

GN(A) 3 (Issued 1982) Guidance Note on Treatment of Reserve Created on Revaluation of Fixed Assets

1. In the preparation of the financial statements of a company, various fixed assets are stated on the basis of their historical cost. Sometimes, in order to bring into the Balance Sheet their replacement cost, a company revalues its fixed assets on the basis of a valuation made by competent valuers. When the value of fixed assets is written up in the books of account of a company on revaluation, a corresponding credit is given to the Revaluation Reserve. Such reserve represents the difference between the estimated present market values and the book values of the fixed assets. When such reserve is created, a question arises about its nature and the manner in which it can be utilised. This guidance note deals with accounting treatment of the reserve created on revaluation of fixed assets (herein referred to as "Revaluation Reserve").
2. Part I of Schedule VI to the Companies Act, 1956 provide that every company shall classify its fixed assets under convenient heads and show under each head the original cost, additions/deductions and the total depreciation provided upto the end of each accounting period. When a company revalues its fixed assets, it is necessary for the company to show separately the date of revaluation and, for a period of five years thereafter, the amount of increase made.
3. When a company revalues its fixed assets, depreciation should be provided on the basis of the revalued figures.
4. A view has been expressed in some quarters that, for measurement of profits, revenue is deemed to have arisen when it is actually collected or when a justifiable claim to collect it arises (e.g. credit sale) or when there is knowledge and evidence that it is capable of being collected if a sale were to be made (i.e. prevailing market price). According to this view, this principle will apply equally to current and fixed assets and, therefore, when fixed assets are written up to their present value, the corresponding Revaluation Reserve cannot be considered as an unrealised reserve. It is, therefore, argued that past accumulated losses as well as depreciation for the year or arrears of depreciation for earlier years which are required to be provided under Section 205 of the Companies Act can be written off or adjusted against such Revaluation Reserve.
5. There is a contrary view that such Revaluation Reserve is created as a result of a book adjustment only and, therefore, such a reserve is an unrealized reserve which is not available for distribution as dividends. When accounts are prepared on the basis of historical cost, measurement of profits can be made by comparing the cost of the assets at the beginning and at the end of the *Treatment of Reserve Created on Revaluation of Fixed Assets* 1 accounting period. As such there is no justification for taking credit for unrealised gains because the increase in market value may be due to various extraneous factors such as fall in the purchasing power of currency or other factors not related to the operations of the company. So far as fixed assets are concerned, these are held for the use in the business and not for sale in the normal course of business. In the circumstance, the difference between the market value and the book value does not represent realised gain and cannot be treated as such in the books of account.
6. Section 205 of the Companies Act provides that a company can declare or pay dividend only out of its profits. The profits for this purpose are to be arrived at after providing for depreciation. If dividend

is to be declared out of the profits of any earlier year or years, it is necessary that such profits should be arrived at after providing for depreciation for the respective years.

7. Proviso (a) to Section 205 (1) of the Companies Act reads as under:

"(a) if the company has not provided for depreciation for any previous financial year or years which falls or fall after the commencement of the Companies (Amendment) Act, 1960, it shall before declaring or paying dividend for any financial year provide for such depreciation out of the profits of that financial year or out of the profits of any other previous financial year or years."

This proviso makes it clear that it is necessary to provide for arrears of depreciation of earlier years, if any dividend is to be declared out of profits of any subsequent year. For this purpose depreciation (or arrears of depreciation) is to be provided out of the profits of the company. Indeed, a reference to Part II of Schedule VI to the Companies Act indicates that the Profit and Loss Account is to be so made as clearly to disclose the result of working of the company during the period covered by the account.

8. When accumulated losses and depreciation (including arrears of depreciation) are adjusted against Revaluation Reserve it will amount to setting off actual losses against unrealised gains. If dividend is declared out of the current profits after adjusting accumulated losses or arrears of depreciation against the Revaluation Reserve, it will mean that dividend is declared out of profits which should, in fact, have been utilised in setting off past losses and arrears of depreciation. In effect, the company will be declaring dividend out of profits which are not available for distribution. By adopting this method, the company will be declaring dividend out of unrealised gains appearing in the accounts in the form of Revaluation Reserve. Accordingly, accumulated losses or arrears of depreciation should not be set off against Revaluation Reserve.

9. A question may arise, as to whether the additional depreciation provision required in consequence of revaluation can be adjusted against "Revaluation Reserve". As stated earlier, depreciation is required to be provided with reference to the total value of the fixed assets as appearing in the account after revaluation. However, for certain statutory purposes e.g., dividends, managerial remuneration etc., only depreciation relatable to the historical cost of the fixed assets is to be provided out of the current profits of the company. In the circumstance, the additional depreciation relatable to revaluation may be adjusted against "Revaluation Reserve" by transfer to Profit and Loss Account.

