8 Revenue

8.1 Introduction

8.1.1 Recognition Criteria

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

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

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

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

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

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

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

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

8.1.2 Exclusions

AC 111 does not deal with revenue arising from:

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

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

8.2 Measurement

8.2.1 Fair Value

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

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

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

8.2.2 Identification of Transactions

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

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

8.3 Transactions and Events

8.3.1 Sale of Goods

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

(a) the enterprise has transferred to the buyer significant risks and rewards of ownership of the goods;

(b) the enterprise retains neither continuing managerial involvement to the degree usually associated with ownership nor the effective control over the goods sold;

(c) the amount of revenue can be measured reliably;

(d) it is probable that the economic benefits associated with the transaction will flow to the enterprise; and

(e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.

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

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

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

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

(a) when the enterprise retains an obligation for unsatisfactory performance not covered by normal warranty provisions;

(b) when the receipt of the revenue from a particular sale is contingent on the derivation of revenue by the buyer from its sale of the goods (e.g. consignment inventories);

(c) when the goods are shipped subject to installation and the installation is a significant part of the contract which has not yet been completed by the enterprise;

(d) when the buyer has the right to rescind the purchase for the reasons specified in the sales contract and the enterprise is uncertain about the probability of return.

(AC 111 paragraph 18)

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

8.3.2 Rendering of Services

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

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

(a) the amount of revenue can be measured reliably;

(b) it is probable that the economic benefits associated with the transaction will flow to the enterprise;

(c) the stage of completion of the transaction at the balance sheet date can be measured reliably; and

(d) the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

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

(a) each party's enforceable rights regarding the service to be provided and received by the parties;

(b) the consideration to be exchanged; and

(c) the manner and terms of settlement.

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

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

(a) surveys of work performed;

(b) services performed to date as a percentage of total services to be performed; or

(c) the proportion that costs incurred to date bear to the estimated total costs of the transaction. Only costs that reflect services performed to date are included in costs incurred to date.

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

8.3.3 Interest, Royalties and Dividends

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

(a) it is probable that the economic benefits associated with the transaction will flow to the enterprise; and

(b) the amount of the revenue can be measured reliably.

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

(a) interest should be recognised on a time proportion basis that takes into account the effective yield on the asset;

(b) royalties should be recognised on the accrual basis in accordance with the substance of the relevant agreement; and

(c) dividends should be recognised when the shareholder's right to receive payment is established.

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

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

8.3.4 Examples

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

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

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

8.4 Financial Statement Presentation

8.4.1 Accounting Policy

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

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

8.4.2 Companies Act

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

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

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

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

8.4.3 AC 111

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

(a) the accounting policies adopted for the recognition of revenue including the methods adopted to determine the stage of completion of transactions involving the rendering of services;

(b) the amount of each significant category of revenue recognised during the period. These categories include the sale of goods, the rendering of services, interest, royalties, and dividends; and

(c) the amount of revenue arising from exchanges of goods or services analysed by each category.

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

9 Net Profit for the Period

9.1 Introduction

9.1.1 International Harmonisation

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

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

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

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

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

9.1.2 Definitions

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

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

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

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

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

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

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

9.2 Net Profit or Loss for the Period

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

	R
Net profit from ordinary activities	XX
Extraordinary item	XX
Net profit for the period	XX

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

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

*A note to these line items would provide additional disclosures in terms of AC 103 – see section 9.2.3.
†A note to net profit on ordinary activities would highlight separate disclosures (see section 9.2.2), together with the taxation effect and outside shareholders (if applicable).
Profit per share would be based on this line item and would be disclosed on the face of the income statement. This figure could be reconciled to the company's assessment of a sustainable earnings per share figure.

9.2.1 Extraordinary Items

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

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

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

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

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

9.2.2 Separate Disclosures

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

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

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

9.2.3 Discontinued Operations

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

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

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

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

Discontinued Operation

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

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

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

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

9.2.4 Changes in Accounting Estimates

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

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

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

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

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

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

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

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

9.3 Changes in Accounting Policies

9.3.1 Criteria

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

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

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

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

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

9.3.2 Retrospective Change

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

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

9.3.3 Prospective Change

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

9.3.4 Disclosure

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

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

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

9.3.5 Example

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

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

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

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

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

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

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

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

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

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

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

> The accounting policy for inventory valuation was changed during the year from the LIFO to the FIFO basis in order to comply with the new accounting standard, AC 103.
>
> The effect of the change was as follows:

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

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

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

9.4 Fundamental Errors

9.4.1 Criteria

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

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

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

9.4.2 Disclosure

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

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

in the comparative information detailing, in the notes to the financial statements, the taxation effect and any amount attributable to outside shareholders; and

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

(AC 103 paragraph 35).

9.5 Financial Statement Presentation

9.5.1 Companies Act

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

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

9.5.2 AC 103

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

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

10 Foreign Exchange

10.1 Introduction

10.1.1 Foreign Currency Accounting

Business enterprises may enter into transactions that are denominated in a different currency to their own. For example, a South African company may import raw materials from Botswana at a price quoted in Pula. Since financial statements are produced in one currency, known as the reporting currency, the transaction will need to be translated into the reporting currency for incorporation in the financial statements.

Alternatively, a South African company may establish a UK branch to handle the marketing and selling of its products in Europe. The UK branch would maintain its own accounting records in Pounds and could be a subsidiary or a division of the South African company. In order to consolidate or incorporate the results of the branch with the financial statements of the South African company, the results will need to be translated into the main reporting currency.

A South African company would generally report its results in Rand and the effects of paying for raw materials in Pula and incurring expenses in Pounds, need to be expressed in Rands. It is appropriate, therefore, that AC 112, Accounting for the Effects of Changes in Foreign Currency Exchange Rates, provides guidance for the appropriate treatment for the translation of foreign currency transactions and operations into the reporting currency (i.e. Rands). It is worth noting that the reporting currency need not be Rands. South African companies are not compelled to prepare their financial statements in Rands.

