AS 5 Net profit or loss for the period, prior period items and changes in Accounting Policies

Points to be remembered while reading: wherever the para numbers are mentioned try to remember so as to present in exams to get the extra edge of positive impression to examiner while correcting paper. However it is optional and not compulsory
But **Para 12** of this standard is important to remember with the para number

Scope:

Para 1, this standard should be applied by an enterprise in presenting the profit and loss from
i) ordinary activities,
ii) extraordinary activities and
iii) prior period items in the statement of Profit and loss a/c
iv) changes in accounting estimates and
v) disclosure of changes in accounting policies
(**Note**: the above standard is not applicable for the tax implication in case of the above items listed)

The above standard is applicable for all the enterprises

Definitions:

i) Ordinary Activities: **Para 4.1**, any activities which are undertaken by an enterprise as a part of its business and such related activities in which the enterprise engages in furtherance of, incidental to, or arising from, these activities.
ii) Extraordinary Activities: **Para 4.2**, 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.
iii) Prior Period items: **Para 4.3**, income or expenses which arise in current period as a result of errors or omissions in the preparation of financial statements of one or more prior periods.
iv) Accounting policies: **Para 4.4**, they are the specific principles and the methods of applying those principles adopted by an enterprise in the preparation of financial statements.

Net profit or loss for the period:

- **Para 5**, all 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.

- **Para 7**, the net profit or loss for the period comprises the following components, each of which should be disclosed on the face of the statement of profit and loss;
  a) Profit or loss from ordinary activities; and
  b) Extraordinary items

- Profit or loss from ordinary activities:

  i) **Para 12,** when items of income and expense with in 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

  ii) Circumstances which may give rise to separate disclosure of items of income and expense in accordance with Para 12 include
     1. The write down inventories to Net realisable value as well as the reversal of such write-downs
     2. A restructuring of the activities of an enterprise and the reversal of any provisions for the costs of restructuring
     3. Disposal of items of fixed assets
     4. Disposal of long term investments
     5. Legislative changes having retrospective application
     6. Litigation settlements, and
     7. Other reversals of provisions

- Extraordinary items:

  i) **Para 8**, Extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived.

  ii) 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 so 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.

  iii) Events that generally give rise to extraordinary items are attachment of property of the enterprise, or an earthquake

Prior Period items:

- **Para 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.

- The term 'prior period items', as defined in this Standard , refers only to 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. The term does not include other adjustments necessitated by circumstances, which though related to prior periods, are determined in the current period, e.g., arrears payable to workers as a result of revision of wages with retrospective effect during the current period.

- Prior period items are normally included in the determination of net profit or loss for the current period. Alternatively, where prior period items are not taken in computation of current profit, they can be added (or deducted as the case may be) from current profit. In either case, the objective is to indicate the effect of such items on the current profit or loss.

Changes in Accounting Estimates:

- Many items in the financial statements are estimates rather than precise measures. For example, provision for doubtful debts etc.

- An estimate may have to be revised if changes occur regarding the circumstances on which the estimate was based.

- When there is difficulty in deciding the change as change in estimate or change in policy, then such change should be considered as change in estimate with appropriate disclosure.

- **Para 23**, the effect of change in an accounting estimate should be included in the determination of net profit or loss in;
  a) The period of change, if the change affects the period only, or
  b) The period of change and future periods, if the change affects both

- **Para 25**, the effect of change in an accounting estimate should be classified using the same classification in the statement of profit and loss as was used previously for the estimate.
  For example, if the change of an accounting estimate affects an item previously classified as extraordinary item, the effect of change should also be taken as extraordinary item

- **Para 27**, the nature and amount of a change in an accounting estimate which 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.

Changes in Accounting Policies:

- **Para29,** A change in an accounting policy should be made only if the adoption of a different accounting policy is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise.

- **Para 32,** Any change in an accounting policy which has a material effect should be disclosed. The impact of, and the adjustments resulting from, such change, if material, should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change.

  Where the effect of such change is not ascertainable, wholly or in part, the fact should be indicated.

  If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

Practical Questions

Study Material Examples:

1) An extract from the statement profit and loss of a company for 2010-11 is given below

Particulars	Rs. 000's	Rs. 000's
Sales		3,000
Opening Stock	500	
Production cost	2,800	
	3,300	
Less: Closing stock	(600)	2,700
Gross Profit		300
Expenses		(250)
Profit before tax		50
Tax		20
Profit after tax		30

The closing stock includes stock damaged in a fire in 2009-10. On 31/03/2010, the estimated net realisable value of this stock was Rs. 15,000. The revised estimate of net realisable value included in closing stock of 2010-11 is Rs.5,000 Rewrite the statement of profit and loss if necessary to comply with requirements of AS 5.

