noted that the general principle for the recording of transactions at the spot rate on the transaction date may not apply in certain circumstances. These circumstances, set out in paragraph 31 of AC 112, allow the forward rate to be used to record the transaction. All of the following criteria are necessary before use of the forward rate is permissible:

- The forward exchange contract is set to mature within normal credit terms.
- The forward exchange contract has been entered into prior to, at or immediately after the transaction date in order to establish the reporting currency amount of the purchase or sale.
- The purchase or sale is in respect of normal trade transactions.
- The related or matching forward exchange contract is denominated in the same currency as the monetary item.

(AC 112 paragraph 31)

Where **all** of these criteria are met then the transaction can be recorded at the forward rate and the premium or discount on the forward exchange contract is effectively capitalised to the cost of the asset and not treated as a period cost or gain. For example, if a company imported stock costing 10 000, immediately took out forward cover at a rate of R5,20 = R1 and met the above conditions, then the transaction would be recorded by the following entry

Dr	Stock	52 000	
	Cr	Creditor	52 000

The spot rate at the transaction date is no longer relevant for accounting purposes. Note that only *trade* transactions may be recorded at the forward rate; i.e. the purchase of, say, plant and machinery could not be recorded at the forward rate.

10.3.3 Rolling of Forward Cover

Forward cover contracts are not always available for the entire period over which protection from foreign currency fluctuations is required. For example, it is often difficult to obtain cover for a period exceeding 12 months and in order to take out forward cover for, say, 18 months, it is necessary to enter into two consecutive contracts. The transition from the first contract to the second contract is known as "rolling forward". The accounting implications of rolling forward are reasonably straightforward if the underlying procedures and cash flows are understood.

A company requires 18 months forward cover on 1 January 1906 for a foreign liability of 100 000. The maximum forward cover period obtainable on 1 January 1906 is 12 months and the rate is R5,60 (spot rate on 1 January 1906 is R5,00). The company decides to take out the 12 month contract and then enter into another contract for six months on 1 January 1907, when the spot rate is R5,55 and the six month forward rate is R5,80.

On 1 January 1906, the company recognises a forward premium of R60 000 ($100\,000 \times (5,60 - 5,00)$) by restating the liability to the forward cover rate. The premium is recognised as a period cost (i.e. evenly over the 12 month contract period). When the contract matures on 1 January 1907, the company, in terms of the forward cover contract, receives 100 000 in return for R560 000. However, the company does not require the Pounds yet so sells them back to the bank at the spot rate for R555 000. Note that the company's net cash flow is R5 000 outflow (R560 000 paid to the bank and R555 000 received from the bank).

The company now enters into a second contract. This contract is for six months and the attributable premium is the difference between the forward rate (5,80) and the spot rate on 1 January 1907 (5,55), i.e. R25 000. The total premium for 18 months is R60 000 + R25 000 = R85 000. The total cash cost for settling the liability is, therefore, R585 000 (original liability of £100 000 × 5 = R500 000 and premium of R85 000). Note, however, that the cash flow relating to this transaction is the cash outflow of R5 000 on 1 January 1907 when the forward cover was rolled and the R580 000 cash outflow when the second contract matures.

The accounting implications take into account the cash flow when the contract is rolled forward. Following are the related entries:

01-01-06	Dr	Asset	500 000	
	Dr	Forward Premium	60 000	
		Cr Liability		560 000
(Assuming a 31 December year end, the entire premium is expensed in 1906.)				
01-01-07	Dr	Liability	5 000	
		Cr Cash		5 000
(Note that the liability is now stated at the spot rate at 01-01-07 and the new forward cover contract can be accounted for in the normal way.)				
01-01-07	Dr	Forward Premium	25 000	
		Cr Liability		25 000
01-07-07	Dr	Liability	580 000	
		Cr Cash		580 000

Although the above entries are prepared on the basis that the forward premiums are paid only at the conclusion of the contracts, banks sometimes require the premium to be paid in advance. This situation does not change the principles and the above entries are easily amended to cater for the advance payment of the premium.

10.3.4 Speculative Transactions

Forward exchange contracts are sometimes taken out on a speculative basis, i.e. where there is no underlying foreign currency denominated item to cover. A speculative contract is based on a profit motive, i.e. an enterprise believes that the actual rate in three months' time will be substantially different to the forward rate offered by the market. For example, on 1 January 1908 a three month US dollar forward contract at R3,90 is available but

a company has reason to believe that the actual rate on 1 April 1908 (i.e. in 3 months) will be R4,10. If the company enters into the contract on 1 January 1908 for US\$100 000 then it will have to pay R390 000 for its US\$100 000. However, these dollars may immediately be sold for R410 000 on that date if the company's estimates were accurate, thereby netting a speculative profit of R20 000 (R410 000 – R390 000). Note that if its estimate was wrong and the actual rate on 1 April 1908 was R3,80 then a speculative loss of R10 000 would arise.

The presence of a year end complicates the accounting treatment slightly. If the company's year end was 28 February then it is necessary to compute a profit or loss based on "the difference between the forward rate available for the remaining maturity of the contract and the contracted forward rate" (AC 112 paragraph 35), i.e. at 28 February 1908, it is necessary to obtain the one month forward cover rate for US dollars. Assuming that that rate is R4,00 then the company may recognise a profit of R10 000 ($100\,000 \times (4,00 - 3,90)$) in terms of paragraph 35 of AC 112 for the year ended 28 February 1908 and the remaining profit of R10 000 ($100\,000 \times (4,10 - 4,00)$) is recognised in the subsequent period, provided that the spot rate on 1 April 1908 was, as estimated, R4,10.

10.4 Foreign Operations

As noted in section 10.1.2, foreign operations may be classified according to their characteristics as either foreign entities or integrated foreign operations. The method of translating the financial statements of a foreign operation is determined by an assessment of its operations in order to classify it either as an entity or as a foreign operation.

10.4.1 Foreign Entities

This section is concerned with the translation of foreign entities. Foreign entities are those operations that "accumulate cash and other monetary items, incur expenses and costs, realise revenues and arrange borrowings, all substantially in the foreign currency" (AC 112 paragraph 37). Changes in the exchange rate have little or no effect on the operating cash flows of either the foreign entity or the reporting entity because they act independently. The reporting entity is not affected by the foreign entity's operations on a day to day basis; rather the reporting entity's results are affected only to the extent of its net investment in the foreign operation.

A foreign entity is viewed primarily as a separate, independent operation to the reporting entity. For this reason, it is important to "preserve as far

as possible the results and the interrelationships of amounts appearing in the foreign balance sheet and income statement'' (AC 112 paragraph 38) as these results and interrelationships provide the best indication of the foreign entity's performance and financial position. It is appropriate, therefore, to translate a foreign entity's trial balance on the following basis:

- Assets and liabilities at the closing rate.
- Income Statement items at actual rates or at appropriate weighted average rates.

This method is known as the closing rate (the balance sheet is effectively translated at the closing rate) or net investment method. The translation of the trial balance using different exchange rates will result in an exchange difference. The difference can arise from:

- translating income statement items at a different rate to the balance sheet items;
- translating the opening net investment in the foreign entity at an exchange rate different to that previously reported;
- changes to owners' interests in the foreign entity arising during the year.

The exchange difference is taken directly to owners' interests as a "change in the exchange rate has little or no direct effect on the present and future cash flows from operations of either the reporting entity or the foreign entity" (AC 112 paragraph 40). The exchange difference is usually disclosed with non distributable reserves and is known as a Foreign Currency Translation Reserve (FCTR).

The following example illustrates the closing rate method. Handy Ltd purchase an 80% share in Selkirk (PLC) on 1 January 1901, upon incorporation of the latter. The trial balances of the two companies at 31 December 1905 are set out below.

	HANDY R'000	SELKIRK £'000
Share Capital	480	200
Retained Income (Opening)	—	425
Deferred Taxation	—	70
Long Term liabilities	—	300
Operating Income	<u>200</u>	<u>228</u>
	<u>680</u>	<u>1 223</u>

	HANDY R'000	SELKIRK £'000
Investment in Selkirk	480	—
Land and Buildings	—	250
Plant and Machinery	—	357
Accumulated Depreciation	—	(136)
Net Current Assets	—	572
Depreciation	—	45
Interest paid	—	22
Dividends paid	200	50
Taxation	—	63
	<u>680</u>	<u>1 223</u>

Selkirk (PLC) is considered to be a foreign entity and the closing rate method is applied.

In order to translate the trial balance of Selkirk, it is necessary to obtain the average exchange rate for 1905 and the closing rates at 31 December 1904 and 1905.

Assume exchange rates as follows (£1,00 =)

	R
01-01-01	3,00
31-12-04	4,80
31-12-05	5,00
Average for 1905	4,90

In addition, it is necessary to identify the Rand value of the post acquisition increase in the subsidiary's reserves up to the start of the current year (1905). Selkirk has only one reserve, namely retained income, and the opening consolidated retained income attributable to Selkirk can easily be obtained from the 1904 consolidated financial statement workings. Assume that this amounts to R1 915 000; note that this would be the Rand value of 100% of Selkirk's retained income that was consolidated in the period 1901 to 1904 and Handy's share of this amounts to $80\% \times R1\ 915\ 000 = R1\ 532\ 000$.

It is now possible to proceed with the translation of Selkirk and a useful starting point is an analysis of the equity of Selkirk.

	£'000	RATE	100%	R'000 80%	20%
At acquisition					
Share capital	200	3,00	600	480	120
Post acquisition					
Retained Income to 31-12-04	425	prior yrs	1 915	1 532	383
FCTR (Balancing figure)	—		<u>485</u>	<u>388</u>	<u>97</u>
Equity at 31-12-04 at closing rate	625	4,80	3 000	2 400	600

(Note that the R1 915 is a figure obtained from prior year financial statement workings and that the total equity of Selkirk at 31 December 1904 must have been translated at the closing rate then (i.e. $625 \times 4,80$) to give equity in Rands of R3 000. This gives rise to an exchange difference of R485 (which is the balancing figure in the 100% column) that is taken direct to NDR).

Post acquisition (continued)

Net Income 1905 (228-45-22-63)	98	4,90	480,2	384,16	96,04
Dividends paid	(50)	5,00	(250)	(200)	(50)
FCTR (Balancing figure)	—		<u>134,8</u>	<u>107,84</u>	<u>26,96</u>
Equity at 31-12-05 at closing rate	<u>673</u>	5,00	<u>3 365</u>	<u>2 692</u>	<u>673</u>

Note that (i) dividends paid are translated at the actual rate obtained by Handy Ltd upon receipt thereof (Handy Ltd is reflecting dividend income of R200 000); this ensures that intra-group dividends are netted off and eliminated – refer to the trial balance below, (ii) net income is translated at the average rate and (iii) the FCTR is calculated in exactly the same way as the opening balance on the FCTR from previous years. The total FCTR is 619,8 (485 + 134,8). Using this information, it is a straightforward process to draft the consolidated financial statements. Alternatively, the trial balance may be translated as follows:

	SELKIRK	RATE	SELKIRK	HANDY	CONSOL ADJUST (cr in brackets)	CONSOL
	£'000		R'000	R'000		R'000
Share Capital	200	3,00	600	480	600	480
Retained Income (opening)	425	?*	1 915	—	383	1 532
Deferred Tax	70	5,00	350	—	—	350
Long Term Liabilities	300	5,00	1 500	—	—	1 500
Operating Income	228	4,90	1 117,2	200	200	1 117,2
Outside Shareholders	—	—	—	—	(673)†	673
FCTR (balancing figure)	—	—	619,8	—	123,96	495,84
	<u>1 223</u>		<u>6 102</u>	<u>680</u>		<u>6 148,04</u>
Investment in Selkirk	—	—	—	480	(480)	—
Land and Buildings	250	5,00	1 250	—	—	1 250
Plant and Machinery	357	5,00	1 785	—	—	1 785
Accumulated depreciation	(136)	5,00	(680)	—	—	(680)
Net Current Assets	572	5,00	2 860	—	—	2 860
Depreciation	45	4,90	220,5	—	—	220,5
Interest paid	22	4,90	107,8	—	—	107,8
Dividends paid	50	5,00	250	200	(250)	200
Taxation	63	4,90	308,7	—	—	308,7
Outside Shareholders (I/S)	—	—	—	—	96,04	96,04
	<u>1 223</u>		<u>6 102</u>	<u>680</u>	<u>NIL</u>	<u>6 148,04</u>

*This rate is not calculated; it is a composite rate from prior years that gives rise to a translated retained income of R1 915 that is obtained from the prior year consolidation workings.

†The net credit balance for outside shareholders' balance on the balance sheet is made up of:

	(R'000s)
Share Capital at acq (20% × 600)	120
FCTR (20% × 619,8)	123,96
Post Acq RI (20% × 1 915)	383
Current Year RI [(1 117,2 – 107,8 – 250 – 308,7 – 220,5) × 20%]	46,04
	<u>673</u>

The foreign currency translation reserve (FCTR) is disclosed in the consolidated balance sheet with non-distributable reserves. The usual Schedule 4 requirements for an NDR apply; i.e. details of the opening balance (R388 000), the movement (R107 840) in the current year and the closing balance (R495 840) should be disclosed.

In this example there was no goodwill arising on consolidation of Selkirk. If goodwill of, say, R100 000 had arisen on acquisition of the 80% interest in Selkirk (note that this is a hypothetical assumption as Selkirk was purchased upon incorporation) then the goodwill figure is not usually recalculated each year. The R100 000 of goodwill represents the value of the business over its net assets as assessed at a point in time (acquisition) and recorded in the reporting currency.

The closing rate or net investment method should also be used for the translation of investments in overseas associates. The net assets would be translated using the same calculations as for a subsidiary, but would be included in the group financial statements on the equity accounted basis and not on a line by line basis.

10.4.2 Integrated Foreign Operations

As the name suggests, integrated foreign operations comprise foreign activities that are an integral part of the operations of the reporting entity. This integration results in changes in the exchange rate having an immediate effect on the reporting entity's cash flow from operations. This effect is similar to that which would occur if the reporting entity had conducted the operation itself. "Thus, the effect of an exchange rate change on a foreign operation that is an integral part of the reporting entity's operations is related to the monetary items held by the foreign operation rather than to the reporting entity's net investment in that operation" (AC 112 paragraph 41).

A distinguishing feature of an integrated operation is the extent to which the activities of the foreign operation are interlinked with the reporting entity. The closing rate method is appropriate where the foreign operation is a largely independent concern that does not depend on the parent company for its activities, but where the foreign operation's results are regarded as being more dependent on the economic environment of the reporting entity's currency than on its own currency then the temporal method is more appropriate.

The temporal method recognises the integral nature of the foreign operation's activities to the reporting entity by incorporating the foreign operation's results as if all its transactions had been entered into by the investing company itself in its own currency.

Examples of integral foreign operations include a selling agency receiving stock from the reporting entity, a raw material supplier for the reporting entity or an operation located overseas for tax or exchange control reasons. A number of factors affect the classification of a foreign operation, including the extent to which the cash flows of the foreign operation have a direct impact on the reporting entity, the extent to which management of the foreign operation is dependent on the reporting entity, the main trading currency of the foreign operation, and the major currency used by the foreign operation in its financing structure. The classification of foreign operations between integral operations and entities is often not clear cut and professional judgement should be exercised.

Paragraph 43 of AC 112 sets out the procedures that are applied when translating results using the temporal method:

- Monetary items, unless covered forward, are translated at the closing rate.
- Non monetary items (e.g. fixed assets) recorded at historical cost are translated at historical rates, i.e. the exchange rates that existed when the relevant transactions occurred. Depreciation is translated on the basis of the historical rate.
- Revalued non monetary items are translated at the exchange rates ruling on the dates of their revaluation.
- Non monetary items acquired by the foreign operation prior to the reporting entity's investment in that operation are translated at the rate ruling when the reporting entity acquired the investment.
- Owner's equity is translated at historical rates.
- Income statement items are translated at actual exchange rates or at a weighted average exchange rate for the period.

Exchange differences which arise on translation using the temporal method are taken to income for the period.

We can use the previous example to illustrate the temporal method if Selkirk is considered to be an extension of Handy Ltd's business. Some further assumptions are necessary:

- All of the fixed assets were acquired when the exchange rate was £1,00 = R3,10.
- Net current assets are all monetary with the exception of stock of 100 000 which was acquired at an average exchange rate of R4,95.
- Consolidated retained income at 31 December 1904 amounted to R1 162 400, after outside shareholders' share of R290 600, i.e. total retained income of Selkirk from acquisition to 31 December 1904 was translated at R1 453 000.

Applying the temporal method to the translation of Selkirk's trial balance, the following Rand denominated trial balance is obtained:

	£'000	RATE	R'000
Share Capital	200	3,00 (h)	600
Retained Income (Opening)	425	Given (from prior yrs)	1 453
Deferred Tax	70	5,00 (c)	350
Long Term Liabilities	300	5,00 (c)	1 500
Operating Income	228	4,90 (a)	1 117,2
Exchange Gain (Balancing figure)			100,9
	<u>1 223</u>		<u>5 121,1</u>
Land and Buildings	250	3,10 (h)	775
Plant and Machinery	357	3,10 (h)	1 106,7
Accumulated depreciation	(136)	3,10 (h)	(421,6)
Net Current Assets			
(excluding stock)	472	5,00 (c)	2 360
Stock	100	4,95 (h)	495
Depreciation	45	3,10 (h)	139,5
Interest paid	22	4,90 (a)	107,8
Dividends paid	50	5,00 (h)	250
Taxation	63	4,90 (a)	308,7
	<u>1 223</u>		<u>5 121,1</u>

NOTES

(a) *The average rate is used for income statement items except where they apply to specific historic or actual rates (e.g. depreciation and dividends).*

(c) *The closing rate is used for all monetary assets and liabilities.*

(h) *Historic (or actual) rates are used as follows:*

- *owner's equity – acquisition rate*
- *fixed assets (i.e. non monetary) and depreciation – historical actual rate*
- *stock – historical actual rate*
- *dividends – actual rate.*

This trial balance may then be used to draft the consolidated trial balance in much the same way as the procedure for the closing rate method. Note that the equity of Selkirk may be analysed as follows:

	£'000	RATE	100%	R'000 80%	20%
At Acquisition					
Share Capital	200	3,00	600	480	120
Post Acquisition					
Retained Income	425	—	1 453	1 162,4	290,6
Operating Income	228	4,90	1 117,2		
Depreciation	(45)	3,10	(139,5)		
Interest	(22)	4,90	(107,8)		
Taxation	(63)	4,90	(308,7)		
			561,2	448,96	112,24
Dividend	(50)	5,00	(250)	(200)	(50)
Exchange Difference			100,9	80,72	20,18
	<u>673</u>		<u>2 465,1</u>	<u>1 972,08</u>	<u>493,02</u>

The temporal method has, in effect, applied historical exchange rates to the post acquisition equity of Selkirk and is a close approximation of the results that would be obtained if Handy Ltd had carried out the same operations itself from South Africa. Note the difference between the value of the translated equity of Selkirk (£673 000) using the temporal method (R2 465 100) and the closing rate method (R3 365 000). The temporal method has resulted in an average exchange rate of R3,66 (2 465,1/673) against the closing rate method's exchange rate of R5,00.

Situations may arise where there is a change in the position of a foreign operation and it is no longer appropriate to treat it in the same way as before. For example, an integrated foreign operation (accounted for using the temporal method) may become a foreign entity as the result of a group reorganisation. Alternatively, a foreign entity may become an integrated foreign operation.

It is submitted that these changes are not accounting policy changes, but rather changes in status as a result of different underlying circumstances. As such, the amounts at the time of the change in status should be treated as the starting point for the new method. The effect of the change is therefore accounted for in the period in which the change in status takes place.

10.4.3 Transactions between Group Companies

Situations may arise whereby transactions take place between companies within a group of companies that includes a foreign operation. In this case, each company should calculate exchange gains and losses as normal, and include them in their respective income statements. Provided that both

companies used the exchange rate on the same day for the recording and settlement of the transaction then the gains and losses should be eliminated on consolidation; i.e. the exchange gain arising in one company should be exactly offset by the loss in the other company.

10.4.4 Net Investment in a Foreign Entity

A foreign equity investment is sometimes financed or hedged by foreign borrowings. Where the foreign operation is classified as a foreign entity, exchange differences on translation are taken directly to reserves (FCTR) but exchange differences on the foreign borrowings would normally be recognised by the reporting entity in income of the current period. This appears illogical as any exchange loss on the foreign borrowings will be matched by a gain on the net investment in the foreign entity. Therefore, in terms of AC 112, it is appropriate to offset the exchange differences arising on each, provided that:

- the foreign borrowings are specifically and formally linked to the net investment in the foreign entity; and
- disclosure is made of the net investment in the foreign entity and the related foreign currency loans or balances.

(AC 112 paragraph 48)

For example, a company purchases a US subsidiary for US\$ 1m from proceeds of a loan from Citibank for US\$ 1m. In the first year of operation the US subsidiary, which is classified as a foreign entity, makes no profit and no loss, but the Rand/US Dollar rate has moved from R3,60 to R3,80. The loan and the investment now have a value of R3,8m; an increase of R200 000. The gain of R200 000 in the investment gives rise to a FCTR on translation of the investment while an exchange loss of R200 000 on the loan is recorded by the South African company. In terms of paragraph 48 of AC 112, the loss of R200 000 may be offset against the FCTR of R200 000 in the consolidated financial statements.

Although no specific guidance is given in AC 112, it is submitted that in the holding company's own financial statements, the exchange loss and gain may also be set off as the two items are closely related and effectively hedge each other. (Note that the investment in the subsidiary is not strictly speaking a monetary asset in the holding company's balance sheet and would therefore be kept at the original cost established by reference to the historical exchange rate. In order to hedge the investment and loan, both items require restatement to R3,8m in the holding company's financial statements.)

It should be noted that AC 112 does not require that the investment and borrowings be denominated in the same currency. It is also worth noting that if the borrowings are repaid then the hedge effectively falls away and the non-monetary asset (investment in foreign subsidiary) is accounted for in the normal manner.

10.4.5 Disposal of Foreign Entities

Where an investment in a foreign entity is sold or abandoned in part, or in whole, then the amount of FCTR attributable to the proportion of the investment disposed of is transferred to distributable reserves. For example, if Handy Ltd had sold $\frac{1}{4}$ of its 80% investment in Selkirk (refer Section 10.4.1) on 31 December 1905 for R800 000 then a group profit on sale of R127 000 (R800 000 – R673 000 (carrying value of 20% of equity)) arises and a transfer of R123 960 (20% of total FCTR of R619 800) may be made from NDR (FCTR) to retained income.

10.4.6 Accounting Periods

Foreign enterprises whose results are incorporated with those of the reporting entity should have financial year ends which are coterminous with the reporting entity. If this is not practicable then this fact should be disclosed and the rate used to translate the balance sheet of the foreign operation is that at the accounting date of the reporting entity (AC 112 paragraph 51). This date is appropriate as the financial statements purport to be a reflection of the position at that date.

With respect to the translation of the income statement, it may be appropriate to use the average over the foreign operation's accounting period since this is the period covered by the operation's results. Alternatively the average rate applicable to the reporting entity could be used. Neither option is wholly satisfactory and the year ends should be coterminous if this is at all possible.

10.4.7 Hyperinflation

A company may have an investment in a foreign operation which maintains its own accounting records in a currency subject to hyperinflation. Translating these results without adjusting for the hyperinflation may produce misleading figures. "Non monetary assets which have been owned by the entity for some time would therefore be stated at low amounts and the loss of purchasing power of the foreign currency unit, in terms of the reporting currency from a net monetary asset position, would not be recognised in income" (AC 112 paragraph 49).

In cases of hyperinflation, therefore, it is appropriate to adjust the foreign currency financial statements of the foreign operation for the effects of inflation before applying the normal translation rules for a foreign entity.

10.5 Financial Statement Presentation

10.5.1 Accounting Policy

An appropriate accounting policy may be as follows:

Foreign assets and liabilities of South African group companies

Foreign assets and liabilities of South African group companies, other than those which are covered by forward exchange contracts, are translated to Rands at rates of exchange ruling at the end of the financial year. Gains and losses on translation are included in operating profit.

Translation of foreign currency financial statements

The balance sheets of consolidated foreign operations are translated into Rands at rates of exchange ruling at the end of the financial year. The related income statements are translated at the weighted average rates of exchange for the year. Exchange differences on translation of foreign subsidiaries are taken directly to non distributable reserves.

10.5.2 Companies Act

Schedule 4 to the Companies Act requires the following disclosures:

Paragraph 38	The nature, the exchange rates used on conversion and amounts of uncovered foreign currency monetary items at the balance sheet date.
Paragraph 42(q)	The amount of foreign exchange gains and losses taken to the income statement which relate to foreign currency denominated loans.
Paragraph 47	Sufficient information on forward exchange contracts entered into which do not relate to specific balance sheet items to enable an assessment to be made of the foreign currency exposure.

10.5.3 AC 112

In addition to the Schedule 4 requirements, AC 112 requires disclosure of:

- In respect of foreign currency transactions:

- information on uncovered foreign currency monetary items at the balance sheet date, including the nature and amounts of these items and distinguishing between current and non current assets and liabilities, in each foreign currency involved. In addition, details of the settlement terms of long term items;
 - the difference in rand amounts between the original forward rate and the spot rate on the maturity date (which is received or paid in cash) when a forward exchange contract is rolled before the anticipated transaction takes place, should be included with prepayments or accruals and disclosed accordingly at the balance sheet date;
 - the unallocated portion of the premium/discount on a forward exchange contract at balance sheet date should be disclosed as part of the related monetary item.
- In respect of foreign operations:
 - method used to translate the results and financial position of the foreign operation;
 - net exchange differences that were taken directly to owner's interests in the period;
 - accumulated FCTR balance;
 - the fact must be disclosed where uniform accounting dates between the foreign subsidiary and the South African company is not practical;
 - the net investment in a foreign entry as well as the linked foreign loan where exchange differences are set off against each other (refer to section 10.4.4).

10.6 Taxation

10.6.1 Deferred Taxation

Until recently, deferred taxation frequently arose when accounting for foreign currency transactions as a result of timing differences between the recognition of exchange differences for taxation purposes and for accounting purposes. During 1993, however, amendments to the Income Tax Act simplified the process. In general, the Receiver of Revenue applies GAAP principles (i.e. AC 112) for purposes of determining the taxation implications of accounting for foreign currency transactions. In certain limited circumstances, timing differences may well arise, but for the majority of foreign currency transactions, there are no deferred taxation implications.

11 Leases

11.1 Introduction

11.1.1 Leasing of Assets

Where an enterprise purchases an asset for use in its business then it acquires both the legal title to the asset and the benefits and risks of ownership. In order to finance the acquisition of the asset, an enterprise may:

- use existing cash resources;
- utilise an overdraft facility;
- utilise the proceeds of a long term, unsecured loan; or
- utilise the proceeds of a loan to be secured on the asset.

Whichever financing method is used, the accounting implications are fairly straightforward; the asset is raised in the balance sheet and the other side of the entry is either an increase in a liability or a reduction in bank balances.

The accounting implications are not so straight forward when the “right” to use an asset and not the legal title is acquired. In this situation, an enterprise may carry the benefits and risks of ownership (through the right of use) but the legal title is held by another enterprise. This split complicates the accounting treatment as one party has the benefits of ownership, but the other party holds the legal title. The problem arises, therefore, in which parties’ balance sheet should the asset be recorded? Lease agreements and instalment sale agreements often split the benefits of ownership from the legal title of an asset. AC 105, Accounting for Leases in the Financial Statements of Lessees, and AC 113, Lessor Accounting, deal with the appropriate accounting treatment for lease agreements. South Africa is unusual in that lessors and lessees are dealt with in two separate statements; the international standard (IAS 17) and the UK (SSAP 21) both deal with lessors and lessees in a single statement. There is therefore some repetition of certain paragraphs in AC 105 and AC 113; for example, a lease is defined by both statements as “an agreement conveying the right to use assets for an agreed period of time in return for a payment or a series of payments by the lessee to the lessor” (AC 105 paragraph 4; AC 113 paragraph 3).

Similarly, both statements exclude the following specialised types of leases:

- lease agreements to explore for or use natural resources, such as oil, gas, timber, metals and other minerals;

- licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

It is worth noting that there are a number of reasons why an enterprise might choose to lease instead of purchasing an asset:

- leasing may be the only means of obtaining the asset;
- insufficient funds to purchase the asset;
- temporary use only of the asset is required; and
- the avoidance of potential technological and obsolescence factors.

11.1.2 Types of Leases

Leases can generally be classified into two categories: operating leases and finance leases.

A lease contract in which substantially all of the risks and rewards associated with ownership remain with the lessor, and in which the lessee is hiring the use of an asset for a specified period, are classified as **operating leases**. The general accounting implication is that the lessor accounts for the asset as a fixed asset and records the lease rentals as income. For example, Easy-hire Ltd may hire cranes and other building equipment for use in the construction industry. The cranes are hired by contractors for R1 000 per day; Easyhire would include the cost of the crane (less accumulated depreciation) with fixed assets and would reflect the hiring fee of R1 000 per day as income (depreciation on the crane would be charged against income). The contractor would expense the R1 000 per day of crane hire as lease payments.

On the other hand, where a lease contract transfers substantially all the risks and rewards associated with ownership to the lessee, but without the lessee becoming the legal owner, then it is classified as a **finance lease**. This is because the substance of the contract is similar to a purchase contract and the characteristics are more akin to a financing arrangement than a leasing agreement.

Both AC 105 (paragraph 3) and AC 113 (paragraph 1) require that lease transactions be accounted for according to their **substance** and not merely their legal form. For this reason, a finance lease is accounted for in much the same way as a purchase contract. For example, Finance House Ltd leases an asset with a market value of R1m to Capital Ltd. Substantially all the risks and rewards of ownership associated with the asset are transferred to Capital Ltd. Finance House Ltd should account for the transaction as a disposal

of the asset and raise a corresponding asset (debtor) for the “purchase” price. Lease instalments would be accounted for as part repayment of the debtor and interest income on the capital balance of the debtor outstanding. Similarly, Capital Ltd should record the acquisition of an asset and a related liability. The asset is depreciated and the lease instalments are split between repayment of the liability and interest paid on the outstanding amount payable.

Both AC 105 and AC 113 classify leases as either finance or operating leases. The determination of whether or not substantially all the risks and rewards of ownership pass to the lessee is therefore a key factor in determining the appropriate accounting treatment for leases. Paragraph 13 of AC 105 gives some guidance about the risks and rewards of ownership:

“The risks associated with ownership include the possibility of losses from damage, breakdown, under utilisation of capacity, obsolescence or losses on realisation of the asset. The rewards associated with ownership include profits arising from the use of the asset and gains on realisation.”

These factors, together with further indicators of the transfer of the risks and rewards of ownership are considered in more detail in sections 11.2 and 11.3. It should be appreciated that the difference between an operating and a finance lease is solely one of degree and not a fundamental difference. All leases, to a certain extent, transfer some of the risks and benefits of ownership. The key is to establish whether or not **substantially** all of the risks and rewards of ownership are transferred.

Both AC 105 (paragraph 1) and AC 113 (paragraph 1) state that the accounting treatment prescribed for finance leases applies also to instalment credit agreements, such as hire purchase or suspensive sale agreements. Although the accounting treatment is basically identical, it is important to distinguish between a hire purchase agreement and a finance lease. Generally, in terms of a hire purchase contract, it is agreed at the **inception** of the contract that the purchaser (or his nominee) will become owner of the asset at termination of the agreement. A finance lease, on the other hand, is a lease agreement whereby the right to use an asset for a specified period is acquired, but the agreement includes a right or option for the lessee to obtain legal ownership providing certain conditions are met. Legal ownership, therefore, is not decided upon at the time of entering into the lease agreement.

11.1.3 Conceptual Issues

We have established that in the case of finance leases, a lessee capitalises

a leased asset while the lessor effectively records a sale of the leased asset, which is replaced by an investment in a leased asset (i.e. a long term debtor).

The lessee is recording its rights in the asset, rather than the underlying asset itself, together with the discounted value of the obligation to make future lease payments. The lessee's rights are in substance little different from those of a purchaser. Thus, despite having no legal title, the lessee recognises an asset and a related liability.

It is important to ensure that the lessee's asset and liability meet the definitions of assets and liabilities embodied in the framework, AC 000. In the case of a finance lease, the lessee controls the asset (the resource), and the asset is expected to yield future income (economic benefits) and is as a result of a past event. The recognition criteria are usually met in that the cost of the asset is measurable and the future economic benefits are probable (the lessee should have performed a capital budgeting technique (e.g. Net Present Value) to ensure the latter criteria).

Similarly, the lease liability is a present obligation arising from a past event (signing the lease) and which will result in an outflow of economic benefits (interest portion of lease payments). This liability is recognised as equal but opposite (i.e. an asset) by the lessor in that the lease agreement gives rise to an inflow of economic benefits to the lessor. Thus, the accounting treatment of finance leases by the lessor is generally the mirror image of the lessee's accounting treatment. This is illustrated in section 11.4.2.

11.2 Lessors

A lessor is the party to a lease agreement that grants to another party (the lessee) the right to use an asset acquired (or manufactured) for an agreed period of time in return for a payment or series of payments.

11.2.1 Accounting Implications of Operating Leases

Lease agreements are classified as operating leases where the risks and rewards associated with ownership remain with the lessor. The following accounting implications arise:

- the lessor retains the asset on the balance sheet; i.e. no sale is recorded;
- the lessor depreciates the asset (unless an investment property)
 - over its useful life
 - on a systematic basis;

- lease rentals (excluding receipts for services provided such as insurance and maintenance) are allocated to the lessor's income on a systematic basis (usually straight line) over the lease term;
- costs incurred in earning lease rental income are charged against income;
- initial direct costs incurred specifically to obtain the operating lease are either deferred and allocated to income over the lease term in proportion to lease rental income, or are written off immediately.

11.2.2 Accounting Implications of Finance Leases

Lease agreements are classified as finance leases where substantially all the risks and rewards associated with ownership transfer to the lessee. Such agreements are usually non cancellable and secure the recovery of the initial capital outlay and a return on funds invested for the lessor. The following additional conditions are necessary in terms of AC 113 for the recognition of a finance lease by a lessor:

- the collectibility of the minimum lease payments is reasonably assured (or the amount that is not collectible can be estimated);
- no significant uncertainty exists regarding the amount of costs to be incurred and borne by the lessor under the lease; and
- **one** of the following:
 - the lease agreement transfers ownership of the asset to the lessee at the end of the lease term;
 - the lease contains a bargain purchase option and the exercise of the option is reasonably assured;
 - the lease term is equal to or greater than the major portion (usually 75%) of the leased asset's estimated economic life; or
 - the present value of the minimum lease payments (at the inception of the lease) is equal to or greater than substantially all (usually 90%) of the open market value of the leased asset less the present value of any grants and non recoupable tax allowances due to the lessor.

(AC 113 paragraph 19)

Minimum lease payments are defined (AC 113 paragraph 8) as "the payments that the lessee is, or can be, required to make (excluding costs for services and taxes paid by, and reimbursed to, the lessor) in connection with the lease together with:

- any residual guaranteed to the lessor by either the lessee or a party related to the lessee or an independent third party financially capable of meeting this guarantee.
- any payment that the lessee must make or can be required to make upon failure to renew or extend the lease at the expiration of the lease term."

The **present value** of the minimum lease payments is the discounted value of those payments based on a discount factor which is the interest rate implicit in the lease.

The following accounting implications arise for the lessor in the case of a finance lease:

- the agreement is treated as a sale of the asset and a loan to the lessee, on which finance income is earned;
- lease rentals received are accounted for as part repayments of principal and part finance income;
- finance income is recognised on a systematic basis over the lease term;
- initial direct costs (e.g. legal fees) are either charged against income immediately or allocated over the lease term.

The following examples illustrate the basic accounting treatments for an operating lease and a finance lease by a lessor.

11.2.3 Operating Lease Example

Oples Ltd built a warehouse during 1903 for R380 000. The warehouse was built on a vacant piece of land that has been owned by Oples for years. The warehouse is rented to companies in need of storage space. On 1 January 1904 they signed a two year lease with Storage Ltd that allows the latter use of the warehouse for 24 months in return for R3 000 per month, payable in advance. Oples Ltd is responsible for maintenance and insurance of the building which is expected to have a 60 year useful life and a residual value of R20 000. Depreciation is on a straight line basis. Oples Ltd paid a once off fee of R12 000 to Realtor, the property agents who introduced Storage Ltd to Oples Ltd. Both companies have a 31 December year end.

The first step in determining the appropriate accounting treatment is to categorise the lease. The definition of an operating lease in AC 113 is "a lease other than a finance lease" (paragraph 5). It is therefore appropriate to first determine whether the lease fits the definition of a finance lease. Using the criteria set out earlier, the first two criteria appear to be met, i.e.

the collectability of the lease payments is reasonably assured and there is no significant uncertainty about the costs to be incurred by the lessor. However, the third criteria is not met because not one of the following conditions is satisfied; i.e

- ownership is **not** transferred at the end of the lease;
- there is no purchase option;
- the lease is only for 2/60 of the estimated useful life of the asset (i.e. <75%); and
- the present value of the lease payments is less than 90% of the open market value of the asset.

Clearly this lease is **not** a finance lease and is therefore an operating lease. (While this is intuitively obvious from the terms of the lease and the nature of the agreement (i.e. to hire an asset), it is appropriate to apply the above criteria to all lease agreements where any uncertainty exists. It is not uncommon for finance houses to specifically design lease agreements that only just avoid classification as finance leases; – in the case of lessees, this ensures that lease liabilities are left off the balance sheet.)

The accounting implications of the above lease for Oples Ltd are therefore as follows:

INCOME STATEMENT	1905 R	1904 R
Lease rentals	36 000	36 000
Depreciation (1)	6 000	6 000
Realtor fee (2)	6 000	6 000
BALANCE SHEET		
Fixed Assets		
– Cost	380 000	380 000
– Accumulated Depreciation	(12 000)	(6 000)
	<u>368 000</u>	<u>374 000</u>

(1) Depreciation is calculated as follows:

$$1/60 \times (380\,000 - 20\,000)$$

(2) Note that this fee could also have been recognised in full in 1904; i.e. R12 000 in 1904 and nil in 1905 (AC 113 paragraph 38).

The above accounting implications do not take into account any finance that Oples Ltd may have had to raise in order to build the warehouse. If the company raised a loan then this would result in recognition of a liability on the balance sheet and interest paid in the income statement.

11.2.4 Finance Lease Example

Finles Ltd leased a new item of plant to Usage Ltd on 1 January 1903 for five years. Five lease instalments of R90 000 each are payable annually in advance. In addition, Usage Ltd have guaranteed a residual value of R100 000 (i.e. at the end of the lease, Usage Ltd will pay R100 000 for the plant to Finles Ltd). The cost of the asset to Finles Ltd was R400 000 which is the market price. The plant has an average useful life of six years. Assume 31 December year ends.

Before considering the classification of this lease, it is necessary to calculate a few figures:

The minimum lease payments in terms of AC 113 (paragraph 08) are $R90\,000 \times 5$ (R450 000) and the guaranteed residual of R100 000 (i.e. R550 000). The lessor, therefore, has paid out R400 000 for the plant but expects to receive R550 000 over the next five years. The difference of R150 000 (R550 000 – R400 000) represents income, or a return on capital to Finles Ltd for financing the asset. The expected future lease rentals could, therefore, be viewed by Finles Ltd as having a **present value** (or capital balance) of R400 000 which is made up of R550 000 less finance income of R150 000. If Finles Ltd only reported every five years instead of every year, the company would show finance income of R150 000; being the net difference between the cash outflow of R400 000 and the inflows of R550 000. However, because Finles reports every year, the finance income has to be accrued on a systematic basis.

The finance income can be recognised by Finles Ltd on the basis of the outstanding balance of capital, i.e. after Usage Ltd pays the first rental (immediately) of R90 000, the capital balance outstanding is reduced to R310 000 (R400 000 – R90 000) but interest accrues for the next twelve months on the outstanding balance of R310 000 until the next payment by Usage Ltd of R90 000 which will be part capital, part interest. The amount of interest charged is that rate which discounts the future lease instalments to R400 000 and can be calculated (either by a financial calculator or trial and error) as 14,5509%. This is demonstrated below:

	TIME PERIOD (Years)	INSTAL- MENT R	PV FACTOR (14,5509%)	PRESENT VALUE R
01-01-03	0	90 000	1,0000	90 000
01-01-04	1	90 000	0,8730	78 568
01-01-05	2	90 000	0,7621	68 588
01-01-06	3	90 000	0,6653	59 875
01-01-07	4	90 000	0,5808	52 269
01-01-08	5	100 000	0,5070	50 700
		<u>550 000</u>		<u>400 000</u>

It is now possible to determine the appropriate classification of this lease. As in the operating lease example, the two criteria concerning the collectibility of lease instalments and the certainty of any costs to be borne by the lessor are met fairly easily. The third criteria is also easily satisfied in that either of the following two (of the four) "sub criteria" are met:

- the present value of the minimum lease payments is greater than 90% of the value of the asset (in this case, because the residual is guaranteed, the present value is equal to the value of the asset);
- the lease term is greater than 75% of the useful life of the asset (lease term is five years, useful life is six years).