A foreign currency is any currency other than the reporting currency which is the currency used when presenting financial statements (for ease of understanding, the reporting currency can be regarded as Rands in all circumstances). The relative value of currencies fluctuates continuously and is determined by the market. Currencies are usually quoted by the market in terms of their relative worth on a buy and sell basis. Daily prices are quoted in newspapers as an indication of the relative closing price between currencies. For example, the price for US dollars may be quoted at close of trading as follows:

	09–12–03		10–12–03	
	SELL	BUY	SELL	BUY
US Dollars (1$ = R)	3,38	3,36	3,39	3,365

These prices indicate that US dollars may be purchased from a bank for R3,38 for each dollar on 9 December 1903 but $1 exchanged for Rands would only have netted R3,36 on 9 December 1903. Note that the prices have changed on 10 December. The difference between the ''Buy'' and ''Sell'' rates represents the return made by the market participant (i.e. the bank) for undertaking the transaction. Note that the bank always benefits; for example, $1 exchanged for Rands on 9 December 1903 would have yielded R3,36 and an exchange of the latter would only have netted 99,41 US cents. The net cost of entering into the transaction would be 0,59 US cents which does not appear significant until applied to transactions involving millions of dollars (e.g. on $1m, the cost amounts to approximately $5 900 or R20 000).

Theoretically, accountants should distinguish between the ''buy'' and ''sell'' rate for purposes of expressing foreign currency denominated debtors (''buy'' rate) and creditors (''sell'' rate) in Rands, but for practical purposes an average rate is usually used.

Although the relative prices of currencies fluctuate constantly, it is possible to ''lock-in'' on a price in advance. This possibility ensures that an exchange rate is fixed for a particular transaction and the risk associated with currency fluctuations is avoided, in return for a premium. The mechanism that is often used to achieve this is known as a forward exchange contract.

There are two broad categories of foreign currency operations in which an enterprise engages.

Firstly, enterprises may directly undertake transactions which are denominated in foreign currencies. For example, an enterprise may ''purchase or sell goods for which payment is made in a foreign currency or it may lend or borrow amounts denominated in a foreign currency'' (AC 112 paragraph 23). Since financial statements are produced in one currency, the results of these **transactions** are translated into the reporting currency for incorporation into the financial statements.

Secondly, enterprises may conduct business through foreign operations which maintain their own accounting records in a foreign currency. In order to prepare the financial statements of such an enterprise, the financial statements of its **foreign operation** need to be translated into the reporting currency.

AC 112 distinguishes between the accounting treatment for foreign transactions and foreign operations.

10.1.2 Terminology

Proficiency with the accounting treatment of foreign currency transactions and operations requires mastery of the associated terminology. AC 112 incorporates no fewer than twenty definitions and some of the more important definitions are considered in this section.

The **spot rate** is the ''exchange rate for immediate delivery of currencies to be exchanged at a particular time'' (AC 112 paragraph 08). For example, the ruling price at close of the market on 9 December 1903 of R3,38 for US$1,00 is indicative of the spot rate that would apply if you wanted ''immediate delivery'' of US Dollars. Similarly, the **closing rate** is the spot rate ruling at the close of business at the balance sheet date.

Forward exchange contracts are agreements to ''exchange different currencies at a specified future date and at a specified rate (the forward rate)'' (AC 112 paragraph 15). For example, a newspaper may quote a particular bank's rates as follows:

	SPOT RATE	FORWARD RATE (at 09–12–03)	
	09–12–03	09–01–04	09–03–04
British Pounds (£1 = R)	5,02	5,06	5,14

These prices indicate that on 9 December 1903, the bank will exchange Pounds at a rate of R5,02 or on the same day will contract to exchange Pounds at a rate of R5,06 in one month's time and R5,14 in three months' time. Note that the forward rate is contractually fixed and even if the spot rate were actually R5,50 (or R4,80) on 9 March 1904, the bank would honour the agreement and exchange Pounds at R5,14 on that date. Entering into a forward exchange contract with a bank, therefore, eliminates the risks associated with foreign currency movements.

The difference between the spot rate on 9 December 1903 and the forward rates quoted on that day represents a premium on a forward exchange contract of 4 cents for every Pound in terms of the one month contract and 12 cents for every Pound in terms of the three month contract. The difference could also be a discount; if the one month forward contract rate was quoted at R4,96 then the discount would be 6 cents (R5,02 – R4,96) for every Pound.

Where an enterprise enters into a forward exchange contract it is said to have ''covered forward''. Note that an enterprise can take forward cover

to minimise the risk of currency fluctuations (i.e. fix a currency rate of exchange) or to speculate. When speculating, the enterprise is not contractually fixing an amount of a foreign currency denominated debtor or creditor in Rands, rather the enterprise is ''playing'' the market. For example, if the one month forward rate is R5,06 for each Pound, the spot rate is R5,02 and it is considered that the rate will actually be R5,15 for each Pound in one month's time then it could be profitable to contractually agree to buy Pounds at R5,06 in one month's time. If the presumption proves to be right then in one month's time the Pounds purchased in terms of the contract can be sold for R5,15, thereby making a profit of 9 cents for every forward contract Pound purchased. The accounting treatment for speculative versus non-speculative forward cover differs (refer to sections 10.3.2 and 10.3.4).

A **foreign operation** is a ''subsidiary, associate, joint venture or branch whose activities are based or conducted in a country other than the country of the reporting entity'' (AC 112 paragraph 03). Foreign operations are either an integral part of the activities of the reporting enterprise (integrated foreign operation) or a separate **foreign entity**. Note that a foreign operation does not have to be an incorporated entity and that the definition includes branches within its scope.

10.2 Conceptual Issues

10.2.1 Risks and Rewards of Ownership

The general rule for recording a foreign currency transaction is that it should be translated using the actual rate at the date on which the transaction took place. For example, an enterprise importing an item of plant costing US$100 000 would record the plant in Rands using the rate applicable on the date of the transaction. Consistent with revenue recognition principles (AC 111) and the framework (AC 000), the date of the transaction should be determined with reference to the transfer of the risks and rewards of ownership. For this reason, AC 112 defines the transaction date as ''the date on which the significant risks and rewards of ownership of an asset have been transferred or a service has been performed'' (AC 112 paragraph 16).

