

AS 5

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

NB Pg. No.

? Question 1

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.

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 2

NB Pg. No.

Fuel surcharge is billed by the State Electricity Board at provisional rates. Final bill for fuel surcharge of ₹ 5.30 lakhs for the period October, 20X1 to September, 20X7 has been received and paid in February, 20X8. However, the same was accounted in the year 20X8-X9. Comment on the accounting treatment done in the said case.

Solution :

The final bill having been paid in February, 20X8 **should have been accounted for in the annual accounts** of the company for the year ended 31st March, 20X8. However, **it seems that as a result of error or omission in the preparation of the financial statements of prior period** i.e., for the year ended 31st March 20X8, this material charge has arisen in the current period i.e., year ended 31st March, 20X9. Therefore, it **should be treated as 'Prior period item'** as per AS 5. As per AS 5, prior period items are normally included in the determination of net profit or loss for the current period. An alternative approach is to show such items 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.

It may be mentioned that it is an expense arising from the ordinary course of business. Although abnormal in amount or infrequent in occurrence, such an expense does not qualify an extraordinary item as per AS 5. For better understanding, the fact that power bill is accounted for at provisional rates billed by the state electricity board and final adjustment thereof is made as and when final bill is received may be mentioned as an accounting policy.

Question 3

- During the year 20X1-20X2, a medium size manufacturing company wrote down its inventories to net realisable value by ₹ 5,00,000. Is a separate disclosure necessary?
- A company signed an agreement with the Employees Union on 1.9.20X2 for revision of wages with retrospective effect from 30.9.20X1. This would cost the company an additional liability of ₹ 5,00,000 per annum. Is a disclosure necessary for the amount paid in 20X2-X3?

Solution :

- 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 require 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**.

- It is given that revision of wages took place on 1st September, 20X2 with retrospective effect from 30.9.20X1. Therefore **wages payable for the half year** from 1.10.20X2 to 31.3.20X3 **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

The company finds that the inventory sheets of 31.3.20X1 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 Omega Ltd. for the year ended 31st March, 20X2.

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 vide AS 5. Separate disclosure of this item as a prior period item is required as per AS 5.

Question 5 (RTP Nov'21, May'20, Sep'24)

Explain whether the following will constitute a change in accounting policy or not as per AS 5.

- Introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement.
- Management decided to pay pension to those employees who have retired after completing 5 years of service in the organisation. Such employees will get pension of ₹ 20,000 per month. Earlier there was no such scheme of pension in the organisation.

Solution :

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.

- (i) Accordingly, introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement is **not a change in an accounting policy**.
- (ii) Similarly, the adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial will **not be treated as a change in an accounting policy**.

? Question 6

NB Pg. No.

In the current year, A Ltd. changed the depreciation method from the Straight Line Method (SLM) to Written Down Value (WDV) method. When A Ltd. Recomputed depreciation retrospectively as per the new method, deficiency arose in depreciation in respect of past years. Therefore, it reduced the carrying amount of the asset by the amount of deficiency and such change in carrying amount (deficiency amount) has been debited to the statement of profit and loss as an extraordinary expense.

Whether the change in the carrying amount of assets due to the change in depreciation method should be treated as an extraordinary item?

Solution :

No.

As per AS 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" 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.

A change in the method of charging depreciation is not an event that is clearly distinct from the ordinary activities of the entity. In the instant case, A Ltd. Has changed the depreciation method and treated the reduction in carrying amount (or amount of deficiency in depreciation) of the asset as an extraordinary expense. This is not correct. Such deficiency should be treated as a normal expense. A change in the estimated useful life of a depreciable asset (i.e. change in depreciation method) affects the depreciation 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.

The change in depreciation method is considered as a change in accounting estimate as per the provisions of AS 5.

? Question 7

NB Pg. No.

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 Rs. 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. Recognising such payments as an **extra-ordinary item is contrary to AS 5.**

Question 8 (MTP April 21)

NB Pg. No.

S.T.B. Ltd. makes provision for expenses amounting Rs. 7,00,000 as on March 31, 2020, but the actual expenses during the year ending March 31, 2021 comes to Rs. 9,00,000 against provision made during the last year. State with reasons whether difference of Rs. 2,00,000 is to be treated as prior period item as per AS 5.

(5 Marks)

Solution :

As per AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', 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 judgments 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 the 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 omissions 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. 2 lakhs, is not a prior period item. Therefore, in the given case **expenses amounting Rs. 2,00,000** (i.e. Rs. 9,00,000 – Rs. 7,00,000) recorded in the current year, **should not be regarded as prior period item.**

Question 9 (MTP March'21, April'22)

NB Pg. No.