Therefore, on either of these two points, the lease is classified as a finance lease. The total finance income of R150 000 can be allocated to each accounting period on the basis of the capital balance outstanding, using the interest rate implicit in the lease. The following table summarises the allocation:

	TOTAL INSTALMENTS (Gross Investment)		NET INVESTMENT (Present Value)	
Lease signed 01-01-03	550 000		400 000	
Rental No. 1 01-01-03	(90 000)		(90 000)	
			<u>310 000</u>	
Interest accrued 31-12-03 (i)	—		45 108	a
Balance 31-12-03	460 000	(ii)	355 108	
Rental No. 2 01-01-04	(90 000)		(90 000)	
			<u>265 108</u>	
Interest accrued 31-12-04	—		38 575	b
Balance 31-12-04	370 000		303 683	
Rental No. 3 01-01-05	(90 000)		(90 000)	
			<u>213 683</u>	
Interest accrued 31-12-05	—		31 093	c
Balance 31-12-05	280 000		244 776	
Rental No. 4 01-01-06	(90 000)		(90 000)	
			<u>154 776</u>	
Interest accrued 31-12-06	—		22 521	d
Balance 31-12-06	190 000		177 297	
Rental No. 5 01-01-07	(90 000)		(90 000)	
			<u>87 297</u>	
Interest accrued 31-12-07	—		12 703	e
Balance 31-12-07	100 000		100 000	
Guaranteed residual	(100 000)		(100 000)	
	<u>NIL</u>		<u>NIL</u>	

NOTES

- (i) Interest accrued is calculated on the basis of 14,5509% of the capital balance outstanding (i.e. the net investment). Interest accrued and recognised as income in 1903 amounts to 14,5509% of R310 000 (the capital balance outstanding at 1 January 1903); i.e. $R310\ 000 \times 14,5509\% = R45\ 108$. Similarly, interest accrued in 1904 is $R265\ 108 \times 14,5509\% = R38\ 575$. Note that the instalment of R90 000 paid on 01-01-04 is effectively a payment of R45 108 settling accrued interest and R44 892 (R90 000 – R45 108) of capital.
- (ii) The gross investment at any point in time is made up of lease instalments outstanding. These instalments include the finance or interest income, whereas the net investment balance (i.e. the capital balance) reflects the net present value of the lease instalments outstanding. Therefore, at any point in time, the difference between the running total of the two columns reflects finance income not yet earned, but expected to be earned over the remainder of the lease term. At the inception of the lease, therefore, R150 000 of finance income is expected but has not been taken to income, whereas at 31 December 1904, R66 317 (R370 000 – R303 683) of finance income is expected to be earned over the remainder of the lease term; i.e. of the original R150 000 of finance income, R83 683 (R45 108 + R38 575) has been recognised in income, leaving an unearned balance of R66 317 (R150 000 – R83 683).

It follows, therefore, that the total interest recognised in income over five years (i.e. $a + b + c + d + e$) is R150 000.

The recognition of finance income may be done using a different basis to that shown above. The above allocation method is known as the “net investment method”. In section 11.5.3 the net cash investment method and the sum of the digits method are illustrated.

The accounting implications, using the net investment method, for Finles are as follows (based on the above table):

INCOME STATEMENT

	1907 R	1906 R	1905 R	1904 R	1903 R	TOTAL R
Finance income (i.e. interest)	12 703	22 521	31 093	38 575	45 108	150 000

BALANCE SHEET (31 December)

						1903 (1 Jan)
Lease Debtor (Gross)	100 000	190 000	280 000	370 000	460 000	550 000
Less: Unearned finance income	—	(12 703)	(35 224)	(66 317)	(104 892)	(150 000)
Net Debtor	<u>100 000</u>	<u>177 297</u>	<u>244 776</u>	<u>303 683</u>	<u>355 108</u>	<u>400 000</u>

A further point to note about lessors and their finance leases is that manufacturers or dealers (and not merely financial intermediaries) may lease assets directly to customers. A finance lease may in these circumstances give rise to two types of income:

- an amount equivalent to the usual profit (or loss) which would ordinarily result from an outright sale of the asset, less volume or trade discounts; and
- finance income over the lease term.

(AC 113 paragraph 29)

The accounting implications of manufacturer or dealer leases are considered in more detail in section 11.5.2.

11.3 Lessees

A lessee is the party to a lease agreement that makes a payment or a series of payments to another party (the lessor) in return for the right to use an asset for an agreed period of time.

Lease agreements are classified either as operating leases or finance leases.

11.3.1 Accounting Implications of Operating Leases

A lease agreement is classified as an operating lease where the risks and rewards of ownership of the leased asset remain with the lessor. The accounting implication for the lessee is as follows:

- lease payments are charged against income on a systematic basis related to the benefit derived from use of the leased asset. The following conditions may require lease payments to be deferred or provision made for future payments in order to relate the charge of the lease payments against income to the benefits derived:
 - lease payments not spread equally over the lease term;
 - lease payments made prior to bringing the leased asset into use;
 - the initial term of the lease is significantly less than the period over which benefit is to be derived and the lease is likely to be renewed at lease payments significantly less or more than the initial lease payments.An example of this situation is considered in section 11.4.1.

11.3.2 Accounting Implications of Finance Leases

A lease agreement is classified as a finance lease where it transfers substantially all the risks and rewards associated with ownership to the lessee. If

any one of the following conditions is met then there is a presumption of a finance lease:

- the lease agreement transfers ownership of the asset to the lessee at the end of the lease term;
- the lease contains a bargain purchase option and the exercise of the option is reasonably assured;
- the lease is equal to or greater than the major portion (usually 75%) of the leased asset's estimated economic life; or
- the present value of the minimum lease payments (at the inception of the lease) is equal to or greater than substantially all (usually 90%) of the open market value of the leased asset.

(AC 105 paragraph 15)

These criteria are very similar to those applicable to lessors (contained in AC 113) that were examined in section 11.2.2. Normally, therefore, there is symmetry of classification between lessors and lessees; i.e. a lease agreement classified as a finance lease for a lessor is also a finance lease to the lessee, and vice versa. However, the definition of minimum lease payments is different for lessors and lessees. The definition in AC 105, reproduced below, has one significant difference from the AC 113 definition which was considered in section 11.2.2.

"Minimum lease payments are the payments that the lessee is, or can be, required to make in terms of the lease, excluding payments in respect of maintenance or other expenses, other than finance costs, and including:

- any residual value guaranteed to the lessor by either the lessee or a party related to the lessee, or
- any payment that the lessee is, or can be, required to make upon failure to renew or extend the lease at the expiration of the lease term."

(AC 105 paragraph 9)

The difference relates to the guarantee of residual values (i.e. the first bullet) in that for lessors, any residual value guaranteed by an "independent third party financially capable of meeting this guarantee" (AC 113 paragraph 8), is included in minimum lease payments. The implication is that the 90% test for the present value of minimum lease payments may yield different results for lessees and lessors because of the inclusion of residuals guaranteed by third parties (for example, the manufacturer of the lease) in the determination of minimum lease payments for lessors. This somewhat contrived situation may result in a lease being classified as a finance lease for the lessor and an operating lease for the lessee.

The following accounting implications arise for the lessee in the case of a finance lease:

- The leased asset is capitalised at the open market value of the leased asset at the commencement of the lease.
- The leased asset is depreciated over the expected useful life of the leased asset to the lessee, or where there is no reasonable certainty that the lessee will obtain ownership at the end of the lease term, over the shorter of the lease term or the asset’s useful life.
- A lease liability is recognised at an amount equivalent to that of the capitalised leased asset.
- Lease payments are apportioned between the amount of finance charge for the period and the amount to be applied in reduction of the lease liability.
- The following examples (identical facts to the examples applicable to lessors in section 11.2.3 and 11.2.4) illustrate the basic accounting treatment for an operating lease and a finance lease for lessees.

11.3.3 Operating Lease Example

On 1 January 1904, Storage Ltd, needing temporary storage space for their finished goods, signed a two year lease with Oples Ltd for a warehouse. Lease payments are R3 000 per month, payable in advance.

By applying exactly the same criteria as for lessors (section 11.2.3), this lease is classified as an operating lease. Storage Ltd are basically hiring the warehouse for a 24 month period.

The only accounting implication for Storage Ltd is the recognition of lease payments:

INCOME STATEMENT	1905	1904
	R	R
Lease payments	36 000	36 000

11.3.4 Finance Lease Example

Usage Ltd leased a new item of plant from Finles Ltd on 1 January 1903 in return for five annual payments, in advance, of R90 000 each and a guaranteed residual amount of R100 000. The terms of the lease indicate that ownership of the asset will pass to Usage Ltd upon payment of the guaranteed residual and that the interest rate implicit in the lease is 14,5509%. Usage

Ltd consider the plant to have a scrap value of R10 000 at the end of its six year useful life. The plant has an open market value of R400 000. Depreciation is on the straight line basis.

The lease should be classified as a finance lease if it meets one of the four criteria discussed above. In this case, three of the four criteria are met:

- ownership of the asset is transferred at the end of the lease term;
- the present value of the minimum lease payments is 90% (in fact, 100%) of the open market value of the leased asset; and
- the lease term is for at least 75% of the useful life of the asset.

The fourth criteria of a bargain purchase option is not applicable in this case.

The lease agreement may therefore be classified as a finance lease. The asset acquired has an open market value of R400 000 and is capitalised with a corresponding lease liability. The payments made over five years to settle the liability amount to R550 000 ($5 \times \text{R90 000}$ plus the residual of R100 000) and the difference of R150 000 (R550 000 payments less R400 000 liability) represents finance charges. These charges should be recognised on a systematic basis over the lease term. The most appropriate systematic basis is the actuarial method which applies the interest rate implicit in the lease to the outstanding balance of the lease liability to determine the finance charges relating to a specific period, but a sum of the digits approach is also acceptable. Using the actuarial method, the following table can be computed:

DATE	PERIOD	CAPITAL BR/FWD	PAYMENT	NET CAPITAL OUT- STANDING	INT AT 14,5509%	CAPITAL C/FWD
31-12-03	1	400 000	(90 000)	310 000	45 108	355 108
31-12-04	2	355 108	(90 000)	265 108	38 575	303 683
31-12-05	3	303 683	(90 000)	213 683	31 093	244 776
31-12-06	4	244 776	(90 000)	154 776	22 521	177 297
31-12-07	5	177 297	(90 000)	87 297	12 703	100 000
01-01-08	6	100 000	(100 000)	—	—	—
			<u>550 000</u>		<u>150 000</u>	

Note that this table is very similar to that used for lessors (refer section 11.2.4). Using these figures, the following accounting implications may be derived:

INCOME STATEMENT

	1908 R	1907 R	1906 R	1905 R	1904 R	1903 R	TOTAL R
Finance charges	—	12 703	22 521	31 093	38 575	45 108	150 000
Depreciation (i)	65 000	65 000	65 000	65 000	65 000	65 000	390 000

BALANCE SHEET

(31 December)

Fixed Assets

– Leased	400 000	400 000	400 000	400 000	400 000	400 000	
Accumulated Depreciation	(390 000)	(325 000)	(260 000)	(195 000)	(130 000)	(65 000)	
	10 000	75 000	140 000	205 000	270 000	335 000	

Lease Liability

– long term	—	—	87 297	154 776	213 683	265 108	
– current (ii)	—	87 297	67 479	58 907	51 425	44 892	
	—	87 297	154 776	213 683	265 108	310 000	

Accruals

(interest payable) (iii)		12 703	22 521	31 093	38 575	45 108	
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NOTES

- (i) Depreciation is based on the six year useful life and a residual of R10 000, i.e. $1/6 \times (R400\,000 - R10\,000)$.
- (ii) The current portion of the lease liability is the proportion of the next lease instalment that is a repayment of capital. This can be derived from the interest schedule, i.e. the payment on 1 January 1904 of R90 000 is R45 108 of interest and R44 892 ($R90\,000 - R45\,108$) of capital. The same procedure is used for each period.
- (iii) Accruals represent the net interest payable, i.e. that proportion of the next instalment that constitutes interest. Note how the accrual plus the current portion of the lease liability totals R90 000 for each year (except for 1907 where the next instalment is the guaranteed residual of R100 000). This is to be expected as each instalment is made on the first day of the financial year.

11.4 Recording

11.4.1 Operating Leases

Assuming the same information as used for the example in sections 11.2.3 and 11.3.3 which is summarised below, the underlying journal entries in the lessor's and lessee's ledgers are illustrated.

Leased Asset:	Warehouse, cost of R380 000 (December 1903)
Lease Term:	24 months R3 000 per month in advance. Commenced 01-01-04.
Useful Life:	60 years, straight line. Residual Value R20 000.
Costs of obtaining Lease:	R12 000 paid on 01-03-04; Expensed Immediately.

DATE		LESSOR			LESSEE	
		DR	CR		DR	CR
1. 12-1903	Land & Buildings	380 000		No entry		
	Cash/loan		380 000			
	Being acquisition of asset					
2. 01-01-04	Cash	3 000		Rent Paid	3 000	
	Rent received		3 000	Cash		3 000
	Being recognition of rent received (This entry is repeated each month for two years.)			Being payment of rent (This entry is repeated each month for two years.)		
3. 01-03-04	Commission paid	12 000		No entry		
	Cash		12 000			
	Being agent's fee expensed					
4. 31-12-04	Depreciation	6 000		No entry		
	Accumulated Depreciation		6 000			
	Being depreciation for year ($\frac{1}{60} \times (380\,000 - 20\,000)$) (This entry is repeated in 1905.)					

Note that if the lease payments were structured as one payment on 1 January 1904 of R54 000 and six monthly payments of R3 000 each commencing on 1 July 1905 then the R54 000 payment should be accrued and recognised in income (lessor) or charged to income (lessee) **over the 18 month period** i.e. at 31-12-04, the lessor would have recognised R36 000 of the R54 000 as income and the remaining R18 000 would be included with current liabilities as "rentals received in advance" and the lessee would similarly reflect a charge of R36 000 being rentals paid and a debtor of R18 000, being "rental prepayments".

11.4.2 Finance Leases

Assuming the same information as used for the example in sections 11.2.4 and 11.3.4 which is summarised below, the underlying journal entries in the lessor's and lessee's ledgers are illustrated.

Leased Asset: Plant, Open market value of R400 000
 Lease Term: 5 years; Instalments of R90 000 payable annually in advance. Commenced 01-01-03.
 Useful Life: 6 years, straight line. Scrap Value R10 000
 Guaranteed Residual: R100 000 payable on 01-01-08.
 Interest Rate: 14,5509% p.a.

DATE		LESSOR			LESSEE	
		DR	CR		DR	CR
01-01-03	1. Gross investment in lease	550 000		Leased plant	400 000	
	Unearned Finance Income		150 000	Lease liability		400 000
	Fixed Asset		400 000			
	Being recording of investment in finance lease			Being recognition of asset leased under a finance lease		
01-01-03	2. Cash	90 000		Lease liability	90 000	
	Gross investment in lease		90 000	Cash		90 000
	Being receipt of first instalment			Being payment of first instalment		
31-12-03	3. Unearned Finance Income	45 108		Interest expense	45 108	
	Interest Income		45 108	Accruals		45 108
	Being recognition of interest on net investment in lease			Being recognition of interest accrued		
31-12-03	4. No entry			Depreciation	65 000	
				Accumulated Dep		65 000
				Being depreciation for the year ($\frac{1}{6} \times (400\,000 - 10\,000)$)		
01-01-04	5. Cash	90 000		Lease liability	44 892	
	Gross investment in lease		90 000	Accruals	45 108	
	Being receipt of second instalment			Cash		90 000
	Being payment of second instalment			Being payment of second instalment		
31-12-04	6. Unearned Finance Income	38 575		Interest expense	38 575	
	Interest Income		38 575	Accruals		38 575
	Being recognition of interest on net investment in lease			Being recognition of interest accrued		
31-12-04	7. No entry			Depreciation	65 000	
				Accumulated Depreciation		65 000
				Being depreciation for the year		
01-01-05	8. Cash	90 000		Lease liability	51 425	
				Accruals	38 575	

DATE		LESSOR			LESSEE	
		DR	CR		DR	CR
	Gross investment in lease		90 000	Cash		90 000
	Being receipt of third instalment			Being payment of third instalment		
31-12-05	9. Unearned Finance Income	31 093		Interest expense	31 093	
	Interest Income		31 093	Accruals		31 093
	Being recognition of interest on net investment in lease			Being recognition of interest accrued		
31-12-05	10. No entry			Depreciation	65 000	
				Accumulated Depreciation		65 000
				Being depreciation for the year		
01-01-06	11. Cash	90 000		Lease liability	58 907	
				Accruals	31 093	
	Gross investment in lease		90 000	Cash		90 000
	Being receipt of fourth instalment			Being payment of fourth instalment		
31-12-06	12. Unearned Finance Income	22 521		Interest expense	22 521	
	Interest Income		22 521	Accruals		22 521
	Being recognition of interest on net investment in lease			Being recognition of interest accrued		
31-12-06	13. No entry			Depreciation	65 000	
				Accumulated Depreciation		65 000
				Being depreciation for the year		
01-01-07	14. Cash	90 000		Lease liability	67 479	
				Accruals	22 521	
	Gross investment in lease		90 000	Cash		90 000
	Being receipt of fifth instalment			Being payment of fifth instalment		
31-12-07	15. Unearned Finance Income	12 703		Interest expense	12 703	
	Interest Income		12 703	Accruals		12 703
	Being recognition of interest on net investment in lease			Being recognition of interest accrued		
31-12-07	16. No entry			Depreciation	65 000	
				Accumulated Depreciation		65 000
				Being depreciation for the year		

DATE		LESSOR		LESSEE	
		DR	CR	DR	CR
01-01-08	17. Cash	100 000		Lease liability	87 297
				Accruals	12 703
	Gross investment in lease		100 000	Cash	100 000
	Being receipt of guaranteed residual			Being payment of guaranteed residual	
31-12-08	18. No entry			Depreciation	65 000
				Accumulated Dep	65 000
				Being depreciation for the year	

Notice the symmetry between the lessor’s entries and the lessee’s entries.

11.5 Specific Issues

11.5.1 Unguaranteed Residuals

Where residual values are guaranteed then they can generally be treated as normal lease instalments. However, where a residual value is not guaranteed then the lessor accounts for the residual only upon receipt thereof; i.e. no anticipation is made of unguaranteed residual values. This is achieved by **excluding** unguaranteed residual payments from the present value of the minimum lease payments calculation. Note, however, that the unguaranteed residual is included in the gross investment in the lease. In this way, the unguaranteed residual is only recognised as income if received by the lessor.

11.5.2 Manufacturer or Dealer Leases

A lessor who is the manufacturer or dealer of the leased asset does not recognise profit or loss on sale at the commencement of an **operating** lease. This is because no sale has been recorded. However, a profit or loss should be recognised on a finance lease as this, in effect, amounts to a sale. The amount recognised is restricted to the normal profit or loss on outright sales. For example, if the asset that Finles Ltd leased to Savage Ltd had been manufactured for R320 000 by Finles Ltd and the normal selling price of the asset is R400 000 then R80 000 would be recognised as gross profit on sale of the asset.

Sometimes leases are structured at an artificially low rate of return in order to boost sales. In effect, the manufacturer or dealer is foregoing gross profit by charging interest at rates that are below market rates. In the example used, if Finles Ltd’s specified implicit interest rate of 14,5509% was signifi-

cantly below the average commercial rates of interest on finance leases of say, 22% then the true selling price is in fact the PV of the lease instalments ($5 \times R90\ 000$ and a residual of R100 000) at 22%, or R351 428. The reality, therefore, is that Finles Ltd has made a gross profit of only R31 428 (R351 428 – R320 000) and finance income (at 22%) to be earned over the period of the lease is R198 572 (R550 000 – R351 428). The journal entry would be as follows to record the inception of the lease:

Dr	Gross Investment in the lease	550 000	
Dr	Cost of Sales	320 000	
	Cr Sales		351 428
	Cr Unearned Finance Income		198 572
	Cr Stock		320 000

The finance income of R198 572 is recognised over the period of the lease, resulting in an effective 22% interest rate for the lessor.

11.5.3 Allocation of Income: Net Cash Investment

The lessor uses the net investment in a finance lease to determine the carrying value of the debtor on the balance sheet. In the example in section 11.2.4, we allocated finance income on the basis of the net investment from year to year. However, a lessor would usually consider the pattern of cash flows associated with a lease when assessing the rate of return on the lease and the allocation of finance income on the basis of the net **cash** investment in the lease may be more appropriate.

The presence of outside funding for the lease or the granting of accelerated taxation allowances will result in cash flow implications for the lessor. The lessor's net cash invested in a finance lease would therefore be different to the net investment in the lease.

Using the same facts as in previous examples (i.e. five instalments of R90 000 commencing on 1 January 1903 and a guaranteed residual of R100 000), assume further that the lessor is granted wear and tear allowances by the Receiver of Revenue of 50% in 1903; 30% in 1904 and 20% in 1905 and that the guaranteed residual was paid on 31 December 1907.

If we assume further that tax at 40% is payable on 31 December of each year and that the lessor (Finles Ltd) has sufficient rental income from other leases to permit full utilisation of the tax allowances, then the following cash flows can be identified:

			TAXATION
1903:	Rental Income	90 000	
	Wear & Tear ($400\,000 \times 50\%$)	<u>(200 000)</u>	
	Taxable Income reduction	<u>(110 000)</u>	
	$\therefore$ Tax saving $\times 40\%$		(44 000)
1904:	Rental Income	90 000	
	Wear & Tear ($400\,000 \times 30\%$)	<u>(120 000)</u>	
	Taxable Income reduction	<u>(30 000)</u>	
	$\therefore$ Tax saving $\times 40\%$		(12 000)
1905:	Rental Income	90 000	
	Wear & Tear ($400\,000 \times 20\%$)	<u>(80 000)</u>	
	Taxable Income increase	10 000	
	$\therefore$ Tax Payable $\times 40\%$		4 000
1906:	Rental Income	90 000	
	Wear & Tear	<u>NIL</u>	
	Taxable Income increase	90 000	
	$\therefore$ Tax Payable $\times 40\%$		36 000
1907:	Rental Income	90 000	
	Residual Value	<u>100 000</u>	
	Taxable Income increase	190 000	
	$\therefore$ Tax Payable $\times 40\%$		76 000
	Total of tax cash flows		<u>60 000</u>

(Note that total taxable income of Finles Ltd over five years should amount to the finance income on the lease: i.e. R150 000 (instalments of R550 000 less R400 000 cost of asset). Tax at 40% on R150 000 = R60 000; this corresponds to the cash flows calculated above.)

The cash flows can be summarised as follows:

	INSTALMENTS	TAXATION	TOTAL
01-01-1903	90 000		90 000
01-01-1904	90 000	44 000	134 000
01-01-1905	90 000	12 000	102 000
01-01-1906	90 000	(4 000)	86 000
01-01-1907	90 000	(36 000)	54 000
31-12-1907	<u>100 000</u>	<u>(76 000)</u>	<u>24 000</u>
	550 000	(60 000)	490 000

The total column reflects the after tax **cash** flows associated with the lease. The interest rate that, when applied to these cash flows, results in a net present value of R400 000 would represent the **after tax** return to the lessor on the net **cash** investment (R400 000 is the cash outflow that the lessor makes at the inception of the lease in order to acquire the asset). This can be calculated at 12,018% and is illustrated as follows:

CASH FLOW R	PV FACTOR (12,018%)	PRESENT VALUE R
90 000	1,0	90 000
134 000	0,893	119 624
102 000	0,797	81 288
86 000	0,711	61 184
54 000	0,635	34 297
<u>24 000</u>	<u>0,567</u>	<u>13 607</u>
490 000		400 000

This table may be used to calculate the timing of the recognition of the finance income at 12,018%:

		NET CASH INVESTMENT	FINANCE INCOME (AFTER TAX)
01-01-03	Purchase Instalment No. 1	400 000 (90 000) <u>310 000</u>	
31-12-03	Finance Income at 12,018% (i.e. 310 000 × 12,018)	37 256	37 256
31-12-03	Taxation saving (cash flow)	<u>(44 000)</u> 303 256	
01-01-04	Instalment No. 2	<u>(90 000)</u> 213 256	
31-12-04	Finance Income at 12,018%	25 629	25 629
31-12-04	Taxation saving (cash flow)	<u>(12 000)</u> 226 885	
01-01-05	Instalment No. 3	<u>(90 000)</u> 136 885	
31-12-05	Finance Income at 12,018%	16 451	16 451
31-12-05	Taxation Paid	<u>4 000</u> 157 336	
01-01-06	Instalment No. 4	<u>(90 000)</u> 67 336	
31-12-06	Finance Income at 12,018%	8 092	8 092
31-12-06	Taxation Paid	<u>36 000</u> 111 428	
01-01-07	Instalment No. 5	<u>(90 000)</u> 21 428	
31-12-07	Finance Income at 12,018%	2 575	2 575
31-12-07	Taxation Paid	<u>76 000</u> 100 003	
31-12-07	Residual Payment	<u>(100 000)</u>	
	(Small rounding difference)	NIL	90 000

Finance income before tax is calculated by grossing up the after tax recognition of finance income on the net cash investment:

	FINANCE INCOME AFTER TAX	FINANCE INCOME BEFORE TAX
1903	37 256	62 093
1904	25 629	42 715
1905	16 451	27 418
1906	8 092	13 487
1907	<u>2 575</u>	<u>4 292</u>
(Small rounding differences)	<u>90 000</u>	<u>150 000</u>

Notice that the total finance income recognised on both the net investment method and the net cash investment method amounts to R150 000. The only difference relates to the timing of the recognition of the income. The effective return, however, before tax is a constant 20,03% ($12,018\%/0,60$) on the lessor's **net cash investment** and 14,5509% on the lessor's **net investment**. The presence of accelerated tax allowances has effectively improved the lessor's net return.

The following table summarises the timing of the recognition of finance income for the two methods:

	NET CASH INVESTMENT	NET INVESTMENT (see section 10.2.4)
1903	62 093	45 108
1904	42 715	38 575
1905	27 418	31 093
1906	13 487	22 521
1907	<u>4 292</u>	<u>12 703</u>
	150 000	150 000

A further permissible alternative for the allocation of finance income is the sum of the digits method. (See AC 113 paragraph 22.) The sum of digits method over five years applied to finance income of R150 000 would use the following allocation (note that $5 + 4k + 3k + 2k + 1 = 15$).

SUM OF DIGITS METHOD	
1903	50 000
1904	40 000
1905	30 000
1906	20 000
1907	<u>10 000</u>
	150 000

The sum of digits method should only be used "Occasionally, where it is more practical and where it gives substantially the same result" (AC 113 paragraph 22).

11.5.4 Interest Rate Variations

A finance lease may include an interest rate variation clause whereby the instalments payable will be affected by changes in interest rates. The guidance given in AC 105 (paragraph 26) states that the total finance charge to be allocated to subsequent periods will change but no adjustments are made to previously recognised amounts. A simple example illustrates the principle.

An enterprise leases an asset costing R100 000 for five equal annual instalments of R30 000, payable in **arrears**. The effective interest rate on this lease is 15,239% as shown below:

YEAR	INSTALMENT	CAPITAL REPAYMENT	INTEREST (15,239%)
1	30 000	14 761	15 239
2	30 000	17 010	12 990
3	30 000	19 603	10 397
4	30 000	22 590	7 410
5	30 000	<u>26 032</u>	<u>3 968</u>
(Slight difference due to rounding)		<u>100 000</u>	<u>50 000</u>

The lease is subject to interest rate variations and in the third year instalments decrease to R29 000 as a result of a fall in interest rates. This reduces the total instalments to R147 000 ((R30 000 × 2) + (R29 000 × 3)) and the total interest charge to R47 000. At the end of year 2, the net amount of capital and interest paid is as follows:

Capital: 14 761 + 17 010 = R31 771

Interest: 15 239 + 12 990 = R28 229.

The net amount outstanding (based on the revised lease instalments) is:

Capital: 100 000 – 31 771 = R68 229

Interest: 47 000 – 28 229 = R18 771.

In terms of AC 105 (paragraph 26), the new instalments of R29 000 should be applied to the net amounts outstanding at the time of the interest rate variation; i.e. the three remaining instalments of R29 000 must repay the outstanding capital of R68 229 and interest of R18 771 over the three year period. This results in an effective interest rate of 13,21%:

	INSTALMENT	CAPITAL	INTEREST (13,21%)
Year 3	29 000	19 987	9 013
Year 4	29 000	22 627	6 373
Year 5	29 000	<u>25 615</u>	<u>3 385</u>
		<u>68 229</u>	<u>18 771</u>

The variation in the interest rate has, in effect, been treated as a change in accounting estimate. The effect of the change in estimate is spread forward, but it is not spread backwards.

11.5.5 Sale and Leaseback

A sale and leaseback transaction involves the sale of an asset by an enterprise and the leasing of the same asset back to that enterprise. The lease payments and the sales price are usually interdependent as they are negotiated as a package and need not represent fair values. The accounting treatment of a sale and leaseback transaction depends upon the type of lease involved.

Generally speaking, the existence of a sale and leaseback transaction has no effect on the lessor's (i.e. the buyer) accounting treatment. The transaction is accounted for in the normal way. Although the cost of the asset may not be its fair value, the effect of this is automatically spread over the term of the lease.

In the case of lessees, however, the accounting treatment of a sale and leaseback transaction depends on the type of lease. If the leaseback is a finance lease, the transaction is a means whereby the lessor provides finance to the lessee, with the asset as security. Therefore, apparent profit or loss on sale should not be recognised. For example, a company sells an asset with a carrying amount of R52 000 for R60 000 and leases it back under a finance lease. The apparent profit of R8 000 should not be treated as income. Instead, the asset should be left at its original value and the amount received on sale is recognised as a creditor. The lease payments (more properly described as repayments) are then treated as partly a repayment of the amount of the principal (i.e. the original liability of R60 000) and partly as interest on the principal.

If the leaseback is an operating lease then different considerations apply. The lessee has disposed of the risk and rewards of ownership and a profit or loss on sale should be recognised. Where the selling price is equal to the open market value (or fair value) of the asset then the profit or loss on sale

is recognised immediately as this represents a genuine profit or loss. However, this is not the only possibility:

- (i) If the selling price is above open market value then the excess over open market value should be deferred and amortised over the period of the lease. The deferral is a liability and the amortisation thereof has the effect of decreasing the lease payments over the period of the lease. This compensates for the increased lease instalments inherent in the lease as a result of an inflated selling price.
- (ii) If the selling price is below open market value then any profit or loss should be recognised immediately except that if the loss is compensated by future lease instalments at below market value then it should to that extent be deferred and amortised over the period of the lease.

The following simple example illustrates the principles. Assume three different situations (a), (b) and (c):

	(a)	(b)	(c)
Open Market Value	500	400	500
Selling Price	600	400	400
Carrying Amount (i.e. Book Value)	350	350	475

Under situation (a), a profit of R150 000 (500 – 350) is recognised immediately but the additional “profit” of R100 000 is deferred and taken to income over the period of the lease. (This compensates for the increased lease instalments that are based on the inflated selling price of R600 000.)

Under situation (b), a profit on sale of R50 000 is recognised immediately.

Under situation (c), a profit of R25 000 (500 – 475) is recognised immediately but the “loss” of R100 000 (500 – 400) is deferred and charged to income over the period of the lease. (This compensates for the artificially reduced lease instalments that are based on the low selling price of R400 000.)

The accounting treatment for profits and losses on sale and leaseback transactions can be summarised as follows:

1	$S < C < M$	$(M - C)$	profit recognised immediately
		$(M - S)$	loss deferred
2	$S < M < C$	$(C - M)$	loss recognised immediately
		$(M - S)$	loss deferred
3	$C < S < M$	$(M - C)$	profit recognised immediately
		$(M - S)$	loss deferred
4	$C < M < S$	$(M - C)$	profit recognised immediately
		$(S - M)$	profit deferred

5	$M < C < S$	$(C - M)$	loss recognised immediately
		$(S - M)$	profit deferred
6	$M < S < C$	$(C - M)$	loss recognised immediately
		$(S - M)$	profit deferred
	S	$=$	Selling Price
	C	$=$	Carrying Amount (Book Value)
	M	$=$	Market Value

The disclosure requirements relating to sale and leaseback transactions are considered in section 11.6.

11.6 Financial Statement Presentation

11.6.1 Accounting Policy

An accounting policy for lessees may be as follows:

Assets acquired under finance lease agreements that transfer substantially all the risks and rewards of ownership to the group are capitalised. The capital portion of the leasing commitment is disclosed under long term liabilities. Lease instalments are apportioned between their capital and interest components using the effective interest rate method.

Lease instalments in respect of assets leased under operating lease agreements are charged to income as they are incurred.

An accounting policy for lessors may be as follows:

Assets leased under finance lease agreements are regarded as financing transactions and rentals receivable thereunder, less unearned finance charges, are included on the balance sheet. Finance charges earned are computed at the effective rates of interest inherent in the lease agreements and are brought to income in proportion to balances outstanding under each agreement, such balances being adjusted where appropriate to reflect the benefits of cash flow resulting from accelerated taxation allowances.

11.6.2 Companies Act

Schedule 4 to the Companies Act requires the following disclosures in respect of lease transactions:

- Paragraph 15(b) Separate disclosure of long term borrowings arising from capitalised leased assets, including the rates of interest and instalment details.
- Paragraph 20 Separate identification of capitalised leased assets.
- Paragraph 42(r) The amount of operating lease charges distinguishing between the major categories of assets held under operating lease.
- Paragraph 42(t) The profit or loss, after adjustment for any difference between the selling price and fair value, on a sale and leaseback transaction that gives rise to an operating lease. (A sale and leaseback transaction is defined in paragraph 4(y).)

11.6.3 AC 113

The disclosure requirements of AC 113 (lessors) are as follows:

- Paragraph 53 Gross investment in finance leases, the related unearned finance income and unguaranteed residual values.
- Paragraph 54 The effect of reduced tax charges resulting from non-recoupable allowances on leased assets.
- Paragraph 55 The basis used for allocating finance income; i.e. net investment or net cash investment method.
- Paragraph 56 Details of leveraged lease participation.
- Paragraph 57 Where significant, operating leased assets by major class of asset together with accumulated depreciation.

11.6.4 AC 105

The disclosure requirements of AC 105 (lessees) are as follows:

- Paragraph 50 The carrying amount of capitalised leased assets, distinguishing between major categories.
- Paragraph 51 The amount of liabilities relating to capitalised leased assets, highlighting:
 - interest rates
 - amounts and dates of repayments
 - current and long term portions.
- Paragraph 52 Depreciation and finance charges relating to capitalised leased assets.
- Paragraph 53 Operating lease payments charged to income, analysed between major categories of assets.
- Paragraph 54 In respect of sale and leaseback transactions (relating to operating leases only):

- profit or loss, after adjustment for any difference between the selling price and open market value;
- deferred profit or loss, separately identifying the amount amortised during the period and the balance remaining;
- details about any repurchase commitment, contingency or option arising from the sale and leaseback transaction.

11.7 Taxation

11.7.1 Deferred Taxation: Lessors

Lessors are taxed on lease instalments accrued. The Receiver of Revenue does not recognise a finance lease as a “sale” of an asset and the lessor is therefore allowed to claim wear and tear allowances on all assets, irrespective of whether they are subject to finance leases or not. In contrast, for accounting purposes a lessor recognises finance charges in respect of finance leases.

The difference between the accounting treatment and the taxation treatment of finance leases gives rise to a timing difference for the lessor. This timing difference is accounted for in the normal way (refer chapter 2) and gives rise to a deferred tax balance.

11.7.2. Deferred Taxation: Lessees

For taxation purposes, lessees are entitled to a deduction from gross income for lease instalments paid and payable during an accounting period. However, when accounting for a finance lease, a lessee expenses only the interest portion of lease instalments and charges depreciation in respect of capitalised leased assets. This treatment results in a timing difference between accounting and taxation recognition. This timing difference is accounted for in the normal way (refer chapter 2) and gives rise to a deferred tax balance.

The deferral of a profit or loss on a sale and leaseback transaction may also give rise to a timing difference which is accounted for in the usual way.

12 Segmental Reporting

12.1 Introduction

The latter part of the 20th century has led to increased corporate diversification across industry sectors and continents. Where a group of companies operates in more than one industry sector or in more than one part of the world, then users of financial statements need disaggregated (or segment) information when assessing the prospects and risks of a diversified enterprise. This information may not be determinable from the aggregated data.

Consolidation procedures aggregate the financial statements of legal entities. Segment reporting, on the other hand, disaggregates the consolidated information over economic lines of business or geographical locations or both. These lines of business or geographic locations are called segments and often differ from legal structures within a group because a subsidiary may be involved in a number of lines of business, or a number of subsidiaries may be located in the same geographical area.

12.1.1 The Need for Segmental Reporting

Segmental reporting of large diversified groups' results enable the user to assess the quality of the earnings, the specific risks to which a company or group is subject, and the areas where long term growth may be expected of the different operations within that diversified group.

The basic reason, therefore, for a reporting enterprise to provide segmental information is to assist the users of financial statements to appreciate more thoroughly the results and financial position of the enterprise and to be aware of the impact that changes in significant components of that enterprise may have on the enterprise as a whole. Of the users identified in AC 000, investors, lenders and the government are the most likely to benefit from segmental information.

Research, mostly in the UK and US, carried out on the benefits of segmental information to shareholders, indicates that the disaggregated data improves their ability to predict a business enterprise's future profitability. In addition, much of the demand for segmental reporting has come from investment analysts who act on behalf of the investor user group.

Lenders benefit from segmental information in that any improvement in their ability to predict cash flows will assist them to make decisions regarding the liquidity and solvency of their debtor.

The government benefits from segmental reporting through improved assessment of national versus foreign activities, macro-economic statistical data and economic decision making.

AC 115 makes it clear that reporting segment information involves decisions that are based in part on judgement. These decisions involve the identification of segments, the allocation of revenues, expenses and assets to those segments and an assessment of any competitive prejudice that might arise from the disclosure of such information.

12.2 Conceptual Issues

12.2.1 The Objective of Financial Statements

The conceptual framework (AC 000 paragraph 12) states that the objective of financial statements is “to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions”.

As noted above where companies are extremely diverse or operate globally, the aggregation of their consolidated information results in a decrease in the amount of information available to users about individual results within that company or group.

As segmental reporting is concerned with the disaggregation of diversified operations and enterprises trading across continents, segment disclosures are usually applicable only to listed companies or other economically significant enterprises whose financial statements are widely available (AC 115 paragraph 2).

Segmental reporting provides information about the prospects and risks facing segments of a diversified enterprise. As these prospects and risks may differ between industry sector and/or different parts of the world, segment reporting is usually reported for both industry segments and geographic segments.

Example

The following example, an extract from South African Breweries' 1994 annual report, shows disclosure of turnover, trading profit and net assets by industry segment. (All figures Rm.)

	<i>Turnover</i>		<i>Trading Profit</i>		<i>Net Assets</i>	
	<i>1994</i>	<i>1993</i>	<i>1994</i>	<i>1993</i>	<i>1994</i>	<i>1993</i>
Beer Interests						
SAB	5 741	5 248	1 126	1 104	4 063	3 426
Westgate	<u>1 101</u>	<u>949</u>	<u>201</u>	<u>182</u>	<u>1 062</u>	<u>659</u>
	6 842	6 197	1 327	1 286	5 125	4 085
Complimentary						
Beverages						
ABI	1 208	1 162	143	148	469	413
Appletiser SA	294	259	5	8	8	87
TBI	100	85	10	9	29	31
Wines & Spirits	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>441</u>	<u>291</u>
	1 602	1 506	158	165	947	822
Retail and Hotels						
Edgars	3 679	3 176	455	425	1 243	935
OK Bazaars	5 367	5 020	(31)	48	794	1 106
Amrel	1 180	1 251	63	81	658	657
Hotel Interests	<u>509</u>	<u>491</u>	<u>—</u>	<u>(16)</u>	<u>837</u>	<u>821</u>
	10 735	9 938	487	538	3 532	3 519
Manufacturing						
Plate Glass	3 241	2 775	354	270	735	643
Afcol	865	789	56	39	374	312
Da Gama	267	254	21	25	240	231
Lion Match	238	294	36	42	261	172
Conshu	<u>668</u>	<u>—</u>	<u>60</u>	<u>—</u>	<u>230</u>	<u>40</u>
	5 279	4 112	527	376	1 840	1 398
Miscellaneous	<u>(7)</u>	<u>26</u>	<u>(59)</u>	<u>(30)</u>	<u>35</u>	<u>473</u>
	<u>24 451</u>	<u>21 779</u>	<u>2 440</u>	<u>2 335</u>	<u>11 479</u>	<u>10 297</u>

Details of divisional earnings, SAB share of earnings, taxed operating return, cash flow from operations and net cash invested is also presented.

A geographical breakdown of turnover, divisional earnings and net assets is presented in a pie-chart format showing South Africa, Rest of Africa, and UK, Europe and other.

(SAB Ltd, extract from the annual report for the year ended 31 March 1994, pp 16-17.)

12.2.2 Industry Segments

An industry segment is a distinguishable component of an enterprise that is engaged in providing a different product or service, or a different group

of related products or services, primarily to parties outside the enterprise. The determination of industry segments would depend on, inter alia:

- the nature of the products or services;
- the nature of the production processes;
- the markets available to sell the products or services;
- the distribution channels for the products;
- the manner in which the entities' activities are organised; and
- any separate legislative framework relating to part of a business.

12.2.3 Geographic Segments

A geographical segment is a distinguishable component of an enterprise that is engaged in operations in individual countries or groups of countries. A geographical analysis of activities allows users to assess how changes in a political or economic climate may affect the prospects and risks of a diversified enterprise. For example, geographical segment information may allow the user to determine:

- (a) how changes in the economic conditions in a particular geographic area will affect the enterprise as a whole;
- (b) how political changes might affect the enterprise;
- (c) how exchange control regulations could affect the enterprise;
- (d) how exchange rate fluctuations may affect the enterprise.

