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

AS 05

- Net profit or Loss for the period
  - Ordinary activity
  - Extra-ordinary item
- Prior Period items
- Changes in Accounting estimates
- Changes in Accounting policies

NET PROFIT OR LOSS FOR THE PERIOD		
General rule	All items of income & expense which are recognized in a period should be included in the determination of Net Profit or loss for the period including extra-ordinary items, effects of changes in accounting estimates.	
Profit or loss from ordinary activity	Meaning	These are the principle revenue producing and generating activities and incidental items. 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. <u>For example:</u> Profit on sale of merchandise, loss on sale of unsold inventory at the end of the season.
	Requirement under AS-5 (PARA 12)	The <u>nature and amount</u> of such items is to be disclosed separately if they are of <u>such size, nature or incidence</u> that their disclosure is relevant to explain the performance of enterprise for the period.
	Example	➢ Writing down of inventories to NRV or vice-versa ➢ Disposal of fixed assets ➢ Disposal of long-term investments ➢ Legislative changes having retrospective effect ➢ Litigation settlements ➢ Restructuring of activities of an enterprise & reversal of provisions for the costs of restructuring.
Extra-ordinary Items	Meaning	These are the activities which are not ordinary. These are irregular & infrequent in nature. Only on rare occasions, an event or transactions gives rise to an extra-ordinary item.
	Requirement under AS-5 (PARA 8)	Should be disclosed in the Statement of P&L as a part of Net Profit or loss for the period.

<table>
<tr><td rowspan="2"></td><td></td><td>Their <u>nature and amount</u> should always be separately disclosed in the statement of P&L in a manner that its <u>impact on current profit or loss can be perceived</u>.</td></tr>
<tr><td>Example</td><td>➢ Loss by earthquake, flood etc.
➢ Attachment of property of the enterprise (confiscation of property by tax officials)
➢ Government grant becoming refundable.</td></tr>
<tr><th colspan="3">PRIOR PERIOD ITEM</th></tr>
<tr><td>Meaning</td><td colspan="2">These are the items of incomes and expenses which arise in the current period as a result of error or omissions in the preparation of financial statements of one or more previous periods.</td></tr>
<tr><td>Reasons</td><td colspan="2">These may occur due to:
✓ Mathematical mistakes
✓ Mistakes in applying accounting policies
✓ Due to over sight</td></tr>
<tr><td>Requirement as per AS-5 (PARA 15)</td><td colspan="2">Their <u>nature and amount</u> is to be separately disclosed in the Statement of P&L in such a manner that their impact on the current profit or loss can be perceived.</td></tr>
<tr><td>Example</td><td colspan="2">➢ Revenue expenditure treated as capital expenditure or vice –versa
➢ Wrong totaling of stock.</td></tr>
<tr><th colspan="3">CHANGE IN ACCOUNTING ESTIMATES</th></tr>
<tr><td>Meaning of Accounting estimate</td><td colspan="2">As a result of uncertainties inherent in business activities, many financial statement items cannot be measured with precisions but can only be estimated.
The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.</td></tr>
<tr><td>Example</td><td colspan="2">➢ Estimate of bad debts
➢ Useful life of depreciable assets
➢ Estimates of inventory obsolescence</td></tr>
<tr><td>When change in accounting estimates occur</td><td colspan="2">✓ As a result of new information
✓ As a result of more experience
✓ As a result of subsequent development
✓ If changes occur regarding the circumstances on which the estimate was based</td></tr>
<tr><td>Notes</td><td colspan="2">✓ It is not a prior period item
✓ The revision of the estimate by its nature does not bring the adjustments within the definitions of an extraordinary item or prior period item.
✓ 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</td></tr>
</table>

	✓ 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 *(Para 27)*
CHANGE IN ACCOUNTING POLICY	
General rule	Accounting policy once adopted should not be changed i.e. these should be applied consistently.
When is change recommended	A change in accounting policy should be made only if adoption of different accounting policy is required → By Statute i.e. by Law or → For Compliance with an Accounting standard or → If it is considered that change would result in more appropriate presentation of financial statements.
Disclosure requirements	✓ Any change in accounting policy having material effect is to be disclosed. ✓ If the effect of such change is material it should be shown in financial statement of the period in which such change is made. ✓ Where effect of change is not ascertainable, fact should be disclosed. ✓ If the impact of such change is not material in current period but is expected in later periods, then the fact of change is to be disclosed.
Notes	Sometimes it is difficult to distinguish between a change in accounting policy and a change in accounting estimate. In such cases, the change is treated as "change in accounting estimate" with appropriate disclosure. *The following are not changes in accounting policies*: ○ The adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, e.g., introduction of formal retirement gratuity scheme by an employer in place of adhoc ex-gratia payments to employees on retirement. ○ The adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial.

