SSAP 2
STATEMENT OF STANDARD ACCOUNTING PRACTICE 2
NET PROFIT OR LOSS FOR THE PERIOD, FUNDAMENTAL ERRORS AND CHANGES IN ACCOUNTING POLICIES

(Revised March 1984, December 1993 and May 1999 and October 2001)

*The standards, which have been set in **bold italic type**, should be read in the context of the background material and implementation guidance and in the context of the Foreword to Statements of Standard Accounting Practice, Interpretations and Accounting Guidelines. Statements of Standard Accounting Practice are not intended to apply to immaterial items (see paragraph 8 of the Foreword).*

Objective

The objective of this Statement is to prescribe the classification, disclosure and accounting treatment of certain items in the income statement so that all enterprises prepare and present an income statement on a consistent basis. This enhances comparability both with the enterprise's financial statements of previous periods and with the financial statements of other enterprises. Accordingly, this Statement requires the classification and disclosure of extraordinary items and the disclosure of certain items within profit or loss from ordinary activities. It also specifies the accounting treatment for changes in accounting estimates, changes in accounting policies and the correction of fundamental errors.

Scope

1. This Statement should be applied in presenting profit or loss from ordinary activities and extraordinary items in the income statement, and in accounting for changes in accounting estimates, fundamental errors and changes in accounting policies.

2. This Statement supersedes SSAP 2 "Extraordinary items and prior period adjustments" approved in 1984 and revised in 1993.

3. This Statement deals with, among other things, the disclosure of certain items of net profit or loss for the period. These disclosures are made in addition to any other disclosures required by other Accounting Standards.

~~4. This Statement also deals with certain disclosures relating to discontinued operations. It does not deal with the recognition and measurement issues related to discontinued operations.~~

Definitions

5. ***The following terms are used in this Statement with the meanings specified:***

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

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

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

"Fundamental errors" are errors discovered in the current period that are of such significance as to invalidate the true and fair view of previously issued financial statements in respect of one or more prior periods.

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

Net profit or loss for the period

6. ***All items of income and expense recognised in a period should be included in the determination of the net profit or loss for the period unless an Accounting Standard or, in the absence of a relevant Accounting Standard, the law requires or permits otherwise.***

7. Normally, all items of income and expense recognised in a period are included in the determination of the net profit or loss for the period. This includes extraordinary items and the effects of changes in accounting estimates. However, circumstances may exist when certain items may be excluded from net profit or loss for the current period. This Statement deals with two such circumstances: the correction of fundamental errors and the effect of changes in accounting policies.

8. Other Accounting Standards deal with items which may meet the Framework definitions of income or expense but which are usually excluded from the determination of the net profit or loss. Examples include revaluation surpluses (see SSAP 17 "Property, plant and equipment" and SSAP 13 "Accounting for investment properties") and gains and losses arising on the translation of the financial statements of a foreign entity (see SSAP 11 "Foreign currency translation").

9. ***The net profit or loss for the period comprises the following components, each of which should be disclosed on the face of the income statement:***

- ***a.*** ***profit or loss from ordinary activities; and***
- ***b.*** ***extraordinary items.***

Extraordinary items

10. ***The nature and the amount of each extraordinary item should be separately disclosed.***

11. Virtually all items of income and expense included in the determination of net profit or loss for the period arise in the course of the ordinary activities of the enterprise. Therefore, only on rare occasions does an event or transaction give rise to an extraordinary item

12. Whether an event or transaction is clearly distinct from the ordinary activities of the enterprise is determined by the nature of the event or transaction in relation to the business ordinarily carried on by the enterprise rather than by the frequency with which such events are expected to occur. Therefore, an event or transaction may be extraordinary for one enterprise but not extraordinary for another enterprise because of the differences between their respective ordinary activities. For example, losses sustained as a result of an earthquake may qualify as an extraordinary item for many enterprises. However, claims from policyholders arising from an earthquake do not qualify as an extraordinary item for an insurance enterprise that insures against such risks.

13. Examples of events or transactions that generally give rise to extraordinary items for most enterprises are:

    a. the expropriation of asset; or

    b. an earthquake or other natural disaster.

14. The disclosure of the nature and amount of each extraordinary item may be made on the face of the income statement, or when this disclosure is made in the notes to the financial statements, the total amount of all extraordinary items is disclosed on the face of the income statement. The extraordinary items may be presented net of related taxation and minority interests with the gross amount of each shown in the notes to the financial statements.

