# 13 Equity Accounting

## 13.1 Introduction

### 13.1.1 Objective

Under the cost method of accounting for investments, the investor records its investment in the investee at cost. The investor recognises income only to the extent that it receives distributions from the accumulated net profits of the investee arising subsequent to the date of acquisition by the investor. Distributions received in excess of such profits are considered a recovery of investment and are therefore recorded as a reduction in the cost of the investment and not as dividend income.

For example, assume that A Ltd purchased 10% of the equity share capital of B Ltd when the latter's distributable reserves amounted to R100 000. If B Ltd currently has distributable reserves of R150 000, then the post acquisition reserves (from A Ltd's perspective) of B Ltd amount to R50 000. If B Ltd declares a dividend of R60 000 then A Ltd will receive R6 000 in cash. Of this amount, R1 000 represents a return of capital and should be credited to the investment account as follows:

| | | | |
|---|---|---|---|
| Dr | Cash | 6 000 | |
| | Cr Dividend Income | | 5 000 |
| | Cr Investment in B Ltd | | 1 000 |

The cost method is used by holding companies to account in their own financial statements for investments in subsidiaries. Consolidated financial statements combine the underlying assets and liabilities as well as post acquisition profits of the subsidiaries with the holding company's accounts. Consolidated financial statements, however, are only drawn up when control can be exercised over the investee. There are often circumstances where an investor is unable to exercise control but is able to significantly influence the operating and financial policy decisions of an investee. In this case, it is appropriate to account for such investments on a different basis (known as the equity method) to the cost method because the cost method provides no useful information about the underlying assets and liabilities of the investee over which influence can be exercised.

AC 110, Accounting for Investments in Associates and Non-Consolidated Subsidiaries, details the appropriate accounting treatment for investments over which significant influence is exercised. Significant influence is regarded

as ''the ability to participate in the financial and operating policy decisions of the investee, but it is not control or joint control over those policies'' (AC 110 paragraph 7).

Investees over which significant influence can be exercised are known as associates and the objective of accounting for investments in associates is ''to provide users of financial statements with information concerning the investor's interest in the earnings and in the underlying assets and liabilities of the associates'' (AC 110 paragraph 2).

Extending the above example, assume that A Ltd had acquired 30% of B Ltd's equity share capital when the latter's reserves amounted to R100 000. Assume further that the 30% was sufficient to give A Ltd the ability to participate in the financial and operating policy decisions of B Ltd; i.e. significant influence. In the first accounting period post acquisition, B Ltd made R30 000 and paid a dividend of R10 000. A Ltd would equity account for its investment in B Ltd as follows:

| | | | | |
|---|---|---|---|---|
| (i) | Dr | Cash | 3 000 | |
| | Cr | Dividend Income | | 3 000 |
| (ii) | Dr | Investment in B Ltd | 6 000 | |
| | Cr | Income from Associate (NDR) | | 6 000 |

The first journal entry is consistent with the cost method of accounting for investments but the second journal entry accounts for the underlying earnings of the investment in the associate (B Ltd). These earnings are recognised in the income statement and subsequently transferred to a non distributable reserve.

### 13.1.2 Equity Accounting

AC 110 defines an associate as ''an incorporated or unincorporated enterprise in which an investor has long term interests and over which it has the ability to exercise significant influence and which is neither a subsidiary nor a joint venture of the investor'' (AC 110 paragraph 5).

AC 110 uses qualitative criteria for the determination of significant influence. The ability to **participate** in the financial and operating policy decisions of the investee, but not to control or have joint control over those policies is regarded as significant influence by AC 110.

The investor accounts for the significant influence by adjusting the carrying value of the investment that is initially recorded at cost for post acquisition retained equity income (or losses) and other changes in the investee's net assets. The investor, therefore, accounts for its effective interest in the

retained earnings or loss (net of distributions received or accrued) for the accounting period. This share in the retained earnings or loss is transferred to a non distributable reserve.

Significant influence by an investor over an investee may be demonstrated by one or more of the following:

- representation on the board of directors or equivalent governing body of the investee;
- participation in policy making processes;
- material transactions between the investor and investee;
- inter change of managerial personnel; and
- provision of essential technical information.

An investment of 20% or more of the voting power of the investee is presumed to be significant influence unless demonstrated otherwise.

Equity accounting is also appropriate for subsidiaries that are not consolidated into group financial statements.

Proportionate consolidation is not an appropriate accounting treatment for associates as neither control nor joint control is exercised over an associate. Proportionate consolidation is used to account for joint ventures that are jointly controlled entities (refer chapter 14).

### 13.1.3 Exclusions

If the investor is a wholly owned subsidiary of another company incorporated in South Africa then the equity method need not be applied as the investor's holding company will apply the equity method to the investor's associates.

Where the associate is a mining enterprise that uses the appropriation method of accounting then the equity method is not normally used for that associate.

### 13.1.4 Example

In 1901 Holdain Ltd paid R3m for a 30% investment in Alliance Ltd upon the incorporation of the latter. Both groups are listed on the JSE. Extracts from the 1908 consolidated financial statements of the two groups are as follows (R000's):

| | HOLDAIN | ALLIANCE |
|---|---|---|
| Profit on ordinary activities after taxation | 13 200 | 5 000 |
| Outside shareholders | 4 000 | 1 000 |
| Net profit | 9 200 | 4 000 |
| Dividends paid | 4 000 | 1 000 |
| Retained profit for the year | 5 200 | 3 000 |
| Opening retained earnings | 95 000 | 17 000 |
| Closing retained earnings | 100 200 | 20 000 |

Assume that Alliance has no reserves other than retained earnings and its earnings yield (based on 10m R1 shares) at 31 December 1908 was 12,5%.

The effect of equity accounting its investment in Alliance Ltd on Holdain's consolidated financial statements may be summarised as follows:

- Adjust cost of investment and NDR for post acquisition earnings of Alliance up to the start of the current period (i.e. 17 000 × 30% = 5 100) – "retained equity earnings" from prior years.
- Accrue for current year's retained equity earnings (i.e. 3 000 × 30% = 900).
- Transfer current year's retained equity earnings to NDR.
- Ensure separate disclosure of dividends received from Alliance (i.e. 1 000 × 30% = 300).
- Ensure that carrying amount of investment does not exceed fair value.

After equity accounting for Alliance Ltd, extracts from Holdain's consolidated financial statements would be as follows (R000's):

INCOME STATEMENT EXTRACT

| | | |
|---|---|---|
| Profit on ordinary activities after taxation (13 200 – 300 (divs)) | | 12 900 |
| Profit from Associate – Retained Equity Earnings | 900 | |
| Dividends | 300 | 1 200 |
| | | 14 100 |
| Outside shareholders | | 4 000 |
| Net Profit | | 10 100 |
| Dividends Paid | | 4 000 |
| Retained Profit for the year | | 6 100 |
| Transfer to NDR | | (900) |
| Opening retained earnings | | 95 000 |
| Closing retained earnings | | 100 200 |

BALANCE SHEET EXTRACT

| | |
|---|---|
| Non Distributable Reserves | |
| Equity accounted earnings (5 100 + 900) | 6 000 |
| Investment in Associate (3 000 + 5 100 + 900) (disclosed under long term assets) | 9 000 |

NOTES

(i) Dividend income from the associate is often disclosed with other investment income in practice (and not, as above, with Profit from Associate). Either approach is acceptable; the important issue is that separate disclosure is necessary.

(ii) The carrying amount of the investment in associate of R9m is made up of cost (R3m) plus R6m of post acquisition retained equity earnings. (Including where applicable extraordinary items, prior year adjustments and changes in the associate's equity). This carrying amount must be compared to fair value for consideration of any impairment in value that is "other than temporary" (AC 110 paragraph 33). Note that investments in associates must be considered individually for evaluation of impairment in total and not in aggregate. The fair value of the investment in Alliance Ltd may be based on the market price and can be calculated as follows:

EPS = 4 000/10 000 = 40 cents
Earnings Yield = 12,5%
Therefore, price = 40/0,125 = 320 cents

3m shares in Alliance Ltd are ∴ worth R3,2 × 3m = R9,6m.
Therefore, no write down is necessary.

(iii) The market value of R9,6m of the shares in Alliance would have to be disclosed in terms of Schedule 4 (refer section 13.4.2).

The above example illustrates that equity accounting is, in effect, one line consolidation. Holdain reflects its share of the net assets of the associate in one line (investment in associate) on the consolidated balance sheet, rather than the total of the separate assets and liabilities as with subsidiaries. Similarly, Holdain Ltd accounts for its share of the associate's after tax profits, whether or not those profits have been distributed. The amount at which the investment is stated may include goodwill or discount on acquisition.

# 13.2 Conceptual Issues

## 13.2.1 The Objective of Financial Statements

The conceptual framework (AC 000 paragraph 12) states that the objective of financial statements is ''to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions''.

The recognition of profit on the basis only of distributions received may not be an adequate measure of the profit earned by an investor on an investment in an associate because the distributions received may bear little relationship to the performance of the associate. The investor has significant influence over the associate and therefore a measure of responsibility for the associate's performance and the return on its investment. The investor accounts for its stewardship by extending the scope of the cost method of accounting to incorporate its share of the results of an associate and by providing an analysis of earnings and investment. This information provides more informative reporting of the net assets and net profit of the investor and facilitates a more useful calculation of relevant financial ratios.

Disclosure of the existence of significant influence as well as accounting for the underlying reality of that influence provides information about the financial position, performance and changes in financial position of the investor that is useful to a wide range of users in making economic decisions.

## 13.2.2 Recording

Associates are accounted for under the equity method in either:

- the consolidated financial statements of the investor; or
- the investor's own financial statements where consolidated financial statements are not presented.