ASSIGNMENT QUESTIONS

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 fixed assets 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 31.3.2019 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, 2020.

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. Separate disclosure of this item as a prior period item is required as per Para 15 of AS 5.

Question 3 *(ICAI Study Material)*

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, 2012 to September, 2018 has been received and paid in February, 2019. However, the same was accounted in the year 2019-20. Comment on the accounting treatment done in the said case.

Solution
The final bill having been paid in February, 2019 should have been accounted for in the annual accounts of the company for the year ended 31st March, 2019. 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 2019, this material charge has arisen in the current period i.e., year ended 31st March, 2020. 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 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 4 *(Inter May 2018 (5 Marks) / RTP May 2019)*

PQR Ltd. is in the process of finalizing its accounts for the year ended 31st March, 2020. The company seeks your advice on the following:

(i) Goods worth ₹ 5,00,000 were destroyed due to flood in September, 2017. A claim was lodged with insurance company. But no entry was passed in the books for insurance claim in the financial year 2017-18. In March, 2020, 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 31st March, 2020.

(ii) Company created a provision for bad and doubtful debts at 2.5% on debtors in preparing the financial statements for the year 2019-20. 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 31.03.2020. 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

(i) 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 2017-18. Hence, claim received in the financial year 2019-20 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 2019-2020. 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 & loss account for the year ending 31st March, 2020

Question 5

S.T.B. Ltd. makes provision for expenses worth ₹ 7,00,000 for the year ending March 31, 2019, but the actual expenses during the year ending March 31, 2020 comes to ₹ 9,00,000 against provision made during the last year. State with reasons whether difference of ₹ 2,00,000 is to be treated as prior period item as per AS-5.

Solution

As per AS 5, 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 ₹ 2 lakhs, is not a prior period item.

Therefore, in the given case expenses amounting ₹ 2,00,000 (i.e. ₹ 9,00,000 – ₹ 7,00,000) relating to the previous year recorded in the current year, should not be regarded as prior period item.

Question 6

X Co. Ltd. signed an agreement with its employees union for revision of wages in June, 2020. The wage revision is with retrospective effect from 1.4.2016. The arrear wages upto 31.3.2020 amounts to ₹ 80 lakhs. Arrear wages for the period from 1.4.2020 to 30.06.2020 (being the date of agreement) amounts to ₹ 7 lakhs. Decide whether a separate disclosure of arrear wages is required.

Solution

It is given that revision of wages took place in June, 2020 with retrospective effect from 1.4.2016. The arrear wages payable for the period from 1.4.2016 to 31.3.2020 cannot be taken as an error or omission in the preparation of financial statements of earlier years and hence this expenditure cannot be taken as a prior period item.

Additional wages liability of ₹ 87 lakhs (from 1.4.2016 to 30.6.2020) 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 (Revised),' Net Profit or loss for the Period, Prior Period Items and Changes in the Accounting Policies', 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.

However, wages payable for the current year (from 1.4.2020 to 30.6.2020) amounting ₹ 7 lakhs is not a prior period item hence need not be disclosed separately. This may be shown as current year's wages.

Question 7

An extract from the statement profit and loss of a company for 2019-20 is given below:

	₹ '000	₹ '000
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

Closing stock includes stock damaged in a fire in 2018-19. On 31/03/19, estimated net realisable value of this stock was ₹ 15,000. The revised estimate of net realisable value included in closing stock of 2019-20 is ₹ 5,000. Rewrite statement of profit & loss if necessary to comply with requirements of AS 5.

Question 8

Closing Stock for the year ending on 31st March, 2020 is ₹ 1,50,000 which includes stock damaged in a fire in 2018-19. On 31st March, 2019, the estimated net realizable value of the damaged stock was ₹ 12,000. The revised estimate of net realizable value of damaged stock included in closing stock at 2019-20 is ₹ 4,000. Find the value of closing stock to be shown in Profit and Loss Account for the year 2019-20, using provisions of Accounting Standard 5.