Solution:

The fall in the net realisable value of damaged stock Rs.10,000 is the effect of change in accounting estimate. As per **Para 25**, the effect of change in accounting estimate should be classified in the statement of profit and loss as was used previously for the estimate.
The difference between cost of the stock and its net realisable value is presumably classified as loss on fire in 2009-10. This loss on fire is an extraordinary item.
Para 8 of the standard required the extraordinary items to be disclosed in such a manner that their impact on current profit or loss can be perceived. To comply with this requirement, enterprises should present profit/loss before and after extraordinary items.

Particulars	Rs. 000's	Rs. 000's
Sales		3,000
Opening Stock (500-15)	485	
Production cost	2,800	
	3,285	
Less: Closing Stock (600-5)	(595)	(2,690)
Gross Profit		310
Expenses		250
Profit before loss on fire		**60**
Less: Loss on fire		(10)
Profit before Tax		50
Tax		20
Profit after tax		30

2) Cost of a machine acquired on 01/04/2008 was Rs. 1Lakh. The machine is expected to realise Rs. 5,000 at the end of its working life of 10 years. Straight line depreciation of Rs. 9,500 per year has been charged up to 2009-10. For and from 2010-11, the company switched over to 17% p.a. reducing balance method of depreciation in respect of the machine. The new rate of depreciation is based on revised useful life of 13 years. The new rate shall apply with retrospective effect from 1/04/2008

Solutions:

WDV of the asset up to 2009-10 under SLM = Rs.1,00,000-9,500*2= Rs.81,000
WDV of the asset up to 2009-10 under WDV= Rs.1,00,000-[1,00,000*17% + (1,00,000-17,000)*17%]=Rs.68,890

Depreciation to be charged for 2010-11 = (81,000-68,890) + (68,890*17%) = Rs. 23,821

The revision of remaining useful life is change in accounting estimate, and adoption of reducing balance method of depreciation instead of the straight-line method is change accounting policy

Since it is difficult to segregate impact of these two changes, the entire amount of difference between depreciation at old rate and depreciation for 2010-11 (Rs.23,821- Rs.9,500) = Rs. 14,321 is regarded as effect of change in accounting estimate as per para 22 of the standard

3) When can an item qualify to be prior period item as per AS 5?

Solution:

According to para 16 of AS 5 on "Net profit or loss for the period, prior period items and changes in accounting policies', prior period items refers to those income or expenses, which arise in the current period as a result of errors or omission in the preparation of financial statements of one or more prior periods.

The term does not include other adjustments necessitated by circumstances, which though related to prior periods, are determined in the current period e.g., arrears payable to workers in current period as a result of revision of wages with retrospective effect.

4) The company finds that the stock sheets of 31.03.2010 did not include two pages containing details of inventory worth Rs. 20 Lakhs. State, how will you deal with this matter in the accounts of A Ltd., for the year ended 31st March, 2011 with reference to AS 5?

Solution:

As per para 16 of AS 5 on 'Net Profit or loss for the period, prior period items and changes in accounting policies', Omission of two pages containing details of inventory worth Rs. 20Lakhs in 31.03.2010 is a prior period item.

As per para 19 of the standard, prior period items are normally included in the determination of net profit or loss for the current period. Accordingly, Rs. 20 Lakhs must be added to the opening stock of 1.4.2010.
An alternative approach is to show such item in the statement of profit and loss after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profit or loss.

5) Explain the provisions of AS 5 regarding accounting treatment of prior period items.

Solution:

As per AS 5, prior period items are income or expenses, which arise, in the current period as a result of errors or omission in the preparation of financial statements of one or more prior periods. The term does not include other adjustments necessitated by circumstances, which though related to prior periods, are determined in the current period. Example, arrears payable to workers in current period as a result of retrospective revision of wages

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

As per para 19 of AS 5, prior period items are normally included in determination of net profit or loss for the current profit, they can be added (or deducted as the case may be) from the current profit. An alternative approach is to show the items in the statement of profit or loss after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profit or loss.

Practice Manual Questions:

6) A limited company created a provision for bad and doubtful debts at 2.5% on debtors in preparing the financial statements for the year 2010-11
Subsequently on a review of the credit period allowed and financial capacity of the customers, the company decided to increase the provision to 8% on debtors as on 31.03.2011. The company accounts were not approved by the Board of Directors till the date of decision. While applying the relevant accounting standard can this revision be considered as an extra ordinary item or prior period? **(N04 4M)**

Solution:

The preparation of financial statements involves making estimates which are based on the circumstances existing at the time when the financial statements are prepared. It may be necessary to revise an estimate in a subsequent period if there is a change in the circumstances on which the estimate was based. Revision of an estimate, by its nature, does not bring the adjustment within the definitions of a prior period items or an extraordinary item.

In the given case, a limited company created 2.5% provision for doubtful debts for the year 2010-11. Subsequently in 2011 they revised the estimated based on the changed circumstances and wants to create 8% provision. As per AS 5, this change in estimate is neither a prior period item nor an extraordinary item.

However, as per para 27 of AS 5, a change in accounting estimate which has material effect in the current period, should be disclosed and quantified. Any change in the accounting estimate which is expected to have a material effect in later periods should also be disclosed.