(AC 110 paragraph 19)

This factor has different implications for recording – adjustments to consolidated financial statements are pro forma adjustments and therefore need to be repeated each year whereas actual journal entries would be processed for the equity accounting adjustments where no consolidated financial statements are prepared. The necessary entries, using the information in section 13.1.4 may be summarised as follows:

(a) *Equity Accounting in Consolidated Financial Statements*

**Pro forma** Journal Entries for 1908 (R000's):

| | DR | CR |
|---|---|---|
| Investment in Associate | 5 100 | |
| NDR | | 5 100 |
| Being recording of prior year retained equity earnings. | | |
| Investment in Associate | 900 | |
| Profit from Associate (Income Statement) | | 900 |
| Being recording of current period retained equity earnings. | | |
| Retained Earnings | 900 | |
| NDR | | 900 |
| Being transfer to NDR of current period retained equity income. | | |

NOTES

(i) Holdain would already have accounted for the R300 of dividend income from Alliance, i.e. Dr Cash; Cr Dividend Income.

(ii) The two entries for the current year's retained earnings could be combined or rearranged; the important point is that two ''legs'' are necessary in order to show the recognition of the associate's profit in the income statement and the transfer of that profit to NDR.

(iii) In 1909, the first **pro forma** journal entry would reflect the cumulative post acquisition retained equity income to 31 December 1908 of R6m, i.e. Dr Investment in Associate; Cr NDR.

(b) *Equity Accounting in the investor's own financial statements*

In this case the cumulative retained equity earnings of R5,1m has already been accounted for by the investor so the only entries required for 1908 are (R000's):

| | DR | CR |
|---|---|---|
| Investment in Associate | 900 | |
| Profit from Associate (Income Statement) | | 900 |
| Being recording of current period retained equity earnings. | | |
| Retained Earnings | 900 | |
| NDR | | 900 |
| Being transfer to NDR of current period retained equity earnings. (This entry would form part of the company's closing entries.) | | |

NOTE

(i) These entries are actually processed in the company's general ledger. Therefore, the entries do not have to be repeated in future years.

## 13.3 Specific Issues

### 13.3.1 Extraordinary and Significant Items

AC 110 requires investors to recognise their share of extraordinary items of the associate from the date of acquisition. The extraordinary items attributable to the investor must be separately disclosed (AC 110 paragraph 37).

From the date of acquisition the investor would also recognise its share of items of income or expense within the associate's profit or loss from ordinary activities that were disclosed due to their relevance relating to the performance of the associate (previously known as abnormal items). However, the investor would not necessarily disclose its share. This is because these items, while they may be material for the associate, may not be material enough to warrant disclosure for the investor. Note that the investor would only be disclosing its share (e.g. 25%) of these items of the associate.

It is submitted that the same argument regarding materiality should be applied to extraordinary items despite a requirement of AC 110 to disclose the investor's attributable share of the investee's extraordinary items.

### 13.3.2 Prior Year Adjustments

Where an associate records a prior year adjustment as a result of a change in accounting policy then the investor must recognise its share of the prior year adjustment of the associate from the date of acquisition and give disclosure of the attributable prior year adjustment in the year in which it arises.

### 13.3.3 Changes in Associate's Equity

Changes in an associate's equity that have not been included in the income statement may arise from time to time. For example, the associate may revalue land and buildings, giving rise to an increase in equity for the revaluation surplus. Such adjustments should be recognised by the investor to the extent that they have not already been taken into account in the investor's original cost of the investment and to the extent to which the investment carrying amount does not exceed fair value.

To illustrate this accounting treatment, assume that a 30% interest in an associate had been purchased for R300 000 on 1 January 1901. At the date of

acquisition the associate's land and buildings were considered undervalued by R100 000. On 1 January 1904 the carrying amount of the investment in the associate was R450 000 and the associate decided to revalue land and buildings by R250 000. This revaluation should be recognised by the investor to the extent that it was not taken into account at acquisition. Therefore, 30% of R150 000 (R250 000 – R100 000) or R45 000 should be accounted for as:

| | | | |
|---|---|---|---|
| Dr | Investment in associate | 45 000 | |
| | Cr Non distributable reserve | | 45 000 |

The total carrying amount of the investment is now R495 000 and should be checked against the fair value of the 30% share of the associate. If the associate had one million shares in issue at 1 January 1904 then the share price (assuming fair value) should be at least R4,95 otherwise the revaluation of land and buildings should only have been recognised to the extent that the carrying value did not exceed the fair value of the investment in the associate.

### 13.3.4 Goodwill

The amount of goodwill or discount on acquisition is not separately recognised when equity accounted.

Any goodwill or discount on acquisition is included in the investor's cost of investment and is only taken into account when determining the profit or loss on disposal of a portion or whole of the investment in the associate.

For example, a 30% investment may have been purchased for R1,1m when the underlying fair net asset value was only R1m. The difference of R100 000 represents goodwill, but it is not described as such when equity accounting. Instead the cost of investment is R1,1m and post acquisition income is recognised in the usual way. When sold, the profit or loss on sale will be the difference between the carrying amount of the investment and the proceeds.

This approach is different to that envisaged by IAS 28 which requires amortisation of the difference between the cost of the investment and the investor's share of the fair values of the net identifiable assets (IAS 28 paragraph 14).

### 13.3.5 Coterminous Year Ends

Often the financial year end of an associate will differ from that of an investor. The most recent available audited financial statements of associates

should be used by the investor for purposes of equity accounting. It is permisshpible to use unaudited information in the interests of timeous disclosure where the most recent available audited financial statements are for a period ended more than six months prior to the investor's year end. This is subject to a requirement that the results have been made publicly available and that the investor is satisfied as to their reliability (AC 110 paragraph 24).

Any difference in reporting dates (i.e. non coterminous year ends) must be disclosed as well as the date up to which the associate's results have been incorporated. This requirement is considered in more detail in section 13.4.

When financial statements with a different financial year end are used, adjustments should be made for the effect of any significant events or transactions between the investor and the associate that occur between the date of the associate's financial statements and the date of the investor's financial statements.

### 13.3.6 Intragroup Transactions

Where intragroup transactions are carried out on an arm's length basis then AC 110 does not require adjustment for the elimination of unrealised profits arising from the intragroup transactions. Where, however, intragroup transactions are clearly not at an arm's length basis then unrealised profits or losses would be eliminated in the same way as the elimination of unrealised profits and losses in consolidated financial statements.

It is also not normally considered appropriate for the investor to adjust for differences between the investor's and the associate's accounting policies.

### 13.3.7 Associate's Losses

The recognition of an investor's share of losses of an associate results in a decrease in the carrying amount. Where the investor's share of losses equals or exceeds the carrying amount of its investment, then the investor should discontinue including its share of further losses unless guarantees are in place by the investor. This treatment is similar to that which applies where a holding company accounts for its investment on the cost basis.

Once the investment has been written off to nil or a nominal amount then the investor will cease using the equity method unless it has incurred obligations or made payments on behalf of the associate to satisfy obligations of the associate that the investor has guaranteed or otherwise committed, in which case provision must be made for additional losses. If the associate

subsequently reports profits then the investor should resume applying the equity method only after its share of net profit equals the share of net losses not recognised during the period where the equity method was not being used.

Disclosure should be given of the aggregate of equity profits and losses and not just the net equity earnings. This is detailed in section 13.4.

### 13.3.8 Acquisitions and Disposals

An investee may qualify as an associate for the first time due to the purchase of additional shares or the gaining of significant influence by the investor. This would give rise to an investment that was previously accounted for on the cost basis now being accounted for on the equity basis. The investor is entitled to take credit for post acquisition retained equity earnings or deficit which accrued while the investee was accounted for on the cost basis. This retained equity earnings or deficit is accounted for by adjusting the carrying value of the investment and the non distributable reserve. There is therefore no effect on the income statement for the post acquisition earnings attributable to the investor up until the time that the investee becomes an associate.

From the time that the investment is classified as an associate then the equity method is applied in the normal way.

For example, assume that H Ltd acquired 10% of A Ltd upon incorporation of the latter and a further 15% on 1 January 1903 when A Ltd's reserves amounted to R200 000. The cost of H Ltd's investments were R10 000 and R45 000 respectively. H Ltd will commence equity accounting for its investment in A Ltd from 1 January 1903 – the date from which it has significant influence from its 25% holding. H Ltd is entitled to take credit for the post acquisition increase in reserves since incorporation of A Ltd to January 1903 relating to the original 10% investment. This amounts to R20 000 (R200 000 × 10%) and is accounted for as follows:

| | | | |
|---|---|---|---|
| Dr | Investment in Associate | 20 000 | |
| | Cr NDR | | 20 000 |

The total of the investment in associate is now stated at R75 000 (10 000 + 45 000 + 20 000) which equates to 25% of A Ltd's equity (R100 000 share capital and R200 000 reserves). From 1 January 1903, the 25% holding is equity accounted in the normal way.

Disposals and partial disposals are accounted for in the same way as in consolidated financial statements. The profit or loss on disposal of the investment in the associate is the difference between the proceeds received and the carrying amount for equity accounting purposes. The difference, therefore, between the profit recognised on the equity basis and the profit recognised on the cost basis will be the post acquisition retained earnings or deficit that has been taken into account by the investor in relation to that portion of its investment in the associate that it is disposing of. Previously accounted for retained equity earnings should be transferred from NDR to retained earnings.

Using the same details as the above example, assume that H Ltd sold its 25% investment in A Ltd for R100 000 on 1 January 1904 when A Ltd's reserves amounted to R250 000. In H Ltd's financial statements, a profit of R45 000 will be recorded (R100 000 proceeds less R55 000 cost of investment). In H Ltd's consolidated financial statements, however, the investment in A Ltd would have been equity accounted and the carrying value will amount to R87 500 (10 000 cost + 20 000 post acquisition profits relating to 10% holding + 45 000 cost + 12 500 post acquisition profits relating to 25% holding ((250 000 − 200 000) × 25%)). In addition, a NDR of R32 500 would be included in H Ltd's consolidated balance sheet, being the total of post acquisition income relating to the 25% holding. Upon sale of the investment, a profit of R12 500 (R100 000 − R87 500) will be shown in the consolidated income statement. In addition, a transfer of R32 500 will be made from NDR to retained earnings. The total credit to retained earnings amounts, therefore, to R45 000 (12 500 + 32 500), the same as the profit recognised on the cost basis.