Profit or loss from ordinary activities

15. ***When items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.***

16. Although the items of income and expense described in paragraph 15 are not extraordinary items, the nature and amount of such items may be relevant to users of financial statements in understanding the financial position and performance of an enterprise and in making projections about financial position and performance. Disclosure of such information is usually made in the notes to the financial statements.

17. Circumstances which may give rise to the separate disclosure of items of income and expense in accordance with paragraph 15 include:

    a. the write-down of inventories to net realisable value or property, plant and equipment to recoverable amount, as well as the reversal of such write-downs;

    b. a restructuring of the activities of an enterprise and the reversal of any provisions for the costs of restructuring;

    c. disposals of items of property, plant and equipment;

d. disposals of long-term investments;

~~e. discontinued operations;~~

~~f~~e. litigation settlements; and

~~g~~f. other reversals of provisions.

~~Discontinued operations~~

~~18. While the disposal of investments or other major assets may be sufficiently important to warrant disclosure of the related items of income or expense, occasionally an enterprise sells or abandons a separate, major line of business which is distinguishable from other business activities. When this constitutes a discontinued operation as defined in this Statement, the disclosures contained in paragraph 19 are relevant to users of financial statements.~~

~~19. The following disclosures should be made for each discontinued operation:~~

~~a. the nature of the discontinued operation;~~

~~b. the industry and geographical segments in which it is reported (if applicable);~~

~~c. the effective date of discontinuance for accounting purposes;~~

~~d. the manner of discontinuance (sale or abandonment);~~

~~e. the gain or loss on discontinuance and the accounting policy used to measure that gain or loss; and~~

~~f. the revenue and profit or loss from ordinary activities of the operation for the period, together with the corresponding amounts for each prior period presented.~~

~~20. The results of a discontinued operation are generally included in profit or loss from ordinary activities. However, in the rare circumstances that the discontinuance is the result of events or transactions that are clearly distinct from the ordinary activities of the enterprise and therefore are not expected to recur frequently or regularly, the income or expenses that arise from the discontinuance are treated as extraordinary items. For example, if a subsidiary is expropriated by a foreign government, the income or expense that arise from the expropriation may qualify as an extraordinary item. The disclosure requirements in paragraph 19 are applied for all discontinued operations including those that give rise to extraordinary items.~~

~~21. When it is known at the date on which the financial statements are authorised for issue that an operation was discontinued after the balance sheet date or that it will be discontinued, the disclosure requirements of paragraph 19 are applied to the extent that the information can be reliably estimated. The accounting and disclosure of such post balance sheet events are also specified in SSAP 9 "Events after the balance sheet date" "Accounting for post balance sheet events ".~~

Changes in accounting estimates

22. As a result of the uncertainties inherent in business activities, many financial statement items cannot be measured with precision but can only be estimated. The estimation process involves judgements based on the latest information available. Estimates may be required, for example, of bad debts, inventory obsolescence or the useful lives or expected pattern of consumption of economic benefits of depreciable assets. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

23. An estimate may have to be revised if changes occur regarding the circumstances on which the estimate was based or as a result of new information, more experience or subsequent developments. By its nature, the revision of the estimate does not bring the adjustment within the definitions of an extraordinary item or a fundamental error.

24. Sometimes it is difficult to distinguish between a change in accounting policy and a change in an accounting estimate. In such cases, the change is treated as a change in an accounting estimate, with appropriate disclosure.

25. The effect of a change in an accounting estimate should be included in the determination of net profit or loss in:

a. the period of the change, if the change affects the period only; or

b. the period of the change and future periods, if the change affects both.

26. A change in an accounting estimate may affect the current period only or both the current period and future periods. For example, a change in the estimate of the amount of bad debts affects only the current period and therefore is recognised immediately. However, a change in the estimated useful life or the expected pattern of consumption of economic benefits of a depreciable asset affects the depreciation expense in the current period and in each period during the remaining useful life of the asset. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods is recognised in future periods.

27. The effect of a change in an accounting estimate should be included in the same income statement classification as was used previously for the estimate.

28. To ensure the comparability of financial statements of different periods, the effect of a change in an accounting estimate for estimates which were previously included in the profit or loss from ordinary activities is included in that component of net profit or loss. The effect of a change in an accounting estimate for an estimate which was previously included as an extraordinary item is reported as an extraordinary item.

29. The nature and amount of a change in an accounting estimate that has a material effect in the current period or which is expected to have a material effect in subsequent periods should be disclosed. If it is impracticable to quantify the amount, this fact should be disclosed.