In other words, as per the requirements of Part II of Schedule VI to the Companies Act, the company will have to provide the depreciation on the total book value of the fixed assets (including the increased amount as a result of revaluation) in the Profit and Loss Account of the relevant period, and thereafter the company can transfer an amount equivalent to the additional depreciation from the Revaluation Reserve. Such transfer from Revaluation

Reserve should be shown in the Profit and Loss Account separately and an appropriate note by way of disclosure would be desirable. Such a disclosure would appear to be in consonance with the requirement of Part I of Schedule VI to the Companies Act, prescribing disclosure of write-up in the value of fixed asset for the first five years after revaluation.

10. If a company has transferred the difference between the revalued figure and the book value of fixed assets to the "Revaluation Reserve" and has charged the additional depreciation related thereto to its Profit and Loss Account, it is possible to transfer an amount equivalent to accumulated additional depreciation from the revaluation reserve to the Profit and Loss Account or to the General Reserve as the circumstances may permit, provided suitable disclosure is made in the accounts as recommended in this guidance note.

11. The Revaluation Reserve is not available for payment of dividends. This view is also supported by the Companies (Declaration of Dividend out of Reserves) Rules, 1975. Similarly,

accumulated losses or arrears of depreciation should not be set off against Revaluation Reserve. However, the revaluation reserve can be utilised for adjustment of the additional depreciation on the increased amount due to revaluation from year to year or on the retirement of the relevant fixed assets (as discussed in paras 9 and 10 above respectively).

Treatment of Reserve Created on Revaluation of Fixed Assets

12. The revaluation of fixed assets is normally done in order to bring into books the replacement cost of such assets. This is a healthy trend as it recognises the importance of retaining sufficient funds through additional depreciation in the business for replacement of fixed assets. As such, it will be prudent not to charge the additional depreciation against revaluation reserve, though this may result in reduction of distributable profits. This practice would also give a more realistic appraisal of the company's operations in an inflationary situation.

GN(A) 5 (Issued 1983) Guidance Note on Terms Used in Financial Statements

The following is the text of the guidance note issued with a view to clarify the important terms (including phrases) commonly used in the preparation and presentation of 'general purpose financial statements'. These statements include balance sheet, statement of profit and loss and other statements and explanatory notes which form part thereof, issued for the use of shareholders/members, creditor, employees and public at large.

Introduction

1. The objective of this guidance note is to facilitate a broad and basic understanding of the various terms as well as to promote consistency and uniformity in their usage. As such it does not purport to provide a comprehensive or rigid dictionary.
2. The basic considerations to be borne in mind when selecting terms for use in the financial statements are clarity, significance and consistency.
3. This guidance note does not primarily cover the terms used in a specific sense by certain specialised institutions, e.g., banks, insurance companies, financial institutions or electricity companies. However, it is possible that some of the terms defined here may have common application for such institutions.
4. Many of the terms have, over a period of time, acquired a worldwide usage and recognition. Therefore, while formulating this guidance note, the Accounting Standards Board has taken into consideration the terminologies in use in various countries as formulated by their respective professional bodies.
5. The terms have been defined in this note, keeping in view their usage in the preparation and presentation of the financial statements. Some of these terms may have different meanings when used in the context of certain special enactments.
6. The definitions of the terms in this guidance note do not spell out the accounting procedure and are not prescriptive of a course of action.

General Definitions

1.01 Absorption Costing

A method whereby the *cost* is determined so as to include the appropriate share of both *variable* and *fixed costs*.

1.02 Acceptance

The drawee's signed assent on *bill of exchange*, to the order of the drawer. This term is also used to describe a *bill of exchange* that has been accepted.

1.03 Account Receivable

See Sundry Debtor

1.04 Accounting Policies

The specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements.

1.05 Accrual

Recognition of *revenues* and *costs* as they are earned or incurred (and not as money is received or paid). It includes recognition of transactions relating to *assets* and *liabilities* as they occur irrespective of the actual receipts or payments.

1.06 Accrual Basis of Accounting

The method of recording transactions by which *revenues*, *costs*, *assets* and *liabilities* are reflected in the accounts in the period in which they accrue. The 'accrual basis of accounting' includes considerations relating to *deferrals*, allocations, *depreciation* and *amortisation*. This basis is also referred to as **mercantile basis of accounting**.

