

16 Research and Development Costs

16.1 Introduction

16.1.1 Research and Development

Research and development costs are frequently incurred by enterprises, especially those operating in certain specialised sectors of the economy. AC 122, Research and Development Costs, prescribes the appropriate accounting treatment for these costs.

Research is defined as "original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding" (AC 122 paragraph 7).

Development is defined as "the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use" (AC 122 paragraph 7).

The primary accounting issue when considering costs of research and development activities is whether such costs should be recognised as an asset or as an expense. AC 122 uses the recognition criteria established in AC 000, Framework for the Preparation and Presentation of Financial Statements, to determine that research costs should be recognised as an expense in the period in which they are incurred and that development costs should be recognised as an expense in the period incurred unless certain criteria are met, in which case the development costs may be capitalised as an asset. AC 122 is closely based on IAS 9 (revised 1993).

16.1.2 Exclusions

AC 122 should be applied by all enterprises when accounting for research and development costs. Certain exceptions, however, to the general rule are identified by the statement.

AC 122 does not apply to the costs of exploration for and development of oil, gas and mineral deposits in the extractive industries. It does apply, however, to the costs of other research and development activities in those industries.

Where an enterprise carries out research and development activities under contract for another enterprise (i.e. on behalf of a third party) then the

substance of the arrangement is usually that the risks and benefits associated with the research and development activities are transferred to another enterprise. In this case, the enterprise conducting the research and development (on behalf of a third party) accounts for the costs incurred in accordance with AC 108 or AC 109.

Therefore, if research and development activities are carried out under contract for another enterprise, whereby that other enterprise will reimburse the costs, either directly or indirectly through the price charged, then AC 122 does not apply to the enterprise conducting the research and development. The costs incurred by the enterprise carrying out the research and development would be treated as either stock (AC 108) or long term contract work-in-progress (AC 109) and accounted for accordingly. The recipient of the risks and benefits of the research and development activities (i.e. the third party) would account for its costs in accordance with AC 122.

If the substance of the arrangement with the third party is such that the risks and benefits associated with the research and development activities are not, or will not be, transferred to others, then the research and development activities should be accounted for in accordance with AC 122 by the enterprise carrying out the research and development. The factors which indicate whether or not the risks and benefits of research and development activities have transferred include:

- (a) the enterprise conducting the research and development activities is contractually obligated to repay any of the funds provided by the other enterprise, regardless of the outcome of the research and development activities, for example, a research loan from the CSIR;
- (b) even though the contract does not require the enterprise conducting the research and development activities to repay any of the funds provided by the other enterprise, repayment could be required at the option of the other enterprise or the surrounding conditions indicate that repayment is probable.

16.2 Conceptual Issues

16.2.1 Research Activities

In order to assist in distinguishing between research and development activities, AC 122 lists examples of activities typically included in research:

- (a) activities aimed at obtaining new knowledge;
- (b) the search for application of research findings or other knowledge;

- (c) the search for product or process alternatives, and
- (d) the formulation and design of possible new or improved product or process alternatives.

(AC 122 paragraph 9)

Because all research expenditure is expensed when incurred there is no need to distinguish between pure and applied research expenditure.

16.2.2 Development Activities

Examples of activities typically included in development are:

- (a) the evaluation of product or process alternatives;
- (b) the design, construction and testing of pre-production prototypes and models;
- (c) the design of tools, jigs, moulds and dies involving new technology, and
- (d) the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production.

(AC 122 paragraph 10)

The use of the word "typically" by AC 122 indicates that the above classifications will not necessarily always hold. While the above examples can be taken as a useful guide, they must not be treated as absolutes and there may well be occasions where the treatment of an item given in the examples will be the opposite of that suggested. For example, the evaluation of product or process alternatives could be regarded as research since that activity in certain circumstances may be speculative and without certain commercial application.

AC 122 also gives examples of activities that while they may be closely associated with research and development activities, are neither research nor development. These examples are:

- (a) engineering follow through in an early phase of commercial production;
- (b) quality control during commercial production, including routine testing of products;
- (c) trouble shooting in connection with breakdowns during commercial production;
- (d) routine efforts to refine, enrich or otherwise improve upon the qualities of an existing product;

- (e) adaptation of an existing capability to a particular requirement or customer's need as part of a continuing commercial activity;
- (f) seasonal or other periodic design changes to existing products;
- (g) routine design of tools, jigs, moulds and dies; and
- (h) activities, including design and construction engineering related to the construction, relocation, rearrangement, or start up of facilities or equipment other than facilities or equipment used solely for a particular research and development project.

(AC 122 paragraph 11)

16.2.3 Recognition of Research Costs

AC 122 requires research costs to be recognised as an expense in the period in which they are incurred. This does not imply that the research will have no benefits for the enterprise. It is simply an indication that the costs do not meet the asset recognition criteria of AC 000 because there is insufficient certainty that future economic benefits will be realised as a result of specific research expenditures.

It should be appreciated that it is not usually feasible to allocate the benefit of research expenditure to particular accounting periods. Therefore, the simplest treatment is to write off the costs when incurred. It may well be that in future years a direct link can be established between economic benefits flowing to an enterprise and a particular research project, but this is of no value when preparing financial statements for the period in which the research expenditure was incurred. In addition, the probability of there ever being any future income is unlikely in that there is no guarantee at the research stage of a future economic benefit flow.

16.2.4 Recognition of Development Costs

The nature of development activities is such that the enterprise can more easily determine the probability of receiving future economic benefits than it can determine such a probability from research activities. This is usually because the project is further advanced at the development stage than the research stage and the viability of future markets for the product are more certain.

AC 122 requires that development costs be recognised as an expense in the period incurred unless all of the following criteria are met:

- (a) the product or process is clearly defined and the costs attributable to the product or process can be separately identified and reliably measured;

- (b) the technical feasibility of the product or process can be demonstrated;
- (c) the enterprise intends to produce and market or use the product or process;
- (d) the existence of a market for the product or process or, if it is to be used internally rather than sold, its usefulness to the enterprise can be determined, and
- (e) adequate resources exist, or their availability can be demonstrated to complete the project and market or use the product or process.

(AC 122 paragraph 18)

It is clear in terms of the framework (AC 000) that development costs meets the definition of an asset in that the expenditure is a resource controlled by the enterprise, as a result of a past event, and from which future economic benefits are expected to flow. The recognition criteria are the key to whether or not development costs should be recognised as an asset.

In terms of AC 000, the development costs may be recognised as an asset when the costs incurred can be reliably measured and where the economic benefits associated with those costs are probable. The above criteria of AC 122 fulfil these requirements in that (a) is concerned with the measurement of the costs and (b) to (e) are concerned with the probability of future economic benefit flows.

Note that the phrasing of AC 122 is not prescriptive regarding the capitalisation of development costs. The statement expresses a preference for development costs to be expensed in requiring the recognition criteria to be applied in a negative manner. The statement would have indicated a more positive link with AC 000 if it had required development costs to be capitalised unless any of the criteria listed were not met.

AC 122 also requires that where development costs are initially recognised as an expense then they should not be recognised as an asset in a subsequent period, i.e. if the costs do not meet asset recognition criteria when initially incurred then they are written off once and for all.

16.2.5 Limit on Value of Capitalised Asset

The amount of development costs recognised as an asset should not exceed the amount that, taken together with further development costs, related production costs, and selling and administrative costs directly incurred in marketing the product is probable of being recovered from related future economic benefits. Future economic benefits include revenue from the sale

of the product or process and/or costs or savings or other benefits resulting from the use of the product or process by the enterprise itself. The estimates of the revenues and cost savings should be based on prices or conditions prevailing at the end of the period. However, if it is probable that future selling prices will be lower than those prevailing at the end of the period and the lower selling prices will not be fully offset by additional cost savings, then the estimates of the revenues and cost savings are based on such future prices and costs.

