Institute of Chartered Accountants of New Zealand

FINANCIAL REPORTING STANDARD NO. 7
1994

EXTRAORDINARY ITEMS AND FUNDAMENTAL ERRORS

Issued by the Financial Reporting Standards Board of the Institute of Chartered Accountants of New Zealand

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This Standard replaces FRS-7: Extraordinary Items and Fundamental Errors (1993), although that Standard will continue to apply until the completion of accounting periods which end prior to 1 July 1994.

This Standard should be read in the context of the Explanatory Foreword to General Purpose Financial Reporting published by the Council, Institute of Chartered Accountants of New Zealand.

The Accounting Standards Review Board (the Board) has approved FRS-7: Extraordinary Items and Fundamental Errors, for the purposes of the Financial Reporting Act 1993, to apply to reporting entities, the Crown and all departments, Offices of Parliament and Crown entities (each of which is defined in the Act).

The Board has also approved this Standard to apply to local authorities (as defined in the Act) from 1 July 1998, except that paragraph 5.1 shall not apply in the first year of application of FRS-7 with regard to the adoption of a new basis of valuation for the valuation of physical assets.

1 INTRODUCTION

COMMENTARY

1.1 The value of the statement of financial performance is enhanced if items of revenue and expense which:

- are not expected to occur frequently in the future; and
- arise from events or transactions that are distinct from the ordinary operations of an entity; and
- are outside the control or influence of managers or owners

are separately disclosed. Therefore, this Standard places emphasis on the separate disclosure of extraordinary items.

1.2 Changes in estimate and/or accounting policy fall under the control of management and/or arise from the decisions of and estimates made by management. Such changes require recognition and disclosure in the statement of financial performance in the current period.

1.3 Fundamental errors which have been made in prior periods require retroactive adjustment of the financial reports of those periods.

1.4 Financial reporting standards are paragraphs in bold type-face in this Standard. Where appropriate, interpretive commentary paragraphs in plain type-face follow the financial reporting standards.

2 APPLICATION

STANDARD

2.1 This Standard applies to the general purpose financial reports of all entities.

2.2 The financial reporting standards set out in this Standard shall apply to all financial reports where such application is of material consequence. A statement, fact, or item is material if it is of such a nature or amount that its disclosure, or the method of treating it, given full consideration of the circumstances applying at the time the financial report is completed, is likely to influence the users of the financial report in making decisions or assessments.

2.3 This Standard applies to general purpose financial reports covering periods ending on or after 1 July 1994.

3 STATEMENT OF PURPOSE

COMMENTARY

3.1 The purpose of this Standard is to establish criteria for the identification and disclosure of extraordinary items and fundamental errors so that users of

the financial report are provided with information which is necessary for an understanding of the results of the entity for a period.

4 DEFINITIONS

STANDARD

The following terms are used in this Standard with these meanings:

4.1 "Extraordinary items" are those items of revenue or expense which derive from events or transactions that:

(a) are not expected to occur frequently, and

(b) are distinct from the ordinary operations of the entity, and

(c) are outside the control or influence of managers or owners.

4.2 "Fundamental error" An error is considered to be fundamental where it is so significant that it destroys the fair presentation of the financial report taken as a whole.

COMMENTARY

4.3 Errors in financial reports result from mathematical mistakes, mistakes in the application of generally accepted accounting practice, or oversight or misuse of facts that existed at the time the financial statements were prepared.

4.4 A change in accounting estimate results from new information or subsequent developments and accordingly from better insight or improved judgement. An error is therefore distinguishable from a change in estimate.

5 FINANCIAL REPORTING

STANDARD

5.1 The net surplus or deficit for an accounting period reported in the statement of financial performance shall, subject to paragraph 5.2, take into account all recognised revenues and expenses arising in that period, unless required by any financial reporting standard to be incorporated in the statement of movements in equity:

(a) irrespective of whether they are attributable to the ordinary operations of the reporting entity during the period or to events or transactions outside these operations; and

(b) even though they may relate to prior periods.

5.2 When an entity changes an accounting policy in order to comply with a financial reporting standard or a statutory requirement either of which specifically requires the making of an initial accounting entry to give retroactive effect to the changed policy, any resulting revenue or expense shall

be adjusted directly against equity at the beginning of the accounting period in which the change is made and adequate disclosure shall be made in the financial report.

COMMENTARY

5.3 In paragraph 5.2, equity includes retained earnings or accumulated losses or other components of shareholders' funds or of the equivalent of shareholders' funds. Revenue or expense adjustments are to be made directly against retained earnings or accumulated losses.

5.4 In assessing or evaluating the accountability and financial performance of an entity, the users of a financial report are interested both in the absolute amount of the results of operations and in the quality and nature of the revenue and expenses comprising those results and in the comparison of those results with prior periods.

5.5 It is necessary to identify and disclose separately in the financial report those items which are likely to affect the evaluation of the accountability or financial performance of the entity.