The transaction date is determined by reference to the contract; i.e. if the plant was shipped FOB (free on board) then the risks and rewards of ownership pass on the date of loading the ship whereas if the plant was shipped CIF (cost, insurance, freight) then the risks and rewards of ownership only pass upon arrival in the port of destination. Alternatively, ownership may only pass in terms of the contract when the plant is delivered and installed.

The transaction date is a key determinant of the appropriate accounting treatment for any foreign currency transaction and care should be exercised to ensure that the substance of an agreement is accounted for and not merely its legal form. It is worth noting, however, that in practice it is often not practicable to determine the transaction date for each and every transaction. For this reason, delivery date is often used as the effective transaction date. In the case of stock purchases, this approach has very little effect on the ''bottom line'' as any fluctuation in the exchange rate is either expensed through cost of sales or exchange differences. If the stock is unsold at year end, a temporary difference may arise but over time this difference is ''smoothed''. Alternatively, an appropriate average rate is often used in practice as an approximation of the transaction rate. Although this is not in keeping with AC 112, it is an approach sanctioned in the UK by SSAP 20, provided that rates do not fluctuate significantly.

10.2.2 Objectives of Translation

The objective of financial statements is to provide ''information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions'' (AC 000 paragraph 12). The translation of foreign currency transactions and financial statements should, therefore, produce results which are generally compatible with the effects of rate changes on an enterprise's cash flows and its equity and should ensure that the financial statements fairly present management's actions. It also follows that consolidated financial statements should incorporate the financial position, performance and changes in financial position of a foreign operation as measured in the foreign currency financial statements prior to translation.

10.3 Foreign Currency Transactions

10.3.1 Uncovered Transactions

The general principle for the recording of transactions is that the spot rate at the transaction date is used for translation purposes. A purchase of plant from the UK that was shipped FOB on 15 January 1903 and invoiced (£100 000) on 31 January 1903 should be recorded at the spot rate ruling on 15 January (the transaction date). The exchange rate ruling on either 31 January 1903 or the final delivery date is not relevant. The journal entry processed to record the acquisition of plant, assuming an exchange rate of R5,02 = £1,00 on 15 January 1903 and 90 days credit from invoice date, is:

Dr	Plant and Machinery	502 000	
	Cr Creditor		502 000
Being purchase of plant of £100 000			

Note that the creditor is payable on 30 April 1903 and that the amount in Rands needed to settle the creditor will depend on the spot rate on the date of payment. For example, if the spot rate is R5,15 on 30 April 1903 then R515 000 is required to settle the creditor of £100 000. On the other hand, if the spot rate is R4,90 on 30 April 1903 then only R490 000 is required to settle the creditor of 100 000. Because the spot rate is unlikely to be R5,02 on 30 April 1903, a difference will arise between the amount at which the initial liability was recorded and the amount paid in settlement of the liability. This difference is known as an exchange difference and may either be a loss or a gain, depending on the ruling spot rate at the date of settlement.

Assuming that the liability was settled on 30 April 1903 for R490 000 (i.e. exchange rate R4,90 = 1,00), then the journal entry is as follows:

Dr	Creditor	502 000	
	Cr Exchange gain		12 000
	Cr Cash		490 000

Similarly, if the exchange rate had been R5,15 then the credit to cash would have been R515 000 and a debit to exchange loss of R13 000 would have arisen.

The above example illustrates that the transaction is effectively recorded in "two legs", i.e. the cost of the non monetary asset is fixed based on the spot rate on the transaction date while the payment for the asset is accounted for separately, depending on the settlement rate. Note that the presence of a year end between the transaction date and the settlement rate poses a potential problem in that the exchange rate at the year end is likely to differ from the transaction rate and the settlement rate. However, the year end rate, known as the closing rate, is the best estimate of the liability at the year end. The liability is, therefore, restated at the closing rate for year end reporting purposes.

Assuming an exchange rate of R5,10 at 28 February 1903 (the year end), then a closing entry to restate the liability is recorded:

Dr	Exchange loss	8 000	
	Cr Creditor		8 000

The creditor is now reflected at R510 000 (502 000 + 8 000) which is the best estimate of the amount payable at year end. Note that the closing rate is that ruling at the actual year end date (i.e. balance sheet date) and not the reporting date. The movement in foreign currency exchange rates subsequent to the balance sheet date does not affect the condition of assets or liabilities at that date and is, therefore, a non-adjusting post balance sheet event (see chapter 19).

On 1 March 1903 (i.e. the first day of the financial year), the creditor is brought forward at R510 000 and the exchange difference that arises in the 1903/1904 financial year will be the difference between the amount actually paid to settle the liability and R510 000, i.e. if the exchange rate is R5,15 on 30 April 1903 then the journal entry to record the settlement of the liability is:

Dr	Creditor	510 000	
Dr	Exchange loss	5 000	
	Cr Cash		515 000

Note that the total exchange difference relating to this transaction remains at R13 000 (R8 000 in the period ended 28 February 1903 and R5 000 in the period ended 28 February 1904).

The above principles are equally applicable to any transaction involving foreign currency payments or receipts, for example, purchases of raw materials or stock and sales of fixed assets and stock. Note, however, that it is only foreign currency (denominated) items that give rise to exchange differences. If a company sells stock to an overseas buyer and invoices in Rands then there are no foreign exchange complications. However, if the same company invoices its sales in, say, French Francs, then the sale (and debtor) is recorded at the spot rate (between the Rand and the French Franc) on the transaction date and any subsequent movement in exchange rate between the transaction date and the debtor's settlement date gives rise to an exchange difference.