Circumstances may arise whereby the use of the equity method is no longer appropriate. AC 110 (paragraph 31) identifies the following circumstances:

- the investee ceases to meet the definition of an associate but the investor retains, either in whole or in part, its investment;
- the associate operates under severe long term restrictions that significantly impair its ability to transfer funds to the investor;
- a decision has been made to dispose of the investment in the associate.

Under either of these circumstances, the investment continues to be stated at the carrying amount established under the equity method at the date that the circumstance arose. Thereafter, the investment is accounted for on the cost basis.

### 13.3.9 Dilution in Holding

If it is probable that future changes in the associate's equity will have the effect of diluting the investor's interest in the associate (for example a rights issue by the associate in which the investor does not take up its proportion of the rights) then it is appropriate for the investor to quantify and account for the effect of the dilution. In other words, if an investor has a 30% holding in an associate and this percentage is expected to decrease to 27% in the first few months of the next financial period then it is appropriate for the investor to only equity account for the 27% anticipated holding. Full disclosure of any potential dilutions should be given.

## 13.4 Financial Statement Presentation

### 13.4.1 Accounting Policy

An appropriate accounting policy note is as follows:

> Associate companies are those companies in which long term investments are held and over which the group has the power to exercise significant influence over the financial and operating policies. The group's share of post acquisition results of associates are included in the consolidated income statement using the equity method and are transferred to non distributable reserves.

### 13.4.2 Companies Act

Schedule 4 to the Companies Act defines an "associated company" (paragraph 4(c)) and "retained equity income or deficit of an associated company" (paragraph 4(x)). These definitions are similar to those incorporated in AC 110.

The following disclosure requirements of schedule 4 are applicable to investments in associates:

| | |
|---|---|
| Paragraph 26(2)(a) | The market value in respect of investments in listed associates. |
| Paragraph 26(2)(b) | The aggregate of the director's valuation of the associates that are unlisted investments. |
| Paragraph 27 | Details concerning the names of associates and the shareholdings. |
| Paragraph 42(a) | Income from unlisted associates. |
| Paragraph 42(m) | Dividend income, retained equity income or deficit, extraordinary items and prior year adjustments relating to associates. |

### 13.4.3 AC 110

The following disclosure requirements of AC 110 apply to all investments in associates:

- the investor's income statement (or notes) should separately reflect for its investments in associates:
  - retained equity income or deficit,
  - distributions received or accrued (ie dividends),
  - share of extraordinary items and/or prior year adjustments, and
  - gain/loss on disposal of shares in associate by investor;
- transfer to NDR of retained equity income, attributable extraordinary items and prior year adjustments;
- investments in associates disclosed as a separate item in the balance sheet under long term assets;
- details of and reasons for any associates not accounted for using the equity method; and
- total market value of listed investments in associates and the total directors' valuation of unlisted investments in associates.

Additional disclosure is required where the year ends of the investor and the associate are not coterminous:

- the accounting periods for which the financial statements of the associates have been prepared; and
- the amount relating to any significant unadjusted transactions or events accruing between the dates of the associate's and investor's financial statements.

Where an investment in an associate is significant to the results of operations and/or the financial position of the investor, the following items should be disclosed for those associates:

- the name, the nature of business, the proportion owned, and the proportion of voting power held of the associate;
- the carrying value of the investment in the associate;
- the gross amounts of loans to *and* from the associate by the investor;

- the investor's share of current year and cumulative retained equity income or deficit of the associate; and
- summarised financial information in regard to assets, liabilities and the results of operations of the associate.

### 13.4.4 IAS 28

The disclosure requirements of AC 110 are more comprehensive than those included in IAS 28.

Therefore, compliance with AC 110 ensures compliance with IAS 28. The only significant point of departure between IAS 28 and AC 110 relates to the separate identification and amortisation of goodwill at acquisition (required by IAS 28 but not separately identified or amortised in terms of AC 110). Refer section 13.3.4 for further discussion.

# 14 Joint Ventures

## 14.1 Introduction

### 14.1.1 Joint Ventures

The degree of influence that an investor exercises over an investee may vary from no influence at all to outright control. Generally speaking, the accounting literature identifies four different types of influence, namely control, joint control, significant influence and no influence. Once an investee is classified under one of these four headings then the appropriate accounting treatment is as follows:

| | |
|---|---|
| Control | – Consolidate |
| Joint control | – Proportionate consolidation |
| Significant influence | – Equity account |
| No influence | – Cost basis. |

This chapter is concerned with the appropriate accounting treatment for when an investor exercises joint control over an investee.

Where joint control exists, there is usually a joint venture. AC 119, Accounting for Interests in Joint Ventures, defines a joint venture as ''a contractual arrangement whereby two or more venturers undertake an economic activity which is subject to joint control'' (AC 119 paragraph 3). Joint ventures have in the past been a popular form of off balance sheet financing and it is only recently (1993) that an accounting statement was issued to prescribe the appropriate accounting treatment for joint ventures. AC 119 is effective for periods beginning on or after 1 January 1993 and prescribes the proportionate consolidation method of accounting for joint ventures that are jointly controlled entities.

AC 119 identifies three different types of joint ventures – jointly controlled operations, jointly controlled assets and jointly controlled entities. Jointly controlled operations and jointly controlled assets are relatively easy to account for as the objectives of AC 119 are met without preparing separate financial statements. In the case of a jointly controlled entity, however, the venturer's share of the venturer's assets, liabilities, income, expenses and cash flows is incorporated into the venturer's consolidated financial statements. (Refer to section 14.2.1 for further discussion.)

There are two characteristics that are common to all joint ventures; (i) two or more venturers must be bound by a contractual arrangement and (ii) the contractual arrangement should, in effect, establish joint control.

### 14.1.2 Joint Control

Joint control is "the contractually agreed sharing of control over a joint venture by two or more venturers such that not one of the venturers is in a position to exercise unilateral control over the joint venture" (AC 119 paragraph 5). The existence of a contractual arrangement is a necessary condition for joint control and therefore joint ventures. It follows that activities not governed by a contractual arrangement to establish joint control are not joint ventures but may be situations of control, significant influence or no influence and involve consolidation, equity accounting or cost basis accounting respectively.

A contractual arrangement will normally be in writing and deal with matters such as the activity, duration and reporting obligations of the joint venture, the manner in which the venture is to be directed and administered, the capital contributions by the venturers, and the sharing by the venturers of the results of the joint venture.

The contractual arrangement may be an actual contract between the venturers or minutes of discussions between the venturers. Alternatively, it may be incorporated into the articles or other by-laws of the joint venture. The contractual arrangement may identify one venturer as the operator or manager of the joint venture but this one venturer should in no way be able to unilaterally control the joint venture and should be obliged to act within the terms of the contractual arrangement. If the operator has the power to unilaterally govern the financial and operating policies of the economic activity then control is exercised and the venture should be accounted for as a subsidiary by the operator.

## 14.2 Conceptual Issues

### 14.2.1 Proportionate Consolidation

AC 119 states that the objective of the statement is to prescribe the accounting treatment for interests in joint ventures. The statement requires "the reporting of joint venture assets, liabilities, income, expenses and cash flows in the financial statements of venturers and investors, regardless of the structures or forms under which the joint venture activities take place" (AC 119 paragraph 2).

The objective of AC 119 is readily achieved by the form of two of the three different types of joint ventures, namely jointly controlled operations and jointly controlled assets. Jointly controlled operations involve the use of the

assets and other resources of the venturers rather than the establishment of an enterprise that is separate from the venturers themselves. This means that each venturer uses its own property, plant and equipment and carries its own stock as well as incurs its own expenses and liabilities. The nature of a jointly controlled operation is such that each venturer includes in its accounting records the assets that it controls and the liabilities that it incurs, the expenses that it incurs and its share of the income that it earns from the sale of goods or services by the joint venture, and the cash flows generated or utilised. For this reason joint ventures that are jointly controlled operations are included in the venturer's own financial statements and, where applicable, in its consolidated financial statements. Because these results are already included in the financial statements and the consolidated financial statements, no adjustments or other consolidation procedures are necessary.

An example of a jointly controlled operation is where two or more venturers combine their operations, resources and expertise in order to develop and market, say, jet aircraft. Different stages of the development process may be carried out by each of the venturers and each venturer bears its own costs and takes its share of the revenue generated by the sale of the jet aircraft. A contractual agreement sets out the conditions and agreed sharing of benefits relating to the joint venture.

Other joint ventures may involve joint control, and often joint ownership, of one or more assets contributed to or acquired for the purposes of a joint venture. These assets are used to obtain benefits for the venturers and each venturer may take a share of the output from the assets and bear an agreed share of the expenses incurred. An example of a jointly controlled asset may be an oil pipeline, or land and buildings whereby each venturer takes a share of the rents received and bears a share of the expenses. Because these joint ventures do not involve the establishment of an enterprise that is separate from the venturers themselves, the venturer's share of the jointly controlled assets, classified according to the nature of the assets rather than as an investment, is included in its financial statements and where applicable in its consolidated financial statements. For these reasons, no adjustments or other consolidation procedures are required for joint ventures that are jointly controlled assets.

The third type of joint venture identified by AC 119, a jointly controlled entity, gives rise to certain accounting problems. A jointly controlled entity is a joint venture which is conducted through a company, partnership or other entity in which each venturer has an interest. The entity usually operates in the same way as other enterprises, except that a contractual

arrangement exists between the investors which establishes joint control over the economic activity of the separate entity. Many jointly controlled entities are similar in nature to joint ventures that are jointly controlled operations or jointly controlled assets. Frequently jointly controlled assets or jointly controlled operations are transferred into a jointly controlled entity for taxation or legal reasons. Each venturer usually contributes cash or other resources to the jointly controlled entity. These contributions are recognised in the venturer's financial statements as an investment in a jointly controlled entity. In order to ensure consistency with the accounting treatment of jointly controlled operations and jointly controlled assets, it is necessary to incorporate the assets, liabilities, income, expenses and cash flows of the joint venture with the joint venturer's financial statements. This incorporation is achieved using the proportionate consolidation method which AC 119 defines as ''a method of accounting and reporting whereby a venture's share of each of the assets, liabilities, income, expenses and cash flows of a jointly controlled entity is combined on a line by line basis with similar items in the venturer's financial statements'' (AC 119 paragraph 7). The application of the proportionate consolidation method, therefore, achieves the same results for a jointly controlled entity as if the joint venture was carried out through either jointly controlled operations or jointly controlled assets.