1.07 Accrued Asset

A developing but not yet enforceable claim against another person which accumulates with the passage of time or the rendering of service or otherwise. It may arise from the rendering of services (including the use of money) which at the date of accounting have been partly performed, and are not yet billable.

1.08 Accrued Expense

An *expense* which has been incurred in an accounting period but for which no enforceable claim has become due in that period against the enterprise. It may arise from the purchase of services (including the use of money) which at the date of accounting have been only partly performed, and are not yet billable.

1.09 Accrued Liability

A developing but not yet enforceable claim by another person which accumulates with the passage of time or the receipt of service or otherwise. It may arise from the purchase of services (including the use of money) which at the date of accounting have been only partly performed, and are not yet billable.

1.10 Accrued Revenue

Revenue which has been earned in an accounting period but in respect of which no enforceable claim has become due in that period by the enterprise. It may arise from the rendering of services (including the use of money) which at the date of accounting have been partly performed, and are not yet billable.

1.11 Accumulated Depletion

The total to date of the periodic *depletion* charges on *wasting assets*.

1.12 Accumulated Depreciation

The total to date of the periodic *depreciation* charges on *depreciable assets*.

1.13 Actual Cost

See Cost

1.14 Ad-valorem

A method of levying tax or duty on goods by using their assessable value as the tax base.

1.15 Added Value

See Value Added

1.16 Added Value Statement

See Value Added Statement

1.17 Advance

Payment made on account of, but before completion of, a contract, or before acquisition of goods or receipt of services.

1.18 Amortisable Amount

See Amortisation

1.19 Amortisation

The gradual and systematic writing off of an *asset* or an account over an appropriate period. The amount on which *amortisation* is provided is referred to as *amortisable amount*. *Depreciation* accounting is a form of amortisation applied to *depreciable assets*. *Depletion* accounting is another form of amortisation applied to *wasting assets*. Amortisation also refers to gradual extinction or *provision* for extinction of a debt by gradual *redemption* or *sinking fund* payments or the gradual writing off to *revenue* of miscellaneous expenditure carried forward, e.g., *share issue expenses*, *preliminary expenses*, etc.

1.20 Amortised Value

The *amortisable amount* less any portion already provided by way of *amortisation*.

1.21 Annual Report

The information provided annually by the management of an enterprise to the owners and other interested persons concerning its operations and financial position. It includes the information statutorily required, e.g., in the case of a company, the *balance sheet*, *profit and loss statement* and notes on accounts, the *auditor's report* thereon, and the report of the Board of Directors. It also includes other information voluntarily provided e.g., *value added statement*, graphs, charts, etc.

1.22 Appropriation Account

An account sometimes included as a separate section of the *profit and loss statement* showing application of *profits* towards *dividends*, *reserves*, etc.

1.23 Assets

Tangible objects or intangible rights owned by an enterprise and carrying probable future benefits.

1.24 Auditor's Report

The formal expression of opinion by an independent external auditor on the financial statements of an enterprise including such reservations, qualifications and negations as may be called for and incorporating, where appropriate, such statutory affirmations as may be prescribed.

1.25 Authorised Share Capital

The number and par value, of each class of shares that an enterprise may issue in accordance with its instrument of incorporation. This is sometimes referred to as **nominal share capital**.

1.26 Average Cost

The *cost* of an item at a point of time as determined by applying an average of the cost of all items of the same nature over a period. When weightages are also applied in the computation, it is termed as **weighted average cost**.

2.01 Bad Debts

Debts owed to an enterprise which are considered to be irrecoverable.

2.02 Balance Sheet

A statement of the financial position of an enterprise as at a given date, which exhibits its *assets, liabilities, capital, reserves* and other account balances at their respective *book values*.

2.03 Bill of Exchange

An instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only, to or to the order of a certain person or to the bearer of the instrument.

2.04 Bond

See *Debenture*

2.05 Bonus Shares

Shares allotted by capitalisation of the *reserves* or *surplus* of a corporate enterprise.

2.06 Book Value

The amount at which an item appears in the books of account or financial statements. It does not refer to any particular basis on which the amount is determined e.g., *cost*, replacement value, etc.

3.01 Call

A demand pursuant to terms of issue to pay a part or whole of the balance remaining payable on shares or *debentures* after allotment.

3.02 Called-up Share Capital

That part of the *subscribed share capital* which shareholders have been required to pay.

3.03 Capital

Generally refers to the amount invested in an enterprise by its owners e.g. *paid-up share capital* in a corporate enterprise. It is also used to refer to the interest of owners in the assets of an enterprise.