Solution

The fall in estimated net realisable value of damaged stock ₹ 8,000 is the effect of change in accounting estimate. As per AS 5, the effect of a 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. It is presumed that the loss by fire in the year ended 31.3.2019, i.e. difference of cost and NRV was shown in the profit and loss account as an extra-ordinary item. Therefore, in the year 2019-20, revision in accounting estimate should also be classified as extra-ordinary item in the profit and loss account and closing stock should be shown excluding the value of damaged stock.

Value of closing stock for the year 2019-20 will be as follows:

Closing Stock (including damaged goods)	1,50,000
Less: Revised value of damaged goods	(4,000)
Closing stock (excluding damaged goods)	1,46,000

Question 9

X Limited was making provisions up to 31-3-2019 for non-moving inventories based on no issues for the last 12 months. Based on a technical evaluation the company wants to make provisions during the year 31-03-2020 in the following manner:

Total value of inventory ₹ 3 crores
Provision required based on 12 months ₹ 8 lakhs.
Provision required based on technical evaluation ₹ 7.50 lakhs.

Does this amount to change in accounting policy?
Can the company change the method of provision?

Solution

Basis of provisioning whether on no issues or on technical evaluation is the basis of making estimates and cannot be considered as Accounting Policy. As per AS 5, due to 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. 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.

The basis of change in provisioning is a guideline and the better way of estimating the provision for non-moving inventory on account of change. Hence, it is not a change in accounting policy.

Further, the company should be able to demonstrate satisfactorily that having regard to circumstances provision made on the basis of technical evaluation provides more satisfactory results than provision based on 12 months issue. If that is the case, then the company can change the method of provision.

Question 10 *(RTP May 2018)/ (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.

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 11 *(RTP May 2020) / (ICAI Study Material)*

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

(i) Introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement.

(ii) 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.

Solution

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.

(i) Accordingly, introduction of formal retirement gratuity scheme by an employer in place of adhoc ex-gratia payments to employees on retirement is not change in accounting policy.

(ii) Similarly, adoption of 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 12 *(RTP Nov 2018) / (RTP Nov 2019) / (RTP Nov 2020) (Similar)/ (RTP May 2022)*

The Accountant of Mobile Limited has sought your opinion with relevant reasons, whether the following transactions 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;

(a) 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%.

(b) 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.

(c) 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.

(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, 2020, there was change in cost formula in measuring the cost of inventories

Solution

(a) In the given case, Mobile limited 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.

(b) 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.

(c) 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.

(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 not a change in accounting policy.

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

Question 13

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 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 14 *(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.

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 15 *(ICAI Study Material)*

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. Recognizing such payments as an extra-ordinary item is contrary to AS 5.

Question 16 *(Inter Nov 2023) (5 Marks)*

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.

PRACTICE QUESTIONS

Question 1 *(Inter May 2019) (2 Marks)*

State whether the following statements are 'True' or 'False'. Also give reason for your answer.

(1) 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.

(2) As per the provisions of AS-4, a contingency is a condition or situation, the ultimate outcome of which (gain or loss) will be known or determined only on the occurrence of one or more uncertain future events.

Solution

(1) 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

(2) False: A contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events

Question 2

A limited company created a provision for bad and doubtful debts at 2.5% on debtors in preparing the financial statements for the year 2019-2020. 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 31.3.2020. 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 extraordinary item or prior period item?

Solution

As per AS 5, 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 item or an extraordinary item.

In the given case, a limited company created 2.5% provision for doubtful debts for the year 2019-2020. Subsequently in 2020 the company revised the estimates 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 and quantified

Question 3

A company created a provision of ₹ 75,000 for staff welfare while preparing the financial statements for the year 2019-20. On 31st March, in a meeting with staff welfare association, it was decided to increase the amount of provision for staff welfare to ₹ 1,00,000. The accounts were approved by Board of Directors on 15th April, 2020. Explain the treatment of such revision in financial statements for the year ended 31st March, 2020.

Solution

As per AS 5, the change in amount of staff welfare provision amounting ₹ 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.

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 4 *(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 5 *(Inter May 2022) (5 Marks)*

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.

