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

CA Final Course Paper 1 Financial Reporting Chapter 1 Unit 6

CA. B. Ganesh
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Objective

To prescribe the classification and disclosure of certain items in the statement of profit and loss so that all enterprises prepare and present such a statement on a uniform basis.

Enhances the comparability of the financial statements of an enterprise over time and with the financial statements of other enterprises.

Requires classification and disclosure of extraordinary and prior period items, and the disclosure of certain items within profit or loss from ordinary activities.

It also specifies the accounting treatment for changes in accounting estimates and the disclosures to be made in the financial statements regarding changes in accounting policies.
Scope

It should be applied by an enterprise in presenting profit or loss from ordinary activities, extraordinary items and prior period items in the statement of profit and loss, in accounting for changes in accounting estimates, and in disclosure of changes in accounting policies.

It deals with the disclosure of certain items of net profit or loss for the period. These disclosures are made in addition to any other disclosures required by other Accounting Standards.

It does not deal with the tax implications of extraordinary items, prior period items, changes in accounting estimates, and changes in accounting policies for which appropriate adjustments will have to be made depending on the circumstances.
Definitions

**Ordinary activities** are 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.

**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.

**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.

**Accounting policies** are the specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements.
Net Profit or Loss for the Period

All items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise.

All items of income and expense which are recognised in a period are included in the determination of the net profit or loss for the period. This includes extraordinary items and the effects of changes in accounting estimates.

The net profit or loss for the period comprises the following components, each of which should be disclosed on the face of the statement of profit and loss:

- profit or loss from ordinary activities; and
- extraordinary items.
Extraordinary Items

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.

All items of income and expense included in the determination of net profit or loss for the period arise in the course of the ordinary activities of the enterprise.

Only on rare occasions does an event or transaction give rise to an extraordinary item.

Whether an event or transaction is clearly distinct from the ordinary activities of the enterprise is determined by the nature of the event or transaction in relation to the business ordinarily carried on by the enterprise rather than by the frequency with which such events are expected to occur.
An event or transaction may be extraordinary for one enterprise but not so for another enterprise because of the differences between their respective ordinary activities.

For instance, losses sustained as a result of an earthquake may qualify as an extraordinary item for many enterprises. However, claims from policyholders arising from an earthquake do not qualify as an extraordinary item for an insurance enterprise that insures against such risks.

Examples of extraordinary items:

- attachment of property of the enterprise; or
- an earthquake.
Profit or loss from Ordinary items

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.

Although the items of income and expense described above are not extraordinary items, the nature and amount of such items 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. Disclosure of such information is sometimes made in the financial statements.
Circumstances in which separate disclosures are required:

• the write-down of inventories to net realisable value as well as the reversal of such write-downs
• a restructuring of the activities of an enterprise and the reversal of any provisions for the costs of restructuring
• disposals of items of fixed assets
• disposals of long-term investments
• legislative changes having retrospective application
• litigation settlements
• other reversals of provisions
Prior period items

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

The term ‘prior period items’, as defined in this Standard, refers only to income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.

The term does not include other adjustments necessitated by circumstances, which though related to prior periods, are determined in the current period, e.g., arrears payable to workers as a result of revision of wages with retrospective effect during the current period.
Errors in the preparation of the financial statements of one or more prior periods may be discovered in the current period.

Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts, or oversight.
Prior period items (contd.)

Prior period items are generally infrequent in nature and can be distinguished from changes in accounting estimates.

Accounting estimates by their nature are approximations that may need revision as additional information becomes known.

For example, income or expense recognised on the outcome of a contingency which previously could not be estimated reliably does not constitute a prior period item.
Prior period items (contd.)

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.
Changes in Accounting Estimates

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.

Estimates may be required, for example, of bad debts, inventory obsolescence or the useful lives of depreciable assets.
The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

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 revision of the estimate, by its nature, does not bring the adjustment within the definitions of an extraordinary item or a prior period item.
Sometimes, it is difficult to distinguish between a change in an accounting policy and a change in an accounting estimate. In such cases, the change is treated as a change in an accounting estimate, with appropriate disclosure.