3.04 Capital Assets

Assets, including *investments* not held for sale, conversion or consumption in the ordinary course of business.

3.05 Capital Commitment

Future *liability* for capital expenditure in respect of which contracts have been made.

3.06 Capital Employed

The finances deployed by an enterprise in its *net fixed assets*, *investments* and *working capital*. Capital employed in an operation may, however, exclude *investments* made outside that operation.

3.07 Capital Loss

See **Capital Profit**

3.08 Capital Profit

Excess of the proceeds realised from the sale, transfer, or exchange of the whole or a part of a *capital asset* over its *cost*. When the result of this computation is negative, it is referred to as **capital loss**.

3.09 Capital Redemption Reserve

A *reserve* created on *redemption* of the *redeemable preference shares* of a corporate enterprise out of its *profits* which would otherwise have been available for distribution as *dividend*.

3.10 Capital Reserve

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

3.11 Capital Work-in-progress

Expenditure on *capital assets* which are in the process of construction or completion.

3.12 Cash Basis of Accounting

The method of recording transactions by which *revenues* and *costs* and *assets* and *liabilities* are reflected in the accounts in the period in which actual receipts or actual payments are made.

3.13 Cash Discount

A reduction granted by a supplier from the invoiced price in consideration of immediate payment or payment within a stipulated period.

3.14 Cash Profit

The *net profit* as increased by non-cash costs, such as *depreciation*, *amortisation*, etc. When the result of the computation is negative, it is termed as **cash loss**.

3.15 Changes in Financial Position, Statement of

A financial statement which summarises, for the period covered by it, the changes in the financial position including the sources from which funds were obtained by the enterprise and the specific uses to which such funds were applied. This is also called the **funds flow statement**.

3.16 Charge

An encumbrance on an *asset* to secure an indebtedness or other obligations. It may be fixed or floating.

3.17 Cheque

A *bill of exchange* drawn upon a specified banker and not expressed to be payable otherwise than on demand.

3.18 Collateral Security

Security which is given in addition to the principal security against the same *liability* or obligation.

3.19 Contingency

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.

3.20 Contingent Asset

An *asset* the existence, ownership or value of which may be known or determined only on the occurrence or non-occurrence of one or more uncertain future events.

3.21 Contingent Liability

An obligation relating to an existing condition or situation which may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events.

3.22 Contra Account

One or two or more accounts which partially or wholly off-set another or other accounts.

3.23 Cost

The amount of *expenditure* incurred on or attributable to a specified article, product or activity.

3.24 Cost of Purchase

The purchase price including duties and taxes, freight inwards and other *expenditure* directly attributable to acquisition, less *trade discounts*, rebates, duty drawbacks, and subsidies in respect of such purchase.

3.25 Cost-plus Contract

A contract under which the contractor is reimbursed for allowable or otherwise defined *costs* as increased by a percentage of such *costs* or an agreed fee.

3.26 Cost of Goods Sold

The cost of goods sold during an accounting period. In manufacturing operations, it includes (i) cost of materials; (ii) labour and factory overheads; selling and administrative expenses are normally excluded.

3.27 Cost of Sales

Cost of goods sold plus selling and administrative expenses.

3.28 Conversion Cost

Cost incurred to convert raw materials or components into finished or semi-finished products. This normally includes *costs* which are specifically attributable to units of production, i.e., direct labour, direct expenses and subcontracted work, and production overheads as applicable in accordance with either the *direct cost* or *absorption costing method*. Production overheads exclude expenses which relate to general administration, finance, selling and distribution.

3.29 Convertible Bond

See *Convertible Debenture*

3.30 Convertible Debenture

A *debenture* which gives the holder a right to its conversion, wholly or partly, in shares in accordance with the terms of issue.

3.31 Creditor

See **Sundry Creditor**

3.32 Cumulative Dividend

A *dividend* payable on *cumulative preference shares* which, if unpaid, accumulates as a claim against the earnings of a corporate enterprise, before any distribution is made to the other shareholders.

3.33 Cumulative Preference Shares

A class of preference shares entitled to payment of *cumulative dividends*. Preference shares are always deemed to be cumulative, unless they are expressly made non-cumulative.

3.34 Current Assets

Cash and other *assets* that are expected to be converted into cash or consumed in the production of goods or rendering of services in the normal course of business.

3.35 Current Liability

Liability including loans, deposits and bank overdraft which falls due for payment in a relatively short period, normally not more than twelve months.

