Tutorial Material for Personal Study

Prepared by
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THE RAPID RESULTS COLLEGE

FINANCIAL ACCOUNTING

STATEMENTS OF GENERALLY ACCEPTED ACCOUNTING PRACTICE

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REPORTING FINANCIAL INFORMATION
BY SEGMENT
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REPORTING FINANCIAL INFORMATION BY SEGMENT

Contents

The South African Institute of
Chartered Accountants

Introduction

.01 This statement deals with reporting financial information by segments of an enterprise, specifically by different industries and by different geographical areas in which the enterprise operates.

.02 The requirements of this statement apply to listed companies and to other economically significant enterprises whose financial statements are widely available. Where, in the opinion of management, the disclosure of any information required by this 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.

.03 When both parent company and consolidated financial statements are presented, segment information need be presented only in respect of the consolidated financial statements.

Objective

.04 The objective of reporting financial information by segment is to provide users of financial statements with information to assist them in assessing the relative size, contribution, and growth trend of the different industries and geographical areas in which an enterprise operates.

Definitions

.05 **Segments of an enterprise** are industry and geographical components whose activities, assets and results of operations are clearly distinguishable physically, operationally and for financial reporting purposes, from the other activities, assets and results of operations of the enterprise.

.06 **Industry segments** are the distinguishable components of an enterprise each engaged in providing a different product or service, or a different group of related products or services, primarily to parties outside the enterprise.

.07 **Geographical segments** are the distinguishable components of an enterprise each engaged in operations in individual countries or groups of countries within particular geographical areas as may be determined to be appropriate to the particular circumstances of an enterprise.

.08 **Segment revenues** are revenues that are directly attributable to a segment, or the relevant portion of revenues that can be allocated on a reasonable basis to a segment, and that are derived from transactions with parties outside the enterprise and from other segments of the same enterprise.

Segment expenses are expenses that are directly attributable to a segment or the relevant portion of expenses that can be allocated on a reasonable basis to a segment, and that are derived from transactions with parties outside the enterprise and from other segments of the same enterprise. .09

Segment result is the difference between segment revenues and segment expenses. .10

Segment assets, for the purpose of this statement, are the assets net of non interest bearing liabilities that are directly attributable to a segment or the relevant portion of assets and non interest bearing liabilities that can be allocated on a reasonable basis to a segment. .11

Explanatory notes

Background

Users of financial statements need segment information to assist in assessing the prospects and risks of a diversified enterprise which may not be determinable from the aggregated data. .12

Segment information is not intended to convey the impression that such segments may be considered as independent businesses or that comparisons between similarly labelled segments of different enterprises would necessarily be valid. .13

Reporting segment information involves decisions that are based in part on judgement. Such decisions include the identification of segments and the allocation of revenues, expenses and assets to those segments. Disclosure of information about the bases used in the preparation of financial information by segment may enhance the user's understanding of the resulting data. .14

Concern is sometimes expressed that disclosing financial information by segment may weaken an enterprise's competitive position because more detailed information is made available to competitors, customers, suppliers and others. For this reason, some consider it appropriate to allow the withholding of certain segment information where disclosure is deemed to be seriously prejudicial to the enterprise. Others believe that this difficulty is overstated and that the type of information that might be disclosed is not likely, in most cases, to be sufficiently detailed to cause commercial problems. They believe that this disclosure is no more .15

prejudicial to the diversified enterprise than is the disclosure of the information required of an enterprise operating in only one industry or geographical area. Also, analysis by segment of the aggregated financial information of a diversified enterprise is generally deemed to provide useful data that assists users in making a better assessment of the past performance and future prospects of the enterprise.

.16 The information reported is a disaggregation of financial information included in the financial statements of the enterprise. Accordingly, the segment information reported with respect to the consolidated financial statements is based on information included in the consolidated financial statements, not information reported in the individual financial statements of each subsidiary.

.17 Enterprises do not usually report by segment financial information pertaining to associated companies and nonconsolidated subsidiaries.

Identification of reporting segments

.18 Industry and geographical segments are the usual bases for presenting information on operations by segment. An enterprise would provide information on both bases if both were relevant to its operations.

.19 Industry segment information is usually presented on the basis of general groupings of related products and services, or by types of customers.

.20 Geographical segment information is presented sometimes on the basis of the location of operations of the enterprise, sometimes on the basis of markets and sometimes on both. The domestic operations of an enterprise are generally considered to be a separate geographical segment. Where sales of products and services by domestic operations of an enterprise to foreign customers outside the enterprise are significant, the amount of such export sales is usually disclosed.

.21 Where an enterprise trades with a single or relatively small number of customers, one industry or a government body, such information is usually disclosed. Specific information about the identity of individual customers or the importance of individual customers in each of the markets concerned is not usually given.

.22 No single set of characteristics is universally applicable in determining industry and geographical segments of all enterprises, nor is any single characteristic determinable in all cases. Consequently determination of industry and geographical segments of an enterprise must depend to a considerable extent on the judgement of the management of an enterprise. Broad categories such as manufacturing, wholesaling, retailing and consumer products are not in themselves indicative of the industries in which an enterprise operates.

Organisational groupings, such as divisions or subsidiaries, are usually .23
created according to management requirements. Such groupings often correspond with the determinable segments of the enterprise, thus facilitating the reporting of financial information by segment. Where this is not so, the reporting of financial information by segment may require reclassification of financial information.

It is appropriate to establish guidelines in terms of which a segment is .24
considered material before it is reported separately and to limit the segments to a reasonable number so as to avoid unnecessary complexity. Such guidelines may be 10 per cent of turnover, operating profit or total assets, although such quantitative guidelines are not the sole factors in identifying segments for reporting.

Intersegment revenues and expenses

Intersegment sales and other intersegment operating revenues and in- .25
tersegment expenses are reported on the basis on which the enterprise accounts for them internally. Disclosure of the amount of such revenues and expenses is useful and an explanation of the intersegment pricing basis (such as fair market value, cost or market price less a discount) is made when it is significant to a proper appreciation of the segment information.

Segment result

The measure of the profitability of a segment is disclosed as the segment .26
result and generally reflects net operating income or loss, although other bases are sometimes more appropriate. Interest earned and interest expense are not normally included in the segment result unless operations of the segment are primarily of a financial nature. For this reason it is not appropriate to draw comparisons between the various segments, particularly where the value of assets employed in each of the segments varies significantly. Taxes on income, outside owners' interests, extraordinary items and financial information relating to associates and nonconsolidated subsidiaries are also not usually included in the segment result.

Where revenues and expenses are not directly attributable to a segment .27
but a reasonable basis for allocation exists, they may be allocated

thereto on that basis. In many enterprises, however, 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.

Segment assets

.28 The disclosure of segment assets indicates the resources employed in generating segment operating results. Such assets include all tangible and intangible assets and all non interest bearing liabilities that can be identified with a particular segment. Assets shared by two or more segments may be allocated between or among those segments if a reasonable basis exists for such allocation. Interest bearing liabilities are generally not allocated either because they are considered to relate to the enterprise as a whole or because they are viewed as having a financing rather than an operating result. Where a segment result is arrived at after interest and finance charges, it may be appropriate to allocate interest bearing liabilities on the same basis.

Information Reported

.29 The financial statements of an enterprise normally disclose a description of the activities of each reported industry segment and an indication of the composition of each reported geographical segment.

.30 The disclosure of the following information, expressed either in monetary terms or as percentages of the consolidated totals, for each reported segment in the annual financial statements of an enterprise, is generally considered appropriate:

- sales or other operating revenues
- segment result
- segment assets employed.

.31 The relationship between the sum of the information on individual segments and the aggregated information in the financial statements is clarified by providing reconciliations where necessary.

.32 Other information such as depreciation, depletion, amortisation, research and development and capital expenditures for the period is sometimes disclosed for each segment. Disclosure of non-financial information, such as the number of employees for each reported segment, is also useful.

Consistency of analysed information is important. Accordingly comparative amounts are restated, unless this is not practical, following a change which has a material impact on the segment information in either: .33

- identification of segments
- the accounting practices used in reporting segment information
- the accounting policies of segments.

In such circumstances, a description of the nature of the change and an explanation of the reasons for the change are also disclosed.

Interim reports
It is desirable for enterprises to include in their interim reports financial information for the industry and geographical segments which are significant to the enterprise. .34

Statement of accounting practice

Reporting financial information by segment
Enterprises to which this statement applies should report in the financial statements the segment information described in paragraphs .36 — .40 for both industry and geographical segments. When both parent company and consolidated financial statements are presented, segment information need be presented only in respect of the consolidated financial statements. .35

Disclosure
The enterprise should describe the activities of each reported industry segment and indicate the composition of each reported geographical area. .36

For each reported industry and geographical segment, the following financial information, expressed either in monetary terms or as percentages of the consolidated totals, should be disclosed: .37

- sales or other operating revenues
- segment result
- segment assets employed.

When it is necessary for a proper appreciation of the segment information the extent to which revenue and expenses are derived from in- .38

tersegment transactions and the basis of intersegment pricing should also be disclosed.

.39 Where necessary the enterprise should disclose reconciliations between the sum of the information on individual segments and the aggregated information in the financial statements.

.40 Changes in:

- identification of segments
- the accounting practices used in reporting segment information
- the accounting policies of segments

which have a material effect on segment information should be disclosed. Such disclosure should comprise a description of the nature of the change, an explanation of the reasons for the change and, unless this is not practical, a restatement of comparative amounts.

Transitional provisions

.41 No comparative figures need be presented in the first period in respect of which this statement is introduced if such information is not readily available.

Effective date

.42 The requirements set out in this statement should be applied as soon as possible and regarded as standard for financial statements covering all periods commencing on or after 1 July, 1986.

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DISCLOSURE OF RETIREMENT BENEFIT
INFORMATION IN FINANCIAL STATEMENTS
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AC 116

STATEMENT OF GENERALLY ACCEPTED ACCOUNTING PRACTICE

DISCLOSURE OF RETIREMENT BENEFIT INFORMATION IN FINANCIAL STATEMENTS

This Statement of Generally Accepted Accounting Practice has been approved for issue by the Accounting Practices Board, which body has as its principal object:

> "To establish and to procure the negotiation and acceptance of what the Board considers is or should be generally accepted accounting practice."

The provisions of this statement should be read in conjunction with AC 100—PREFACE TO STATEMENTS OF GENERALLY ACCEPTED ACCOUNTING PRACTICE and should be applied to all items in financial statements. Disclosure requirements need not be applied to immaterial items.

The South African Institute of
Chartered Accountants

DISCLOSURE OF RETIREMENT BENEFIT INFORMATION IN FINANCIAL STATEMENTS

Contents

Introduction

.01 The provision of retirement benefits is becoming increasingly significant to employers. Accounting for retirement benefit costs involves particular problems of estimation and allocation. It is therefore important that users of financial statements should be given sufficient information to enable them to understand the basis of the charge for retirement benefit costs, and to appreciate its importance in relation to the current and future financial position of the enterprise.