Fundamental errors

30. Errors in the preparation of the financial statements of one or more prior periods may be discovered in the current period. Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts, fraud or oversights. The correction of these errors even if material is normally included in the determination of net profit or loss for the current period.

31. On rare occasions, an error has such a significant effect on the financial statements of one or more prior periods that those financial statements can no longer be considered to have shown a true and fair view at the date of their issue. These errors are referred to as fundamental errors. An example of a fundamental error is the inclusion in the financial statements of a previous period of material amounts of work in progress and receivables in respect of fraudulent contracts which cannot be enforced. The correction of fundamental errors that relate to prior periods requires the restatement of the comparative information.

32. The correction of fundamental errors can be distinguished from changes in accounting estimates. Accounting estimates by their nature are approximations that may need revision as additional information becomes known. For example, the gain or loss recognised on the outcome of a contingency which previously could not be estimated reliably does not constitute the correction of a fundamental error.

33. The amount of the correction of a fundamental error that relates to prior periods should be reported by adjusting the opening balance of retained earnings. Comparative information should be restated, unless it is impracticable to do so and this fact is disclosed.

34. The financial statements, including the comparative information for prior periods, are presented as if the fundamental error had been corrected in the period in which it was made. Therefore, the amount of the correction that relates to each period presented is included within the net profit or loss for that period. The amount of the correction relating to periods prior to those included in the comparative information in the financial statements is adjusted against the opening balance of retained earnings in the earliest period presented. Any other information reported with respect to prior periods, such as historical summaries of financial data, is also restated.

35. The restatement of comparative information does not necessarily give rise to the amendment of financial statements which have been approved by shareholders or registered or filed with regulatory authorities.

36. An enterprise should disclose the following for each separate fundamental error:

a. the nature of the fundamental error;

b. the amount of the correction for the current period and for each prior period presented;

c. the amount of the correction relating to periods prior to those included in the comparative information; and

d. the fact that comparative information has been restated or that it is impracticable to do so.

Changes in accounting policies

37. Users need to be able to compare the financial statements of an enterprise over a period of time to identify trends in its financial position, performance and cash flows. Therefore, the same accounting policies are normally adopted in each period.

38 A change in accounting policy should be made only if required by statute, or by an Accounting Standard, or if the change will result in a more appropriate presentation of events or transactions in the financial statements of the enterprise.

39. A more appropriate presentation of events or transactions in the financial statements occurs when the new accounting policy results in more relevant or reliable information about the financial position, performance or cash flows of the enterprise.

40. The following are not changes in accounting policies:

    a. the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions; and

    b. the adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial.

    The initial adoption of a policy to carry property, plant or equipment at revalued amounts is a change in accounting policy but it is dealt with as a revaluation in accordance with SSAP 17 "Property, plant and equipment" rather than in accordance with paragraphs 45 to 49 of this Statement.

41. A change in accounting policy is applied retrospectively or prospectively in accordance with the requirements of this Statement. Retrospective application results in the new accounting policy being applied to events and transactions as if the new accounting policy had always been in use. Therefore, the accounting policy is applied to events and transactions from the date of origin of such items. Prospective application means that the new accounting policy is applied to the events and transactions occurring after the date of the change. No adjustments relating to prior periods are made either to the opening balance of retained earnings or in reporting the net profit or loss for the current period because existing balances are not recalculated. However, the new accounting policy is applied to existing balances as from the date of the change.

Adoption of an Accounting Standard

42. A change in accounting policy which is made on the adoption of an Accounting Standard should be accounted for in accordance with the specific transitional provisions, if any, in that Accounting Standard. In the absence of any transitional provisions, the change in accounting policy should be applied in accordance with the treatment prescribed in paragraphs 45, 48 and 49 of this Statement.

43. The transitional provisions in an Accounting Standard may require either a retrospective or a prospective application of a change in accounting policy.

44. When an enterprise has not adopted a new Accounting Standard which has been published by the Hong Kong Society of Accountants but which has not yet come into effect, the enterprise is encouraged to disclose the nature of the future change in accounting policy and an estimate of the effect of the change on its net profit or loss and financial position.

Other changes in accounting policies

45. A change in accounting policy should be applied retrospectively unless the amount of any resulting adjustment that relates to prior periods is not reasonably determinable. Any resulting adjustment should be reported as an adjustment to the opening balance of retained earnings or reserves, as appropriate. Comparative information should be restated unless it is impracticable to do so.