For example, a company may have incurred development costs of R3 million. The future total costs of producing and selling the goods developed (i.e. future development costs, related production costs, and selling and administrative costs, directly incurred in marketing the product) are expected to be R5 million. Unless the amount expected from the related future economic benefits associated with this product (i.e. the future revenue generated) is at least R8 million, then development costs may not be capitalised beyond the expected future revenue. If, for example, the future expected revenue is R9 million then the development costs of R3 million may be capitalised. However if the future expected revenue is only R7,5 million then only R2,5 million of the development costs should be capitalised as an asset. Once capitalised, the development costs should be amortised on a systematic basis – refer section 16.3.2.

If the selling price of the product developed is expected to fall then the reduced selling price should be used when estimating future economic benefits.

16.3 Specific Issues

16.3.1 Components of Research and Development Costs

Research and development costs should include all costs that are directly attributable to research and development activities or that can be allocated on a reasonable basis to such activities.

Research and development costs include:

- (a) the salaries, wages and other employment related costs of personnel directly involved in research and development activities;
- (b) the costs of materials and services consumed in research and development activities;
- (c) the depreciation of property, plant and equipment to the extent that these assets are used for research and development activities;

- (d) overhead costs related to research and development activities, which are allocated on bases similar to those used in allocating overhead costs to stock, and
- (e) other costs, such as the amortisation of patents and licences, to the extent that these assets are used for research and development activities.

(AC 122 paragraph 13)

Selling costs and general administrative costs are not included in research and development costs.

Borrowing costs may be included in development costs where appropriate, i.e. if capitalised in accordance with AC 114.

16.3.2 Amortisation of Development Costs

AC 122 requires that where development costs are recognised as an asset they should be amortised as an expense on a systematic basis so as to reflect the pattern in which the related economic benefits are recognised.

It is often difficult to determine the relationship between development costs and the economic benefits that the enterprise derives because of the nature of development activities. AC 122 suggests two bases for the amortisation of development costs. The enterprise should amortise development costs **either** by reference to the sale or use of the product or process **or** over the time period which the product or process is expected to be sold or used.

If development costs are amortised by reference to the sale or use of a product or process then the amortisation may well be bell shaped, i.e. low at first as the product or process struggles to gain market share, high in the middle as the market share is maximised, and then low at the end as sales drop off.

An enterprise would normally use the straight line method for the amortisation of development costs over a time period in which the product or process is expected to be sold or used.

Whichever basis of amortisation is used, the length of time over which the amortisation should occur must be selected. Technological and economic obsolescence creates uncertainties about the future period over which development costs are to be allocated. In addition, it is often difficult to estimate the further costs and related future revenues of a new product or process beyond a shorter period. AC 122, therefore, suggests that development costs are normally amortised over a period **not** exceeding five years.

Amortisation commences in the accounting period in which the product or process is ready for sale or use.

The write off or amortisation of development costs may result in development costs being capitalised to the cost of another asset, for example inventory. Development costs allocated to other assets in this way are recognised as an expense at the same time as the other costs of those assets, i.e. where development costs have been amortised to the cost of inventory the development costs are effectively only recognised as an expense when the inventory is taken to cost of sales.

16.3.3 Impairment of Development Costs

As noted above in section 16.2.4 development costs capitalised as an asset should not exceed, when taken together with further development costs, related production costs, and selling and administrative costs directly incurred in marketing the product, the amount expected to be recovered from future economic benefits, i.e. future sales or cost savings. Therefore, development costs capitalised as an asset (the unamortised balance of development costs) should be written down to the extent that the balance taken together with those further costs is probable of being recovered from the expected future economic benefits.

If any of the criteria (listed above in section 16.2.4) for recognition of development costs as an asset are no longer met, then the unamortised balance of development costs of a project should be written off immediately.

Write downs or write offs of unamortised development costs should be recognised as an expense or expenses in the period in which the write down or write offs arise.

As a general rule, once development costs have been written off then they cannot be reinstated unless they were previously capitalised. Therefore, where the expenditure of development costs never met the criteria for recognition as an asset then once expensed they always remain expensed. This is in contrast to the treatment for write downs or write offs of development costs that have been capitalised. AC 122 (paragraph 31) allows development costs written down or written off to be written back when the circumstances and events that led to the write down or write off cease to exist and there is persuasive evidence that the new circumstances and events will persist for the foreseeable future.

A proviso to the reinstatement of development costs that have been written down or written off is that the amount written back should be reduced

by the amount that would have been recognised as amortisation had the write down or write off not occurred. The amount written back is recognised as income and classified as a reduction in the expense of development costs for the period. This process takes into account that the enterprise has recognised revenue or other benefits from the sale or use of the product or process during the periods in which the asset was written down or written off. This is illustrated in the following example.

Devres Ltd has incurred R3 million of development costs for a new product that they launch on 1 January 1901. The development costs of R3 million meet the criteria for recognition as an asset as set out in AC 122. Production costs and selling and administrative costs directly incurred in marketing the new product over the next five years are expected to amount to R5 million while sales of R2 million per annum are expected from the new product for the next five years. Devres has decided to amortise the development costs of R3 million on the 20% straight line method commencing on 1 January 1901. The year end is 31 December.

As the total development costs (R3 million) and future production and selling costs (R5 million) total R8 million and this is less than the total expected sales proceeds of R10 million ($R2 \text{ million} \times 5 \text{ years}$) there is no impairment of development costs and the R3 million may be amortised on the straight line basis. Therefore, in the absence of any other factors, Devres would amortise R600 000 ($R3 \text{ million} \times 20\%$) of development costs per annum for the next five years and thereby recognise the expense of R3 million evenly over the five year period.

At 1 January 1902 the selling price of the new product had to be reduced as a result of competitors entering the market. The new estimate of sales for the remaining four years is only R6 million i.e. R1,5 million per annum. Total unamortised development costs at 1 January 1902 are R2,4 million (3 million less 0,6 million amortised in 1901) and future production and selling expenses are unchanged at R4 million (i.e. R1 million per annum \times four years). The total development costs and future production and selling costs are therefore R6,4 million ($2,4 + 4$) against expected future economic benefits (i.e. sales) of only R6 million. The development costs need to be written down by R400 000 to ensure that the total of development costs and future production and selling expenses does not exceed future sales.

The write down of R400 000 of the unamortised development costs on 1 January would leave a balance remaining of R2 million. This R2 million now needs to be written off on the straight line basis over the four remaining years that we expect to receive future economic benefits. The write down per annum is therefore R0,5 million.

The total charge to the income statement for development costs expensed during 1902 amounts to R900 000 (R400 000 write down of unamortised development costs and R500 000 amortisation of development costs). This leaves unamortised development costs at 31 December 1902 of R1,5 million which taken together with future production and selling costs of R3 million gives a total balance of R4½ million. Assuming no change in the selling price or sales projections of the product, R4½ million amounts to the future economic benefits expected to be received from the sale of the product. No further write down is therefore necessary.

The amortisation of development costs in 1903 would amount to R500 000 (i.e. 2 000 000 × 25%).

On 1 January 1904 the competitor that entered the market two years previously went insolvent and Devres were able to raise their selling price substantially. Sales expected over the next two years are R3 million per annum. The future economic benefits that are expected to flow to Devres are now therefore R6 million and in terms of AC 122 it is permissible to reinstate the write down of previously written down development costs. The write down of R400 000 may therefore be reinstated. This write back, however, is reduced by the amount that would have been amortised had the write down not occurred. This amounts to R200 000 (100 000 × 2 years) which is the difference between the original amortisation estimate of R600 000 and the revised amortisation required of R500 000 as a result of the changed circumstance over the two years.

