CA INTERMEDIATE

MARATHON

Advanced Accounting

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

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

Net Profit or Loss for the Period

Profit/Loss from Ordinary activity

Principle revenue producing & generating activities

Items which are of such size, nature or incidence that their disclosure is relevant

(Exceptional Items)

* Writing down of Inventories to NRV
* Legislative changes having retrospective effect
* Litigation settlements

Extraordinary Item

Clearly distinct from ordinary activities & not expected to recur frequently or regularly.

* Loss by earthquake, flood
* Attachment of property of enterprise
* Govt grant becoming refundable

Nature & Amount to be separately disclosed to perceive impact on current Profit/Loss

Prior Period Items

Item of income or expenses which arise in current period due to error or omissions in previous periods.

* Revenue expenditure treated as capital expenditure
* Wrong totalling of stock
* Capitalisation of Borrowing cost on working capital

Nature & Amount to be separately disclosed to perceive impact on current Profit/Loss

Change in Accounting Estimate

Meaning of A/cing Estimate : Uncertainities inherent in business activities, many items can only be estimated.

When Change Occur : New information, more experience, subsequent development, etc.

- Change in estimate of provision for doubtful debts
- Change in useful life, residual value of fixed assets

Note : Not a prior period or extraordinary item.
Effect of change classified using same classification as used for estimate.

Disclosure Requirement : If Material effect in current / subsequent period → Disclose Nature & Amount
Disclose Fact if impracticable to quantify amount

Change in Accounting Policy

General Rule : Accounting policy once adopted should be followed consistently.

When change Recommended :

- Required by Statute / Law
- For compliance with AS
- More appropriate presentation of financial statements

- Change in cost formula in measuring inventories
- Change from cost model to Revaluation model to value PPE

Disclosure Requirement :

Material Effect
- Current
  - Amount ✓ → Disclose Amount
  - Amount ✗ → Disclose Fact
- Later → Disclose Fact

Not change in A/cing Policy :

- Adoption of policy that differ in substance from previously occurring event
  (Introduction of formal retirement gratuity scheme in place of adhoc exgratia)
- Adoption of new policy which did not occur previously.
  (Introduction of Pension scheme for first time)

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NET PROFIT OR LOSS FOR THE PERIOD, PRIOR PERIOD ITEMS & CHANGES IN ACCOUNTING POLICIES

AS 5

Question 1:

Give two examples on each of the following items:

a) Change in Accounting Policy
b) Change in Accounting Estimate
c) Extra Ordinary Items
d) Prior Period Items.

Solution

a) Examples of Changes in Accounting Policy:
  (i) Change of method to value PPE from Cost to Revaluation model.
  (ii) Change in cost formula in measuring the cost of inventories.

b) Examples of Changes in Accounting Estimates:
  (i) Change in estimate of provision for doubtful debts on sundry debtors.
  (ii) Change in estimate of useful life of fixed assets.

c) Examples of Extraordinary items:
  (i) Loss due to earthquakes / fire / strike
  (ii) Attachment of property of the enterprise by government

d) Examples of Prior period items:
  (i) Applying incorrect rate of depreciation in one or more prior periods.
  (ii) Omission to account for income or expenditure in one or more prior periods.

Question 2: ICAI Study Material

The company finds that the inventory sheets of 31.3.2024 did not include two pages containing details of inventory worth ₹14.5 lakhs. State, how you will deal with the following matters in the accounts of Pure Ltd. for the year ended 31st March, 2025.

Prior Period Items

Solution

AS 5 on Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, defines Prior Period items as "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".

Rectification of error in inventory valuation is a prior period item as per AS 5. Accordingly, ₹14.5 lakhs must be added to opening stock of 1.4.2024. Alternative approach is to show such items in the statement of profit & loss after determination of current net profit or loss. In either case, the objective is to include the effect of such items on the current profit or loss.

Question 3: ICAI Study Material

(i) During the year 2019-2020, a medium size manufacturing company wrote down its inventories to net realisable value by ₹ 5,00,000. Is a separate disclosure necessary?