The overriding concern of AC 119 is that joint ventures are accounted for consistently and that the existence of joint ventures is readily identifiable from financial statements. Therefore, the assets, liabilities, income, expenses and cash flows associated with joint ventures should be separately identified and, regardless of the form that a joint venture takes, the investor's share of the assets, liabilities, income and expenses and cash flows of the joint venture should be incorporated on a line by line basis in the joint venturer's financial statements or, where applicable, the joint venturer's consolidated financial statements. These requirements are assessed below in relation to AC 000, The Framework for the Preparation and Presentation of Financial Statements, and in particular, the objective of financial statements.

### 14.2.2 Objective of Financial Statements

Paragraph 12 of AC 000 states that ''the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions''. It is argued that by combining the assets, liabilities, income, expenses and cash flows of a joint venture with the venturer's financial statements, users are assisted in their assessment

of the potential income or loss resulting from the involvement in the joint venture, and in their understanding of the manner in which assets, liabilities and cash flows are utilised and exposed to risk (AC 119 paragraph 1). Before this argument may be challenged it is necessary to examine whether the assets, liabilities and income statement items of a joint venture meet the definitions of the elements of financial statements given in AC 000.

AC 000 defines an asset as a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise (paragraph 49). It is clear therefore that an asset must be controlled by an enterprise prior to recognition. In the case of a joint venture, outright control is not exercised over the underlying assets. However, joint control is assumed to imply sufficient control for purposes of meeting the definition of an asset in terms of AC 000. A similar argument applies to the liabilities and income statement components.

A venturer that invests in jointly controlled operations or jointly controlled assets will almost always have direct control (albeit partial) over the underlying operations and assets. In a jointly controlled entity, the venturer has joint control over its share of future economic benefits through its share of the assets and liabilities of the venture. AC 119 argues that ''the substance and economic reality is reflected in the consolidated financial statements of the venturer when the venturer reports its interests in the assets, liabilities, income, expenses and cash flows of the jointly controlled entity by using the proportionate consolidation method'' (AC 119 paragraph 27).

Although the use of the proportionate consolidation method may be justified in terms of AC 000, it has been criticised on the basis that wholly controlled assets are combined with jointly controlled assets on the consolidated balance sheet. The combination of assets that are owned outright with only partly owned assets is potentially misleading to users of financial statements. AC 119 overcomes this criticism by requiring both proportionate consolidation and disaggregation, i.e. AC 119 requires disclosure of the underlying assets, liabilities, income, expenses and cash flows of joint ventures that have been incorporated into the joint venturer's financial statements. This disclosure requirement is considered further in section 14.4.3.

In line with providing only useful information to users, if a venturer ceases to have joint control over a jointly controlled entity, it should discontinue the use of proportionate consolidation from the date of losing joint control (AC 119 paragraph 31). In addition, where an interest in a jointly controlled entity is held with a view to disposal in the near future, or where it operates under severe long term restrictions impairing its ability to transfer funds

to the venturer, the proportionate consolidation method should not be used and the interest should be accounted for as an investment (AC 119 paragraph 32).

## 14.3 Specific Issues

### 14.3.1 Equity Accounting

The proportionate consolidation method of accounting for interests in jointly controlled entities is not universally accepted. IAS 31, for example, permits, but does not recommend, the equity accounting method for investments in jointly controlled entities. AC 119 rejects the equity method because ''proportionate consolidation better reflects the substance and economic reality of a venturer's interest in a jointly controlled entity'' (AC 119 paragraph 29).

However, AC 119 recognises that there may be exceptional circumstances where, ''while the form of the agreement or structure may indicate the existence of joint control, the intention and substance underlying the creation of such a structure makes it inappropriate to apply the proportionate consolidation method'' (AC 119 paragraph 30). AC 119 gives an example of these exceptional circumstances, namely where a voting pool agreement is used in order to bind the interests of investors having significant influence and joint control was never envisaged but may arise as a result of the voting pool agreement. There has been some criticism of the fact that AC 119, in effect, allows use of only the proportionate consolidation method but the arguments for proportionate consolidation over equity accounting carry more weight when the principles of AC 000 are taken into account.

### 14.3.2 Application of Proportionate Consolidation

The basic procedures involved in proportionate consolidation require that the consolidated balance sheet of the venturer includes its share of the assets that it controls jointly and its share of the liabilities for which it is jointly responsible in the jointly controlled entity and that the consolidated income statement and cash flow statement of the venturer include its share of the related items.

Proportionate consolidation is achieved by the venturer combining its share of each of the assets, liabilities, income, expenses and cash flows of the jointly controlled entity with the similar items in its financial statements on a line by line basis. For example, the venturer combines its share of the jointly controlled entity's debtors with its debtors in the consolidated balance sheet

and its share of the jointly controlled entity's taxation expense with its taxation expense in the consolidated income statement.

As the name suggests, proportionate consolidation takes place in consolidated financial statements. Where a joint venturer has no subsidiaries and consolidated financial statements are not prepared, then separate proportionately consolidated financial statements should be prepared.

Assets or liabilities should not be offset unless a legal right of set off exists and the offsetting represents the expectation as to the realisation of the asset or the settlement of the liability.

Goodwill is accounted for in the normal way when any difference between the cost of acquisitions and the venturer's share of the net identifiable assets is recognised. Note that if at acquisition certain assets of the joint venture are considered to be undervalued then an adjustment to the valuation of the assets should be made for the purposes of proportionately consolidating.

The accounting policies of the jointly controlled entity and the venturer should be the same where possible. ''If it is not practicable to use uniform accounting policies in preparing the financial statements, that fact is disclosed together with an estimate of the effect or significance thereof in the consolidated financial statements in which different accounting policies have been applied'' (AC 119 paragraph 37).

The application of the proportionate consolidation method is not without its technical difficulties; transactions between a venturer and a joint venture often result in complicated accounting adjustments. Generally speaking, the joint venturer can recognise a profit on sale of an asset or an item of stock to a joint venture to the extent of the profit attributable to the interests of the other venturers. Therefore, where a venturer contributes or sells an asset to a jointly controlled entity at a profit then the venturer should recognise in its consolidated financial statements only that portion of the profit attributable to the interests of the other venturers. This process takes into account that although the asset is retained by the jointly controlled entity, the significant risks and rewards of ownership have been passed to the jointly controlled entity and the joint venturer shares only in its contractually agreed portion of the jointly controlled entity.

Where, however, transactions between a venturer and a jointly controlled entity occur at a loss to the venturer then the full amount of any loss should be recognised by the venturer in its consolidated financial statements. This takes into account that the transfer or the sale of an asset to the joint venture

at a loss to the venturer is indicative of a reduction in the net realisable value of the asset transferred and, unless this decline was temporary, the loss would have been recognised by the venturer in any event.

A similar, but opposite, accounting treatment applies when a venturer purchases assets from a jointly controlled entity. The jointly controlled entity recognises a profit or loss on sale of the asset but the venturer does not recognise its share of the profits in the jointly controlled entity until it resells the assets to an independent party or until they are otherwise realised. The venturer recognises its share of the losses immediately when they represent a reduction in the net realisable value of current assets or a decline, other than temporary, in the carrying amount of long term assets.

Where a loan is made to a jointly controlled entity by a venturer then the interest received on such a loan is recognised in the venturer's own financial statements but is only brought to account in the consolidated financial statements to the extent of the other venturer's share of such loans and interest received. In effect, the venturer's share is eliminated.

The example below illustrates the accounting treatment for inter-company transactions and inter-company loans in the case of a jointly controlled entity that is proportionately consolidated.

**Example**

Vineyard Ltd has an equal share with three other partners in a joint venture, Apricot (Pty) Ltd, for which it paid R500 000 upon incorporation of Apricot. Vineyard Ltd lent R500 000 at 12% per annum to Apricot on 1 January 1903 and purchased stock of R200 000 (at a 25% mark up on cost) from Apricot during 1903. Stock purchased from Apricot amounted to R50 000 in Vineyard's books at 31 December 1903 (1902: NIL). Summarised financial statements are set out below:

INCOME STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 1903

| | VINEYARD R'000 | APRICOT R'000 |
|---|---|---|
| Gross revenue | 23 000 | 4 500 |
| Operating Profit | 2 140 | 674 |
| Interest received/(paid) | 160 | (60) |
| Profit on ordinary activities before taxation | 2 300 | 614 |
| Taxation – SA normal | 920 | 244 |
| Profit on ordinary activities after taxation | 1 380 | 370 |
| Dividends paid | 600 | 180 |
| Retained profit for the year | 780 | 190 |
| Opening retained earnings | 9 000 | 400 |
| Closing retained earnings | 9 780 | 590 |

BALANCE SHEETS AT 31 DECEMBER

| | VINEYARD R'000 | APRICOT R'000 |
|---|---|---|
| Share Capital | 5 000 | 2 000 |
| Retained Earnings | 9 780 | 590 |
| Long term loans | 1 000 | 500 |
| | 15 780 | 3 090 |
| Fixed Assets | 10 000 | 2 000 |
| Investment in Joint Venture | 1 000 | – |
| Stock | 2 500 | 700 |
| Debtors | 3 000 | 600 |
| Cash | 1 500 | 60 |
| Creditors (2 220) | (270) | |
| | 15 780 | 3 090 |

The starting point for proportionate consolidation is to calculate Vineyard's share (25% of Apricot's income and expenses) after having adjusted for transactions between the two companies. Note that sales of R200 000 that relate to Vineyard have been included in Apricot's gross revenue, and that included in Apricot's operating profit is an unrealised profit of R10 000 (R50 000 – (R50 000/1,25)) arising from the sale of stock to Vineyard that is still on hand at 31 December 1903. Taking into account these adjustments, Vineyard's share of Apricot's income and expenses is as follows:

| | R'000 |
|---|---|
| Gross revenue (4 500 – 200) × 25% | 1 075 |
| Operating Profit (674 – 10) × 25% | 166 |
| Interest paid (60 × 25%) | 15 |
| Profit on ordinary activities before taxation | 151 |
| Taxation (244 × 25%) | 61 |
| Profit on ordinary activities after taxation | 90 |
| Dividends (180 × 25%) | 45 |
| Retained profit for the year | 45 |
| Opening retained earnings (400 × 25%) | 100 |
| Closing retained earnings | 145 |

Before drafting the consolidated financial statements, it is necessary to note the following about Vineyard's summarised financial statements:

- Included in operating profit is a dividend of R45 000 received from Apricot.
- Included in interest received is R60 000 from Apricot; only the other venturer's share of this (i.e. 75%) may be recognised by Vineyard. This is automatically achieved by taking into account 25% of the interest paid (i.e. R15 000) when proportionately consolidating Apricot.