10.3.2 Forward Cover

The general principle that the spot rate ruling on the transaction date is used to record a transaction also applies where forward cover is taken out in order to provide protection from fluctuations in foreign exchange rates. However, in certain circumstances a transaction may be recorded at the forward cover rate. This is considered further below but firstly it is necessary

to consider the appropriate accounting treatment for recording the cost of forward cover where the general principle is applied.

A company may wish to take out forward cover as protection against currency fluctuations. This protection (often referred to as hedging) is usually obtained at a premium and the cost of the premium should be treated as a period cost. If a company imports an item of plant costing US$1 000 000, payable in 90 days, and the transaction date is 15 September 1904 then it may wish to cover forward for the three month credit period. Relevant exchange rates on 15 September 1904 are as follows:

	US$1,00 = R
Spot	3,36
3 month forward	3,44

Applying the general principle of recording the plant at the spot rate on the transaction date, the cost of the plant is fixed at R3 360 000. However, the related liability is contractually fixed at R3 440 000 and the difference between the cost of the plant and the amount of the liability is the forward exchange premium. The entry on 15 September 1904 to record this transaction is:

Dr	Plant and Machinery	3 360 000	
Dr	Forward Premium	80 000	
	Cr Creditor (Forward Exchange Contract)		3 440 000

The forward premium is expensed in the period to which it relates and the entry on 15 December 1904 when the creditor is paid is:

Dr	Creditor	3 440 000	
	Cr Cash		3 440 000

Because the forward premium is a period cost, care should be exercised when a financial year end occurs during the period of the forward exchange contract. If, for example, the company's year end was 30 November then only ⅚ of the premium should be expensed in the year ended 30 November 1904 and the remaining ⅙ is expensed in the subsequent period. The following entry therefore would be processed at 30 November 1904 (80 000 × ⅙):

Dr	Unallocated Premium (B/S)	13 333	
	Cr Forward Premium		13 333

Note that for balance sheet presentation purposes, the unallocated premium is ''disclosed as part of the related monetary item'' (AC 112 paragraph 29), i.e. the creditor is included in the balance sheet at the net amount of R3 426 667 (R3 440 000 – R13 333). The amount of forward premium expensed in the year ended 30 November 1904 is R66 667 (R80 000 × ⅚) while R13 333 (R80 000 × ⅙) is expensed in the subsequent year.

There may be circumstances where a forward exchange contract is entered into in respect of a commitment to purchase or sell goods. For example, on 1 June 1905 a company may sign a contract to take delivery of US$100 000 of stock in three months' time. In order to obtain protection from currency fluctuations, the company decides to cover forward on 1 June 1905 until the expected settlement date of 1 December 1905. The forward cover premium amounts to R6 000. In this case, ''the premium or discount (on forward cover) up to the transaction date may be allocated to the value of the transaction as this premium or discount is not considered to be a financing cost'' (AC 112 paragraph 30).

The application of paragraph 30 to this example allows the premium attributable to the period prior to the delivery date to be included in cost of stock, i.e. R3 000 of the forward cover premium (R6 000 × ⅙) is capitalised to the cost of stock while the remaining R3 000 is treated in the normal way as a period cost. This approach results in stock being recorded at the approximate spot rate on the transaction date.

At the start of this section, it was noted that the general principle for the recording of transactions at the spot rate on the transaction date may not apply in certain circumstances. These circumstances, set out in paragraph 31 of AC 112, allow the forward rate to be used to record the transaction. All of the following criteria are necessary before use of the forward rate is permissible:

- The forward exchange contract is set to mature within normal credit terms.
- The forward exchange contract has been entered into prior to, at or immediately after the transaction date in order to establish the reporting currency amount of the purchase or sale.
- The purchase or sale is in respect of normal trade transactions.
- The related or matching forward exchange contract is denominated in the same currency as the monetary item.

(AC 112 paragraph 31)

Where **all** of these criteria are met then the transaction can be recorded at the forward rate and the premium or discount on the forward exchange contract is effectively capitalised to the cost of the asset and not treated as a period cost or gain. For example, if a company imported stock costing 10 000, immediately took out forward cover at a rate of R5,20 = R1 and met the above conditions, then the transaction would be recorded by the following entry

Dr	Stock	52 000	
	Cr Creditor		52 000

The spot rate at the transaction date is no longer relevant for accounting purposes. Note that only *trade* transactions may be recorded at the forward rate; i.e. the purchase of, say, plant and machinery could not be recorded at the forward rate.

10.3.3 Rolling of Forward Cover

Forward cover contracts are not always available for the entire period over which protection from foreign currency fluctuations is required. For example, it is often difficult to obtain cover for a period exceeding 12 months and in order to take out forward cover for, say, 18 months, it is necessary to enter into two consecutive contracts. The transition from the first contract to the second contract is known as "rolling forward". The accounting implications of rolling forward are reasonably straightforward if the underlying procedures and cash flows are understood.

A company requires 18 months forward cover on 1 January 1906 for a foreign liability of 100 000. The maximum forward cover period obtainable on 1 January 1906 is 12 months and the rate is R5,60 (spot rate on 1 January 1906 is R5,00). The company decides to take out the 12 month contract and then enter into another contract for six months on 1 January 1907, when the spot rate is R5,55 and the six month forward rate is R5,80.

On 1 January 1906, the company recognises a forward premium of R60 000 (100 000 × (5,60 − 5,00)) by restating the liability to the forward cover rate. The premium is recognised as a period cost (i.e. evenly over the 12 month contract period). When the contract matures on 1 January 1907, the company, in terms of the forward cover contract, receives 100 000 in return for R560 000. However, the company does not require the Pounds yet so sells them back to the bank at the spot rate for R555 000. Note that the company's net cash flow is R5 000 outflow (R560 000 paid to the bank and R555 000 received from the bank).