(ii) A company signed an agreement with the Employees Union on 1.10.2019 for revision of wages with retrospective effect from 30.9.2018. This would cost the company an additional liability of ₹ 5,00,000 per annum. Is a disclosure necessary for the amount paid in 2019-20?

Solution

(i) Although the case under consideration does not relate to extraordinary item, but the nature and amount of such item 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. AS 5 on 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies' states that: "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."

Circumstances which may give to separate disclosure of items of income and expense in accordance with AS 5 include the write-down of inventories to net realisable value as well as the reversal of such write-downs.

(ii) It is given that revision of wages took place on 1st October, 2019 with retrospective effect from 30.9.2018. Therefore wages payable for the half year from 1.10.2019 to 31.3.2020 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 ₹ 7,50,000 (for 1½ years @ ₹ 5,00,000 per annum) 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. Such an expense does not qualify as an extraordinary item. However, as per AS 5, 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.

Question 4: RTP Jan 2025

During the course of the last three years, a company owning and operating Helicopters lost four Helicopters. The company's accountant felt that after the crash, the maintenance provision created in respect of the respective helicopters was no longer required, and proposed to write it back to the Profit and Loss account as a prior period item. Is the company's proposed accounting treatment correct? Discuss

Extraordinary item

Solution

The balance amount of maintenance provision written back to profit and loss account, no longer required due to crash of the helicopters, is not a prior period item because there was no error in the preparation of previous periods' financial statements. The balance amount left in the provision created earlier is not as a result of error in the past. So it will not be considered as prior period item. Such write back of provision is not an ordinary feature of the business, it shall be considered as an extra-ordinary item.

As per paragraph 8 of AS 5, 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. Hence, the amount so written-back (if material) should be disclosed as an extraordinary item as per AS 5 rather than as prior period items.

Question 5: ICAI Study Material

From the past 5 financial years, an old outstanding balance of ₹50,000 was still appearing as sundry creditor in the current year balance sheet of People Ltd. The company is certain that this amount is not payable due to one or more reasons. Therefore, it decided to write off the said amount in its current year's books of accounts and recognize it as income. The company treated the amount of ₹ 50,000 written off as a prior period item and made the adjustments accordingly. The company is of the view that since sundry balances were recognized in the prior period(s), its related written-off amount should be treated as a prior period item.

Not a Prior Period Item.

Solution

No, the company is not correct in treating the amount written off as a prior period item.

As per AS 5, prior period items are income or expenses which arise in a current year due to errors or omissions in the preparation of the financial statements of one or more prior period(s). Writing off an old outstanding balance in the current year which is appearing in its books of accounts from the past 5 financial years does not mean that there has been an error or omission in the preparation of financial statements of prior period(s).

It is just a practice adopted by the company to write off the old outstanding balances of more than 5 years in its current year books of accounts. Therefore, the amount written off is not treated as a prior period item.

Hence, adjusting the amount ₹50,000 written off as a prior period item on the basis that sundry balances were recognized in prior period(s) is not in line with AS 5.

Question 6: RTP Nov 2022

Bela Ltd. has a vacant land measuring 20,000 sq. mts, which it had no intention to use in the future. The Company decided to sell the land to tide over its liquidity problems and made a profit of ₹10 Lakhs by selling the said land. There was a fire in the factory and a part of the unused factory shed valued at ₹ 8 Lakhs was destroyed. The loss from fire was set off against the profit from sale of land and profit of ₹2 lakhs was disclosed as net profit from sale of assets. Do you agree with the treatment and disclosure? If not, state your views.

Extraordinary Item

Solution

As per para 8 of AS 5, 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.

In the given case the selling of land to tide over liquidation problems as well as fire in the Factory does not constitute ordinary activities of the Company. These items are distinct from the ordinary activities of the business. Both the events are material in nature and expected not to recur frequently or regularly. Thus, these are Extraordinary Items.