A company created a provision of Rs. 7,50,000 for staff welfare while preparing the financial statements for the year 2020-21. On 31st March 2021, in a meeting with staff welfare association, it was decided to increase the amount of provision for staff welfare to Rs. 10,00,000. The accounts were approved by Board of Directors on 15th April, 2021. You are required to explain the treatment of such revision in financial statements for the year ended 31st March 2021 in line with the provisions of AS 5?

(4 Marks)

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. 2,50,000 is neither a prior period item nor an extraordinary item. It is a change in estimate, which has been occurred in the year 2020-21. As per the provisions of the standard, normally, all items of income and expense which are recognized 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.**

Question 10 (MTP May'20, Oct'22, RTP Nov'20, May'20, May 22, PYQ Nov'22)

NB Pg. No.

The Accountant of a company has sought your opinion with relevant reasons, whether the following

will be treated as change in Accounting Policy or not for the year ended 31st March, 2020. Please advise him in the following situations in accordance with the provisions of relevant Accounting Standard;

- Provision for doubtful debts was created @ 2% till 31st March, 2019. From the Financial year 2019-2020, the rate of provision has been changed to 3%.
- During the year ended 31st March, 2020, the management has introduced a formal gratuity scheme in place of ad-hoc ex-gratia payments to employees on retirement.
- Till the previous year the furniture was depreciated on straight line basis over a period of 5 years. From current year, the useful life of furniture has been changed to 3 years.
- 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 Rs. 20,000 per month. Earlier there was no such scheme of pension in the organization.
- During the year ended 31st March, 2020, there was change in cost formula in measuring the cost of inventories.

Solution :

(5 Marks)

- In the given case, company has created 2% provision for doubtful debts till 31st March, 2019. Subsequently in 2019-20, the company revised the estimates based on the changed circumstances and wants to create 3% 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.**
- As per AS 5, 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 policy, will **not be treated as change in an accounting policy.**
- Change in useful life of furniture from 5 years to 3 years is a change in estimate and is **not a change in accounting policy.**
- 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 **not a change in accounting policy.**
- Change in cost formula used in measurement of cost of inventories is a **change in accounting policy.**

? Question 11 (RTP Nov 21)

There was a major theft of stores valued at Rs. 10 lakhs in the preceding year which was detected only during current financial year (2020-2021). How will you deal with this information in preparing the financial statements of R Ltd. for the year ended 31st March, 2021.

NB Pg. No.

Solution :

Due to major theft of stores in the preceding year (2019-2020) which was detected only during the current financial year (2020-2021), there was overstatement of closing inventory of stores in the preceding year. This must have also resulted in the overstatement of profits of previous year, brought forward to the current year. The adjustments are required to be made in the current year as 'Prior Period Items' as per AS 5 (Revised) on Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies. Accordingly, the **adjustments relating to both opening inventory of the current year and profit brought forward from the previous year should be separately disclosed in the statement of profit and loss together with their nature and amount in a manner that their impact on the current profit or loss can be perceived.**

Alternatively, it may be assumed that in the **preceding year, the value of inventory** of stores as found out by physical verification of inventories was considered in the preparation of financial statements of the preceding year. In such a case, **only the disclosure** as to the theft and the resulting loss is required in the notes to the accounts for the current year i.e, year ended 31st March, 2021.

Question 12 (RTP May 18 & Nov 22) **NB Pg. No.**

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 Rs.10 Lakhs by selling the said land. Moreover, there was a fire in the factory and a part of the unused factory shed valued at Rs. 8 Lakhs was destroyed. The loss from fire was set off against the profit from sale of land and profit of Rs. 2 lakhs was disclosed as net profit from sale of assets.

You are required to examine the treatment and disclosure done by the company and advise the company in line with AS 5.

Solution :
As per AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" 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 13 (RTP May'23, PYQ Jan 21) **NB Pg. No.**

State whether the following items are examples of change in Accounting Policy / Change in Accounting Estimates / Extraordinary items / Prior period items / Ordinary Activity:

- (i) Actual bad debts turning out to be more than provisions.
- (ii) Change from Cost model to Revaluation model for measurement of carrying amount of PPE.
- (iii) Government grant receivable as compensation for expenses incurred in previous accounting period.
- (iv) Treating operating lease as finance lease.
- (v) Capitalization of borrowing cost on working capital.
- (vi) Legislative changes having long term retrospective application.
- (vii) Change in the method of depreciation from straight line to WDV.
- (viii) Government grant becoming refundable.
- (ix) Applying 10% depreciation instead of 15% on furniture.
- (x) Change in useful life of PPE.