.02 This statement deals with the extent of disclosure of retirement benefit information in the financial statements of employers, which should be made in order to meet users' needs. It does not establish a standard practice for calculating the charge in the income statement. There is an element of uncertainty with regard to accounting for retirement benefit costs. For example, it is uncertain whether past service costs relate to present or future periods, or whether or not an actuarial shortfall is a liability of the enterprise. This statement does not seek to resolve these uncertainties. The accounting alternatives are, however, discussed in order to provide a background to the required disclosure.

.03 Retirement benefit plans, by virtue of the Pension Funds Act, No 24 of 1956, normally involve separate funds to which contributions are made and from which retirement benefits are paid; this statement applies whether or not such a fund is created. Employment termination indemnities, deferred compensation arrangements, long service leave benefits, health and welfare plans, and bonus plans are not dealt with in this statement. If their predominant characteristics, however, are the same as those of retirement benefits it would normally be appropriate to disclose similar information to retirement benefit plans.

.04 A common investment vehicle for such separate funds is an insurance policy. The benefits insured by such a policy need have no direct or automatic relationship with the obligations undertaken by the employer. Retirement benefit plans involving insurance policies are subject to the same relationships of accounting and funding as privately invested arrangements and are, accordingly, within the scope of this statement. These insured funds may not be actuarially valued on an individual basis.

.05 Although in some circumstances and under some actuarial valuation methods, actuarial calculations are made for each participating employee, the discussion in this statement, for simplicity, is written in terms of groups of employees rather than in terms of individuals.

Definitions

Retirement benefit plans are arrangements, formal or informal, whereby an employer provides benefits for employees on or after termination of service, in the form of an annual income or a lump sum or both, when such benefits can be determined or estimated in advance of retirement from the provisions of a written undertaking or from the employer's practices. .06

Defined contribution plans are retirement benefit plans under which amounts to be paid as retirement benefits are determined by contributions to a fund together with investment earnings thereon. .07

Defined benefit plans are 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. .08

Funding is the irrevocable transfer of assets to a fund separate from the employer's enterprise to meet future obligations for the payment of retirement benefits. .09

Actuarial valuation is the process used by an actuary to estimate the present value of benefits to be paid under a retirement benefit plan and the present value of plan assets and sometimes of future contributions. .10

Current service cost is the cost to an employer under a retirement benefit plan for the services of participating employees exclusive of those elements of cost identified as past service cost, experience adjustments and the effects of a change in an actuarial assumption. .11

Past service cost is the actuarially determined cost arising on the introduction of a retirement benefit plan, on the making of improvements to such a plan, or on the completion of minimum service requirements for eligibility in such a plan, all of which give employees credit for benefits for service prior to the occurrence of one or more of those events. .12

Experience adjustments are adjustments to retirement benefit costs arising from the differences between the previous actuarial assumptions as to future events and what actually occurred. .13

Explanatory notes

Background

There are many different forms of retirement benefit plans. The type of retirement benefit plan which the enterprise has undertaken can have a significant impact on the cost of the plan and the degree of uncertainty .14

associated with this cost. The cost of a defined contribution plan, e.g. a provident fund, is more predictable than that of a defined benefit plan. Furthermore the employer's commitment under a defined benefit plan which is based on pensionable remuneration at or near retirement (a final pay plan) is likely to be more difficult to determine and consequently more variable than one based on an employee's average pensionable remuneration during his term of employment (a career average plan).

.15 There are many variations within these broad categories and while users of financial statements do not necessarily need specific details, it is important that they understand the general nature of the retirement benefit plan. For example, in South Africa most defined benefit plans are final pay plans and where this is not the situation, it may be appropriate to draw attention to this fact.

.16 The Pension Funds Act, No 24 of 1956, governs most contractual retirement benefit plans and sets down rules regarding the funding, and the frequency and methods of valuation of the plans. For this reason it is important to disclose whether or not the retirement benefit plan is governed by the Pension Funds Act and the extent of any exemptions to which it is entitled.

.17 An assessment of the likely future trend of the cost of retirement benefits requires information not only about the employer's obligations, but also about commitments which the employer, as opposed to the plan, may have undertaken, for example, supplemental benefits to retired employees to offset the effects of increases in the cost of living. Disclosure of information about any such commitments is therefore necessary.

Accounting and funding objectives distinguished

.18 When there is a separate retirement benefit fund, the position is sometimes taken that the amount paid by an employer to the fund during an accounting period provides an appropriate charge to income. While, in many cases, the amount funded may provide a reasonable approximation of the amount to be charged against income, there is a vital distinction between the periodic funding of retirement benefits and the accounting allocation of the cost of providing those benefits.

.19 The objective of funding is to make available amounts to meet future obligations for the payment of retirement benefits. Funding is a financing procedure and normally having estimated the cost of the promised retirement benefits a decision will be taken as to what funds need to be paid to the plan on some periodic basis.

Actuaries have a range of systematic approaches to this task which may be termed "valuation methods". These differ essentially as to the proportion of the ultimate benefit being taken into account at the time of valuation and the manner in which, and the period over which, its estimated cost will be met. For example, the more usual valuation method values the promised retirement benefits based on current service and projected pensionable remuneration; another values the promised retirement benefits based on current service and current pensionable remuneration; and yet another values the promised retirement benefits payable if the plan were to be discontinued at the valuation date. The contribution rate recommended by the actuary will normally be influenced by such other factors as the availability of funds and tax considerations. .20

On the other hand, the objective of accounting for the cost of a retirement benefit plan is to ensure that the cost of benefits is allocated to accounting periods on a systematic basis related to the receipt of the employee's services. The cost of retirement benefits to an employer results from receiving services from the employees who are entitled to receive such benefits. Consequently, the cost of retirement benefits is normally accounted for in the period during which these services are rendered. Accounting for retirement benefit costs only when employees retire or receive benefit payments does not allocate those costs to the periods in which the service was rendered. .21

An indication of the pace of funding of a plan is given by the difference between the amounts funded since the inception of the plan and the amounts charged to income over the same period. Where there is a difference between the amounts funded since the inception of the plan and the amounts charged to income over the same period, such difference gives rise to either a provision or a prepayment in the balance sheet. For this reason, the disclosure of this provision or prepayment is useful information. .22

Current service costs

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. .23

Under a defined benefit plan, the employer's cost can only be estimated since there are many variables that influence the amount of the ultimate benefits and, hence, the cost of those benefits. For example, the amount .24

of future retirement benefits will be determined by employees' earnings or by their years of service or both. The cost to an employer will also be affected by factors such as the investment earnings on retirement fund assets and employee turnover.

.25 As stated, a number of actuarial valuation methods have been developed by the actuarial profession to estimate employer obligations under defined benefit plans. While primarily designed to calculate funding requirements, these methods are frequently used to determine retirement benefit costs for accounting purposes.

.26 The actuarial method selected and the assumptions made can have a significant effect on the charge to be recorded in each accounting period. Therefore, in carrying out a periodic valuation, an actuary chooses an appropriate valuation method and, in consultation with the employer, makes appropriate assumptions about the variable elements affecting the computations.

.27 The assumptions are applied to the expected inflow from future contributions and from investments as well as to the expected outflow for benefits. The uncertainty inherent in projecting future trends in rates of inflation, pensionable remuneration and earnings on investments are taken into consideration by the actuary in the actuarial valuations by using a set of compatible assumptions. For example, the basis of valuing fund assets should be compatible with the interest assumption used for determining the actuarial obligation. Usually these projections will be extended until the expected date of death of the last pensioner and are, accordingly, long term.

.28 The remuneration paid to employees normally provides the best available accounting estimate of the benefit received by an enterprise over the working lives of the participating employees. Accordingly, in allocating the cost of retirement benefits over the period in which employees' services are rendered, it is usually appropriate to use an actuarial method that, on the assumptions adopted, will result in annual current service costs that bear a reasonably stable relationship to remuneration. Valuation methods which take account of projected pensionable remuneration to date of retirement will normally meet this criterion.

.29 Valuation methods which do not take account of projected pensionable remuneration usually produce an annual contribution rate that increases significantly in proportion to related current remuneration if the average age of existing employees rises. This effect may be compounded if retirement benefits are based on final pensionable remuneration and may be further compounded by the impact of inflation on pensionable remuneration.

In valuing retirement benefit plans governed by the Pension Funds Act, actuaries are limited in their choice of valuation method. They are required to use a valuation method based on projected pensionable remuneration to retirement. As noted above, this will normally provide an acceptable annual accounting cost for retirement benefits. For the same reason, the method used to determine the cost of retirement benefit plans not governed by the Pension Funds Act, should also incorporate assumptions regarding estimated pensionable remuneration to the date of retirement of the employees. .30

For accounting purposes, current service costs are normally allocated to income systematically over the expected remaining working lives of the employees covered by the retirement benefit plan. In order to permit a proper understanding of the likely future financial effects, the financial statements normally disclose the basis of allocation of current service costs to the income statement, and the funding policy if different. .31

Past Service Costs

Special problems arise where: .32

- a new retirement benefit plan is established and past service is recognised for the purpose of determining retirement benefits
- retirement or other benefits payable to present employees are increased.

In these situations 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. This past service deficit may be funded by an immediate lump sum payment, the utilisation of surplus funds in the plan or by an increase in the contribution rate for some specified future time periods. .33

Views differ as to how to account for past service costs. One view is that the entitlements giving rise to past service costs have been earned by employees through their service in prior periods and, therefore, this cost should be recognised as an expense as soon as it has been determined. .34

Others believe that the entitlements giving rise to past service cost are in return for services to be rendered by employees in the future and that, .35

therefore, the cost ought to be allocated over the periods during which the services are to be rendered. Those who support this view maintain that, regardless of whether these costs are computed by reference to employee service in previous periods, the cost relates to current and future periods.

.36 Information as to the accounting and funding policy of the enterprise for past service costs may be required for fair presentation. Where the incidence of past service costs gives rise to an abnormal item, it is disclosed.

Experience adjustments

.37 The assumptions on which an actuarial valuation is made, such as projected pensionable remuneration and turnover of employees, are based on long term considerations. It may be necessary to modify these assumptions from time to time. For example, pensionable remuneration increases may have exceeded the assumed rate of increase and this trend may be expected to continue. On the other hand, the higher pensionable remuneration may have been due to special circumstances not expected to recur so that the initial assumption about pensionable remuneration increases is expected to be valid in the future.

.38 If the estimated future cost to the employer is altered as the result of a change in an actuarial assumption, the usual accounting treatment is to spread the new cost over future periods, perhaps the expected remaining working lives of the participating employees or, alternatively, it can be charged immediately to income.

.39 Actuarial valuations may lead to the identification of experience adjustments because the events covered by the assumptions used to make previous valuations did not coincide with what actually occurred. For example, rates of employee turnover since the prior valuation may have differed from those assumed.

.40 Since experience adjustments are necessary to correct past estimates, one view is that they are similar to changes in accounting estimates, such as provisions for doubtful accounts receivable, and are therefore to be accounted for by a charge or credit to income as they arise. A different view is that experience adjustments are merely normal fluctuations in the long term cost of the plan to be allocated over future periods. Whichever basis of recognition is normally used, if the experience adjustment is the result of an isolated event, such as the closing of a plant, it may be appropriate to charge the adjustment to income in the period in which the event took place.