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 & 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 6

Priya Ltd had to pay delayed cotton clearing charges over and above the negotiated price for taking delayed delivery of cotton from the supplier's godown. Upto 2018-19, the company has regularly included such charges in the valuation of closing stock. This charge, being in the nature of interest, the company has decided to exclude it from closing stock valuation. This would result in decrease of profit by ₹ 8.60 lakhs. What will be its treatment in the financial statements for year ended 31st March, 2020?

Solution

AS 5 states that a change in an accounting policy should be made only if
a) It is required by statute, or
b) for compliance with an accounting standard, or
c) if it is considered that the change would result in a more appropriate presentation of the financial statements of an enterprise.

Therefore the change in the method of stock valuation is justified in view of the fact that the change is in line with the recommendations of AS 2 'Valuation of Inventories' and would result in more appropriate preparation of the financial statements. Accordingly, cost formula used for inventory valuation will exclude the delayed clearing charges being in the nature of interest. Due to change in the cost formula, the value of inventory and resulting profit will decrease by ₹ 8.60 lakhs. Appropriate disclosures should be made in the financial statements for this change.

Question 7

Shama was working with ABC Ltd. drawing monthly salary of ₹ 25,000 per month. She went on maternity leave with pay for 7 months i.e. from 1-01-2019 to 31-7-19. Her salary for 3 months was not provided for in financial statements for F.Y. 2018-19 due to omission. When she joined after leave period, the whole salary for 7 months was paid to her.

You are required to:

(i) Pass the necessary journal entries in F.Y. 2019-20 to record the above transaction as per accounting standard-5 and state reason for the same.

(ii) Would the treatment have been different, if Shama was terminated on 01-01-2019 and was reinstated in service by the court w.e.f. 01-08-2019 with instruction to pay Shama salary for the intervening period i.e. 1-01-2019 to 31-07-2019

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 Shama for 3 months i.e 1.1.2019 to 31.3.2019 ₹ 75,000 will be classified as prior period item in FY 2019-20 and following journal entry shall be passed:

(i) Journal entry in FY 2019-20

Salary A/c (₹ 25,000 x 4)	Dr.	1,00,000	
Prior period item (₹ 25,000 x 3)	Dr.	75,000	
To Bank A/c			1,75,000
(Salary related to 7 months paid out of which 3'months' salary is prior period item)			

Alternative Entry

Salary A/c (prior period item)	Dr.	75,000	
To Bank A/c			75,000
(Salary related to 3 months i.e. January, 2019 to March 2019 paid in 2019-2020)			
Salary A/c	Dr.	1,00,000	
To Bank A/c			1,00,000
(Salary related to 4 months paid on 1.8.2019 for April to July, 2019)			

(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 Shama was terminated on 1.1.2019 i.e. in 2018-2019, yet she was reinstated due to court's order in 2019-2020, with the instruction by the court to pay the salary for the intervening period i.e. with retrospective effect from January, 2019. The adjustment of salary of ₹ 75,000 (for January 2019 to March, 2019) 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 ₹ 1,75,000 for January, 2019 to July, 2019 is a current year expense only.

Salary A/c (₹ 25,000 x 7)	Dr.	1,75,000	
To Bank A/c			1,75,000
(Salary related to 7 months paid i.e. for the period 1.1.2019 to 31.7.2019)			

Question 8 *(RTP Nov 2021)*

a) There was a major theft of stores valued at ₹ 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 financial statements of R Ltd. for the year ended 31st March, 2021.

b) 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 organization.

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

Solution

a) 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.

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. Accordingly, the adoption of a new accounting policy of paying pension to retired employees is a policy for events or transactions which did not occur previously. Hence, it will not be treated as a change in an accounting policy.

Question 9 *(ICAI Study Material)*

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 10 *(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 the furniture was depreciated on straight line basis over a period of 5 years. From the Financial year 2020-2021, the 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 11 *(Inter Jan 2021) (5 Marks) / (RTP May 2023)*

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) Capitalisation 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 fixed assets.

Solution

(i) Change in Accounting Estimates
(ii) Change in Accounting Policy
(iii) Extra -ordinary Items
(iv) Prior- period Items
(v) Prior-period Items (as interest on working capital loans is not eligible for capitalization)
(vi) Ordinary Activity
(vii) Change in Accounting Estimates
(viii) Extra -ordinary Items
(ix) Prior- period Items
(x) Change in Accounting Estimates