The company now enters into a second contract. This contract is for six months and the attributable premium is the difference between the forward rate (5,80) and the spot rate on 1 January 1907 (5,55), i.e. R25 000. The total premium for 18 months is R60 000 + R25 000 = R85 000. The total cash cost for settling the liability is, therefore, R585 000 (original liability of £100 000 × 5 = R500 000 and premium of R85 000). Note, however, that the cash flow relating to this transaction is the cash outflow of R5 000 on 1 January 1907 when the forward cover was rolled and the R580 000 cash outflow when the second contract matures.

The accounting implications take into account the cash flow when the contract is rolled forward. Following are the related entries:

01–01–06	Dr	Asset	500 000	
	Dr	Forward Premium	60 000	
		Cr Liability		560 000
(Assuming a 31 December year end, the entire premium is expensed in 1906.)				
01–01–07	Dr	Liability	5 000	
		Cr Cash		5 000
(Note that the liability is now stated at the spot rate at 01–01–07 and the new forward cover contract can be accounted for in the normal way.)				
01–01–07	Dr	Forward Premium	25 000	
		Cr Liability		25 000
01–07–07	Dr	Liability	580 000	
		Cr Cash		580 000

Although the above entries are prepared on the basis that the forward premiums are paid only at the conclusion of the contracts, banks sometimes require the premium to be paid in advance. This situation does not change the principles and the above entries are easily amended to cater for the advance payment of the premium.

10.3.4 Speculative Transactions

Forward exchange contracts are sometimes taken out on a speculative basis, i.e. where there is no underlying foreign currency denominated item to cover. A speculative contract is based on a profit motive, i.e. an enterprise believes that the actual rate in three months' time will be substantially different to the forward rate offered by the market. For example, on 1 January 1908 a three month US dollar forward contract at R3,90 is available but

a company has reason to believe that the actual rate on 1 April 1908 (i.e. in 3 months) will be R4,10. If the company enters into the contract on 1 January 1908 for US$100 000 then it will have to pay R390 000 for its US$100 000. However, these dollars may immediately be sold for R410 000 on that date if the company's estimates were accurate, thereby netting a speculative profit of R20 000 (R410 000 – R390 000). Note that if its estimate was wrong and the actual rate on 1 April 1908 was R3,80 then a speculative **loss** of R10 000 would arise.

The presence of a year end complicates the accounting treatment slightly. If the company's year end was 28 February then it is necessary to compute a profit or loss based on ''the difference between the forward rate available for the remaining maturity of the contract and the contracted forward rate'' (AC 112 paragraph 35), i.e. at 28 February 1908, it is necessary to obtain the one month forward cover rate for US dollars. Assuming that that rate is R4,00 then the company may recognise a profit of R10 000 (100 000 × (4,00 – 3,90)) in terms of paragraph 35 of AC 112 for the year ended 28 February 1908 and the remaining profit of R10 000 (100 000 × (4,10 – 4,00)) is recognised in the subsequent period, provided that the spot rate on 1 April 1908 was, as estimated, R4,10.

10.4 Foreign Operations

As noted in section 10.1.2, foreign operations may be classified according to their characteristics as either foreign entities or integrated foreign operations. The method of translating the financial statements of a foreign operation is determined by an assessment of its operations in order to classify it either as an entity or as a foreign operation.

10.4.1 Foreign Entities

This section is concerned with the translation of foreign entities. Foreign entities are those operations that ''accumulate cash and other monetary items, incur expenses and costs, realise revenues and arrange borrowings, all substantially in the foreign currency'' (AC 112 paragraph 37). Changes in the exchange rate have little or no effect on the operating cash flows of either the foreign entity or the reporting entity because they act independently. The reporting entity is not affected by the foreign entity's operations on a day to day basis; rather the reporting entity's results are affected only to the extent of its net investment in the foreign operation.

A foreign entity is viewed primarily as a separate, independent operation to the reporting entity. For this reason, it is important to ''preserve as far

as possible the results and the interrelationships of amounts appearing in the foreign balance sheet and income statement'' (AC 112 paragraph 38) as these results and interrelationships provide the best indication of the foreign entity's performance and financial position. It is appropriate, therefore, to translate a foreign entity's trial balance on the following basis:

- Assets and liabilities at the closing rate.
- Income Statement items at actual rates or at appropriate weighted average rates.

This method is known as the closing rate (the balance sheet is effectively translated at the closing rate) or net investment method. The translation of the trial balance using different exchange rates will result in an exchange difference. The difference can arise from:

- translating income statement items at a different rate to the balance sheet items;
- translating the opening net investment in the foreign entity at an exchange rate different to that previously reported;
- changes to owners' interests in the foreign entity arising during the year.

The exchange difference is taken directly to owners' interests as a ''change in the exchange rate has little or no direct effect on the present and future cash flows from operations of either the reporting entity or the foreign entity'' (AC 112 paragraph 40). The exchange difference is usually disclosed with non distributable reserves and is known as a Foreign Currency Translation Reserve (FCTR).

The following example illustrates the closing rate method. Handy Ltd purchase an 80% share in Selkirk (PLC) on 1 January 1901, upon incorporation of the latter. The trial balances of the two companies at 31 December 1905 are set out below.

	HANDY R'000	SELKIRK £'000
Share Capital	480	200
Retained Income (Opening)	–	425
Deferred Taxation	–	70
Long Term liabilities	–	300
Operating Income	200	228
	680	1 223

	HANDY R'000	SELKIRK £'000
Investment in Selkirk	480	–
Land and Buildings	–	250
Plant and Machinery	–	357
Accumulated Depreciation	–	(136)
Net Current Assets	–	572
Depreciation	–	45
Interest paid	–	22
Dividends paid	200	50
Taxation	–	63
	680	1 223

Selkirk (PLC) is considered to be a foreign entity and the closing rate method is applied.

In order to translate the trial balance of Selkirk, it is necessary to obtain the average exchange rate for 1905 and the closing rates at 31 December 1904 and 1905.