This net write back of R200 000 would offset the write off or the amortisation required in 1904 of R600 000 giving a net charge of development costs as an expense of R400 000. Assuming no changed circumstances the write off in 1905 would amount to R600 000.

The development costs of R3 million have in this situation been expensed on the following basis:

	R
1901	600 000
1902	900 000
1903	500 000
1904	400 000
1905	<u>600 000</u>
	<u>3 000 000</u>

16.3.4 Software Development Costs

The statement does not detail the appropriate accounting treatment for software development costs other than the limited guidance contained in paragraph 4 that "the specific nature of the research and development activity should be considered in relation to the asset recognition criteria and definition of research and development costs". It is submitted that criteria similar to those contained in paragraph 18 of AC 122 be met prior to capitalising software development costs; i.e. the following should be established about the software development process:

- the software development is clearly defined and the costs attributable to the software production can be separately identified and reliably measured;
- the development of the software must have reached a stage such that its technical feasibility can be demonstrated;
- the enterprise must intend to either use or market the software;
- a market for the software should exist, or if the software is to be used internally, its usefulness to the enterprise should be demonstrated; and
- sufficient resources should exist in order to complete the software development project so that the software may either be marketed or used internally.

16.4 Financial Statement Presentation

16.4.1 Accounting Policy

Appropriate wording for an accounting policy note is as follows:

Research costs are written off as incurred. Development costs are written off as incurred unless the costs are considered recoverable from probable future cost savings or sales revenues. Where development costs are deferred then they are written off on the straight line basis over four years.

16.4.2 Companies Act

Schedule 4 to the Companies Act requires the following disclosure for intangible assets:

Paragraph 22(2) the amount of development costs capitalised and the amounts written off since the date of acquisition.

16.4.3 AC 122

The disclosure requirements of AC 122 are as follows:

- an accounting policy note;
- the amount of research and development costs recognised as an expense in the period;
- the amortisation methods used;
- the useful lives or amortisation rates used;
- details of development costs that are being amortised over more than five years;
- the costs and the aggregate amounts provided as written off since the date of acquisition, and
- a reconciliation of the balance of unamortised development costs at the beginning and end of the period showing:
 - development costs recognised as an asset,
 - development costs recognised as an expense,
 - development costs allocated to other asset accounts,
 - amounts written back as assets,
 - other reconciling items where applicable.

An enterprise is also encouraged to disclose a description of its research and development activities and any circumstances or events that led to the recognition of an expense for the impairment of development costs or the write back of development costs.

16.5 Taxation

16.5.1 Deferred Taxation

Deferred taxation may arise where development costs are capitalised as the Receiver of Revenue normally allows development costs to be deducted in full in the year in which they arise. This gives rise to timing differences between the recognition of development costs for accounting purposes and taxation purposes. These timing differences are treated in the normal way (refer chapter 2) and give rise to a deferred tax liability.

17 Retirement Benefit Information

17.1 Introduction

17.1.1 Retirement Benefit Plans

Most companies provide benefits for employees on or after termination of service, in the form of an annual income or a lump sum or both. Retirement benefit plans are arrangements, formal or informal, whereby such benefits are determined or estimated in advance of retirement from the company. The plan accumulates assets (as a result of contributions from the employer and/or employees) to fund liabilities that arise upon the retirement (or to a lesser extent, withdrawal) of employees from the employer.

In South Africa, most retirement benefit plans are formal arrangements between the employer and its employees or their representatives. The plans are usually established by the employer as a normal part of the remuneration package for its employees. However, in certain circumstances the plans may be required by statute or industry arrangement. Retirement benefit plans may also be informal arrangements or evidenced only by the employer's practices.

The cost to an employer of providing retirement benefits arises as services are rendered by employees. The recognition of retirement benefit costs only when employees retire or receive retirement benefits does not allocate those costs to the period in which the services were rendered. Therefore, the cost of retirement benefits is usually recognised as an expense in the period during which the services are rendered. It is sometimes difficult to determine the periods during which the services are rendered and certain estimation procedures are necessary. These are covered further in section 17.2 and section 17.3.

The employer's cost of providing retirement benefits to employees is often quite material. In addition, there is a great deal of uncertainty surrounding the measurement of the employer's cost in certain circumstances. It is important, therefore, that users of financial statements are able to obtain an adequate understanding of the effects that retirement benefit costs might have on the position of the business. AC 116, Disclosure of Retirement Benefit Information in Financial Statements, was issued in September 1986 in order to regulate financial statement disclosures.

Retirement benefit plans are classified as either defined contribution plans or defined benefit plans.

17.1.2 Defined Contribution Plans

Defined contribution plans are defined as "retirement benefit plans under which amounts to be paid as retirement benefits are determined by contributions to a fund together with investment earnings thereon" (AC 116 paragraph 7). Under a defined contribution plan, the employer's obligation is to make agreed contributions to a retirement plan (usually defined contribution plans are provident funds). The benefits paid under a defined contribution fund will depend upon the funds available at the time of payment. These funds are derived from contributions made plus investment earnings arising from the contributions. The benefits paid are therefore directly related to and dependent on the contributions made.

An actuary's advice is not usually required when accounting for the costs of defined contribution plans as the cost to the employer is measurable with reasonable certainty; the cost being the amount of contributions payable in respect of any particular accounting period. An actuary's advice is sometimes used in order to estimate future retirement benefits that may be achievable based on present contribution levels and estimates of investment earnings.

17.1.3 Defined Benefit Plans

Defined benefit plans are defined as "retirement benefit plans under which amounts to be paid as retirement benefits are determinable, usually by reference to employee's pensionable remuneration or years of service or both" (AC 116 paragraph 8).

Defined benefit plans could be regarded as the reverse of defined contribution plans. The employer's obligation is the amount of the expected payments to existing and retired employees determined by reference to a formula that is usually based on employees' earnings and/or years of service. Although the liability for the defined benefits that will be paid to employees rests with the actual defined benefit fund, the employer may have contractual undertakings or ongoing commitments of a moral nature to meet the liabilities or potential liabilities of the fund. Because the final cost to the employer of funding a defined benefit plan is very uncertain, the present value of the promised retirement benefit is usually measured with the periodic advice of an actuary. The actuary recommends the future contribution levels to any fund.

There is an important distinction between the funding objective of a defined benefit plan and the accounting objective. The funding objective, established in terms of the fund, is intended to ensure that the assets (investments) of

the fund are sufficient to meet the liabilities (pension payments) at any point in time. As noted above, an actuary is often employed to ensure that this objective is achieved. The accounting objective, however, is concerned with the allocation of total costs to a particular period. The funding objective might require, for example, short term additional payments by the employer to the fund as the result of a shortfall of assets in the fund. The accounting objective requires that these payments be recognised on a systematic basis that is related to the benefits arising from the employee's services. (Note that AC 116 is not prescriptive about the accounting implications of such a shortfall.)

Defined benefit plans may be funded or unfunded. When the plan is funded then the payment of retirement benefits when they fall due will be met by the fund. When a plan is unfunded (i.e. not held in a separate fund), however, the payment of retirement benefits depends on the ability of the employer to meet the retirement benefit obligations as they fall due.

17.2 Conceptual Issues

17.2.1 Current Service Costs

Current service costs are the costs to an employer for the services rendered in the current period by participating employees in a retirement benefit plan, exclusive of those costs identified as past service costs, experience adjustments and the effects of changes in actuarial assumptions.

Current service costs meet the definition of an expense in terms of AC 000 in that the costs are "decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities" (AC 000 paragraph 70).

Under a defined contribution plan, the employer's cost is determined by a formula stated in the plan and can normally be calculated with certainty each year.