Extraordinary Items

STANDARD

5.6 Extraordinary items shall be disclosed separately in the statement of financial performance following the operating surplus (deficit).

5.7 The amount of each extraordinary item shall be shown individually either on the face of the statement of financial performance or in the notes to the financial report. The amount of any taxation attributable to extraordinary items shall be disclosed separately. An adequate description of each extraordinary item shall be given to enable its nature to be understood.

COMMENTARY

5.8 It is considered that only on rare occasions will items of revenue or expense fall within the definition of extraordinary items.

5.9 Each of the three criteria specified in the definition of an extraordinary item is to be met before an item of revenue or expense is classified as extraordinary. These three criteria are:

(a) the event or transaction is expected to occur infrequently;
(b) the event or transaction is distinct from the ordinary operations of the entity;
(c) the event or transaction is outside the control or influence of managers or owners.

Expected Infrequency of Occurrence

5.10 The determination of whether or not a particular event or transaction is reasonably expected to occur usually involves determining its occurrence in the

past and the likelihood of its recurrence in the future. An event or transaction is deemed to recur, or to be likely to recur, if it is similar in nature to, although not precisely the same as, another event or transaction. For example, if an area is subject to periods of drought and floods, these two events are to be considered similar in nature.

Distinct from the Ordinary Operations of the Entity

5.11 The ordinary operations of an entity are not restricted to the trading activities but embrace all activities carried on by the entity so as to achieve its objectives. Gains or losses resulting from the risks inherent in carrying on the ordinary operations of the entity are not to be considered extraordinary. For example, gains and losses from the write-down or sale of fixed assets, including land and investments, are the results of normal business risks and are not to be considered extraordinary. Similarly, bad debt losses, which are the result of normal business risks, are not to be considered extraordinary. In a forestry operation, risks of losses by fire or strong winds are usually a normal business risk, but losses by cyclone or tornado, when these events are not anticipated in the area and would not have been considered a normal business risk, may be considered extraordinary.

Outside the Control or Influence of Managers or Owners

5.12 A transaction or event is presumed to be outside the control or influence of management or owners if their decisions or determinations do not normally influence the occurrence of that transaction or event. For example, a loss arising from earthquake damage, where such a loss is not reasonably expected to occur, or is not a normal business risk, is to be considered extraordinary. Other examples are the expropriation of property or the destruction of property by action external to the entity where the likelihood of either such event occurring was not high. However, a gain or loss arising because of a change of plan to sell an asset rather than holding it is not to be considered extraordinary because the result was within the control or influence of management.

5.13 For a discontinued activity to be classified as an extraordinary item, it must meet each of the three criteria specified in the definition of an extraordinary item.

Presentation of Extraordinary Items

5.14 Each extraordinary item is to be shown separately and described suitably either on the face of the statement of financial performance or in the notes to the financial report. Individual elements of revenue and expense (excluding taxation) which derive from a single extraordinary transaction or event constitute a single extraordinary item and are therefore to be aggregated. There may be circumstances when, although the net result of an extraordinary event is not significant in itself, it may be necessary to show separately the financial elements of extraordinary revenue and extraordinary expense for the financial report to give a fair presentation.

5.15 The calculation of tax attributable to extraordinary items involves computing income tax on results with and without extraordinary items and attributing the difference to the extraordinary items. This method ensures that the tax on the result of ordinary operations is the same as it would be if there were no extraordinary items.

Fundamental Errors

STANDARD

5.16 The after-tax effects of fundamental errors shall be accounted for by adjusting the opening balance of equity and, where practicable, restating the comparative figures for the previous period. In a historical summary, the amounts relating to prior periods shall be restated where practicable and the fact of their restatement disclosed.

5.17 There shall be full disclosure of the amount and nature of any fundamental error and the reasons for it.

COMMENTARY

5.18 Fundamental errors do not include changes in accounting estimates and changes in accounting policies.

5.19 In paragraph 5.16, equity means retained earnings or accumulated losses or other components of shareholders' funds or of the equivalent of shareholders' funds. Revenue or expense adjustments are to be made directly against retained earnings or accumulated losses.

Corrections of Fundamental Errors

5.20 In exceptional circumstances a financial report may have been issued containing an error which is of such significance as to destroy its fair presentation. That financial report would have been withdrawn had the error been recognised at the time. The correction of such a fundamental error is to be accounted for, not by inclusion in the statement of financial performance of the current period, but by restating the prior period(s) with the result that the opening balance of retained earnings will be adjusted accordingly.

Changes in Accounting Estimates

5.21 Items which relate to prior periods other than fundamental errors are to be dealt with in the statement of financial performance of the period in which they are recognised. They arise mainly from the corrections and adjustments which are the natural result of estimates inherent in accounting and more particularly in the preparation of periodic financial reports.