Physical proximity does not necessarily imply a geographical segment, for example, the risks and prospects facing enterprises operating in Mozambique are very different to the risks and prospects facing enterprises that operate in say South Africa or Zimbabwe. It is not appropriate therefore to combine the operations of Mozambique, Zimbabwe and South Africa into one geographical segment of "Southern Africa". Combining these countries into one segment may agree with physical location, but would give the user of the financial statements very little useful information (assuming materiality of the geographical segments).

12.2.4 Segment Disclosures

Apart from details about the activities/composition of segments, disclosure is generally required of:

- segment sales;
- segment result; and
- segment asset employed.

The calculation of these figures is considered in section 12.5 on financial statement presentation.

It is important that segmental information is disclosed on a consistent basis and so will be comparable from one period to the next. Caution should be exercised when making inter-firm segmental comparisons as the identification of segments is a discretionary and subjective process. The use of similar phrases in separate annual reports does not necessarily imply the use of identical criteria for inclusion in each segment.

12.3 Recording Segment Information

12.3.1 Generation of Segment Information

Segment information would often be generally available to management as a result of their internal reporting procedures. This is particularly the case where reported segments are determined on the basis of internal divisions within a company or groups of companies within a consolidated group.

Geographic segment information may also be generated internally by management for their own decision making process and would sometimes coincide with the industry segments. Where segment information is not, however, readily available from internally generated information then it is a simple procedure to adjust standard reporting accounting packages that are used for consolidation purposes to flag segment information that is relevant on both an industry and geographic basis.

It is logical that segment information should only be presented where it is of significance to the entity as a whole. AC 115 states that it is appropriate to establish qualifying guidelines in terms of which a segment is considered material for separate reporting. It is also appropriate to limit the number of segments to a reasonable level so as to avoid unnecessary complexity.

The usual guideline for materiality is that a segment is only reportable where it constitutes at least ten per cent of turnover, operating profit or total assets, while the total number of segments reported on is seldom more than ten.

12.4 Specific Issues

12.4.1 Segment Identification

There are many possible bases for identifying segments, for example industry and product lines, organisational lines, classes of customers and markets, and geographical areas. The determination of the segments to be reported by an enterprise is the responsibility of the directors of that enterprise.

AC 115 emphasises that the determination of industry and geographical segments of an enterprise depends to a considerable extent on the judgement of management. This implies that management should consider the main purpose of segment reporting in arriving at their classification of segments. Segments should be determined by management after considering the information that is likely to be of value to the user of financial statements. Factors that may be useful in determining whether a part of the business qualifies as a separate segment are:

- (a) where the return on the investment differs from that for the enterprise as a whole;
- (b) where there are different degrees of risk;
- (c) where there are different rates of growth; and
- (d) where there are different levels of potential for future development and growth.

There is no reason why a company should not disaggregate its consolidated data by two different "industry" segment bases. For example, a UK company, United Biscuits (Holdings), analyses group sales by product as well as division.

Where an enterprise trades with a single or relatively small number of customers, one industry or a government body, such information should be disclosed. Specific information about the identity of the individual customer or the importance of individual customers in each of the markets concerned is not usually given.

Geographic segment information is presented either on the basis of the location of operations of the enterprise or on the basis of markets or on both. In addition where there are significant export sales from a local segment, these sales are usually disclosed.

12.4.2 Inter Segment Trading

Inter segment trading is usually eliminated in consolidated financial statements. In the case of segment reporting, however, it is not considered appropriate to eliminate inter segment sales and other inter segment operating revenues and inter segment expenses. In order to reconcile segmental results with consolidated results it is necessary to give a reconciliation of inter segment trading that has been eliminated when arriving at consolidated results. The disclosure of this reconciliation is considered in more detail in section 12.5 on financial statement presentation.

12.4.3 Unallocated Items

Management should be careful to ensure that the quality of disaggregated information does not deteriorate as a result of arbitrary allocation procedures of costs and assets that are not necessarily directly attributable to a segment.

AC 115 allows revenues and expenses that are not directly attributable to a segment but where a reasonable basis for allocation exists to be allocated to segments. The allocation of central costs is necessarily an arbitrary process and the allocation problem can have serious implications for segment reporting.

It is relatively easy for management to select a reasonable basis for the allocation of central costs in order to disguise underlying segment profit information. For example, consider XYZ Ltd which had the following divisional results for the year ended 31 December 1901:

	DIV A	DIV B	DIV C
Gross revenue	1 500	15 000	6 000
Net assets	360	360	3 600
Divisional profit	450	600	1 800

Should management disclose the above divisional results as segment information in their financial statements then the success (in terms of profit margin) in Division C would be only too apparent. Management may decide therefore that Head Office costs of 1 000 should be allocated on the basis of the net assets employed in each division. This would result in divisional profit for each division being as follows:

DIVISION A	DIVISION B	DIVISION C
367	517	967

The relative performance of Division C is effectively disguised by the allo-

cation procedure for the Head Office costs. Had the Head Office costs been allocated on the basis of turnover then the effect on divisional profit would have been quite different and the relative result of Division C would be greatly enhanced:

DIVISION A	DIVISION B	DIVISION C
383	(67)	1 532

Great care, therefore, should be exercised when allocating common items of income, expense, and assets. It is important to note the intention of segmental reporting – the provision of useful information about the various activities, operations and markets of the reporting enterprise. Arbitrary cost allocations could reduce the quality of the information provided and make the segmental analysis misleading. AC 115 notes that in many enterprises, common items such as Head Office expenses are not allocated to individual segments because they are not shared in such a way that any allocation among the segments is considered useful.

12.4.4 Competitive Prejudice Concerns

AC 115 (paragraph 2) allows where, in the opinion of management, “the disclosure of any information required by the statement would be seriously prejudicial to the interests of the enterprise, that information need not be disclosed, but the fact that any such information has not been disclosed must be stated”. This seriously prejudicial clause therefore provides an escape route from the disclosure requirements of AC 115. The clause is justified on the basis that the disclosure of financial information by segment may weaken an enterprise’s competitive position because more detailed information is made available to competitors, customers, suppliers and others. The clause can be used in order to omit all of the segmental information normally required, but it can also be used to omit just part of that information.

While there is no such clause in the International Standard IAS 14, a similar exemption is included in the UK standard, SSAP 25.

12.4.5 Interest Bearing Liabilities

Interest bearing liabilities are generally not allocated to segments, either because they are considered to relate to the enterprise as a whole or because they are viewed as having a financing rather than operating result. The interest earned or incurred by a segment is, therefore, a result of the group’s overall financing policy rather than a reflection of the results of the various

segments. However, where a segment result is arrived at after charging interest, it is then appropriate to allocate interest bearing liabilities on the same basis as the interest was allocated to segments.

12.4.6 Associated Companies and Non-Consolidated Subsidiaries

AC 115 does not require enterprises to report segment financial information pertaining to associated companies and non-consolidated subsidiaries. However, where associated companies and non-consolidated subsidiaries are material in relation to the results and the net assets of the reporting enterprise for the period then segment information should be provided in respect of those companies. The information would be presented for associated undertakings and non-consolidated subsidiaries taken as a whole and would be shown separately from the amounts in respect of group members in the segment report.

12.5 Financial Statement Presentation

12.5.1 Companies Act

Paragraph 67(1) of Schedule 4 of the Companies Act requires disclosure in the Director's report of a "statement of the estimated proportion of profit or loss attributable to the various classes of business of the company".

12.5.2 AC 115

AC 115 requires disclosure, for both industry and geographical segments, of:

- a description of the activities/composition of each reported industry/geographic segment;
- the following, expressed in monetary terms or as a percentage of the consolidated totals:
 - sales or other operating revenues,
 - segment result, and
 - segment assets employed;
- the extent of inter segment transactions and the basis of inter segment pricing;
- a reconciliation between the sum of the individual segments and the aggregated information in the financial statements;

- a description of the nature of and reasons for any change in:
 - the identification of segments;
 - the accounting practices used in reporting segment information; or
 - the accounting policies of segments;

including, where practical, a restatement of comparatives.

Suggested disclosures are depreciation, research and development and capital expenditure by segment, as well as the number of employees for each segment.

Disclosure of segmental information in interim reports is encouraged.

The above disclosure requirements are similar to those included in IAS 14.

Segment result is usually net operating income (or loss) before interest, taxation, outside shareholders' interest, extraordinary item and equity accounted income. In practice, some listed companies provide segmented information for a number of income statement components; i.e. operating income and net income after taxation.

Segment assets are linked to segment result in that the disclosure should reflect the resources employed in generating segment operating results. Therefore, all tangible and intangible assets (including the reasonable allocation of assets common to more than one segment) less all non-interest bearing liabilities would usually constitute segment assets. (Refer also to section 12.4.5.) However, where a segment result is calculated after accounting for interest then the corresponding segment assets figure would be net of interest bearing liabilities. This allows a "return on investment" type calculation to be performed by users and is illustrated in the example below (12.5.3 Example).

It should be noted that IAS 14 differs to AC 115 in that non-interest bearing liabilities (usually operating liabilities; i.e. creditors) are excluded from the calculation of segment assets. All tangible and intangible assets that can be identified with a particular segment, including an allocation of assets shared between that segment and one or more other segments, constitute segment assets.

12.5.3 Example

The following figures were extracted from the Disag Ltd group's standard reporting package at 31 December 1902 (all figures in R000's):

	PACKAGING DIVISION	CONSTRUCTION DIVISION	SOUTH AFRICA	SPAIN
Gross Revenue	35 565	69 435	81 500	18 500
Operating Profit	7 010	8 990	13 545	1 455
Interest pd (to Head Office)	2 320	3 194	4 211	1 303
Total Assets	32 143	56 494	72 437	15 200
Creditors	3 131	5 695	7 004	1 822
Loan from Head Office	15 467	21 293	28 073	8 687
Capital Expenditure	3 000	7 000	2 000	8 000
Number of Employees	300	1 000	1 150	150

Head Office Costs of R1,3m, assets of R3,189m and 100 employees are not allocated to the above segments.

An extract from the consolidated income statement and balance sheet reveals:

	R000's
Turnover	100 000
Operating Profit (after interest paid of R3,7m)	10 000
Total Assets	90 826
Creditors	8 826

The segment report would be presented as follows:

Disag Ltd

Group Segmental Report

for the period ended 31 December 1902.

INDUSTRY SEGMENTS

The group operates through two distinct divisions, packaging and construction. The packaging division supplies corrugated cardboard packaging containers to the removal industry and major consumer goods manufacturers. The construction division specialises in the development and construction of low cost housing projects.

The segment sales, segment result and segment assets employed for each division is set out below, together with details regarding capital expenditure and employees:

	R000's									
	SEGMENT SALES		SEGMENT RESULTS		SEGMENT ASSETS EMPLOYED		CAPITAL EXPENDITURE		NUMBER OF EMPLOYEES	
	1902	1901	1902	1901	1902	1901	1902	1901	1902	1901
Packaging	35 565	XXX	7 010	XXX	29 012	XXX	3 000	XX	300	XX
Construction	69 435	XXX	8 990	XXX	50 799	XXX	7 000	XX	1 000	XX
	<u>105 000</u>	<u>XXX</u>	<u>16 000</u>	<u>XXX</u>	<u>79 811</u>	<u>XXX</u>	<u>10 000</u>	<u>XX</u>	<u>1 300</u>	<u>XX</u>
Intersegment sales	(5 000)	(XXX)	(1 000)	(XXX)	(1 000)	(XXX)				
Unallocated Costs/Assets	—	—	(1 300)	(XXX)	3 189	XXX			100	XX
Interest Paid	—	—	(3 700)	(XXX)	—	—				
Consolidated Totals	<u>100 000</u>	<u>XXX</u>	<u>10 000</u>	<u>XXX</u>	<u>82 000</u>	<u>XXX</u>	<u>10 000</u>	<u>XX</u>	<u>1 400</u>	<u>XX</u>

The basis for intersegment pricing is normal selling price.

GEOGRAPHIC SEGMENTS

The group's operations are located primarily in South Africa with the Spanish operation, begun in 1901, expanding rapidly. The Spanish operation is involved with both packaging and construction activities.

Export sales during the year were negligible.

The segment sales, segment result and segment assets employed for the South African and Spanish operations is set out below, together with details regarding capital expenditure and employees:

	R000's									
	SEGMENT SALES		SEGMENT RESULTS		SEGMENT ASSETS EMPLOYED		CAPITAL EXPENDITURE		NUMBER OF EMPLOYEES	
	1902	1901	1902	1901	1902	1901	1902	1901	1902	1901
South Africa	81 500	XX	13 545	XX	65 433	XX	2 000	XX	1 150	XX
Spain	18 500	XX	1 455	XX	13 378	XX	8 000	XX	150	XX
	<u>100 000</u>	<u>XX</u>	<u>15 000</u>	<u>XX</u>	<u>78 811</u>	<u>XX</u>	<u>10 000</u>	<u>XX</u>	<u>1 300</u>	<u>XX</u>
Unallocated Costs/Assets	—	—	(1 300)	XX	3 189	XX	—	—	100	XX
Interest Paid	—	—	(3 700)	XX	—	—	—	—	—	—
Consolidated Totals	<u>100 000</u>	<u>XX</u>	<u>10 000</u>	<u>XX</u>	<u>82 000</u>	<u>XX</u>	<u>10 000</u>	<u>XX</u>	<u>1 400</u>	<u>XX</u>

NOTES

- (i) In the above example there were no inter-geographic segment sales. If there had been then these would have been treated on the same basis as for industry segments; i.e. reversal of sales of R5m and adjustment of R1m unrealised (to the group) profit against segment results and segment assets (i.e. stock).

- (ii) The interest paid to head office is excluded from segment result as the financing of operations is done centrally-evidenced by head office interest charged of R5,514m (R2,32m + R3,194m) against total group interest paid of only R3,7m. Segment assets, therefore, are total assets less non-interest bearing liabilities (creditors) and *not* less the head office loans. Refer also to point (vi) below.
- (iii) If details of depreciation and research and development costs were available by segment then these details should be disclosed.
- (iv) If management are of the opinion that segment disclosures will seriously prejudice the group's interests then the disclosures need not be given, but the fact of non-disclosure should be stated.
- (v) Most companies present segmental information in a note to the financial statements or in a separate statement alongside the primary statements. Some companies, however, incorporate the information into the Chairman's (or Chief Executive's) Review; a section of the annual report that is not usually covered by the report of the auditors. Care should be exercised to ensure that the information presented is subject to audit.
- (vi) Application of IAS 14 would have resulted in non-interest bearing liabilities being excluded from the calculation of segment assets employed; i.e. packaging assets employed would be disclosed as R32 143 000. The consolidated total forming part of the reconciliation would become R90 826 000.

13 Equity Accounting

13.1 Introduction

13.1.1 Objective

Under the cost method of accounting for investments, the investor records its investment in the investee at cost. The investor recognises income only to the extent that it receives distributions from the accumulated net profits of the investee arising subsequent to the date of acquisition by the investor. Distributions received in excess of such profits are considered a recovery of investment and are therefore recorded as a reduction in the cost of the investment and not as dividend income.

For example, assume that A Ltd purchased 10% of the equity share capital of B Ltd when the latter’s distributable reserves amounted to R100 000. If B Ltd currently has distributable reserves of R150 000, then the post acquisition reserves (from A Ltd’s perspective) of B Ltd amount to R50 000. If B Ltd declares a dividend of R60 000 then A Ltd will receive R6 000 in cash. Of this amount, R1 000 represents a return of capital and should be credited to the investment account as follows:

Dr	Cash	6 000	
	Cr Dividend Income		5 000
	Cr Investment in B Ltd		1 000

The cost method is used by holding companies to account in their own financial statements for investments in subsidiaries. Consolidated financial statements combine the underlying assets and liabilities as well as post acquisition profits of the subsidiaries with the holding company’s accounts. Consolidated financial statements, however, are only drawn up when control can be exercised over the investee. There are often circumstances where an investor is unable to exercise control but is able to significantly influence the operating and financial policy decisions of an investee. In this case, it is appropriate to account for such investments on a different basis (known as the equity method) to the cost method because the cost method provides no useful information about the underlying assets and liabilities of the investee over which influence can be exercised.

AC 110, Accounting for Investments in Associates and Non-Consolidated Subsidiaries, details the appropriate accounting treatment for investments over which significant influence is exercised. Significant influence is regarded

as "the ability to participate in the financial and operating policy decisions of the investee, but it is not control or joint control over those policies" (AC 110 paragraph 7).

Investees over which significant influence can be exercised are known as associates and the objective of accounting for investments in associates is "to provide users of financial statements with information concerning the investor's interest in the earnings and in the underlying assets and liabilities of the associates" (AC 110 paragraph 2).

Extending the above example, assume that A Ltd had acquired 30% of B Ltd's equity share capital when the latter's reserves amounted to R100 000. Assume further that the 30% was sufficient to give A Ltd the ability to participate in the financial and operating policy decisions of B Ltd; i.e. significant influence. In the first accounting period post acquisition, B Ltd made R30 000 and paid a dividend of R10 000. A Ltd would equity account for its investment in B Ltd as follows:

(i) Dr	Cash	3 000	
	Cr Dividend Income		3 000
(ii) Dr	Investment in B Ltd	6 000	
	Cr Income from Associate (NDR)		6 000

The first journal entry is consistent with the cost method of accounting for investments but the second journal entry accounts for the underlying earnings of the investment in the associate (B Ltd). These earnings are recognised in the income statement and subsequently transferred to a non distributable reserve.

13.1.2 Equity Accounting

AC 110 defines an associate as "an incorporated or unincorporated enterprise in which an investor has long term interests and over which it has the ability to exercise significant influence and which is neither a subsidiary nor a joint venture of the investor" (AC 110 paragraph 5).

AC 110 uses qualitative criteria for the determination of significant influence. The ability to **participate** in the financial and operating policy decisions of the investee, but not to control or have joint control over those policies is regarded as significant influence by AC 110.

The investor accounts for the significant influence by adjusting the carrying value of the investment that is initially recorded at cost for post acquisition retained equity income (or losses) and other changes in the investee's net assets. The investor, therefore, accounts for its effective interest in the

retained earnings or loss (net of distributions received or accrued) for the accounting period. This share in the retained earnings or loss is transferred to a non distributable reserve.

Significant influence by an investor over an investee may be demonstrated by one or more of the following:

- representation on the board of directors or equivalent governing body of the investee;
- participation in policy making processes;
- material transactions between the investor and investee;
- inter change of managerial personnel; and
- provision of essential technical information.

An investment of 20% or more of the voting power of the investee is presumed to be significant influence unless demonstrated otherwise.

Equity accounting is also appropriate for subsidiaries that are not consolidated into group financial statements.

Proportionate consolidation is not an appropriate accounting treatment for associates as neither control nor joint control is exercised over an associate. Proportionate consolidation is used to account for joint ventures that are jointly controlled entities (refer chapter 14).

13.1.3 Exclusions

If the investor is a wholly owned subsidiary of another company incorporated in South Africa then the equity method need not be applied as the investor's holding company will apply the equity method to the investor's associates.

Where the associate is a mining enterprise that uses the appropriation method of accounting then the equity method is not normally used for that associate.

13.1.4 Example

In 1901 Holdain Ltd paid R3m for a 30% investment in Alliance Ltd upon the incorporation of the latter. Both groups are listed on the JSE. Extracts from the 1908 consolidated financial statements of the two groups are as follows (R000's):

	HOLDAIN	ALLIANCE
Profit on ordinary activities after taxation	13 200	5 000
Outside shareholders	<u>4 000</u>	<u>1 000</u>
Net profit	9 200	4 000
Dividends paid	<u>4 000</u>	<u>1 000</u>
Retained profit for the year	5 200	3 000
Opening retained earnings	<u>95 000</u>	<u>17 000</u>
Closing retained earnings	<u>100 200</u>	<u>20 000</u>

Assume that Alliance has no reserves other than retained earnings and its earnings yield (based on 10m R1 shares) at 31 December 1908 was 12,5%.

The effect of equity accounting its investment in Alliance Ltd on Holdain's consolidated financial statements may be summarised as follows:

- Adjust cost of investment and NDR for post acquisition earnings of Alliance up to the start of the current period (i.e. $17\,000 \times 30\% = 5\,100$) – "retained equity earnings" from prior years.
- Accrue for current year's retained equity earnings (i.e. $3\,000 \times 30\% = 900$).
- Transfer current year's retained equity earnings to NDR.
- Ensure separate disclosure of dividends received from Alliance (i.e. $1\,000 \times 30\% = 300$).
- Ensure that carrying amount of investment does not exceed fair value.

After equity accounting for Alliance Ltd, extracts from Holdain's consolidated financial statements would be as follows (R000's):

INCOME STATEMENT EXTRACT

Profit on ordinary activities after taxation ($13\,200 - 300$ (divs))	12 900
Profit from Associate – Retained Equity Earnings 900	
Dividends <u>300</u>	<u>1 200</u>
	14 100
Outside shareholders	<u>4 000</u>
Net Profit	10 100
Dividends Paid	<u>4 000</u>
Retained Profit for the year	6 100
Transfer to NDR	(900)
Opening retained earnings	<u>95 000</u>
Closing retained earnings	<u>100 200</u>

BALANCE SHEET EXTRACT

Non Distributable Reserves	
Equity accounted earnings (5 100 + 900)	6 000
Investment in Associate (3 000 + 5 100 + 900)	9 000
(disclosed under long term assets)	

NOTES

- (i) Dividend income from the associate is often disclosed with other investment income in practice (and not, as above, with Profit from Associate). Either approach is acceptable; the important issue is that separate disclosure is necessary.
- (ii) The carrying amount of the investment in associate of R9m is made up of cost (R3m) plus R6m of post acquisition retained equity earnings. (Including where applicable extraordinary items, prior year adjustments and changes in the associate's equity). This carrying amount must be compared to fair value for consideration of any impairment in value that is "other than temporary" (AC 110 paragraph 33). Note that investments in associates must be considered individually for evaluation of impairment in total and not in aggregate. The fair value of the investment in Alliance Ltd may be based on the market price and can be calculated as follows:
- $$\begin{aligned} \text{EPS} &= 4\,000/10\,000 = 40 \text{ cents} \\ \text{Earnings Yield} &= 12,5\% \\ \text{Therefore, price} &= 40/0,125 = 320 \text{ cents} \end{aligned}$$
- 3m shares in Alliance Ltd are $\therefore$ worth $R3,2 \times 3\text{m} = R9,6\text{m}$.
Therefore, no write down is necessary.
- (iii) The market value of R9,6m of the shares in Alliance would have to be disclosed in terms of Schedule 4 (refer section 13.4.2).

The above example illustrates that equity accounting is, in effect, one line consolidation. Holdain reflects its share of the net assets of the associate in one line (investment in associate) on the consolidated balance sheet, rather than the total of the separate assets and liabilities as with subsidiaries. Similarly, Holdain Ltd accounts for its share of the associate's after tax profits, whether or not those profits have been distributed. The amount at which the investment is stated may include goodwill or discount on acquisition.

13.2 Conceptual Issues

13.2.1 The Objective of Financial Statements

The conceptual framework (AC 000 paragraph 12) states that the objective of financial statements is “to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions”.

The recognition of profit on the basis only of distributions received may not be an adequate measure of the profit earned by an investor on an investment in an associate because the distributions received may bear little relationship to the performance of the associate. The investor has significant influence over the associate and therefore a measure of responsibility for the associate’s performance and the return on its investment. The investor accounts for its stewardship by extending the scope of the cost method of accounting to incorporate its share of the results of an associate and by providing an analysis of earnings and investment. This information provides more informative reporting of the net assets and net profit of the investor and facilitates a more useful calculation of relevant financial ratios.

Disclosure of the existence of significant influence as well as accounting for the underlying reality of that influence provides information about the financial position, performance and changes in financial position of the investor that is useful to a wide range of users in making economic decisions.

13.2.2 Recording

Associates are accounted for under the equity method in either:

- the consolidated financial statements of the investor; or
- the investor’s own financial statements where consolidated financial statements are not presented.

(AC 110 paragraph 19)

This factor has different implications for recording – adjustments to consolidated financial statements are pro forma adjustments and therefore need to be repeated each year whereas actual journal entries would be processed for the equity accounting adjustments where no consolidated financial statements are prepared. The necessary entries, using the information in section 13.1.4 may be summarised as follows:

(a) *Equity Accounting in Consolidated Financial Statements*

Pro forma Journal Entries for 1908 (R000’s):

	DR	CR
Investment in Associate	5 100	
NDR		5 100
Being recording of prior year retained equity earnings.		
Investment in Associate	900	
Profit from Associate (Income Statement)		900
Being recording of current period retained equity earnings.		
Retained Earnings	900	
NDR		900
Being transfer to NDR of current period retained equity income.		

NOTES

- (i) Holdain would already have accounted for the R300 of dividend income from Alliance, i.e. Dr Cash; Cr Dividend Income.
- (ii) The two entries for the current year's retained earnings could be combined or rearranged; the important point is that two "legs" are necessary in order to show the recognition of the associate's profit in the income statement and the transfer of that profit to NDR.
- (iii) In 1909, the first **pro forma** journal entry would reflect the cumulative post acquisition retained equity income to 31 December 1908 of R6m, i.e. Dr Investment in Associate; Cr NDR.

(b) *Equity Accounting in the investor's own financial statements*

In this case the cumulative retained equity earnings of R5,1m has already been accounted for by the investor so the only entries required for 1908 are (R000's):

	DR	CR
Investment in Associate	900	
Profit from Associate (Income Statement)		900
Being recording of current period retained equity earnings.		
Retained Earnings	900	
NDR		900
Being transfer to NDR of current period retained equity earnings. (This entry would form part of the company's closing entries.)		

NOTE

- (i) These entries are actually processed in the company's general ledger. Therefore, the entries do not have to be repeated in future years.

13.3 Specific Issues

13.3.1 Extraordinary and Significant Items

AC 110 requires investors to recognise their share of extraordinary items of the associate from the date of acquisition. The extraordinary items attributable to the investor must be separately disclosed (AC 110 paragraph 37).

From the date of acquisition the investor would also recognise its share of items of income or expense within the associate's profit or loss from ordinary activities that were disclosed due to their relevance relating to the performance of the associate (previously known as abnormal items). However, the investor would not necessarily disclose its share. This is because these items, while they may be material for the associate, may not be material enough to warrant disclosure for the investor. Note that the investor would only be disclosing its share (e.g. 25%) of these items of the associate.

It is submitted that the same argument regarding materiality should be applied to extraordinary items despite a requirement of AC 110 to disclose the investor's attributable share of the investee's extraordinary items.

13.3.2 Prior Year Adjustments

Where an associate records a prior year adjustment as a result of a change in accounting policy then the investor must recognise its share of the prior year adjustment of the associate from the date of acquisition and give disclosure of the attributable prior year adjustment in the year in which it arises.

13.3.3 Changes in Associate's Equity

Changes in an associate's equity that have not been included in the income statement may arise from time to time. For example, the associate may revalue land and buildings, giving rise to an increase in equity for the revaluation surplus. Such adjustments should be recognised by the investor to the extent that they have not already been taken into account in the investor's original cost of the investment and to the extent to which the investment carrying amount does not exceed fair value.

To illustrate this accounting treatment, assume that a 30% interest in an associate had been purchased for R300 000 on 1 January 1901. At the date of

acquisition the associate’s land and buildings were considered undervalued by R100 000. On 1 January 1904 the carrying amount of the investment in the associate was R450 000 and the associate decided to revalue land and buildings by R250 000. This revaluation should be recognised by the investor to the extent that it was not taken into account at acquisition. Therefore, 30% of R150 000 (R250 000 – R100 000) or R45 000 should be accounted for as:

Dr	Investment in associate	45 000	
	Cr Non distributable reserve		45 000

The total carrying amount of the investment is now R495 000 and should be checked against the fair value of the 30% share of the associate. If the associate had one million shares in issue at 1 January 1904 then the share price (assuming fair value) should be at least R4,95 otherwise the revaluation of land and buildings should only have been recognised to the extent that the carrying value did not exceed the fair value of the investment in the associate.

13.3.4 Goodwill

The amount of goodwill or discount on acquisition is not separately recognised when equity accounted.

Any goodwill or discount on acquisition is included in the investor’s cost of investment and is only taken into account when determining the profit or loss on disposal of a portion or whole of the investment in the associate.

For example, a 30% investment may have been purchased for R1,1m when the underlying fair net asset value was only R1m. The difference of R100 000 represents goodwill, but it is not described as such when equity accounting. Instead the cost of investment is R1,1m and post acquisition income is recognised in the usual way. When sold, the profit or loss on sale will be the difference between the carrying amount of the investment and the proceeds.

This approach is different to that envisaged by IAS 28 which requires amortisation of the difference between the cost of the investment and the investor’s share of the fair values of the net identifiable assets (IAS 28 paragraph 14).

13.3.5 Coterminous Year Ends

Often the financial year end of an associate will differ from that of an investor. The most recent available audited financial statements of associates

should be used by the investor for purposes of equity accounting. It is permissible to use unaudited information in the interests of timely disclosure where the most recent available audited financial statements are for a period ended more than six months prior to the investor's year end. This is subject to a requirement that the results have been made publicly available and that the investor is satisfied as to their reliability (AC 110 paragraph 24).

Any difference in reporting dates (i.e. non coterminous year ends) must be disclosed as well as the date up to which the associate's results have been incorporated. This requirement is considered in more detail in section 13.4.

When financial statements with a different financial year end are used, adjustments should be made for the effect of any significant events or transactions between the investor and the associate that occur between the date of the associate's financial statements and the date of the investor's financial statements.

13.3.6 Intragroup Transactions

Where intragroup transactions are carried out on an arm's length basis then AC 110 does not require adjustment for the elimination of unrealised profits arising from the intragroup transactions. Where, however, intragroup transactions are clearly not at an arm's length basis then unrealised profits or losses would be eliminated in the same way as the elimination of unrealised profits and losses in consolidated financial statements.

It is also not normally considered appropriate for the investor to adjust for differences between the investor's and the associate's accounting policies.

13.3.7 Associate's Losses

The recognition of an investor's share of losses of an associate results in a decrease in the carrying amount. Where the investor's share of losses equals or exceeds the carrying amount of its investment, then the investor should discontinue including its share of further losses unless guarantees are in place by the investor. This treatment is similar to that which applies where a holding company accounts for its investment on the cost basis.

Once the investment has been written off to nil or a nominal amount then the investor will cease using the equity method unless it has incurred obligations or made payments on behalf of the associate to satisfy obligations of the associate that the investor has guaranteed or otherwise committed, in which case provision must be made for additional losses. If the associate

subsequently reports profits then the investor should resume applying the equity method only after its share of net profit equals the share of net losses not recognised during the period where the equity method was not being used.

Disclosure should be given of the aggregate of equity profits and losses and not just the net equity earnings. This is detailed in section 13.4.

13.3.8 Acquisitions and Disposals

An investee may qualify as an associate for the first time due to the purchase of additional shares or the gaining of significant influence by the investor. This would give rise to an investment that was previously accounted for on the cost basis now being accounted for on the equity basis. The investor is entitled to take credit for post acquisition retained equity earnings or deficit which accrued while the investee was accounted for on the cost basis. This retained equity earnings or deficit is accounted for by adjusting the carrying value of the investment and the non distributable reserve. There is therefore no effect on the income statement for the post acquisition earnings attributable to the investor up until the time that the investee becomes an associate.

From the time that the investment is classified as an associate then the equity method is applied in the normal way.

For example, assume that H Ltd acquired 10% of A Ltd upon incorporation of the latter and a further 15% on 1 January 1903 when A Ltd's reserves amounted to R200 000. The cost of H Ltd's investments were R10 000 and R45 000 respectively. H Ltd will commence equity accounting for its investment in A Ltd from 1 January 1903 – the date from which it has significant influence from its 25% holding. H Ltd is entitled to take credit for the post acquisition increase in reserves since incorporation of A Ltd to January 1903 relating to the original 10% investment. This amounts to R20 000 (R200 000 × 10%) and is accounted for as follows:

Dr	Investment in Associate	20 000	
	Cr NDR		20 000

The total of the investment in associate is now stated at R75 000 (10 000 + 45 000 + 20 000) which equates to 25% of A Ltd's equity (R100 000 share capital and R200 000 reserves). From 1 January 1903, the 25% holding is equity accounted in the normal way.

Disposals and partial disposals are accounted for in the same way as in consolidated financial statements. The profit or loss on disposal of the investment in the associate is the difference between the proceeds received and the carrying amount for equity accounting purposes. The difference, therefore, between the profit recognised on the equity basis and the profit recognised on the cost basis will be the post acquisition retained earnings or deficit that has been taken into account by the investor in relation to that portion of its investment in the associate that it is disposing of. Previously accounted for retained equity earnings should be transferred from NDR to retained earnings.

Using the same details as the above example, assume that H Ltd sold its 25% investment in A Ltd for R100 000 on 1 January 1904 when A Ltd's reserves amounted to R250 000. In H Ltd's financial statements, a profit of R45 000 will be recorded (R100 000 proceeds less R55 000 cost of investment). In H Ltd's consolidated financial statements, however, the investment in A Ltd would have been equity accounted and the carrying value will amount to R87 500 (10 000 cost + 20 000 post acquisition profits relating to 10% holding + 45 000 cost + 12 500 post acquisition profits relating to 25% holding ((250 000 – 200 000) × 25%)). In addition, a NDR of R32 500 would be included in H Ltd's consolidated balance sheet, being the total of post acquisition income relating to the 25% holding. Upon sale of the investment, a profit of R12 500 (R100 000 – R87 500) will be shown in the consolidated income statement. In addition, a transfer of R32 500 will be made from NDR to retained earnings. The total credit to retained earnings amounts, therefore, to R45 000 (12 500 + 32 500), the same as the profit recognised on the cost basis.

Circumstances may arise whereby the use of the equity method is no longer appropriate. AC 110 (paragraph 31) identifies the following circumstances:

- the investee ceases to meet the definition of an associate but the investor retains, either in whole or in part, its investment;
- the associate operates under severe long term restrictions that significantly impair its ability to transfer funds to the investor;
- a decision has been made to dispose of the investment in the associate.

Under either of these circumstances, the investment continues to be stated at the carrying amount established under the equity method at the date that the circumstance arose. Thereafter, the investment is accounted for on the cost basis.

13.3.9 Dilution in Holding

If it is probable that future changes in the associate's equity will have the effect of diluting the investor's interest in the associate (for example a rights issue by the associate in which the investor does not take up its proportion of the rights) then it is appropriate for the investor to quantify and account for the effect of the dilution. In other words, if an investor has a 30% holding in an associate and this percentage is expected to decrease to 27% in the first few months of the next financial period then it is appropriate for the investor to only equity account for the 27% anticipated holding. Full disclosure of any potential dilutions should be given.

13.4 Financial Statement Presentation

13.4.1 Accounting Policy

An appropriate accounting policy note is as follows:

Associate companies are those companies in which long term investments are held and over which the group has the power to exercise significant influence over the financial and operating policies. The group's share of post acquisition results of associates are included in the consolidated income statement using the equity method and are transferred to non distributable reserves.

13.4.2 Companies Act

Schedule 4 to the Companies Act defines an "associated company" (paragraph 4(c)) and "retained equity income or deficit of an associated company" (paragraph 4(x)). These definitions are similar to those incorporated in AC 110.

The following disclosure requirements of schedule 4 are applicable to investments in associates:

- | | |
|--------------------|--|
| Paragraph 26(2)(a) | The market value in respect of investments in listed associates. |
| Paragraph 26(2)(b) | The aggregate of the director's valuation of the associates that are unlisted investments. |
| Paragraph 27 | Details concerning the names of associates and the shareholdings. |
| Paragraph 42(a) | Income from unlisted associates. |
| Paragraph 42(m) | Dividend income, retained equity income or deficit, extraordinary items and prior year adjustments relating to associates. |

13.4.3 AC 110

The following disclosure requirements of AC 110 apply to all investments in associates:

- the investor's income statement (or notes) should separately reflect for its investments in associates:
 - retained equity income or deficit,
 - distributions received or accrued (ie dividends),
 - share of extraordinary items and/or prior year adjustments, and
 - gain/loss on disposal of shares in associate by investor;
- transfer to NDR of retained equity income, attributable extraordinary items and prior year adjustments;
- investments in associates disclosed as a separate item in the balance sheet under long term assets;
- details of and reasons for any associates not accounted for using the equity method; and
- total market value of listed investments in associates and the total directors' valuation of unlisted investments in associates.

Additional disclosure is required where the year ends of the investor and the associate are not coterminous:

- the accounting periods for which the financial statements of the associates have been prepared; and
- the amount relating to any significant unadjusted transactions or events accruing between the dates of the associate's and investor's financial statements.

Where an investment in an associate is significant to the results of operations and/or the financial position of the investor, the following items should be disclosed for those associates:

- the name, the nature of business, the proportion owned, and the proportion of voting power held of the associate;
- the carrying value of the investment in the associate;
- the gross amounts of loans to *and* from the associate by the investor;

- the investor's share of current year and cumulative retained equity income or deficit of the associate; and
- summarised financial information in regard to assets, liabilities and the results of operations of the associate.

13.4.4 IAS 28

The disclosure requirements of AC 110 are more comprehensive than those included in IAS 28.

Therefore, compliance with AC 110 ensures compliance with IAS 28. The only significant point of departure between IAS 28 and AC 110 relates to the separate identification and amortisation of goodwill at acquisition (required by IAS 28 but not separately identified or amortised in terms of AC 110). Refer section 13.3.4 for further discussion.

14 Joint Ventures

14.1 Introduction

14.1.1 Joint Ventures

The degree of influence that an investor exercises over an investee may vary from no influence at all to outright control. Generally speaking, the accounting literature identifies four different types of influence, namely control, joint control, significant influence and no influence. Once an investee is classified under one of these four headings then the appropriate accounting treatment is as follows:

Control	– Consolidate
Joint control	– Proportionate consolidation
Significant influence	– Equity account
No influence	– Cost basis.

This chapter is concerned with the appropriate accounting treatment for when an investor exercises joint control over an investee.

Where joint control exists, there is usually a joint venture. AC 119, Accounting for Interests in Joint Ventures, defines a joint venture as “a contractual arrangement whereby two or more venturers undertake an economic activity which is subject to joint control” (AC 119 paragraph 3). Joint ventures have in the past been a popular form of off balance sheet financing and it is only recently (1993) that an accounting statement was issued to prescribe the appropriate accounting treatment for joint ventures. AC 119 is effective for periods beginning on or after 1 January 1993 and prescribes the proportionate consolidation method of accounting for joint ventures that are jointly controlled entities.

AC 119 identifies three different types of joint ventures – jointly controlled operations, jointly controlled assets and jointly controlled entities. Jointly controlled operations and jointly controlled assets are relatively easy to account for as the objectives of AC 119 are met without preparing separate financial statements. In the case of a jointly controlled entity, however, the venturer’s share of the venturer’s assets, liabilities, income, expenses and cash flows is incorporated into the venturer’s consolidated financial statements. (Refer to section 14.2.1 for further discussion.)

There are two characteristics that are common to all joint ventures; (i) two or more venturers must be bound by a contractual arrangement and (ii) the contractual arrangement should, in effect, establish joint control.

14.1.2 Joint Control

Joint control is “the contractually agreed sharing of control over a joint venture by two or more venturers such that not one of the venturers is in a position to exercise unilateral control over the joint venture” (AC 119 paragraph 5). The existence of a contractual arrangement is a necessary condition for joint control and therefore joint ventures. It follows that activities not governed by a contractual arrangement to establish joint control are not joint ventures but may be situations of control, significant influence or no influence and involve consolidation, equity accounting or cost basis accounting respectively.

A contractual arrangement will normally be in writing and deal with matters such as the activity, duration and reporting obligations of the joint venture, the manner in which the venture is to be directed and administered, the capital contributions by the venturers, and the sharing by the venturers of the results of the joint venture.

The contractual arrangement may be an actual contract between the venturers or minutes of discussions between the venturers. Alternatively, it may be incorporated into the articles or other by-laws of the joint venture. The contractual arrangement may identify one venturer as the operator or manager of the joint venture but this one venturer should in no way be able to unilaterally control the joint venture and should be obliged to act within the terms of the contractual arrangement. If the operator has the power to unilaterally govern the financial and operating policies of the economic activity then control is exercised and the venture should be accounted for as a subsidiary by the operator.

14.2 Conceptual Issues

14.2.1 Proportionate Consolidation

AC 119 states that the objective of the statement is to prescribe the accounting treatment for interests in joint ventures. The statement requires “the reporting of joint venture assets, liabilities, income, expenses and cash flows in the financial statements of venturers and investors, regardless of the structures or forms under which the joint venture activities take place” (AC 119 paragraph 2).

The objective of AC 119 is readily achieved by the form of two of the three different types of joint ventures, namely jointly controlled operations and jointly controlled assets. Jointly controlled operations involve the use of the

assets and other resources of the venturers rather than the establishment of an enterprise that is separate from the venturers themselves. This means that each venturer uses its own property, plant and equipment and carries its own stock as well as incurs its own expenses and liabilities. The nature of a jointly controlled operation is such that each venturer includes in its accounting records the assets that it controls and the liabilities that it incurs, the expenses that it incurs and its share of the income that it earns from the sale of goods or services by the joint venture, and the cash flows generated or utilised. For this reason joint ventures that are jointly controlled operations are included in the venturer's own financial statements and, where applicable, in its consolidated financial statements. Because these results are already included in the financial statements and the consolidated financial statements, no adjustments or other consolidation procedures are necessary.

An example of a jointly controlled operation is where two or more venturers combine their operations, resources and expertise in order to develop and market, say, jet aircraft. Different stages of the development process may be carried out by each of the venturers and each venturer bears its own costs and takes its share of the revenue generated by the sale of the jet aircraft. A contractual agreement sets out the conditions and agreed sharing of benefits relating to the joint venture.