Under a defined benefit plan, however, the employer's cost can only be estimated since there are many variables that influence the amount of the ultimate benefits. The amount of future retirement benefits depends on the employees' earnings or their years of service and is affected by factors such as the investment performance of the assets held by the fund and employee turnover. As a result, significant estimates have to be made in order to determine the current service costs relating to a defined benefit plan.

The difficulties in estimating current service costs under a defined benefit

plan result in changes in estimate as and when actuarial valuations arise. These changes in estimates may result in the recognition of an asset or prepayment for accounting purposes. This is considered in more detail below.

17.2.2 Recognition of Assets/Liabilities

Changes in estimates of contributions to defined benefit plans may give rise to a significant increase or decrease in contribution levels. For example, the rate of employee withdrawal from a defined benefit plan may be less than what was originally assumed and this may give rise to an underfunded situation. In order to rectify the situation, the employer might have to make additional contributions. From an accounting point of view, the additional contribution should either be expensed or, if it meets the definition of an asset, it may be capitalised and amortised over the period in which future economic benefits are expected.

In terms of the framework, the additional contribution meets the definition of an asset in that the contribution or prepayment is a resource controlled by the enterprise, as a result of a past event, and from which future economic benefits are expected to flow to the enterprise. The expected future economic benefits are the future services of employees. The expense should be amortised over the period that the enterprise is expected to benefit from those future services.

This treatment is consistent with the notion of recognising expenses on the basis of an association between costs and income derived from future services of the employees. Clearly, the future economic benefit embodied in the once off contribution is the potential of the employees to contribute directly or indirectly to the flow of cash and cash equivalents to the enterprise.

In addition to changes in estimate, the amount funded by an employer during a period may be similar to the amount recognised as an expense in the period but is not necessarily the same. This is because there is an important distinction between the funding of retirement benefits and the allocation of the cost of providing those benefits for purposes of recognising the expense. (I.e. an employer may inject a lump sum into a defined benefit plan, over and above that which is estimated as necessary by an actuary, in order to obtain taxation relief. The excess over that required represents an advance.)

It should be noted that funding is a financial procedure and may be influenced by factors such as the availability of cash and taxation considerations.

In contrast, the objective of accounting is to ensure that the cost of retirement benefits is recognised as an expense when services are rendered by the employees who are entitled to receive benefits. The accounting treatment, therefore, of retirement benefit costs should not necessarily be determined by the physical cash flows of retirement benefit contributions to the retirement benefit plans.

Example

A company has an actuarially determined shortfall of R500 000 in its defined benefit pension scheme.

The company decides to fund this shortfall by two annual payments of R250 000 to the scheme but will expense the shortfall over the average remaining service life of employees, which is 10 years.

The effect of this on the company's financial statements can be summarised as follows:

<i>Year</i>	<i>Income Statement Charge</i>	<i>Balance Sheet Asset (Prepayment)</i>	<i>Cash Flow</i>
1	50 000	200 000	250 000
2	50 000	400 000	250 000
3	50 000	350 000	—
4	50 000	300 000	—
5	50 000	250 000	—
6	50 000	200 000	—
7	50 000	150 000	—
8	50 000	100 000	—
9	50 000	50 000	—
10	50 000	—	—

Note the following:

- (i) The company would also contribute its standard level of pension contribution (for example, 10% of salary costs). This contribution (current service costs) would be expensed as incurred; an accrual or prepayment may arise on the balance sheet date if actual payment is made in a different period.
- (ii) In terms of AC 116, the payments of R250 000 could be expensed in the year that they were made (see section 17.2.3) whereas IAS 19 (revised) requires that the payments be spread over the remaining working lives of existing employees (see, also, section 17.3.2).

- (iii) If the facts in the above example were reversed, in that a R500 000 surplus in the fund allowed the employer to stop contributions for two years, then a provision (instead of the prepayment in the case of the shortfall) would arise if the benefit of the surplus was spread over the 10 years, i.e. at the end of year 1, a credit balance of R50 000 would be created on the balance sheet. This balance represents a deferral and not a "present obligation" and is, therefore, not strictly speaking a liability in terms of the framework definition. However, it is necessary to classify the balance as a liability for reporting purposes.
- (iv) In practice, a new actuarial valuation of the fund will take place every three years and a further variation (e.g. surplus/shortfall) may arise. This raises the problem of how to account for two or more variations relating to the same fund. It is submitted that the variations should be treated entirely separately, and both amortised over the period originally calculated.

17.2.3 AC 116

AC 116 is essentially a disclosure document and does not concern itself with measurement or valuation issues. It therefore allows alternative accounting treatments for the recognition of retirement benefit costs, in that these costs may either be spread over the period in which benefits are expected to flow from employees or may be expensed immediately. This is in contrast to IAS 19 (revised 1993) which requires the amortisation of costs other than current service costs over the period in which economic benefits are expected to flow to the employer. These other costs are considered in more detail in section 17.3.

17.3 Specific Issues

17.3.1 Past Service Costs

Past service costs arise when a retirement benefit plan is first introduced or when an existing plan is modified. Employees who have been employed by the enterprise or have been members of an existing plan for longer than others are usually promised additional benefits in compensation for that service.

In this situation the amount, if any, set aside in prior periods may no longer be sufficient to meet the costs of retirement benefits applicable to prior periods. The past service deficit is funded either by an immediate lump sum payment, or the utilisation of surplus funding or by an increase in the contribution rate for a specified period.

It is often argued that past service costs should be written off immediately because they relate to services rendered in the past. However, it could be argued that the promise to give older or longer serving employees compensation for past service is simply a means of increasing their future remuneration in order to encourage them to provide service in the future. Therefore it would be appropriate to recognise the costs as an asset and amortise them over the period in which future economic benefits, as a result of the services of the employees, are expected to flow to the enterprise.

AC 116 is not prescriptive on the accounting treatment for past service costs and allows the costs either to be capitalised and amortised over a future period or to be expensed immediately. However, information as to the accounting and funding policy of the enterprise for past service costs may be required for fair presentation. In addition, where the incidence of past service costs results in an abnormal item, separate disclosure is required.

IAS 19 (revised 1993) recommends a different treatment for past service costs. In the case of defined contribution plans, when the additional contributions are determined by reference to employee service in prior periods and are in return for services to be rendered by existing employees in the current and future periods, then the increased contributions are recognised as an expense systematically over the expected remaining working lives of those employees. However, when additional contributions relate to retired employees then those contributions are recognised as an expense in the period in which the promise of additional contributions is made, since no further services are expected to be received by the employer from those employees. (See also section 17.3.4.)

In the case of defined benefit plans, IAS 19 (revised 1993) argues that a plan may be improved to provide additional benefits, for example, when retirement benefits are deemed to be inadequate, because of inflation or for other reasons. These entitlements to retirement benefits are in return for services to be rendered by employees in the future. Therefore the past service cost is usually allocated over the current and future periods during which the services are to be rendered, regardless of the fact that these costs are computed by reference to employee service in previous periods.

17.3.2 Experience Adjustments

Experience adjustments arise when actual events differ from expected events in terms of actuarial assumptions. An example of an experience adjustment is that the rate of employee turnover may be different from that assumed in the previous actuarial valuation.

Experience adjustments give rise to either expense or income (in the form of reduced contributions or "a pension fund holiday"). If costs are adjusted whenever there is a difference between actual experience and the previous actuarial assumptions then an erratic retirement benefit expense may result from period to period. Therefore, experience adjustments (in terms of IAS 19) should be allocated over the expected remaining working lives of existing employees.

AC 116, being a disclosure document, does not require this accounting treatment and allows income or expense items as a result of experience adjustments, either to be capitalised and spread on a systematic basis or to be recognised immediately.