4.01 Debenture

A formal document constituting acknowledgment of a debt by an enterprise usually given under its common seal and normally containing provisions regarding payment of interest, repayment of principal and security, if any. It is transferable in the appropriate manner.

4.02 Debenture Redemption Reserve

A *reserve* created for the *redemption* of *debentures* at a future date.

4.03 Debtor

See **Sundry Debtor**

4.04 Deferral

Postponement of recognition of a *revenue* or *expense* after its related receipt or payment (or incurrance of a *liability*) to a subsequent period to which it applies. Common examples of deferrals include prepaid rent and taxes, unearned subscriptions received in advance by newspapers and magazine selling companies, etc.

4.05 Deferred Expenditure

Expenditure for which payment has been made or a *liability* incurred but which is carried forward on the presumption that it will be of benefit over a subsequent period or periods. This is also referred to as **deferred revenue expenditure**.

4.06 Deferred Revenue

Revenue or *income* received or recorded before it is earned and carried forward to a subsequent period or periods to which it relates.

4.07 Deferred Revenue Expenditure

See **Deferred Expenditure**

4.08 Deficiency

The excess of *liabilities* over *assets* of an enterprise at a given date. The debit balance in the *profit and loss statement*.

4.09 Deficit

The debit balance in the profit and loss statement.

4.10 Depletion

A measure of exhaustion of a *wasting asset* represented by periodic write off of *cost* or other substituted value.

4.11 Depreciable Amount

The historical cost, or other amount substituted for historical cost of a *depreciable asset* in the financial statements, less the estimated residual value.

4.12 Depreciable Asset

Asset which is expected to be used during more than one accounting period, has a limited *useful life*, and is held by an enterprise for use in the production or supply of goods, and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.

4.13 Depreciation

A measure of the wearing out, consumption or other loss of value of a *depreciable asset* arising from use, effluxion of time or *obsolescence* through technology and market changes. It is allocated so as to charge a fair proportion in each accounting period during the *useful life* of the *asset*. It includes *amortisation* of *assets* whose *useful life* is predetermined and *depletion* of *wasting assets*.

4.14 Depreciation Method

Any method of calculating *depreciation* for an accounting period.

4.15 Depreciation Rate

A percentage applied to the historical cost or the substituted amount of a *depreciable asset* (or in case of *diminishing balance method*, the historical cost or the substituted amount less *accumulated depreciation*).

4.16 Development Allowance Reserve

A *reserve* created in compliance with one of the conditions for claiming development allowance under the Income-tax Act, 1961.

4.17 Development Rebate Reserve

A *reserve* created in compliance with one of the conditions for claiming development rebate under the Income-tax Act, 1961.

4.18 Diminishing Balance Method

A method under which the periodic charge for *depreciation* of an *asset* is computed by applying a fixed percentage to its historical cost or substituted amount less *accumulated depreciation* (net book value). This is also referred to as **written down value method**.

4.19 Direct Cost

An item of *cost* that can be reasonably identified with a specific unit of product or with a specific operation or other cost center.

4.20 Direct Costing

A method whereby the *cost* is determined so as to include the appropriate share of *variable costs* only, all *fixed costs* being charged against *revenue* in the period in which they are incurred.

4.21 Discount

A reduction from a list price, quoted price or invoiced price. It also refers to the price for obtaining payment on a bill before its maturity.

4.22 Dividend

A distribution to shareholders out of *profits* or *reserves* available for this purpose.

4.23 Dividend Equalisation Reserve

A *reserve* created to maintain the rate of *dividend* in future years.

5.01 Earnings Per Share

The earnings in monetary terms attributable to each *equity share*, based on the *net profit* for the period, before taking into account *prior period items*, *extraordinary items* and adjustments resulting from changes in *accounting policies* but after deducting tax appropriate thereto and preference *dividends*, divided by the number of equity shares issued and ranking for dividend in respect of that period.

5.02 Entity Concept

The view of the relationship between the accounting entity and its owners which regards the entity as a separate person, distinct and apart from its owners.

5.03 Equity Share

A share which is not a preference share. Also sometimes called **ordinary share**.

5.04 Expenditure

Incurring a *liability*, disbursement of cash or transfer of property for the purpose of obtaining *assets*, goods or services.

5.05 Expense

A *cost* relating to the operations of an accounting period or to the *revenue* earned during the period or the benefits of which do not extend beyond that period.

5.06 Expired Cost

That portion of an *expenditure* from which no further benefit is expected. Also termed as **expense**.

5.07 Extraordinary Item

Gain or loss which arises from events or transactions that are distinct from ordinary activities of the enterprise and which are both material and expected not to recur frequently or regularly. This would also include material adjustments necessitated by circumstances, which, though related to previous periods, are determined in the current period.