(5 Marks)

Solution :

Classification of given items is as follows:

Sr. No.	Particulars	Remarks
(i)	Actual bad debts turning out to be more than provisions	Change in Accounting Estimates

(ii)	Change from Cost model to Revaluation model for measurement of carrying amount of PPE	Change in Accounting Policy
(iii)	Government grant receivable as compensation for expenses incurred in previous accounting period	Extra -ordinary Items
(iv)	Treating operating lease as finance lease.	Prior- period Items
(v)	Capitalization of borrowing cost on working capital	Prior-period Items (as interest on working capital loans is not eligible for capitalization)
(vi)	Legislative changes having long term retrospective application	Ordinary Activity
(vii)	Change in the method of depreciation from straight line to WDV	Change in Accounting Estimates
(viii)	Government grant becoming refundable	Extra -ordinary Items
(ix)	Applying 10% depreciation instead of 15% on furniture	Prior- period Items
(x)	Change in useful life of PPE	Change in Accounting Estimates

Question 14 (PYQ May 19)

NB Pg. No.

As per the provisions of AS-5, extraordinary items should not be disclosed in the statement of profit and loss as a part of net profit or loss for the period.

Solution :

(1 Mark)

False: 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.

Question 15 (PYQ May 18, RTP May 19)

NB Pg. No.

PQR Ltd. is in the process of finalizing its accounts for the year ended 31st March, 2018. The company seeks your advice on the following:

- Goods worth ₹ 5,00,000 were destroyed due to flood in September, 2015. A claim was lodged with insurance company. But no entry was passed in the books for insurance claim in the financial year 2015-16. In March, 2018, the claim was passed and the company received a payment of ₹ 3,50,000 against the claim. Explain the treatment of such receipt in final account for the year ended 31 st March, 2018.
- Company created a provision for bad and doubtful debts at 2.5% on debtors in preparing the financial statements for the year 2017-18. Subsequently, on a review of the credit period allowed and financial capacity of the customers, the company decides to increase the provision to 8% on debtors as on 31.03.2018. The 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 item?

Solution :

(5 Marks)

- As per the provisions 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 error or omissions in the preparation of 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 and 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/omission in preparation of financial

statements for the year 2015- 16. Hence, **claim received** in the financial year 2017- 18 is a **prior period item** and should be separately disclosed in the statement of Profit and Loss.

- (ii) In the given case, a limited company created 2.5% provision for doubtful debts for the year 2017-2018. Subsequently, the company **revised the estimates** based on the changed circumstances and wants to create 8% provision. As per AS 5, the revision in rate of provision for doubtful debts will be considered as change in estimate and is neither a prior period item nor an extraordinary item.

The effect of **such change should be shown in the profit and loss account** for the year ending 31st March, 2018.

Question 16 (PYQ May'22)

NB Pg. No.

TQ Cycles Ltd. is in the manufacturing of bicycles, a labour intensive manufacturing sector. In April 2022, the Government enhanced the minimum wages payable to workers with retrospective effect from the 1st January, 2022. Due to this legislative change, the additional wages for the period from January 2022 to March 2022 amounted to ₹ 30 lakhs. The management asked the Finance manager to charge ₹ 30 lakhs as prior period item while finalizing financial statements for the year 2022-23.

Further, the Finance manager is of the view that this amount being abnormal should be disclosed as extra-ordinary item in the Profit and loss account for the financial year 2021-22.

Discuss with reference to applicable Accounting Standards.

(5 Marks)

Solution :

As per 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 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.

It is given that revision of wages took place in April, 2022 with retrospective effect from 1st January, 2022. Therefore, wages payable for the period from 1.01.2022 to 31.3.2022 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. The full amount of wages payable to workers will be treated as an expense of current year and it will be charged to profit & loss account for the year 2022-23 as normal expenses.

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. Therefore, finance manager is incorrect in treating increase as 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.

Therefore, additional wages liability of ₹ 30 lakhs should be disclosed separately in the financial statements of TQ Cycles Ltd. for the year ended 31st March, 2023.

Question 17 (PYQ Nov'23)

NB Pg. No.

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:

- Non-provision for salary already due in earlier year.
- Attachment of the property of the enterprise.
- Introduction of new pension scheme for employees.

- v) Change in Reserve for obsolete inventory.
- v) Settlement of litigation case.
- vi) Actual Bad debts exceeds 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.

(5 Marks)

Solution :

- (i) Prior Period item
- (ii) Attachment of property of enterprise is an extraordinary item.
- (iii) Introduction of new pension scheme for employees 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.

? Question 18 (RTP Jan'25)

NB Pg. No.

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.

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 term 'prior period items', as defined in AS 5 (revised) "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", refer 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 **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.