5.22 Estimating future events and their effects requires the exercise of judgement and will require reappraisal as new events occur, as more experience is acquired or as additional information is obtained. Since a change in estimate arises from new

information or developments, it is not to be given retrospective effect by a restatement of prior periods.

Changes in Accounting Policies

5.23 It is often extremely difficult to distinguish between a change in accounting policy and a change in estimate. When accounting standards have allowed all changes in accounting policy to be accounted for by adjusting the financial reports of prior periods, changes in estimate have frequently been given retrospective effect by being accounted for as changes in accounting policy. This has impaired the relevance and reliability of financial reports.

5.24 This Standard adopts the view that the financial effect of all changes in accounting policy which impact upon the measurement of financial performance is to be recognised in the statement of financial performance in the period in which the decisions to change the policies are made and applied except for an adjustment against opening equity where this is required in accordance with paragraph 5.2. Where material, such adjustments are to be disclosed separately. This Standard therefore emphasises the qualitative characteristics of relevance and reliability in general purpose financial reporting over the requirement to produce information that is consistent from one period to another.

5.25 It is customary for business entities to present historical summaries of financial data for a number of periods (commonly five years) in financial reports, typically as a form of supplementary information. To enhance comparability in such statements it is of value to indicate how any changes in accounting policy would have affected accounting periods prior to the period in which the change was made, had a retrospective adjustment been applied. This may be presented by making a line adjustment in the historical summary and explaining the adjustment in a note to that summary.

APPENDIX

Comparison of FRS-7 with International and Australian Accounting Standards

This comparison appendix, which was prepared as at 30 December 1993 and deals only with significant differences in the standards, is produced for information purposes only and does not form part of the standards in FRS-7. The International Accounting Standard referred to in this Appendix was promulgated by the International Accounting Standards Committee.

The International and Australian Accounting Standards comparable with FRS-7 are:

- IAS-8 (1993): *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies*;
- AASB 1018 (1992): *Profit and Loss Accounts*; and
- AAS-1 (1992): *Profit and Loss or Other Operating Statements*.

FRS-7, IAS-8, AASB 1018 and AAS-1 differ to a certain extent in their definition of extraordinary items. This difference is outlined below. The accounting standards are, however, similar in their treatment and disclosure of extraordinary items. AAS-1 and AASB 1018 treat fundamental errors differently from FRS-7 and IAS-8; this is also outlined below.

There is substantial agreement between the New Zealand and Australian standards on the treatment of the effects of changes in accounting policies but those standards are more restrictive than the International standard.

Extraordinary Items

There is a difference in the definition of extraordinary items. All financial reporting standards define extraordinary items in terms of their being infrequent and outside the ordinary operations of the entity, and all standards note that only on rare occasions will items of revenue or expense fall within the definition of extraordinary items.

FRS-7 adds the requirement that to be extraordinary, the item must also be outside the control or influence of managers and owners. The consequence of this additional condition is to significantly limit the classification of items as extraordinary. Certain items which in the past in New Zealand, or currently in overseas jurisdictions, may have been classified as extraordinary will no longer meet the definition of extraordinary. For example, the gain or loss arising from the sale of an investment not acquired with the intention of resale would not be classified as extraordinary.

Changes in Accounting Policy

FRS-7, AAS-1 and AASB 1018 require that the effect of a change in accounting policy be reflected in the statement of financial performance in the year of change. The only exception is where an accounting standard or statutory requirement specifically requires a direct adjustment against equity to give retroactive effect to the changed policy.

The International standard allows the retroactive adjustment against equity where it is considered that the change relates to prior periods and will result in a more appropriate presentation of events or transactions. This is the benchmark treatment in the new IAS standard. The allowed alternative treatment is to reflect the adjustment in the statement of financial performance in the year of change.

FRS-7, AAS-1 and AASB 1018 comply with the benchmark treatment of IAS-8 regarding an accounting standard or statutory requirement specifically requiring an adjustment to be made against equity. They follow the allowed alternative treatment of IAS-8 regarding the effects of other changes in accounting policy.

Fundamental Errors

FRS-7 complies with the benchmark treatment in IAS-8 in that fundamental errors affecting prior periods should be adjusted against the opening equity.

AAS-1 and AASB 1018 do not refer specifically to fundamental errors. Effectively these standards do not recognise the concept of fundamental errors being able to be adjusted against opening equity and require an item which would meet the FRS-7 or IAS-8 definition of fundamental error to be recognised in the statement of financial performance.

HISTORY

Previously issued accounting standards superseded by this Financial Reporting Standard:

FRS-7 *Extraordinary Items and Fundamental Errors (issued April 1993 and effective for periods commencing on or after 1 July 1993).*

SSAP-7: *Extraordinary Items and Prior Period Adjustments (issued December 1986 and effective for periods ending on or after 31 December 1986).*

SSAP-7: *Extraordinary Items and Prior Period Adjustments (issued December 1977 and effective for periods ending on or after 31 March 1978).*

FRS-7

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