17.3.3 Actuarial Assumption Changes

The treatment of changes in actuarial assumptions should be identical to that of experience adjustments in that changes in actuarial assumptions may give rise to expense or income. An actuarial assumption change is made when the actual experience in the long term consistently differs to the original assumptions so that the assumptions are changed to match the expected experience. The equivalent to a change in actuarial assumption is a change in accounting estimate relating to the useful life of an asset. AC 116 does not distinguish between experience adjustments and changes in actuarial assumptions and allows the effects of both changes to either be expensed immediately or to be spread over a future period. However, AC 116 requires information to be disclosed about the accounting policy and funding policy, if different, being applied to experience adjustments.

IAS 19 (revised 1993) requires the effects of changes in actuarial assumptions to be allocated over the expected remaining working lives of existing employees.

17.3.4 Retired Employees

Often there are changes in a retirement benefit plan that increase benefits paid to retired employees or once-off gratuities are paid to retired employees. The effect of providing amended retirement benefits for retired employees has no further benefits in the nature of future services expected to be received by the employer from those employees. For this reason, the effect of increased retirement benefits for retired employees should be recognised as an expense in the period in which the planned amendment is made. AC 116, however, allows the effect of changing retirement benefit plans as a result of amendments in respect of retired employee benefits to either be expensed or allocated over future periods.

17.4 Financial Statement Presentation

17.4.1 Accounting Policy

AC 116 requires the financial statements to disclose the accounting policy, and the funding policy if different from the accounting policy, indicating the basis used to allocate retirement benefit costs to the income statement. If necessary, current service costs, experience adjustments, past service costs, and cost of supplemental benefits to retired employees should be separately identified, where there is a difference between the accounting policy and the funding policy. In addition, IAS 19 (revised 1993) requires a description of the actuarial valuation method or methods used.

An example of an accounting policy is:

The company operates a defined benefit scheme providing benefits based on final pensionable salary. Contributions to the fund are charged against income so as to spread the costs over employees' working lives with the company. The contributions are determined by a qualified actuary on the basis of tri-annual valuations using the accrued benefit valuation method.

Alternatively, in the case of a large group which has a number of different pension funds, the following policy wording could be inserted into the above:

The group operates a number of pension funds. Over 85% of employees are members of defined benefit type pension funds. The funds are valued on a tri-annual basis by a qualified actuary using appropriate valuation methods.

17.4.2 Accounting Standards

In addition to an accounting policy, AC 116 requires disclosure of the nature of:

- the retirement benefit plan (i.e. whether defined benefit or defined contribution);
- whether or not the retirement benefit plan is governed by the Pension Fund Act;
- any commitment of the enterprise to meet unfunded benefits; and
- an indication of the proportion of the enterprise's employees covered by retirement benefit plans.

In the case of retirement benefit plans which are actuarially valued the following information should be disclosed:

- the effective date of the most recent actuarial valuation;
- the opinion of the actuary and any alteration to the contribution rate recommended by the actuary, specifying the nature, amount and duration of the alteration and whether or not the recommendation is being implemented;
- the year of the next actuarial valuation (in the case of funds not governed by the Pension Fund Act); and
- any unusual events since the date of the previous actuarial valuation that could have a material effect, as well as the action being taken to deal with a qualified actuarial opinion.

Where retirement benefit plans are not actuarially valued then disclose:

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

Other disclosure requirements of AC 116 relate to material changes in the amount charged to income in any one period. These should be disclosed separately. Disclosure should be made of any differences between the accounting policy and funding policy and the resultant provisions or prepayment in the balance sheet.

IAS 19 (revised 1993) requires additional information relating to the actuarial valuation. These requirements are as follows:

- the actuarial present value of promised retirement benefits at the date of the most recent actuarial valuation;
- if the plan is funded, the fair value of the planned assets at the date of the most recent actuarial valuation;
- the actuarial present value of the vested benefits, the rights to which (under the conditions of the retirement benefit plan) are not conditional on continued employment; and
- the principle actuarial assumptions used in determining the cost of retirement benefits and any significant changes in those assumptions.

Note that where a group has a number of retirement benefit plans in operation then it may be impractical to provide full disclosure in respect of each plan, since the level of detail required would outweigh the benefits. In such cases, it may be appropriate for the group to give disclosure on a combined basis, provided that a fair reflection of the overall pension position is provided.

17.4.3 Companies Act

The retirement benefit information requirements of Schedule 4 are included in paragraphs 39 and 40.

Paragraph 39 requires "sufficient information concerning retirement benefit plans to provide a broad understanding of the significance of retirement benefit costs in the accounting period and of actual and contingent liabilities and commitments at the accounting date".

Paragraph 40 incorporates most of the AC 116 disclosure requirements, with the following exceptions.

Schedule 4 does **not** require disclosure of:

- in the case of an actuary's qualified opinion, details of the action being taken to deal with the situation;
- in the case of retirement benefit plans that are not actuarially valued, details of:
 - that fact;
 - any decision to change the rate of contribution or to make special contributions; and
 - the expected impact on future financial statements of any significant changes in the terms of the retirement benefit plan;
- material changes in the amount charged to income in any one period;
- differences between the accounting policy and funding policy.

17.5 Taxation

17.5.1 Deferred Taxation

Deferred taxation may arise where there is a difference between the funding policy and accounting policy for retirement benefit information.

The Receiver of Revenue would normally allow the amount paid over to a retirement benefit plan to be deducted from income as the payment is made in the production of income. This may give rise to a timing difference between when items of expenditure are recognised for accounting purposes versus for taxation purposes. These timing differences would be treated in the normal way and would give rise to either deferred tax liabilities or deferred tax assets.

18 Contingencies

18.1 Introduction

A contingency is a condition that exists at the reporting date, where the outcome will be confirmed only on the occurrence or non occurrence of one or more uncertain future events. For example, an unsettled (at the balance sheet date) law suit against an enterprise may result in an outflow of economic benefits should the courts decide against the enterprise. The future event is the decision of the court.

Users need to be kept informed about matters of uncertainty. Where the outcome of an event is not yet known, but where the outcome may have a material effect on the enterprise then information about the contingency is vital to users.

By disclosing contingencies, users are able to make a better assessment of the effect of possible outcomes and thereby gain a better understanding of the position of the business. The omission of contingencies may render financial statements misleading.

Most countries have issued accounting statements to regulate the disclosure of contingent gains and losses. AC 107, Contingencies and Events Occurring after the Balance Sheet Date, deals with the treatment in financial statements of contingencies and events occurring after the balance sheet date. The events occurring after the balance sheet date side of the statement is considered in Chapter 18. AC 107 and IAS 10, Contingencies and Events Occurring after the Balance Sheet Date, are virtually identical in content and form. Both of these statements are primarily concerned with disclosure. The disclosure requirements of AC 107 are considered in more detail in section 18.4.

18.2 Definitions

AC 107 defines a contingency as "a condition or situation, the ultimate outcome of which, gain or loss, will be confirmed only on the occurrence, or non occurrence of one or more future events" (AC 107 paragraph 2).

Contingencies could result in either a gain or a loss. A contingent gain or contingent loss is therefore defined as "a gain or a loss dependent on the outcome of a contingency" (AC 107 paragraph 3).

Contingencies are restricted to conditions or situations at the reporting date,

the financial effect of which is to be determined by future events which may or may not occur. Therefore, conditions or situations that are usually reflected in provisions in financial statements in accordance with the accounting framework and the four fundamental accounting concepts (AC 101) are also contingencies. Such contingencies are usually provided for in the accounting period in which the related transactions took place. Examples of other contingencies include:

- (a) guarantees and warranties provided in the normal course of business;
- (b) bills which have been discounted with recourse; and
- (c) guarantees given on behalf of third parties (usually group companies).

