Common Errors found by FRRB in implementation of AS 5: *Net Profit or Loss for the Period, Prior Period Items* and Changes in Accounting Policies and AS 9: *Revenue Recognition*

Financial Statements are the paramount source in hands of the stakeholders to understand the financial well-being of an enterprise. The users are highly reliant on the information depicted in the financial statements and therefore the preparers ought to ensure that the information presented in the financial statement is correct, complete, relevant and in adherence to the regulatory requirements. Financial Reporting Review Board (hereinafter referred as FRRB or Board) reviews the General Purpose Financial Statements (GPFS) of enterprises with the view to identify the non-compliances with Accounting and Auditing Standards, CARO, Companies Act, and other statutory requirements applicable in preparation and presentation of the financial statements. The non-compliances observed by the Board are compiled from time to time and published under the name of "Study on Compliance with Financial Reporting Requirement", till date three volumes of the aforesaid publication has been released by the Board. In addition, the Board publishes articles in the 'Journal' of the Institute and also conduct 'webinar' on non-compliances with various reporting requirements to disseminate the awareness amongst the members as well as general masses. This article deals with the non-compliances, observed by the Board, with disclosure requirements prescribed under Accounting Standard – 5 and 9.

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AS 5: Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

1. Certain Items of Expenditure have been directly debited to Reserve and Surplus

Case

From the Annual Reports of some companies, it has been noted that the following items of expenditure have been directly debited to Reserves and Surplus:

- Short provision for Bonus
- Provision for Income Tax relating to earlier years
- Investment Written Off

Principle

It may be noted that paragraph 5 of AS 5, provides as follows:

"5. All the items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise."

Observation

It was noted that short provision for bonus and provision for income tax relating to earlier years have been directly debited to Reserves and Surplus. Such liability may have arisen either as a result of error/omissions in the preparation of financial statements of one or more prior periods or that there were circumstances in the current period that have determined the liability in the current period though related to previous period. It was viewed that in either case, **these expenses should be included in determination of profit or loss of the current period. Similarly, investment written off is also an expenditure of the current period.**

Accordingly, it was viewed that all these items should be recognised in the Statement of Profit and Loss as required under paragraph 5 of AS 5.

2. Non-Disclosure of Nature of Prior Period Items.

Case

In the Annual Reports of some companies following information has been disclosed with regard to prior period items:

- Prior period Income – shown under Other Income.
- Prior period expenses – shown in Profit and Loss Account.
- Prior period adjustments (Net) – shown below Profit after Tax.

Principle

It may be noted that paragraph 15 of AS 5, provides that:

"15. The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived."

Observation

It was noted that prior period income/ expenses/ adjustments have been disclosed either in the Statement of Profit and Loss or in the notes forming part thereof. However, the **nature of such income/ expenses/ adjustments has not been disclosed as required by paragraph 15 of AS 5.**

3. 'Sundry balances written off' were wrongly disclosed under prior period adjustments.

Case

In the Annual Report of a company, 'Sundry Balances written-off' has been disclosed as prior period adjustment.

Principle

It may be noted that paragraph 4.3 of AS 5, states that:

"4.3 Prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods".

Observation

It was noted that the prior period adjustments include the amount of sundry balances written-off. **It was viewed that sundry balances recognised in prior years but written-off in the current year should not be considered as prior period item because such writing-off has not arisen due to any error or omission in preparation of financial statements of prior period/s.** In fact there has been a change in estimate or change in circumstances due to which company has decided to write-off these balances in the current year.

Hence, it was viewed that presenting sundry balances written-off as prior period adjustment is not in line with the requirement of AS 5.

4. Wrong presentation of certain items as an exceptional item in the Statement of Profit and Loss.

Case

From the Annual Reports of some companies, it has been noted that the following items of income/ expenses have been disclosed in the Statement of Profit and Loss as exceptional items:

- Gain on Finance Lease Arrangement
- Write back of compensation under employee stock option scheme
- Foreign Currency Translation Reserve written off
- Foreign Exchange Fluctuation Difference
- Gain on payment of FCCB
- Tax impact on credit/charge in respect of exceptional items

Principle

It may be noted that paragraphs 4.1 and 12 of AS 5 provide that:

"4.1 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."

Exceptional Item

"12. 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."

Futher, paragraph 4.3 of AS 22**,** Accounting for Taxes on Income, provide that:

"4.3 Tax expense (tax saving) is the aggregate of current tax and deferred tax charged or credited to the statement of profit and loss for the period."

Observation

It was observed that the **transactions referred to in these cases have arisen from ordinary activities of the enterprises. Further, the size of these transactions does not warrant their classification as 'exceptional items'.** Therefore, it was viewed that presentation of these transactions as exceptional items is not in line with the requirements of AS 5.

It was further noted that in one case income tax has been separately deducted under the head 'exceptional items'. In other words, its impact is not considered in the profit/ loss of the year when current tax and deferred tax for the period are measured and recognised. **It was viewed that the tax impact of these items should be included as tax expense in the Statement of Profit and Loss.**

AS 9: Revenue Recognition

1. Recognition of Revenue on Receipt Basis

Case

From the Annual Reports of some companies, it has been noted that one of the items of income as shown in the Statement of Profit and Loss is income from advertisement and ticket sales and the related accounting policy states as follows:

'Revenue from sale of tickets is recognised when the tickets have been sold. Advertisement revenue is recognised when advertisements and net realisation are confirmed.'