6.01 Fair Market Value

The price that would be agreed to in an open and unrestricted market between knowledgeable and willing parties dealing at arm's length who are fully informed and not under any compulsion to transact. Arm's length is a term applied to any transaction on the assumption that the parties to the transaction would act without being influenced by each other or by any other person.

6.02 Fictitious Asset

Item grouped under *assets* in a *balance sheet* which has no real value (e.g. the debit balance of the *profit and loss statement*).

6.03 First Charge

A *charge* having priority over other charges.

6.04 First In, First Out (FIFO)

Computation of the *cost* of items sold or consumed during a period as though they were sold or consumed in order of their acquisition.

6.05 Fixed Asset

Asset held for the purpose of providing or producing goods or services and that is not held for resale in the normal course of business.

6.06 Fixed Cost

That cost of production which by its very nature remains relatively unaffected in a defined period of time by variations in the volume of production.

6.07 Fixed Deposit

Deposit for a specified period and at specified rate of interest.

6.08 Fixed or Specific Charge

A *charge* which attaches to a particular *asset* which is identified when the charge is created, and the identity of the *asset* does not change during the subsistence of the *charge*.

6.09 Floating Charge

A general *charge* on some or all *assets* of an enterprise which are not attached to specific *assets* and are given as security against a debt.

6.10 Foreign Currency, Translation of

The process of expressing amounts stated in a foreign currency into equivalent amounts in local currency by using an exchange rate between the two currencies.

6.11 Foreign Currency Conversion

The process of expressing amounts stated in a foreign currency into equivalent amounts in local currency by using the exchange rate at which the foreign currency is bought or sold.

6.12 Forfeited Share

A share to which title is lost by a member for non-payment of call money or default in fulfilling any engagement between members or expulsion of members where the articles specifically provide therefor.

6.13 Free Reserve

A *reserve* the utilisation of which is not restricted in any manner.

6.14 Functional Classification

A system of classification of *expenses* and *revenues* and the corresponding *assets* and *liabilities* to each function or activity, rather than by reference to their nature.

6.15 Fund

An account usually of the nature of a *reserve* or a *provision* which is represented by specifically earmarked *assets*.

6.16 Fundamental Accounting Assumptions

Basic accounting assumptions which underlie the preparation and presentation of financial statements. They are *going concern*, consistency and *accrual*. Usually, they are not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed.

6.17 Funds Flow Statement

See *Changes in Financial Position, Statement of 7.01 Gain*

A monetary benefit, *profit* or advantage resulting from a transaction or group of transactions.

7.02 General Reserve

A *revenue reserve* which is not earmarked for a specific purpose.

7.03 Going Concern Assumption

An accounting assumption according to which an enterprise is viewed as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations.

7.04 Goodwill

An *intangible asset* arising from business connections or trade name or reputation of an enterprise.

7.05 Gross Margin or Gross Profit

The excess of the proceeds of goods sold and services rendered during a period over their *cost*, before taking into account administration, selling, distribution and financing expenses. When the result of this computation is negative it is referred to as **gross loss**.

7.06 Gross Sales

See *Sales Turnover*

7.07 Gross Turnover

See *Sales Turnover*

8.01 Income

See *Revenue*

8.02 Income and Expenditure Statement

A financial statement, often prepared by non-profit making enterprises like clubs, associations etc. to present their *revenues* and *expenses* for an accounting period and to show the excess of *revenues*

over *expenses* (or vice versa) for that period. It is similar to profit and loss statement and is also called **revenue and expense statement**.

8.03 Intangible Asset

Asset which does not have a physical identity e.g. *goodwill*, patents, copyright etc.

8.04 Internal Audit

An independent appraisal activity within an enterprise whether by the staff of the enterprise or by a firm of accountants appointed for that purpose, for the review of accounting, financial and other operations and controls as a basis for service to management. It involves a specialised application of the techniques of auditing.

8.05 Internal Check

A system of allocation of responsibility, division of work, and methods of recording transactions, whereby the work of an employee or group of employees is checked continuously by correlating it with the work of others. An essential feature is that no one employee or group of employees has exclusive control over any transaction or group of transactions.

8.06 Internal Control

The entire system of controls, financial and otherwise, established by the management in order to carry on the business of the enterprise in an orderly and efficient manner, ensure adherence to management policies, safeguard the *assets* and secure as far as possible the accuracy and completeness of the records.