- Included in the investment in the joint venture account is the cost of R500 000 (eliminated when consolidating) and the loan of R500 000 to Apricot. 25% of the loan is effectively to itself, so only 75% may be recognised i.e. R375 000 in the consolidated financial statements.
- Included in Vineyard's stock is an unrealised profit of R10 000 relating to the inter-company sale of stock. Vineyard's share (25%) may not be recognised (see paragraph 39 of AC 119) and, therefore, R2 500 is eliminated. This adjustment must, however, be processed against **Apricot**'s stock balance when preparing the disclosure note about the group's interests in the joint venture. This ensures that the note disclosure balances – this is discussed further below with the relevant disclosures for the example.

The above adjustments result in the following summarised consolidated financial statements:

CONSOLIDATED INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 1903

| | R'000 |
|---|---|
| Gross Revenue (23 000 + 1 075) | 24 075 |
| Operating Profit (2 140 – 4 + 166) | 2 261 |
| Interest received (160 – 15) | 145 |
| Profit on ordinary activities before taxation | 2 406 |
| Taxation – SA Normal (920 + 61) | 981 |
| Profit on ordinary activities after taxation | 1 425 |
| Dividends paid | 600 |
| Retained profit for the year | 825 |
| Opening retained earnings (9 000 + 100) | 9 100 |
| Closing retained earnings | 9 925 |

CONSOLIDATED BALANCE SHEET AT 31 DECEMBER 1903

| | R'000 |
|---|---|
| Share Capital | 5 000 |
| Retained Earnings | 9 925 |
| Long term loans | 1 000 |
| | 15 925 |
| Fixed Assets (10 000 + 2 000 × 25%) | 10 500 |
| Loan to Joint Venture (500 × 75%) | 375 |
| Stock (2 500 – 2,5 + 700 × 25%) | 2 672,5 |
| Debtors (3 000 + 600 × 25%) | 3 150 |
| Cash (1 500 + 60 × 25%) | 1 515 |
| Creditors (2 220 + 270 × 25%) | (2 287,5) |
| | 15 925 |

Apart from disclosing details of any contingencies or commitments relating to the joint venturer and the other venturers (refer to section 14.4.3) the venturer should disclose the following notes:

## (i) Analysis of Retained Earnings

| | R'000 |
|---|---|
| Retained Earnings relating to – the company | 9 780 |
| – joint venture | 145 |
| Consolidated Retained earnings | 9 925 |

## (ii) Joint Venture

The consolidated results include the following amounts relating to the group's interest in a joint venture:

| | R'000 |
|---|---|
| Gross revenue | 1 075 |
| Profit on ordinary activities before taxation | 151 |
| Taxation | 61 |
| Profit on ordinary activities after taxation | 90 |
| Share of retained earnings – current year | 45 |
| – prior years | 100 |
| | 145 |
| Fixed Assets (2 000 × 25%) | 500 |
| Net Current Assets ((700 + 600 + 60 – 270 – 10*) × 25%) | 270 |
| Long term Liabilities (500 × 25%) | (125) |
| | 645 |
| Comprising: | |
| Cost of Investment | 500 |
| Share of Retained Earnings | 145 |

* The unrealised profit of R2 500 (R10 000 × 25%) relates to stock that is carried on Vineyard's balance sheet. Strictly speaking, therefore, the R2 500 reduction in stock should be against Vineyard's stock and not Apricot's stock. However, the related income statement debit (reversal of unrealised profit) of R2 500 is against Apricot's income. Therefore, in order for this note disclosure to balance, the reduction in stock has to be shown against Apricot's stock balance. Note that in the consolidated financial statements this discussion is not relevant as the stock figures of Apricot (25%) and Vineyard are combined.

Note that the procedure for proportionate consolidation has a different starting point to consolidation where control is exercised. In the latter, the starting point is usually the aggregated trial balances of group companies and these balances are then adjusted by pro-forma journal entries. In the case

of proportionate consolidation, it is more appropriate to start with the venturer's financial statements (or consolidated financial statements, if applicable) and to make adjustments for its share of the joint venture's balances. Pro-forma journal entries would not normally be used when proportionately consolidating as the workings are easily done on a simple worksheet. However, it is relatively straight forward to use pro-forma journal entries and two methods are illustrated for the above example, depending on the starting point:

(a) Pro-Forma Journal Entries to proportionately consolidate Apricot, starting with the trial balance of Vineyard only.

| | R'000 | |
|---|---|---|
| | DR | CR |
| (i) Investment in Joint Venture | 45 | |
| Taxation | 61 | |
| Interest Received | 15 | |
| Operating Profit (Dividends Received) | 45 | |
| Operating Profit (from Joint Venture) | | 166 |
| Being recognition of current year share of JV's income and expenses. | | |
| (ii) Investment in Joint Venture | 100 | |
| Retained Earnings | | 100 |
| Being recognition of prior year's share of JV's retained earnings. | | |
| (iii) Fixed Assets | 500 | |
| Stock ((700 − 10) × 25%) | 172,5 | |
| Debtors | 150 | |
| Cash | 15 | |
| Creditors | | 67,5 |
| Investment in Joint Venture | | 645 |
| Loan to Joint Venture | | 125 |
| Being elimination of Investment in Joint Venture against proportionate share of JV's assets and liabilities. | | |
| (iv) Loan to Joint Venture | 500 | |
| Investment in Joint Venture | | 500 |
| Being reclassification of loan to JV from investment account to loan account. | | |

(b) Pro-Forma Journal Entries to proportionately consolidate Apricot, starting with an aggregated trial balance that consists of Vineyard's trial balance combined with 25% of Apricot's balances.

| | | | |
|---|---|---|---|
| (i) | Share Capital | 500 | |
| | Inv in JV | | 500 |
| | Being elimination of equity at acquisition against the investment account | | |
| (ii) | Operating Profit | 2,5 | |
| | Stock | | 2,5 |
| | Being adjustment for the unrealised profit in closing stock | | |
| (iii) | Long term loan | 125 | |
| | Inv in JV | | 125 |
| | Being elimination of the Inter-co loan | | |
| (iv) | Loan to JV | 375 | |
| | Inv in JV | | 375 |
| | Being reclassification of loan to JV from investment account to loan account | | |
| (v) | Interest Rec | 15 | |
| | Interest Paid | | 15 |
| | Being elimination of inter-co interest | | |
| (vi) | Operating Profit (Dividends Received) | 45 | |
| | Dividends Paid | | 45 |
| | Being elimination of inter-co dividends | | |

## 14.4 Financial Statement Presentation

### 14.4.1 Accounting Policy

Appropriate wording for an accounting policy is as follows:

> The results of the group's investments in joint ventures that are jointly controlled entities are accounted for by the proportionate consolidation method and the group's attributable share of the joint venture's revenue, expenditure, assets, liabilities and cash flows is included in the consolidated financial statements. Profits on transactions between the group and its joint ventures are recognised only to the extent of the profit attributable to the interests of the other venturers.

### 14.4.2 Companies Act

Joint ventures are not defined in the Companies Act and therefore Schedule 4 does not have any disclosure requirements for joint ventures. It should be noted, however, that paragraph 5 of Schedule 4 refers to the application of generally accepted accounting practice and it follows that the disclosure requirements and accounting treatment as laid down by AC 119 apply to all companies in terms of the Companies Act.

### 14.4.3 AC 119

AC 119 has a number of disclosure requirements, the more important of which relate to contingencies and commitments:

Paragraph 56 A venturer should disclose the nature and aggregate amounts of the following contingencies:

- contingencies affecting the venturer as a result of its interests in a joint venture and its share of each of its contingencies which have arisen jointly with other venturers;
- its share of the contingencies of a joint venture itself for which it is contingently liable; and
- those contingencies that arise because the venturer is contingently liable for the liabilities of the other venturers of a joint venture.

Paragraph 57 A venturer should disclose the aggregate amount of the following commitments:

- any capital commitments of the venturer in relation to its interests in joint ventures and its share of the capital commitments that have been incurred jointly with other venturers; and
- its share of the capital commitments of the joint ventures themselves.

The remaining disclosure requirements of AC 119 are as follows:

- Analysis of retained earnings and other reserves in the consolidated financial statements between reserves of the venturer and its subsidiaries and reserves from the joint venture.
- Any significant information relating to the joint venture that is not reflected in the balance sheet or income statement of the venturer.
- A listing and description of all significant joint ventures and the proportion of ownership interest held in jointly controlled entities.
- The aggregate amount of current assets, long term assets, current liabilities, long term liabilities, income, expenses and cash flows related to jointly controlled entities that have been proportionately consolidated (where these are significant to the results of operations, the financial position or the cash flows of the venturer. This disclosure could also be given individually for each joint venture, i.e. not only in aggregate).

