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AS 5 = NET PROFIT OR LOSS FOR THE PERIOD, PRIOR PERIOD ITEMS AND CHANGES IN ACCOUNTING POLICIES

SYNOPSIS

1. Objective

The objective of AS-5 is to prescribe the classification and disclosure of certain items in the statement of profit and loss so that all entities prepare and present such a statement on a uniform basis.

AS – 5 Discusses

Presentation & Disclosure of
- ❖ Certain Ordinary activities;
- ❖ Extraordinary activities;
- ❖ Prior period items;

Accounting Treatment & Presentation and disclosure of
- ❖ Changes in Accounting estimates;
- ❖ Changes in Accounting policies;

This Standard doesn't deal with tax effect of the above items.

2. Net Profit or Loss for the Period

All items of income and expense which are recognised in a financial year should be **part of P&L a/c** for the period. If any Accounting Standard or Law suggests or permits a different treatment, it should be accounted as guided by that AS/Law. (As Accounting standard cannot override the law);

Net profit or loss for the period includes:

1. Profit or loss from **ordinary** activities; and
2. Profit or loss from **extraordinary** items;

Concept capsule 1

X Ltd. has received ₹2,00,000 dividend income from investments of debenture redemption reserve. Should this dividend income be credited to P&L a/c OR Debenture Redemption Reserve a/c (DRR).

Suggested answer

As per AS-5 – All income and expenses during the period should be part of P&L a/c. Transfer of income directly to the specific reserve is NOT a requirement of accounting standard or Companies Act. Hence the dividend income on DRR investments should be transferred to P&L a/c only.

If the amount is directly credited to DRR (without routing through P&L a/c), it amounts to non-compliance of AS-5 and understatement of profit during the period.

The company should always recognise the dividend income in the statement P&L and DRR should be created by transferring profits from retained earnings.

Let us understand the meaning of these terms below: (read the definitions carefully)

3. Ordinary and Extraordinary Activities

Ordinary Activities
are

Entity's business activities & Related & incidental to such business activities

- These activities arise in the normal course of business, so the frequency of the activities is high;
- These activities are ***expected to occur*** as part of business;

E.g. Sale of goods, providing services, sale of scrap, interest income/expense, salary expense, provisions, profit or loss on sale of fixed assets, etc.

Extraordinary items are

- Activities which are **clearly distinct** from the ordinary activities of the entity;
- These are **not expected to occur as part of business;**
- Generally, frequency of such transactions is low. But frequency is **not the only** criterion to determine;
- Classification of items is based on the NATURE of the item but NOT on frequency;
- Classification requires some degree of professional judgement.

E.g., An earthquake, attachment of property (seizure) by the Government, Refund of government grant (as per AS-12), etc. These are not expected to occur as a **part of business.**

- These events may be extraordinary for one entity and may not be for another entity.

Examples

(a) Earthquakes and floods are extraordinary items for many entities, but it is not for insurance companies.

(b) Hurricane may be an extraordinary item for Indian companies, but it may not be the same for US, because hurricanes are very likely to hit Florida during certain times of the year.

Presentation & Disclosure Requirements

Separate disclosure of certain items in the statement of P&L may be relevant to users of financial statements in understanding the financial position (i.e. Balance sheet) and performance of an entity (i.e. P&L) and in making **projections** about financial position and performance.

Disclosure of such information is sometimes made in the notes to the financial statements.

Extraordinary activities:

Extraordinary activities should be **separately disclosed in P&L a/c** to show the impact on profit and loss. *(Refer the disclosure with example given at the end of this standard).*

Ordinary Items

Generally, ordinary items are not presented separately in the statement of P&L. But certain ordinary items which are called exceptional items need separate disclosure in the statement of P&L.

What are Exceptional items?

These are **Ordinary activities** as they are **expected to occur** as part of a business. But based on **size, nature, or incidence (circumstances)** of transactions those activities require ***separate*** disclosure in the statement of P&L.These items are generally termed as ***exceptional items***.