Other joint ventures may involve joint control, and often joint ownership, of one or more assets contributed to or acquired for the purposes of a joint venture. These assets are used to obtain benefits for the venturers and each venturer may take a share of the output from the assets and bear an agreed share of the expenses incurred. An example of a jointly controlled asset may be an oil pipeline, or land and buildings whereby each venturer takes a share of the rents received and bears a share of the expenses. Because these joint ventures do not involve the establishment of an enterprise that is separate from the venturers themselves, the venturer's share of the jointly controlled assets, classified according to the nature of the assets rather than as an investment, is included in its financial statements and where applicable in its consolidated financial statements. For these reasons, no adjustments or other consolidation procedures are required for joint ventures that are jointly controlled assets.

The third type of joint venture identified by AC 119, a jointly controlled entity, gives rise to certain accounting problems. A jointly controlled entity is a joint venture which is conducted through a company, partnership or other entity in which each venturer has an interest. The entity usually operates in the same way as other enterprises, except that a contractual

arrangement exists between the investors which establishes joint control over the economic activity of the separate entity. Many jointly controlled entities are similar in nature to joint ventures that are jointly controlled operations or jointly controlled assets. Frequently jointly controlled assets or jointly controlled operations are transferred into a jointly controlled entity for taxation or legal reasons. Each venturer usually contributes cash or other resources to the jointly controlled entity. These contributions are recognised in the venturer's financial statements as an investment in a jointly controlled entity. In order to ensure consistency with the accounting treatment of jointly controlled operations and jointly controlled assets, it is necessary to incorporate the assets, liabilities, income, expenses and cash flows of the joint venture with the joint venturer's financial statements. This incorporation is achieved using the proportionate consolidation method which AC 119 defines as "a method of accounting and reporting whereby a venture's share of each of the assets, liabilities, income, expenses and cash flows of a jointly controlled entity is combined on a line by line basis with similar items in the venturer's financial statements" (AC 119 paragraph 7). The application of the proportionate consolidation method, therefore, achieves the same results for a jointly controlled entity as if the joint venture was carried out through either jointly controlled operations or jointly controlled assets.

The overriding concern of AC 119 is that joint ventures are accounted for consistently and that the existence of joint ventures is readily identifiable from financial statements. Therefore, the assets, liabilities, income, expenses and cash flows associated with joint ventures should be separately identified and, regardless of the form that a joint venture takes, the investor's share of the assets, liabilities, income and expenses and cash flows of the joint venture should be incorporated on a line by line basis in the joint venturer's financial statements or, where applicable, the joint venturer's consolidated financial statements. These requirements are assessed below in relation to AC 000, *The Framework for the Preparation and Presentation of Financial Statements*, and in particular, the objective of financial statements.

14.2.2 Objective of Financial Statements

Paragraph 12 of AC 000 states that "the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions". It is argued that by combining the assets, liabilities, income, expenses and cash flows of a joint venture with the venturer's financial statements, users are assisted in their assessment

of the potential income or loss resulting from the involvement in the joint venture, and in their understanding of the manner in which assets, liabilities and cash flows are utilised and exposed to risk (AC 119 paragraph 1). Before this argument may be challenged it is necessary to examine whether the assets, liabilities and income statement items of a joint venture meet the definitions of the elements of financial statements given in AC 000.

AC 000 defines an asset as a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise (paragraph 49). It is clear therefore that an asset must be controlled by an enterprise prior to recognition. In the case of a joint venture, outright control is not exercised over the underlying assets. However, joint control is assumed to imply sufficient control for purposes of meeting the definition of an asset in terms of AC 000. A similar argument applies to the liabilities and income statement components.

A venturer that invests in jointly controlled operations or jointly controlled assets will almost always have direct control (albeit partial) over the underlying operations and assets. In a jointly controlled entity, the venturer has joint control over its share of future economic benefits through its share of the assets and liabilities of the venture. AC 119 argues that "the substance and economic reality is reflected in the consolidated financial statements of the venturer when the venturer reports its interests in the assets, liabilities, income, expenses and cash flows of the jointly controlled entity by using the proportionate consolidation method" (AC 119 paragraph 27).

Although the use of the proportionate consolidation method may be justified in terms of AC 000, it has been criticised on the basis that wholly controlled assets are combined with jointly controlled assets on the consolidated balance sheet. The combination of assets that are owned outright with only partly owned assets is potentially misleading to users of financial statements. AC 119 overcomes this criticism by requiring both proportionate consolidation and disaggregation, i.e. AC 119 requires disclosure of the underlying assets, liabilities, income, expenses and cash flows of joint ventures that have been incorporated into the joint venturer's financial statements. This disclosure requirement is considered further in section 14.4.3.

In line with providing only useful information to users, if a venturer ceases to have joint control over a jointly controlled entity, it should discontinue the use of proportionate consolidation from the date of losing joint control (AC 119 paragraph 31). In addition, where an interest in a jointly controlled entity is held with a view to disposal in the near future, or where it operates under severe long term restrictions impairing its ability to transfer funds

to the venturer, the proportionate consolidation method should not be used and the interest should be accounted for as an investment (AC 119 paragraph 32).

14.3 Specific Issues

14.3.1 Equity Accounting

The proportionate consolidation method of accounting for interests in jointly controlled entities is not universally accepted. IAS 31, for example, permits, but does not recommend, the equity accounting method for investments in jointly controlled entities. AC 119 rejects the equity method because “proportionate consolidation better reflects the substance and economic reality of a venturer’s interest in a jointly controlled entity” (AC 119 paragraph 29).

However, AC 119 recognises that there may be exceptional circumstances where, “while the form of the agreement or structure may indicate the existence of joint control, the intention and substance underlying the creation of such a structure makes it inappropriate to apply the proportionate consolidation method” (AC 119 paragraph 30). AC 119 gives an example of these exceptional circumstances, namely where a voting pool agreement is used in order to bind the interests of investors having significant influence and joint control was never envisaged but may arise as a result of the voting pool agreement. There has been some criticism of the fact that AC 119, in effect, allows use of only the proportionate consolidation method but the arguments for proportionate consolidation over equity accounting carry more weight when the principles of AC 000 are taken into account.

14.3.2 Application of Proportionate Consolidation

The basic procedures involved in proportionate consolidation require that the consolidated balance sheet of the venturer includes its share of the assets that it controls jointly and its share of the liabilities for which it is jointly responsible in the jointly controlled entity and that the consolidated income statement and cash flow statement of the venturer include its share of the related items.

Proportionate consolidation is achieved by the venturer combining its share of each of the assets, liabilities, income, expenses and cash flows of the jointly controlled entity with the similar items in its financial statements on a line by line basis. For example, the venturer combines its share of the jointly controlled entity’s debtors with its debtors in the consolidated balance sheet

and its share of the jointly controlled entity's taxation expense with its taxation expense in the consolidated income statement.

As the name suggests, proportionate consolidation takes place in consolidated financial statements. Where a joint venturer has no subsidiaries and consolidated financial statements are not prepared, then separate proportionately consolidated financial statements should be prepared.

Assets or liabilities should not be offset unless a legal right of set off exists and the offsetting represents the expectation as to the realisation of the asset or the settlement of the liability.

Goodwill is accounted for in the normal way when any difference between the cost of acquisitions and the venturer's share of the net identifiable assets is recognised. Note that if at acquisition certain assets of the joint venture are considered to be undervalued then an adjustment to the valuation of the assets should be made for the purposes of proportionately consolidating.

The accounting policies of the jointly controlled entity and the venturer should be the same where possible. "If it is not practicable to use uniform accounting policies in preparing the financial statements, that fact is disclosed together with an estimate of the effect or significance thereof in the consolidated financial statements in which different accounting policies have been applied" (AC 119 paragraph 37).

The application of the proportionate consolidation method is not without its technical difficulties; transactions between a venturer and a joint venture often result in complicated accounting adjustments. Generally speaking, the joint venturer can recognise a profit on sale of an asset or an item of stock to a joint venture to the extent of the profit attributable to the interests of the other venturers. Therefore, where a venturer contributes or sells an asset to a jointly controlled entity at a profit then the venturer should recognise in its consolidated financial statements only that portion of the profit attributable to the interests of the other venturers. This process takes into account that although the asset is retained by the jointly controlled entity, the significant risks and rewards of ownership have been passed to the jointly controlled entity and the joint venturer shares only in its contractually agreed portion of the jointly controlled entity.

Where, however, transactions between a venturer and a jointly controlled entity occur at a loss to the venturer then the full amount of any loss should be recognised by the venturer in its consolidated financial statements. This takes into account that the transfer or the sale of an asset to the joint venture

at a loss to the venturer is indicative of a reduction in the net realisable value of the asset transferred and, unless this decline was temporary, the loss would have been recognised by the venturer in any event.

A similar, but opposite, accounting treatment applies when a venturer purchases assets from a jointly controlled entity. The jointly controlled entity recognises a profit or loss on sale of the asset but the venturer does not recognise its share of the profits in the jointly controlled entity until it resells the assets to an independent party or until they are otherwise realised. The venturer recognises its share of the losses immediately when they represent a reduction in the net realisable value of current assets or a decline, other than temporary, in the carrying amount of long term assets.

Where a loan is made to a jointly controlled entity by a venturer then the interest received on such a loan is recognised in the venturer's own financial statements but is only brought to account in the consolidated financial statements to the extent of the other venturer's share of such loans and interest received. In effect, the venturer's share is eliminated.

The example below illustrates the accounting treatment for inter-company transactions and inter-company loans in the case of a jointly controlled entity that is proportionately consolidated.

Example

Vineyard Ltd has an equal share with three other partners in a joint venture, Apricot (Pty) Ltd, for which it paid R500 000 upon incorporation of Apricot. Vineyard Ltd lent R500 000 at 12% per annum to Apricot on 1 January 1903 and purchased stock of R200 000 (at a 25% mark up on cost) from Apricot during 1903. Stock purchased from Apricot amounted to R50 000 in Vineyard's books at 31 December 1903 (1902: NIL). Summarised financial statements are set out below:

INCOME STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 1903

	VINEYARD R'000	APRICOT R'000
Gross revenue	23 000	4 500
Operating Profit	2 140	674
Interest received/(paid)	160	(60)
Profit on ordinary activities before taxation	2 300	614
Taxation – SA normal	920	244
Profit on ordinary activities after taxation	1 380	370
Dividends paid	600	180
Retained profit for the year	780	190
Opening retained earnings	9 000	400
Closing retained earnings	9 780	590

BALANCE SHEETS AT 31 DECEMBER

	VINEYARD R'000	APRICOT R'000
Share Capital	5 000	2 000
Retained Earnings	9 780	590
Long term loans	1 000	500
	<u>15 780</u>	<u>3 090</u>
Fixed Assets	10 000	2 000
Investment in Joint Venture	1 000	—
Stock	2 500	700
Debtors	3 000	600
Cash	1 500	60
Creditors (2 220)	(270)	
	<u>15 780</u>	<u>3 090</u>

The starting point for proportionate consolidation is to calculate Vineyard's share (25% of Apricot's income and expenses) after having adjusted for transactions between the two companies. Note that sales of R200 000 that relate to Vineyard have been included in Apricot's gross revenue, and that included in Apricot's operating profit is an unrealised profit of R10 000 ($R50\,000 - (R50\,000/1,25)$) arising from the sale of stock to Vineyard that is still on hand at 31 December 1903. Taking into account these adjustments, Vineyard's share of Apricot's income and expenses is as follows:

	R'000
Gross revenue ($4\,500 - 200$) $\times$ 25%	1 075
Operating Profit ($674 - 10$) $\times$ 25%	166
Interest paid ($60 \times 25\%$)	15
Profit on ordinary activities before taxation	151
Taxation ($244 \times 25\%$)	<u>61</u>
Profit on ordinary activities after taxation	90
Dividends ($180 \times 25\%$)	<u>45</u>
Retained profit for the year	45
Opening retained earnings ($400 \times 25\%$)	<u>100</u>
Closing retained earnings	<u>145</u>

Before drafting the consolidated financial statements, it is necessary to note the following about Vineyard's summarised financial statements:

- Included in operating profit is a dividend of R45 000 received from Apricot.
- Included in interest received is R60 000 from Apricot; only the other venturer's share of this (i.e. 75%) may be recognised by Vineyard. This is automatically achieved by taking into account 25% of the interest paid (i.e. R15 000) when proportionately consolidating Apricot.

- Included in the investment in the joint venture account is the cost of R500 000 (eliminated when consolidating) and the loan of R500 000 to Apricot. 25% of the loan is effectively to itself, so only 75% may be recognised i.e. R375 000 in the consolidated financial statements.
- Included in Vineyard's stock is an unrealised profit of R10 000 relating to the inter-company sale of stock. Vineyard's share (25%) may not be recognised (see paragraph 39 of AC 119) and, therefore, R2 500 is eliminated. This adjustment must, however, be processed against **Apricot's** stock balance when preparing the disclosure note about the group's interests in the joint venture. This ensures that the note disclosure balances – this is discussed further below with the relevant disclosures for the example.

The above adjustments result in the following summarised consolidated financial statements:

**CONSOLIDATED INCOME STATEMENT FOR THE YEAR ENDED
31 DECEMBER 1903**

	R'000
Gross Revenue (23 000 + 1 075)	24 075
Operating Profit (2 140 – 4 + 166)	2 261
Interest received (160 – 15)	145
Profit on ordinary activities before taxation	2 406
Taxation – SA Normal (920 + 61)	981
Profit on ordinary activities after taxation	1 425
Dividends paid	600
Retained profit for the year	825
Opening retained earnings (9 000 + 100)	9 100
Closing retained earnings	<u>9 925</u>

CONSOLIDATED BALANCE SHEET AT 31 DECEMBER 1903

	R'000
Share Capital	5 000
Retained Earnings	9 925
Long term loans	1 000
	<u>15 925</u>
Fixed Assets (10 000 + 2 000 × 25%)	10 500
Loan to Joint Venture (500 × 75%)	375
Stock (2 500 – 2,5 + 700 × 25%)	2 672,5
Debtors (3 000 + 600 × 25%)	3 150
Cash (1 500 + 60 × 25%)	1 515
Creditors (2 220 + 270 × 25%)	<u>(2 287,5)</u>
	<u>15 925</u>

Apart from disclosing details of any contingencies or commitments relating to the joint venturer and the other venturers (refer to section 14.4.3) the venturer should disclose the following notes:

(i) Analysis of Retained Earnings

	R'000
Retained Earnings relating to – the company	9 780
– joint venture	<u>145</u>
Consolidated Retained earnings	<u>9 925</u>

(ii) Joint Venture

The consolidated results include the following amounts relating to the group's interest in a joint venture:

	R'000
Gross revenue	<u>1 075</u>
Profit on ordinary activities before taxation	151
Taxation	<u>61</u>
Profit on ordinary activities after taxation	<u>90</u>
Share of retained earnings – current year	45
– prior years	<u>100</u>
	<u>145</u>
Fixed Assets ($2\ 000 \times 25\%$)	500
Net Current Assets ($((700 + 600 + 60 - 270 - 10^*) \times 25\%)$)	270
Long term Liabilities ($500 \times 25\%$)	<u>(125)</u>
	645
Comprising:	
Cost of Investment	<u>500</u>
Share of Retained Earnings	<u>145</u>

* The unrealised profit of R2 500 ($R10\ 000 \times 25\%$) relates to stock that is carried on Vineyard's balance sheet. Strictly speaking, therefore, the R2 500 reduction in stock should be against Vineyard's stock and not Apricot's stock. However, the related income statement debit (reversal of unrealised profit) of R2 500 is against Apricot's income. Therefore, in order for this note disclosure to balance, the reduction in stock has to be shown against Apricot's stock balance. Note that in the consolidated financial statements this discussion is not relevant as the stock figures of Apricot (25%) and Vineyard are combined.

Note that the procedure for proportionate consolidation has a different starting point to consolidation where control is exercised. In the latter, the starting point is usually the aggregated trial balances of group companies and these balances are then adjusted by pro-forma journal entries. In the case

of proportionate consolidation, it is more appropriate to start with the venturer's financial statements (or consolidated financial statements, if applicable) and to make adjustments for its share of the joint venture's balances. Pro-forma journal entries would not normally be used when proportionately consolidating as the workings are easily done on a simple worksheet. However, it is relatively straight forward to use pro-forma journal entries and two methods are illustrated for the above example, depending on the starting point:

- (a) Pro-Forma Journal Entries to proportionately consolidate Apricot, starting with the trial balance of Vineyard only.

	R'000	
	DR	CR
(i) Investment in Joint Venture	45	
Taxation	61	
Interest Received	15	
Operating Profit (Dividends Received)	45	
Operating Profit (from Joint Venture)		166
Being recognition of current year share of JV's income and expenses.		
(ii) Investment in Joint Venture	100	
Retained Earnings		100
Being recognition of prior year's share of JV's retained earnings.		
(iii) Fixed Assets	500	
Stock $((700 - 10) \times 25\%)$	172,5	
Debtors	150	
Cash	15	
Creditors		67,5
Investment in Joint Venture		645
Loan to Joint Venture		125
Being elimination of Investment in Joint Venture against proportionate share of JV's assets and liabilities.		
(iv) Loan to Joint Venture	500	
Investment in Joint Venture		500
Being reclassification of loan to JV from investment account to loan account.		

- (b) Pro-Forma Journal Entries to proportionately consolidate Apricot, starting with an aggregated trial balance that consists of Vineyard's trial balance combined with 25% of Apricot's balances.

(i) Share Capital	500	
Inv in JV		500
Being elimination of equity at acquisition against the investment account		
(ii) Operating Profit	2,5	
Stock		2,5
Being adjustment for the unrealised profit in closing stock		
(iii) Long term loan	125	
Inv in JV		125
Being elimination of the Inter-co loan		
(iv) Loan to JV	375	
Inv in JV		375
Being reclassification of loan to JV from investment account to loan account		
(v) Interest Rec	15	
Interest Paid		15
Being elimination of inter-co interest		
(vi) Operating Profit (Dividends Received)	45	
Dividends Paid		45
Being elimination of inter-co dividends		

14.4 Financial Statement Presentation

14.4.1 Accounting Policy

Appropriate wording for an accounting policy is as follows:

The results of the group's investments in joint ventures that are jointly controlled entities are accounted for by the proportionate consolidation method and the group's attributable share of the joint venture's revenue, expenditure, assets, liabilities and cash flows is included in the consolidated financial statements. Profits on transactions between the group and its joint ventures are recognised only to the extent of the profit attributable to the interests of the other venturers.

14.4.2 Companies Act

Joint ventures are not defined in the Companies Act and therefore Schedule 4 does not have any disclosure requirements for joint ventures. It should be noted, however, that paragraph 5 of Schedule 4 refers to the application of generally accepted accounting practice and it follows that the disclosure requirements and accounting treatment as laid down by AC 119 apply to all companies in terms of the Companies Act.

14.4.3 AC 119

AC 119 has a number of disclosure requirements, the more important of which relate to contingencies and commitments:

Paragraph 56 A venturer should disclose the nature and aggregate amounts of the following contingencies:

- contingencies affecting the venturer as a result of its interests in a joint venture and its share of each of its contingencies which have arisen jointly with other venturers;
- its share of the contingencies of a joint venture itself for which it is contingently liable; and
- those contingencies that arise because the venturer is contingently liable for the liabilities of the other venturers of a joint venture.

Paragraph 57 A venturer should disclose the aggregate amount of the following commitments:

- any capital commitments of the venturer in relation to its interests in joint ventures and its share of the capital commitments that have been incurred jointly with other venturers; and
- its share of the capital commitments of the joint ventures themselves.

The remaining disclosure requirements of AC 119 are as follows:

- Analysis of retained earnings and other reserves in the consolidated financial statements between reserves of the venturer and its subsidiaries and reserves from the joint venture.
- Any significant information relating to the joint venture that is not reflected in the balance sheet or income statement of the venturer.
- A listing and description of all significant joint ventures and the proportion of ownership interest held in jointly controlled entities.
- The aggregate amount of current assets, long term assets, current liabilities, long term liabilities, income, expenses and cash flows related to jointly controlled entities that have been proportionately consolidated (where these are significant to the results of operations, the financial position or the cash flows of the venturer. This disclosure could also be given individually for each joint venture, i.e. not only in aggregate).

The latter disclosure is particularly applicable where preparers and users are concerned that the combination of wholly controlled assets and liabilities

with jointly controlled assets and liabilities is misleading. This disclosure enables users to remove the proportionately consolidated results to arrive at the financial position and results of the joint venturer without the joint venture.

14.4.4 IAS 31

The disclosure requirements of AC 119 are virtually identical to the requirements of IAS 31 and the only point of departure between the two documents is that IAS 31 sanctions the use of the equity method when accounting for interests in jointly controlled entities. AC 119 only allows the equity method to be used in exceptional circumstances (refer section 14.3.1).

15 Cash Flow Statements

15.1 Introduction

15.1.1 Cash Flow Information

Financial reporting has traditionally developed on a historical cost basis with particular emphasis on accrual accounting, but there is growing acceptance that historical cash flow information is a useful indicator of the amount, timing and certainty of future cash flows. The weaknesses of the accrual based historical cost method of reporting earnings is to some extent overcome by the disclosure of cash flow information. AC 118 deals with the presentation of cash flow information in financial statements. The Accounting Practices Committee issued an exposure draft (ED 101) based on IAS 7 (revised). The release of the exposure draft is part of the South African Institute of Chartered Accountants' harmonisation programme. ED 101 is likely to replace AC 118 during 1996. There are a number of differences between AC 118 and ED 101; these differences will be examined throughout this chapter.

The high rates of inflation recently experienced in South Africa frequently gave rise to significant increases in working capital (particularly receivables and inventories) which were not always matched by corresponding increases in accounts payable. An increased working capital balance does not provide cash; rather it represents net income not yet received in cash. AC 118 and ED 100 attempt to identify cash flow from operations by taking into account the net movement in working capital components, i.e. the net income for the period is adjusted for the net investment in working capital to arrive at a cash flow as opposed to an income from operations. Cash flow from operations is an important source of cash for an enterprise and "in the long term, a satisfactory return on capital, the maintenance of a sound capital base and prospects for expansion come from a healthy cash flow from operations" (AC 118 paragraph 16).

A feature of AC 118 is its starting point; cash flow from operations is arrived at by adjusting net income before tax for non fund flow items and working capital movements. This is known as the indirect method. An alternative approach (the direct method) arrives at cash flow from operations by grouping together the major classes of gross cash receipts and gross cash payments, such as receipts from customers and payments to suppliers. ED 101 allows use of either the direct method or the indirect method, but favours the former because the "direct method provides information which may be

useful in estimating future cash flows and which is not available under the indirect method'' (paragraph 20).

In terms of AC 118, net cash flow from operations is separately disclosed and reconciled to the net cash flows from investing and financing activities that have taken place during the accounting period; these investing and financing activities are normally determinable from the movements in balance sheet elements during the accounting period. ED 101 however reconciles the net cash flows from operating, investing and financing activities with the net increase in cash and cash equivalents. In both AC 118 and ED 101, cash flows arising from interest, dividends and taxation are disclosed under operating activities. The following table illustrates the difference in format between AC 118 and ED 100:

<i>AC 118 Categories</i>	<i>ED 100 Categories</i>
<i>Cash generated/ utilised by operating activities</i>	<i>Cash flows from operating activities (incorporating cash flows from returns on investments and servicing of finance and taxation paid)</i>
<i>+ / -</i>	
<i>Cash utilised/ generated by investing activities</i>	
<i>=</i>	<i>+ / -</i>
	<i>Cash flows from investing activities</i>
	<i>+ / -</i>
<i>Net financing raised/ repaid</i>	<i>Cash flows from financing activities</i>
	<i>=</i>
	<i>Net movement in cash and cash equivalents</i>

Note that ED 101 reconciles cash flows to the net movement in cash balances for the year whereas AC 118 includes this movement in the net financing raised category.

The objective of a cash flow statement is ''to provide users of financial statements with information concerning the source and use of all financial resources during the period: in particular details of cash generated or utilised by operations, investing activities and financing activities'' (AC 118 paragraph 3).

The objective of a cash flow statement is, according to ED 101 (paragraph 01), ''to provide users of financial statements with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash flows''.

15.1.2 Definitions

Cash is defined by AC 118 and ED 101 as cash on hand and demand deposits. Cash equivalents are short term, highly liquid investments that are readily convertible to a known amount of cash. For example, money market instruments would be regarded as a cash equivalent. Cash flows are inflows and outflows of cash and cash equivalents.

Operating activity cash flows are generally the cash effects of transactions and other events that enter in to the determination of income while investing activity cash flows are those cash flows relating to the acquisition and disposal of fixed assets and investments. The third category of cash flows, financing activities, arises from changes in the size and composition of the debt and capital funding of the reporting entity.

15.2 Conceptual Issues

15.2.1 Objective of Financial Statements

“The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions” (AC 000 paragraph 12).

Cash flow information, when used in conjunction with the rest of the financial statements, provides information that enables users to evaluate the changes in net assets of an enterprise, its financial structure and its ability to respond to changing circumstances and opportunities.

A cash flow statement is useful in assessing the ability of an enterprise to generate cash and enables users to develop models for assessment and comparison of the forecast future cash flows of different enterprises. In addition, comparability of operating performance by different enterprises is enhanced because cash flow information eliminates the effects of using different accounting treatments for the same transactions and events. For example, two similar companies may use different accounting treatments for deferred tax; one company may be on the partial method while the other may be using the comprehensive method. These companies would both report different earnings figures but their choice of deferred tax policy has no effect on their cash flows.

Historical cash flow information is often used by various user groups as an indicator of the amount, timing and certainty of future cash flows. It is also useful in checking the accuracy of past assessment of future cash flows and

in examining the relationship between profitability and net cash flow as well as the impact of changing prices. Cash flow statements also highlight the liquidity and working capital management of an enterprise. This enables users to be better informed about management performance during the accounting period.

15.2.2 Direct Method

There are two methods for drawing up a cash flow statement; the direct method and the indirect method. The AC 118 cash flow statement is based on the indirect method, whereby net operating income for the period is adjusted for the effects of transactions of a non cash nature, deferrals or accruals of past or future operating cash flows and items of income or expense associated with investing or financing activities. The indirect method involves a direct articulation between profit per the income statement and balance sheet movements during the accounting period. The direct method, however, uses the cash book and not the income statement as its starting point. The direct method, favoured by ED 101, involves major classes of gross cash receipts and gross cash payments being disclosed. Although application of both the direct method and, the indirect method results in substantially the same cash flow statement, the starting point is fundamentally different. This is illustrated in section 15.3.

The appendix to ED 101 includes a detailed example that considers the mechanics of drafting a cash flow statement on both the direct and indirect method. The example used in the remainder of this chapter illustrates the format of the AC 118 and the ED 101 cash flow statement rather than the mechanics of drafting the statements. Readers are referred to the appendix of ED 101 for an example that includes the mechanics of drafting a cash flow statement.

15.3 Specific Issues

15.3.1 Operating Activities

As noted above in section 15.1.1, the starting point of a cash flow statement is cash generated from operations. This cash effectively represents the difference between cash received during the period from customers and cash paid during the period for goods and services used in operations plus/minus cash flows from returns on investments and servicing of finance minus taxation paid. Examples of cash flows from operating activities are:

- cash receipts from the sale of goods and the rendering of services;

- cash receipts from royalties, fees, commissions and other revenue;
- cash payments to suppliers for goods and services;
- cash payments to and on behalf of employees;
- cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits;
- cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities;
- cash receipts and payments from contracts held for dealing or trading purposes.

Where the indirect method is used, cash generated by operations is usually calculated by adjusting operating income before tax for items which do not involve the movement of cash. For example, depreciation, provisions and unrealised exchange differences. In addition, the amount of cash utilised to finance an increase in working capital (inventories, debtors and creditors) is disclosed on the face of the cash flow statement as an adjustment against cash generated by operations. This separate disclosure of the investment in working capital (or the amount of cash derived from the reduction in working capital) highlights the importance of working capital management and enables users to assess the extent to which income generated has been tied up in increased working capital.

When calculating the adjustment to cash generated by operations for any investment in working capital, it is important to separately identify amounts that relate to investing activities and not operating activities. For example, any amount owing in respect of the disposal of fixed assets in debtors should be excluded from the working capital calculation and reflected as a short term financing activity.

Where the direct method is used, cash generated by operations is usually obtained from the accounting records of the enterprise and consists of gross receipts from customers less cash payments to, *inter alia*, suppliers and employees.

Note that, in terms of AC 118, income from investments forms part of cash generated by operating activities and is disclosed separately because of its nature. ED 101 includes income from investments also with cash flows from operating activities but distinguishes between interest received and dividends received. In terms of AC 118, finance costs, taxation and dividends are included with operating activities. The cash amount of interest, tax and dividends actually paid during the accounting period are disclosed separately

on the face of the cash flow statement. These three items effectively show the extent to which the cash generated by operations has been used to pay taxation, interest, and dividends during the accounting period. Although interest paid and dividends paid are classified as operating activities because they enter into the determination of net profit retained for the period, they could also be classified as financing cash flows because these are costs of obtaining financial resources. This approach is sanctioned by IAS 7 (revised) but AC 118 expresses a clear preference for these items to be disclosed as operating activities (AC 118 paragraph 21).

The AC 118 format of the operating activities' section of the cash flow statement is disclosed in the following hierarchy:

OPERATING ACTIVITIES	NOTES	1902 R'000	1901 R'000
Cash generated by operations	1	2 360	2 170
Investment income		225	116
Utilised to increase working capital	2	(649)	(407)
Cash generated by operating activities		1 936	1 879
Finance costs		(380)	(364)
Taxation paid	3	(482)	(352)
Cash available from operating activities		1 074	1 163
Dividends paid	4	(384)	(456)
Cash retained from operating activities		<u>690</u>	<u>707</u>

NOTES

1. Cash generated by operations			
Operating income before interest & taxation		2 069	1 793
Adjusted for – Depreciation		556	483
– Profit/loss on disposal of fixed assets		(40)	10
– Investment income		(225)	(116)
		<u>2 360</u>	<u>2 170</u>
2. Utilised to increase working capital			
Increase in inventories		391	287
Increase in debtors		437	314
Increase in creditors		(179)	(194)
		<u>649</u>	<u>407</u>
3. Taxation paid			
Amount unpaid at beginning of year		284	93
Amount charged to income statement		456	543
Amount unpaid at end of year		(258)	(284)
		<u>482</u>	<u>352</u>
4. Dividends paid			
Amount unpaid at beginning of year		184	190
Amount charged to income statement		400	450
Amount unpaid at end of year		(200)	(184)
		<u>384</u>	<u>456</u>

The ED 101 format of the operating activities section is as follows (note that this example is based on the direct method and comparatives have been ignored):

	NOTES	1902 R'000
Cash flows from operating activities		
Cash receipts from customers		29 311
Cash paid to suppliers and employees		<u>(27 600)</u>
Cash generated from operations	1	1 711
Interest received		120
Interest paid		(500)
Dividends received		225
Dividends paid		(384)
Normal tax paid		(457)
Secondary tax on companies paid		<u>(25)</u>
Net cash inflow from operating activities		690

NOTE

1. Reconciliation of net profit before taxation to cash generated from operations.

Net profit before taxation	1 689
Adjustments for:	
Depreciation	556
Profit on disposal of fixed assets	(40)
Investment income	(225)
Net interest expense	<u>380</u>
Operating profit before working capital changes	2 360
Working Capital changes:	(649)
Increase in inventories	(391)
Increase in debtors	(437)
Increase in creditors	<u>179</u>
Cash generated from operations	<u>1 711</u>

15.3.2 Investing Activities

Cash flows from investing activities are separately disclosed because it is important to show the extent to which cash expenditures have been made for resources intended to generate future income and cash flows . Examples of investing activity cash flows are as follows:

- cash payments to acquire fixed assets;
- cash receipts from the sales of fixed assets;

- cash payments to acquire equity or debt instruments of other enterprises, and interests in joint ventures;
- cash receipts from the sales of equity or debt instruments of other enterprises, and interests in joint ventures;
- cash advances and loans made to other parties;
- cash receipts from the repayment of advances and loans made to other parties;
- cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and
- cash receipts from futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

In addition to the disclosure of all direct cash payments and cash receipts into and out of the enterprise during the period relating to investing activities, AC 118 requires disclosure of flows of cash which increase or decrease fixed assets or other investments regardless of the form of acquisition. For example, where an enterprise acquires an asset under a finance lease, then AC 118 requires disclosure under investing activities in the cash flow statement of the acquisition of the asset. This is contrary to the actual cash flow effect on the enterprise which consists only of the lease instalment paid under the finance lease during the accounting period. Similarly "where an enterprise has issued its shares in order to acquire an interest in another enterprise, fair presentation requires that the issue of shares be disclosed under financing activities and the acquisition of the interest in the other enterprise as an investing activity" (AC 118 paragraph 23).

AC 118 therefore specifically recognises the concept of substance over form in that fair presentation overrides disclosure of the actual cash flow. This approach ensures that the cash flow statement articulates correctly with the movement in balance sheet components apparent from the balance sheet, i.e. a finance lease capitalised during the accounting period would be shown as an acquisition of an asset and the acquisition of a liability on the cash flow statement.

This approach is not sanctioned by ED 101 which requires that the cash effect of such transactions be disclosed in the cash flow statement, i.e. a lease instalment under a finance lease would be shown as in part a payment of interest and in part a repayment of a lease liability. ED 101 adopts a pure

cash flow approach whereas AC 118 adopts an all financial resource approach. Nevertheless, ED 101 requires information about a non-cash transaction to be disclosed in a note to the cash flow statement. A share exchange, therefore, would not be shown on the cash flow statement, but note disclosure would reflect information about the transaction. An example of such a note is "during the period additional share capital was issued in exchange for 1 000 shares in A Ltd". This type of disclosure enables users to understand the movements in components of the balance sheet during the period.

Cash flows involving investing activities should be distinguished between those that relate to the maintenance of operating capacity and cash flows that are associated with the expansion of operating capacity. For example, the acquisition of a fixed asset might involve the maintenance only of a company's operating capacity, i.e. it is replacing a fixed asset whereas a cash flow associated with the acquisition of a fixed asset not previously used by the enterprise would involve an expansion of its operating capacity. These cash flows should be distinguished wherever possible and "the deduction for that expenditure which maintains present operating capacity is shown before the investment of cash in the expansion of the operations" (AC 118 paragraph 27).

Cash flows that maintain the present operating capacity may be disclosed under cash generated by operating activities where management believes it would be more meaningful due to the fact that fixed asset replacements are carried out on a consistent basis. This is seldom done in practice.

The following is an illustration of the disclosure of investing activity cash flows in accordance with AC 118 (note that this section of the cash flow statement follows directly after operating activities).

INVESTING ACTIVITIES	NOTES	1902 R'000	1901 R'000
Investment to maintain operations			
Replacement of fixed assets	5	(232)	(150)
Proceeds on disposal of fixed assets	6	160	60
		<u>(72)</u>	<u>(90)</u>
Investment to expand operations			
Additions to fixed assets	7	(339)	(98)
Purchase of subsidiary	8	<u>(477)</u>	<u>(308)</u>
		<u>(816)</u>	<u>(406)</u>
Cash utilised in investing activities		<u>(888)</u>	<u>(496)</u>

NOTES

5. Replacement of fixed assets

Plant and machinery	190	110
Vehicles	30	28
Office equipment	<u>12</u>	<u>12</u>
	<u>232</u>	<u>150</u>

6. Proceeds on disposal of fixed assets

Book value of assets disposed	120	70
Profit/loss on disposal	<u>40</u>	<u>(10)</u>
	<u>160</u>	<u>60</u>

7. Additions to fixed assets

Plant and Machinery	149	98
Land and Buildings	<u>190</u>	<u>—</u>
	<u>339</u>	<u>98</u>

8. Purchase of subsidiary

Assets acquired — Fixed Assets	330	200
— Working Capital	72	58
— Investments	<u>20</u>	<u>—</u>
	<u>422</u>	<u>258</u>
Premium paid on acquisition (goodwill)	<u>55</u>	<u>50</u>
	<u>477</u>	<u>308</u>

Note that at this stage, the cash flow statement shows net cash generated by operating activities of R690 000 (1901: R707 000) [see section 15.3.1] and cash utilised by investing activities of R888 000 (1901: R496 000). The net cash required (1901: surplus) during the year was, therefore, R198 000 (690 000 – 888 000). The 1901 surplus was R211 000 (707 000 – 496 000). The net effect of this cash deficit and surplus for the two years is identified in the financing activities section of the cash flow statement which is considered in section 15.3.3.

The ED 101 format of the investing activities, assuming that all transactions were cash based, is as follows for 1902:

	NOTES	1902 R'000
Cash flows from investing activities		
Purchase of property, plant and equipment		(571)
Replacement of property, plant and equipment		(232)
Additions to property, plant and equipment		(339)
Proceeds from sale of equipment		160
Acquisition of subsidiary, net of cash acquired	2	(477)
Net cash outflow from investing activities		(888)

NOTE

2. Acquisition of subsidiary

During the year the group acquired subsidiary X. The fair value of assets acquired and liabilities assumed were as follows:

	(R'000)
Inventories	50
Debtors	42
Property, plant and equipment	330
Creditors	(20)
Investments	20
Premium paid on Acquisition	55
Total purchase price	<u>477</u>

The following points should be noted about the ED 101 format:

- (a) The net assets of a subsidiary acquired for cash are separately disclosed in a note to the cash flow statement. It is important for the *net* cash flow to be shown on the face of the cash flow statement, i.e. if a subsidiary whose only asset was cash of R100 was acquired for R100 then no net cash flow arises and note disclosure only of the acquisition would be given.
- (b) If a subsidiary had been acquired by the issue of shares then no cash flow would be reported on the face of the cash flow statement; rather a note indicating the assets acquired and the mechanism for settling the purchase price is disclosed under a heading “Non-cash investing and financing activities”. A similar note is required to show assets acquired under finance lease agreements.

15.3.3 Financing Activities

The separate disclosure of the cash effects of financing activities enables users to predict claims on future cash flows by providers of capital to the enterprise. Cash flows arising from financing activities include the cash proceeds from issuing shares, cash payments to redeem shares, cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other borrowings, and cash repayments of amounts borrowed. In addition, cash payments by a lessee to settle the capital element of outstanding finance lease obligations is a financing activity cash flow. Note that, in terms of AC 118, the commencement of a finance lease gives rise to “cash proceeds from borrowings” (matched by an acquisition of an asset for a similar amount under investing activities) despite the lack of associated cash flows. In contrast, no cash flow

is reported in terms of ED 101 upon commencement of the finance lease, while the lease payments will be split between the interest payment (returns on investments and servicing of finance) and the capital element of the repayments (financing activities).

AC 118 includes movements in cash and cash equivalents with financing activities whereas ED 101 reconciles to net movements in cash and cash equivalents. An example of the AC 118 format for financing activities follows:

FINANCING ACTIVITIES	NOTES	1902 R'000	1901 R'000
Decrease in long term borrowings	9	(110)	(40)
Increase/(Decrease) in short term borrowings	10	58	(171)
Proceeds of rights issue	11	250	—
Cash generated/(utilised)		<u>198</u>	<u>(211)</u>
NOTES			
9. Decrease in long term borrowings			
Loans raised		200	485
Loans repaid		<u>(310)</u>	<u>(525)</u>
		<u>(110)</u>	<u>(40)</u>
10. Increase/Decrease in short term borrowings			
Net increase in short term borrowings		98	—
Increase in cash on hand		<u>(40)</u>	<u>(171)</u>
		<u>58</u>	<u>(171)</u>
11. Proceeds of rights issue			
100 000 ordinary shares % R2,60/share		260	—
Costs of issue		<u>(10)</u>	<u>—</u>
		<u>250</u>	<u>—</u>

The ED 101 format of financing activities is as follows for 1902:

	1902 R'000
Cash flows from financing activities	
Proceeds from rights issue	250
Proceeds from long term borrowings	200
Proceeds from short term borrowings	98
Repayment of long term borrowings	<u>(310)</u>
Net cash inflow from financing activities	<u>238</u>
Net increase in cash and cash equivalents (690 – 888 + 238)	<u>40*</u>

* This net increase should be reconciled to the balance sheet movement in cash and cash equivalent balances.

The overall cash flow statements can be summarised as follows for 1902 (all figures R'000):

AC 118		ED 100	
Cash generated by operating activities	690	Cash inflow from operating activities	690
Cash utilised by investing activities	(888)	Cash outflow from investing activities	(888)
Net financing raised	<u>198</u>	Cash inflow from financing activities	<u>238</u>
		Net increase in cash and cash equivalents	<u>40</u>

15.3.4 Consolidated Financial Statements

Where consolidated financial statements are prepared, then a consolidated statement of cash flow information is presented.

When preparing a consolidated cash flow statement cognisance is taken of the entity concept and total group cash flows are recognised, i.e. without deducting the outside shareholders' interests in the underlying cash flows. Flows of cash between the group (i.e. the entity) and outside owners are disclosed separately. This situation arises where partly owned subsidiaries declare dividends to the outside shareholders in the group and where there are changes in the capital of a subsidiary that involve flows of cash between the outside shareholders and the group.

Note that a consolidated cash flow statement, like a consolidated income statement or balance sheet, only deals with transactions that are external to the group. The consolidated cash flow statement can either be prepared by combining the separate cash flow statements of each group company or by using the consolidated income statement and balance sheet. The second approach is common practice among South African groups as the elimination of intra-group transactions has already been performed.

Where an enterprise reports its interest in a jointly controlled entity using proportionate consolidation then its consolidated cash flow statement includes its proportionate share of the jointly controlled entity's cash flows.