Principle

It may be noted that paragraph 12 of AS 9, provides that:

"12. In a transaction involving the rendering of services, performance should be measured either under the completed service contract method or under the proportionate completion method, whichever relates the revenue to the work accomplished. Such performance should be regarded as being achieved when no significant uncertainty exists regarding the amount of the consideration that will be derived from rendering the service."

Observation

It was noted that the enterprise under review render services. Therefore, revenue from sale of tickets should be recognised as per the completed contract method. However, as per the accounting policy adopted by these enterprises, the revenue from sale of tickets is recognised when tickets are sold. It may be noted that tickets are sold before the event takes place. Accordingly, **in case of advance booking of tickets there is**

always a time gap between the sale of tickets and actual event. Hence, such revenue cannot be considered to have been earned until and unless the event has taken place. If the event doesn't take place, it may be necessary even to refund the amount. However, in the given case the enterprise does not consider the happening of the related event for recognition of revenue.

Same principle is applicable to income from advertisement as well. The revenue from advertisements should be recognised when the advertisements is accepted and not on realisation of bills. Thus, recognising revenue when advertisement and net realisations are confirmed is not in line with the requirements of AS 9.

2. Revenue from Service transaction should be recognised when the services are performed.

Case

The accounting policy of revenue recognition as given in the Annual Report of a company *inter alia* states that revenue from online educational services (if charged) is recognised upon receipt of subscription fee (in case of non-refundable) otherwise apportioned over the subscription period.

In the Annual Report of another company, the following accounting policy has been disclosed:

"Revenue from online educational services is recognised upon receipt of subscription fees. ..."

Principle

It may be noted that paragraph 7.1 of AS 9, provides that:

"7.1 Revenue from service transactions should be recognised as the service is performed, either by the proportionate completion method or by the completed service contract method."

It may also be noted that illustrations B.5 and A.7 to AS 9 lays down principles for recognition of tuition fees and subscription fees respectively as follows:

"5. Tuition Fees

Revenue should be recognised over the period of instruction."

"7.Subscription for publications

Revenue received or billed should be deferred and recognised either on a straight line basis over time or, where the items delivered vary in value from period to period, revenue should be based on the sales value of the item delivered in relation to the total sales value of all items covered by the subscription."

Observation

From the above, it was viewed that the period when services are rendered should be considered for recognition of revenue. Accordingly, if revenue is received it should be deferred and recognised over the period when services are rendered.

It was further viewed that **the subscription fee for online educational services should be recognised apportioned over the service period.**

Accordingly, it was viewed that the accounting policy followed in these cases is not in line with the requirements of AS 9.

3. Timing of Revenue Recognition w.r.t. Insurance Claims.

Case

From the Annual Report of a company, it has been noted that the company has recognised as income the entire cost of garments destroyed by fire under other operating income (stock loss claim) based on filing of insurance claim. With regard to partially damaged stocks, the related inventory has been valued at net realisable value, and insurance claim against the same is taken as other income. Insurance claim against loss of fixed assets has also been recognised based on the claim filed with the insurance company. The note further states that said income has been recognised as per the AS 9.

Principle

It may be noted that paragraph 4.1 and 9.2 of AS 9, states that:

"4.1 Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, rendering of services, and from use by others of enterprise resources…."

"9.2 Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g., for escalation of price, export incentives, interest etc., revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by instalments."

Observation

It was noted that insurance claims do not fall within the definition of 'Revenue' as given in AS 9. However, it was viewed that as in the case of sale of goods or rendering of services, the recognition of insurance claims also requires that the amount realisable is measurable and it is not unreasonable to expect ultimate collection. Accordingly, **recognising insurance claims at the time of filing the claims with the insurance company without considering the uncertainty relating to its measurability is not appropriate.**

Accordingly, it was viewed that recognition of revenue at the time of filing of claims is not in line with the principles of AS 9.

4. Recognition of Dividend Income when the right to receive payment is established.

Case

The accounting policies regarding recognition of dividend income have been disclosed as follows in the Annual Reports of some companies:

- Dividend is accounted as and when received.
- Income & Expenditures are recognised on accrual basis except dividend on shares and units of Mutual Funds, which are recognised on cash basis.

Principle

It may be noted that paragraph 13 of AS 9, states that:

"13. Revenue arising from the use by others of enterprise resources yielding interest, royalties and dividends should only be recognised when no significant uncertainty as to measurability or collectability exists. These revenues are recognised on the following bases:

iii) Dividends from investments in shares: when the owner's right to receive payment is established."

Observation

It was observed that the dividend income has been recognised on receipt basis while paragraph 13 of **AS 9 requires recognition of dividend income when the right to receive payment is established.**

Accordingly, it was viewed that the recognition of dividend income on receipt basis is not in line with the requirements of AS 9.

5. Timing of Recognition of Revenue.

Case

The following accounting policies on Revenue Recognition have been disclosed in the Annual Reports of some companies:

- Revenue (income) is recognised when no significant uncertainty as to measurability or collectability exists.
- Revenue/Income and Cost/Expenditure are accounted for on accrual basis.
- Sales are accounted for on dispatch of products.

Principle

It may be noted that paragraph 11 of AS 9 states as follows:

"11. In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

(i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods."

Observation

It was observed in the first case that revenue has been recognised when there is no uncertainty as to measurability and collectability whereas in the second case it simply states accrual basis. However, **in none of these cases the timing of recognition of revenue i.e. when the enterprise has transferred significant risk and reward to the buyer has been disclosed.** In the last case also, it was not clear whether significant risk and rewards associated with the ownership of goods stands transferred when the products are dispatched.

Thus, it was viewed that the accounting policies for revenue recognition as disclosed in the financial statements are not in line with the requirements of paragraph 11 of AS 9. ■