8.07 Interim Report

The information provided with reference to a date before the close of the accounting period by the management of an enterprise to owners or other interested persons concerning its operations or financial position.

8.08 Inventory

Tangible property held for sale in the ordinary course of business, or in the process of production for such sale, or for consumption in the production of goods or services for sale, including maintenance supplies and consumables other than machinery spares.

8.09 Investment

Expenditure on *assets* held to earn interest, *income*, *profit* or other benefits.

8.10 Investments

Assets held not for operational purposes or for rendering services i.e. *assets* other than *fixed assets* or *current assets* (e.g. securities, shares, *debentures*, immovable properties).

8.11 Investment Allowance Reserve

A *reserve* created in compliance with one of the conditions for claiming investment allowance under the Income-tax Act, 1961.

8.12 Issued Share Capital

That portion of the *authorised share capital* which has actually been offered for subscription. This includes any *bonus shares* allotted by the corporate enterprise.

9.01 Last In, First Out (LIFO)

Computation of the *cost* of items sold or consumed during a period on the basis that the items last acquired were sold or consumed first.

9.02 Liability

The financial obligation of an enterprise other than owners' funds.

9.03 Lien

Right of one person to satisfy a claim against another by holding or retaining possession of that other's *assets/property*.

9.04 Long-term Liability

Liability which does not fall due for payment in a relatively short period, i.e., normally a period not more than twelve months.

9.05 Loss

See Profit

10.01 Materiality

An accounting concept according to which all relatively important and relevant items, i.e., items the knowledge of which might influence the decisions of the user of the financial statements are disclosed in the financial statements.

10.02 Mercantile Basis of Accounting

See Accrual Basis of Accounting

10.03 Mortgage

A transfer of interest in specific immovable property for the purpose of securing a loan advanced, or to be advanced, an existing or future debt or the performance of an engagement which may give rise to a pecuniary *liability*. The security is redeemed when the loan is repaid or the debt discharged or the obligations performed.

11.01 Net Assets

The excess of the *book value of assets* (other than *fictitious assets*) of an enterprise over its *liabilities*. This is also referred to as **net worth** or **shareholders' funds**.

11.02 Net Fixed Assets

Fixed assets less accumulated depreciation thereon up-to-date.

11.03 Net Loss

See Net Profit

11.04 Net Profit

The excess of *revenue* over *expenses* during a particular accounting period. When the result of this computation is negative, it is referred to as **net loss**. The net profit may be shown before or after tax.

11.05 Net Realisable Value

The actual/estimated selling price of an *asset* in the ordinary course of the business less cost of completion and cost necessarily to be incurred in order to make the sale.

11.06 Net Sales

See Sales Turnover

11.07 Net Turnover

See Sales Turnover

11.08 Net Worth

See Net Assets

11.09 Nominal Share Capital

See Authorised Share Capital

12.01 Obsolescence

Diminution in the value of an *asset* by reason of its becoming out-of date or less useful due to technological changes, improvement in production methods, change in market demand for the product or service output of the *asset*, or legal or other restrictions.

12.02 Operating Profit

The *net profit* arising from the normal operations and activities of an enterprise without taking account of extraneous transactions and expenses of a purely financial nature.

13.01 Paid-up Share Capital

That part of the *subscribed share capital* for which consideration in cash or otherwise has been received. This includes *bonus shares* allotted by the corporate enterprise.

13.02 Pari Passu Charge

Charge created by an enterprise on its *assets* in favour of more than one person on the condition that each such person has equal rights of realization out of the assets as the other(s).

13.03 Pledge

Deposit of goods by one person (pledgor or pawnor) to another person (pledgee or pawnee) as a security for payment of a debt or performance of a promise. The pledgee has a special *lien* right on the property in the pledged goods with a right to sell the same after notice if the pledgor fails to discharge the debt or perform his promise on the stipulated date.

13.04 Preference Share Capital

That part of the *share capital* of a corporate enterprise which enjoys preferential rights in respect of payments of fixed *dividend* and repayment of *capital*. Preference shares may also have full or partial participating rights in surplus profits or surplus capital.

13.05 Preferential Payment

Payment which in a winding up or insolvency has to be made in priority to all other debts as per statute.

13.06 Preliminary Expenses

Expenses relating to the formation of an enterprise. These include legal, accounting and share issue expenses incurred for formation of the enterprise.

13.07 Pre-paid Expense

Payment for *expense* in an accounting period, the benefit for which will accrue in the subsequent accounting period(s).

13.08 Prime Cost

The total *cost* of direct materials, direct wages and other direct production expenses.