When an enterprise acquires a subsidiary then it acquires control over various assets and liabilities that are used to generate future revenue. In the enterprise's own cash flow statement this transaction is shown as an acquisition of shares under investing activities. In the consolidated cash flow

statement, the cost of the investment is shown as a single line item and the note to the statement provides details of the assets and liabilities acquired, distinguishing between cash, working capital and other assets and liabilities. Similarly, disposals of investments in subsidiaries involve the recognition of the sales proceeds as a cash flow shown under investing activities and any profit or loss on disposal is excluded from the cash generated from operating activities (this profit or loss on disposal is a non fund flow that would be adjusted against operating income when arriving at cash generated by operating activities). The notes to the cash flow statement would disclose information about the underlying assets and liabilities that were disposed.

The relevant disclosure for the acquisition of a subsidiary was shown in section 15.3.2.

The separate disclosure of the cash flow effects of acquisitions and disposals of subsidiaries as single line items, together with separate disclosure of the amounts of assets and liabilities acquired or disposed of, helps to distinguish those cash flows from the cash flows arising from the other operating, investing and financing activities of the enterprise.

An acquisition of a subsidiary during the accounting period, therefore, complicates the preparation of the group cash flow statement. Since the acquisition of the subsidiary is accounted for as a single entry, many of the movements in the balance sheet components for the accounting period cannot be calculated solely by comparing the balance sheets. For example, the movement in working capital components will no longer be the net movement in the balance sheet for the period as a result of the acquisition during the year of the subsidiary.

The movement should be calculated on the following basis, using debtors as an example:

	R000's
Closing balance of debtors	1 000
Less: Opening balance of debtors	<u>(700)</u>
Total Movement	300
Debtors acquired through subsidiary	<u>(100)</u>
Net movement in debtors	<u>200</u>

The implication is that the only part of the debtors movement attributable to the new subsidiary is the change in the debtor value from acquisition to the year end, i.e. movements in the subsidiary's working capital are only reflected in the group cash flow statement after acquisition of the subsidiary.

Similar adjustments must be made to all other items appearing in the cash flow statement.

A similar situation arises on the disposal of a subsidiary in that the movement in working capital items consists of two parts:

- the movement from the previous reporting date to the disposal date including the subsidiary and
- the movement from the date of disposal to the current balance sheet date excluding the subsidiary.

A similar calculation is performed for all working capital items as well as any other assets or liabilities relating to the subsidiary disposed of.

15.3.5 Value Added Taxation

AC 118 is silent about the appropriate treatment of Value Added Tax (VAT) in the case of cash flow statements. The cash flows of an entity include VAT where appropriate and therefore the various elements of the cash flow statement should include VAT. However, this approach does not take into account the fact that VAT is normally a short term timing differences as far as the entity's overall cash flows are concerned and the inclusion of VAT in the cash flows may distort the allocation of cash flows to the standard components of the cash flow statement. This approach means that the amounts attributable to VAT included in trade debtors and creditors need not be eliminated in showing the movement in the balance over the period, and the actual reporting date balances of debtors and creditors may be used to record the net movement in working capital. This is the approach sanctioned by the UK statement FRS 1 and with no specific guidance given by AC 118 is the usual practice of South African companies.

ED 101 only refers to VAT in paragraph 27 (c) where it states that the cash receipts and payments of value added tax may be reported on a net basis.

15.3.6 Extraordinary Items

Cash flows associated with an extraordinary item should be classified under either operating, investing or financing activities and separately disclosed. This enables users to understand the nature and effect of the extraordinary item on the present and future cash flows of the enterprise.

15.3.7 Foreign Currency Cash Flows

In terms of ED 101 (paragraph 32), the cash flows of a foreign subsidiary should be translated at the exchange rate ruling on the date of the cash flows.

As with the translation of income statement items, an average rate that approximates the actual rate may be used. It is not permissible to use the exchange rate ruling at the balance sheet date.

Cash flows arising from transactions in a foreign currency (ED 101 paragraph 31) should be translated at the exchange rate ruling at the date of the cash flow. An average rate that approximates the actual rate may be used. The treatment of foreign currency transactions is not as complex as it might appear; if the transaction has been settled during the period then the amount of cash that has changed hands must appear in the cash flow statement. In the case of operating activities, this happens automatically – the transaction is recorded at the transaction date (at year end this amount is either inventory or cost of sales) and the exchange difference on settlement is included in operating profit, hence the net cash paid is “picked up” in operating activities.

In the case of a transaction that does not form part of operating activities, the exchange difference will usually have to be eliminated from the cash flow from operating activities. For example, if a company imports an item of plant for R100 000, but by the time of payment, it pays R110 000 for the plant. The exchange loss in operating profit will have to be eliminated (“added back”) when calculating the cash flow from operating activities. The amount that will then appear under investing activities will be R110 000.

Exchange differences may arise on cash and cash equivalents denominated in a foreign currency. In terms of ED 101, these differences should appear as a reconciling item in the analysis of changes in the balance of cash and cash equivalents. Unrealised gains and losses arising from changes in foreign currency exchange rates are not cash flows.

15.4 Financial Statement Presentation

15.4.1 Companies Act

Schedule 4 to the Companies Act defines both financing activities and investing activities but not operating activities. (This is relatively consistent with AC 118 where operating activities are defined as all activities other than investing and financing activities (AC 118 paragraph 7).) The Schedule 4 definitions (paragraph 4(o) and 4(s)) are virtually identical to the AC 118 definitions for financing activities and investing activities. The requirements of schedule 4 for cash flow information are as follows:

Paragraph 49 Comparatives should be given except in the case of the first statement of cash flow information.

Paragraph 50 Cash flow statement should disclose:

- (a) cash generated by operations;
- (b) investment income;
- (c) changes to non cash components of working capital (i.e. stock, debtors and creditors);
- (d) cash effects of finance costs and taxation;
- (e) cash effects of dividends paid;
- (f) cash effects of investing activities; and
- (g) cash effects of financing activities.

(Note that the (a) to (e) requirements all relate to operating activities cash flows.)

Paragraph 51 A reconciliation between operating income shown on the income statement and cash generated by operations on the cash flow statement (i.e. the non cash items that have been removed from operating income in order to arrive at cash from operations).

15.4.2 AC 118

The disclosure requirements of AC 118 incorporate all of the Schedule 4 requirements as well as:

- gross amounts of borrowings raised and repaid, or settled, during the period should be disclosed where **appropriate and practicable**;
- cash effects of capital transactions with owners;
- financing activities between outside shareholders and the group.

AC 118 includes an appendix with a specimen cash flow statement that illustrates the required format, and in particular the correct hierarchy of the cash flows. This appendix was used as the basis for the examples of disclosure shown in sections 15.3.1, 15.3.2, and 15.3.3 of this chapter.

15.4.3 ED 101

ED 101 requires certain disclosures over and above those of AC 118.

ED 101 requires disclosure, together with a commentary by management, of cash and cash equivalent balances that are technically not available for use by the group, for example cash balances held by a foreign subsidiary operating under exchange control restrictions.

In addition, the following disclosures are encouraged:

- undrawn borrowing faculties, indicating any restrictions on the use thereof;
- aggregate amounts of cash flows from each of operating activities, investing and financing activities related to interests in joint ventures; and
- the amount of the cash flows arising from the operating activities, investing and financing activities of each reported industry and geographical segment.

16 Research and Development Costs

16.1 Introduction

16.1.1 Research and Development

Research and development costs are frequently incurred by enterprises, especially those operating in certain specialised sectors of the economy. AC 122, Research and Development Costs, prescribes the appropriate accounting treatment for these costs.

Research is defined as “original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding” (AC 122 paragraph 7).

Development is defined as “the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use” (AC 122 paragraph 7).

The primary accounting issue when considering costs of research and development activities is whether such costs should be recognised as an asset or as an expense. AC 122 uses the recognition criteria established in AC 000, Framework for the Preparation and Presentation of Financial Statements, to determine that research costs should be recognised as an expense in the period in which they are incurred and that development costs should be recognised as an expense in the period incurred unless certain criteria are met, in which case the development costs may be capitalised as an asset. AC 122 is closely based on IAS 9 (revised 1993).

16.1.2 Exclusions

AC 122 should be applied by all enterprises when accounting for research and development costs. Certain exceptions, however, to the general rule are identified by the statement.

AC 122 does not apply to the costs of exploration for and development of oil, gas and mineral deposits in the extractive industries. It does apply, however, to the costs of other research and development activities in those industries.

Where an enterprise carries out research and development activities under contract for another enterprise (i.e. on behalf of a third party) then the

substance of the arrangement is usually that the risks and benefits associated with the research and development activities are transferred to another enterprise. In this case, the enterprise conducting the research and development (on behalf of a third party) accounts for the costs incurred in accordance with AC 108 or AC 109.

Therefore, if research and development activities are carried out under contract for another enterprise, whereby that other enterprise will reimburse the costs, either directly or indirectly through the price charged, then AC 122 does not apply to the enterprise conducting the research and development. The costs incurred by the enterprise carrying out the research and development would be treated as either stock (AC 108) or long term contract work-in-progress (AC 109) and accounted for accordingly. The recipient of the risks and benefits of the research and development activities (i.e. the third party) would account for its costs in accordance with AC 122.

If the substance of the arrangement with the third party is such that the risks and benefits associated with the research and development activities are not, or will not be, transferred to others, then the research and development activities should be accounted for in accordance with AC 122 by the enterprise carrying out the research and development. The factors which indicate whether or not the risks and benefits of research and development activities have transferred include:

- (a) the enterprise conducting the research and development activities is contractually obligated to repay any of the funds provided by the other enterprise, regardless of the outcome of the research and development activities, for example, a research loan from the CSIR;
- (b) even though the contract does not require the enterprise conducting the research and development activities to repay any of the funds provided by the other enterprise, repayment could be required at the option of the other enterprise or the surrounding conditions indicate that repayment is probable.

16.2 Conceptual Issues

16.2.1 Research Activities

In order to assist in distinguishing between research and development activities, AC 122 lists examples of activities typically included in research:

- (a) activities aimed at obtaining new knowledge;
- (b) the search for application of research findings or other knowledge;

- (c) the search for product or process alternatives, and
- (d) the formulation and design of possible new or improved product or process alternatives.

(AC 122 paragraph 9)

Because all research expenditure is expensed when incurred there is no need to distinguish between pure and applied research expenditure.

16.2.2 Development Activities

Examples of activities typically included in development are:

- (a) the evaluation of product or process alternatives;
- (b) the design, construction and testing of pre-production prototypes and models;
- (c) the design of tools, jigs, moulds and dies involving new technology, and
- (d) the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production.

(AC 122 paragraph 10)

The use of the word “typically” by AC 122 indicates that the above classifications will not necessarily always hold. While the above examples can be taken as a useful guide, they must not be treated as absolutes and there may well be occasions where the treatment of an item given in the examples will be the opposite of that suggested. For example, the evaluation of product or process alternatives could be regarded as research since that activity in certain circumstances may be speculative and without certain commercial application.

AC 122 also gives examples of activities that while they may be closely associated with research and development activities, are neither research nor development. These examples are:

- (a) engineering follow through in an early phase of commercial production;
- (b) quality control during commercial production, including routine testing of products;
- (c) trouble shooting in connection with breakdowns during commercial production;
- (d) routine efforts to refine, enrich or otherwise improve upon the qualities of an existing product;

- (e) adaptation of an existing capability to a particular requirement or customer's need as part of a continuing commercial activity;
- (f) seasonal or other periodic design changes to existing products;
- (g) routine design of tools, jigs, moulds and dyes; and
- (h) activities, including design and construction engineering related to the construction, relocation, rearrangement, or start up of facilities or equipment other than facilities or equipment used solely for a particular research and development project.

(AC 122 paragraph 11)

16.2.3 Recognition of Research Costs

AC 122 requires research costs to be recognised as an expense in the period in which they are incurred. This does not imply that the research will have no benefits for the enterprise. It is simply an indication that the costs do not meet the asset recognition criteria of AC 000 because there is insufficient certainty that future economic benefits will be realised as a result of specific research expenditures.

It should be appreciated that it is not usually feasible to allocate the benefit of research expenditure to particular accounting periods. Therefore, the simplest treatment is to write off the costs when incurred. It may well be that in future years a direct link can be established between economic benefits flowing to an enterprise and a particular research project, but this is of no value when preparing financial statements for the period in which the research expenditure was incurred. In addition, the probability of there ever being any future income is unlikely in that there is no guarantee at the research stage of a future economic benefit flow.

16.2.4 Recognition of Development Costs

The nature of development activities is such that the enterprise can more easily determine the probability of receiving future economic benefits than it can determine such a probability from research activities. This is usually because the project is further advanced at the development stage than the research stage and the viability of future markets for the product are more certain.

AC 122 requires that development costs be recognised as an expense in the period incurred unless all of the following criteria are met:

- (a) the product or process is clearly defined and the costs attributable to the product or process can be separately identified and reliably measured;

- (b) the technical feasibility of the product or process can be demonstrated;
- (c) the enterprise intends to produce and market or use the product or process;
- (d) the existence of a market for the product or process or, if it is to be used internally rather than sold, its usefulness to the enterprise can be determined, and
- (e) adequate resources exist, or their availability can be demonstrated to complete the project and market or use the product or process.

(AC 122 paragraph 18)

It is clear in terms of the framework (AC 000) that development costs meets the definition of an asset in that the expenditure is a resource controlled by the enterprise, as a result of a past event, and from which future economic benefits are expected to flow. The recognition criteria are the key to whether or not development costs should be recognised as an asset.

In terms of AC 000, the development costs may be recognised as an asset when the costs incurred can be reliably measured and where the economic benefits associated with those costs are probable. The above criteria of AC 122 fulfil these requirements in that (a) is concerned with the measurement of the costs and (b) to (e) are concerned with the probability of future economic benefit flows.

Note that the phrasing of AC 122 is not prescriptive regarding the capitalisation of development costs. The statement expresses a preference for development costs to be expensed in requiring the recognition criteria to be applied in a negative manner. The statement would have indicated a more positive link with AC 000 if it had required development costs to be capitalised unless any of the criteria listed were not met.

AC 122 also requires that where development costs are initially recognised as an expense then they should not be recognised as an asset in a subsequent period, i.e. if the costs do not meet asset recognition criteria when initially incurred then they are written off once and for all.

16.2.5 Limit on Value of Capitalised Asset

The amount of development costs recognised as an asset should not exceed the amount that, taken together with further development costs, related production costs, and selling and administrative costs directly incurred in marketing the product is probable of being recovered from related future economic benefits. Future economic benefits include revenue from the sale

of the product or process and/or costs or savings or other benefits resulting from the use of the product or process by the enterprise itself. The estimates of the revenues and cost savings should be based on prices or conditions prevailing at the end of the period. However, if it is probable that future selling prices will be lower than those prevailing at the end of the period and the lower selling prices will not be fully offset by additional cost savings, then the estimates of the revenues and cost savings are based on such future prices and costs.

For example, a company may have incurred development costs of R3 million. The future total costs of producing and selling the goods developed (i.e. future development costs, related production costs, and selling and administrative costs, directly incurred in marketing the product) are expected to be R5 million. Unless the amount expected from the related future economic benefits associated with this product (i.e. the future revenue generated) is at least R8 million, then development costs may not be capitalised beyond the expected future revenue. If, for example, the future expected revenue is R9 million then the development costs of R3 million may be capitalised. However if the future expected revenue is only R7,5 million then only R2,5 million of the development costs should be capitalised as an asset. Once capitalised, the development costs should be amortised on a systematic basis – refer section 16.3.2.

If the selling price of the product developed is expected to fall then the reduced selling price should be used when estimating future economic benefits.

16.3 Specific Issues

16.3.1 Components of Research and Development Costs

Research and development costs should include all costs that are directly attributable to research and development activities or that can be allocated on a reasonable basis to such activities.

Research and development costs include:

- (a) the salaries, wages and other employment related costs of personnel directly involved in research and development activities;
- (b) the costs of materials and services consumed in research and development activities;
- (c) the depreciation of property, plant and equipment to the extent that these assets are used for research and development activities;

- (d) overhead costs related to research and development activities, which are allocated on bases similar to those used in allocating overhead costs to stock, and
- (e) other costs, such as the amortisation of patents and licences, to the extent that these assets are used for research and development activities.

(AC 122 paragraph 13)

Selling costs and general administrative costs are not included in research and development costs.

Borrowing costs may be included in development costs where appropriate, i.e. if capitalised in accordance with AC 114.

16.3.2 Amortisation of Development Costs

AC 122 requires that where development costs are recognised as an asset they should be amortised as an expense on a systematic basis so as to reflect the pattern in which the related economic benefits are recognised.

It is often difficult to determine the relationship between development costs and the economic benefits that the enterprise derives because of the nature of development activities. AC 122 suggests two bases for the amortisation of development costs. The enterprise should amortise development costs **either** by reference to the sale or use of the product or process **or** over the time period which the product or process is expected to be sold or used.

If development costs are amortised by reference to the sale or use of a product or process then the amortisation may well be bell shaped, i.e. low at first as the product or process struggles to gain market share, high in the middle as the market share is maximised, and then low at the end as sales drop off.

An enterprise would normally use the straight line method for the amortisation of development costs over a time period in which the product or process is expected to be sold or used.

Whichever basis of amortisation is used, the length of time over which the amortisation should occur must be selected. Technological and economic obsolescence creates uncertainties about the future period over which development costs are to be allocated. In addition, it is often difficult to estimate the further costs and related future revenues of a new product or process beyond a shorter period. AC 122, therefore, suggests that development costs are normally amortised over a period **not** exceeding five years.

Amortisation commences in the accounting period in which the product or process is ready for sale or use.

The write off or amortisation of development costs may result in development costs being capitalised to the cost of another asset, for example inventory. Development costs allocated to other assets in this way are recognised as an expense at the same time as the other costs of those assets, i.e. where development costs have been amortised to the cost of inventory the development costs are effectively only recognised as an expense when the inventory is taken to cost of sales.

16.3.3 Impairment of Development Costs

As noted above in section 16.2.4 development costs capitalised as an asset should not exceed, when taken together with further development costs, related production costs, and selling and administrative costs directly incurred in marketing the product, the amount expected to be recovered from future economic benefits, i.e. future sales or cost savings. Therefore, development costs capitalised as an asset (the unamortised balance of development costs) should be written down to the extent that the balance taken together with those further costs is probable of being recovered from the expected future economic benefits.

If any of the criteria (listed above in section 16.2.4) for recognition of development costs as an asset are no longer met, then the unamortised balance of development costs of a project should be written off immediately.

Write downs or write offs of unamortised development costs should be recognised as an expense or expenses in the period in which the write down or write offs arise.

As a general rule, once development costs have been written off then they cannot be reinstated unless they were previously capitalised. Therefore, where the expenditure of development costs never met the criteria for recognition as an asset then once expensed they always remain expensed. This is in contrast to the treatment for write downs or write offs of development costs that have been capitalised. AC 122 (paragraph 31) allows development costs written down or written off to be written back when the circumstances and events that led to the write down or write off cease to exist and there is persuasive evidence that the new circumstances and events will persist for the foreseeable future.

A proviso to the reinstatement of development costs that have been written down or written off is that the amount written back should be reduced

by the amount that would have been recognised as amortisation had the write down or write off not occurred. The amount written back is recognised as income and classified as a reduction in the expense of development costs for the period. This process takes into account that the enterprise has recognised revenue or other benefits from the sale or use of the product or process during the periods in which the asset was written down or written off. This is illustrated in the following example.

Devres Ltd has incurred R3 million of development costs for a new product that they launch on 1 January 1901. The development costs of R3 million meet the criteria for recognition as an asset as set out in AC 122. Production costs and selling and administrative costs directly incurred in marketing the new product over the next five years are expected to amount to R5 million while sales of R2 million per annum are expected from the new product for the next five years. Devres has decided to amortise the development costs of R3 million on the 20% straight line method commencing on 1 January 1901. The year end is 31 December.

As the total development costs (R3 million) and future production and selling costs (R5 million) total R8 million and this is less than the total expected sales proceeds of R10 million ($R2 \text{ million} \times 5 \text{ years}$) there is no impairment of development costs and the R3 million may be amortised on the straight line basis. Therefore, in the absence of any other factors, Devres would amortise R600 000 ($R3 \text{ million} \times 20\%$) of development costs per annum for the next five years and thereby recognise the expense of R3 million evenly over the five year period.

At 1 January 1902 the selling price of the new product had to be reduced as a result of competitors entering the market. The new estimate of sales for the remaining four years is only R6 million i.e. R1,5 million per annum. Total unamortised development costs at 1 January 1902 are R2,4 million (3 million less 0,6 million amortised in 1901) and future production and selling expenses are unchanged at R4 million (i.e. R1 million per annum $\times$ four years). The total development costs and future production and selling costs are therefore R6,4 million ($2,4 + 4$) against expected future economic benefits (i.e. sales) of only R6 million. The development costs need to be written down by R400 000 to ensure that the total of development costs and future production and selling expenses does not exceed future sales.

The write down of R400 000 of the unamortised development costs on 1 January would leave a balance remaining of R2 million. This R2 million now needs to be written off on the straight line basis over the four remaining years that we expect to receive future economic benefits. The write down per annum is therefore R0,5 million.

The total charge to the income statement for development costs expensed during 1902 amounts to R900 000 (R400 000 write down of unamortised development costs and R500 000 amortisation of development costs). This leaves unamortised development costs at 31 December 1902 of R1,5 million which taken together with future production and selling costs of R3 million gives a total balance of R4½ million. Assuming no change in the selling price or sales projections of the product, R4½ million amounts to the future economic benefits expected to be received from the sale of the product. No further write down is therefore necessary.

The amortisation of development costs in 1903 would amount to R500 000 (i.e. 2 000 000 × 25%).

On 1 January 1904 the competitor that entered the market two years previously went insolvent and Devres were able to raise their selling price substantially. Sales expected over the next two years are R3 million per annum. The future economic benefits that are expected to flow to Devres are now therefore R6 million and in terms of AC 122 it is permissible to reinstate the write down of previously written down development costs. The write down of R400 000 may therefore be reinstated. This write back, however, is reduced by the amount that would have been amortised had the write down not occurred. This amounts to R200 000 (100 000 × 2 years) which is the difference between the original amortisation estimate of R600 000 and the revised amortisation required of R500 000 as a result of the changed circumstance over the two years.

This net write back of R200 000 would offset the write off or the amortisation required in 1904 of R600 000 giving a net charge of development costs as an expense of R400 000. Assuming no changed circumstances the write off in 1905 would amount to R600 000.

The development costs of R3 million have in this situation been expensed on the following basis:

	R
1901	600 000
1902	900 000
1903	500 000
1904	400 000
1905	<u>600 000</u>
	<u>3 000 000</u>

16.3.4 Software Development Costs

The statement does not detail the appropriate accounting treatment for software development costs other than the limited guidance contained in paragraph 4 that “the specific nature of the research and development activity should be considered in relation to the asset recognition criteria and definition of research and development costs”. It is submitted that criteria similar to those contained in paragraph 18 of AC 122 be met prior to capitalising software development costs; i.e. the following should be established about the software development process:

- the software development is clearly defined and the costs attributable to the software production can be separately identified and reliably measured;
- the development of the software must have reached a stage such that its technical feasibility can be demonstrated;
- the enterprise must intend to either use or market the software;
- a market for the software should exist, or if the software is to be used internally, its usefulness to the enterprise should be demonstrated; and
- sufficient resources should exist in order to complete the software development project so that the software may either be marketed or used internally.

16.4 Financial Statement Presentation

16.4.1 Accounting Policy

Appropriate wording for an accounting policy note is as follows:

Research costs are written off as incurred. Development costs are written off as incurred unless the costs are considered recoverable from probable future cost savings or sales revenues. Where development costs are deferred then they are written off on the straight line basis over four years.

16.4.2 Companies Act

Schedule 4 to the Companies Act requires the following disclosure for intangible assets:

Paragraph 22(2) the amount of development costs capitalised and the amounts written off since the date of acquisition.

16.4.3 AC 122

The disclosure requirements of AC 122 are as follows:

- an accounting policy note;
- the amount of research and development costs recognised as an expense in the period;
- the amortisation methods used;
- the useful lives or amortisation rates used;
- details of development costs that are being amortised over more than five years;
- the costs and the aggregate amounts provided as written off since the date of acquisition, and
- a reconciliation of the balance of unamortised development costs at the beginning and end of the period showing:
 - development costs recognised as an asset,
 - development costs recognised as an expense,
 - development costs allocated to other asset accounts,
 - amounts written back as assets,
 - other reconciling items where applicable.

An enterprise is also encouraged to disclose a description of its research and development activities and any circumstances or events that led to the recognition of an expense for the impairment of development costs or the write back of development costs.

16.5 Taxation

16.5.1 Deferred Taxation

Deferred taxation may arise where development costs are capitalised as the Receiver of Revenue normally allows development costs to be deducted in full in the year in which they arise. This gives rise to timing differences between the recognition of development costs for accounting purposes and taxation purposes. These timing differences are treated in the normal way (refer chapter 2) and give rise to a deferred tax liability.

17 Retirement Benefit Information

17.1 Introduction

17.1.1 Retirement Benefit Plans

Most companies provide benefits for employees on or after termination of service, in the form of an annual income or a lump sum or both. Retirement benefit plans are arrangements, formal or informal, whereby such benefits are determined or estimated in advance of retirement from the company. The plan accumulates assets (as a result of contributions from the employer and/or employees) to fund liabilities that arise upon the retirement (or to a lesser extent, withdrawal) of employees from the employer.

In South Africa, most retirement benefit plans are formal arrangements between the employer and its employees or their representatives. The plans are usually established by the employer as a normal part of the remuneration package for its employees. However, in certain circumstances the plans may be required by statute or industry arrangement. Retirement benefit plans may also be informal arrangements or evidenced only by the employer's practices.

The cost to an employer of providing retirement benefits arises as services are rendered by employees. The recognition of retirement benefit costs only when employees retire or receive retirement benefits does not allocate those costs to the period in which the services were rendered. Therefore, the cost of retirement benefits is usually recognised as an expense in the period during which the services are rendered. It is sometimes difficult to determine the periods during which the services are rendered and certain estimation procedures are necessary. These are covered further in section 17.2 and section 17.3.

The employer's cost of providing retirement benefits to employees is often quite material. In addition, there is a great deal of uncertainty surrounding the measurement of the employer's cost in certain circumstances. It is important, therefore, that users of financial statements are able to obtain an adequate understanding of the effects that retirement benefit costs might have on the position of the business. AC 116, Disclosure of Retirement Benefit Information in Financial Statements, was issued in September 1986 in order to regulate financial statement disclosures.

Retirement benefit plans are classified as either defined contribution plans or defined benefit plans.

17.1.2 Defined Contribution Plans

Defined contribution plans are defined as “retirement benefit plans under which amounts to be paid as retirement benefits are determined by contributions to a fund together with investment earnings thereon” (AC 116 paragraph 7). Under a defined contribution plan, the employer’s obligation is to make agreed contributions to a retirement plan (usually defined contribution plans are provident funds). The benefits paid under a defined contribution fund will depend upon the funds available at the time of payment. These funds are derived from contributions made plus investment earnings arising from the contributions. The benefits paid are therefore directly related to and dependent on the contributions made.

An actuary’s advice is not usually required when accounting for the costs of defined contribution plans as the cost to the employer is measurable with reasonable certainty; the cost being the amount of contributions payable in respect of any particular accounting period. An actuary’s advice is sometimes used in order to estimate future retirement benefits that may be achievable based on present contribution levels and estimates of investment earnings.

17.1.3 Defined Benefit Plans

Defined benefit plans are defined as “retirement benefit plans under which amounts to be paid as retirement benefits are determinable, usually by reference to employee’s pensionable remuneration or years of service or both” (AC 116 paragraph 8).

Defined benefit plans could be regarded as the reverse of defined contribution plans. The employer’s obligation is the amount of the expected payments to existing and retired employees determined by reference to a formula that is usually based on employees’ earnings and/or years of service. Although the liability for the defined benefits that will be paid to employees rests with the actual defined benefit fund, the employer may have contractual undertakings or ongoing commitments of a moral nature to meet the liabilities or potential liabilities of the fund. Because the final cost to the employer of funding a defined benefit plan is very uncertain, the present value of the promised retirement benefit is usually measured with the periodic advice of an actuary. The actuary recommends the future contribution levels to any fund.

There is an important distinction between the funding objective of a defined benefit plan and the accounting objective. The funding objective, established in terms of the fund, is intended to ensure that the assets (investments) of

the fund are sufficient to meet the liabilities (pension payments) at any point in time. As noted above, an actuary is often employed to ensure that this objective is achieved. The accounting objective, however, is concerned with the allocation of total costs to a particular period. The funding objective might require, for example, short term additional payments by the employer to the fund as the result of a shortfall of assets in the fund. The accounting objective requires that these payments be recognised on a systematic basis that is related to the benefits arising from the employee's services. (Note that AC 116 is not prescriptive about the accounting implications of such a shortfall.)

Defined benefit plans may be funded or unfunded. When the plan is funded then the payment of retirement benefits when they fall due will be met by the fund. When a plan is unfunded (i.e. not held in a separate fund), however, the payment of retirement benefits depends on the ability of the employer to meet the retirement benefit obligations as they fall due.

17.2 Conceptual Issues

17.2.1 Current Service Costs

Current service costs are the costs to an employer for the services rendered in the current period by participating employees in a retirement benefit plan, exclusive of those costs identified as past service costs, experience adjustments and the effects of changes in actuarial assumptions.

Current service costs meet the definition of an expense in terms of AC 000 in that the costs are "decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities" (AC 000 paragraph 70).

Under a defined contribution plan, the employer's cost is determined by a formula stated in the plan and can normally be calculated with certainty each year.

Under a defined benefit plan, however, the employer's cost can only be estimated since there are many variables that influence the amount of the ultimate benefits. The amount of future retirement benefits depends on the employees' earnings or their years of service and is affected by factors such as the investment performance of the assets held by the fund and employee turnover. As a result, significant estimates have to be made in order to determine the current service costs relating to a defined benefit plan.

The difficulties in estimating current service costs under a defined benefit

plan result in changes in estimate as and when actuarial valuations arise. These changes in estimates may result in the recognition of an asset or prepayment for accounting purposes. This is considered in more detail below.

17.2.2 Recognition of Assets/Liabilities

Changes in estimates of contributions to defined benefit plans may give rise to a significant increase or decrease in contribution levels. For example, the rate of employee withdrawal from a defined benefit plan may be less than what was originally assumed and this may give rise to an underfunded situation. In order to rectify the situation, the employer might have to make additional contributions. From an accounting point of view, the additional contribution should either be expensed or, if it meets the definition of an asset, it may be capitalised and amortised over the period in which future economic benefits are expected.

In terms of the framework, the additional contribution meets the definition of an asset in that the contribution or prepayment is a resource controlled by the enterprise, as a result of a past event, and from which future economic benefits are expected to flow to the enterprise. The expected future economic benefits are the future services of employees. The expense should be amortised over the period that the enterprise is expected to benefit from those future services.

This treatment is consistent with the notion of recognising expenses on the basis of an association between costs and income derived from future services of the employees. Clearly, the future economic benefit embodied in the once off contribution is the potential of the employees to contribute directly or indirectly to the flow of cash and cash equivalents to the enterprise.

In addition to changes in estimate, the amount funded by an employer during a period may be similar to the amount recognised as an expense in the period but is not necessarily the same. This is because there is an important distinction between the funding of retirement benefits and the allocation of the cost of providing those benefits for purposes of recognising the expense. (I.e. an employer may inject a lump sum into a defined benefit plan, over and above that which is estimated as necessary by an actuary, in order to obtain taxation relief. The excess over that required represents an advance.)

It should be noted that funding is a financial procedure and may be influenced by factors such as the availability of cash and taxation considerations.

In contrast, the objective of accounting is to ensure that the cost of retirement benefits is recognised as an expense when services are rendered by the employees who are entitled to receive benefits. The accounting treatment, therefore, of retirement benefit costs should not necessarily be determined by the physical cash flows of retirement benefit contributions to the retirement benefit plans.

Example

A company has an actuarially determined shortfall of R500 000 in its defined benefit pension scheme.

The company decides to fund this shortfall by two annual payments of R250 000 to the scheme but will expense the shortfall over the average remaining service life of employees, which is 10 years.

The effect of this on the company's financial statements can be summarised as follows:

Year	Income Statement Charge	Balance Sheet Asset (Prepayment)	Cash Flow
1	50 000	200 000	250 000
2	50 000	400 000	250 000
3	50 000	350 000	—
4	50 000	300 000	—
5	50 000	250 000	—
6	50 000	200 000	—
7	50 000	150 000	—
8	50 000	100 000	—
9	50 000	50 000	—
10	50 000	—	—

Note the following:

- (i) The company would also contribute its standard level of pension contribution (for example, 10% of salary costs). This contribution (current service costs) would be expensed as incurred; an accrual or prepayment may arise on the balance sheet date if actual payment is made in a different period.
- (ii) In terms of AC 116, the payments of R250 000 could be expensed in the year that they were made (see section 17.2.3) whereas IAS 19 (revised) requires that the payments be spread over the remaining working lives of existing employees (see, also, section 17.3.2).

- (iii) If the facts in the above example were reversed, in that a R500 000 surplus in the fund allowed the employer to stop contributions for two years, then a provision (instead of the prepayment in the case of the shortfall) would arise if the benefit of the surplus was spread over the 10 years, i.e. at the end of year 1, a credit balance of R50 000 would be created on the balance sheet. This balance represents a deferral and not a "present obligation" and is, therefore, not strictly speaking a liability in terms of the framework definition. However, it is necessary to classify the balance as a liability for reporting purposes.
- (iv) In practice, a new actuarial valuation of the fund will take place every three years and a further variation (e.g. surplus/shortfall) may arise. This raises the problem of how to account for two or more variations relating to the same fund. It is submitted that the variations should be treated entirely separately, and both amortised over the period originally calculated.

17.2.3 AC 116

AC 116 is essentially a disclosure document and does not concern itself with measurement or valuation issues. It therefore allows alternative accounting treatments for the recognition of retirement benefit costs, in that these costs may either be spread over the period in which benefits are expected to flow from employees or may be expensed immediately. This is in contrast to IAS 19 (revised 1993) which requires the amortisation of costs other than current service costs over the period in which economic benefits are expected to flow to the employer. These other costs are considered in more detail in section 17.3.

17.3 Specific Issues

17.3.1 Past Service Costs

Past service costs arise when a retirement benefit plan is first introduced or when an existing plan is modified. Employees who have been employed by the enterprise or have been members of an existing plan for longer than others are usually promised additional benefits in compensation for that service.

In this situation the amount, if any, set aside in prior periods may no longer be sufficient to meet the costs of retirement benefits applicable to prior periods. The past service deficit is funded either by an immediate lump sum payment, or the utilisation of surplus funding or by an increase in the contribution rate for a specified period.

It is often argued that past service costs should be written off immediately because they relate to services rendered in the past. However, it could be argued that the promise to give older or longer serving employees compensation for past service is simply a means of increasing their future remuneration in order to encourage them to provide service in the future. Therefore it would be appropriate to recognise the costs as an asset and amortise them over the period in which future economic benefits, as a result of the services of the employees, are expected to flow to the enterprise.

AC 116 is not prescriptive on the accounting treatment for past service costs and allows the costs either to be capitalised and amortised over a future period or to be expensed immediately. However, information as to the accounting and funding policy of the enterprise for past service costs may be required for fair presentation. In addition, where the incidence of past service costs results in an abnormal item, separate disclosure is required.

IAS 19 (revised 1993) recommends a different treatment for past service costs. In the case of defined contribution plans, when the additional contributions are determined by reference to employee service in prior periods and are in return for services to be rendered by existing employees in the current and future periods, then the increased contributions are recognised as an expense systematically over the expected remaining working lives of those employees. However, when additional contributions relate to retired employees then those contributions are recognised as an expense in the period in which the promise of additional contributions is made, since no further services are expected to be received by the employer from those employees. (See also section 17.3.4.)

In the case of defined benefit plans, IAS 19 (revised 1993) argues that a plan may be improved to provide additional benefits, for example, when retirement benefits are deemed to be inadequate, because of inflation or for other reasons. These entitlements to retirement benefits are in return for services to be rendered by employees in the future. Therefore the past service cost is usually allocated over the current and future periods during which the services are to be rendered, regardless of the fact that these costs are computed by reference to employee service in previous periods.

17.3.2 Experience Adjustments

Experience adjustments arise when actual events differ from expected events in terms of actuarial assumptions. An example of an experience adjustment is that the rate of employee turnover may be different from that assumed in the previous actuarial valuation.

Experience adjustments give rise to either expense or income (in the form of reduced contributions or "a pension fund holiday"). If costs are adjusted whenever there is a difference between actual experience and the previous actuarial assumptions then an erratic retirement benefit expense may result from period to period. Therefore, experience adjustments (in terms of IAS 19) should be allocated over the expected remaining working lives of existing employees.

AC 116, being a disclosure document, does not require this accounting treatment and allows income or expense items as a result of experience adjustments, either to be capitalised and spread on a systematic basis or to be recognised immediately.

17.3.3 Actuarial Assumption Changes

The treatment of changes in actuarial assumptions should be identical to that of experience adjustments in that changes in actuarial assumptions may give rise to expense or income. An actuarial assumption change is made when the actual experience in the long term consistently differs to the original assumptions so that the assumptions are changed to match the expected experience. The equivalent to a change in actuarial assumption is a change in accounting estimate relating to the useful life of an asset. AC 116 does not distinguish between experience adjustments and changes in actuarial assumptions and allows the effects of both changes to either be expensed immediately or to be spread over a future period. However, AC 116 requires information to be disclosed about the accounting policy and funding policy, if different, being applied to experience adjustments.

IAS 19 (revised 1993) requires the effects of changes in actuarial assumptions to be allocated over the expected remaining working lives of existing employees.

17.3.4 Retired Employees

Often there are changes in a retirement benefit plan that increase benefits paid to retired employees or once-off gratuities are paid to retired employees. The effect of providing amended retirement benefits for retired employees has no further benefits in the nature of future services expected to be received by the employer from those employees. For this reason, the effect of increased retirement benefits for retired employees should be recognised as an expense in the period in which the planned amendment is made. AC 116, however, allows the effect of changing retirement benefit plans as a result of amendments in respect of retired employee benefits to either be expensed or allocated over future periods.

17.4 Financial Statement Presentation

17.4.1 Accounting Policy

AC 116 requires the financial statements to disclose the accounting policy, and the funding policy if different from the accounting policy, indicating the basis used to allocate retirement benefit costs to the income statement. If necessary, current service costs, experience adjustments, past service costs, and cost of supplemental benefits to retired employees should be separately identified, where there is a difference between the accounting policy and the funding policy. In addition, IAS 19 (revised 1993) requires a description of the actuarial valuation method or methods used.

An example of an accounting policy is:

The company operates a defined benefit scheme providing benefits based on final pensionable salary. Contributions to the fund are charged against income so as to spread the costs over employees' working lives with the company. The contributions are determined by a qualified actuary on the basis of tri-annual valuations using the accrued benefit valuation method.

Alternatively, in the case of a large group which has a number of different pension funds, the following policy wording could be inserted into the above:

The group operates a number of pension funds. Over 85% of employees are members of defined benefit type pension funds. The funds are valued on a tri-annual basis by a qualified actuary using appropriate valuation methods.

17.4.2 Accounting Standards

In addition to an accounting policy, AC 116 requires disclosure of the nature of:

- the retirement benefit plan (i.e. whether defined benefit or defined contribution);
- whether or not the retirement benefit plan is governed by the Pension Fund Act;
- any commitment of the enterprise to meet unfunded benefits; and
- an indication of the proportion of the enterprise's employees covered by retirement benefit plans.

In the case of retirement benefit plans which are actuarially valued the following information should be disclosed:

- the effective date of the most recent actuarial valuation;
- the opinion of the actuary and any alteration to the contribution rate recommended by the actuary, specifying the nature, amount and duration of the alteration and whether or not the recommendation is being implemented;
- the year of the next actuarial valuation (in the case of funds not governed by the Pension Fund Act); and
- any unusual events since the date of the previous actuarial valuation that could have a material effect, as well as the action being taken to deal with a qualified actuarial opinion.

Where retirement benefit plans are not actuarially valued then disclose:

- the fact that it is not actuarially valued;
- any decision to change the rate of contribution or to make special contributions; and
- the expected effects on future financial statements of any significant changes in the terms of the retirement benefit plan should be disclosed.

Other disclosure requirements of AC 116 relate to material changes in the amount charged to income in any one period. These should be disclosed separately. Disclosure should be made of any differences between the accounting policy and funding policy and the resultant provisions or prepayment in the balance sheet.

IAS 19 (revised 1993) requires additional information relating to the actuarial valuation. These requirements are as follows:

- the actuarial present value of promised retirement benefits at the date of the most recent actuarial valuation;
- if the plan is funded, the fair value of the planned assets at the date of the most recent actuarial valuation;
- the actuarial present value of the vested benefits, the rights to which (under the conditions of the retirement benefit plan) are not conditional on continued employment; and
- the principle actuarial assumptions used in determining the cost of retirement benefits and any significant changes in those assumptions.

Note that where a group has a number of retirement benefit plans in operation then it may be impractical to provide full disclosure in respect of each plan, since the level of detail required would outweigh the benefits. In such cases, it may be appropriate for the group to give disclosure on a combined basis, provided that a fair reflection of the overall pension position is provided.

17.4.3 Companies Act

The retirement benefit information requirements of Schedule 4 are included in paragraphs 39 and 40.

Paragraph 39 requires "sufficient information concerning retirement benefit plans to provide a broad understanding of the significance of retirement benefit costs in the accounting period and of actual and contingent liabilities and commitments at the accounting date".

