GAAP HANDBOOK 1996

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Financial Accounting and Reporting Practice, including Specimen Annual Financial Statements

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First edition, first impression 1996
First edition, second impression 1996

ISBN 0 86981 950 X

Typeset by Pretoria Setters, Pretoria
Printed and bound by Sigma Press (Pty) Ltd, Pretoria
Published by Unisa Press,
University of South Africa,
PO Box 392, 0001 Pretoria

House editor: Sarie Moolman
Cover design: Celéste Burger

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Preface

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

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

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

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

Pretoria
December 1995

The authors

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1 The Accounting Framework

1.1 Introduction

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

1.1.1 The Need for a Framework

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

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

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

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

1.1.2 The South African Framework (AC 000)

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

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

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

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

(a) the objective of financial statements;

(b) the qualitative characteristics that determine the usefulness of information in financial statements;

(c) the definition, recognition and measurement of the elements from which financial statements are constructed; and

(d) the concepts of capital and capital maintenance.

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

1.2 The Objective of Financial Statements

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

- financial position
- performance and
- changes in financial position

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

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

1.2.1 Users and their Information Needs

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

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

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

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

1.2.2 Components of Financial Statements

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

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

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

1.2.3 Underlying Assumptions

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

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

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

1.3 The Qualitative Characteristics of Financial Statements

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

- understandability
- relevance
- reliability and
- comparability.

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

1.3.1 Understandability

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

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

1.3.2 Relevance

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

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

1.3.3 Reliability

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

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

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

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

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

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

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

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

In summary, the reliability characteristic of information implies that:

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

1.3.4 Comparability

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

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

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

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

1.3.5 Constraints

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

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

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

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

1.4 The Elements of Financial Statements

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

1.4.1 Assets

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

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

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

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

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

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

1.4.2 Liabilities

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

1. It embodies a present responsibility to one or more other entities that entails settlement by probable future transfer of economic benefits. These economic benefits could be transferred either through use of the enterprises assets at a specified or determinable date, on occurrence of a specified event, or on demand. Settlement of a liability may occur by the payment of cash, the transfer of assets, the provision of services, the waiving of the creditor's rights, the replacement of that obligation with another obligation, or the conversion of the obligation to equity.

2. The responsibility obligates the enterprise, leaving it little or no discretion to avoid the future sacrifice of economic benefits.

3. The transaction or other event obligating the entity has already happened.

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

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

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

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

1.4.3 Equity

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

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

1.4.4 Income

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

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

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

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

1.4.5 Expenses

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

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

1.5 Recognition Issues

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

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

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

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

1.5.1 Probability of Future Economic Benefits

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

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

1.5.2 Reliability of Measurement

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

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

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

1.6 Measurement Issues

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

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

1.6.1 Historical Cost

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

1.6.2 Current Cost

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

1.6.3 Realisable Value

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

1.6.4 Present Value

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

1.7 Concepts of Capital Maintenance

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

1.7.1 Financial Capital

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

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

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

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

1.7.2 Physical Capital

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

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

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

1.8 Conclusion

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

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

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