Because of the potentially significant effect of differences between assumptions and experience, it is necessary to obtain actuarial valuations at least every three years, as is required by the Pension Funds Act. Additional valuations may be necessary in intervening years when important changes in the circumstances of the plan are known to have taken place or when events indicate that one or more of the assumptions may have to be modified. .41

In order to obtain a proper appreciation of the likely effects on future financial statements, it may be necessary to disclose information about the accounting policy, and funding policy if different, being applied to experience adjustments. Where experience adjustments give rise to abnormal item, it is disclosed. .42

Retired employees

Sometimes there are changes in a retirement benefit plan that increase benefits paid to retired employees or gratuitous payments are made to retired employees. Some consider that, since retired employees provide no ongoing services, the resulting cost should be charged to income in the period of change. Others consider that such action is taken to maintain the image of the enterprise among current employees and, therefore, the resulting cost should be allocated over future periods which will benefit from the improved image. It may be necessary to disclose the accounting policy, and funding policy if different, applied by the enterprise to cater for these situations. .43

When benefits supplemental to the plan, which constitute a continuing commitment, are promised to retired employees, the present value of the cost of the supplemental benefits is recognised in income in the period the commitment is made, or the cost of the supplemental benefits is recognised in the future periods expected to benefit from the improved image. .44

Valuations of retirement benefit plans

Normally the financial soundness of a retirement benefit plan and the amount of contributions required to sustain it are assessed every three years by an actuary, who has been approved by the Registrar of Financial Institutions. A statement to that effect should be made, or, if this is not the case, the fact should be disclosed. .45

The outcome of an actuarial valuation depends on the method used and can be significantly affected by the actuarial assumptions. There is, .46

therefore, a case for the disclosure of both the actuarial valuation method and the major assumptions. However, this statement does not require the disclosure of actuarial assumptions for the following reasons:

- assumptions may validly vary from one plan to another since they depend on the circumstances of the individual plan
- since the assumptions and the actuarial valuation method are interdependent, disclosure of particular assumptions without disclosure of the sensitivity of the valuation to variations in them may not be helpful
- any meaningful disclosure could be disproportionately long.

.47 Where a retirement benefit plan is valued by an actuary, the valuation method will be based on current service and projected pensionable remuneration, and the disclosures set out in paragraphs .53, .54 and .55 should be given.

.48 Where, in the opinion of the actuary, a retirement benefit plan is financially unsound, disclosure of this fact is important. The extent of the deficiency will, however, depend on the actuarial assumptions used in the valuation. Because of the significant variations which can arise depending on the particular assumptions used, the actual amount of the deficiency is not considered meaningful disclosure. It is, however, important to disclose the action being taken in future periods to correct this deficiency.

Statement of accounting practice

General disclosures

.49 Disclosure should be made in financial statements of sufficient information concerning retirement benefit plans to enable users of the financial statements to gain a broad understanding of the significance of retirement benefit costs in the accounting period and of actual and contingent liabilities and commitments at the balance sheet date. Towards this general objective of fair presentation, the financial statements should disclose the information outlined in the following paragraphs. The financial statements should also disclose any further information which has had a material impact on the enterprise's undertaking to pay retirement benefits.

.50 In the case of group financial statements or of individual enterprises which have a number of different retirement benefit plans, the information required should be provided in a summarised form which is appropriate and reasonable in the circumstances. Where applicable, the impact on minority interests should also be disclosed.

Nature of retirement benefit plans

The financial statements should disclose, in relation to retirement benefit plans undertaken by an enterprise, the following: .51

- whether or not the retirement benefit plan is governed by the Pension Funds Act
- the nature of the retirement benefit plan; whether it is a defined contribution plan or a defined benefit plan
- any commitment of the enterprise, formal or otherwise, to meet unfunded benefits
- an indication of the proportion of the enterprise's employees covered by retirement benefit plans.

Accounting policy

The financial statements should 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. It may be appropriate to differentiate between: .52

- current service costs
- experience adjustments
- past service costs
- cost of supplemental benefits to retired employees.

Retirement benefit plans which are actuarially valued

Where retirement benefit plans are actuarially valued, the following information should be disclosed: .53

- the effective date of the most recent actuarial valuation
- the opinion of the actuary as to whether or not the plan was in a sound financial position
- 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, unless the plan is governed by the Pension Funds Act and is valued on the normal three yearly basis.

.54 If, in the opinion of the management of the enterprise, any unusual events have occurred since the date of the last actuarial valuation which could have materially affected the financial position of the plan, appropriate disclosure should be made in the financial statements.

.55 Where the actuary is of the opinion that the retirement benefit plan is not in a sound financial position, the financial statements should disclose the action being taken to deal with it in future financial statements.

Retirement Benefit plans which are not actuarially valued

.56 Where the retirement benefit plan is not actuarially valued the financial statements should disclose:

- the fact that it is not actuarially valued
- any decisions to change the rate of contributions or to make special contributions
- the expected effects on future financial statements of any significant changes in the terms of the retirement benefit plan.

Other disclosures

.57 Where the amount charged to income in any one period is materially affected, for example, by additional charges to cover the cost of post retirement awards, special lump sum contributions, contribution holidays or temporary reductions due to experience gains, the effect should be disclosed as an abnormal item.

.58 Where there is a difference between the accounting policy and the funding policy, any provisions or prepayments in the balance sheet which result from this should be disclosed.

Effective date

.59 The requirements set out in this statement should be applied as soon as possible and regarded as standard for financial statements covering all periods commencing on or after 1 January, 1987.

ACCOUNTING FOR DISCONTINUED OPERATIONS

AC 117

STATEMENT OF GENERALLY ACCEPTED
ACCOUNTING PRACTICE

ACCOUNTING FOR DISCONTINUED OPERATIONS

This Statement of Generally Accepted Accounting Practice has been approved for issue by the Accounting Practices Board, which body has as its principal object:

> "To establish and to procure the negotiation and acceptance of what the Board considers is or should be generally accepted accounting practice."

The provisions of this statement should be read in conjunction with AC 100 PREFACE TO STATEMENTS OF GENERALLY ACCEPTED ACCOUNTING PRACTICE and should be applied to all items in financial statements. Disclosure requirements need not be applied to immaterial items.

The South African Institute of
Chartered Accountants

ACCOUNTING FOR DISCONTINUED OPERATIONS

Contents

Introduction

.01 This statement is concerned with the discontinuance by an enterprise of a distinct sector of activity. In particular, it deals with the identification and accounting treatment of the resultant profit or loss on discontinuance. It also deals with the recommended accounting treatment of results up to the discontinuance date. It does not deal with the normal run down period associated with the erosion of wasting assets in the extractive industries.

Objectives

.02 The objectives of this statement are to clarify the determination and accounting treatment of the profit or loss on discontinuance and to encourage, where appropriate, the separate disclosure of the results of a discontinued operation prior to the discontinuance date.

Definitions

.03 **Discontinued operations** are the operations of a significant identifiable part of an enterprise in respect of which management has initiated and committed itself to a formal plan of discontinuance, whether by sale or abandonment.

.04 **A significant identifiable part of an enterprise** is a distinct sector of activity, the assets, results of operations and activities of which may be clearly distinguished physically, operationally and for financial reporting purposes from the other assets, results of operations and activities of the enterprise.

.05 **Discontinuance date** is the date from which management has reasonable assurance as to the eventual conclusion of a formal plan of discontinuance.

.06 **Disposal date** is the date the risks and rewards of ownership pass from the seller, if the discontinuance is by sale, or the date that operations cease, if the discontinuance is by abandonment.

Explanatory notes

Background

.07 At present the profit or loss on sale or abandonment of a discontinued operation is usually disclosed as an extraordinary item. However, the methods of calculating this profit or loss are subjective and diverse.

.08 Some view the results of the discontinued operation up to the discontinuance date as being typical of ordinary trading and operating activities and so include them in income for the period. Others view these results as no longer being part of ordinary trading and operating activities and therefore seek to include them as part of the extraordinary item.

This statement clarifies the situation. It accepts that the results of any discontinued operation up to the discontinuance date normally arise from occurrences the underlying nature of which is typical of ordinary trading and operating activities. It also accepts that because these results derive from operations that are being discontinued, there may be merit in separately identifying them from those results which derive from other operations. Results after the discontinuance date are not generally considered representative of ordinary trading activities because of the incidence of items of income and expense related solely to the discontinuance. Accordingly, they are normally included in the determination of the profit or loss on discontinuance which is disclosed as an extraordinary item. .09

Results of discontinued operations prior to the discontinuance date

The initiation of, and commitment by management to, a formal plan of discontinuance does not necessarily have an impact on the results of operations. However since the operations are to be sold or abandoned they no longer form part of the remaining operations of the enterprise. Separate disclosure of the results of discontinued operations prior to the discontinuance date from the results of the other operations, either on the face of the income statement or in a note to the financial statements, but not as an extraordinary item, may therefore assist users in achieving a full understanding of the financial statements. .10

If disclosure of the results of discontinued operations prior to the discontinuance date is made on the face of the income statement, where practical, the prior year comparative figure is normally adjusted and the amount attributable to the discontinued operation disclosed. Otherwise this comparative amount is normally given in the notes. .11

Where it is considered necessary for a proper appreciation of the financial results, the portion of other separately identified items, for example, finance charges and turnover attributable to the discontinued operation, are separately disclosed. .12

Where it is considered appropriate to disclose separately the results of a discontinued operation prior to the discontinuance date, the estimated tax charge or saving attributable to such results and the effect on outside owners' interest are normally similarly disclosed. .13

Determination of the profit or loss on discontinuance

.14 The determination of the profit or loss resulting from the sale or abandonment of a discontinued operation is made from the discontinuance date based on best estimates, at the reporting date, of:

- results of the discontinued operation from the discontinuance date to the expected disposal date, unless these are unlikely to be affected by the decision to discontinue
- costs and expenses directly associated with the discontinuance
- proceeds of disposal less net carrying values of assets and liabilities of the discontinued operation.

.15 At the discontinuance date there is reasonable assurance as to the eventual conclusion of the formal plan of discontinuance. Such reasonable assurance normally requires that activities which give effect to the decision to discontinue have commenced and that management can:

- identify the activities and related net assets being discontinued
- identify the method of discontinuance
- identify the period expected to be required for completion of the discontinuance
- estimate the results of the discontinued operation from the discontinuance date to the disposal date
- estimate the proceeds to be realised on disposal.

In the case of a discontinuance by sale, in addition to the above, reasonable assurance will normally require an identified buyer.

.16 Once there is reasonable assurance as to the conclusion of the formal plan of discontinuance, it is likely that the results of the discontinued operation will be affected by items of income and expense which flow from the decision to discontinue. For this reason results after the discontinuance date are included in the determination of the profit or loss on discontinuance which is disclosed as an extraordinary item except where these are unaffected by the decision to discontinue.