AC 107 is not concerned with ongoing possibilities that accounting estimates will prove inaccurate (for example, the estimation of the useful lives of fixed assets). Rather, the statement is primarily concerned with once off occurrences which are outside the normal range of accounting estimates. The usual example of a contingency is that of a court case where the uncertainty is resolved when the court's decision has been reached.

18.3 Conceptual Issues

18.3.1 Contingent Liabilities

The recognition of a contingent loss will give rise to a contingent liability being recognised on an enterprise's balance sheet. This link requires careful consideration of the definition of the liability and the related recognition criteria for determining whether a contingent loss should be provided for or not. (A contingent loss could also give rise to the impairment of an asset; the conceptual arguments are the same as those used below in terms of the probability and measurability of reduced inflows of economic benefits.)

In terms of AC 000, a liability is defined as "a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits" (AC 000 paragraph 49). In the case of a court action against the enterprise, should the court case be lost and damages be paid to a third party then clearly there would be an outflow from the enterprise of resources embodying economic benefits. The important factor, therefore, is whether the contingency relates to a **present** obligation of the enterprise that arises from **past events**.

If the court case arose as a result of, for example, a defect in a good supplied by the enterprise which caused losses to a third party, then arguably

there is a present obligation which resulted from a past event; the past event being the selling of the product and the present obligation being the amount of damages that may be paid to the third party. The key to the recognition of a contingent loss and the related contingent liability are the recognition criteria set out in AC 000.

“A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably” (AC 000 paragraph 91). This principle is included in AC 107 (which was issued prior to AC 000) in paragraph 29 which states that the amount of a contingent loss should be provided for by a charge in the income statement if “it is probable that future events will confirm that, after taking into account any related probable recovery, the value of an asset has been impaired or a liability has been incurred at the balance sheet date and a reasonable estimate of the amount of the resulting loss can be made”. The contingent event must be **probable** and the related economic benefit flows (from the enterprise) must be **measurable**.

Therefore, both AC 000 and AC 107 (and IAS 10) are consistent in the accounting treatment for contingent losses.

It is important to note that where a reasonable estimate of the amount of the resulting loss cannot be made then the existence of the contingent loss should be disclosed in the financial statements (AC 107 paragraph 30) even though no provision (or contingent liability) has been made. This is confirmed by AC 000 which states that where a claim cannot be reliably measured then it would not be recognised as a liability but the existence of the claim would be disclosed in the notes or explanatory material. (See AC 000 paragraphs 86 to 88 for further discussion.)

18.3.2 Contingent Assets

A similar argument may be used in the case of contingent gains as was used for contingent losses; i.e. the recognition of a contingent gain will give rise to a contingent asset being recognised in the balance sheet. Such a gain should only be recognised where the contingent asset meets the definition and recognition criteria of an asset.

Using the same arguments as for contingent liabilities, a contingent asset should be recognised when it is probable that the future economic benefits associated with that contingency will flow to the enterprise and the asset has a cost or value that can be measured reliably. However, AC 107 does not allow for the recognition of contingent gains. Instead, the existence of

contingent gains should only be disclosed if it is probable that the gain will be realised i.e. accrual is not made for contingent gains that are probable and can be reliably measured.

Therefore, AC 107 (and IAS 10) apply the fundamental accounting principle of prudence to override the conceptual issues contained in AC 000. The application of the principle of prudence results in the treatment of contingent assets being different from that of contingent liabilities.

18.3.3 Setting off Contingent Gains and Contingent Losses

In certain cases a contingent gain and a contingent loss may be connected. AC 107 provides some guidance on the appropriate accounting treatment.

“A potential loss to an enterprise may be reduced or avoided because a contingent loss is matched by a related counter claim or claim against a third party. In such cases the amount of any provision may be determined after taking into account the probable recovery under the claim” (AC 107 paragraph 12).

This situation would arise where, if a claim **against** the company succeeds, and it is virtually certain that the claim **by** the company will also succeed, then the contingent gain would be set off the contingent loss. This could apply where the likelihood of either claim succeeding was seen as probable, possible or remote; i.e. the test is to assess the certainty surrounding the two opposing claims.

Offsetting is only allowed in the above circumstances as although the likelihood of two claims succeeding may be probable, both claims should stand or fall together before offsetting takes place. Otherwise, a company should accrue for the total amount of the claim against it (the contingent loss) and merely note the likelihood of success of the counter claim or claim against a third party (the contingent gain). It is only where the two contingencies or claims are so closely related that if one happens the other will happen that offsetting is allowed in terms of paragraph 12 of AC 107.

18.3.4 Determination of the Amount of Contingencies

The amount at which a contingency is stated is based on the information that is available at the date on which the financial statements are authorised for issue. Therefore, events occurring after the balance sheet date that indicate that an asset may have been impaired or a liability may have existed at the balance sheet date, are taken into account in identifying contingencies and in determining the amounts at which such contingencies are included in the financial statements.

Contingent losses are only provided for when a reasonable estimate of the amount of the resulting loss can be made. A number of factors should be taken into account by management in estimating the amount of the contingent loss. For example, in the case of a legal claim, management should evaluate at the date on which the financial statements are authorised for issue the opinions of legal experts or other advisers, the experience of the enterprise in similar cases and the experience of other enterprises in similar situations when estimating the amount of the loss.

Where contingent losses are not provided for then disclosure of the amount and financial effect of the contingency should be disclosed (refer section 18.4.2). The amount and the financial effect may often differ; for example, where guarantees of group overdrafts are provided by the holding company then the financial effect is the total guarantee whereas the amount of the overdrafts at the balance sheet date may be considerably less than the total of the guarantees.

If the amount and the financial effect can not be estimated then AC 107 waives the requirement, provided a statement to that effect is given. This is logical as the disclosure of inaccurate estimates may mislead users.

If the uncertainties that create a contingency in respect of individual transactions are common to a large number of similar transactions, then the amount of the contingency need not be individually determined, but may be based on the group of similar transactions. Such contingencies usually relate to warranties for products sold and the estimated uncollectable portion of accounts receivable (i.e. bad debt provisions).

18.4 Financial Statement Presentation

18.4.1 Companies Act

Schedule 4 (paragraph 35) to the Companies Act requires disclosure of particulars of any contingencies not already recognised in the financial statements including details of

- (a) the nature of the contingency;
- (b) the uncertain factors that may affect the future outcome; and
- (c) the estimated amount and its effect before and after taxation.

There is no exception for remoteness given in schedule 4. Accordingly, guarantees and bills discounted with recourse are disclosed even though the likelihood of a loss being incurred may be remote.

18.4.2 AC 107

Where a contingent loss has been provided for by a charge in the income statement then in terms of AC 107 no disclosure is necessary. However, where a contingent loss has not been provided for then the disclosure requirements as set out in schedule 4 should be given unless the possibility of a loss is remote and the disclosure of the existence of a contingent loss would be misleading.

It is clear, therefore, that the disclosure requirements of schedule 4 are more onerous than the disclosure requirements of AC 107 in relation to contingent losses in that schedule 4 requires disclosure of all contingencies not provided for whereas AC 107 does not require disclosure of contingencies where the possibility of a loss is remote.

AC 107 requires disclosure of contingent gains only where it is probable that the gain will be realised.

The following matrix summarises the disclosure requirements of AC 107 for contingent gains and contingent losses:

LIKELIHOOD	CONTINGENT GAIN	CONTINGENT LOSS
Probable	Do not accrue, but note in financial statements.	Accrue, no separate disclosure required.
Possible	Ignore*	Do not accrue, but note in financial statements.
Remote	Ignore*	Ignore*

* Schedule 4 requires note disclosure of these contingencies.