The effect of a change in an accounting estimate should be included in the determination of net profit or loss in:

- the period of the change, if the change affects the period only; or
- the period of the change and future periods, if the change affects both.
Changes in Accounting Estimates (contd.)

A change in an accounting estimate may affect the current period only or both the current period and future periods.

For example, a change in the estimate of the amount of bad debts is recognised immediately and therefore affects only the current period. However, a change in the estimated useful life of a depreciable asset 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.
Changes in Accounting Estimates  
(contd.)

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.

To ensure the comparability of financial statements of different periods, the effect of a change in an accounting estimate which was previously included in the profit or loss from ordinary activities is included in that component of net profit or loss. The effect of a change in an accounting estimate that was previously included as an extraordinary item is reported as an extraordinary item.

The nature and amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods, should be disclosed. If it is impracticable to quantify the amount, this fact should be disclosed.
Changes in Accounting Policies

Users need to be able to compare the financial statements of an enterprise over a period of time in order to identify trends in its financial position, performance and cash flows. Therefore, the same accounting policies are normally adopted for similar events or transactions in each period.

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

A more appropriate presentation of events or transactions in the financial statements occurs when the new accounting policy results in more relevant or reliable information about the financial position, performance or cash flows of the enterprise.
Changes in Accounting Policies

Following are not changes to 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 a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement; and
- the adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial.

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

Where the effect of such change is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be disclosed.
Investment Estates Limited, is a company in real estate business. One of the projects it handles is construction of dams in the Uttarakhand state. During the recent floods and landslides the Company had incurred losses, which it wouldn’t have incurred in ordinary course of its business.

Is the loss an extraordinary item?
Case Study 1

Yes. The loss on account of landslide and floods is an extraordinary loss for the Company.

As per Para 8, of the Accounting Standard, 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.
Case Study 2

Oil Omissions Limited, a company had purchased new building premises during the financial year 2011-12. However inadvertently, the finance team did not capture the depreciation on account of the same.

When the auditor raised this query during the audit for Financial year 2012-13 as to why shall this not be a prior period item, the finance head replied that they would correct it this year and provide for the depreciation and so it would not be a prior period item anymore.

Is the Finance Head right in stating that its not a prior period item?
Case Study 2

No. The Finance Head is not correct in his contention.

As per para 15 of the Accounting Standard, “the nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived.”

As per para 16 “prior period refers only to income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.

Hence it is a prior period item and appropriate disclosures shall be made for the same.
Nano Limited, a software company, used the discount rate of 8% for the purposes of determining the amount for provision towards gratuity since quite long time. But during the FY 2012-13 it decided to revise the discount rate to 8.5%.

The auditor is of the opinion that it is a change in accounting estimate and not change in accounting policy. While the finance team does not agree to it.

Who is correct?
The auditor of the Company is correct, as it amounts to change in accounting estimate and not change in accounting policy.

As per para 21 of the Accounting Standard, “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.

As per para 22, Sometimes, it is difficult to distinguish between a change in an accounting policy and a change in an accounting estimate. In such cases, the change is treated as a change in an accounting estimate, with appropriate disclosure.
Seiko Manufacturing Ltd, a wrist watch manufacturing company followed LIFO method for valuing its inventory. During the year 2012-13, the Management based on the industry study and internal processes decided to change the method of inventory valuation from LIFO to FIFO.

The management is now posed with a question whether this amounts to change in accounting policy. If yes, whether the monetary impact on account of the change in the policy be disclosed in the financial statements of the Company.

Can you please help.
Case Study 4

The decision of the management to change to FIFO as the method for valuation of inventory amounts to change in the accounting policy. As the same has a material impact on the financial statements the same shall be disclosed.

As per para 32 of the accounting standard, “Any change in an accounting policy which has a material effect should be disclosed. The impact of, and the adjustments resulting from, such change, if material, should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change.”
Lesson Summary