.17 The estimated amounts of operating income from discontinued operations, between the discontinuance date and the disposal date, included in the determination of the profit or loss on discontinuance should be limited to those amounts which can be projected with reasonable assurance.

The profit or loss on discontinuance does not include adjustments, costs or expenses associated with normal business activities that should properly have been recognised on a going concern basis up to the discontinuance date, such as adjustment of accruals on long term contracts or amounts provided against receivables, stock, property, plant, equipment used in the business, equipment leased to others and intangible assets. However, the calculation of the profit or loss on discontinuance does include any adjustments, costs or expenses that are both: .18

- clearly a direct result of the decision to discontinue
- clearly not adjustments to net carrying values, costs or expenses that should have been recognised on a going concern basis prior to the discontinuance date.

Costs and expenses directly associated with the decision to discontinue may include some or all of the following items: .19

- severance pay
- additional pension provisions
- retention payments to key personnel during any winding up period
- provisions for doubtful debts, only where these are likely to arise as a direct result of the decision to discontinue
- losses due to penalty clauses in cancelled contracts
- costs associated with the termination of any long term leases or other commitments
- employee relocation expenses.

If a loss is expected from the discontinuance, then full provision is made for this estimated loss determined from the discontinuance date. If a profit is expected from the discontinuance this profit is recognised only when realised or realisation of the profit is reasonably certain. .20

If the profit or loss on discontinuance is not yet known and cannot be estimated this fact is normally disclosed. .21

Reporting the profit or loss on the sale or abandonment of a discontinued operation requires estimates of associated costs and expenses, and associated revenues based on judgement and an evaluation of the facts known at the time of first accounting for the event. Adjustments in the current period to profits or losses on discontinuance that were reported in a prior period are treated as changes in estimates and, accordingly, disclosed as extraordinary items. .22

Disclosure

.23 In addition the financial statements disclose:

- the identity of the discontinued operation
- the expected disposal date, if determinable
- the remaining assets and liabilities of the discontinued operation at the balance sheet date, if not separately disclosed in the balance sheet.

Statement of accounting practice

Determination of the profit or loss on discontinuance

.24 The determination of the profit or loss on discontinuance should be made from the discontinuance date, based on information available at the reporting date.

.25 The profit or loss on discontinuance should not include any amount which should properly have been recognised on a going concern basis in the results of operations prior to the discontinuance date. However, it should include all costs and expenses directly associated with the discontinuance.

.26 The determination of the profit or loss on discontinuance should include best estimates at the reporting date of:

- the results of the discontinued operations from the discontinuance date to the expected disposal date, unless these were unaffected by the decision to discontinue
- costs and expenses directly associated with the discontinuance
- proceeds of disposal less net carrying values of assets and liabilities of the discontinued operation.

.27 Any estimated amounts of operating income from discontinued operations, between the discontinuance date and the disposal date, included in the determination of profit or loss on discontinuance should be limited to those amounts which can be projected with reasonable assurance.

.28 If a loss on discontinuance is expected, the estimated loss should be provided for in full from the discontinuance date. If a profit is expected, it should be recognised only when it is realised or realisation of the profit is reasonably certain.

Disclosure of the profit or loss on discontinuance

The profit or loss on discontinuance should be disclosed as an extraordinary item. .29

If the profit or loss on discontinuance is not yet known and cannot be estimated this fact should be disclosed. .30

Other disclosures

The financial statements should also disclose: .31

- the identity of the discontinued operation
- the expected disposal date, if determinable
- the remaining assets and liabilities of the discontinued operation at the balance sheet date, if not separately disclosed in the balance sheet.

Results of discontinued operations prior to the discontinuance date

The results of discontinued operations prior to the discontinuance date should not be treated as an extraordinary item except for items of income and expense directly associated with the decision to discontinue. Where it is considered that it will assist users in achieving a full understanding, such results should be disclosed separately from the results of other operations, either on the face of the income statement or in a note. Where practical, the prior year comparative amounts should also be disclosed. .32

Where such separate disclosure is made the estimated tax charge or saving attributable to the results of discontinued operations and the effect on outside owners' interests should be similarly identified. .33

Effective date

The requirements set out in this statement should be applied as soon as possible and regarded as standard for financial statements covering all periods commencing on or after 1 January, 1987. .34

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A WORD BETWEEN LECTURES

The rest of these lectures contain ACCOUNTING GUIDELINES issued by the S.A. Institute of Chartered Accountants. These guidelines have been reproduced here for you with the kind permission of the Institute.

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They do, however, represent the Institute's considered view on the appropriate practices to be followed should financial statements incorporate a topic addressed in a guideline.

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DISCLOSURE OF EFFECTS OF CHANGING PRICES ON FINANCIAL RESULTS

Contents

The South African Institute of
Chartered Accountants

Introduction

.01 This guideline recommends disclosure of the major effects of price changes on the results of operations. Such information will assist users of the financial statements in evaluating the performance and liquidity of the business taking into account current costs and the need to retain sufficient funds to finance its continued existence.

.02 In this guideline, the concept of current cost accounting is applicable to all segments of an organisation where the continuation of operations presumes the replacement of assets consumed in that segment.

Summary of recommendations

.03 Disclosure in a supplementary current cost income statement of the effect of changing prices on financial results as reported in the financial statements. Three adjustments are envisaged:

- depreciation (paragraphs .23 — .33)
- cost of sales (paragraphs .34 — .37)
- financial gearing (paragraphs .38 — .44).

.04 This supplementary income statement recognises two measurements of current cost income — the entity operating income and the owners' income:

- the entity operating income is calculated in relation to the assets employed in the business and does not take into consideration the financial gearing adjustment
- the owners' income adjusts the entity operating income for the effects of financial gearing.

.05 Where consolidated financial statements are presented, the supplementary current cost income statement should be presented in relation to the consolidated financial results only.

.06 Where information relating to depreciation and/or cost of sales adjustments only is available, this information should be disclosed, but should not be presented in the form of a current cost income statement. Any financial statement purporting to be a current cost income statement should give effect to the three adjustments referred to in paragraph .03 above.

Glossary of terms

Plant and equipment

.07 In addition to its usual meaning, plant and equipment should be taken to include other assets used in the production of income or the provision of services, such as motor vehicles, office and EDP equipment, fixtures and fittings, ships and aircraft.

Gross current cost

Gross current cost of an asset is the cost that would have to be incurred to obtain and install at the date of the valuation an equivalent asset in new condition. .08

Net current cost

Net current cost of an asset is that part of the gross current cost which reflects the unexpired portion of its total useful life. .09

Net realisable value

Net realisable value of an asset is the estimated proceeds from a sale in the open market less all the costs expected to be incurred in the realisation. .10

Recoverable amount

Recoverable amount of an asset is that portion of net current cost which is expected to be recovered in the course of normal business operations through future depreciation charges and ultimate net realisable value. .11

Depreciable value to the business — plant and equipment

The depreciable value to the business of plant and equipment will be its net current cost at the end of the year but before charging depreciation for the current year, unless: .12

- the asset will not be replaced at the expiry of its useful life to the business, in which case its net current cost should be reduced to the greater of its recoverable amount and net realisable value
- the asset is no longer in use, in which case its net current cost should be replaced by its net realisable value.

Depreciable value to the business — land

The depreciable value to the business of land is its open market value, as if unimproved, plus estimated acquisition costs. .13

Depreciable value to the business — buildings

The depreciable value to the business of buildings should be the net current cost of the buildings (and other improvements) at the end of the year, but before charging depreciation for the current year unless: .14

- in the case of general purpose buildings or rental producing properties, this amount is greater than the open market value of the land and the buildings together (including estimated acquisition costs), in which case such open market value should be used, or

- the building will not be replaced at the expiry of its useful life to the business, in which case its net current cost should be reduced to the greater of its recoverable amount and net realisable value, or
- the asset is no longer in use, in which case its net current cost should be replaced by its net realisable value.

.15 The net realisable value would normally include the value of land. Accordingly the ultimate net realisable value of the land should be taken into consideration when determining the depreciable value of the buildings.

Value to the business — stock and work in progress

.16 The value to the business of an item of stock or work in progress or contract work in progress is the lower of current cost and net realisable value. Current cost is the cost of obtaining an equivalent asset at the date of valuation or consumption.

Monetary assets

.17 Monetary assets are money held and amounts to be received in money. All other assets are nonmonetary assets.

Monetary liabilities

.18 Monetary liabilities are amounts to be paid in money. All other liabilities are nonmonetary liabilities. However, for the purposes of the financial gearing adjustment, preference shares and deferred taxation are normally regarded as nonmonetary liabilities. (See paragraph .41)

Supplementary current cost income statement

.19 The supplementary current cost income statement should disclose: (See Appendix 1 for illustration)

	Paragraph reference
• turnover (unadjusted)	—
• operating income (or loss) before tax and interest determined on the historical cost basis	—
• current cost adjustment (the sum of: the cost of sales adjustment, the depreciation adjustment, and other adjustments relating to sales of fixed assets)	.22 - .37
• entity operating income (or loss) before taxation	.04
• net amount of interest payable and receivable (unadjusted)	—
• adjustment for financial gearing	.38 - .44
• owners' income (or loss) for the period	.04
• taxation (unadjusted)	.45

	Paragraph reference
• net income (or loss) for the period after taxation	.46
• share of after tax income (or loss) of associated companies	47 - .49
• outside shareholders' interest	.50
• net income (or loss) before extraordinary items	.51
• extraordinary items	.52
• net income (or loss)	—
• other adjustments (describe)	53 - .56
• amounts of any dividends (unadjusted)	—
• retained income for the year	—

Notes to the supplementary current cost income statement Appendix 1 Notes

The notes to the current cost income statement should disclose (if not disclosed separately in the income statement): .20

	Paragraph reference
• the totals of the individual adjustments which comprise the current cost adjustment	.22 - .37
• the basis of the calculation of the individual adjustments comprising the current cost adjustment	—
• the basis of the calculation of the adjustment for financial gearing	.38 - .44
• the basis of calculation of other adjustments	.53 - .56
• the amount of the share of the after tax income or loss of associated companies which has been determined on a basis other than current cost	.47 - .49
• the amount of depreciation provided on assets valued at other than net current cost	—

Corresponding amounts

Except in the first year of presentation, corresponding amounts for the previous period should be given for items disclosed in paragraph .19. Corresponding amounts should not be adjusted for changes in prices that have occurred since that period. .21

Current cost adjustment

General principle

The current cost adjustment should be the difference between book value of, and the value to the business of, the assets consumed. .22

Depreciation of land and buildings

.23 Where it is the policy of the business to depreciate land and buildings (including land which is a wasting asset, such as a quarry) the entity operating income or loss should be stated after charging depreciation of the depreciable value to the business of the asset by apportioning such value over the estimated remaining useful life of the asset at the beginning of the period.

.24 Land and/or buildings should be valued by a professionally qualified valuer at least once in every five years. In the intervening years, the directors should assess the value of the land and/or buildings.

Depreciation of plant and equipment

.25 The entity operating income or loss should be stated after charging depreciation of the depreciable value to the business of plant and equipment by apportioning such value over the estimated remaining useful life of the asset at the beginning of the period.