- The writing down of inventories to net realisable value (NRV) as well as the *reversal* of the same;
- A restructuring of the activities of an entity and the reversal of any provisions for the costs of restructuring; *(Restructuring means changing the nature of business or structure of the company)*
- Profit or loss on disposal of fixed assets;
- Profit or loss on disposal of long-term investments;
- Legislative changes having retrospective application;
- Litigation settlements; and
- Other reversals of provisions;

Some more examples of exceptional items

Embezzlement (stealing) of cash, voluntary retirement expense, retrospective increase of salaries, a suit for damages for breach of contract, pilferage (stealing) of stock, etc.

Students generally have a question, why embezzlement of cash is exceptional & why not extraordinary?

Cash embezzlement is common for any business. It is 100% expected to occur. I say, if you are not expecting this to occur, *"please leave your wallet & mobile today in the classroom only and collect it tomorrow"*.

What should be disclosed?

Disclose

- the nature of the transaction;
- Amount of the transactions and
- All other relevant information in notes on accounts.

The following example explains how separate disclosure helps the user of financial statements:

Example

If X Ltd. presents P&L statement in the following manner, how do you interpret the results.

	20X2 (CY)	20X1 (PY)
Net profit for the year	150 Cr	100 Cr

In general any user interprets that the company is performing excellently, as net profit is increased by ₹50 Cr i.e. 50% and based on the current year performance user estimates (projects) the next year profits and takes economic decisions.

If the same company presents the financials in the following manner, just think how does the user interpret?

	20X2(CY)	20X1 (PY)
Net profit from day to day operations	110 Cr	100 Cr
Profit from sale of fixed assets	30 Cr	Nil
Profit from sale of Long-term investments	10 Cr	Nil
Total Net profit for the year	**150 Cr**	**100 Cr**

Now the interpretation of the user changes, obviously. The reason for the change is the separate disclosure. Now user understands that profit from sale of investments, fixed assets is **not recurring** in nature and user understands that there is 10% growth during the year and based on the interpretations, user estimates the next year profits and takes economic decisions accordingly.

Concept Capsule 2

During the year, X Ltd. undertook restructuring exercise of its operations at a cost of ₹150 lakh. This amount stood included in "miscellaneous expenditure to the extent not written off" (Old Schedule VI). Discuss.

Suggested answer

As per AS-5, Ordinary activities are business activities and activities related to business. Restructuring is an ordinary activity but it is an exceptional item based on its size, nature or incidence of the transaction and as it is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

Restructuring expenses don't satisfy the asset definition and as per AS-26, it should be charged to P&L a/c. Hence, the entire restructuring cost of ₹150 lakh needs to be charged to P&L a/c and requires separate disclosure.

Concept Capsule 3

X Ltd. as part of overall cost cutting measures announced voluntary retirement (VRS) to its employees, to reduce the number of employees. During June, the company paid ₹100 lakh for those who availed the scheme. The chief accountant wants to include it as part of general salaries and wages paid by the company. Is this correct?

Suggested answer

VRS payment is an ordinary activity (NOT extraordinary item). This is an exceptional item based on its size and nature of the transaction. Hence it requires separate disclosure on the face of P&L a/c or requires detailed disclosure in the notes on accounts. Even if the accountant includes it as part of salaries and wages, the detailed break up and other information should be given in the notes on account.

Concept capsule 4

During the year 20X1-X2, a medium size manufacturing company wrote down its inventories to net realisable value by ₹5,00,000. Is there any requirement of a separate disclosure?

Suggested answer

Writing down inventory to NRV is an **ordinary** activity. But by its nature, size and incidence of the transaction it requires **separate** disclosure. Disclosure 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.

Circumstances which may give rise to separate disclosure of items of income and expense in accordance with **para 12 of AS-5** includes the write-down of inventories to net realisable value as well as the reversal of such write-downs.