The latter disclosure is particularly applicable where preparers and users are concerned that the combination of wholly controlled assets and liabilities

with jointly controlled assets and liabilities is misleading. This disclosure enables users to remove the proportionately consolidated results to arrive at the financial position and results of the joint venturer without the joint venture.

### 14.4.4 IAS 31

The disclosure requirements of AC 119 are virtually identical to the requirements of IAS 31 and the only point of departure between the two documents is that IAS 31 sanctions the use of the equity method when accounting for interests in jointly controlled entities. AC 119 only allows the equity method to be used in exceptional circumstances (refer section 14.3.1).

# 15 Cash Flow Statements

## 15.1 Introduction

### 15.1.1 Cash Flow Information

Financial reporting has traditionally developed on a historical cost basis with particular emphasis on accrual accounting, but there is growing acceptance that historical cash flow information is a useful indicator of the amount, timing and certainty of future cash flows. The weaknesses of the accrual based historical cost method of reporting earnings is to some extent overcome by the disclosure of cash flow information. AC 118 deals with the presentation of cash flow information in financial statements. The Accounting Practices Committee issued an exposure draft (ED 101) based on IAS 7 (revised). The release of the exposure draft is part of the South African Institute of Chartered Accountants' harmonisation programme. ED 101 is likely to replace AC 118 during 1996. There are a number of differences between AC 118 and ED 101; these differences will be examined throughout this chapter.

The high rates of inflation recently experienced in South Africa frequently gave rise to significant increases in working capital (particularly receivables and inventories) which were not always matched by corresponding increases in accounts payable. An increased working capital balance does not provide cash; rather it represents net income not yet received in cash. AC 118 and ED 100 attempt to identify cash flow from operations by taking into account the net movement in working capital components, i.e. the net income for the period is adjusted for the net investment in working capital to arrive at a cash flow as opposed to an income from operations. Cash flow from operations is an important source of cash for an enterprise and ''in the long term, a satisfactory return on capital, the maintenance of a sound capital base and prospects for expansion come from a healthy cash flow from operations'' (AC 118 paragraph 16).

A feature of AC 118 is its starting point; cash flow from operations is arrived at by adjusting net income before tax for non fund flow items and working capital movements. This is known as the indirect method. An alternative approach (the direct method) arrives at cash flow from operations by grouping together the major classes of gross cash receipts and gross cash payments, such as receipts from customers and payments to suppliers. ED 101 allows use of either the direct method or the indirect method, but favours the former because the ''direct method provides information which may be

useful in estimating future cash flows and which is not available under the indirect method'' (paragraph 20).

In terms of AC 118, net cash flow from operations is separately disclosed and reconciled to the net cash flows from investing and financing activities that have taken place during the accounting period; these investing and financing activities are normally determinable from the movements in balance sheet elements during the accounting period. ED 101 however reconciles the net cash flows from operating, investing and financing activities with the net increase in cash and cash equivalents. In both AC 118 and ED 101, cash flows arising from interest, dividends and taxation are disclosed under operating activities. The following table illustrates the difference in format between AC 118 and ED 100:

| *AC 118 Categories* | *ED 100 Categories* |
|---|---|
| *Cash generated/utilised by operating activities* | *Cash flows from operating activities (incorporating cash flows from returns on investments and servicing of finance and taxation paid)* |
| *+/–* | |
| *Cash utilised/generated by investing activities* | |
| | *+/–* |
| *=* | *Cash flows from investing activities* |
| | *+/–* |
| *Net financing raised/repaid* | *Cash flows from financing activities* |
| | *=* |
| | *Net movement in cash and cash equivalents* |

Note that ED 101 reconciles cash flows to the net movement in cash balances for the year whereas AC 118 includes this movement in the net financing raised category.

The objective of a cash flow statement is ''to provide users of financial statements with information concerning the source and use of all financial resources during the period: in particular details of cash generated or utilised by operations, investing activities and financing activities'' (AC 118 paragraph 3).

The objective of a cash flow statement is, according to ED 101 (pargraph 01), ''to provide users of financial statements with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash flows''.

### 15.1.2 Definitions

Cash is defined by AC 118 and ED 101 as cash on hand and demand deposits. Cash equivalents are short term, highly liquid investments that are readily convertible to a known amount of cash. For example, money market instruments would be regarded as a cash equivalent. Cash flows are inflows and outflows of cash and cash equivalents.

Operating activity cash flows are generally the cash effects of transactions and other events that enter in to the determination of income while investing activity cash flows are those cash flows relating to the acquisition and disposal of fixed assets and investments. The third category of cash flows, financing activities, arises from changes in the size and composition of the debt and capital funding of the reporting entity.

## 15.2 Conceptual Issues

### 15.2.1 Objective of Financial Statements

''The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions'' (AC 000 paragraph 12).

Cash flow information, when used in conjunction with the rest of the financial statements, provides information that enables users to evaluate the changes in net assets of an enterprise, its financial structure and its ability to respond to changing circumstances and opportunities.

A cash flow statement is useful in assessing the ability of an enterprise to generate cash and enables users to develop models for assessment and comparison of the forecast future cash flows of different enterprises. In addition, comparability of operating performance by different enterprises is enhanced because cash flow information eliminates the effects of using different accounting treatments for the same transactions and events. For example, two similar companies may use different accounting treatments for deferred tax; one company may be on the partial method while the other may be using the comprehensive method. These companies would both report different earnings figures but their choice of deferred tax policy has no effect on their cash flows.

Historical cash flow information is often used by various user groups as an indicator of the amount, timing and certainty of future cash flows. It is also useful in checking the accuracy of past assessment of future cash flows and

in examining the relationship between profitability and net cash flow as well as the impact of changing prices. Cash flow statements also highlight the liquidity and working capital management of an enterprise. This enables users to be better informed about management performance during the accounting period.

### 15.2.2 Direct Method

There are two methods for drawing up a cash flow statement; the direct method and the indirect method. The AC 118 cash flow statement is based on the indirect method, whereby net operating income for the period is adjusted for the effects of transactions of a non cash nature, deferrals or accruals of past or future operating cash flows and items of income or expense associated with investing or financing activities. The indirect method involves a direct articulation between profit per the income statement and balance sheet movements during the accounting period. The direct method, however, uses the cash book and not the income statement as its starting point. The direct method, favoured by ED 101, involves major classes of gross cash receipts and gross cash payments being disclosed. Although application of both the direct method and, the indirect method results in substantially the same cash flow statement, the starting point is fundamentally different. This is illustrated in section 15.3.

The appendix to ED 101 includes a detailed example that considers the mechanics of drafting a cash flow statement on both the direct and indirect method. The example used in the remainder of this chapter illustrates the format of the AC 118 and the ED 101 cash flow statement rather than the mechanics of drafting the statements. Readers are referred to the appendix of ED 101 for an example that includes the mechanics of drafting a cash flow statement.

## 15.3 Specific Issues

### 15.3.1 Operating Activities

As noted above in section 15.1.1, the starting point of a cash flow statement is cash generated from operations. This cash effectively represents the difference between cash received during the period from customers and cash paid during the period for goods and services used in operations plus/minus cash flows from returns on investments and servicing of finance minus taxation paid. Examples of cash flows from operating activities are:

- cash receipts from the sale of goods and the rendering of services;

- cash receipts from royalties, fees, commissions and other revenue;
- cash payments to suppliers for goods and services;
- cash payments to and on behalf of employees;
- cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits;
- cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities;
- cash receipts and payments from contracts held for dealing or trading purposes.

Where the indirect method is used, cash generated by operations is usually calculated by adjusting operating income before tax for items which do not involve the movement of cash. For example, depreciation, provisions and unrealised exchange differences. In addition, the amount of cash utilised to finance an increase in working capital (inventories, debtors and creditors) is disclosed on the face of the cash flow statement as an adjustment against cash generated by operations. This separate disclosure of the investment in working capital (or the amount of cash derived from the reduction in working capital) highlights the importance of working capital management and enables users to assess the extent to which income generated has been tied up in increased working capital.

When calculating the adjustment to cash generated by operations for any investment in working capital, it is important to separately identify amounts that relate to investing activities and not operating activities. For example, any amount owing in respect of the disposal of fixed assets in debtors should be excluded from the working capital calculation and reflected as a short term financing activity.

Where the direct method is used, cash generated by operations is usually obtained from the accounting records of the enterprise and consists of gross receipts from customers less cash payments to, *inter alia*, suppliers and employees.

Note that, in terms of AC 118, income from investments forms part of cash generated by operating activities and is disclosed separately because of its nature. ED 101 includes income from investments also with cash flows from operating activities but distinguishes between interest received and dividends received. In terms of AC 118, finance costs, taxation and dividends are included with operating activities. The cash amount of interest, tax and dividends actually paid during the accounting period are disclosed separately

on the face of the cash flow statement. These three items effectively show the extent to which the cash generated by operations has been used to pay taxation, interest, and dividends during the accounting period. Although interest paid and dividends paid are classified as operating activities because they enter into the determination of net profit retained for the period, they could also be classified as financing cash flows because these are costs of obtaining financial resources. This approach is sanctioned by IAS 7 (revised) but AC 118 expresses a clear preference for these items to be disclosed as operating activities (AC 118 paragraph 21).