Assume exchange rates as follows (£1,00 =)

	R
01–01–01	3,00
31–12–04	4,80
31–12–05	5,00
Average for 1905	4,90

In addition, it is necessary to identify the Rand value of the post acquisition increase in the subsidiary's reserves up to the start of the current year (1905). Selkirk has only one reserve, namely retained income, and the opening consolidated retained income attributable to Selkirk can easily be obtained from the 1904 consolidated financial statement workings. Assume that this amounts to R1 915 000; note that this would be the Rand value of 100% of Selkirk's retained income that was consolidated in the period 1901 to 1904 and Handy's share of this amounts to 80% × R1 915 000 = R1 532 000.

It is now possible to proceed with the translation of Selkirk and a useful starting point is an analysis of the equity of Selkirk.

	£'000	RATE	100%	R'000 80%	20%
At acquisition					
Share capital	200	**3,00**	600	480	120
Post acquisition					
Retained Income to 31–12–04	425	**prior yrs**	1 915	1 532	383
FCTR (Balancing figure)			485	388	97
Equity at 31–12–04 at closing rate	625	**4,80**	3 000	2 400	600

(Note that the R1 915 is a figure obtained from prior year financial statement workings and that the total equity of Selkirk at 31 December 1904 must have been translated at the closing rate then (i.e. 625 × 4,80) to give equity in Rands of R3 000. This gives rise to an exchange difference of R485 (which is the balancing figure in the 100% column) that is taken direct to NDR).

Post acquisition (continued)

Net Income 1905 (228–45–22–63)	98	**4,90**	480,2	384,16	96,04
Dividends paid	(50)	**5,00**	(250)	(200)	(50)
FCTR (Balancing figure)			134,8	107,84	26,96
Equity at 31–12–05 at closing rate	673	**5,00**	3 365	2 692	673

Note that (i) dividends paid are translated at the actual rate obtained by Handy Ltd upon receipt thereof (Handy Ltd is reflecting dividend income of R200 000); this ensures that intra-group dividends are netted off and eliminated – refer to the trial balance below, (ii) net income is translated at the average rate and (iii) the FCTR is calculated in exactly the same way as the opening balance on the FCTR from previous years. The total FCTR is 619,8 (485 + 134,8). Using this information, it is a straightforward process to draft the consolidated financial statements. Alternatively, the trial balance may be translated as follows:

	SELKIRK	RATE	SELKIRK	HANDY	CONSOL ADJUST (cr in brackets)	CONSOL
	£'000		R'000	R'000		R'000
Share Capital	200	3,00	600	480	600	480
Retained Income (opening)	425	?*	1 915	–	383	1 532
Deferred Tax	70	5,00	350	–		350
Long Term Liabilities	300	5,00	1 500	–		1 500
Operating Income	228	4,90	1 117,2	200	200	1 117,2
Outside Shareholders	–			–	(673)†	673
FCTR (balancing figure)	–		619,8	–	123,96	495,84
	1 223		6 102	680		6 148,04
Investment in Selkirk	–		–	480	(480)	–
Land and Buildings	250	5,00	1 250	–		1 250
Plant and Machinery	357	5,00	1 785	–		1 785
Accumulated depreciation	(136)	5,00	(680)	–		(680)
Net Current Assets	572	5,00	2 860	–		2 860
Depreciation	45	4,90	220,5	–		220,5
Interest paid	22	4,90	107,8	–		107,8
Dividends paid	50	5,00	250	200	(250)	200
Taxation	**63**	4,90	308,7	–		308,7
Outside Shareholders (I/S)				–	96,04	96,04
	1 223		6 102	680	NIL	6 148,04

*This rate is not calculated; it is a composite rate from prior years that gives rise to a translated retained income of R1 915 that is obtained from the prior year consolidation workings.

†The net credit balance for outside shareholders' balance on the balance sheet is made up of:

	(R'000s)
Share Capital at acq (20% × 600)	120
FCTR (20% × 619,8)	123,96
Post Acq RI (20% × 1 915)	383
Current Year RI [(1 117,2 – 107,8 – 250 – 308,7 – 220,5) × 20%]	46,04
	673

The foreign currency translation reserve (FCTR) is disclosed in the consolidated balance sheet with non-distributable reserves. The usual Schedule 4 requirements for an NDR apply; i.e. details of the opening balance (R388 000), the movement (R107 840) in the current year and the closing balance (R495 840) should be disclosed.

In this example there was no goodwill arising on consolidation of Selkirk. If goodwill of, say, R100 000 had arisen on acquisition of the 80% interest in Selkirk (note that this is a hypothetical assumption as Selkirk was purchased upon incorporation) then the goodwill figure is not usually recalculated each year. The R100 000 of goodwill represents the value of the business over its net assets as assessed at a point in time (acquisition) and recorded in the reporting currency.

The closing rate or net investment method should also be used for the translation of investments in overseas associates. The net assets would be translated using the same calculations as for a subsidiary, but would be included in the group financial statements on the equity accounted basis and not on a line by line basis.

10.4.2 Integrated Foreign Operations

As the name suggests, integrated foreign operations comprise foreign activities that are an integral part of the operations of the reporting entity. This integration results in changes in the exchange rate having an immediate effect on the reporting entity's cash flow from operations. This effect is similar to that which would occur if the reporting entity had conducted the operation itself. ''Thus, the effect of an exchange rate change on a foreign operation that is an integral part of the reporting entity's operations is related to the monetary items held by the foreign operation rather than to the reporting entity's net investment in that operation'' (AC 112 paragraph 41).

A distinguishing feature of an integrated operation is the extent to which the activities of the foreign operation are interlinked with the reporting entity. The closing rate method is appropriate where the foreign operation is a largely independent concern that does not depend on the parent company for its activities, but where the foreign operation's results are regarded as being more dependent on the economic environment of the reporting entity's currency than on its own currency then the temporal method is more appropriate.

The temporal method recognises the integral nature of the foreign operation's activities to the reporting entity by incorporating the foreign operation's results as if all its transactions had been entered into by the investing company itself in its own currency.