Paragraph 40 incorporates most of the AC 116 disclosure requirements, with the following exceptions.

Schedule 4 does **not** require disclosure of:

- in the case of an actuary's qualified opinion, details of the action being taken to deal with the situation;
- in the case of retirement benefit plans that are not actuarially valued, details of:
 - that fact;
 - any decision to change the rate of contribution or to make special contributions; and
 - the expected impact on future financial statements of any significant changes in the terms of the retirement benefit plan;
- material changes in the amount charged to income in any one period;
- differences between the accounting policy and funding policy.

17.5 Taxation

17.5.1 Deferred Taxation

Deferred taxation may arise where there is a difference between the funding policy and accounting policy for retirement benefit information.

The Receiver of Revenue would normally allow the amount paid over to a retirement benefit plan to be deducted from income as the payment is made in the production of income. This may give rise to a timing difference between when items of expenditure are recognised for accounting purposes versus for taxation purposes. These timing differences would be treated in the normal way and would give rise to either deferred tax liabilities or deferred tax assets.

18 Contingencies

18.1 Introduction

A contingency is a condition that exists at the reporting date, where the outcome will be confirmed only on the occurrence or non occurrence of one or more uncertain future events. For example, an unsettled (at the balance sheet date) law suit against an enterprise may result in an outflow of economic benefits should the courts decide against the enterprise. The future event is the decision of the court.

Users need to be kept informed about matters of uncertainty. Where the outcome of an event is not yet known, but where the outcome may have a material effect on the enterprise then information about the contingency is vital to users.

By disclosing contingencies, users are able to make a better assessment of the effect of possible outcomes and thereby gain a better understanding of the position of the business. The omission of contingencies may render financial statements misleading.

Most countries have issued accounting statements to regulate the disclosure of contingent gains and losses. AC 107, Contingencies and Events Occurring after the Balance Sheet Date, deals with the treatment in financial statements of contingencies and events occurring after the balance sheet date. The events occurring after the balance sheet date side of the statement is considered in Chapter 18. AC 107 and IAS 10, Contingencies and Events Occurring after the Balance Sheet Date, are virtually identical in content and form. Both of these statements are primarily concerned with disclosure. The disclosure requirements of AC 107 are considered in more detail in section 18.4.

18.2 Definitions

AC 107 defines a contingency as "a condition or situation, the ultimate outcome of which, gain or loss, will be confirmed only on the occurrence, or non occurrence of one or more future events" (AC 107 paragraph 2).

Contingencies could result in either a gain or a loss. A contingent gain or contingent loss is therefore defined as "a gain or a loss dependent on the outcome of a contingency" (AC 107 paragraph 3).

Contingencies are restricted to conditions or situations at the reporting date,

the financial effect of which is to be determined by future events which may or may not occur. Therefore, conditions or situations that are usually reflected in provisions in financial statements in accordance with the accounting framework and the four fundamental accounting concepts (AC 101) are also contingencies. Such contingencies are usually provided for in the accounting period in which the related transactions took place. Examples of other contingencies include:

- (a) guarantees and warranties provided in the normal course of business;
- (b) bills which have been discounted with recourse; and
- (c) guarantees given on behalf of third parties (usually group companies).

AC 107 is not concerned with ongoing possibilities that accounting estimates will prove inaccurate (for example, the estimation of the useful lives of fixed assets). Rather, the statement is primarily concerned with once off occurrences which are outside the normal range of accounting estimates. The usual example of a contingency is that of a court case where the uncertainty is resolved when the court's decision has been reached.

18.3 Conceptual Issues

18.3.1 Contingent Liabilities

The recognition of a contingent loss will give rise to a contingent liability being recognised on an enterprise's balance sheet. This link requires careful consideration of the definition of the liability and the related recognition criteria for determining whether a contingent loss should be provided for or not. (A contingent loss could also give rise to the impairment of an asset; the conceptual arguments are the same as those used below in terms of the probability and measurability of reduced inflows of economic benefits.)

In terms of AC 000, a liability is defined as "a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits" (AC 000 paragraph 49). In the case of a court action against the enterprise, should the court case be lost and damages be paid to a third party then clearly there would be an outflow from the enterprise of resources embodying economic benefits. The important factor, therefore, is whether the contingency relates to a **present** obligation of the enterprise that arises from **past events**.

If the court case arose as a result of, for example, a defect in a good supplied by the enterprise which caused losses to a third party, then arguably

there is a present obligation which resulted from a past event; the past event being the selling of the product and the present obligation being the amount of damages that may be paid to the third party. The key to the recognition of a contingent loss and the related contingent liability are the recognition criteria set out in AC 000.

“A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably” (AC 000 paragraph 91). This principle is included in AC 107 (which was issued prior to AC 000) in paragraph 29 which states that the amount of a contingent loss should be provided for by a charge in the income statement if “it is probable that future events will confirm that, after taking into account any related probable recovery, the value of an asset has been impaired or a liability has been incurred at the balance sheet date and a reasonable estimate of the amount of the resulting loss can be made”. The contingent event must be **probable** and the related economic benefit flows (from the enterprise) must be **measurable**.

Therefore, both AC 000 and AC 107 (and IAS 10) are consistent in the accounting treatment for contingent losses.

It is important to note that where a reasonable estimate of the amount of the resulting loss cannot be made then the existence of the contingent loss should be disclosed in the financial statements (AC 107 paragraph 30) even though no provision (or contingent liability) has been made. This is confirmed by AC 000 which states that where a claim cannot be reliably measured then it would not be recognised as a liability but the existence of the claim would be disclosed in the notes or explanatory material. (See AC 000 paragraphs 86 to 88 for further discussion.)

18.3.2 Contingent Assets

A similar argument may be used in the case of contingent gains as was used for contingent losses; i.e. the recognition of a contingent gain will give rise to a contingent asset being recognised in the balance sheet. Such a gain should only be recognised where the contingent asset meets the definition and recognition criteria of an asset.

Using the same arguments as for contingent liabilities, a contingent asset should be recognised when it is probable that the future economic benefits associated with that contingency will flow to the enterprise and the asset has a cost or value that can be measured reliably. However, AC 107 does not allow for the recognition of contingent gains. Instead, the existence of

contingent gains should only be disclosed if it is probable that the gain will be realised i.e. accrual is not made for contingent gains that are probable and can be reliably measured.

Therefore, AC 107 (and IAS 10) apply the fundamental accounting principle of prudence to override the conceptual issues contained in AC 000. The application of the principle of prudence results in the treatment of contingent assets being different from that of contingent liabilities.

18.3.3 Setting off Contingent Gains and Contingent Losses

In certain cases a contingent gain and a contingent loss may be connected. AC 107 provides some guidance on the appropriate accounting treatment.

“A potential loss to an enterprise may be reduced or avoided because a contingent loss is matched by a related counter claim or claim against a third party. In such cases the amount of any provision may be determined after taking into account the probable recovery under the claim” (AC 107 paragraph 12).

This situation would arise where, if a claim **against** the company succeeds, and it is virtually certain that the claim **by** the company will also succeed, then the contingent gain would be set off the contingent loss. This could apply where the likelihood of either claim succeeding was seen as probable, possible or remote; i.e. the test is to assess the certainty surrounding the two opposing claims.

Offsetting is only allowed in the above circumstances as although the likelihood of two claims succeeding may be probable, both claims should stand or fall together before offsetting takes place. Otherwise, a company should accrue for the total amount of the claim against it (the contingent loss) and merely note the likelihood of success of the counter claim or claim against a third party (the contingent gain). It is only where the two contingencies or claims are so closely related that if one happens the other will happen that offsetting is allowed in terms of paragraph 12 of AC 107.

18.3.4 Determination of the Amount of Contingencies

The amount at which a contingency is stated is based on the information that is available at the date on which the financial statements are authorised for issue. Therefore, events occurring after the balance sheet date that indicate that an asset may have been impaired or a liability may have existed at the balance sheet date, are taken into account in identifying contingencies and in determining the amounts at which such contingencies are included in the financial statements.

Contingent losses are only provided for when a reasonable estimate of the amount of the resulting loss can be made. A number of factors should be taken into account by management in estimating the amount of the contingent loss. For example, in the case of a legal claim, management should evaluate at the date on which the financial statements are authorised for issue the opinions of legal experts or other advisers, the experience of the enterprise in similar cases and the experience of other enterprises in similar situations when estimating the amount of the loss.

Where contingent losses are not provided for then disclosure of the amount and financial effect of the contingency should be disclosed (refer section 18.4.2). The amount and the financial effect may often differ; for example, where guarantees of group overdrafts are provided by the holding company then the financial effect is the total guarantee whereas the amount of the overdrafts at the balance sheet date may be considerably less than the total of the guarantees.

If the amount and the financial effect can not be estimated then AC 107 waives the requirement, provided a statement to that effect is given. This is logical as the disclosure of inaccurate estimates may mislead users.

If the uncertainties that create a contingency in respect of individual transactions are common to a large number of similar transactions, then the amount of the contingency need not be individually determined, but may be based on the group of similar transactions. Such contingencies usually relate to warranties for products sold and the estimated uncollectable portion of accounts receivable (i.e. bad debt provisions).

18.4 Financial Statement Presentation

18.4.1 Companies Act

Schedule 4 (paragraph 35) to the Companies Act requires disclosure of particulars of any contingencies not already recognised in the financial statements including details of

- (a) the nature of the contingency;
- (b) the uncertain factors that may affect the future outcome; and
- (c) the estimated amount and its effect before and after taxation.

There is no exception for remoteness given in schedule 4. Accordingly, guarantees and bills discounted with recourse are disclosed even though the likelihood of a loss being incurred may be remote.

18.4.2 AC 107

Where a contingent loss has been provided for by a charge in the income statement then in terms of AC 107 no disclosure is necessary. However, where a contingent loss has not been provided for then the disclosure requirements as set out in schedule 4 should be given unless the possibility of a loss is remote and the disclosure of the existence of a contingent loss would be misleading.

It is clear, therefore, that the disclosure requirements of schedule 4 are more onerous than the disclosure requirements of AC 107 in relation to contingent losses in that schedule 4 requires disclosure of all contingencies not provided for whereas AC 107 does not require disclosure of contingencies where the possibility of a loss is remote.

AC 107 requires disclosure of contingent gains only where it is probable that the gain will be realised.

The following matrix summarises the disclosure requirements of AC 107 for contingent gains and contingent losses:

LIKELIHOOD	CONTINGENT GAIN	CONTINGENT LOSS
Probable	Do not accrue, but note in financial statements.	Accrue, no separate disclosure required.
Possible	Ignore*	Do not accrue, but note in financial statements.
Remote	Ignore*	Ignore*

* Schedule 4 requires note disclosure of these contingencies.

19 Post Balance Sheet Events

19.1 Introduction

Events occurring after the balance sheet date are those events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are authorised for issue (AC 107 paragraph 4). The date on which financial statements are authorised for issue is usually the date on which the financial statements are approved by the board of directors.

The definition of post balance sheet events would appear to include every transaction that a company undertakes during this period. However, AC 107 is concerned with firstly those events that come to light which provide additional information about the financial condition of the enterprise at the balance sheet date, and secondly, events that are indicative of conditions that arose subsequent to the balance sheet date but are relevant to users in assessing the future prospects of the enterprise, even though these events have no effect on the amounts shown in the financial statements.

There are therefore two separate types of post balance sheet events, usually known as adjusting and non adjusting events.

19.2 Post Balance Sheet Events

19.2.1 Adjusting Post Balance Sheet Events

Adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information for determining the amounts relating to conditions existing at the balance sheet date.

The example given in AC 107 (paragraph 20) of an adjusting event is where evidence that a trade accounts receivable is insolvent may be received after the end of the accounting period. This would require that the amount owed by the debtor be written off i.e. the financial statements would be adjusted to reflect the write off of the debtor, but not if the cause of insolvency was, say, a fire in the post balance sheet period. (In the latter case, the condition did not exist at the balance sheet date.)

A further example of an adjusting post balance sheet event occurred quite recently in South Africa when the transition levy of 5% was announced in the 1994 Budget Speech by the Minister of Finance. The announcement was

made in June 1994 that the levy would be charged in respect of financial years ending during the period 1 April 1994 to 31 March 1995. Therefore, a company with, say, a 30 April year end that had not finalised its financial statements for the year ended 30 April 1994 at the time of the Minister's announcement would be required to account for the levy as an adjusting post balance sheet event. The announcement clearly provided additional information for determining the tax liability for the year ended 30 April 1994.

It should be appreciated that if a company with a 31 March year end had not finalised its financial statements at the time of the Minister's announcement then the levy would still give rise to a post balance sheet event. However, this event would be non-adjusting in nature – the levy would not be based on earnings for the year ended 31 March 1994 (the conditions existing at the balance sheet date) but on the earnings for the year ending 31 March 1995. Therefore, the announcement would be treated as a non adjusting post balance sheet event which is discussed further in section 19.2.2.

The UK standard, SSAP 17, provides a list of possible adjusting events. These include:

- fixed assets; the subsequent determination of the purchase price or of the proceeds on sale of assets purchased or sold before the year end;
- stock and work-in-progress; the receipt of proceeds from sales after the balance sheet date or other evidence concerning the net realisable value of stock and the receipt of evidence that the previous estimate of accrued profit on a long term construction contract was materially inaccurate;
- taxation; the receipt of information regarding rates of taxation;
- claims; amounts received or receivable in respect of insurance claims which were in the course of negotiation at the balance sheet date.

AC 107 also requires that any indications about the going concern assumption in relation to the whole or part of the enterprise no longer being appropriate be regarded as an adjusting post balance sheet event.

19.2.2 Non-adjusting Post Balance Sheet Events

If post balance sheet events do not relate to conditions existing at the balance sheet date then adjustments to assets and liabilities are not generally appropriate. Disclosure of these events is usually made if they represent unusual changes to the condition of assets or liabilities at the balance sheet date; for example, the destruction of a major item of plant as a result of a fire after the balance sheet date. Once again, SSAP 17 gives examples of possible non adjusting post balance sheet events. These include:

- mergers and acquisitions;
- issue of shares and debentures;
- purchases and sales of fixed assets and investments;
- losses of fixed assets or stock as a result of catastrophes such as fire or flood;
- opening new trading activities or extending existing trading activities;
- a decline in the value of property and investment held as fixed assets, if it can be demonstrated that the decline occurred after the year end;
- changes in the rate of foreign exchange;
- government action, such as nationalisation;
- strikes and other labour disputes.

There are events which, although they take place after the balance sheet date, are usually reflected in the financial statements because of a statutory requirement. For example, the dividend proposed or declared after the balance sheet date in respect of the period covered by the financial statements.

19.3 Financial Statement Presentation

19.3.1 Companies Act

Schedule 4 (paragraph 72) (b) requires the director's report to deal with any material fact or circumstance which has occurred in the group between the accounting date and the date of the report. This requirement appears to relate only to group financial statements but should as good practice be given in all financial statements.

19.3.2 AC 107

The requirements of AC 107 are that in the case of non adjusting post balance sheet events, the following information should be provided:

- the nature of the event;
- an estimate of the financial effect, both before and after taxation, or a statement that such an estimate cannot be made.

20 Secondary Tax on Companies

20.1 Introduction

A new tax called Secondary Tax on Companies (STC) was introduced during 1993. At the same time, the standard rate of taxation on company and close corporation earnings was reduced. There have been subsequent changes to the rate of STC and corporate taxation as well as the introduction of a “once-off” transition levy. These changes to the corporate tax system have consequential effects on the appropriate accounting treatment for, *inter alia*, deferred taxation, contingencies and extraordinary items. There is no GAAP on accounting for STC – the South African Institute of Chartered Accountants has issued two Accounting Issues Task Force **Opinions**, namely AC 303 and AC 304. Although the primary focus of this book is on GAAP, in the light of the controversy that has surrounded the appropriate accounting treatment for STC, this chapter examines the content and implications of AC 303 and AC 304.

20.1.1 1993 Budget Speech and AC 303

The Minister of Finance announced in his 1993 budget a reduction in the corporate tax rate (applicable to companies and close corporations) from 48% to 40% and a new tax called STC of 15% on distributed income.

STC applies to all dividends declared on or after 17 March 1993 as well as those declared before, but not paid by 17 March 1993. STC is a tax imposed on the company declaring the dividend and not on the shareholder.

The dividend subject to STC is the amount of any dividend declared during the relevant dividend cycle, less dividend income (including foreign sourced dividends) received during that cycle. Each dividend cycle (except the first) commences on the day after the previous one ended and ends on the date on which the next dividend accrues to shareholders.

The Accounting Issues Task Force of the South African Institute of Chartered Accountants issued AC 303 in November 1993 to provide guidance on the appropriate accounting treatment for STC and for the change in the corporate tax rate. In essence, AC 303 suggests the following:

- STC is considered an expense of the company and should be charged against income (that is, included with the tax charge).

- The adjustment to the deferred taxation balance as a result of the decrease in the corporate tax rate should be disclosed either as an extraordinary item or as an adjustment to the tax charge in the income statement.
- Any contingent liability for STC based on undistributed income should be disclosed by way of a note, unless the possibility of future distributions of the undistributed income is remote.

These issues will be considered further in the remainder of this chapter.

20.1.2 1994 Budget Speech and AC 304

The Minister of Finance announced in his 1994 budget a further reduction in the corporate tax rate to 35% (from 40% in 1993) and an increase in the rate of STC from 15% to 25% for dividends declared on or after 22 June 1994. In addition, a once-off transition levy of 5% on companies' and close corporations' taxable income greater than R50 000 was announced for financial years ending between 1 April 1994 and 31 March 1995.

The Accounting Issues Task Force issued AC 304 in July 1994 to provide guidance on the appropriate accounting treatment for the transition levy and the change in the corporate tax rate. In essence, AC 304 suggests the following:

- The transition levy is a tax on the company and should be disclosed as part of the tax charge in the income statement.
- The adjustment to the deferred tax balance as a result of the decrease in the corporate tax rate should be disclosed as an adjustment to the tax charge in the income statement.

These issues will be considered further in the remainder of this chapter.

20.2 Changes in the Tax Rate

20.2.1 Deferred Tax Balance

Reductions in the corporate tax rate give rise to adjustments to deferred tax balances whether provided on the comprehensive or partial basis (refer to section 2.3.1 in chapter 2). The primary accounting issue is one of disclosure; should the adjustment be reflected as an extraordinary item or as part of the tax charge? This issue is considered in section 20.2.2.

The adjustment to the deferred tax balance is likely to result in a credit to the income statement as most companies have deferred tax liabilities on the

balance sheet. Where a company has created a deferred tax asset, however, the reduction in the tax rate gives rise to a charge in the income statement.

Companies that provide for deferred tax on the comprehensive basis often have substantial deferred tax balances and the effect of the change in tax rate gives rise to a significant adjustment to the income statement. For example, each R1m of a credit deferred taxation balance gives rise to the following credits to the income statement:

1993/94	166 667	$(1\ 000\ 000 \times 8/48)$
1994/95	125 000	$(1\ 000\ 000 \times 5/40)$

20.2.2 Extraordinary Item or Not?

The effect on the deferred tax balance of the change in tax rate could be disclosed in two possible ways; either as part of the tax charge or as an extraordinary item. The debate, to a certain extent, has become academic – AC 103 (see chapter 9) has made extraordinary items largely redundant. Nevertheless, a great deal of debate has centred around this issue. Essentially, the key issue is whether the introduction of STC and the dual tax system constitutes a “fundamental change in the basis of taxation” (AC 102 paragraph 64). If so, then in terms of AC 102, the adjustment to the deferred tax balance should be treated as an extraordinary item. As no guidance is given in AC 102 as to what constitutes a “fundamental change”, most companies have considered their own particular circumstances in determining whether or not the introduction of STC had a fundamental impact on them. During 1993/94, therefore, listed companies disclosed the effect of the rate change either as extraordinary, or as part of the tax charge, depending on their interpretation of the impact of STC. This approach is consistent with the AC 303 opinion.

The further reduction in the corporate tax rate announced in the 1994 budget gives rise to another adjustment to the opening deferred tax balance. The argument above about the appropriate disclosure (i.e. either as extraordinary or as part of the tax charge) remains relevant. AC 304, however, argues that the “narrower definition of extraordinary items now being followed internationally and the general acceptance for this approach by the South African business community” (paragraph 10) requires that the adjustment be disclosed as part of the tax charge. This approach has an unfortunate effect on consistency and comparability; a company might have disclosed the adjustment as extraordinary in 1993 (in accordance with AC 303) and as part of the tax charge in 1994 (in accordance with AC 304). AC 304 recognises this problem and encourages companies that previously treated

the deferred tax adjustment as an extraordinary item to restate the comparative financial information (and treat the adjustment as part of the tax charge).

20.3 STC Disclosure

20.3.1 Expense vs Appropriation

Both AC 303 and AC 304 hold the view that STC should be disclosed as part of the tax charge. STC, therefore, is considered to be an expense of a corporation. Although most companies appear to be disclosing STC as part of their tax charge, there have been exceptions – Pick 'n Pay is a recent example. At issue is whether STC constitutes an expense as defined by AC 000. As discussed in chapter 1, the framework defines expenses as “decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity other than those relating to distributions to equity participants”. It is important, therefore, to determine whether STC is a tax on corporations, and hence an expense, or a tax relating to a distribution and hence an appropriation. Certain companies have adapted the latter viewpoint and disclosed STC with the dividend charge on the income statement. In the case of listed companies, this approach has obvious advantages in that the STC charge is excluded from the EPS calculation.

It is worth noting that companies, without current period income, that declare a dividend would reflect a taxation charge despite a zero level of activity. This scenario suggests that STC is a tax on distributions and not merely another tax on the company and should, therefore, be disclosed as an appropriation with dividends. Nevertheless, most companies appear to show STC as part of the tax charge in accordance with AC 303 and AC 304. STC appears, generally, to be regarded as a tax on the company and therefore an expense of that company.

20.3.2 Contingency

In terms of AC 107 (refer chapter 18), a contingent liability exists for STC based on the undistributed income of a corporation. In the case of companies, Schedule 4 requires disclosure of any contingency (however remote) except where disclosure of its existence would be misleading. It is difficult to envisage disclosure of the STC contingency as being misleading so in terms of Schedule 4, all companies should disclose the contingency. AC 107 requires disclosure of possible contingencies and not remote contingencies. The payment of dividends out of retained earnings (or undrawn profits in

The disclosure requirements of AC 303 are set out below:

- the amount provided for STC;
- a commentary that will assist in an understanding of factors affecting the charge for STC. Such a commentary would be relevant where the STC charge is a significant component of the total tax charge or where the effective rate of STC varies substantially from the standard rate;
- the amount of unutilised STC credits which arise where dividend income exceeds dividends declared.

(AC 303 paragraph 9)

20.4 The Transition Levy

The once-off transition levy on companies and close corporations is 5% of taxable income after an abatement of R50 000, but before the set-off of any assessed losses carried forward from previous years. The levy is charged on financial years ending during the period 01 April 1994 to 31 March 1995.

20.4.1 Disclosure

The transition levy is regarded as a tax on the company by AC 304 and therefore "should be included in the taxation charge and be separately disclosed" (paragraph 3). The Task Force Opinion rejects the possibility of the levy being disclosed as extraordinary for a number of reasons, but essentially because of the new definition of extraordinary item (refer to chapter 9).

20.5 Post Balance Sheet Events

The transition levy and tax rate changes were announced on 22 June 1994 and apply to years ending during the twelve month period to 31 March 1995. The announcement of the levy, therefore, constitutes a post balance sheet event for companies that had not approved their 1994 financial statements for issue by 22 June 1994. This post balance sheet event was non-adjusting for those companies reporting on year ends up to 31 March 1994 but **adjusting** for those companies reporting year ends on or after 01 April 1994. Refer to chapter 19 for further discussion of post balance sheet events.

SPECIMEN ANNUAL FINANCIAL STATEMENTS

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Persons, companies and other entities referred to in these specimen statements are fictitious and any resemblance to any actual persons, companies or other entities is coincidental.

The authors acknowledge the assistance of Price Waterhouse in drafting these specimen financial statements. No assurance is given by the authors, the publisher or Price Waterhouse as to the correctness of information contained herein and no liability is accepted for any statement or opinion or for any error or omission.

XYZ HOLDINGS LIMITED**

(Registration number: xxxx)

[SPECIMEN] GROUP ANNUAL FINANCIAL STATEMENTS
for the year ended 30 June 19X1

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NOTES

- 1 These specimen annual financial statements are prepared on the basis of the requirements of Schedule 4 of the Companies Act, 1973, as amended, statements of generally accepted accounting practice issued by the Accounting Practices Board up to 30 September 1995 and the Johannesburg Stock Exchange disclosure requirements.

The purpose of these specimen financial statements is to highlight disclosure requirements and to serve as a convenient reference to source material. They do not necessarily serve as indicators of best accounting practice or presentation nor should they be considered to be the only acceptable form of presentation. The form and content of the company's financial statements are ultimately the responsibility of the directors.

These financial statements are in respect of a listed holding company but do not attempt to cover all the disclosure requirements of specialised entities (e.g. finance companies, insurance companies, banking institutions, etc).

* Refer to commentary on page 20, note 2.

** Where a company has changed its name during the financial year the previous name should be disclosed i.e XYZ Holdings Limited (formerly xxx).

Although not mandatory, listed companies should consider including the following disclosure in their annual report:

- Chairman’s statement,
- Value added statement,
- Five/seven year financial review,
- Detailed narrative review of segments,
- Management responsibility statement,
- Corporate mission statement,
- Employee report,
- Corporate governance statement, and
- List of definitions.

2 Summary of references used in the margin:

- S – Section of the Companies Act, 1973, as amended
- P – Paragraph reference in Schedule 4 of the Companies Act, 1973, as amended
- AC – Statement/Guideline/Opinion of Generally Accepted Accounting Practice
- JSE – Requirements for companies listed on the Johannesburg Stock Exchange

XYZ HOLDINGS LIMITED
(Registration number : xxxx)

NOTICE OF ANNUAL GENERAL MEETING

Notice is hereby given that the annual general meeting of members of the company in respect of the year ended 30 June 19X1 will be held at 90 Table Road, Cape Town, on Friday 23 August 19X1 at 12h00 for the following purposes, namely:

- | | |
|---------|---|
| S286(1) | <ol style="list-style-type: none"> 1 To receive and adopt the annual financial statements and group annual financial statements for the year ended 30 June 19X1. 2 To elect Messrs P Smith and R A Black as directors. Messrs I T Irwin and C E Smythe retire by rotation in accordance with the provisions of the company's articles of association, and offer themselves for re-election. |
| S221(2) | <ol style="list-style-type: none"> 3 To place xxx unissued ordinary shares of Rx each in the capital of the company at the disposal of the directors for allotment and issue to such persons, at such times and generally on such terms and conditions, and for such considerations, whether payable in cash or otherwise, as the directors in their sole discretion may think proper, subject to the provisions of the Companies Act and the approval of the Johannesburg Stock Exchange. 4 To place xxx unissued redeemable cumulative preference shares of Rx each in the capital of the company at the disposal of the directors for allotment and issue to such persons, and at such times and generally on such terms and conditions, and for such considerations, whether payable in cash or otherwise, as the directors in their sole discretion may think proper, subject to the provisions of the Companies Act and the approval of the Johannesburg Stock Exchange. 5 To consider the payment of a final dividend of xx cents per ordinary share and xx cents per preference share/the distribution of a capitalisation award as proposed by the directors. |

Any member entitled to attend and vote is entitled to appoint a proxy or proxies to attend, speak and vote in his stead, and the person so appointed need not be a member. Proxy forms should be forwarded to reach the registered office of the company or the office of the transfer secretaries at least 48 hours before the time fixed for the holding of the meeting.

Notice is also given that the transfer books of the company will be closed from 21 to 22 August 19X1, both dates inclusive.

By order of the board

Group secretary

Johannesburg
31 July 19X1

NOTES RE NOTICE OF ANNUAL GENERAL MEETING

- 1 The notice of meeting is required to be issued in compliance with the provisions of the company's articles of association and in accordance with the Companies Act, which requires not less than 21 days notice prior to the date of the meeting (S186(1)).
- 2 Listed companies are required in terms of the JSE Listing Requirements, JSE 3.2.3, to submit to the Listings Division notices of annual general meetings of shareholders and the annual financial statements of the company.

XYZ HOLDINGS LIMITED
(Registration number: xxxx)

FORM OF PROXY

I/We _____ (name in full)

being the holder(s) of _____ shares

of XYZ Holdings Limited hereby appoint _____

or failing him _____

or failing him _____

or failing him, the chairman of the meeting as my/our proxy to vote for me/us on my/our behalf at the annual general meeting of the company to be held at 12h00 on Friday 23 August 19X1 and at every adjournment thereof, as follows:

	In favour of*	Against*	Abstain*
1 Resolution to adopt the annual financial statements			
2 Resolution to elect new directors and to re-elect retiring directors			
3 Resolution to place all ordinary shares held in reserve under the control of the directors			
4 Resolution to place all unissued redeemable cumulative preference shares under the control of the directors			
5 Resolution to approve the payment of a final dividend of xx cents per ordinary share and xx cents per preference share as proposed by the directors.			

* Please place an X in the appropriate spaces above to indicate how you wish your votes to be cast.

Unless otherwise instructed my proxy may vote as he thinks fit.

Signed at _____ this day of _____ 19X1

Member _____

A member entitled to attend and vote at the above-mentioned meeting is entitled to appoint a proxy (who need not be a member of the company) or more than one proxy (who also need not be members of the company but alternatively to each other) to attend and speak and, on a poll, to vote in his stead.

Proxy forms must be received at least 48 hours before the time of the meeting by the Company at its registered office or by the transfer secretaries, ZY Registrars Limited, PO Box xxx, Johannesburg, 2000.

XYZ HOLDINGS LIMITED
(Registration number: xxxx)

DIRECTORATE AND ADMINISTRATION

P(68)f	The Directors (names with titles)	} changes during the accounting period
P(68)f	The Secretary (name, business and postal addresses)	
	Registered office (postal and business addresses and telephone number)	
	Transfer secretaries (address)	
	Auditors (name)	
	Attorneys (name)	
	Bankers (name)	

APPROVAL OF ANNUAL FINANCIAL STATEMENTS

The annual financial statements and group annual financial statements which appear on pages 8 to 40 have been approved by the board of directors and are signed on its behalf by:

S298

DIRECTOR	DIRECTOR
2 August 19X1	

NOTES

- 1 The example above includes certain items which are not required by statute or the JSE Listing Requirements, but are traditionally included as being information suitable for inclusion in the annual financial statements.*
- 2 Other details for possible inclusion on this page would vary with the range and number of the company's operations, major subsidiaries (including foreign) etc, and would be determined by the policy of the board of directors regarding disclosure of such details for the information of shareholders and others.*
- 3 In terms of S171(1), the nationality of the directors who are not South African citizens must be stated.*

S298

- 4 The annual financial statements are required to be signed by two directors, or if there is only one director, by that director.*

REPORT OF THE INDEPENDENT AUDITORS

To the members of
XYZ Holdings Limited

S286/S301

We have audited the annual financial statements and group annual financial statements set out on pages 8 to 40. These financial statements are the responsibility of the company's directors whilst our responsibility is to report thereon.

We conducted our audit in accordance with generally accepted auditing standards which require that we plan and carry out the audit to obtain reasonable assurance that fair presentation is achieved in the financial statements in all material respects. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting policies used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We consider that our audit procedures were appropriate in the circumstances to express the opinion presented below.

S300/S301

In our opinion these annual financial statements fairly present the financial position of the company and the group at 30 June 19X1 and the results of their operations and cash flow information for the year then ended in conformity with generally accepted accounting practice and in the manner required by the Companies Act.

ABC and Associates
Chartered Accountants (SA)
Sandton
2 August 19X1

NOTES

- 1 Where a listed company is also listed on a foreign stock exchange, or has significant foreign shareholders, the Companies Act in terms of which the financial statements have been prepared should be identified. In the above example, "South African Companies Act, 1973" would replace the reference to "Companies Act".
- 2 The date of the auditors' report must not precede the date of approval of the financial statements by the directors and is usually the same date.
- 3 In general, the auditors' report should be produced on letter-head paper, except in the case of listed companies or joint audits.

XYZ HOLDINGS LIMITED

S299 **DIRECTORS' REPORT**
for the year ended 30 June 19X1

P66 The directors present their annual report which forms part of the audited annual financial statements of the company and of the group for the year ended 30 June 19X1.

P68(a) 1 PRINCIPAL ACTIVITIES OF THE GROUP

The principal activities of the group are the manufacture and distribution of fishing tackle and motor vehicle rental services. The group is also involved in property and land development and holds a portfolio of listed and unlisted investments.

During the year the holding company acquired a majority interest in a company whose sole activity is the provision of motor vehicle rental services.

P67(1) 2 OPERATING RESULTS

The net profit of the group for the year was RXXX (19X0: RXXX), after deducting taxation of RXXX (19X0: RXXX) and income attributable to outside shareholders in subsidiaries of RXXX (19X0: RXXX). (Detailed financial information by segment is provided in note 29 to the annual financial statements.)

P67(1) 3 REVIEW OF OPERATIONS

The Companies Act does not provide guidance as to the extent of comments required in the review of operations. It is submitted that the comments should cover at least the following:

Gross revenue

- The amount of consolidated gross revenue for the year, the percentage change from the previous year and the reasons for the changes.
- AC115(37)** – The amounts of gross revenue for the year by segment (if relevant), the percentage change from the previous year and the reasons for the change.
- Reasons for the change could include references to significant new activities and significant discontinued activities; effects of sales volume variations (including new products or new markets) and prices; impact of new products; competition; etc.

Operating profit

- The amount of consolidated operating profit, before extraordinary items and taxation, and the percentage change from the previous year and reasons.

- Reasons for the change could include the effects of sales volume variations; margin variations; product rationalisation; impact of significant items; particular operating circumstances (eg factory close downs, etc); inflation; financing costs; technology changes; impact of foreign currency exchange rate movements; etc.

Taxation

- The impact of any unusual items (eg use of tax losses).

Extraordinary items

- The nature and amounts of individual items.

Other major items

- Comments on other significant items for example, details of research and development projects.

Share capital

Details of issues during the year or a statement to the effect that there were no changes.

P68(d)

4 DIVIDENDS

The directors propose a final dividend of xx cents (19X0 = xx cents) per share on ordinary shares and xx cents (19X0: xx cents) per share on preference shares to be paid out of profits for the year ended 30 June 19X1 to shareholders registered on 23 August 19X1. An interim dividend of xx cents per ordinary share was paid during the year.

	19X1	19X0
	R	R
Ordinary shares:		
Interim dividend paid 9 January 19X1	000	000
Proposed final dividend payable 29 August 19X1	<u>000</u>	<u>000</u>
	<u>000</u>	<u>000</u>

(Where there is a capitalisation share award with cash election:)
A final capitalisation award of new ordinary shares of RX each will be issued as fully paid up by way of a capitalisation of part of the company's distributable reserves, in the ratio of X new capitalisation shares for every XX ordinary shares held. Shareholders are entitled to decline to receive the award and to renounce their capitalisation shares for cash to the equivalent of X cents per existing ordinary share held.

Preference shares:

Proposed final dividend payable 29 August 19X1	<u>000</u>	<u>000</u>
--	------------	------------

5 REVIEW OF THE GROUP'S FINANCIAL POSITION

- P72** *This paragraph primarily relates to changes in the composition of the group's balance sheet. The particulars of significant changes in the state of affairs of the group may include the following:*
- P72** – *Subsidiaries acquired or disposed of during the year and the consideration for each.*
- P68(b)** – *Details of shares, debentures and convertible instruments issued or redeemed during the year, and the purpose for which the securities were issued.*
- *Details of major asset revaluations and the assets affected.*
- P68(c)** – *Significant fixed asset additions or disposals, or a change in the nature of the fixed assets.*
- JSE8.52(b)** – *Significant increases or decreases in borrowings.*
- *Significant investments acquired or disposed of.*

6 EVENTS SUBSEQUENT TO BALANCE SHEET DATE

- AC107/
P67(2)/
P72(b)** *In respect of events which occurred after the balance sheet date and do not affect the condition of the assets or liabilities at that date, but which are significant to a proper assessment of the company or group, disclosure should be made of the nature of the event and an estimate of the financial effect thereof.*

Where no such events have occurred, the statement may be made that the directors are not aware of any matter or circumstance arising since the end of the financial year, not otherwise dealt with in the report or group annual financial statements, that would affect the operations of the group or the results of those operations significantly.

P68(g) 7 HOLDING COMPANY

The company's holding company is ABC (Proprietary) Limited and its ultimate holding company is DCF Holdings PLC, incorporated in the United Kingdom.

8 SUBSIDIARIES**

- P69(a)/P70** The following information relates to the company's financial interests in its subsidiaries. All companies with the exception of X (Proprietary) Limited were subsidiaries throughout the year. With effect from 1 March 19X1 X (Proprietary) Limited was acquired for a cash consideration amounting to Rxx. Details of the assets acquired and consideration paid are given in note 30.8. Y (Proprietary) Limited and Z (Proprietary) Limited are engaged in property and land development and X (Proprietary) Limited rents motor vehicles.

	Details of holding company's interest					
	Issued ordinary share capital and proportion held		Shares at cost less provisions and amounts written off		Indebtedness	
	R000	%	19X1 R000	19X0 R000	19X1 R000	19X0 R000
X (Proprietary) Limited	000	00	000	—	000	—
*Y (Proprietary) Limited	000	00	000	000	000	000
Z (Proprietary) Limited	000	00	000	000	000	000
	<u>000</u>	<u>00</u>	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>

* Incorporated in the United Kingdom.

** Note that this information is only required in respect of material subsidiaries and it is not necessary to list each subsidiary.

P71 The holding company's interest in the aggregate income earned and losses incurred by subsidiaries, after taxation, amounted to Rxxx (19X0: Rxxx) and Rxxx (19X0: Rxxx) respectively.

JSE 8.52(k) The following significant special resolutions were passed by subsidiaries since the date of the previous directors' report:

ABC Ltd 5 April 19X1 Increase in borrowing powers
DEF (Pty) Ltd 16 May 19X1 Approval for capital expenditure

JSE 8.52(d) 9 DIRECTORS' INTERESTS IN SHARE CAPITAL OF THE COMPANY

At 30 June 19X1 the directors of the company were directly and indirectly interested in the issued share capital of the company as follows:

	19X1 %	19X0 %
Ordinary shares		
– Beneficially	00	00
– Non-beneficially	00	00
Redeemable cumulative preference shares		
– Beneficially	00	00

Subsequent to year end there have been the following changes in directors' interest:

or

Subsequent to year end there have been no changes in directors' interests.

The following directors held in excess of 1%:

	19X1 2%	19X0 2%
Mr X	2%	2%
Mr Y	2%	2%

10 EXECUTIVE SHARE INCENTIVE SCHEME

JSE 8.52(g) During the year options over 000 (19X0: 000) shares were granted, bringing the total number of shares under option at year end to 000 (19X0: 000). The balance of the unissued share capital of the company which is available in terms of the share incentive scheme is 000 (19X0: 000).

11 COMPLIANCE WITH THE CODE OF CORPORATE CONDUCT AND PRACTICE

NOTE

All companies listed on the JSE Main Board must provide a statement of commenting on the extend of their compliance or non compliance with such Code. This statement may be contained in a separate section of the annual report and need not be audited.

NOTES

S299(1) 1 Where the company is a wholly-owned subsidiary of a company incorporated in South Africa, a directors' report is not required. The following wording may be inserted preceding the directors' approval paragraph:

"A directors' report and group annual financial statements have not been prepared as the company is a wholly-owned subsidiary of XYZ Investment Holdings Limited, a company incorporated in the Republic of South Africa."

2 The date of approval must either be the same as or precede the auditors' opinion date.

P69(a) 3 Where details of subsidiaries are given, if a company is not incorporated in this country, the country of incorporation must be stated.

4 Where the financial year end of any subsidiary differs to that of the company, the reasons for the difference, and the accounting period of the subsidiary in respect of which the financial information has been accounted for, should be stated.

XYZ HOLDINGS LIMITED
INCOME STATEMENTS
for the year ended 30 June 19X1

		Notes	Group		Company	
			19X1	19X0	19X1	19X0
			R000	R000	R000	R000
P43	GROSS REVENUE (TURNOVER)		000	000	000	000
	Continuing operations		000	000	000	000
	Acquisitions		000	000	000	000
			000	000	000	000
AC103(19f)	Discontinued operations		000	000	000	000
AC108(34a)	Cost of sales		000	000	000	000
	Gross profit		000	000	000	000
	Operating costs		000	000	000	000
	OPERATING PROFIT	1	000	000	000	000
	Continuing operations		000	000	000	000
	Acquisitions		000	000	000	000
			000	000	000	000
AC103(19f)	Discontinued operations	24	000	000	000	000
	Loss on the sale of discontinued operation	24	(000)	(000)	(000)	(000)
AC103(9)	PROFIT ON ORDINARY ACTIVITIES BEFORE INTEREST		000	000	000	000
P42(f)	Financing costs	2	(000)	(000)	(000)	(000)
	PROFIT ON ORDINARY ACTIVITIES BEFORE TAXATION		000	000	000	000
P422(d)	Taxation	3	000	000	000	000
	PROFIT ON ORDINARY ACTIVITIES AFTER TAXATION		000	000	000	000
AC110(48)	Retained equity income/(deficit) of associate companies		000	000		
	Attributable to outside shareholders		000	000	000	000
	PROFIT BEFORE EXTRAORDINARY ITEMS		000	000	000	000
P46/AC103(9)	Extraordinary items	4	000	000	000	000
	NET PROFIT/(LOSS)		000	000	000	000
P42(c)	Dividends paid	25	000	000	000	000
P11(a)	RETAINED PROFIT FOR THE YEAR		000	000	000	000
	Opening retained earnings as restated		000	000	000	000
	Opening retained earnings as previously reported		000	000	000	000
AC103(33)	Correction of fundamental error	22	000		000	
AC103(45)	Change in accounting policy	23	000	000	000	000
P42(k)	Transfers (to)/from reserves	8	000	000	000	000
P11(a)	CLOSING RETAINED EARNINGS		000	000	000	000
P42(1)	EARNINGS PER ORDINARY SHARE (cents)	5	000	000		
AC104(33)	DIVIDENDS PER ORDINARY SHARE (cents)		000	000		
AC104(37)	FULLY DILUTED EARNINGS PER ORDINARY SHARE (cents)	5	000	000		

NOTES 1 The earnings per share figure need only be shown in respect of listed companies.