46. The financial statements, including the comparative information for prior periods, are presented as if the new accounting policy had always been in use. Therefore, comparative information is restated in order to reflect the new accounting policy. The amount of the adjustment relating to periods prior to those included in the financial statements is adjusted against the opening balance of retained earnings or reserves, as appropriate, of the earliest period presented. Any other information with respect to prior periods, such as historical summaries of financial data, is also restated.

47. The restatement of comparative information does not necessarily give rise to the amendment of financial statements which have been approved by shareholders or registered or filed with regulatory authorities.

48. The change in accounting policy should be applied prospectively when the amount of the adjustment to the opening balance of retained earnings required by paragraph 45 cannot be reasonably determined.

49. When a change in accounting policy has a material effect on the current period or any prior period presented, or may have a material effect in subsequent periods, an enterprise should disclose the following:

- ***a. the reasons for the change;***
- ***b. the amount of the adjustment for the current period and for each period presented;***
- ***c. the amount of the adjustment relating to periods prior to those included in the comparative information; and***
- ***d. the fact that comparative information has been restated or that it is impracticable to do so.***

Effective date

50. The accounting practices set out in this Statement should be regarded as standard in respect of financial statements relating to accounting periods beginning on or after 1 January 1999. Earlier adoption is encouraged but not required.

Note on legal requirements in Hong Kong

51. Paragraph 17(6) of the Tenth Schedule to the Companies Ordinance requires the following to be stated by way of note if not otherwise shown:

"Any material respects in which any items shown in the profit and loss account are affected -

a. by transactions of a sort not usually undertaken by the company or otherwise by circumstances of an exceptional or non-recurrent nature; or

b. by any change in the basis of accounting."

Compliance with International Accounting Standards

52. International Accounting Standard No 8 (revised 1993) "Net profit or loss for the period, fundamental errors and changes in accounting policies" allows a benchmark treatment for presenting the correction of a fundamental error that relates to prior periods by restating the comparative information and a benchmark treatment for presenting the change in accounting policy by making resulting adjustment to the opening balance of retained earnings. It also permits as alternative treatments the presentation of additional pro forma information for the correction of a fundamental error and the change in accounting policy. The respective requirements of this Statement accord very closely with the benchmark treatments permitted under IAS 8.

In addition, IAS 8 gives a different definition of fundamental errors as compared to the respective definition as stated in paragraph 5 of this Statement. Except for the above differences, compliance with this Statement ensures compliance in all material respects with IAS 8.

Appendix

The Appendix is illustrative only and does not form part of the Statement of Standard Accounting Practice. The purpose of this Appendix is to illustrate the application of the Statement of Standard Accounting Practice to assist in clarifying its meaning. Extracts from income statements and statements of retained earnings are provided to show the effects on these financial statements of the transactions described below. These extracts do not necessarily conform with all the disclosure and presentation requirements of other Statements of Standard Accounting Practice.

Extraordinary items and discontinued operations

Alpha Co

Extract from the income statement

	20-2 $	20-1 $
Gross profit	10,000	12,000
Loss on sale of truck engine valve manufacturing operation (Note 1)	(3,000)	-
Taxation	(2,100)	(3,600)
Profit from ordinary activities	4,900	8,400
Extraordinary item - loss on expropriation of car engine valve manufacturing operation in country R (Net of taxation of $1,350)(Note 2)	-	(3,150)
Net profit	4,900 ======	5,250 ======

Extracts from notes to the financial statements

1. On 1 July 20-2, Alpha sold its truck engine valve manufacturing operation. The results of this operation had previously been reported in the valve manufacturing industry segment and the domestic geographical segment. The loss is the difference between the proceeds from the sale of the operation and the net carrying amount of the assets and liabilities of the operation at the date of sale. The revenues recognised relating to this operation from 1 January 20-2 until 1 July 20-2 were $15,000 ($35,000 -- 20-1) and the profits before tax were $5,000 ($10,000 -- 20-1).
2. On 1 October 20-1, Alpha's car engine valve manufacturing operation in country R was expropriated, without compensation, by the Government. The results of this operation had previously been reported in the valve manufacturing industry segment and the Pacific geographical segment. The loss arising from the expropriation has been accounted for as an extraordinary item. The gross loss arising from the expropriation represents the net carrying value of the assets and liabilities of the operation at the date of expropriation which amounted to $4,500. The revenues recognised relating to this operation from 1 January 20-1 until 1 October 20-1 were $10,000 and the profits before tax were $2,000.