The AC 118 format of the operating activities' section of the cash flow statement is disclosed in the following hierarchy:

| OPERATING ACTIVITIES | NOTES | 1902 R'000 | 1901 R'000 |
|---|---|---|---|
| Cash generated by operations | 1 | 2 360 | 2 170 |
| Investment income | | 225 | 116 |
| Utilised to increase working capital | 2 | (649) | (407) |
| Cash generated by operating activities | | 1 936 | 1 879 |
| Finance costs | | (380) | (364) |
| Taxation paid | 3 | (482) | (352) |
| Cash available from operating activities | | 1 074 | 1 163 |
| Dividends paid | 4 | (384) | (456) |
| **Cash retained from operating activities** | | 690 | 707 |

NOTES

| | | |
|---|---|---|
| 1. **Cash generated by operations** | | |
| Operating income before interest & taxation | 2 069 | 1 793 |
| Adjusted for – Depreciation | 556 | 483 |
| – Profit/loss on disposal of fixed assets | (40) | 10 |
| – Investment income | (225) | (116) |
| | 2 360 | 2 170 |
| 2. **Utilised to increase working capital** | | |
| Increase in inventories | 391 | 287 |
| Increase in debtors | 437 | 314 |
| Increase in creditors | (179) | (194) |
| | 649 | 407 |
| 3. **Taxation paid** | | |
| Amount unpaid at beginning of year | 284 | 93 |
| Amount charged to income statement | 456 | 543 |
| Amount unpaid at end of year | (258) | (284) |
| | 482 | 352 |
| 4. **Dividends paid** | | |
| Amount unpaid at beginning of year | 184 | 190 |
| Amount charged to income statement | 400 | 450 |
| Amount unpaid at end of year | (200) | (184) |
| | 384 | 456 |

The ED 101 format of the operating activities section is as follows (note that this example is based on the direct method and comparatives have been ignored):

| | NOTES | 1902<br>R'000 |
|---|---|---|
| **Cash flows from operating activities** | | |
| Cash receipts from customers | | 29 311 |
| Cash paid to suppliers and employees | | (27 600) |
| Cash generated from operations | 1 | 1 711 |
| Interest received | | 120 |
| Interest paid | | (500) |
| Dividends received | | 225 |
| Dividends paid | | (384) |
| Normal tax paid | | (457) |
| Secondary tax on companies paid | | (25) |
| Net cash inflow from operating activities | | 690 |

NOTE

1. **Reconciliation of net profit before taxation to cash generated from operations.**

| | |
|---|---|
| Net profit before taxation | 1 689 |
| Adjustments for: | |
| Depreciation | 556 |
| Profit on disposal of fixed assets | (40) |
| Investment income | (225) |
| Net interest expense | 380 |
| Operating profit before working capital changes | 2 360 |
| Working Capital changes: | (649) |
| Increase in inventories | (391) |
| Increase in debtors | (437) |
| Increase in creditors | 179 |
| Cash generated from operations | 1 711 |

## 15.3.2 Investing Activities

Cash flows from investing activities are separately disclosed because it is important to show the extent to which cash expenditures have been made for resources intended to generate future income and cash flows. Examples of investing activity cash flows are as follows:

- cash payments to acquire fixed assets;
- cash receipts from the sales of fixed assets;

- cash payments to acquire equity or debt instruments of other enterprises, and interests in joint ventures;
- cash receipts from the sales of equity or debt instruments of other enterprises, and interests in joint ventures;
- cash advances and loans made to other parties;
- cash receipts from the repayment of advances and loans made to other parties;
- cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and
- cash receipts from futures contrcts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

In addition to the disclosure of all direct cash payments and cash receipts into and out of the enterprise during the period relating to investing activities, AC 118 requires disclosure of flows of cash which increase or decrease fixed assets or other investments regardless of the form of acquisition. For example, where an enterprise acquires an asset under a finance lease, then AC 118 requires disclosure under investing activities in the cash flow statement of the acquisition of the asset. This is contrary to the actual cash flow effect on the enterprise which consists only of the lease instalment paid under the finance lease during the accounting period. Similarly ''where an enterprise has issued its shares in order to acquire an interest in another enterprise, fair presentation requires that the issue of shares be disclosed under financing activities and the acquisition of the interest in the other enterprise as an investing activity'' (AC 118 paragraph 23).

AC 118 therefore specifically recognises the concept of substance over form in that fair presentation overrides disclosure of the actual cash flow. This approach ensures that the cash flow statement articulates correctly with the movement in balance sheet components apparent from the balance sheet, i.e. a finance lease capitalised during the accounting period would be shown as an acquisition of an asset and the acquisition of a liability on the cash flow statement.

This approach is not sanctioned by ED 101 which requires that the cash effect of such transactions be disclosed in the cash flow statement, i.e. a lease instalment under a finance lease would be shown as in part a payment of interest and in part a repayment of a lease liability. ED 101 adopts a pure

cash flow approach whereas AC 118 adopts an all financial resource approach. Nevertheless, ED 101 requires information about a non-cash transaction to be disclosed in a note to the cash flow statement. A share exchange, therefore, would not be shown on the cash flow statement, but note disclosure would reflect information about the transaction. An example of such a note is "during the period additional share capital was issued in exchange for 1 000 shares in A Ltd". This type of disclosure enables users to understand the movements in components of the balance sheet during the period.

Cash flows involving investing activities should be distinguished between those that relate to the maintenance of operating capacity and cash flows that are associated with the expansion of operating capacity. For example, the acquisition of a fixed asset might involve the maintenance only of a company's operating capacity, i.e. it is replacing a fixed asset whereas a cash flow associated with the acquisition of a fixed asset not previously used by the enterprise would involve an expansion of its operating capacity. These cash flows should be distinguished wherever possible and "the deduction for that expenditure which maintains present operating capacity is shown before the investment of cash in the expansion of the operations" (AC 118 paragraph 27).

Cash flows that maintain the present operating capacity may be disclosed under cash generated by operating activities where management believes it would be more meaningful due to the fact that fixed asset replacements are carried out on a consistent basis. This is seldom done in practice.

The following is an illustration of the disclosure of investing activity cash flows in accordance with AC 118 (note that this section of the cash flow statement follows directly after operating activities).

| INVESTING ACTIVITIES | NOTES | 1902 R'000 | 1901 R'000 |
|---|---|---|---|
| Investment to maintain operations | | | |
| Replacement of fixed assets | 5 | (232) | (150) |
| Proceeds on disposal of fixed assets | 6 | 160 | 60 |
| | | (72) | (90) |
| Investment to expand operations | | | |
| Additions to fixed assets | 7 | (339) | (98) |
| Purchase of subsidiary | 8 | (477) | (308) |
| | | (816) | (406) |
| **Cash utilised in investing activities** | | (888) | (496) |

NOTES

| | | |
|---|---|---|
| **5. Replacement of fixed assets** | | |
| Plant and machinery | 190 | 110 |
| Vehicles | 30 | 28 |
| Office equipment | 12 | 12 |
| | 232 | 150 |
| **6. Proceeds on disposal of fixed assets** | | |
| Book value of assets disposed | 120 | 70 |
| Profit/loss on disposal | 40 | (10) |
| | 160 | 60 |
| **7. Additions to fixed assets** | | |
| Plant and Machinery | 149 | 98 |
| Land and Buildings | 190 | – |
| | 339 | 98 |
| **8. Purchase of subsidiary** | | |
| Assets acquired – Fixed Assets | 330 | 200 |
| – Working Capital | 72 | 58 |
| – Investments | 20 | – |
| | 422 | 258 |
| Premium paid on acquisition (goodwill) | 55 | 50 |
| | 477 | 308 |

Note that at this stage, the cash flow statement shows net cash generated by operating activities of R690 000 (1901: R707 000) [see section 15.3.1] and cash utilised by investing activities of R888 000 (1901: R496 000). The net cash required (1901: surplus) during the year was, therefore, R198 000 (690 000 – 888 000). The 1901 surplus was R211 000 (707 000 – 496 000). The net effect of this cash deficit and surplus for the two years is identified in the financing activities section of the cash flow statement which is considered in section 15.3.3.

The ED 101 format of the investing activities, assuming that all transactions were cash based, is as follows for 1902:

| | NOTES | 1902 R'000 |
|---|---|---|
| **Cash flows from investing activities** | | |
| Purchase of property, plant and equipment | | (571) |
| Replacement of property, plant and equipment | | (232) |
| Additions to property, plant and equipment | | (339) |
| Proceeds from sale of equipment | | 160 |
| Acquisition of subsidiary, net of cash acquired | 2 | (477) |
| Net cash outflow from investing activities | | (888) |

NOTE

2. **Acquisition of subsidiary**

During the year the group acquired subsidiary X. The fair value of assets acquired and liabilities assumed were as follows:

| | (R'000) |
|---|---|
| Inventories | 50 |
| Debtors | 42 |
| Property, plant and equipment | 330 |
| Creditors | (20) |
| Investments | 20 |
| Premium paid on Acquisition | 55 |
| Total purchase price | 477 |

The following points should be noted about the ED 101 format:

(a) The net assets of a subsidiary acquired for cash are separately disclosed in a note to the cash flow statement. It is important for the *net* cash flow to be shown on the face of the cash flow statement, i.e. if a subsidiary whose only asset was cash of R100 was acquired for R100 then no net cash flow arises and note disclosure only of the acquisition would be given.

(b) If a subsidiary had been acquired by the issue of shares then no cash flow would be reported on the face of the cash flow statement; rather a note indicating the assets acquired and the mechanism for settling the purchase price is disclosed under a heading ''Non-cash investing and financing activities''. A similar note is required to show assets acquired under finance lease agreements.

## 15.3.3 Financing Activities

The separate disclosure of the cash effects of financing activities enables users to predict claims on future cash flows by providers of capital to the enterprise. Cash flows arising from financing activities include the cash proceeds from issuing shares, cash payments to redeem shares, cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other borrowings, and cash repayments of amounts borrowed. In addition, cash payments by a lessee to settle the capital element of outstanding finance lease obligations is a financing activity cash flow. Note that, in terms of AC 118, the commencement of a finance lease gives rise to ''cash proceeds from borrowings'' (matched by an acquisition of an asset for a similar amount under investing activities) despite the lack of associated cash flows. In contrast, no cash flow

is reported in terms of ED 101 upon commencement of the finance lease, while the lease payments will be split between the interest payment (returns on investments and servicing of finance) and the capital element of the repayments (financing activities).