.26 The gross current cost of plant and equipment is obtained by applying the most relevant external index. If another method of valuation (such as suppliers' current price lists, or an internally compiled index) is more appropriate, then that other method of valuation may be adopted.

.27 If the gross current cost of plant and equipment is obtained by applying indices, these should be validated through comparison with specific prices at least every five years. In periods of rapidly changing prices, this may need to be done more frequently.

.28 In certain instances the indexed historical cost of plant and equipment may not provide a value which approximates gross current cost (e.g. because of unusual technological innovation, or foreign currency exchange rate fluctuations) and it may not be appropriate to use suppliers' current price lists. In these circumstances, the value to the business should be calculated by reference to the current cost of the equivalent capacity.

.29 The remaining useful life of plant and equipment should be reviewed regularly. Period over which assets are being depreciated should only be changed when they are materially different from those estimated in previous years.

.30 Where the ultimate net realisable value of the plant and equipment is significant, this should be considered in the determination of net current cost.

Depreciation adjustments

.31 When the estimate of the life of an asset is revised in accordance with paragraph .29, the accumulated depreciation at the beginning of the period should be recalculated on the basis of the revised estimate of the life of the asset. (See paragraph .20 and .55)

When the method of establishing the depreciable value to the business of an asset is changed (e.g. from net current cost to the recoverable amount), the depreciation charge should be calculated on the original basis to the date of the change of value and on the revised value thereafter. Any material deficit, arising on restatement to a new basis of valuation, in excess of prior revaluation surpluses relating to that asset should be treated as an extraordinary or abnormal item depending on the circumstances. .32

Profit/loss on disposal

When an asset is disposed of, the profit or loss on disposal should be determined by comparing the proceeds with the depreciable value to the business after allowing for depreciation to the date of the sale. .33

Cost of sales

The entity operating income or loss should be stated after charging the value to the business (at the date of consumption) of stock sold during the period. The date of consumption should normally be the date of the delivery of goods or a service to a customer. .34

The value to the business should be determined on the basis of current cost. Where the business has developed appropriate methods of computing current cost of sales, these should be used. For example, where information is available from standard costing systems, or from last-in, first-out methods, it may be possible to compute the current cost of sales without resort to other methods. Where this information is not available, the value to the business of stock sold should be determined by reference to suppliers' price lists, the organisation's purchasing experience for items delivered (such as an internally compiled index), or else by using the averaging method. (See Appendix 2) .35

Where there are unusual circumstances underlying the cost of sales adjustment, (for example, where stock, in anticipation of a rise or fall in its price, has been purchased in advance or arrears of the normal purchasing patterns), the calculation using the averaging method may have an abnormal impact on the current cost of sales for the period. In such circumstances, the calculation of current cost of sales should be appropriately adjusted. .36

Where progress payments are received from customers, the cost of sales adjustment should be computed on the amount of stock and work in progress after deducting such payments. To avoid duplication, the pro- .37

gress payments deducted from stock and work in progress should be excluded from the calculation of the financial gearing adjustment.

Financial gearing adjustment

.38 It is recognised that there are differing views on the question of how monetary items should be dealt with when adjusting financial statements to indicate the effect of changing prices thereon. Such differences are unlikely to be resolved without experimentation and the fullest sharing of practical experience gained therefrom. There is concern, however, that the current cost adjustments that charge against income only the value to the business of fixed assets and stocks consumed during the period may result in an incomplete and potentially misleading picture being given to shareholders and other users of financial statements. This guideline therefore emphasises the concept of the owners' income in relation to the entity operating income whereby the future commitment of the entity to replace assets consumed in earning income should be adjusted to reflect the proportion of the additional cost of replacement which will be financed from outside sources if the existing borrowing structure is maintained. Likewise, if owners' equity is financing monetary assets, the adjustment required will be a further charge against the entity operating income to reflect the increase in net monetary assets needed to maintain its scale of operation. (See Appendix 3 paragraph .10)

.39 The financial gearing adjustment should be:

- a charge if there is an excess of monetary assets over liabilities, reflecting the increase in net monetary assets required to maintain the existing level of activities
- a credit if there is an excess of liabilities over monetary assets, based on the proportion of the cost of sales adjustment and the additional depreciation which can be written back because they relate to assets financed by outside sources of capital.

.40 An organisation should identify whether it has held on average, during the period, net monetary assets or net monetary liabilities.

.41 For the purpose of calculating the financial gearing adjustment, preference share capital and deferred taxation should not normally be treated as monetary liabilities. Preference shares represent ownership and the income statement does not bear a borrowing cost in the determination of net income. Likewise, deferred tax does not result in a corresponding interest charge in the income statement.

.42 The definition of monetary liabilities — amounts to be paid in money

— should be consistently applied. Where, for example, notes payable are convertible into shares, these should be regarded as nonmonetary. Likewise, where preference shares are becoming due for redemption and will be redeemed by repayment to the shareholders, they should be regarded as monetary liabilities to the extent the company has set up a capital redemption reserve fund or intends to utilise share premium or reserves for this purpose.

If on average net monetary assets are held during the period, the charge in respect of financial gearing should be calculated in the following way: .43

- the average net monetary assets during the period should be multiplied by such an index of the change in the cost of inputs* during the period as may be most appropriate to the business concerned, or if that is not ascertainable, by the change in the Consumer Price Index, i.e.,

  charge for financial gearing = average net monetary assets x appropriate weighted index. (See Appendix 3)

* In the case of debtors, for example, the index of the change in the cost of inputs would be calculated on the costs of goods sold or the cost of services rendered which give rise to the charge to debtors.

If on average there are net monetary liabilities during the period, the credit in respect of financial gearing should be calculated in the following way: .44

- the current cost adjustment (see paragraph .19) should be multiplied by the average proportion (during the period) which the total of the net monetary liabilities bears to the total of the net monetary liabilities plus the other credit balances not treated as monetary liabilities (e.g. ordinary shareholders' funds, preference shares), i.e.,

  $$\text{credit for financial gearing} = \text{current cost adjustment} \times \frac{\text{net monetary liabilities}}{\text{net monetary liabilities} + \text{other credit balances}}$$

  (See Appendix 3)

- In computing the amount of reserves to be used in this calculation, any material difference between the current cost and historical cost amounts (net of depreciation) for fixed assets and stocks should be added to the reserves shown by the historical cost financial statements.

Taxation

Taxation, including deferred taxation, should be recorded at the historical cost amount. .45

Net income (or loss) for the period after taxation

.46 The net income (or loss) for the period after taxation should represent the income (or loss) for the period less (or plus) the value to the business of assets consumed, and after charging or crediting the financial gearing adjustment.

Share of after tax income (or loss) of associated companies

.47 Where it is the policy to account for associated companies under the equity method, the share of after tax income (or loss) of associated companies should be determined on the basis of the current cost after tax income or loss of these companies.

.48 The share of income and reserves of associated companies recognised in supplementary current cost information must be subject to the requirement that it would not result in the carrying amount of the investment exceeding its value to the business (e.g. market value, earnings valuation).

.49 Where the equity method is applied and current cost figures cannot be prepared in respect of an associated company, there should be separate disclosure of the portion of equity income or loss accounted for on the historical cost basis and on the current cost basis.

Outside shareholders' interest

.50 The outside shareholders' interest should be established by aggregating the outside shareholders' interest in each subsidiary, determined on a current cost basis.

Net income (or loss) before extraordinary items

.51 The net income (or loss) before extraordinary items should represent the after tax income or loss for the period adjusted for the share of after tax income or loss of associated companies and for the interest of outside shareholders in subsidiaries. The earnings per share attributable to ordinary shareholders should be based on this figure, adjusted for preference dividends, and should be disclosed separately from the earnings per share determined on the basis of the historical cost financial statements.

Extraordinary items

.52 Extraordinary items should be adjusted to current cost and stated net of taxation and outside shareholders' interest, where applicable.

Other adjustments

Where, because of the existence of unusual circumstances underlying the financial information used in making the above computation, additional, or reduced funds are required to maintain business operations, an appropriate adjustment should be made to income after extraordinary items and specifically disclosed in the supplementary current cost income statement. .53

Examples of such circumstances are: .54

- where a materially different level of credit or gearing will apply in future, or
- where fixed assets are not being replaced sufficiently regularly for the current cost depreciation charged in the income statement to cover fixed asset acquisitions.
  In businesses where fixed assets are replaced on a regular basis, the amounts set aside for current cost depreciation usually provide sufficient funds in each year to cater for that year's asset replacements. In circumstances where fixed assets are replaced on an irregular basis and significant proportions of the asset are replaced in particular years, the amount set aside for current cost depreciation may not be sufficient to cater for these replacements.

Adjustments to income after extraordinary items should also be made in respect of: .55

- additional funds required, or excess funds previously set aside, to maintain assets where there has been a revision of asset lives. The adjustment should equal the amount by which the opening accumulated depreciation was adjusted because of the revision in lives (see paragraph .31);
- assets with a net depreciable value less than net historical value. The adjustment should equal the amount by which the depreciable value of the assets is less than net historical value.

The reasons for, and the basis of, any additional adjustments should be clearly explained in the supplementary current cost income statement notes. .56

Foreign operations

For the purpose of establishing a supplementary current cost income statement which includes the results of foreign operations, foreign assets and liabilities should be valued in foreign currency on the same principles as South African assets and liabilities. .57

.58 The supplementary current cost income statement of the foreign branch or subsidiary should be translated at the average rate of exchange ruling during its accounting period.

Historical cost financial information

.59 The periods over which fixed assets are being depreciated should be the same in both the historical cost and the current cost financial statements.

.60 All published references to income should clearly indicate whether the figures have been calculated on the historical cost or on the current cost basis.

.61 In preparing historical cost financial statements, it would normally be appropriate to transfer to an appropriate reserve from the historical cost income statement an amount which will result in the historical cost retained income equating the current cost retained income.

.62 Where assets have been revalued, the historical cost financial statements should disclose the net book value based on original cost at the balance sheet date of all assets revalued and the depreciation that would have been provided had these assets not been revalued. If original cost information is not available, the valuation amounts at the earliest revaluation date for which information is available should be used.

Illustrative presentation

Supplementary current cost income statement for the year ended 31 December 19X8

(All amounts expressed in R000's)

	Notes	19X8	19X7
Turnover		8 000	6 500
Operating income before tax and interest per historical cost financial statements		800	600
Current cost adjustment	.02	196	158
Entity operating income		604	442
Interest payable less receivable		50	70
Entity income after interest		554	372
Adjustment for financial gearing	.03	82	60
Owners' income before taxation		636	432
Taxation		290	208
Net income after taxation and before extraordinary items		346	224
Net income attributable to outside shareholders of subsidiaries		36	34
Net income before extraordinary items		310	190
Extraordinary items		40	30
Net income		270	160
Adjustments to accumulated depreciation	.04	20	10
		250	150
Dividends		190	160
Retained income for year		60	(10)
Earnings per share (based on net income before extraordinary items)		31c	19c

Notes to the current cost income statement

Basis of preparation .01

- Gross current cost of fixed assets is determined by revaluations based on latest replacement costs. These valuations are carried out every five years and in the intervening years and externally generated index is applied.
- Depreciation is calculated on the same basis as in the historical financial statements.
- The cost of sales adjustment has been determined using the averaging method.