Therefore, in the given case, disclosing net profits by setting off fire losses against profit from sale of land is not correct. The profit on sale of land, and loss due to fire should be disclosed separately in the statement of profit and loss

Question 7: ICAI Study Material / RTP Jan 2026

A company (Z Ltd.) is engaged in the business of providing consultancy services. A few days back, it received a notice from GST department raising a demand of GST on consultancy services provided by it for ₹ 500,000. Recently Z Ltd. paid the demand. In the books, the payment is recorded as an extraordinary expenditure. Whether payment of tax demand raised by the taxation authority can be recognised as an extraordinary item?

Solution

No, payment of tax cannot be recognised as an extraordinary item.

As per AS 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" an extraordinary item is income or expenses that arise from events or transactions that are clearly distinct from ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly.

In the given case, providing consultancy service is an ordinary activity of Z Ltd. Thus, GST paid pursuant to the demand raised by GST department is also a part of an ordinary activity of Z Ltd. Recognizing such payments as an extra-ordinary item is contrary to AS 5.

Question 8: Inter Nov 2022 (5 Marks)

The Accountant of Shiva Limited had sought your opinion with relevant reasons, whether the following transactions will be treated as change in Accounting Policies or change in Accounting Estimates for the year ended 31st March, 2021. Please advise him in the following situations in accordance with the provisions of AS 5:

a) Provision for doubtful debts was created @3% till 31st March, 2020. From the Financial year 2020-2021, the rate of provision has been changed to 4%.

b) During the year ended 31st March,2021, the management has introduced a formal gratuity scheme in place of ad-hoc ex-gratia payments to employees on retirement.

c) Till 31st March, 2020 furniture was depreciated on straight line basis over a period of 5 years. From Financial year 2020-2021, useful life of furniture has been changed to 3 years.

d) Management decided to pay pension to those employees who have retired after completing 5 years of service in the organization. Such employees will get pension of ₹ 20,000 per month. Earlier there was no such scheme of pension in the organization.

e) During the year ended 31st March 2021, there was change in cost formula in measuring the cost of inventories.

Solution

a) In the given case, company has created 3% provision for doubtful debts till 31st March, 2020. Subsequently from 1st April, 2020, the company revised the estimates based on the changed circumstances and wants to create 4% provision. Thus, change in rate of provision of doubtful debt is change in estimate and is not change in accounting policy. This change will affect only current year.

b) As per AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, will not be considered as a change in accounting policy. Introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement is a transaction which is substantially different from the previous transaction, will neither be treated as change in an accounting policy nor change in accounting estimate.

c) Change in useful life of furniture from 5 years to 3 years is a change in accounting estimate and is not a change in accounting policy.

d) Adoption of a new accounting policy for events or transactions which did not occur previously should not be treated as a change in an accounting policy. Hence the introduction of new pension scheme is neither a change in accounting policy nor a change in accounting estimate.

e) Change in cost formula used in measurement of cost of inventories is a change in accounting policy.

Question 9: Inter Sep 2025 (4 Marks)

Sneha an employee of Omre Limited went on maternity leave with pay for 9 months on 1st January 2024 up to 30th September 2024. Her monthly pay was ₹ 1,50,000. While preparing the financial statements for the year ended 31st March 2024, the salary of Sneha for 3 months (1 January 2024 to 31st March 2024) was not provided due to omission. When Sneha joined on 1st October 2024 the whole salary for 9 months (1st January 2024 to 30th September 2024) was paid to her.

With reference to AS-5 'Net Profit or Loss for the period, Prior Period Items and Change in Accounting Policies' you are required to determine if this is an example of prior period item and are also required to pass journal entry for the F.Y. 2024-2025.

Suppose Sneha was terminated from service on 1st January 2024 and was re-instated in service by the Court on 30th September 2024 and on 1st October 2024 the Company paid the 9 months salary to Sneha. What will be the treatment with reference to AS-5 in this situation? Give journal entry.