7) X Co. Ltd. signed an agreement with its employees union for revision of wages in June, 2004. The wage revision is with retrospective effect from 1.04.2006. The arrear wages up to 31.03.2010 amounts to Rs.80 Lakhs. Arrear wages for the period from 1.4.2010 to 30.06.2010 (being the date of agreement) amounts to Rs. 7 Lakhs. Decide whether a separate disclosure of arrear wages is required. **(N05 4M)**

Solution:

It is given that revision of wages took place in June, 2011 with retrospective effect from 1.04.2006. The arrear wages payable for the period from 1.4.2006 to 30.6.2011 cannot be taken as an error or omission in the preparation of financial statements and hence this expenditure cannot be taken as a prior period item.

Additional wages liability of Rs.87 Lakhs (from 1.4.2006 to 30.6.2011) should be included in current year's wages.

It may be mentioned that additional wages is an expense arising from the ordinary activities of the company. Although abnormal in amount, such an expense does not qualify as an extraordinary item. However, as per para 12 of AS 5, when items of income and expense with in 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.

However, wages payable for the current year (from 1.4.2011 to 30.6.2011) amounting Rs. 7Lakhs is not a prior period item hence need not be disclosed separately. This may be shown as current year wages.

8) Goods of Rs. 5 Lakhs were destroyed due to flood in September 2008. A claim was lodged with insurance company, but no entry was passed in the books for insurance claim.
In March 2011, the claim was passed and the company received a payment of Rs.3,50,000 against the claim. Explain the treatment of such receipt in final account for the year ended 31st March 2011. **(N09 5M)**

Solution:

As per the provision of AS 5, "Net profit or loss for the period, prior period items and changes in accounting policies", prior period items are income or expenses which arise in the current period as a result of errors or omission in the preparation financial statements of one or more prior periods. Further, the nature and amount of prior period items should be separately disclosed in the statement of profit or loss in a manner that their impact on current profit or loss can be perceived.
In the given instance, it is clearly a case of error in preparation of financial statements for the year 2008-09. Hence, claim received in the financial year 2010-11 is a prior period item and should be separately disclosed in the statement of profit and loss.

9) S.T.B Ltd. makes provision for expenses worth Rs. 7Lakhs for the year ending March 31, 2009, but the actual expenses during the year ending March 31, 2010 comes to Rs. 9Lakhs against provision made during the last year. State with reasons whether difference of Rs. 2Lakhs is to be treated as prior period item as per AS 5? (M10

Solution:

As per AS 5, "Net profit or loss for the period, prior period items and changes in accounting policies", as a result of 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. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

Estimates 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.

As per standard, the effect of a change in an accounting estimate should be classified using the same classification in the statement of profit and loss as was used previously for the estimate. Prior period items are income or expenses which arise in the current period as a result of errors or omission in the preparation of the financial statements of one or more prior periods. Thus revision of an estimate by its nature i.e. the difference of Rs. 2Lakhs is not a prior period item.

Therefore, in the given case expense amounting Rs. 2 Lakhs (i.e. 9Lakhs – Rs.7Lakhs) relating to the previous year recorded in the current year, should not be regarded as prior period item.

10) A company created a provision of Rs. 75,000 for staff welfare while preparing the financial statements for the year 2007-08. On 31st March, in a meeting with staff welfare association, it was decided to increase the amount of provision for staff welfare to Rs. 1Lakh. The accounts were approved by BOD on 15th April, 08.

Explain the treatment of such revision in financial statements for the year ended 21st March 08. **(N09)**

Solution:

As per AS 5 "Net profit or loss for the period, prior period items and changes in accounting policies", the change in amount of staff welfare provision amounting Rs.25,000 is neither a prior period item nor an extraordinary item. It is a change in estimate, which has been occurred in the year 2007-08

As per the provisions of the standard, normally, all items of income and expense which are 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, the effect of such change in accounting estimate should be classified using the same classification in the statement of profit and loss, as was used previously, for the estimate.

11) Closing stock for the year ending on 31.03.2010 is Rs. 50,000 which includes stock damaged in a fire in 2008-09. On 31.03.2009 the estimated net realisable value of the damaged stock was Rs. 12,000. The revised estimate of net realisable value of damaged goods amounting Rs.4,000 has been included in closing stock of Rs. 50,000 as on 31.03.2010

Find the value of closing stock to be shown in profit and loss account for the year 2009-10 (M10 IPCC 2M)

Solution:

The fall in estimated net realisable value of damaged stock Rs. 8,000 is the effect of change in accounting estimate. As per AS 5 'Net profit or loss for the period, prior period items and changes in accounting policies', the effect of a change in accounting estimate should be classifies using the same classification in the statement of profit and loss as was used previously for the estimate.

Thus the value of closing stock for the year 2009-10 will be as follows:

Particulars	Rs
Closing stock including damaged goods (-) revised value of damaged goods	50,000 (4,000)
Closing stock excluding damaged goods	46,000