19 Post Balance Sheet Events

19.1 Introduction

Events occurring after the balance sheet date are those events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are authorised for issue (AC 107 paragraph 4). The date on which financial statements are authorised for issue is usually the date on which the financial statements are approved by the board of directors.

The definition of post balance sheet events would appear to include every transaction that a company undertakes during this period. However, AC 107 is concerned with firstly those events that come to light which provide additional information about the financial condition of the enterprise at the balance sheet date, and secondly, events that are indicative of conditions that arose subsequent to the balance sheet date but are relevant to users in assessing the future prospects of the enterprise, even though these events have no effect on the amounts shown in the financial statements.

There are therefore two separate types of post balance sheet events, usually known as adjusting and non adjusting events.

19.2 Post Balance Sheet Events

19.2.1 Adjusting Post Balance Sheet Events

Adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information for determining the amounts relating to conditions existing at the balance sheet date.

The example given in AC 107 (paragraph 20) of an adjusting event is where evidence that a trade accounts receivable is insolvent may be received after the end of the accounting period. This would require that the amount owed by the debtor be written off i.e. the financial statements would be adjusted to reflect the write off of the debtor, but not if the cause of insolvency was, say, a fire in the post balance sheet period. (In the latter case, the condition did not exist at the balance sheet date.)

A further example of an adjusting post balance sheet event occurred quite recently in South Africa when the transition levy of 5% was announced in the 1994 Budget Speech by the Minister of Finance. The announcement was

made in June 1994 that the levy would be charged in respect of financial years ending during the period 1 April 1994 to 31 March 1995. Therefore, a company with, say, a 30 April year end that had not finalised its financial statements for the year ended 30 April 1994 at the time of the Minister's announcement would be required to account for the levy as an adjusting post balance sheet event. The announcement clearly provided additional information for determining the tax liability for the year ended 30 April 1994.

It should be appreciated that if a company with a 31 March year end had not finalised its financial statements at the time of the Minister's announcement then the levy would still give rise to a post balance sheet event. However, this event would be non-adjusting in nature – the levy would not be based on earnings for the year ended 31 March 1994 (the conditions existing at the balance sheet date) but on the earnings for the year ending 31 March 1995. Therefore, the announcement would be treated as a non adjusting post balance sheet event which is discussed further in section 19.2.2.

The UK standard, SSAP 17, provides a list of possible adjusting events. These include:

- fixed assets; the subsequent determination of the purchase price or of the proceeds on sale of assets purchased or sold before the year end;
- stock and work-in-progress; the receipt of proceeds from sales after the balance sheet date or other evidence concerning the net realisable value of stock and the receipt of evidence that the previous estimate of accrued profit on a long term construction contract was materially inaccurate;
- taxation; the receipt of information regarding rates of taxation;
- claims; amounts received or receivable in respect of insurance claims which were in the course of negotiation at the balance sheet date.

AC 107 also requires that any indications about the going concern assumption in relation to the whole or part of the enterprise no longer being appropriate be regarded as an adjusting post balance sheet event.

19.2.2 Non-adjusting Post Balance Sheet Events

If post balance sheet events do not relate to conditions existing at the balance sheet date then adjustments to assets and liabilities are not generally appropriate. Disclosure of these events is usually made if they represent unusual changes to the condition of assets or liabilities at the balance sheet date; for example, the destruction of a major item of plant as a result of a fire after the balance sheet date. Once again, SSAP 17 gives examples of possible non adjusting post balance sheet events. These include:

- mergers and acquisitions;
- issue of shares and debentures;
- purchases and sales of fixed assets and investments;
- losses of fixed assets or stock as a result of catastrophes such as fire or flood;
- opening new trading activities or extending existing trading activities;
- a decline in the value of property and investment held as fixed assets, if it can be demonstrated that the decline occurred after the year end;
- changes in the rate of foreign exchange;
- government action, such as nationalisation;
- strikes and other labour disputes.

There are events which, although they take place after the balance sheet date, are usually reflected in the financial statements because of a statutory requirement. For example, the dividend proposed or declared after the balance sheet date in respect of the period covered by the financial statements.

19.3 Financial Statement Presentation

19.3.1 Companies Act

Schedule 4 (paragraph 72) (b) requires the director's report to deal with any material fact or circumstance which has occurred in the group between the accounting date and the date of the report. This requirement appears to relate only to group financial statements but should as good practice be given in all financial statements.

19.3.2 AC 107

The requirements of AC 107 are that in the case of non adjusting post balance sheet events, the following information should be provided:

- the nature of the event;
- an estimate of the financial effect, both before and after taxation, or a statement that such an estimate cannot be made.

20 Secondary Tax on Companies

20.1 Introduction

A new tax called Secondary Tax on Companies (STC) was introduced during 1993. At the same time, the standard rate of taxation on company and close corporation earnings was reduced. There have been subsequent changes to the rate of STC and corporate taxation as well as the introduction of a "once-off" transition levy. These changes to the corporate tax system have consequential effects on the appropriate accounting treatment for, *inter alia*, deferred taxation, contingencies and extraordinary items. There is no GAAP on accounting for STC – the South African Institute of Chartered Accountants has issued two Accounting Issues Task Force **Opinions**, namely AC 303 and AC 304. Although the primary focus of this book is on GAAP, in the light of the controversy that has surrounded the appropriate accounting treatment for STC, this chapter examines the content and implications of AC 303 and AC 304.

20.1.1 1993 Budget Speech and AC 303

The Minister of Finance announced in his 1993 budget a reduction in the corporate tax rate (applicable to companies and close corporations) from 48% to 40% and a new tax called STC of 15% on distributed income.

STC applies to all dividends declared on or after 17 March 1993 as well as those declared before, but not paid by 17 March 1993. STC is a tax imposed on the company declaring the dividend and not on the shareholder.

The dividend subject to STC is the amount of any dividend declared during the relevant dividend cycle, less dividend income (including foreign sourced dividends) received during that cycle. Each dividend cycle (except the first) commences on the day after the previous one ended and ends on the date on which the next dividend accrues to shareholders.

The Accounting Issues Task Force of the South African Institute of Chartered Accountants issued AC 303 in November 1993 to provide guidance on the appropriate accounting treatment for STC and for the change in the corporate tax rate. In essence, AC 303 suggests the following:

- STC is considered an expense of the company and should be charged against income (that is, included with the tax charge).

- The adjustment to the deferred taxation balance as a result of the decrease in the corporate tax rate should be disclosed either as an extraordinary item or as an adjustment to the tax charge in the income statement.
- Any contingent liability for STC based on undistributed income should be disclosed by way of a note, unless the possibility of future distributions of the undistributed income is remote.

These issues will be considered further in the remainder of this chapter.

20.1.2 1994 Budget Speech and AC 304

The Minister of Finance announced in his 1994 budget a further reduction in the corporate tax rate to 35% (from 40% in 1993) and an increase in the rate of STC from 15% to 25% for dividends declared on or after 22 June 1994. In addition, a once-off transition levy of 5% on companies' and close corporations' taxable income greater than R50 000 was announced for financial years ending between 1 April 1994 and 31 March 1995.

The Accounting Issues Task Force issued AC 304 in July 1994 to provide guidance on the appropriate accounting treatment for the transition levy and the change in the corporate tax rate. In essence, AC 304 suggests the following:

- The transition levy is a tax on the company and should be disclosed as part of the tax charge in the income statement.
- The adjustment to the deferred tax balance as a result of the decrease in the corporate tax rate should be disclosed as an adjustment to the tax charge in the income statement.

These issues will be considered further in the remainder of this chapter.