2 Where there has been a change from profit to loss (or vice versa), the line description should cover both situations.

XYZ HOLDINGS LIMITED

BALANCE SHEETS

at 30 June 19X1

			Group		Company	
		Notes	19X1	19X0	19X1	19X0
			R000	R000	R000	R000
	CAPITAL EMPLOYED					
P8(i)	ORDINARY SHARE CAPITAL	6	000	000	000	000
P8(d)	SHARE PREMIUM	7	000	000	000	000
P11	NON-DISTRIBUTABLE RESERVES	8	000	000	000	000
P11	DISTRIBUTABLE RESERVES	9	000	000	000	000
	ORDINARY SHAREHOLDERS' INTEREST		000	000	000	000
P9	PREFERENCE SHARE CAPITAL	6	000	000	000	000
	TOTAL SHAREHOLDERS' INTEREST		000	000	000	000
	OUTSIDE SHAREHOLDERS' INTEREST IN SUBSIDIARIES		000	000	–	–
P16(c)/ AC102(66)	DEFERRED TAXATION	10	000	000	000	000
P15	LONG-TERM LIABILITIES	11	000	000	000	000
			000	000	000	000
	EMPLOYMENT OF CAPITAL					
P20	FIXED ASSETS	12	000	000	000	000
P23	INTEREST IN SUBSIDIARIES	13	–	–	000	000
AC110(47)	INVESTMENT IN ASSOCIATE COM- PANIES	14	000	000	000	000
P26	INVESTMENTS	15	000	000	000	000
	EMPLOYEE SHARE INCENTIVE SCHEME		000	000	000	000
			000	000	000	000
	CURRENT ASSETS					
P29	Inventory	16	000	000	000	000
	Debtors		000	000	000	000
	Amounts due from clients for con- tracts in progress	17	000	000	000	000
	Short-term loans		000	000	000	000
	Cash resources		000	000	000	000
			000	000	000	000
	CURRENT LIABILITIES					
P13	Creditors and accruals	18	000	000	000	000
P16(b)	Taxation		000	000	000	000
P16(a)	Dividend proposed		000	000	000	000
P15(a)	Bank overdraft		000	000	000	000
			000	000	000	000
	NET CURRENT ASSETS/(LIABILITIES)		000	000	000	(000)
			000	000	000	000

XYZ HOLDINGS LIMITED

CASH FLOW STATEMENTS

for the year ended 30 June 19X1

		Notes	Group		Company	
			19X1	19X0	19X1	19X0
			R000	R000	R000	R000
AC118(41)	CASH (UTILISED IN)/RETAINED FROM OPERATING ACTIVITIES					
AC118(41)*	Cash generated by/(utilised in) operations	30.1	000	(000)	000	(000)
AC118(41)*	Investment income		000	000	000	000
AC118(41)*	(Increase)/decrease in working capital	30.2	(000)	000	(000)	000
AC118	Cash generated by operating activities		000	000	000	000
AC118(41)*	Financing costs		(000)	(000)	(000)	(000)
	Taxation paid	30.3	(000)	(000)	(000)	(000)
	Cash available from operating activities		(000)	000	(000)	000
AC118(41)*	Dividends paid	30.4	(000)	(000)	(000)	(000)
	Extraordinary items		000	000	—	—
			(000)	000	(000)	000
AC118(22)*	CASH UTILISED IN INVESTMENT ACTIVITIES					
	Replacement of fixed assets	30.5	(000)	(000)	(000)	(000)
	Proceeds on disposal of fixed assets	30.6	000	000	000	000
AC118(27)	Investment to maintain operations		(000)	(000)	(000)	(000)
	Additions to fixed assets	30.7	(000)	(000)	(000)	(000)
AC118(39)	Purchase of subsidiary	30.8	(000)	—	(000)	—
	Investment to expand operations		(000)	(000)	(000)	(000)
	Net cash invested		(000)	(000)	(000)	(000)
	Net cash (utilised)/available		(000)	000	(000)	000
AC118(32)*	CASH EFFECTS OF FINANCING ACTIVITIES					
AC118(43)	Decrease in long-term liabilities	30.9	(000)	(000)	(000)	(000)
	Increase/(decrease) in short-term liabilities	30.10	000	(000)	000	(000)
AC118(44)	Proceeds of rights issues	30.11	000	—	000	—
	Net finance raised/(repaid)		000	(000)	000	(000)

* Cash flow information is also required in terms of paragraph 50 to Schedule 4.

XYZ HOLDINGS LIMITED

SUMMARY OF ACCOUNTING POLICIES

for the year ended 30 June 19X1

- P6/AC101(22)** The following are the principal accounting policies of the group which are consistent in all material respects with those applied in the previous year, except as otherwise indicated. The financial statements have been prepared on the historical cost basis, except as modified by the revaluation of freehold land and buildings.

CONSOLIDATION AND GOODWILL

- P57/P63** The consolidated financial statements incorporate the financial statements of the company and its subsidiaries. The results of subsidiaries are included from the effective dates of their acquisition until the effective dates of their disposal. Goodwill, being the excess of the cost of shares in subsidiaries over the fair value of their net assets at date of acquisition, is capitalised and amortised over a period of five years. Intercompany transactions and balances are eliminated on consolidation.

AC119(51) **JOINT VENTURES**

Investments in jointly controlled entities are accounted for by way of the proportionate consolidation method whereby the group's proportionate share of the assets, liabilities, revenues and expenses of joint ventures are combined, on a line by line basis, with similar items in the financial statements of the group. The results of joint ventures are included from the effective dates of their acquisition and up to the effective dates of their disposal.

ASSOCIATE COMPANIES

- AC110(42)** An associate company is one over which the group has the ability to exercise significant influence and which it intends to hold as a long-term investment. The post-acquisition results of associate companies are incorporated in the financial statements, using the equity method of accounting, from the effective dates of their acquisition until the effective dates of their disposal.

- AC110(49)** The group's share of earnings of associates is included in earnings attributable to ordinary shareholders. The retained equity earnings are transferred to non-distributable reserves.

INVESTMENTS

Investments, other than in associates, are stated at cost less any provisions for permanent diminution in value. Dividends are accounted for on the last day for registration in respect of listed shares and when declared in respect of unlisted shares.

FIXED ASSETS AND DEPRECIATION

(i) **Intangible assets**

No value is attributed to internally developed trademarks, concessions, patents and similar rights and assets, including franchises and management contracts. Costs incurred on trademarks, concessions patents and similar rights, whether purchased or created by the Group, are charged to the profit and loss account in the period in which they are incurred.

AC123(66)

(ii) **Property, plant and equipment**

Expenditure on additions and improvements to tangible fixed assets including the cost of related licences is capitalised for major projects on the basis of measured work completed, for other property projects on the basis of orders placed, and for all other projects as the expenditure is incurred.

Surpluses arising from the professional valuations of properties are taken direct to the revaluation reserve. Valuation surpluses realised on sale are transferred from the revaluation reserve to the income statement. Any deficit arising from the professional valuation of properties is taken direct to the revaluation reserve to the extent that such deficit is regarded as temporary. Where a permanent diminution in value of an individual property is identified, the deficit is eliminated against any revaluation reserve in respect of that property with any excess being charged to the income statement.

Freehold land and licences are not depreciated.

Freehold and leasehold properties are written off over 25 years, from the later of the date of acquisition or latest valuation. Leasehold properties are written off over the unexpired term of the lease when less than 25 years.

Cost of plant, machinery, furniture, fittings, tools and equipment (owned or leased) is spread, by equal instalments, over the estimated useful lives of the relevant assets, namely:

AC123(66c)

Plant and machinery	3-20 years
Information technology equipment	3-5 years
Equipment in retail outlets	8-10 years
Vehicles	3-7 years

AC123(67c)

Restoration, dismantling and removal costs relating to property, plant and equipment are recognised as an expense over the life of the asset and a liability for the anticipated amount is raised.

AC114(29a, c)

BORROWING COSTS

Interest costs incurred on the financing of major projects are capitalised. Such interest cost related to expenditure incurred prior to the project becoming operational. The capitalisation rate utilised to determine the amount of borrowing costs eligible for capitalisation is X.

LEASED ASSETS

**AC105(42)/
(45)/(46)** Assets leased in terms of finance lease agreements are capitalised. Capitalised leased assets are depreciated on the straight line method at rates considered appropriate to reduce book values to estimated residual values over their useful lives. Lease finance charges are amortised over the duration of the leases by the effective interest rate method.

All costs relating to operating leases are charged to income as incurred.

INVENTORY

AC108(25/40) Inventory is valued at the lower of cost or estimated net realisable value. Estimated net realisable value is the estimated selling price less any costs of disposal. Cost is determined on the following bases:

Raw materials and consumable stores are valued at average cost.

Finished goods and work in progress are valued at raw material cost plus labour cost and a proportion of manufacturing overhead expenses based on normal capacity. The accounting policy for finished goods changed during the current year and manufacturing overheads are now included in the determination of cost.

Merchandise is valued at invoice cost on a first-in first-out basis.

DEFERRED TAXATION

AC102(62) Deferred taxation is accounted for on the comprehensive basis in respect of all material timing differences which arise from the inclusion of income and expenses or losses in taxable income in periods different from those in which they are included in accounting income. Deferred tax assets are created where their future realisability is assured beyond reasonable doubt.

ENVIRONMENTAL LIABILITIES

The group is exposed to environmental liabilities relating to its operations. Provision for the cost of environmental and other remedial work is made when such expenditure is probable and the cost can be estimated within a reasonable range of possible outcomes.

FOREIGN CURRENCIES

AC112 Transactions in foreign currencies are accounted for at the rates of exchange ruling on transaction dates.

Monetary assets and liabilities denominated in foreign currencies are translated at the rates of exchange ruling at the balance sheet date, or at forward rates where related forward exchange contracts have been entered into. Unrealised differences on monetary assets and liabilities are recognised in the income statement in the period in which they occur.

AC112(63) Assets and liabilities of foreign subsidiaries are translated at rates of exchange approximating those ruling at the financial year end. Income and expenditure of foreign subsidiaries are translated at the weighted average rate of exchange during the year.

Profits and losses arising on the translation of foreign subsidiaries are taken directly to non-distributable reserves.

CONTRACTS IN PROGRESS

AC109(39) Contract revenue is recognised on the stage of completion method.
P29(2) The stage of completion is determined on the basis of the proportion of costs incurred for work performed on the contract to date, to the estimated total costs of the contract. Anticipated losses on incomplete contracts are fully provided for.

RETIREMENT BENEFIT INFORMATION

AC116(51) The group provides for pensions for all employees in the group by payments to independent trust funds and contributions are charged against income when made.

AC122 RESEARCH AND DEVELOPMENT COSTS

Research costs are written off as incurred. Development costs are written off as incurred unless the costs are considered recoverable from probable future cost savings or sales revenues. Where development costs are deferred then they are written off on the straight line basis over four years.

AC111(39a) REVENUE/(TURNOVER)

P43 Revenue comprises the invoiced value of sales in respect of manufacturing and trading operations and the rental of motor vehicles, and excludes investment and other non-operating income and value added taxation. Consolidated turnover excludes sales to group companies.

Revenue from the sale of goods is recognised when significant risks and rewards of ownership of the goods are transferred to the buyer.

Revenue arising from services and royalties is recognised on an accrual basis in accordance with the substance of the relevant agreements.

Dividends are recognised when the right to receive payment is established.

Interest is recognised on a time proportion basis, taking account of the principal outstanding and the effective rate over the period to maturity.

Revenue arising from rendering of services is based on the state of completion determined by reference to physical amount of work performed in relation to the total project.

SHARE CAPITALISATION AWARDS AND CASH DIVIDENDS

Cash dividends and the full cash equivalent of capitalisation share awards are recorded as dividends declared in the income statement. The current dividend liability represents the amount reasonably estimated to be paid in cash and any difference between total dividends declared and this estimate, is transferred to a non-distributable share election reserve pending the outcome of the final share awards.

Capitalisation share awards received are included in dividend income in the income statement.

NOTES

1 Notes on preparation

In drafting an accounting policy note the general requirements of AC 101 should be borne in mind to ensure fair presentation is achieved in the financial statements

2 The accounting policies of the company or group are generally set out as part of the notes to the annual financial statements ('note 1'). Where the accounting policies or notes are numerous, a separate summary of accounting policies is often presented.

3 Accrual and going concern bases

If the financial statements have been prepared otherwise than in accordance with either of these bases this should be disclosed.

4 Where annual financial statements are being prepared for a listed company, which is a significant subsidiary of a foreign shareholder, or where the annual financial statement are to be widely distributed, consideration should be given to the inclusion of the following statement:

"The accounting policies conform in all material respects with the standards issued by the International Accounting Standards Committee, if appropriate."

5 Partial basis of providing deferred taxation

The following wording is appropriate for the accounting policy note:

Deferred taxation

Deferred taxation is accounted for on the partial basis. Accordingly, deferred taxation is provided only where it is probable that taxation will become payable in the foreseeable future as a result of reversing timing differences.

XYZ HOLDINGS LIMITED

NOTES TO THE ANNUAL FINANCIAL STATEMENTS

for the year ended 30 June 19X1

		<u>Group</u>		<u>Company</u>	
		19X1	19X0	19X1	19X0
		<u>R000</u>	<u>R000</u>	<u>R000</u>	<u>R000</u>
1 OPERATING PROFIT					
Operating profit is arrived at after taking into account the following items:					
AC111(39b)	Income from:				
	– Sales of goods	000	000	000	000
	– Rendering of services	000	000	000	000
	– Royalties	000	000	000	000
	– Gains on futures contracts	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
AC111(39c)	Revenue arising from exchanges was:				
	– Sale of goods	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
	– Royalties	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
AC109(39)	Construction contract revenue	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
P42(i)/S283	Auditors' remuneration				
	– Audit fees	000	000	000	000
	– Other services	000	000	000	000
	– Expenses	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
P42(o)/	Depreciation				
AC 123(66d)	– Property – owned	000	000	000	000
	– Plant and equipment – owned	000	000	000	000
	– leased	000	000	000	000
	– Vehicles – owned	000	000	000	000
	– leased	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
		<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
P42(h)	Fees for services				
	– Administrative	000	000	000	000
	– Managerial	000	000	000	000
	– Secretarial	000	000	000	000
	– Technical	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
		<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
AC105(53)/	Rentals in respect of operating leases				
P42(r)	– Land and buildings	000	000	000	000
	– Plant and equipment	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
		<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>

XYZ HOLDINGS LIMITED

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (cont.)
for the year ended 30 June 19X1

		<i>Group</i>		<i>Company</i>	
		19X1	19X0	19X1	19X0
		R000	R000	R000	R000
AC112(71)/ P42(q)	Exchange gains/(losses) relating to foreign currency borrowings	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
AC122(34)	Research and Development costs expensed	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
AC103(15)/ P42(n)	Significant items Profit/(Loss) on disposal of fixed assets	000	000	000	000
AC105(54)	– Plant and equipment – disposals	000	000	000	000
	– Plant and equipment – sale and leaseback	000	000	000	000
	Losses on futures contracts	000	000	000	000
	Inventory write-down	000	000	000	000
	Taxation effect (<i>for each of the above</i>)	(000)	(000)	(000)	(000)
	Attributable to minority shareholders (<i>for each of the above</i>)	<u>(000)</u>	<u>(000)</u>	<u>(000)</u>	<u>(000)</u>
AC108(32d)	Reversal of inventory write-down	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
AC103(29)	Change in accounting estimate	000	000	000	000
	Taxation	(000)	(000)	(000)	(000)
	Outside shareholders	<u>(000)</u>	<u>(000)</u>	<u>(000)</u>	<u>(000)</u>
	(Being change in estimated lives of motor vehicles)	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
P42(a)	Income from investments:				
AC111(39b)/ AC110(37)	Dividend income				
	– associate companies	000	000	000	000
	– listed investments	000	000	000	000
	– unlisted investments	000	000	000	000
AC111(39b)	Interest income				
	– loans	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
		<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
S297/P59	Directors' emoluments				
	For services as directors			000	000
	For managerial services			<u>000</u>	<u>000</u>
				<u>000</u>	<u>000</u>

		<u>Group</u>		<u>Company</u>	
		19X1	19X0	19X1	19X0
		R000	R000	R000	R000
	Pensions:				
	For services as directors			000	000
	For managerial services			<u>000</u>	<u>000</u>
				<u>000</u>	<u>000</u>
	Compensation for loss of office			<u>000</u>	<u>000</u>
	Paid by:				
	Company			000	000
	Subsidiaries			000	000
	Others			<u>000</u>	<u>000</u>
				<u>000</u>	<u>000</u>
P42(b)	Income from subsidiaries				
AC111(39b)	Dividends			000	000
AC111(39b)	Interest			000	000
	Management fees			<u>000</u>	<u>000</u>
				<u>000</u>	<u>000</u>
P42(f)/	2 FINANCING COSTS				
AC114(29b)	Gross financing cost	000	000	000	000
	Less financing costs capitalised	<u>(000)</u>	<u>—</u>	<u>(000)</u>	<u>—</u>
	Financing costs expensed	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
	3 TAXATION				
AC102(63)	South African normal taxation	000	000	000	000
P42(d)	Foreign taxation	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
		000	000	000	000
	Taxation in respect of extraordinary items (refer note 4)	<u>(000)</u>	<u>000</u>	<u>(000)</u>	<u>(000)</u>
	Total taxation	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
AC102(63)/	Comprising:				
P42(e)	Current taxation				
	— current year	000	000	000	000
	— prior years	(000)	000	(000)	000
AC102(63)	Deferred taxation				
	— current year	000	000	000	000
	— prior years	000	(000)	000	(000)
	— change in rate of taxation	(000)	(000)	(000)	(000)
	Secondary tax on companies	000	000	000	000
	Withholding tax on dividends received	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
		<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>

		<i>Group</i>		<i>Company</i>	
		19X1	19X0	19X1	19X0
		%	%	%	%
		%	%	%	%
AC102(65)	Reconciliation of rate of taxation				
	Standard rate of taxation	35	40	35	40
	Adjustment for:				
	Export incentives and other allowances	(00)	(00)	(00)	(00)
	Disallowable expenditure	00	00	00	00
	Utilisation of assessable losses	(00)	(00)	(00)	(00)
	Deferred taxation rate change	(00)	(00)	(00)	(00)
	Non-taxable income	(00)	(00)	(00)	(00)
	Foreign taxation rate differential	00	00	00	00
AC303(16)	Secondary taxation on companies	00	00	00	00
AC304(12)	Transition levy	00	00	00	00
	Prior year (over)/under provision	<u>(00)</u>	<u>00</u>	<u>(00)</u>	<u>00</u>
	Effective rate of taxation	<u>00</u>	<u>00</u>	<u>00</u>	<u>00</u>
	<i>or</i>				
AC102(66)	Taxation has not been provided as export incentive allowances resulted in an assessable loss for the year.				
AC102(66)	Estimated assessable losses available for set off against future taxable income are as follows:	R000	R000	R000	R000
	Total assessable losses	000	000	000	000
	Applied to reduce deferred taxation	<u>(000)</u>	<u>(000)</u>	<u>(000)</u>	<u>(000)</u>
		<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
	4 EXTRAORDINARY ITEMS				
AC103(14)/ P46	Loss on the expropriation of property	(000)	(000)	(000)	(000)
	Share of extraordinary (losses)/profits in associate companies	<u>(000)</u>	<u>000</u>	<u>—</u>	<u>—</u>
		(000)	000	(000)	(000)
	Taxation relief/(charge)	000	(000)	000	000
	Attributable to outside shareholders	<u>000</u>	<u>(000)</u>	<u>—</u>	<u>—</u>
		<u>(000)</u>	<u>000</u>	<u>(000)</u>	<u>(000)</u>
	5 EARNINGS PER SHARE				
AC104(34)	The calculation of earnings per ordinary share is based on the net profit attributable to ordinary shareholders before extraordinary items of R000 (19X0: R000) and the weighted average number 000 (19X0: R000) of ordinary shares in issue during the year.				
AC104(39)	The calculation of fully diluted earnings per share is based on earnings of R000 and the weighted average of 000 ordinary shares in issue during the year. The dilution of 00 cents per share is the result of 000 debentures issued during the year which are convertible into ordinary shares in 19X3 on the basis of 1 ordinary share for each R1 debenture (refer to note 11).				

		<u>Group and company</u>	
		19X1	19X0
		R000	R000
	6 SHARE CAPITAL		
P8(1)	Authorised:		
(a)&(b)	000 Ordinary shares of Rx each	<u>000</u>	<u>000</u>
	000 x% Redeemable cumulative preference shares of Rx each	<u>000</u>	<u>000</u>
	Issued:		
	000 Ordinary shares of Rx each	<u>000</u>	<u>000</u>
	000 x% Redeemable cumulative preference shares of Rx each	<u>000</u>	<u>000</u>
P8(2)	On 1 January 19X1 xx ordinary shares of Rx each were issued at a premium of Rxx each.		
P8(2)(d)	Of the new shares issued xx were issued to directors of the company.		
P9(1)	The 000% redeemable preference shares may be redeemed at the company's option before 1 January 19X5 at a premium of 50 cents per share; if still outstanding at this date, they are required to be redeemed at par.		
P32	The directors are authorised, by resolution of the shareholders and until the forthcoming annual general meeting, to dispose of the unissued shares for any purpose and upon such terms and conditions as they see fit.		

		<u>Group and company</u>	
		19X1	19X0
		R000	R000
	7 SHARE PREMIUM		
	Balance at the beginning of the year	000	000
	Premium on shares issued during the year	000	000
P8(1)(e)	Share issue expenses written off	<u>(000)</u>	<u>(000)</u>
P8(1)(d)	Balance at the end of the year	<u>000</u>	<u>000</u>

		<u>Group</u>		<u>Company</u>	
		19X1	19X0	19X1	19X0
		R000	R000	R000	R000
	8 NON-DISTRIBUTABLE RESERVES				
P11(a)	Balance at the beginning of the year	000	000	000	000
AC110(49)	Attributable retained equity income of associate companies	000	000	—	—
P11(b),(c)	Other movements (<i>specify</i>)	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
P11(a)	Balance at the end of the year	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>

		<u>Group</u>		<u>Company</u>	
		19X1	19X0	19X1	19X0
		R000	R000	R000	R000
	Comprising:				
AC123(41)	Revaluation of fixed assets	000	000	000	000
S98	Capital redemption reserve fund	000	000	000	000
AC112(74)	Foreign currency translation reserve	000	000	–	–
AC110(49)	Attributable retained equity income of associate companies	000	000	–	–
	Share election reserve	000	000	000	000
		<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
P11	9 DISTRIBUTABLE RESERVES				
	General reserve	000	000	000	000
	Retained income	000	000	000	000
		<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
AC119(47)	Group distributable reserves at the end of the year comprise:				
	Company	000	000		
	Subsidiary companies	000	000		
	Joint ventures	000	000		
		<u>000</u>	<u>000</u>		
	Any future dividend declarations out of the distributable reserves of the company or any of its subsidiary companies incorporated in South Africa will be subject to secondary tax on companies at a rate of 25% of the dividend declared.				
AC102(68)	Group distributable reserves include an amount of Rxxx attributable to a foreign subsidiary, which would upon distribution be subject to a withholding tax of			<u>000</u>	<u>000</u>
		<u>Group</u>		<u>Company</u>	
		19X1	19X0	19X1	19X0
		R000	R000	R000	R000
	10 DEFERRED TAXATION				
	Balance at beginning of year	000	000	000	000
	Movements during the year:				
	Timing differences	000	000	000	000
	Change in rate of taxation	(000)	(000)	(000)	(000)
	Balance at the end of the year	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
AC102(66)/	The balance comprises:				
P16(c)	Capital allowances	000	000	000	000
	Provisions	(000)	(000)	(000)	(000)
	Assessable losses	(000)	(000)	(000)	(000)
		<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>

Note: If deferred taxation is provided on the partial basis, refer to note 19 for disclosure relating to the contingent liability for deferred taxation.

		<u>Group</u>		<u>Company</u>	
		19X1	19X0	19X1	19X0
		R000	R000	R000	R000
	11 LONG-TERM LIABILITIES				
P15(b)	Mortgage loan 1	000	000	000	000
	Mortgage loan 2	000	000	—	—
	Convertible debentures	000	—	000	—
	Unsecured loan	000	000	000	000
	Liabilities under capitalised finance lease agreements	000	000	000	000
	Total liabilities	000	000	000	000
	Less — payable before 30 June 19X2 included in short-term liabilities	000	000	000	000
	Total long-term liabilities	000	000	000	000
P15(c)	Interest bearing liabilities:				
	Long and medium term	000	000	000	000
	Short-term	000	000	000	000
	Total interest bearing liabilities	000	000	000	000
	The mortgage loans are secured by mortgages over properties (refer to note 12) with a net book value of	000	000	000	000

Additional information:

	<u>Repayable</u>	<u>Repayment instalments</u>	<u>Interest rate</u>
Mortgage loan 1	19X2–19X5	R000 annually	00%
Mortgage loan 2	19X5	R000 monthly	00%
Unsecured loan	19X6	Indefinite	00%
Liabilities under capitalised finance lease agreements	19X2–19X6	R000 annually	00%

The convertible debentures of R1 each were issued at par on 31 January 19X1. The debentures carry a coupon rate of 12 % per annum, payable six monthly, and are convertible at the option of debenture holders into ordinary shares at any time after 31 January 19X3 on the basis of 1 ordinary share for each debenture held.

12 FIXED ASSETS
19X1 GROUP

	Property R000	Plant & Ma- chinery owned/ leased R000	Furni- ture & Fittings R000	Vehicles owned/ leased R000	Develop- ment costs R000	Total R000
AC123(66e), (66f)						
Carrying amount at 30 June 19X0	000	000	000	000	000	000
At cost or valuation	000	000	000	000	000	000
Accumulated depreciation	(000)	(000)	(000)	(000)	(000)	(000)
Revaluation adjustments	000	000	000	000	000	000
Exchange adjustments	000	000	000	000	000	000
Additions/development costs capitalised or written back	000	000	000	000	000	000
AC114(29b)						
Borrowing costs capitalised	000	000	000	000	000	000
Disposals	(000)	(000)	(000)	(000)	(000)	(000)
Development costs allocated to other assets	000	000	000	000	000	000
Depreciation for the year	(000)	(000)	(000)	(000)	(000)	(000)
Carrying amount at 30 June 19X1	000	000	000	000	000	000
At cost or valuation	000	000	000	000	000	000
Accumulated depreciation	(000)	(000)	(000)	(000)	(000)	(000)

NOTE: A table for 19X1 should be given for the company on the same basis.

The comparative tables for 19X0 should also be given for the group and the company.

P22(4a)

The directors carried out a valuation of the Group's properties at 30 September 19X0 in conjunction with the Group's own professionally qualified staff and XXXX international Property Consultants. The valuation which was incorporated in the financial statements for that year was on an open market basis for existing use in respect of all properties.

Historical cost

The comparable amounts under the historical cost convention for properties which have been revalued would be:

		Group and company				
		19X1 R000	19X0 R000			
14 INVESTMENT IN ASSOCIATE COMPANIES						
AC110(45)	Shares at cost less amounts written off	000	000			
	Share of retained earnings since acquisition	000	000			
		000	000			
AC110(45)/ (46) P27						
	Percentage holding	No. of shares held	Group Carrying amount	Company Cost or valuation		
	19X1	19X0	19X1	19X0	19X1	19X0
Listed						
O Limited	00	00	000	000	000	000
Unlisted						
E (Proprietary) Limited**	00	00	000	000	000	000
C (Proprietary) Limited	00	00	000	000	000	000
S (Proprietary) Limited	00	00	000	000	000	000
				000	000	000
Total investment in associate companies*				000	000	000
Market valuation of listed associate company				000	000	000
Directors' valuation of unlisted associate companies				000	000	000

* All associate companies operate in the retail industry.

** Based on the annual financial statements of E (Proprietary) Limited for the twelve months ended 31 December 19X0. The financial year end of all other associate companies is 30 June 19X1.

AC110(45)	The aggregate assets, liabilities and results of operations of associate companies are summarised as follows:		
		19X1 R000	19X0 R000
	Fixed assets	000	000
	Current assets	<u>000</u>	<u>000</u>
	Total assets	<u>000</u>	<u>000</u>
	Deferred taxation	000	000
	Long-term liabilities	000	000
	Current liabilities	<u>000</u>	<u>000</u>
	Total liabilities	<u>000</u>	<u>000</u>
	Gross revenue	000	000
	Operating profit/(loss)	000	(000)
	Taxation	(000)	—
	Net profit/(loss) attributable to ordinary shareholders	000	(000)
	Extraordinary items	<u>(000)</u>	<u>000</u>

NOTES:

Additional disclosure on associate companies is required in the following circumstances (AC 110 (45) – (49)):

- 1 Where the proportion of voting power in an associate company differs to the proportion of share capital owned;
- 2 Where the financial information of an associate company used for equity accounting purposes relates to an accounting period which differs to that of the investor;
- 3 With regard to any significant unadjusted transactions or events occurring between the dates of the associate's and investor's financial statements;
- 4 Where an associate has not been equity accounted; and
- 5 With regard to any gain or loss on sale of shares in an associate company.

P26(1)**15 INVESTMENTS**

		No. of shares held		Class of shares	Group and company	
		19X1	19X0		19X1 R000	19X0 R000
Listed						
P27	ABC Limited	000	000	Ord. A	000	000
	SBM Limited	000	000	Ord. B	<u>000</u>	<u>000</u>
					<u>000</u>	<u>000</u>
P26(2)(a)	Market value of listed investments				<u>000</u>	<u>000</u>
Unlisted						
P27	JV (Proprietary) Limited	000	000	Pref.	000	000
	W (Proprietary) Limited	000	000	Ordinary	000	000
	Venture Partnership	—	—	—	<u>000</u>	<u>000</u>
					<u>000</u>	<u>000</u>
P26(2b)	Directors' valuation of unlisted investments				<u>000</u>	<u>000</u>
	Loans				000	000
	Loan levy				<u>000</u>	<u>000</u>
					<u>000</u>	<u>000</u>
	Total investments				<u>000</u>	<u>000</u>

Included in loans are the following:

S295

Loans to directors

				Balance at 30 June	
	Purpose	Ad- vances	Repay- ments	19X1 R000	19X0 R000
R A Ormond	Housing	000	000	000	000
I T Urwin	Housing	—	000	—	000
C E Smythe	Car purchase	000	000	—	—
		<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>

**P25/
S38(2)**

Loan to executive share incentive scheme 000 000

— This loan is unsecured, bears interest at xx% and is repayable on demand.

NOTES:

P27

1 Where there are more than five different listed or unlisted investments, the information relating to the names of invested companies and the number and classes of shares held may be provided in a schedule or a register, with a note to the balance sheet indicating that the register is open for inspection.

2 Alternatively, details of equity holdings and related required disclosures in subsidiaries, associated companies and other investments may conveniently all be given in an appendix to the financial statements, suitably described.

P28

3 Where the carrying amount of unlisted investments is arrived at by reference to a valuation, the following details should be disclosed:

- the policy regarding the frequency of revaluations,
- the basis of valuation, and
- the date of the latest revaluation.

S295

4 Even if the directors' loans were made in the current year and have been repaid in full, their existence must be disclosed.

**S37
(a)–(c)**

5 In respect of loans or security provided by a subsidiary to its holding company (or a fellow subsidiary), in accordance with the provisions of section 37 additional disclosure is required:

- name of company to which the loan/security was provided
- relationship between the subsidiary and such company
- details of the date on which the loan was advanced, the amount outstanding at year-end, the highest balance outstanding during the year, interest rate, security and repayment terms.

16 INVENTORY

		<i>Group</i>		<i>Company</i>	
		19X1	19X0	19X1	19X0
		R000	R000	R000	R000
AC108(32b)/ P29(1)	Raw materials	000	000	000	000
	Work in progress	000	000	000	000
	Finished goods	000	000	000	000
	Consumable stores	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
		<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
AC108(32c)	Included in the amounts above are the following inventories carried at net realisable value:				
	Finished goods	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
P29(2)/ AC109(40a)/(42a)	17 AMOUNTS DUE FROM CLIENTS FOR CONTRACTS IN PROGRESS				
	Contract costs to date	000	000	000	000
	Profit recognised to date	000	000	000	000
	Progress billings	<u>(000)</u>	<u>(000)</u>	<u>(000)</u>	<u>(000)</u>
		<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
		<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
		18 CREDITORS AND ACCRUALS			
	Trade creditors	000	000	000	000
P15(a)/ AC105(35)	Current portion of long-term liabilities:				
	– capitalised finance leases	000	000	000	000
	– other liabilities	000	000	000	000
P16(d)	Provisions	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
		<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
P17/P34	The following current assets have been pledged as security to trade creditors:				
	Raw material stocks			<u>000</u>	<u>000</u>
				<u>000</u>	<u>000</u>
		19 CONTINGENT LIABILITIES			
AC107(35)/ P35	Guarantees:				
	Guarantees in respect of secured debentures, loans, promissory notes, overdrafts and other banking facilities of certain subsidiaries and associate companies			<u>000</u>	<u>000</u>
	Joint ventures:				
	The company has issued certain indemnities in respect of the portion of the liabilities of the Venture Partnership (refer to note 27) attributable to the joint venture partner. The amount of the indemnities at year end is			<u>000</u>	<u>000</u>
	<i>If the partial basis of providing for deferred taxation is used the following note should be included:</i>				

P40 Approximately 90% of the employees of the group are members of funds which are defined benefit funds and are subject to the Pension Funds Act, 1956, which requires actuarial valuations every three years. At the last actuarial valuation, 30 June 19X0, the funds were found to be financially sound by the independent consulting actuaries.

OR

AC116(53) The pension funds of two subsidiaries were found to have unfunded actuarially projected liabilities totalling R000. These liabilities are being eliminated by increased contributions by group companies as recommended by the actuary.

21 FOREIGN CURRENCY INFORMATION

AC112(73) The group has entered into the following forward exchange contracts to cover foreign commitments in respect of future imports.

	<i>Maturity dates</i>	<i>Foreign currency</i>	<i>Rand equivalent (at forward cover rates)</i>
US Dollars	Sep–Nov 19X1	000	000
Swiss Francs	August 19X1	000	000

AC112(72) The following foreign currency assets and liabilities of the group, recognised in the balance sheet, are not covered by forward exchange contracts.

	<i>Foreign currency</i>	<i>Rand equivalent</i>
Assets	000	000
Deutsche Mark	000	000
Pounds Sterling	000	000
Liabilities		
Japanese Yen	000	000

22 FUNDAMENTAL ERROR

R000

AC103(35) Correction of fundamental error relating to products sold in 19X0 but incorrectly included in inventory at 30 June 19X0. (The 19X0 figures were restated.) (000)

Taxation relief 000

Outside shareholders' interest 000

Net (000)

23 CHANGE IN ACCOUNTING POLICY

AC103(48) During the year, the company changed its accounting policy with respect to the treatment of borrowing costs. In order to conform with the benchmark treatment in the statement of borrowing costs, the company now expenses rather than capitalises such costs. The comparative amounts have been appropriately restated. The effect of this change is as follows:

	19X1 R000	19X0 R000
Reduction in net profit due to increase in interest expense	(000)	(000)
Taxation	000	000
Outside shareholders' interest	<u>000</u>	<u>000</u>
Net	<u>(000)</u>	<u>(000)</u>
Restatement of opening retained earnings in respect of prior year adjustment	(000)	(000)
Taxation	000	000
Outside shareholders' interest	<u>000</u>	<u>000</u>
Net	<u>(000)</u>	<u>(000)</u>

24 DISCONTINUED OPERATIONS

AC103(19)

On 1 July 19X1, a subsidiary of XYZ Holdings Limited sold its truck engine manufacturing operation. The results of this operation had previously been reported in the manufacturing industry segment and the domestic geographical segment. The results relating to this operation are as follows:

	19X1 R000	19X0 R000
Operating profit	000	000
Taxation	(000)	(000)
Outside shareholders' interest	<u>(000)</u>	<u>(000)</u>
Net	<u>000</u>	<u>000</u>
Loss on sale of discontinued operation	000	000
Taxation	(000)	(000)
Outside shareholders' interest	<u>(000)</u>	<u>(000)</u>
Net	<u>000</u>	<u>000</u>

25 DIVIDENDS

Comprising:

Dividends paid and shares issued in lieu thereof	000	000
Dividends provided as payable in cash	000	000
Estimated non-cash element transferred to share election reserve	<u>000</u>	<u>000</u>

26 BORROWING CAPACITY

JSE8.52(b)

Total borrowings at 30 June	<u>000</u>	<u>000</u>
Including off balance sheet borrowings of	<u>000</u>	<u>000</u>
In terms of the most restrictive covenants imposed by significant loan agreements, the group has reserve borrowing capacity amounting to	<u>000</u>	<u>000</u>
The articles of association of the company and its subsidiaries permit a maximum level of borrowings of	<u>000</u>	<u>000</u>

During the year, subsidiary ABC Limited increased its level of borrowings by 52% to finance the acquisition of property, plant and equipment.

AC119(60)	27 INTERESTS IN JOINT VENTURES	Percentage holding	
		19X1	19X0
	Name of entity		
	JV (Proprietary) Limited	33,3%	33,3%
	Venture Partnership	50%	
	Certain of the group's manufacturing activities are pursued through JV (Proprietary) Limited.		

With effect from 1 July 19X0 the group merged its property and land development operations with those of Three (Proprietary) Limited to create the Venture Partnership, an unincorporated jointly controlled entity in which each partner has a 50% interest.

The group's proportionate share of the assets, liabilities, results of operations and cash flows as incorporated in the consolidated annual financial statements are summarised below:

AC119(60)		19X1	19X0
		R000	R000
	Fixed assets	000	000
	Current assets	000	000
	Total assets	<u>000</u>	<u>000</u>
	Deferred taxation	000	000
	Long term liabilities	000	000
	Current liabilities	000	000
	Total liabilities	<u>000</u>	<u>000</u>
	Gross revenue/(Turnover)	000	000
	Operating income	000	000
	Taxation	(000)	(000)
	Net income attributable to ordinary shareholders	000	000
	Extraordinary items	<u>000</u>	<u>000</u>
	Cash generated by operating activities	000	000
	Net cash utilised	<u>000</u>	<u>000</u>

28 RETIREMENT BENEFITS

Pension and provident schemes

AC116(51)	The Group has made provision for pension and provident schemes covering substantially all employees. All eligible employees are members of either defined benefit or defined contribution schemes administered by the Group, or are members of funds within the various industries in which they are employed. There are thirteen defined benefit schemes and eleven defined contribution schemes. The assets of these schemes are held in administered trust funds separated from the Group's assets. Scheme assets primarily consist of listed shares and property trust units, and fixed income securities. South African funds are governed by the Pension Funds Act of 1956 and all
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other funds are governed by the respective legislation of the country concerned.

AC116(53)

Each defined benefit scheme administered by the Group is valued actuarially at an interval of not more than three years using the projected benefit method. The schemes were last actuarially valued during 199X. At that time all were certified by the reporting actuaries as being in a sound financial position, subject to the continuation of their current contribution rates. In arriving at their conclusion, the actuaries took into account reasonable long-term estimates of inflation, increases in wages, salaries and pensions and return on investments. At the last valuation dates the market value of the combined assets of the schemes was R0 000 million and the actuarial value of the assets was more than sufficient to cover the benefits that had accrued to members allowing for expected future increases in earnings. The next actuarial valuations of the schemes will be during 199Z.

Any deficits advised by the actuaries are funded either immediately or through increased contributions to ensure the ongoing soundness of the schemes. Contributions are fully expensed during the year in which they are funded. The Group's pension cost for the year amounted to R00 million (19X0: R00 million).

29 REPORTING FINANCIAL INFORMATION BY SEGMENT**AC115(36–38)
and (32)**

Industry analysis:	<i>Manufacture and distribu- tion of fishing tackle</i>		<i>Motor vehicle rental</i>		<i>Other</i>		<i>Total</i>	
	19X1	19X0	19X1	19X0	19X1	19X0	19X1	19X0
	R000	R000	R000	R000	R000	R000	R000	R000
Sales								
– Inter-segment	000	000	–	–	000	000	000	000
– Outside customers	<u>000</u>	<u>000</u>	<u>000</u>	<u>–</u>	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
Segment results after charging:	000	000	000	–	000	000	000	000
Depreciation	000	000	000	–	000	000	000	000
Research and develop- ment	<u>000</u>	<u>000</u>	<u>000</u>	<u>–</u>	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
Segment assets as a percentage of consoli- dated assets	00%	00%	00%	00%	00%	00%	00%	00%

Geographical analysis:

	South Africa			United Kingdom		Total
	19X1	19x0	19X1	19X0	19X1	19X0
	R000	R000	R000	R000	R000	R000
Sales						
– Inter-segment	000	000	000	000	000	000
– Outside customers	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
Segment results after charging:	000	000	000	000	000	000
Depreciation	000	000	000	000	000	000
Research and development	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
Segment assets as a percentage of consolidated assets	00%	00%	00%	00%	00%	00%

NOTE:

In terms of AC115(2) segmental information is required to be presented by listed companies and other economically significant enterprises whose financial statements are widely available. However, if in the opinion of management the disclosure of such information would be seriously prejudicial to the group, the information need not be disclosed, but this fact together with the reasons for non-disclosure must be stated.

