

Treatment of reserves arising on amalgamation in the nature of merger

The following is the brief version of an opinion given by the Expert Advisory Committee of the Institute in response to query sent by a member. This is being published for the information of readers.

A. Facts of the Case

1 Three subsidiary companies, viz., Companies A, B and C, are being merged into another company, viz., Company D, with retrospective effect from April 2002. The transferor and transferee companies have received approvals for merger from the respective High Courts in January and February, 2003, respectively.

2 The querist has stated that the amalgamation is in the nature of a merger and will be accounted for under the 'pooling of interests method' in the statutory accounts of Company D. As per the scheme of amalgamation of Company D, the difference, if any, between the amount recorded as fresh share capital issued by the transferee company (Company D) on amalgamation and the amount of share capital of the transferor companies (Companies A, B and C) shall be reflected in the reserves of the transferee company. As per the querist, the above treatment is in accordance with paragraph 35 of Accounting Standard (AS) 14, 'Accounting for Amalgamations', issued by the Institute of Chartered Accountants of India. According to the querist, AS 14 does not specify whether reserves mean capital reserves or general reserves. Similarly, the scheme of amalgamation of Company D also does not specify the nature of reserves. According to the querist, there is a net surplus arising on amalgamation which has to be reflected in the reserves of Company D.

1. The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.

2. The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in 22nd volumes which are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.

B. Query

3 The querist has sought the opinion of the Expert Advisory Committee of the Institute on the following issues:

- (a) What is the nature of the 'reserves' (whether capital or general reserves) for the purpose of AS 14 (paragraph 35) and for the purpose of giving effect to the scheme of amalgamation of Company D in its books of account?
- (b) Whether such reserves are available for the purpose of distribution to shareholders as dividends and/or bonus shares.

C. Points considered by the Committee

4 The Committee, in expressing its opinion, is restricting itself to the issues raised in the query and is not expressing any opinion on other issues, such as whether the amalgamation in question has been properly treated as amalgamation in the nature of merger within the meaning of AS 14. The Committee presumes that the amalgamation has been properly treated as amalgamation in the nature of merger within the meaning of AS 14.

5 The Committee notes that paragraph 35 of AS 14 states as follows:

"35. The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company should be adjusted in reserves."

6 The Committee is of the view that in order to decide whether the reserve for the purpose of paragraph 35 reproduced above should be reflected as capital or general reserve in the books of account of Company D, the nature of the transaction has to be determined. The Committee is of the view that the difference in the share capital issued by the transferee company on amalgama-

tion and the amount of share capital of the transferor companies is of capital nature. Accordingly, the difference should be treated as a capital reserve, since it is akin to share premium. This is because in case of amalgamation in the nature of merger the position has to be seen as if the merged company had existed from the beginning. Had such a situation prevailed the net surplus arising on amalgamation would be of the nature of share premium.

7 The Committee notes the following definition of 'Capital Reserve' given in the 'Guidance Note on Terms Used in Financial Statements', issued by the Institute of Chartered Accountants of India.

“Capital Reserve

A reserve of a corporate enterprise which is not available for distribution as dividend.”

8 On the basis of the above, the Committee is of the view that the reserve created on amalgamation would not be available for distribution as dividend.

9 The Committee notes that Securities and Exchange Board of India has issued SEBI (Disclosure & Investor Protection) Guidelines, 2000, Chapter XV of which lays down 'Guidelines for Bonus Issues'. Since Company 'D'

is a listed company as per the facts separately submitted by the querist, the said Guidelines are applicable to the company. Clause 15.1.1 of the said Guidelines states that “The bonus issue shall be made out of free reserves built out of genuine profits or share premium collected in cash only.” The Committee is of the view that since the capital reserve arising on amalgamation is not built out of genuine profits and even though it is akin to share premium, it is not collected in cash, the said reserve cannot be utilised for the purpose of issue of bonus shares.

D. Opinion

10 Based on the above, the Committee is of the following opinion on the issues raised in paragraph 3 above:

- (a) The difference between the issued share capital of the transferee company and the share capital of the transferor companies should be treated as capital reserve for the purpose of paragraph 35 of AS 14 and for the purpose of giving effect to the scheme of amalgamation of Company D in its books of account.
- (b) Reserve created on amalgamation is not available for the purpose of distribution to shareholders as dividend and/or bonus shares. ■

ANNOUNCEMENT

Information System Audit Faculty Requirement

Information System Auditors (DISA/CISA/CISSP) are required to provide Faculty support for the “Information System Audit” Post qualification course of the Institute for:

- * Presenting Papers/Presentations in ISA PT Sessions
- * Demonstrate Software applications for IS Audit
- * Contribute Case Studies/Articles/ White Papers/ Questions on IS Audit.
- * Preparing/Updating Background Materials
- * Provide Hands-on training on IS Audit applications
- * Assistance in other allied matters concerning IS Audit

The above assignments are on Part Time basis. You may kindly send your profile detailing (a) IS Audit experience, (b) specific interest in making contribution in one of more of the above activities and (c) ISA modules in which you specialize by April 30, 2004 to:

The Secretary
IT Committee

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