.02 **Current cost adjustment**

	19X8	19X7
Additional depreciation	23	19
Cost of sales adjustment (See Appendix 2 for detailed workings)	173	139
Total	196	158

Certain plant stated at gross current cost at 31 December 19X8 of R353 was depreciated during 19X8 over a period of 14 years. In previous years, it was depreciated over a period of 20 years. If the rate previously used had been applied in 19X8, the depreciation charge would have been R4 less. An amount of R11 has been shown as an additional adjustment to adjust accumulated depreciation at 1 January 19X8. (See note .04)

Depreciation on certain buildings stated at recoverable amount amounted to R2 (19x7 R2).

.03 **Adjustment for financial gearing**

The adjustment for financial gearing represents the proportion of the current cost adjustment attributed to the average level of finance provided by outside sources of capital during the year. This average has been calculated with reference to the net monetary liabilities at the beginning and at the end of the year. (See Appendix 3 paragraph .01 for detailed workings)

.04 **Adjustments to accumulated depreciation**

	19X8	19X7
On revision of asset lives (See note .02)	11	—
In view of the irregular pattern of replacing assets	9	10
Total	20	10

The averaging method of establishing current cost of sales

(All amounts expressed in R000's)

The averaging method

The objective of the averaging method of calculating the current cost of sales is to value stock consumed at the average current cost during the period. For this purpose, the value of opening stock is converted to the average current cost during the period; the total of purchases and other costs incurred during the period is left unaltered; the value of closing stock is converted to the average current cost during the period. By using the converted values to calculate the cost of sales any increase, or decrease, in stock volume between the beginning and end of the period will automatically be credited or charged to the cost of sales for the period at the average current cost during the period. .01

This method will produce an acceptable approximation to the current cost of sales where stock volumes have been reasonably constant, or have changed at a fairly steady rate, throughout the period. Where this condition does not hold, the charge to cost of sales should be calculated at the most frequent intervals practicable, for example on a monthly basis. .02

Where the average current cost of stock can be determined from the accounting system, it should be used. Where this cannot be done, the changes in the current cost of stock should be determined by reference to the most appropriate external price index. Where the costs of identifiable elements of stock in progress have changed at materially different rates during the period, the calculation should, where possible, be made separately for each element using the cost index movements appropriate to each element. .03

The current costs of stock consumed determined by this method should be compared with the historical cost of stock consumed and the cost of sales adjustment established. .04

Illustration of the averaging method

A company classifies its stocks into two groups, A and B. Its stock records are kept on a first-in, first-out (FIFO) basis using historical costs. .05
The following is obtained from the stock records:

	A Stock	B Stock
Stock at 1 January 19X8 representing three months' purchases	600	900
Purchasing during the year	2 700	4 550
	3 300	5 450
Stock at 31 December 19X8 representing four months' purchases	750	1 250
Cost of sales	2 550	4 200

Stock indices compiled at quarterly intervals:		
30 September 19X7	100	101
31 December 19X7	106	103
31 March 19X8	110	106
30 June 19X8	114	105
30 September 19X8	118	109
31 December 19X8	121	112

- Calculation of stock indices

  Opening stock

  Stocks at 1 January 19X8 represent three months' purchases, therefore the average FIFO value may be taken as the costs at mid-November 19X7 for which the indices are estimated at:

  $100 + \frac{1}{2}(106\text{-}100) = 103$

  $101 + \frac{1}{2}(103\text{-}101) = 102$

  Closing stock

  Stocks at 31 December 19X8 represent four months' purchases, therefore the average FIFO value may be taken as the costs at 31 October 19X8 for which the indices are estimated at:

  $118 + \frac{1}{3}(121\text{-}118) = 119$

  $109 + \frac{1}{3}(112\text{-}109) = 110$

  Average for year

  Average indices for the year ended 31 December 19X8

  $$\frac{106 + 121}{2} = 113{,}5$$

  $$\frac{103 + 112}{2} = 107{,}5$$

- Revision of opening and closing stocks to average current cost for the year

Stock at 1 January 19X8: at historical cost	600	900
at average current cost:		
A $600 \times \frac{113{,}5}{103}$	661	
B $900 \times \frac{107{,}5}{102}$	949	
Stock at 31 December 19X8: at historical cost	750	1 250
at average current cost:		
A $750 \times \frac{113{,}5}{119}$	715	
B $1\ 250 \times \frac{107{,}5}{110}$	1 222	

	A Stock	B Stock
• Calculation of current cost of sales using revised amounts for opening and closing stocks		
Opening stock	661	949
Purchases	2 700	4 550
	3 361	5 499
Closing stock	715	1 222
Current cost of sales	2 646	4 277
• Calculation of cost of sales adjustment		
Cost of sales (current cost)	2 646	4 277
Cost of sales (historical cost)	2 550	4 200
	96	77
Total	173	

*These averages, where possible, should be more accurately determined by reference to interim levels of the indices.

Adjustment for financial gearing

(All amounts expressed in R000's)

Total monetary liabilities exceed total monetary assets

.01 Set out below is an illustration of the calculation of the adjustment for financing when the business holds net monetary liabilities:
Assume the following balance sheet after adjustment to reserves for the current cost of fixed assets and stocks.

	19X8	19X7
Capital employed		
Share capital	1 000	1 000
Reserves	750	400
Shareholders' interest	1 750	1 400
Outside shareholders' interest	50	50
Long term loans	600	700
Deferred tax	300	250
	2 700	2 400
Employment of capital		
Fixed assets	1 600	1 500
Current assets		
Stock	2 000	1 500
Debtors and cash	1 300	1 000
	3 300	2 500
Current liabilities		
Creditors	2 200	1 600
Net current assets	1 100	900
	2 700	2 400

.02 Calculation of net monetary liabilities

		19X8	19X7
Monetary liabilities			
Long term loans		600	700
Creditors		2 200	1 600
		2 800	2 300
Less			
Monetary assets			
Debtors and cash		1 300	1 000
Net monetary liabilities		1 500	1 300
Average	*	1 400	

.03 Calculation of other credit balances excluding monetary liabilities

		19X8	19X7
Share capital		1 000	1 000
Reserves		750	400
Outside shareholders' interest		50	50
Deferred tax		300	250
Total nonmonetary credit balances		2 100	1 700
Average	*	1 900	

*These averages, where possible, should be more accurately determined by reference to interim balances.

APPENDIX 3 — INFLATION ACCOUNTING

	19X8	19X7	
Calculation of financial gearing proportion			.04
Average net monetary liabilities		1 400	
Average other credit balances	1 900		
Average net monetary liabilities	1 400		
Total of averages of net monetary liabilities and other credit balances		3 300	
Proportion of average net monetary liabilities		42%	
Calculation of financial gearing adjustment			.05
Depreciation adjustment		23	
Cost of sales adjustment		173	
Current cost adjustment		196	
Financial gearing proportion		42%	
Financial gearing adjustment		82	

Total monetary assets exceed total monetary liabilities

In this case, the net balance of monetary assets should be determined and the adjustment calculated by multiplying the net balance of monetary assets by the percentage change in appropriate indices during the accounting year. .06

For illustrative purposes, assume the following balance sheet:

	19X8	19X7
Capital employed		
Shareholders' interest	2 135	1 962
Deferred tax	230	173
	2 365	2 135
Employment of capital		
Fixed assets	922	866
Current assets		
Stock	981	923
Debtors	324	242
Cash	1 060	796
	2 365	1 961
Current liabilities		
Creditors	922	692
Net current assets	1 443	1 269
	2 365	2 135

	19X8	19X7	
Calculation of net monetary assets			.07
Monetary liabilities			
Creditors	922	692	
Cash	1 060	796	
Excess of cash over monetary liabilities (See note (i) below)	138	104	
Debtors	324	242	
Net monetary assets	462	346	
Average (See note (ii) below)	404		

		19X8	19X7
.08	Determination of suitable indices		
	For cash		
	Consumer price index (See note (iii) below)	121	107
	% increase	13,1%	
	For debtors		
	Index of cost of goods sold to debtors (cost of inputs to debtors) (See note (iv) below)	81	70
	% increase	15,7%	
	Proportion of debtors to excess cash over creditors		70:30
	Weighted index = 15,7%x.70 + 13,1%x.30 = 11,0% + 3,9% =		14,9%
.09	Calculation of financial gearing adjustment		
	Average net monetary assets		404
	Percentage increase in weighted index		14,9%
	Financial gearing adjustment		60

Notes:

(i) Cash has been deducted from monetary liabilities first as it has been assumed that it would be used to settle creditors before using the proceeds from debtors.

(ii) This average, where possible, should be more precisely calculated. This is essential in circumstances where the business swings between a net monetary asset and a net monetary liability situation during its operational cycle.

(iii) In this case the cash portion of the net monetary assets has been indexed based on the consumer price index. Any other suitable index representing the average price increases experienced by the business may have been used, e.g. the wholesale price index or the general price level deflator.

(iv) Similarly, the portion of the net monetary assets represented by debtors has been indexed based on the increase in the costs of goods or services rendered as this is the cost to the business of holding these assets.

Basis of financial gearing adjustment

.10 The calculation of the financial gearing adjustment in a net monetary liabilities situation (paragraphs .01 to .05 above) appears to differ from that in a net monetary assets situation (paragraphs .06 to .09 above). However, both these calculations follow one basic premise — the historical cost income should be adjusted only in respect of the increased costs of maintaining the business which can be attributed to the owners. This is illustrated below.

	Net monetary assets situation	Net monetary liabilities situation
Analysis of financing:		
Nonmonetary assets	financed by owners	financed in part by owners and in part by liabilities
Monetary assets	financed in part by owners and in part by liabilities	financed by liabilities
Effect of guideline recommendations:		

Current cost adjustment adjusts for current costs relating to all non-monetary assets, however financed.

Financial gearing adjustment modifies the current cost adjustment by	a charge for the current cost of maintaining monetary assets financed by owners, as this is not taken into account in the current cost adjustment	a credit in respect of current costs of maintaining nonmonetary assets financed by liabilities, as the current cost adjustment has provided for the maintenance of all nonmonetary assets, including those financed by liabilities.

ACCOUNTING FOR FIXED ASSET REVALUATIONS

Contents

The South African Institute of
Chartered Accountants

Introduction

.01 The purpose of this guideline is to recommend methods of accounting for fixed asset revaluations for those enterprises that choose to revalue. By narrowing the choices of accounting methods available, the comparability of financial statements will be improved. This guideline is not intended to require enterprises to revalue fixed assets; as with any accounting policy this is a matter for management to decide.

.02 The accounting treatment recommended in this guideline applies to all tangible fixed assets. It does not apply to intangible assets and investments whether dealt with under the equity method of accounting or otherwise.