Examples of integral foreign operations include a selling agency receiving stock from the reporting entity, a raw material supplier for the reporting entity or an operation located overseas for tax or exchange control reasons. A number of factors affect the classification of a foreign operation, including the extent to which the cash flows of the foreign operation have a direct impact on the reporting entity, the extent to which management of the foreign operation is dependent on the reporting entity, the main trading currency of the foreign operation, and the major currency used by the foreign operation in its financing structure. The classification of foreign operations between integral operations and entities is often not clear cut and professional judgement should be exercised.

Paragraph 43 of AC 112 sets out the procedures that are applied when translating results using the temporal method:

- Monetary items, unless covered forward, are translated at the closing rate.
- Non monetary items (e.g. fixed assets) recorded at historical cost are translated at historical rates, i.e. the exchange rates that existed when the relevant transactions occurred. Depreciation is translated on the basis of the historical rate.
- Revalued non monetary items are translated at the exchange rates ruling on the dates of their revaluation.
- Non monetary items acquired by the foreign operation prior to the reporting entity's investment in that operation are translated at the rate ruling when the reporting entity acquired the investment.
- Owner's equity is translated at historical rates.
- Income statement items are translated at actual exchange rates or at a weighted average exchange rate for the period.

Exchange differences which arise on translation using the temporal method are taken to income for the period.

We can use the previous example to illustrate the temporal method if Selkirk is considered to be an extension of Handy Ltd's business. Some further assumptions are necessary:

- All of the fixed assets were acquired when the exchange rate was £1,00 = R3,10.
- Net current assets are all monetary with the exception of stock of 100 000 which was acquired at an average exchange rate of R4,95.
- Consolidated retained income at 31 December 1904 amounted to R1 162 400, after outside shareholders' share of R290 600, i.e. total retained income of Selkirk from acquisition to 31 December 1904 was translated at R1 453 000.

Applying the temporal method to the translation of Selkirk's trial balance, the following Rand denominated trial balance is obtained:

	£'000	RATE	R'000
Share Capital	200	3,00 (h)	600
Retained Income (Opening)	425	Given (from prior yrs)	1 453
Deferred Tax	70	5,00 (c)	350
Long Term Liabilities	300	5,00 (c)	1 500
Operating Income	228	4,90 (a)	1 117,2
Exchange Gain (Balancing figure)			100,9
	1 223		5 121,1
Land and Buildings	250	3,10 (h)	775
Plant and Machinery	357	3,10 (h)	1 106,7
Accumulated depreciation	(136)	3,10 (h)	(421,6)
Net Current Assets (excluding stock)	472	5,00 (c)	2 360
Stock	100	4,95 (h)	495
Depreciation	45	3,10 (h)	139,5
Interest paid	22	4,90 (a)	107,8
Dividends paid	50	5,00 (h)	250
Taxation	63	4,90 (a)	308,7
	1 223		5 121,1

NOTES

(a) The average rate is used for income statement items except where they apply to specific historic or actual rates (e.g. depreciation and dividends).

(c) The closing rate is used for all monetary assets and liabilities.

(h) Historic (or actual) rates are used as follows:

- *owner's equity – acquisition rate*
- *fixed assets (i.e. non monetary) and depreciation – historical actual rate*
- *stock – historical actual rate*
- *dividends – actual rate.*

This trial balance may then be used to draft the consolidated trial balance in much the same way as the procedure for the closing rate method. Note that the equity of Selkirk may be analysed as follows:

	£'000	RATE		R'000	
			100%	80%	20%
At Acquisition					
Share Capital	200	**3,00**	600	480	120
Post Acquisition					
Retained Income	425	–	1 453	1 162,4	290,6
Operating Income	228	**4,90**	1 117,2		
Depreciation	(45)	**3,10**	(139,5)		
Interest	(22)	**4,90**	(107,8)		
Taxation	(63)	**4,90**	(308,7)		
			561,2	448,96	112,24
Dividend	(50)	**5,00**	(250)	(200)	(50)
Exchange Difference			100,9	80,72	20,18
	673		2 465,1	1 972,08	493,02

The temporal method has, in effect, applied historical exchange rates to the post acquisition equity of Selkirk and is a close approximation of the results that would be obtained if Handy Ltd had carried out the same operations itself from South Africa. Note the difference between the value of the translated equity of Selkirk (£673 000) using the temporal method (R2 465 100) and the closing rate method (R3 365 000). The temporal method has resulted in an average exchange rate of R3,66 (2 465,1/673) against the closing rate method's exchange rate of R5,00.

Situations may arise where there is a change in the position of a foreign operation and it is no longer appropriate to treat it in the same way as before. For example, an integrated foreign operation (accounted for using the temporal method) may become a foreign entity as the result of a group reorganisation. Alternatively, a foreign entity may become an integrated foreign operation.

It is submitted that these changes are not accounting policy changes, but rather changes in status as a result of different underlying circumstances. As such, the amounts at the time of the change in status should be treated as the starting point for the new method. The effect of the change is therefore accounted for in the period in which the change in status takes place.

10.4.3 Transactions between Group Companies

Situations may arise whereby transactions take place between companies within a group of companies that includes a foreign operation. In this case, each company should calculate exchange gains and losses as normal, and include them in their respective income statements. Provided that both

companies used the exchange rate on the same day for the recording and settlement of the transaction then the gains and losses should be eliminated on consolidation; i.e. the exchange gain arising in one company should be exactly offset by the loss in the other company.

10.4.4 Net Investment in a Foreign Entity

A foreign equity investment is sometimes financed or hedged by foreign borrowings. Where the foreign operation is classified as a foreign entity, exchange differences on translation are taken directly to reserves (FCTR) but exchange differences on the foreign borrowings would normally be recognised by the reporting entity in income of the current period. This appears illogical as any exchange loss on the foreign borrowings will be matched by a gain on the net investment in the foreign entity. Therefore, in terms of AC 112, it is appropriate to offset the exchange differences arising on each, provided that:

- the foreign borrowings are specifically and formally linked to the net investment in the foreign entity; and
- disclosure is made of the net investment in the foreign entity and the related foreign currency loans or balances.