20.2 Changes in the Tax Rate

20.2.1 Deferred Tax Balance

Reductions in the corporate tax rate give rise to adjustments to deferred tax balances whether provided on the comprehensive or partial basis (refer to section 2.3.1 in chapter 2). The primary accounting issue is one of disclosure; should the adjustment be reflected as an extraordinary item or as part of the tax charge? This issue is considered in section 20.2.2.

The adjustment to the deferred tax balance is likely to result in a credit to the income statement as most companies have deferred tax liabilities on the

balance sheet. Where a company has created a deferred tax asset, however, the reduction in the tax rate gives rise to a charge in the income statement.

Companies that provide for deferred tax on the comprehensive basis often have substantial deferred tax balances and the effect of the change in tax rate gives rise to a significant adjustment to the income statement. For example, each R1m of a credit deferred taxation balance gives rise to the following credits to the income statement:

1993/94	166 667	(1 000 000 × 8/48)
1994/95	125 000	(1 000 000 × 5/40)

20.2.2 Extraordinary Item or Not?

The effect on the deferred tax balance of the change in tax rate could be disclosed in two possible ways; either as part of the tax charge or as an extraordinary item. The debate, to a certain extent, has become academic – AC 103 (see chapter 9) has made extraordinary items largely redundant. Nevertheless, a great deal of debate has centred around this issue. Essentially, the key issue is whether the introduction of STC and the dual tax system constitutes a “fundamental change in the basis of taxation” (AC 102 paragraph 64). If so, then in terms of AC 102, the adjustment to the deferred tax balance should be treated as an extraordinary item. As no guidance is given in AC 102 as to what constitutes a “fundamental change”, most companies have considered their own particular circumstances in determining whether or not the introduction of STC had a fundamental impact on them. During 1993/94, therefore, listed companies disclosed the effect of the rate change either as extraordinary, or as part of the tax charge, depending on their interpretation of the impact of STC. This approach is consistent with the AC 303 opinion.

The further reduction in the corporate tax rate announced in the 1994 budget gives rise to another adjustment to the opening deferred tax balance. The argument above about the appropriate disclosure (i.e. either as extraordinary or as part of the tax charge) remains relevant. AC 304, however, argues that the “narrower definition of extraordinary items now being followed internationally and the general acceptance for this approach by the South African business community” (paragraph 10) requires that the adjustment be disclosed as part of the tax charge. This approach has an unfortunate effect on consistency and comparability; a company might have disclosed the adjustment as extraordinary in 1993 (in accordance with AC 303) and as part of the tax charge in 1994 (in accordance with AC 304). AC 304 recognises this problem and encourages companies that previously treated

the deferred tax adjustment as an extraordinary item to restate the comparative financial information (and treat the adjustment as part of the tax charge).

20.3 STC Disclosure

20.3.1 Expense vs Appropriation

Both AC 303 and AC 304 hold the view that STC should be disclosed as part of the tax charge. STC, therefore, is considered to be an expense of a corporation. Although most companies appear to be disclosing STC as part of their tax charge, there have been exceptions – Pick 'n Pay is a recent example. At issue is whether STC constitutes an expense as defined by AC 000. As discussed in chapter 1, the framework defines expenses as "decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity other than those relating to distributions to equity participants". It is important, therefore, to determine whether STC is a tax on corporations, and hence an expense, or a tax relating to a distribution and hence an appropriation. Certain companies have adapted the latter viewpoint and disclosed STC with the dividend charge on the income statement. In the case of listed companies, this approach has obvious advantages in that the STC charge is excluded from the EPS calculation.

It is worth noting that companies, without current period income, that declare a dividend would reflect a taxation charge despite a zero level of activity. This scenario suggests that STC is a tax on distributions and not merely another tax on the company and should, therefore, be disclosed as an appropriation with dividends. Nevertheless, most companies appear to show STC as part of the tax charge in accordance with AC 303 and AC 304. STC appears, generally, to be regarded as a tax on the company and therefore an expense of that company.

20.3.2 Contingency

In terms of AC 107 (refer chapter 18), a contingent liability exists for STC based on the undistributed income of a corporation. In the case of companies, Schedule 4 requires disclosure of any contingency (however remote) except where disclosure of its existence would be misleading. It is difficult to envisage disclosure of the STC contingency as being misleading so in terms of Schedule 4, all companies should disclose the contingency. AC 107 requires disclosure of possible contingencies and not remote contingencies. The payment of dividends out of retained earnings (or undrawn profits in

the case of a close corporation) may well be remote for most corporations as dividends are generally only paid out of current earnings. If this is the case, AC 107 would not require disclosure of the STC contingency.

If the contingency is disclosed, note that the calculation is based on the applicable tax fraction; i.e. $25/125 \times$ retained earnings. If retained earnings amount to R1m, then the STC contingency is $25/125 \times$ R1m = R200 000. Therefore, a dividend of R800 000 could be declared, with R200 000 STC being payable. It should be noted that revenue reserves earned prior to a year ended no later than 31 March 1993 and capital reserves, whenever earned, are not subject to STC upon liquidation. The contingency of R200 000 in the above example may, therefore, be considerably less should the company be liquidated. This factor makes the STC contingency even more remote in practice.

It should be appreciated from the above discussion that dividend resolutions should specify that the dividend is being distributed out of current profits of a revenue nature and it may be useful to distinguish capital and revenue reserves in a note to the balance sheet – particularly in the case of (Pty) companies. For example, the R1m retained earnings of A (Pty) Ltd could be disclosed as follows (year end **31 January**)

	R'000
Revenue profits – pre 31-01-1993	750
– post 31-01-1993	100
Capital profits	150

The going concern contingency in this case is R200 000 ($R1m \times 25/125$) whereas the "liquidation contingency" is R20 000 ($100\ 000 \times 25/125$). This example illustrates how remote the R200 000 contingency is at this stage. Nevertheless, earnings in periods ending after 31 March 1993 will steadily accumulate and the "liquidation contingency" will grow considerably in years to come – especially if the rate of STC is increased further.

20.3.3 Other Disclosures

The dividend subject to STC is reduced by dividends received during that cycle. It is conceivable that dividends received exceed dividends declared within a cycle with the result that a company pays no STC. The excess dividends received are carried forward to the next dividend cycle as "STC credits".

In this case, AC 303 requires disclosure of the amount of unutilised STC credits carried forward as well as an explanation for the absence of a STC charge for the period.

The disclosure requirements of AC 303 are set out below:

- the amount provided for STC;
- a commentary that will assist in an understanding of factors affecting the charge for STC. Such a commentary would be relevant where the STC charge is a significant component of the total tax charge or where the effective rate of STC varies substantially from the standard rate;
- the amount of unutilised STC credits which arise where dividend income exceeds dividends declared.

(AC 303 paragraph 9)

20.4 The Transition Levy

The once-off transition levy on companies and close corporations is 5% of taxable income after an abatement of R50 000, but before the set-off of any assessed losses carried forward from previous years. The levy is charged on financial years ending during the period 01 April 1994 to 31 March 1995.

20.4.1 Disclosure

The transition levy is regarded as a tax on the company by AC 304 and therefore "should be included in the taxation charge and be separately disclosed" (paragraph 3). The Task Force Opinion rejects the possibility of the levy being disclosed as extraordinary for a number of reasons, but essentially because of the new definition of extraordinary item (refer to chapter 9).

20.5 Post Balance Sheet Events

The transition levy and tax rate changes were announced on 22 June 1994 and apply to years ending during the twelve month period to 31 March 1995. The announcement of the levy, therefore, constitutes a post balance sheet event for companies that had not approved their 1994 financial statements for issue by 22 June 1994. This post balance sheet event was non-adjusting for those companies reporting on year ends up to 31 March 1994 but **adjusting** for those companies reporting year ends on or after 01 April 1994. Refer to chapter 19 for further discussion of post balance sheet events.