Fundamental errors

During 20-2, Beta Co discovered that certain products that had been sold during 20-1 but were incorrectly included in inventory at 31 December 20-1 at $20,000 as the result of a fraudulent act committed by senior management.

Beta's accounting records for 20-2 show sales of $94,000, cost of goods sold of $86,500 (including $20,000 for error in opening inventory), and taxation of $2,250.

In 20-1, Beta reported:

	$
Sales	90,000
Cost of goods sold	(53,500)
Profit from ordinary activities before taxation	36,500
Taxation	(10,950)
Net profit	25,550

20-1 opening retained earnings was $20,000 and closing retained earnings was $45,550.

Beta's profit tax rate was 30% for 20-2 and 20-1.

Beta Co
Extract from the income statement

	20-2	20-1 (restated)
	$	$
Sales	94,000	90,000
Costs of goods sold	(66,500)	(73,500)
Profit from ordinary activities before taxation	27,500	16,500
Taxation	(8,250)	(4,950)
Net profit	19,250	11,550

Beta Co
Statement of retained earnings

	20-2	20-1 (restated)
	$	$
Opening retained earnings as previously reported	45,550	20,000
Correction of fundamental error (Net of taxation of $6,000) (Note 1)	(14,000)	-
Opening retained earnings as restated	31,550	20,000
Net profit	19,250	11,550
Closing retained earnings	50,800	31,550

Extract from notes to financial statements

1. Certain products that had been sold in 20-1 were incorrectly included in inventory at 31 December 20-1 at $20,000 as the result of a fraudulent act committed by senior management. The financial statements of 20-1 have been restated to correct this error.

Changes in accounting policy

During 20-2, Gamma Co changed its accounting policy with respect to the treatment of borrowing costs that are not directly attributable to the acquisition of a hydro-electric power station which is in course of construction for use by Gamma. In previous periods, Gamma had capitalised such costs net of taxation. Gamma has now decided to expense, rather than capitalise, these costs in order to comply with SSAP 19 "Borrowing costs".

Gamma capitalised borrowing costs incurred of $2,600 during 20-1 and $5,200 in periods prior to 20-1.

Gamma's accounting records for 20-2 show profit from ordinary activities before interest and taxation of $30,000; interest expense of $3,000 (which relates only to 20-2); and taxation of $8,100.

Gamma has not yet recognised any depreciation on the power station because it is not yet in use.

In 20-1, Gamma reported:

	$
Profit from ordinary activities before interest and taxation	18,000
Interest expense	-
Profit from ordinary activities before taxation	18,000
Taxation	(5,400)
Net profit	12,600

20-1 opening retained earnings was $20,000 and closing retained earnings was $32,600.

Gamma's profit tax rate was 30% for 20-2 and 20-1.

Gamma Co
Extract from the income statement

	20-2	20-1 (restated)
	$	$
Profit from ordinary activities before interest and taxation	30,000	18,000
Interest expense	(3,000)	(2,600)
Profit from ordinary activities before taxation	27,000	15,400
Taxation	(8,100)	(4,620)
Net profit	18,900	10,780

Gamma Co
Statement of retained earnings

	20-2	20-1 (restated)
	$	$
Opening retained earnings as previously reported	32,600	20,000
Change in accounting policy with respect to the capitalisation of interest (net of taxation of $2,340 for 20-2 and $1,560 for 20-1) (Note 1)	(5,460)	(3,640)
Opening retained earnings as restated	27,140	16,360
Net profit	18,900	10,780
Closing retained earnings	46,040	27,140

Extract from notes to financial statements

1. During 20-2, Gamma changed its accounting policy with respect to the treatment of borrowing costs that are not directly attributable to the acquisition of a hydro-electric power station which is in course of construction for use by Gamma. In order to conform with the treatment in SSAP 19 "Borrowing costs", the enterprise now expenses rather than capitalises such costs. The resulting interest expense charged in year 20-2 amounting to $3,000.

   This change in accounting policy has been accounted for retrospectively. The comparative statements for 20-1 have been restated to conform to the changed policy. The effect of the change in respect of the year 20-1 is an increase in interest expense of $2,600, and a resulting reduction in net profit of $1,820. Opening retained earnings for 20-1 have been reduced by $3,640 which is the amount of the adjustment in respect of interest capitalised relating to periods prior to 20-1 of $5,200, net of taxation of $1,560.