AC 118 includes movements in cash and cash equivalents with financing activities whereas ED 101 reconciles to net movements in cash and cash equivalents. An example of the AC 118 format for financing activities follows:

| FINANCING ACTIVITIES | NOTES | 1902 R'000 | 1901 R'000 |
|---|---|---|---|
| Decrease in long term borrowings | 9 | (110) | (40) |
| Increase/(Decrease) in short term borrowings | 10 | 58 | (171) |
| Proceeds of rights issue | 11 | 250 | – |
| **Cash generated/(utilised)** | | 198 | (211) |

NOTES

| | | |
|---|---|---|
| 9. **Decrease in long term borrowings** | | |
| Loans raised | 200 | 485 |
| Loans repaid | (310) | (525) |
| | (110) | (40) |
| 10. **Increase/Decrease in short term borrowings** | | |
| Net increase in short term borrowings | 98 | – |
| Increase in cash on hand | (40) | (171) |
| | 58 | (171) |
| 11. **Proceeds of rights issue** | | |
| 100 000 ordinary shares % R2,60/share | 260 | – |
| Costs of issue | (10) | – |
| | 250 | – |

The ED 101 format of financing activities is as follows for 1902:

| | 1902 R'000 |
|---|---|
| **Cash flows from financing activities** | |
| Proceeds from rights issue | 250 |
| Proceeds from long term borrowings | 200 |
| Proceeds from short term borrowings | 98 |
| Repayment of long term borrowings | (310) |
| Net cash inflow from financing activities | 238 |
| **Net increase in cash and cash equivalents (690 – 888 + 238)** | 40* |

* This net increase should be reconciled to the balance sheet movement in cash and cash equivalent balances.

The overall cash flow statements can be summarised as follows for 1902 (all figures R'000):

| *AC 118* | | *ED 100* | |
|---|---|---|---|
| Cash generated by operating activities | 690 | Cash inflow from operating activities | 690 |
| Cash utilised by investing activities | (888) | Cash outflow from investing activities | (888) |
| Net financing raised | 198 | Cash inflow from financing activities | 238 |
| | | Net increase in cash and cash equivalents | 40 |

## 15.3.4 Consolidated Financial Statements

Where consolidated financial statements are prepared, then a consolidated statement of cash flow information is presented.

When preparing a consolidated cash flow statement cognisance is taken of the entity concept and total group cash flows are recognised, i.e. without deducting the outside shareholders' interests in the underlying cash flows. Flows of cash between the group (i.e. the entity) and outside owners are disclosed separately. This situation arises where partly owned subsidiaries declare dividends to the outside shareholders in the group and where there are changes in the capital of a subsidiary that involve flows of cash between the outside shareholders and the group.

Note that a consolidated cash flow statement, like a consolidated income statement or balance sheet, only deals with transactions that are external to the group. The consolidated cash flow statement can either be prepared by combining the separate cash flow statements of each group company or by using the consolidated income statement and balance sheet. The second approach is common practice among South African groups as the elimination of intra-group transactions has already been performed.

Where an enterprise reports its interest in a jointly controlled entity using proportionate consolidation then its consolidated cash flow statement includes its proportionate share of the jointly controlled entity's cash flows.

When an enterprise acquires a subsidiary then it acquires control over various assets and liabilities that are used to generate future revenue. In the enterprise's own cash flow statement this transaction is shown as an acquisition of shares under investing activities. In the consolidated cash flow

statement, the cost of the investment is shown as a single line item and the note to the statement provides details of the assets and liabilities acquired, distinguishing between cash, working capital and other assets and liabilities. Similarly, disposals of investments in subsidiaries involve the recognition of the sales proceeds as a cash flow shown under investing activities and any profit or loss on disposal is excluded from the cash generated from operating activities (this profit or loss on disposal is a non fund flow that would be adjusted against operating income when arriving at cash generated by operating activities). The notes to the cash flow statement would disclose information about the underlying assets and liabilities that were disposed.

The relevant disclosure for the acquisition of a subsidiary was shown in section 15.3.2.

The separate disclosure of the cash flow effects of acquisitions and disposals of subsidiaries as single line items, together with separate disclosure of the amounts of assets and liabilities acquired or disposed of, helps to distinguish those cash flows from the cash flows arising from the other operating, investing and financing activities of the enterprise.

An acquisition of a subsidiary during the accounting period, therefore, complicates the preparation of the group cash flow statement. Since the acquisition of the subsidiary is accounted for as a single entry, many of the movements in the balance sheet components for the accounting period cannot be calculated solely by comparing the balance sheets. For example, the movement in working capital components will no longer be the net movement in the balance sheet for the period as a result of the acquisition during the year of the subsidiary.

The movement should be calculated on the following basis, using debtors as an example:

| | R000's |
|---|---|
| Closing balance of debtors | 1 000 |
| Less: Opening balance of debtors | (700) |
| Total Movement | 300 |
| Debtors acquired through subsidiary | (100) |
| Net movement in debtors | 200 |

The implication is that the only part of the debtors movement attributable to the new subsidiary is the change in the debtor value from acquisition to the year end, i.e. movements in the subsidiary's working capital are only reflected in the group cash flow statement after acquisition of the subsidiary.

Similar adjustments must be made to all other items appearing in the cash flow statement.

A similar situation arises on the disposal of a subsidiary in that the movement in working capital items consists of two parts:

- the movement from the previous reporting date to the disposal date including the subsidiary and
- the movement from the date of disposal to the current balance sheet date excluding the subsidiary.

A similar calculation is performed for all working capital items as well as any other assets or liabilities relating to the subsidiary disposed of.

### 15.3.5 Value Added Taxation

AC 118 is silent about the appropriate treatment of Value Added Tax (VAT) in the case of cash flow statements. The cash flows of an entity include VAT where appropriate and therefore the various elements of the cash flow statement should include VAT. However, this approach does not take into account the fact that VAT is normally a short term timing differences as far as the entity's overall cash flows are concerned and the inclusion of VAT in the cash flows may distort the allocation of cash flows to the standard components of the cash flow statement. This approach means that the amounts attributable to VAT included in trade debtors and creditors need not be eliminated in showing the movement in the balance over the period, and the actual reporting date balances of debtors and creditors may be used to record the net movement in working capital. This is the approach sanctioned by the UK statement FRS 1 and with no specific guidance given by AC 118 is the usual practice of South African companies.

ED 101 only refers to VAT in paragraph 27 (c) where it states that the cash receipts and payments of value added tax may be reported on a net basis.

### 15.3.6 Extraordinary Items

Cash flows associated with an extraordinary item should be classified under either operating, investing or financing activities and separately disclosed. This enables users to understand the nature and effect of the extraordinary item on the present and future cash flows of the enterprise.

### 15.3.7 Foreign Currency Cash Flows

In terms of ED 101 (paragraph 32), the cash flows of a foreign subsidiary should be translated at the exchange rate ruling on the date of the cash flows.

As with the translation of income statement items, an average rate that approximates the actual rate may be used. It is not permissable to use the exchange rate ruling at the balance sheet date.

Cash flows arising from transactions in a foreign currency (ED 101 paragraph 31) should be translated at the exchange rate ruling at the date of the cash flow. An average rate that approximates the actual rate may be used. The treatment of foreign currency transactions is not as complex as it might appear; if the transaction has been settled during the period then the amount of cash that has changed hands must appear in the cash flow statement. In the case of operating activities, this happens automatically – the transaction is recorded at the transaction date (at year end this amount is either inventory or cost of sales) and the exchange difference on settlement is included in operating profit, hence the net cash paid is ''picked up'' in operating activities.

In the case of a transaction that does not form part of operating activities, the exchange difference will usually have to be eliminated from the cash flow from operating activities. For example, if a company imports an item of plant for R100 000, but by the time of payment, it pays R110 000 for the plant. The exchange loss in operating profit will have to be eliminated (''added back'') when calculating the cash flow from operating activities. The amount that will then appear under investing activities will be R110 000.

Exchange differences may arise on cash and cash equivalents denominated in a foreign currency. In terms of ED 101, these differences should appear as a reconciling item in the analysis of changes in the balance of cash and cash equivalents. Unrealised gains and losses arising from changes in foreign currency exchange rates are not cash flows.

## 15.4 Financial Statement Presentation

### 15.4.1 Companies Act

Schedule 4 to the Companies Act defines both financing activities and investing activities but not operating activities. (This is relatively consistent with AC 118 where operating activities are defined as all activities other than investing and financing activities (AC 118 paragraph 7).) The Schedule 4 definitions (paragraph 4(o) and 4(s) are virtually identical to the AC 118 definitions for financing activities and investing activities. The requirements of schedule 4 for cash flow information are as follows:

Paragraph 49 Comparatives should be given except in the case of the first statement of cash flow information.

Paragraph 50 Cash flow statement should disclose:
(a) cash generated by operations;
(b) investment income;
(c) changes to non cash components of working capital (i.e. stock, debtors and creditors);
(d) cash effects of finance costs and taxation;
(e) cash effects of dividends paid;
(f) cash effects of investing activities; and
(g) cash effects of financing activities.

(Note that the (a) to (e) requirements all relate to operating activities cash flows.)

Paragraph 51 A reconciliation between operating income shown on the income statement and cash generated by operations on the cash flow statement (i.e. the non cash items that have been removed from operating income in order to arrive at cash from operations).

### 15.4.2 AC 118

The disclosure requirements of AC 118 incorporate all of the Schedule 4 requirements as well as:

- gross amounts of borrowings raised and repaid, or settled, during the period should be disclosed where **appropriate and practicable**;
- cash effects of capital transactions with owners;
- financing activities between outside shareholders and the group.

AC 118 includes an appendix with a specimen cash flow statement that illustrates the required format, and in particular the correct hierarchy of the cash flows. This appendix was used as the basis for the examples of disclosure shown in sections 15.3.1, 15.3.2, and 15.3.3 of this chapter.

### 15.4.3 ED 101

ED 101 requires certain disclosures over and above those of AC 118.

ED 101 requires disclosure, together with a commentary by management, of cash and cash equivalent balances that are technically not available for use by the group, for example cash balances held by a foreign subsidiary operating under exchange control restrictions.

In addition, the following disclosures are encouraged:

- undrawn borrowing faculties, indicating any restrictions on the use thereof;
- aggregate amounts of cash flows from each of operating activities, investing and financing activities related to interests in joint ventures; and
- the amount of the cash flows arising from the operating activities, investing and financing activities of each reported industry and geographical segment.