	Group		Company	
	19X1	19X0	19X1	19X0
	R000	R000	R000	R000
30 CASH FLOW INFORMATION				
AC118(42) 30.1 Cash generated by/(utilised in) operations				
Operating income before financing costs	000	000	000	000
Adjustment for:				
Depreciation	000	000	000	000
Net (profit)/loss on disposal of fixed assets	(000)	000	(000)	(000)
Income from investments	(000)	(000)	(000)	(000)
Income from subsidiaries	<u>—</u>	<u>—</u>	<u>(000)</u>	<u>(000)</u>
	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
30.2 (Increase)/decrease in working capital				
Increase in inventory	(000)	(000)	(000)	(000)
Increase in debtors	(000)	(000)	(000)	(000)
Increase in creditors	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
	<u>(000)</u>	<u>(000)</u>	<u>(000)</u>	<u>(000)</u>
30.3 Taxation paid is reconciled to the amounts disclosed in the cash flow as follows:				
Balance at beginning of year	000	000	000	000
Current taxation provided	000	000	000	000
Balance at end of year	<u>(000)</u>	<u>(000)</u>	<u>(000)</u>	<u>(000)</u>
	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>

AC118
appendix

	Group		Company	
	19X1	19X0	19X1	19X0
	R000	R000	R000	R000
30.4 Dividends paid is reconciled to the amounts disclosed in the cash flow as follows:				
Balance at beginning of year	000	000	000	000
Charged to the income statement	000	000	000	000
Balance at end of year	(000)	(000)	(000)	(000)
	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
30.5 Replacement of fixed assets				
Plant and equipment	000	000	000	000
Vehicles	000	000	000	000
	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
30.6 Proceeds on disposal of fixed assets				
Book value of plant and equipment disposed of	000	000	000	000
Profit/(loss) on disposal	000	000	000	000
	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
30.7 Additions to fixed assets				
Plant and equipment	000	000	000	000
Land and buildings	000	000	000	000
	<u>000</u>	<u>000</u>	<u>000</u>	<u>000</u>
30.8 Purchase of subsidiary				
Fair value of assets acquired				
Fixed assets	000	—	000	—
Non-cash portion of working capital	000	—	000	—
Cash	000	—	000	—
	<u>000</u>	<u>—</u>	<u>000</u>	<u>—</u>
30.9 Decrease in long-term liabilities comprises:				
Convertible debentures issued	000	—	000	—
Loans repaid	(000)	(000)	(000)	(000)
	<u>(000)</u>	<u>(000)</u>	<u>(000)</u>	<u>(000)</u>
30.10 Increase/(decrease) in short-term liabilities comprises:				
Net increase in short-term borrowings	000	000	000	000
Decrease in cash on hand	000	(000)	(000)	(000)
	<u>000</u>	<u>(000)</u>	<u>000</u>	<u>(000)</u>
30.11 Proceeds of rights issues				
By the company	000	—	000	—
By subsidiaries to outside shareholders	000	—	000	—
Share issue expenses	(000)	—	(000)	—
	<u>000</u>	<u>—</u>	<u>000</u>	<u>—</u>

XYZ HOLDINGS LIMITED

JSE8.52(e), (f) SHAREHOLDERS' INFORMATION
ORDINARY SHAREHOLDING ANALYSIS

Listed below are analyses of holdings extracted from the register of ordinary shareholders at 30 June 19X1:

	<i>Number of shareholders</i>	<i>Percentage of share capital</i>
Portfolio size:		
1 – 1 000	000	000
1 001 – 5 000	000	000
5 001 – 10 000	000	000
10 001 – 25 000	000	000
25 001 – 50 000	000	000
50 001 – 100 000	000	000
100 001 – and over	000	000
	<u>000</u>	<u>000</u>
Category:		
Individuals	000	000
Companies	000	000
Pension and provident funds	000	000
Banks, nominees and finance companies	000	000
Insurance companies	000	000
Trust funds and investment companies	000	000
	<u>000</u>	<u>000</u>

The following shareholders beneficially hold, directly or indirectly, at 30 June 19X1, in excess of 5% of the share capital having normal voting rights:

	%
LMN Insurance	8
OPQ Life Group	13

OR

There are no shareholders that beneficially hold, directly or indirectly, at 30 June 19X1, in excess of 5% of the share capital having normal voting rights.

SHAREHOLDERS' DIARY

Annual general meeting	23 August 19X1
Reports	Published:
Interim, for half-year to 31 December	17 January 19X1
Preliminary announcement of annual results	22 July 19X1
Annual financial statements	28 August 19X1
Dividends	Declared: Paid/Payable:
Interim – ordinary	9 January 19X1
Final – ordinary and preference	23 August 19X1
Redemptions	29 August 19X1
00 redeemable cumulative preference shares	First redemption: 30 September 19X1

*XYZ (PROPRIETARY) LIMITED
(Registration number: xxxx)
[SPECIMEN] ANNUAL FINANCIAL STATEMENTS
for the year ended 30 June 19X1

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The annual financial statements which appear on pages 4 to 19 have been approved by the board of directors and are signed on its behalf by:

S298	DIRECTOR 2 August 19X1	DIRECTOR
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NOTES

- 1 These annual financial statements are prepared on the basis of the requirements of Schedule 4 of the Companies Act 1973, as amended, and statements of generally accepted accounting practice issued by the Accounting Practices Board up to 30 September 1995.
- The purpose of these financial statements is to highlight disclosure requirements and to serve as a convenient reference to source material. They do not necessarily serve as indicators of best accounting practice or presentation nor should they be considered to be the only acceptable form of presentation. The form and content of a company's financial statements are ultimately the responsibility of the directors.
- These financial statements do not cover all the disclosure requirements applicable to specialised entities such as banks and insurance companies.
- 2 This example of a private company's financial statements are not as complete as the example of the group annual financial statements (p292–332). Refer to the group statements for examples of disclosure that could also be applicable to a private company, for example discontinued operations.
- * Where a company has changed its name during the financial year the previous name should be disclosed i e XYZ (Proprietary) Limited (formerly xxx)

3 Summary of references used in the margin

S – Section of the Companies Act, 1973, as amended

P – Schedule 4 to the Companies Act, 1973, as amended

AC – Statement/Guideline/Opinion of Generally Accepted Accounting Practice

Persons, companies and other entities referred to in these specimen statements are fictitious and any resemblance to any actual persons, companies or other entities is coincidental.

REPORT OF THE INDEPENDENT AUDITORS

To the members of XYZ (Proprietary) Limited

S286/S301

We have audited the annual financial statements set out on pages 4 to 19. These financial statements are the responsibility of the company's directors while our responsibility is to report thereon.

We conducted our audit in accordance with generally accepted auditing standards which require that we plan and carry out the audit to obtain reasonable assurance that fair presentation is achieved in the financial statements in all material respects. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting policies used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We consider that our audit procedures were appropriate in the circumstances to express the opinion presented below.

In our opinion these annual financial statements fairly present the financial position of the company at 30 June 19X1 and the results of its operations and cash flow information for the year then ended in conformity with generally accepted accounting practice and in the manner required by the Companies Act.

ABC and Associates
Chartered Accountants (SA)

2 August 19X1

NOTES

1 Where applicable add the following paragraphs:

“The detailed income statement set out in Annexure I does not form part of the annual financial statements and is presented as additional information. We have not audited this annexure and accordingly we do not express an opinion on it.”

“With the written consent of all members we have performed certain accounting and secretarial duties.”

2 The date of the auditors' report must not precede the date of approval of the financial statements by the directors and is usually the same date.

3 In general, the auditors' report should be produced on letterhead paper.

XYZ (PROPRIETARY) LIMITED

S299

DIRECTORS' REPORT

for the year ended 30 June 19X1

P66

The directors present their annual report which forms part of the audited annual financial statements of the company for the year ended 30 June 19X1.

P68(f)

1 DIRECTORS AND SECRETARY

P W Hughes (Chairman)
R A Ormond (Managing Director)
I T Urwin
C E Smythe

The secretary of the company is E R Earle and his business and postal addresses are as follows:

90 Table Road
Cape Town
8000

PO Box 1234
Cape Town
8000

P68(a)

2 PRINCIPAL ACTIVITIES OF THE COMPANY

The principal activities of the company during the year were the manufacture and distribution of fishing tackle.

P67(1)

3 OPERATING RESULTS

The net profit of the company for the year was Rxxx (19X0: Rxxx), after deducting taxation of Rxxx (19X0: Rxxx).

P68(d)

4 DIVIDENDS

A dividend of xx cents per share on the ordinary shares is proposed in respect of the year ended 30 June 19X1.

P67(1)

5 REVIEW OF OPERATIONS

The Companies Act does not provide guidance as to the extent of comments required in the review of operations. While other comments may equally be applicable, it is submitted that the comments should cover at least the following:

Gross revenue

- The amount of gross revenue for the year, the percentage change from the previous year and the reasons for the change.
- Reasons for the change could include references to significant new activities and significant discontinued activities; effects of sales volumes (including new products or new markets) and prices; impact of new products; competition; etc.

Operating profit

- The amount of operating profit, before extraordinary items and taxation, the percentage change from the previous year and reasons.
- Reasons for the change could include the effects of sales volume variations; margin variations; product rationalisation; impact of significant items; particular operating circumstances (eg factory close downs, etc); inflation; financing costs; technology changes; impact of currency exchange rate movements; etc.

Extraordinary items

- The nature and amounts of individual items.

Taxation

- The impact of any unusual items (eg use of tax loss).

Other major items

- Comments on other significant items for example, details of research and development projects.

P68(b)

6 SHARE CAPITAL

There were no changes to the authorised and issued share capital of the company during the financial year.

AC107/P67(2)

7 EVENTS SUBSEQUENT TO BALANCE DATE

The directors are not aware of any matter or circumstance arising since the end of the financial year, not otherwise dealt with in the annual financial statements, which significantly affect the financial position of the company or the results of its operations.

NOTES RE DIRECTORS' REPORT

S299(1)

1 *Where the company is a wholly-owned subsidiary of a company incorporated in South Africa, a directors' report is not required. The following wording may be inserted preceding the directors' approval paragraph:*

"A directors' report has not been prepared as the company is a wholly-owned subsidiary of XYZ Investment Holdings Ltd, a company incorporated in the Republic of South Africa."

2 *The date of approval must either be the same as or precede the auditors' opinion date.*

XYZ (PROPRIETARY) LIMITED

INCOME STATEMENT

for the year ended 30 June 19X1

		Notes	19X1	19X0
			R000	R000
P43	Gross revenue (turnover)		000	000
AC108(34a)	Cost of sales		000	000
	Gross profit		000	000
	Operating costs		000	000
AC103(9)	Profit on ordinary activities before interest	1	000	000
P42(f)	Financing costs	2	(000)	(000)
	Profit on ordinary activities before taxation		000	000
P42(d)	Taxation	3	000	000
	Profit before extraordinary items		000	000
P46/AC103(9)	Extraordinary items	4	000	000
	Net profit/(loss)		000	000
P42(c)	Dividends paid		000	000
P11(a)	Retained profit for the year		000	000
	Opening retained earnings		000	000
P42(k)	Transfers (to)/from reserves	6	(000)	(000)
	Closing retained earnings		000	000

XYZ (PROPRIETARY) LIMITED

BALANCE SHEET

at 30 June 19X1

		Notes	19X1 R000	19X0 R000
	CAPITAL EMPLOYED			
P8(i)	ORDINARY SHARE CAPITAL	5	000	000
P8(d)	SHARE PREMIUM		000	000
P11	NON-DISTRIBUTABLE RESERVES	6	000	000
P11	DISTRIBUTABLE RESERVES	7	<u>000</u>	<u>000</u>
	ORDINARY SHAREHOLDERS' INTEREST		<u>000</u>	<u>000</u>
P16(c)/ AC102(66)	DEFERRED TAXATION	8	000	000
P15	LONG-TERM LIABILITIES	9	<u>000</u>	<u>000</u>
			<u>000</u>	<u>000</u>
	EMPLOYMENT OF CAPITAL			
P20	FIXED ASSETS	10	000	000
	CURRENT ASSETS			
P29	Inventory	11	000	000
	Debtors		000	000
	Short-term loans		000	000
	Cash resources		<u>000</u>	<u>000</u>
			<u>000</u>	<u>000</u>
	CURRENT LIABILITIES			
P13	Creditors and accruals	12	000	000
P16(b)	Bank overdraft		000	000
P16(a)	Taxation		000	000
P15(a)	Dividend proposed		<u>000</u>	<u>000</u>
			<u>000</u>	<u>000</u>
	NET CURRENT ASSETS/(LIABILITIES)		<u>000</u>	<u>(000)</u>
			<u>000</u>	<u>000</u>

XYZ (PROPRIETARY) LIMITED

CASH FLOW STATEMENT
for the year ended 30 June 19X1

		Notes	19X1 R000	19X0 R000
AC118(41)	CASH RETAINED FROM/(UTILISED IN) OPERATING ACTIVITIES			
AC118(41)*	Cash generated by/(utilised in) operations	14.1	000	(000)
AC118(41)*	(Increase)/decrease in working capital	14.2	<u>(000)</u>	<u>000</u>
AC118	Cash generated by operating activities		000	000
AC118(41)*	Financing costs		(000)	(000)
	Taxation paid	14.3	<u>(000)</u>	<u>(000)</u>
	Cash available from operating activities		000	(000)
AC118(41)*	Dividends paid	14.4	(000)	(000)
	Extraordinary items		<u>000</u>	<u>000</u>
			<u>000</u>	<u>(000)</u>
AC118(22)*	CASH UTILISED IN INVESTMENT ACTIVITIES			
	Replacement of fixed assets	14.5	(000)	(000)
	Proceeds on disposal of fixed assets	14.6	<u>000</u>	<u>000</u>
AC118(27)	Investment to maintain operations		<u>(000)</u>	<u>(000)</u>
	Additions to fixed assets	14.7	<u>(000)</u>	<u>(000)</u>
	Investment to expand operations		<u>(000)</u>	<u>(000)</u>
	Net cash invested		<u>(000)</u>	<u>(000)</u>
	Net cash available/(utilised)		<u>000</u>	<u>(000)</u>
AC118(32)*	CASH EFFECTS OF FINANCING ACTIVITIES			
AC118(43)	Decrease in long-term liabilities	14.8	(000)	(000)
	(Decrease)/increase in short-term liabilities	14.9	<u>(000)</u>	<u>000</u>
	Net finance (repaid)/raised		<u>(000)</u>	<u>000</u>

* Cash flow information is also required in terms of paragraph 50 to Schedule 4.

XYZ (PROPRIETARY) LIMITED

SUMMARY OF ACCOUNTING POLICIES

for the year ended 30 June 19X1

P6/AC101(22) The following are the principal accounting policies of the company which are consistent in all material respects with those applied in the previous year, except as otherwise indicated. The financial statements have been prepared on the historical cost basis, modified by the revaluation of freehold land and buildings.

FIXED ASSETS AND DEPRECIATION**(i) Intangible assets**

No value is attributed to internally developed trademarks, concessions, patents and similar rights and assets, including franchises and management contracts. Costs incurred on trademarks, concessions patents and similar rights, whether purchased or created by the Company, are charged to the profit and loss account in the period in which they are incurred.

AC123(66) **(ii) Property, plant and equipment**

Expenditure on additions and improvements to tangible fixed assets including the cost of related licences is capitalised for major projects on the basis of measured work completed, for other property projects on the basis of orders placed, and for all other projects as the expenditure is incurred.

Surpluses arising from the professional valuations of properties are taken direct to the revaluation reserve. Valuation surpluses realised on sale are transferred from the revaluation reserve to the income statement. Any deficit arising from the professional valuation of properties is taken direct to the revaluation reserve to the extent that such deficit is regarded as temporary. Where a permanent diminution in value of an individual property is identified, the deficit is eliminated against any revaluation reserve in respect of that property with any excess being charged to the income statement.

Freehold land and licences are not depreciated.

Freehold and leasehold properties are written off over 25 years, from the later of the date of acquisition or latest valuation. Leasehold properties are written off over the unexpired term of the lease when less than 25 years.

Cost of plant, machinery, furniture, fittings, tools and equipment (owned or leased) is spread, by equal instalments, over the estimated useful lives of the relevant assets, namely:

XYZ (PROPRIETARY) LIMITED

SUMMARY OF ACCOUNTING POLICIES (continued)
for the year ended 30 June 19X1

AC123(66c)	Plant and machinery	4–20 years
	Information technology equipment	3–5 years
	Equipment in retail outlets	8–10 years
	Vehicles	3–7 years

AC123(67c)	Restoration dismantling and removal costs relating to property, plant and equipment are recognised as an expense over the life of the asset and a liability for the anticipated amount is raised.
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AC114(29a, c) BORROWING COSTS

Interest costs incurred on the financing of major projects are capitalised. Such interest cost related to expenditure incurred prior to the project becoming operational. The capitalisation rate utilised to determine the amount of borrowing costs eligible for capitalisation is X.

LEASED ASSETS

AC105(42)/ (45)/(46)	Assets leased in terms of finance lease agreements are capitalised. Capitalised leased assets are depreciated on the straight line method at rates considered appropriate to reduce book values to estimated residual values over their useful lives. Lease finance charges are amortised over the duration of the finance leases by the effective interest rate method.
---------------------------------	--

All costs relating to operating leases are charged to income as incurred.

INVENTORY

AC108(25)/(40)	Inventory is valued at the lower of cost and estimated net realisable value. Estimated net realisable value is the estimated selling price less any costs of disposal. Cost is determined on the following bases:
-----------------------	---

Raw materials and consumable stores are valued at average cost.

Finished goods and work in progress are valued at raw material cost plus labour cost and a proportion of manufacturing overhead expenses based on normal capacity.

DEFERRED TAXATION

AC102(62)	Deferred taxation is accounted for on the comprehensive basis in respect of all material timing differences which arise from the inclusion of income and expenses or losses in taxable income in periods different from those in which they are included in accounting income. Deferred tax assets are created where their future realisability is assured beyond a reasonable doubt.
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RETIREMENT BENEFIT INFORMATION

AC116(51)/(52)	The company provides for pensions for all employees by payments to independent trust funds and contributions are charged against income when made.
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XYZ (PROPRIETARY) LIMITED

SUMMARY OF ACCOUNTING POLICIES (continued)
for the year ended 30 June 19X1**AC111(39a)/
P43****REVENUE (TURNOVER)**

Revenue comprises the invoiced value of sales in respect of manufacturing and trading operations and excludes investment and other non-operating income and value added taxation.

Revenue from the sale of goods is recognised when significant risks and rewards of ownership of the goods are transferred to the buyer.

Revenue arising from services and royalties is recognised on an accrual basis in accordance with the substance of the relevant agreements.

Dividends are recognised when the right to receive payment is established.

Interest is recognised on a time proportion basis, taking account of the principal outstanding and the effective rate over the period to maturity.

Revenue arising from rendering of services is based on the stage of completion determined by reference to physical amount of work performed in relation to the total project.

NOTES**1 Notes on preparation**

In drafting an accounting policy note the general requirements of AC101 should be borne in mind to ensure fair presentation is achieved in the financial statements.

2 The accounting policies of the company are generally set out as part of the notes to the annual financial statements ('note 1'). Where the accounting policies or notes are numerous, a separate summary of accounting policies may be presented.**3 Accrual and going concern bases**

If the financial statements have been prepared otherwise than in accordance with either of these bases this should be disclosed.

4 Partial method of providing deferred taxation

The following is an appropriate accounting policy:

Deferred taxation

Deferred taxation is accounted for on the partial basis. Accordingly, deferred taxation is provided only where it is probable that taxation will become payable in the foreseeable future as a result of reversing timing differences.

XYZ (PROPRIETARY) LIMITED

NOTES TO THE ANNUAL FINANCIAL STATEMENTS

for the year ended 30 June 19X1

		19X1 R000	19X0 R000
	1 PROFIT ON ORDINARY ACTIVITIES BEFORE INTEREST		
	Profit on ordinary activities before interest is arrived at after taking into account the following items:		
AC111(39b)	Income from:		
	– Sales of goods	000	000
	– Rendering of services	000	000
	– Royalties	000	000
	– Gains on futures contracts	<u>000</u>	<u>000</u>
AC111(39c)	Revenue arising from exchanges was:		
	– Sale of goods	<u>000</u>	<u>000</u>
	– Royalties	<u>000</u>	<u>000</u>
P42(i)/ S283	Auditors' remuneration		
	– Audit fees	000	000
	– Other services	000	000
	– Expenses	<u>000</u>	<u>000</u>
P42(o)/ AC123(66d)	Depreciation		
	– Property	000	000
	– Plant and equipment	000	000
	– Vehicles	<u>000</u>	<u>000</u>
		<u>000</u>	<u>000</u>
P42(h)	Fees for services		
	– Administrative	000	000
	– Managerial	000	000
	– Secretarial	000	000
	– Technical	<u>000</u>	<u>000</u>
		<u>000</u>	<u>000</u>
AC103(15)/ P42(n)	Significant items		
	Profit/(Loss) on disposal of fixed assets	000	000
	(Taxation effect of xxx)		
	Losses on futures contracts	000	000
	(Taxation effect of xxx)	<u>000</u>	<u>000</u>
		<u>000</u>	<u>000</u>
AC108(32d)	Reversal of inventory write-down	<u>000</u>	<u>000</u>
S297/P59	Directors' emoluments		
	For services as directors	000	000
	For managerial services	<u>000</u>	<u>000</u>
		<u>000</u>	<u>000</u>

XYZ (PROPRIETARY) LIMITED

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (cont.)
for the year ended 30 June 19X1

		19X1 R000	19X0 R000
	Pensions:		
	For services as directors	000	000
	For managerial services	<u>000</u>	<u>000</u>
		<u>000</u>	<u>000</u>
	Compensation for loss of office	<u>000</u>	<u>000</u>
P42(f)/ AC114(29b)	2 FINANCING COSTS		
	Interest paid	000	000
	Finance lease cost	<u>000</u>	<u>000</u>
		<u>000</u>	<u>000</u>
	3 TAXATION		
AC102(63)	South African normal taxation	000	000
	Taxation relief/(charge) on extraordinary items (refer note 4)	<u>000</u>	<u>(000)</u>
		<u>000</u>	<u>000</u>
AC102(63)/ P42(e)	Comprising:		
	Current taxation		
	– current year	000	000
	– prior years	(000)	000
AC102(63)	Deferred taxation		
	– current year	000	000
	– prior years	000	(000)
	– change in rate of taxation	(000)	(000)
	Secondary tax on companies	<u>000</u>	<u>000</u>
		<u>000</u>	<u>000</u>
		19X1	19X0
		%	%
AC102(65)	Reconciliation of rate of taxation		
	Standard rate of taxation	35	40
	Adjustment for:		
	Export incentive and other allowances	(00)	(00)
	Utilisation of assessable losses	(00)	(00)
	Deferred taxation rate change	(00)	–
	Non-taxable income	(00)	(00)
AC303(16)	Secondary taxation on companies	00	00
AC304(12)	Transition levy	00	00
	Prior year (over)/under provision	<u>(00)</u>	<u>00</u>
	Effective rate of taxation	<u>00</u>	<u>00</u>
	or		

XYZ (PROPRIETARY) LIMITED

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (cont.)
for the year ended 30 June 19X1

		19X1 R000	19X0 R000
AC102(66)	Estimated assessable losses available for set off against future taxable income are as follows:	R	R
	Total assessable losses	000	000
	Applied to reduce deferred taxation	<u>(000)</u>	<u>(000)</u>
		<u>000</u>	<u>000</u>
	4 EXTRAORDINARY ITEMS		
AC103(14)/P46	Loss on the expropriation of property	(000)	—
	Taxation relief/(charge)	<u>000</u>	<u>(000)</u>
		<u>(000)</u>	<u>000</u>
	5 ORDINARY SHARE CAPITAL		
P8(1)(a)&(b)	Authorised:		
	000 Ordinary shares of Rx each	<u>000</u>	<u>000</u>
	Issued:		
	000 Ordinary shares of Rx each	<u>000</u>	<u>000</u>
P32	The directors are authorised, by resolution of the shareholders and until the forthcoming annual general meeting, to dispose of the unissued shares for any purpose and upon such terms and conditions as they see fit.		
	6 NON-DISTRIBUTABLE RESERVES		
P11(a)	Balance at the beginning of the year	000	000
	Movements (<i>specify</i>)	<u>000</u>	<u>000</u>
P11(a)	Balance at the end of the year	<u>000</u>	<u>000</u>
	Comprising:		
AC123(41)	Revaluation of fixed assets	<u>000</u>	<u>000</u>
P11	7 DISTRIBUTABLE RESERVES		
	General reserve	000	000
	Retained income	<u>000</u>	<u>000</u>
		<u>000</u>	<u>000</u>

Any future dividend declarations out of the distributable reserves of the company will give rise to a liability for secondary tax on companies at a rate of 25% of the dividend declared. Included in distributable reserves are revenue profits of R000 that accrued prior to 30 June 1992 and R000 of capital profits. These reserves would not be subject to secondary tax on companies if distributed as part of a liquidation dividend.

XYZ (PROPRIETARY) LIMITED

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (cont.)
for the year ended 30 June 19X1

		19X1 R000	19X0 R000	
	8 DEFERRED TAXATION			
	Balance at beginning of year	000	000	
	Movements during the year:			
	Timing differences	000	000	
	Change in rate of taxation	(000)	(000)	
	Balance at the end of the year	<u>000</u>	<u>000</u>	
AC102(66)/ P16(c)	The balance comprises:			
	Capital allowances	000	000	
	Provisions	(000)	(000)	
	Assessable losses	<u>(000)</u>	<u>(000)</u>	
		<u>000</u>	<u>000</u>	
	9 LONG-TERM LIABILITIES			
P15(b)	Mortgage loan 1	000	000	
	Mortgage loan 2	000	—	
	Unsecured loan	000	000	
	Liabilities under capitalised finance lease agreements	<u>000</u>	<u>000</u>	
	Total liabilities	000	000	
	Less — payable before 30 June 19X2 included in short term liabilities	<u>(000)</u>	<u>(000)</u>	
	Total long-term liabilities	<u>000</u>	<u>000</u>	
P15(c)	Interest bearing liabilities:			
	Long and medium term	000	000	
	Short-term	<u>000</u>	<u>000</u>	
	Total interest bearing liabilities	<u>000</u>	<u>000</u>	
	The mortgage loans are secured by mortgages over properties (refer to note 10) with a net book value of	<u>000</u>	<u>000</u>	
	Additional information:	Repayment	Repayable instalments	Interest rate
	Mortgage loan 1	19X2–19X5	R000 annually	00%
	Mortgage loan 2	19X5	R000 monthly	00%
	Unsecured loan	19X6	Indefinite	00%
	Liabilities under capitalised finance lease agreements	19X2–19X6	R000 annually	00%

XYZ (PROPRIETARY) LIMITED

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (cont.)
for the year ended 30 June 19X1

10 FIXED ASSETS 19X1

	Property R000	Plant & equip- ment R000	Vehicles R000	Total R000
AC123 (66e), (66f)				
Carrying amount at 30 June 19X0	000	000	000	000
At cost or valuation	000	000	000	000
Accumulated depreciation	(000)	(000)	(000)	(000)
Revaluation adjustments	000	000	000	000
Additions	000	000	000	000
AC114(29b)				
Borrowing costs capitalised	000	000	000	000
Disposals	(000)	(000)	(000)	(000)
Depreciation for the year	(000)	(000)	(000)	(000)
Carrying amount at 30 June 19X1	000	000	000	000
At cost or valuation	000	000	000	000
Accumulated depreciation	(000)	(000)	(000)	(000)

NOTE:

A table for 19X0 should be given on the same basis.

P22(4a) The valuations were performed by AC (Pty) Ltd, qualified valuers, on the basis of open market values, on 30 September 19X0.

Historical cost

The comparable amounts under the historical cost convention for properties which have been revalued would be:

		19X1
AC123(70e)	Cost	000
	Accumulated depreciation	000
	Net carrying amount	000
AC123(67e)	The company has the following commitments for the acquisition of property, plant and equipment:	
	XXXX	R000
AC123(67d)	The cost of expenditure on assets in the course of construction amounted to R000 at 30 June 19X1	
AC123(67b)/ P17	Certain properties are encumbered as security for liabilities of the Group (refer note 11).	

XYZ (PROPRIETARY) LIMITED

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (cont.)
for the year ended 30 June 19X1

		19X1	
		R000	
P22(3)	Details of the freehold land and buildings are recorded in a register which may be inspected by members of their duly authorised agents at the company's registered office.		
P22(4)	OR		
P22(3)	Freehold land and buildings comprise:		
	– Stand A, Randburg, factory buildings and a warehouse under construction, acquired in 19X6		
P22(4)	– At valuation in 19X9	000	
	Subsequent additions at cost – 19X0	000	
	Warehouse under construction – 19X1	000	
		000	
	– Stand B, Sandton, and residential buildings, acquired in 19X8	000	
	– At valuation in 19X3	000	
		000	
		<u>000</u>	
P17	Both properties are encumbered as security for the company's liabilities (refer to note 9).		
	11 INVENTORY	19X1	19X0
		R000	R000
AC108(32b)/	Raw materials	000	000
P29(1)	Finished goods	000	000
	Consumable stores	000	000
		<u>000</u>	<u>000</u>
AC108(32c)	Included in the amounts above are the following inventories carried at net realisable value:		
	Finished goods	000	000
	12 CREDITORS AND ACCRUALS		
	Trade creditors	000	000
P15(a)	Current portion of long-term liabilities:		
	– capitalised finance leases	000	000
	– other liabilities	000	000
P16(d)	Provisions	000	000
		<u>000</u>	<u>000</u>
P17/P34	The following current assets have been pledged as security to trade creditors		
	Raw material stocks	000	000
		<u>000</u>	<u>000</u>

XYZ (PROPRIETARY) LIMITED

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (cont.)
for the year ended 30 June 19X1

		19X1 R000	19X0 R000
	13 COMMITMENTS		
P36	13.1 Capital expenditure		
	Contracted	000	000
	Authorised by the directors, but not yet contracted	<u>000</u>	<u>000</u>
	Total future capital expenditure	<u>000</u>	<u>000</u>
	This capital expenditure is to be financed as follows:		
	– internally generated funds	000	000
	– existing credit facilities	<u>000</u>	<u>000</u>
		<u>000</u>	<u>000</u>
	13.2 Pension funds		
AC116(51)	Unfunded actuarial liabilities, to be paid in annual instalments of R000 over the next ten years	<u>000</u>	<u>000</u>
P39 and P40	Approximately 85% of the company's employees belong to funds which are defined benefit funds and are subject to the Pension Funds Act, 1956, which requires actuarial valuations every three years. At the last actuarial valuation, 30 June 19X0, the funds were found to be financially sound by the independent consulting actuaries.		
	14 CASH FLOW INFORMATION		
AC118(42)	14.1 Cash generated by/(utilised in) operations		
	Operating income before financing costs	000	000
	Adjustment for:		
	Depreciation	000	000
	Net loss/(profit) on disposal of fixed assets	<u>000</u>	<u>(000)</u>
		<u>000</u>	<u>(000)</u>
	14.2 (Increase)/decrease in working capital		
	Increase in inventory	(000)	(000)
	Increase in debtors	(000)	(000)
	Increase in creditors	<u>000</u>	<u>000</u>
		<u>(000)</u>	<u>000</u>
	14.3 Taxation paid is reconciled to the amounts disclosed in the cash flow as follows:		
	Balance at beginning of year	000	000
	Current taxation provided	000	000
	Balance at end of year	<u>(000)</u>	<u>(000)</u>
		<u>000</u>	<u>000</u>

XYZ (PROPRIETARY) LIMITED

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (cont.)
for the year ended 30 June 19X1

	19X1 R000	19X0 R000
14.4 Dividends paid is reconciled to the amounts disclosed in the cash flow as follows:		
Balance at beginning of year	000	000
Charged to the income statement	000	000
Balance at end of year	<u>(000)</u>	<u>(000)</u>
	<u>000</u>	<u>000</u>
14.5 Replacement of fixed assets		
Plant and equipment	000	000
Vehicles	<u>000</u>	<u>000</u>
	<u>000</u>	<u>000</u>
14.6 Proceeds on disposal of fixed assets		
Book value of plant and equipment disposed of	000	000
(Loss)/profit on disposal	<u>(000)</u>	<u>000</u>
	<u>000</u>	<u>000</u>
14.7 Additions to fixed assets		
Plant and equipment	000	000
Land and buildings	<u>000</u>	<u>000</u>
	<u>000</u>	<u>000</u>
14.8 Decrease in long-term liabilities comprises:		
Loans raised	000	000
Loans repaid	<u>(000)</u>	<u>(000)</u>
	<u>(000)</u>	<u>(000)</u>
14.9 (Decrease)/increase in short-term liabilities comprises:		
Net increase in short-term borrowings	000	000
Decrease in cash on hand	<u>(000)</u>	<u>(000)</u>
	<u>(000)</u>	<u>000</u>

AC118
appendix

XYZ CC
(Registration No CK85/00007/23)

ANNUAL FINANCIAL STATEMENTS
for the year ended 30 June 19X1

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The annual financial statements which appear on pages 4 to 8 have been approved by all members and are signed on their behalf by:

.....
(MEMBER)
2 August 19X1

.....
(MEMBER)

(The following report is used if an accounting officer reports on the financial statements)

REPORT OF THE ACCOUNTING OFFICER TO THE MEMBERS OF XYZ CC.

We have performed the duties of accounting officer to XYZ CC for the year ended 30 June 19X1, as required by section 62 of the Close Corporation Act, 1984 ("the Act"). An audit is not required in terms of the Act and we have not audited the annual financial statements.

The annual financial statements set out on pages 4 to 8 are the responsibility of the members. We have determined that the financial statements are in agreement with the accounting records and have done so by adopting such procedures and making such enquiries in relation to the books of account and records as we considered necessary in the circumstances. We have also reviewed the accounting policies which have been represented to us as having been applied in the preparation of the annual financial statements and we consider that they are appropriate to the business.

ABC AND ASSOCIATES
Chartered Accountants (SA)

2 August 19X1

Note: The report date should not precede that of the members' approval of the annual financial statements.

NOTES

- 1 Where an audit has been conducted at the request of members, an appropriate report would be:

REPORT OF THE INDEPENDENT AUDITORS TO THE
MEMBERS OF XYZ CC

We have performed the duties of accounting officer to XYZ CC as required by Section 62 of the Close Corporations Act, 1984. We have also audited the annual financial statements of XYZ CC set out on pages 4 to 8. These financial statements are the responsibility of the members of the Close Corporation while our responsibility is to report thereon.

We conducted our audit in accordance with generally accepted auditing standards which require that we plan and carry out the audit to obtain reasonable assurance that fair presentation is achieved in the financial statements in all material respects. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting policies used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We consider that our audit procedures were appropriate in the circumstances to express the opinion presented below.

In our opinion these annual financial statements fairly present the financial position of XYZ CC at 30 June 19X1 and the results of its operations and cash flow information for the year then ended in conformity with generally accepted accounting practice appropriate to the business.

ABC and Associates
Chartered Accountants (SA)

2 August 19X1

- 2 In appropriate circumstances, either or both of the following paragraphs may be added:

- (a) *"We further report that a partner/employee of our firm is a member of the corporation and all the members have consented in writing to our appointment as accounting officer."*
- (b) *"We have become aware of the following contravention of a provision of the Close Corporations Act ..."*

XYZ CC

INCOME STATEMENT

for the year ended 30 June 19X1

	19X1	19X0
	R	R
Gross revenue (turnover)	<u>000</u>	<u>000</u>
Opening stock	<u>000</u>	<u>000</u>
Purchases, net of discounts	<u>000</u>	<u>000</u>
Closing stock	<u>(000)</u>	<u>(000)</u>
Cost of sales	<u>000</u>	<u>000</u>
Gross profit	<u>000</u>	<u>000</u>
Selling, administrative and general expenses:		
– advertising	000	000
– bad debts	000	000
– commission	000	000
– depreciation	000	000
– discounts allowed	000	000
– insurance	000	000
– lights and water	000	000
– loss on disposal of fixed assets	000	000
– rent and rates	000	000
– repairs and maintenance	000	000
– salaries and wages	000	000
– stationery	<u>000</u>	<u>000</u>
Operating profit	000	000
Other income:		
– dividends received	000	000
– interest	<u>000</u>	<u>000</u>
Interest paid	<u>000</u>	<u>000</u>
Profit on ordinary activities before taxation	<u>000</u>	<u>000</u>
Taxation	<u>000</u>	<u>000</u>
Net profit	<u>000</u>	<u>000</u>
Undrawn earnings at beginning of year	<u>000</u>	<u>000</u>
	<u>000</u>	<u>000</u>
Distributions during the year	<u>000</u>	<u>000</u>
Undrawn earnings at end of the year	<u>000</u>	<u>000</u>

NOTES

1 The income statement should refer to appropriate notes to the financial statements.

XYZ CC

BALANCE SHEET

at 30 June 19X1

	19X1	19X0
	R	R
FUNDS EMPLOYED		
Members' contributions	000	000
Revaluation surplus	000	000
Undrawn earnings	<u>000</u>	<u>000</u>
Members' funds	<u>000</u>	<u>000</u>
Loans from members	000	000
Long-term loans	000	000
Deferred taxation	<u>000</u>	<u>000</u>
	<u>000</u>	<u>000</u>
EMPLOYMENT OF FUNDS		
Fixed assets	000	000
Investments	<u>000</u>	<u>000</u>
	000	000
CURRENT ASSETS		
Inventory	000	000
Loans to members	000	000
Debtors	000	000
Cash resources	<u>000</u>	<u>000</u>
	<u>000</u>	<u>000</u>
CURRENT LIABILITIES		
Creditors	000	000
Short-term loans	000	000
Taxation	000	000
Bank overdraft	<u>000</u>	<u>000</u>
	<u>000</u>	<u>000</u>
NET CURRENT ASSETS	<u>000</u>	<u>000</u>
	<u>000</u>	<u>000</u>

NOTE

The balance sheet should refer to appropriate notes to the financial statements.

XYZ CC

CASH FLOW STATEMENT

for the year ended 30 June 19X1

	19X1 R	19X0 R
CASH (UTILISED IN)/RETAINED FROM OPERATING ACTIVITIES		
Cash generated by operations	000	000
Investment income	000	000
(Increase)/decrease in working capital	(000)	000
Cash generated by operating activities	000	000
Financing costs	(000)	(000)
Taxation paid	(000)	(000)
Cash available from operating activities	000	000
Distributions to members	(000)	(000)
	<u>(000)</u>	<u>000</u>
CASH UTILISED IN INVESTING ACTIVITIES		
Investment to maintain operations:		
– Replacement of fixed assets	(000)	(000)
– Proceeds on disposal of fixed assets	000	000
	<u>(000)</u>	<u>(000)</u>
Investment to expand operations:		
– Additions to fixed assets	(000)	(000)
Net cash invested	<u>(000)</u>	<u>(000)</u>
Net cash (utilised)/available	<u>(000)</u>	<u>000</u>
CASH EFFECTS OF FINANCING ACTIVITIES		
Decrease in long-term liabilities	(000)	(000)
Increase in loans from members	000	000
Increase/(decrease in bank overdraft)	000	(000)
Net finance raised/(repaid)	<u>000</u>	<u>(000)</u>

NOTE

The cash flow statement should refer to appropriate notes to the financial statements

XYZ CC

NOTES TO THE ANNUAL FINANCIAL STATEMENTS

for the year ended 30 June 19X1

1 *Notes to the annual financial statements, including notes on accounting policies, should be prepared. The form and presentation of information in the notes should generally be similar to that required in presenting company financial statements (see pages 333–351), with the accounting policies being dealt with in note 1.*

On the basis that the primary purpose of the financial statements is to report to members, it is also recommended that a note to the income statement should summarise any transactions with members which have been included in the determination of net income. An example of such a note is:

Transactions with members

Net profit is arrived at after the following transactions with members:

	<i>Member</i>		<i>Member</i>
	A	B	Total
	R	R	R
Interest paid	000	000	000
Rent	000	000	000
Salaries and wages	<u>000</u>	<u>000</u>	<u>000</u>
	000	000	000
Interest received	<u>(000)</u>	<u>(000)</u>	<u>(000)</u>
	<u>000</u>	<u>000</u>	<u>000</u>

The notes to the annual financial statements should be expanded to include all disclosures required in terms of generally accepted accounting practice. Your attention is drawn to the disclosure in XYZ (Proprietary) Limited specimen annual financial statements (pages 333–351) for further guidance in this regard.

XYZ CC

NOTES TO THE ANNUAL FINANCIAL STATEMENTS *(continued)*
for the year ended 30 June 19X1

2 *Where the information is not available on the face of the balance sheet the following statement will be necessary:*

MEMBERS' NET INVESTMENT STATEMENT
for the year ended 30 June 19X1

	R
MEMBERS' INTEREST	
Balance at beginning of the year	000
Movements during the year:	
– contributions introduced	000
– contributions repaid	(000)
– revaluations	000
– net profit	000
– distributions	(000)
– loans from members	000
– loans to members	(000)
Balance at end of year	<u>000</u>
REPRESENTED BY:	
– members' contributions	000
– revaluations	000
– undrawn earnings	000
– loans from members	000
– loans to members	(000)
Balance at end of the year	<u>000</u>