Solution

As per AS- 5 "Net Profit or Loss for the Period", Prior Period Items and Changes in Accounting Policies, the term 'prior period items', refers 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 nature and amount of prior period items should be separately disclosed in the statement of profit and loss so that their impact on the current profit or loss can be perceived.

Hence, in this case salary paid to Sneha for 3 months i.e. 1.1.2024 to 31.3.2024 ₹4,50,000 (1,50,000 x 3) will be classified as prior period item in FY 2024 -25.

(i) Journal entry in FY 2024-25

Salary A/c (₹ 1,50,000 x 6)	Dr.	9,00,000	
Prior period item (₹ 1,50,000 x 3)	Dr.	4,50,000	
To Bank A/c			13,50,000
(Being salary related to 9 months paid out of which 3 month's salary is prior period item)			

Alternative Entry

Prior Period Item (₹ 1,50,000 x 3) To Bank A/c	Dr.	4,50,000	 4,50,000
(Being Salary related to 3 months is prior period item)			
Salary A/c (₹1,50,000 x 6)	Dr.	9,00,000	
To Bank A/c			9,00,000
(Being salary related to 6 month's salary)			

(ii) AS 5 inter alia states that the term 'prior period items' does not include other adjustments necessitated by circumstances, which though related to prior periods, are determined in the current period. Accordingly, in the second case though Sneha was terminated on 1.1.2024 i.e. in 2023- 2024, yet she was reinstated due to court's order in 2024 -2025, with the instruction by the court to pay the salary for the intervening period i.e. with retrospective effect from January, 2024.

The adjustment of salary of ₹ 4,50,000 (for January 2024 to March, 2024) would not be considered as prior period item and will be accounted for in the books as current year expense. Thus, the entire amount of Salary of ₹ 13,50,000 for January, 2024 to September, 2024 is a current year expense only.

Salary A/c (1,50,000 x 9)	Dr.	13,50,000	
To Bank A/c			13,50,000
(Being 9 month's salary paid during the year)			

Question 10: Inter Nov 2023 (5 Marks) / RTP Jan 2026

The accountant of Beryl Limited has asked you to identify the following items as - Change in Accounting Policies / Change in Accounting Estimates / Extraordinary Items / Prior period items / Ordinary Activity.

(i) Non-provision for salary already due in earlier year.
(ii) Attachment of the property of the enterprise.
(iii) Introduction of new pension scheme for employees.
(iv) Change in Reserve for obsolete inventory.
(v) Settlement of litigation case.
(vi) Actual Bad debts exceed the provision.
(vii) Legislative changes having long term retrospective application.
(viii) Capitalisation of working capital loan interest.
(ix) Change from Cost Model to Revaluation Model for measurement of carrying amount of PPE.
(x) Government sanctioned grant in current year for expenses incurred in previous accounting year.

Solution

(i) Prior Period item
(ii) Attachment of property of enterprise is an extraordinary item.
(iii) Introduction of new pension scheme for employes is not a change in accounting policy. It is an ordinary activity.
(iv) Change in provision for obsolete inventory is a change in accounting estimate.
(v) Litigation settlement is an ordinary activity but requires separate disclosure
(vi) Change in estimate
(vii) Ordinary activity requiring separate disclosure
(viii) Error*
(ix) Change in Accounting policy.
(x) Ordinary activity requiring separate disclosure or extra-ordinary item.

***If it relates to the previous year then it can be considered as a prior period item.**

Some Extra Cases other than above:

(i) Treating operating lease as finance lease.
(ii) Change in the method of depreciation from straight line to WDV. ~~change in policy~~
(iii) Government grant becoming refundable.
(iv) Applying 10% depreciation instead of 15% on furniture.
(v) Change in useful life of fixed assets.

Solution

(i) Prior- period Items
(ii) Change in Accounting Estimates
(iii) Extra -ordinary Items
(iv) Prior- period Items
(v) Change in Accounting Estimates