.03 This guideline does not attempt to consider the merits of the objectives behind the decision by management to adopt a policy of fixed asset revaluations. Management may decide to adopt such a policy of revaluation after considering matters such as;

- capital maintenance (productive or monetary)
- retention of earnings
- balance sheet value of fixed assets
- the amount of depreciation
- other matters taken separately or in combination,

.04 As the reasons for adopting a policy of fixed asset revaluations differ from enterprise to enterprise it is not possible to base the recommended accounting policy on one particular objective. Usually, however, a significant element of the objective is to eliminate one of the main distortions that arises in financial statements prepared in accordance with the historical cost convention in times of changing prices. Fixed assets, that have been held for some time, are susceptible to distortion more than most items in the financial statements especially as regards the carrying value and the allocation of depreciation on the basis of such carrying value.

.05 The objectives have an important bearing on the accounting policies adopted. Consideration should be given to the disclosure in the annual financial statements of the objectives of the revaluation especially in the first year in which the revaluation is made.

.06 Revaluing assets is a partial response to accounting for changing prices but usually does not satisfy all the objectives of either a capital maintenance approach or a full current cost approach. It is unlikely that a system of accounting for changing prices will become the required method in the primary, as distinct from supplementary, financial statements of enterprises for some time. In the meantime, there is widespread acceptance of the view that revaluations are appropriate as a modification of the historical cost accounting system.

The substitution of valuations for historical costs of fixed assets is permitted by the Companies Act, 1973. The terms distributable and nondistributable reserves used in this guideline have the same meaning as is used in Schedule 4 to the Companies Act, 1973. .07

Explanatory notes

Distribution of revaluation surplus

The revaluation of a fixed asset gives rise to an unrealised surplus or deficit. An unrealised surplus is not regarded as being available for distribution until realised. It follows that it is necessary to: .08

- quantify the amount of unrealised surplus or deficit
- ensure that surpluses are not released from nondistributable reserves to distributable reserves before realisation.

Quantification of Unrealised Surpluses or Deficits

The accounting method recommended for revaluations is that the amount of unrealised surplus relating to assets on hand at any one time should be identified and retained in the nondistributable reserve. .09

Revaluations in themselves do not create any further taxation liability as a recoupment of previous tax allowances could occur only if a disposal were to take place. Taxation that will arise on the recoupment of tax allowances previously granted is brought to account by charging the revaluation surplus and crediting the deferred tax account no later than the date on which the decision in principle to sell the asset is made. .10

It is therefore not considered appropriate that part of the surpluses arising on revaluation should be allocated to a deferred tax or so called "tax equalisation account" so as to overcome the impact of charging depreciation on the excess of the valuation over historical cost. This practice is considered unacceptable since depreciation on the excess of valuation over historical cost is a permanent difference. .11

When only a few assets are owned by an enterprise it is usually possible to achieve the objective referred to in paragraph .09 on an asset by asset basis without undue accounting effort. However it becomes increasingly more difficult to do so as the number of assets owned increases. Accordingly, many enterprises apply the accounting policy to groups of assets rather than to individual assets. This method is acceptable provided .12

that estimates are sufficiently reliable to meet the objectives of this guideline.

.13 The number of groups of assets will normally be determined according to their accounting classification; for example — plant and machinery, land and buildings, vehicles etc. However, for a specialised building such as a foundry the plant together with the building may logically form one integrated group for valuation purposes. It follows that consideration of the natural relationships formed between assets of a different accounting classification may be necessary in creating a group of assets.

.14 An important consideration in the revaluation of assets is an assessment of useful lives of such assets. This revision of asset lives may indicate that an overcharge or undercharge of depreciation was made in prior years. However, it is inherent in the nature of provisions, such as provisions for depreciation, that a best estimate is made according to information available at the time of calculating the provision. A subsequent revision in asset lives cannot therefore affect depreciation already charged. Accordingly the amount of the unrealised surplus or deficit is the difference between the valuation and the carrying value of the asset or the group of assets at the date of the valuation.

.15 Some companies which do not incorporate an upward revaluation of fixed assets in their financial statements charge the income statement with amounts of excess depreciation which are unrelated to recorded carrying values or existing asset lives. Whilst this charge attempts to account for the effects of changing prices, it is considered that this charge is an appropriation of reserves and should not be charged against pretax income.

Realisation of surpluses

.16 A transfer from the nondistributable reserve to distributable reserve is sometimes made when the asset has been realised; that is the sale or scrapping can be recognised for accounting purposes. Furthermore a transfer is sometimes made from nondistributable to distributable reserve of an amount equivalent to any depreciation on the revaluation surplus. Whether or not such transfers are made depends on the objectives of management in adopting a policy of fixed asset revaluations and whether or not there are restrictions in its articles of association (or equivalent document of incorporation). These transfers are made direct to distributable reserves and are not reflected in the income statement.

Use of unrealised surpluses

Unrealised surpluses are not used except where: .17

- capitalisation shares are issued in terms of the Companies Act, 1973, wholly or partly from the unrealised surplus arising on fixed asset revaluations, or
- transfers are made from such revaluation reserves to the deferred taxation account. Such transfers are dealt with under paragraph .10, and should not exceed the taxation payable on the revaluation surplus remaining in the nondistributable reserve for that particular asset, or
- surpluses are applied against deficits in terms of paragraph .25.

Although there is a legal precedent permitting the distribution to share- .18
holders of a revaluation surplus in specific circumstances it is widely accepted that revaluation surpluses are not available for distribution until realised.

Valuations of fixed assets

Once a valuation is substituted for the historical cost of fixed assets that .19
valuation replaces the historical cost for all accounting purposes. The valuation remains unchanged until replaced by a more recent valuation. Thus the valuation provides the basis for determining the depreciable amount of an asset and for determining its net book value for the purposes of calculating gains or losses on the disposal of the asset.

Fixed assets should be revalued systematically which may include a cy- .20
clical approach to classes of assets and indexes may be used to update the value of the remainder of the assets in the category between specific valuations. The frequency of such valuations would be determined having regard to the need to minimise distortions in the financial statements. Thus it is desirable that revaluations are made more frequently in time of significantly changing prices or for assets with large depreciable amounts. It is unacceptable for selective or ad hoc valuations to be made in order to avoid recognising gains or losses on a disposal.

The policy established for determining the frequency of valuations is .21
part of the accounting policy and is therefore disclosed.

Valuations are carried out by persons, who in the opinion of manage- .22
ment, are competent to do so. It may be desirable to periodically support internal valuations with independent valuations.

Records

It is desirable to retain records of the historical costs of fixed assets as .23

well as the revaluations substituted therefor, in order to comply with the accounting methods recommended in this guideline.

Recommended accounting methods

Surpluses and deficits arising on asset valuations

.24 Except as provided in paragraphs .25 to .28:

- surpluses arising on valuations should be credited direct to nondistributable reserve
- deficits arising on valuations should be dealt with through the income statement and disclosed as abnormal or extraordinary depending on the circumstances.

.25 Where the surplus or deficit reverses the position that arose on a previous valuation, it should normally be accounted for in a manner reciprocal to that employed previously.

.26 Where the amount of any deficit arising on a revaluation exceeds the balance available in the nondistributable reserve from previous valuations the difference should be charged to income immediately.

.27 Where the amount of a surplus arising on a revaluation exceeds the amount of any deficits from the previous valuation that was charged to income of earlier periods, having reflected in income sufficient portion of such surplus to reverse the previous charges, any excess should be credited to nondistributable reserve.

.28 A deficit may arise at the time of a valuation that is of a temporary nature. Where it can be determined with reasonable certainty that the decline in value is temporary having regard to the life of the asset, it may be appropriate not to charge the income statement with such deficit. However, disclosure of the amount of the deficit and the circumstances of its temporary nature should be given in the notes to the financial statements.

Gains and losses on disposals of fixed assets

.29 The gain or loss recognised in the income statement should be determined by reference to the difference between the carrying value of the asset sold at the time of sale and the proceeds of the sale. A transfer may be made from nondistributable to distributable reserve of any balance in the nondistributable reserve relating to the asset sold. If this is the policy such transfer should not however be reflected in results of operations for the period. The asset should not be revalued shortly prior to the sale with the intention of avoiding the disclosure of a greater of lesser profit or loss in the income statement, unless such revaluation was part of a systematic process of revaluation.

The gain or loss on disposal of fixed assets during an accounting period requires separate disclosure in terms of the Companies Act, 1973. Consideration should be given as to whether any specific gains or losses require disclosure as abnormal or extraordinary items. .30

Depreciation

Depreciation should be calculated on the depreciable amount of the revalued asset and the full amount charged to current income. The charge should be analysed to disclose separately the amount which relates to historical cost and to revaluation, if the information is available and is considered to be useful. .31

Excess depreciation which is not based on existing asset lives and recorded carrying values should not be charged in the income statement. .32

Where transfers are made annually from nondistributable to distributable reserves this policy should be followed consistently. Such transfers should not be dealt with in the income statement. .33

On the occasion of the first valuation the effect of the change in accounting policy should be disclosed. .34

Deferred taxation

Taxation that will arise on the recoupment of the allowances previously granted should be brought to account by charging the revaluation surplus and crediting the deferred tax account no later than the date on which the decision in principle to sell the asset is made. .35

Carrying value

The carrying value of revalued fixed assets in the balance sheet should be equivalent to the valuation amount less any depreciation provided since the most recent valuation. .36

Valuations of fixed assets may be determined according to various criteria such as current replacement value or open market value. Care should be taken that such valuations do not exceed the amount that could be expected to be recovered from the continued use and, where relevant, the ultimate disposal of the asset or assets within the category. .37

Disclosure

A policy of replacing historical costs with valuations is an accounting policy and should be dealt with as such in accordance with statement of .38

Generally Accepted Accounting Practice AC 101. The objectives of the revaluations should be given in the annual financial statements where such explanation would lead to a better understanding of the accounting policies adopted. So far as practicable a policy should be developed regarding the frequency of valuations and this should be disclosed as part of the accounting policy.

.39 The date of the most recent valuation and the basis of valuation should be disclosed. In the year in which assets are valued there should be disclosure of the names and qualifications of the persons making the valuation and whether the valuation was independant or internal.

.40 The gross book value and accumulated depreciation should be disclosed, by way of note in the financial statements.

GUIDELINE

VALUATION OF REAL ESTATE ASSETS

The South African Institute of
Chartered Accountants

.01 Revaluations of real estate assets are frequently undertaken in South Africa and are often incorporated in financial statements.

.02 The South African Institute of Valuers has issued to its members guidance notes on the valuation of real estate assets for accounting purposes which are reproduced as an appendix. These notes were approved by a task committee of the Accounting Practices Committee of The South African Institute of Chartered Accountants. The notes have particular application to valuations for current cost accounting purposes as well.

.03 The accounting treatment resulting from the inclusion of valuations in primary or supplementary financial statements is a technical matter requiring separate consideration and is therefore not dealt with in this guideline or the guidance notes. Such matters, in so far as they relate to supplementary current cost financial statements, are dealt with in Guideline AC 201. Guideline AC 202, "Fixed asset revaluations," issued in October 1983 deals with many aspects of the question of accounting for valuations where these replace historical costs in the primary financial statements.