(AC 112 paragraph 48)

For example, a company purchases a US subsidiary for US$ 1m from proceeds of a loan from Citibank for US$ 1m. In the first year of operation the US subsidiary, which is classified as a foreign entity, makes no profit and no loss, but the Rand/US Dollar rate has moved from R3,60 to R3,80. The loan and the investment now have a value of R3,8m; an increase of R200 000. The gain of R200 000 in the investment gives rise to a FCTR on translation of the investment while an exchange loss of R200 000 on the loan is recorded by the South African company. In terms of paragraph 48 of AC 112, the loss of R200 000 may be offset against the FCTR of R200 000 in the consolidated financial statements.

Although no specific guidance is given in AC 112, it is submitted that in the holding company's own financial statements, the exchange loss and gain may also be set off as the two items are closely related and effectively hedge each other. (Note that the investment in the subsidiary is not strictly speaking a monetary asset in the holding company's balance sheet and would therefore be kept at the original cost established by reference to the historical exchange rate. In order to hedge the investment and loan, both items require restatement to R3,8m in the holding company's financial statements.)

It should be noted that AC 112 does not require that the investment and borrowings be denominated in the same currency. It is also worth noting that if the borrowings are repaid then the hedge effectively falls away and the non-monetary asset (investment in foreign subsidiary) is accounted for in the normal manner.

10.4.5 Disposal of Foreign Entities

Where an investment in a foreign entity is sold or abandoned in part, or in whole, then the amount of FCTR attributable to the proportion of the investment disposed of is transferred to distributable reserves. For example, if Handy Ltd had sold ¼ of its 80% investment in Selkirk (refer Section 10.4.1) on 31 December 1905 for R800 000 then a group profit on sale of R127 000 (R800 000 – R673 000 (carrying value of 20% of equity)) arises and a transfer of R123 960 (20% of total FCTR of R619 800) may be made from NDR (FCTR) to retained income.

10.4.6 Accounting Periods

Foreign enterprises whose results are incorporated with those of the reporting entity should have financial year ends which are coterminous with the reporting entity. If this is not practicable then this fact should be disclosed and the rate used to translate the balance sheet of the foreign operation is that at the accounting date of the reporting entity (AC 112 paragraph 51). This date is appropriate as the financial statements purport to be a reflection of the position at that date.

With respect to the translation of the income statement, it may be appropriate to use the average over the foreign operation's accounting period since this is the period covered by the operation's results. Alternatively the average rate applicable to the reporting entity could be used. Neither option is wholly satisfactory and the year ends should be coterminous if this is at all possible.

10.4.7 Hyperinflation

A company may have an investment in a foreign operation which maintains its own accounting records in a currency subject to hyperinflation. Translating these results without adjusting for the hyperinflation may produce misleading figures. "Non monetary assets which have been owned by the entity for some time would therefore be stated at low amounts and the loss of purchasing power of the foreign currency unit, in terms of the reporting currency from a net monetary asset position, would not be recognised in income" (AC 112 paragraph 49).

In cases of hyperinflation, therefore, it is appropriate to adjust the foreign currency financial statements of the foreign operation for the effects of inflation before applying the normal translation rules for a foreign entity.

10.5 Financial Statement Presentation

10.5.1 Accounting Policy

An appropriate accounting policy may be as follows:

Foreign assets and liabilities of South African group companies

Foreign assets and liabilities of South African group companies, other than those which are covered by forward exchange contracts, are translated to Rands at rates of exchange ruling at the end of the financial year. Gains and losses on translation are included in operating profit.

Translation of foreign currency financial statements

The balance sheets of consolidated foreign operhpations are translated into Rands at rates of exchange ruling at the end of the financial year. The related income statements are translated at the weighted average rates of exchange for the year. Exchange differences on translation of foreign subsidiaries are taken directly to non distributable reserves.

10.5.2 Companies Act

Schedule 4 to the Companies Act requires the following disclosures:

Paragraph 38	The nature, the exchange rates used on conversion and amounts of uncovered foreign currency monetary items at the balance sheet date.
Paragraph 42(q)	The amount of foreign exchange gains and losses taken to the income statement which relate to foreign currency denominated loans.
Paragraph 47	Sufficient information on forward exchange contracts entered into which do not relate to specific balance sheet items to enable an assessment to be made of the foreign currency exposure.

10.5.3 AC 112

In addition to the Schedule 4 requirements, AC 112 requires disclosure of:

- In respect of foreign currency transactions:

- information on uncovered foreign currency monetary items at the balance sheet date, including the nature and amounts of these items and distinguishing between current and non current assets and liabilities, in each foreign currency involved. In addition, details of the settlement terms of long term items;
- the difference in rand amounts between the original forward rate and the spot rate on the maturity date (which is received or paid in cash) when a forward exchange contract is rolled before the anticipated transaction takes place, should be included with prepayments or accruals and disclosed accordingly at the balance sheet date;
- the unallocated portion of the premium/discount on a forward exchange contract at balance sheet date should be disclosed as part of the related monetary item.

• In respect of foreign operations:
  - method used to translate the results and financial position of the foreign operation;
  - net exchange differences that were taken directly to owner's interests in the period;
  - accumulated FCTR balance;
  - the fact must be disclosed where uniform accounting dates between the foreign subsidiary and the South African company is not practical;
  - the net investment in a foreign entry as well as the linked foreign loan where exchange differences are set off against each other (refer to section 10.4.4).

10.6 Taxation

10.6.1 Deferred Taxation

Until recently, deferred taxation frequently arose when accounting for foreign currency transactions as a result of timing differences between the recognition of exchange differences for taxation purposes and for accounting purposes. During 1993, however, amendments to the Income Tax Act simplified the process. In general, the Receiver of Revenue applies GAAP principles (i.e. AC 112) for purposes of determining the taxation implications of accounting for foreign currency transactions. In certain limited circumstances, timing differences may well arise, but for the majority of foreign currency transactions, there are no deferred taxation implications.