Concept capsule 5

A company received ₹10 lakh from insurance company for goods destroyed of ₹8 lakh. It credited this to purchases a/c. Is the treatment correct? (Similarly sale of scrap items adjusted against misc. expenditure)

OR

Cash embezzlement (cash theft) loss was debited to Salary a/c. Comment

Suggested answer

As per AS-5, all items of income and expense which are recognized in a period must be included in the determination of net profit or loss. These activities are classified into ordinary and extraordinary for separate disclosure purpose. An ordinary item does not require separate disclosure but if it is different considering its nature, amount and incidence – it requires separate disclosure;

In the given case, the claim for loss of goods/cash embezzlement is arising out of ordinary activities of business *(these are expected as part of business)*. But because of its exceptional nature, it should be disclosed separately in the P&L (Exceptional items). Adjusting with purchases/salary account does not give true and fair view to financial statements.

The accounting treatment made by the company is not in accordance with AS-5.

4. Prior Period Items

Prior period items are **income or expense** 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.

Errors may occur as a result of

- Mathematical mistakes in calculations;
- Mistakes in application of accounting policies;
- Misinterpretation of facts; or
- Oversight (Failure to notice);

Omission means reliable **information was available** at the time of preparation of PY financial statements, but the information was NOT considered.

Q 1: Whether prior period items are recorded in the current year or previous year?

Answer: These are income or expense which are recorded in the Current year.

Q 2: Is that income/expense related to current year or previous year?

Answer: This income/expense is actually related to previous year(s) but it is recorded in the current year P&L a/c because the entity has not recorded in the previous year(s).

Q 3: Why was it not recorded in the previous year?

Answer: Because of omission it was not recorded in the previous year or there was an error while recording.

Q 4: Does the difference between actual and estimated income/expense constitute to be Prior Period Item?

Answer: **NO.** It does not constitute Prior Period item. Prior period item is the resultant of **omission/error** in previous year/s. The difference between actual and estimated should be disclosed as change in accounting estimates as per AS-5.

Presentation and Disclosure

Prior period items should be **disclosed separately** in the Profit and Loss a/c to show the impact of prior period items in the current year. *(Refer the disclosure with the example at the end of this chapter)*

Concept Capsule 6

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 ₹50 lakh. Is a separate disclosure necessary for the amount paid in 20X2-X3? ***(CA Inter May 2022)***

Suggested answer

Prior period items are income/expense recognised in the current year as a result of errors/omission in the previous year(s). In the given case :

1. Expense (wages) are recognised in the current year;
2. Expense is related to previous year;
3. But Retrospective revision of wages is **NOT an error or omission**. Revision took place on 1.9.20X2 and the entity didn't have any information at the time of preparation of PY financial statements.

Hence it is **NOT a prior period** item and revision in wages is an ordinary activity but based on its size and nature of the item it requires separate disclosure either on the face of P&L a/c or in notes on accounts.

Concept Capsule 7

X Ltd. finds that the stock sheets of 31.3.20X1 did not include two pages containing details of inventory worth ₹14.5 lakh. State, how you will deal with the accounts of X Ltd. for the year ended 31st March, 20X2 with reference to Accounting Standards.

Suggested answer

As per AS-5, 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".

In the given situation, the entity had reliable information as on 31.3.20X1 but it failed to consider (omission) that in preparation of financial statements. It amounts to prior period item as per AS-5. Hence separate disclosure is required. It can be adjusted by adding ₹14.5 lakh to the opening stock of 1.4.20X1. It is also necessary to show ₹14.5 lakh as a prior period adjustment in the Profit and loss Account.

Concept capsule 8

There was a major theft in PY which company could detect only in the current year. How will you deal with this information while preparing FS for current year?

Suggested answer

As per AS-5, 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 company did not account for theft in the PY because of omission. Therefore, this amounts to a prior period item. The company should disclose it separately in the P&L if it is material.

Concept capsule 9

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 recognized 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.

Suggested answer

As per AS-5, prior period items are income or expenses which arise in the 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.