.04 In accordance with generally accepted accounting practice, the valuation of any properties held as trading stock should not be incorporated in financial statements if it is above cost. However, valuations may well be helpful in determining net realisable value for accounting purposes.

.05 The guidance notes set out in the appendix are of particular value to the auditor in the context of the auditing guidelines which recommend that the auditor should obtain a general understanding of the methods or assumptions used by the specialist.

.06 Valuations, as with other exercises in the use of judgement, depend very largely on the methods and assumptions that are used in making them. It is well known that a valuation for one purpose, such as insurance, may well be entirely different from a valuation for another purpose, such as a forced sale. It is important therefore that, in any disclosure relating to a valuation, the basis of the valuation should be clearly stated. The disclosure of the basis used, when alternatives are acceptable, is a recognised feature of generally accepted accounting practice.

Your attention is drawn to the statement in the Appendix: .07

"The only acceptable basis of valuation to arrive at net current replacement cost is the Open Market Value, either on the basis of the Alternative Use Value or the Existing Use Value. Any other approach such as going concern value, cost of replacement as new, insurance value or indemnity value is not appropriate and should not, therefore, be used for normal accounting purposes."

It will be seen that the term "open market value" is used in the guidance notes in a wider sense than is used by some accountants. As used in the notes, the term includes valuations on the depreciated replacement value basis (for specialised property) as well as for valuations based on comparable properties in the open market.

The guidance notes have been issued by The South African Institute .08
of Valuers. Members are expected to use their best endeavours to ensure, in relation to any financial statements with which they are concerned, that the recommendations and the principles involved are observed.

GUIDANCE NOTES ON THE VALUATION OF REAL ESTATE ASSETS FOR ACCOUNTING PURPOSES — NO. G1

(Note: It is emphasised that the definitions contained herein can in no way override any statutory or other definitions of value which may have to be adopted for certain valuations)

This Guidance Note is concerned with the incorporation into a company's financial statements of the value of the real estate assets held by that company.

Current cost accounting requires that fixed assets be stated in a company's financial statements at their value to the business by reference, inter alia, to current costs, which can be assessed as net current replacement cost, that is, the net current cost of a replacement asset. The value of this fixed asset to the business might, therefore, be regarded as a deprival value, that is, the loss that would be suffered by the company if it were to be deprived of those assets.

Real estate may also be held as trading stock and, as such, those assets do not fall to be included with those held as fixed assets.

This note is concerned with the Valuer's role in assessing the net current replacement cost of real estate.

Basis of Valuation

Any valuation of real estate has regard to evidence of open market transactions in similar property, namely the Open Market Value.

The Open Market Value is the price at which the asset might reasonably be expected to sell, assuming an arm's-length transaction between a Willing, Able and Informed Buyer and a Willing, Able and Informed Seller and further that a reasonable time is allowed for the disposal of the asset.

The Open Market Value will reflect either —

(a)
the Alternative Use Value or
(b)
the Existing Use Value.

The Alternative Use Value reflects the value of the real estate as if vacant and available to be used for a purpose other than that for which it is currently used, e.g. a property ripe for demolition and redevelopment of the site.

The Existing Use Value reflects the value of the real estate for the same purpose for which it is currently used. This value may include a special element attributable to the earnings potential of the premises for a particular existing purpose by reason of their nature, location, character and physical construction. Such element of value, if present, exists irrespective of the benefit of the property to the particular individual undertaking of which it forms a part.

The only acceptable basis of valuation to arrive at net current replacement cost is the Open Market Value, either on the basis of the Alternative Use Value or the Existing Use Value. Any other approach such as going concern value, cost of replacement as new, insurance value or indemnity value is not appropriate and should not, therefore, be used for normal accounting purposes.

Valuation of Real Estate Assets

Real estate is generally held as fixed assets by a company in one of the following categories —

(a)
For occupation by the business

(b)
As investment properties

(c)
As surplus to the requirements of the business.

Any property which is the subject of an inter-company leasing arrangement inside a group, falls to be treated as an owner-occupied property.

Owner-occupied properties fall into two classes, namely:

(a)
Specialised Property
A specialised property is 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.

(b)
Non-specialised Property
A non-specialised property is the kind of property for which there is a general demand, with or without some adaption by a variety of busi-

nesses or trades and which is generally bought and sold or leased in the open market, with vacant possession.

It is only the owner-occupied properties that normally fall to be treated as specialised properties. Properties which are held as investments or as surplus to the business, will always be valued as non-specialised properties. Similarly, properties which are normally valued by reference to trading potential such as hotels and cinemas and which are generally bought and sold or leased in the open market, are to be treated as non-specialised properties. It is necessary to establish the category or class which applies to a property or group of properties and this classification, once decided, should not normally be changed.

The Valuer should discuss this division with his client. If he is directed by his client to classify a property as specialised, which in the opinion of the Valuer should be valued as a non-specialised property, the Valuer should include in the valuation a statement to this effect, and indicate whether such a market valuation would be likely to be more or less than the figure provided.

Specialised Buildings

The value to the business of specialised properties is the Depreciated Replacement Value of the real estate. This figure is determined as follows:

The estimated cost of erecting the building or a modern substitute building having the same gross internal area as that existing, together with the estimated cost of ancillary siteworks is first determined. This cost includes relevant professional fees and other associated expenses directly related to the construction of the buildings and ancillary siteworks, but excludes any finance charges. This cost is then depreciated according to age, obsolescence and condition; to which is added the Open Market Value in Continuation of the Existing Use, including acquisition costs, of the land as if vacant. This value is only applied to assets being part of an operating concern and is subject to adequate profitability.

Groups of Buildings

A business may occupy more than one building and some of the buildings may be of a specialised nature, and others of a non-specialised nature. Some companies may also conduct from the same property, a number of different businesses, each of which has a separate identity.

In these circumstances the Valuer will need to consult with the client as to the appropriate basis of valuation. Generally, the whole of any one property will need to be treated as a specialised or a non-specialised property.

Non-specialised Property
The value of these properties will be based upon the sum obtainable for these or comparable properties in the open market.

Alternative Use
It is for the client to decide whether any reference to an Alternative Use Value is made in the Directors' Report or in the notes to the financial statements. The client will normally only make reference in respect of owner-occupied properties, where there is a material difference between the Alternative Use Value and the Existing Use Value. The Valuer should draw the attention of the client to the possibility of the existence of a material difference in the values.

Properties in the Course of Development
Specialised properties, in the course of development, should be valued having regard to their existing state of costs current at the date of valuation on the Depreciated Replacement Value basis subject to adequate potential profitability on completion.

Non-specialised properties in the course of development should be valued at the lower of —

(a) the Open Market Value of the land for the proposed use plus the current cost of development at the date of valuation, or
(b) the current Open Market Value assuming the work had been completed (with the benefit of any contracted lettings) less the estimated expenditure at current costs to complete the development.

Summary
Owner-occupied properties — the value required is the Open Market Value for the Existing Use with vacant possession.

Investment properties — the value required is the Open Market Value.

Properties surplus to requirements or held for disposal (but not as trading stock). The value required for these properties, which in the opinion of the client are either surplus to foreseeable requirements of the business or held for disposal, is the Open Market Value.

Properties Held as Trading Stock
Properties which are purchased with a view to re-sale in substantially the same condition, should be valued on the basis of Open Market Value.

The Valuer

Open Market Valuations should be carried out by Valuers holding recognised professional qualifications with recent post-qualification experience and knowledge of valuing properties in the location and categories of the subject property.

Valuations may be made by internal or external Valuers. Where property assets are material to the business, an external valuation may be necessary, but this is a matter for the client.

The assessment of the Depreciated Replacement Cost of buildings should be made by Valuers, possibly in association with building surveyors, quantity surveyors or other experts having experience in building construction costs.

Frequency of Valuation

Where the land and buildings form a substantial part of the assets of the business, valuations may be needed annually; in other cases, valuations will probably be needed at intervals of not more than five years. This is to try to ensure that the values in the financial statements are not significantly different from current values. In between valuations, it is for the clients to consider in the light of market changes, whether values need updating, and if so, whether they should take advice from their Valuers.

Acquisition and Sale Costs

Where acquisition and sale costs are material in amount and the client's policy requires these to be reflected in the figures for net current replacement cost or recoverable amount, the Valuer may be asked to make a separate estimate at current price levels. The valuation statement should provide only the Open Market Value for the Existing Use or Alternative Use, as appropriate.

Valuation Statement

The valuation statement should clearly indicate —

(a) the description of the property being valued;
(b) the date as at which the valuation has been prepared;
(c) the Open Market Value for the Existing Use;
(d) the Open Market Value for Alternative Use where it is required;
(e) any specific assumptions used in the valuation, e.g. assumptions about planning permissions or development consents not yet obtained; and
(f) the name and address and qualifications of the Valuer.

Supplementary Discussion on Basis of Value

The most meaningful basis of valuation of a real estate asset for accounting purposes is the Open Market Value for the Existing Use. The Valuer is trying to determine the value of an asset to a client in continuation of the purpose for which it is currently used. If a property, by virtue of its special characteristics, location or size, is particularly adapted and suitable for the profit-making business of the client, this should be reflected in the value entered into the financial statements. On the other hand, the value of the asset should not be overstated by stating its cost of replacement with a brand new asset.

As an example, if what is being considered is a company which is essentially a flour-milling organisation having various flour-mills around the country and a city centre head office block, by adopting the Open Market Value for Existing Use, the Valuer will basically apply the Depreciated Replacement Value to the flour-mills and silos, as they are specialised structures.

The Valuer would apply an Open Market Value, arrived at by the capitalisation of a real or notional income flow, to the company's head office. The reasoning is that many people could make use of an office block, whereas very few people are buyers of grain silos in the middle of, say, the Free State.

The Open Market Value for the Existing Use is important. It is the value of the property to that business, for that business, that is, the value of a factory as a factory, not as a value of that factory redeveloped for some other use.

The definition Open Market Value for the Existing Use, ignores any possibility of alternative use. It should also be the value of what subsists at the date of valuation and should ignore any differences in value, say, due to the possibility of achieving a special investment or an investment transaction such as the sale on a lease-back.

This basis values what exists, not only for its existing use, but also in its existing condition and does not pre-suppose redevelopment or refurbishment.

It is considered that it is the duty of a Valuer in valuing for accounting purposes, to draw his client's attention to any material differences that may exist between the Open Market Value for the Existing Use and the Open Market Value for Alternative Use, particularly if the realisation of the asset will produce a higher figure. It is for the clients to decide whether to disclose this additional figure. Knowledge of such an Alternative Use Value can be a very strong form of defence against an asset stripper.

In the vast majority of cases when determining the Open Market Value for the Existing Use, the valuation will be based upon comparable property transactions, but there are properties of a specialised nature which are rarely, if ever, sold except by way of the business as a whole, or are so specialised because of their construction and size or are in a location such that there is no comparable evidence. In those circumstances recourse must be had to the Depreciated Replacement Value.

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