13.09 Prior Period Item

A material charge or credit which arises in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.

13.10 Profit

A general term for the excess of *revenue* over related *cost*. When the result of this computation is negative it is referred to as **loss**. Also see **gross profit, operating profit, net profit**.

13.11 Profit and Loss Statement

A financial statement which presents the *revenues* and *expenses* of an enterprise for an accounting period and shows the excess of *revenues* over *expenses* (or vice versa). It is also known as **profit and loss account**.

13.12 Promissory Note

An instrument in writing (not being a bank note or currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument.

13.13 Propriety Concept

A concept of evaluating performance or specific transactions of an enterprise with reference to the tests of commonly accepted norms, customs and standards of conduct including those based on considerations of public interest.

13.14 Provision

An amount written off or retained by way of providing for *depreciation* or diminution in value of *assets* or retained by way of providing for any known *liability* the amount of which cannot be determined with substantial accuracy.

13.15 Provision for Doubtful Debts

A *provision* made for debts considered doubtful of recovery.

13.16 Prudence

A concept of care and caution used in accounting according to which (in view of the uncertainty attached to future events) *profits* are not anticipated, but recognised only when realised, though not necessarily in cash. Under this concept, *provision* is made for all known *liabilities* and losses, even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.

13.17 Public Deposits

Fixed deposits accepted by an enterprise from the public in accordance with the prevailing Rules made in this behalf.

14.01 Redeemable Preference Share

The preference share that is repayable either after a fixed or determinable period or at any time decided by the management (by giving due notice), under certain conditions prescribed by the instrument of incorporation or the terms of issue.

14.02 Redemption

Repayment as per given terms normally used in connection with preference shares and *debentures*.

14.03 Reduction of Capital

The extinguishment or reduction of shareholders' liability on any of the shares of a corporate enterprise in respect of the *share capital* not fully paid up or the cancellation of *paid-up share capital* of a company which is not represented by available *assets*. It also refers to the return of any *paid-up share capital* in excess of requirements.

14.04 Reserve

The portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a *provision* for *depreciation* or diminution in the value of *assets* or for a known *liability*. The reserves are primarily of two types: *capital reserves* and *revenue reserves*.

14.05 Revaluation Reserve

A *reserve* created on the revaluation of *assets* or *net assets* of an enterprise represented by the surplus of the estimated replacement cost or estimated market values over the *book values* thereof.

14.06 Revenue

The gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and *dividends*. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. It excludes amounts collected on behalf of third parties such as certain taxes. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.

14.07 Revenue and Expense Statement

See Income and Expenditure Statement

14.08 Revenue Reserve

Any reserve other than a capital reserve.

14.09 Right Share

An allotment of shares on the issue of fresh *capital* by a corporate enterprise to which a shareholder is entitled on payment, by virtue of his holding certain shares in the enterprise in proportion to the number of shares already held by him. (Shares allotted to certain categories of *debenture* holders pursuant to the rights enjoyed by them are sometimes called right shares)

15.01 Sales Turnover

The aggregate amount for which sales are effected or services rendered by an enterprise. The terms **gross turnover** and **net turnover** (or **gross sales** and **net sales**) are sometimes used to distinguish the sales aggregate before and after deduction of returns and trade discounts.

15.02 Secured Loan

Loan secured wholly or partly against an *asset*.

15.03 Self-Insurance

The assumption by an enterprise of a risk which is not covered by an external insurance agency and for which internal allocations or *provisions* have been made.

15.04 Share Capital

Aggregate amount of money paid or credited as paid on the shares and/ or stocks of a corporate enterprise.

15.05 Share Discount

The excess of the face value of shares over their issue price.

15.06 Shareholders' Equity

The interest of the shareholders in the *net assets* of a corporate enterprise. However, in the case of liquidation it is represented by the residual *assets* after meeting prior claims.

15.07 Shareholders' Funds

See *Net Assets*

15.08 Share Issue Expenses

Costs incurred in connection with the issue and allotment of shares. These include legal and professional fees, advertising expenses, printing costs, underwriting commission, brokerage, and also expenses in connection with the issue of prospectus and allotment of shares.

15.09 Share Premium

The excess of the issue price of shares over their face value.

15.10 Short-term Liability

See *Current Liability*

15.11 Sinking Fund

A *fund* created for the repayment of a *liability* or for the replacement of an asset.

15.12 Social Cost Benefit Analysis

The identification, measurement and reporting of *social costs* and *benefits* related to a project or an enterprise.

15.13 Social Cost

The cost or the loss to society resulting from the operations of an enterprise in its particular circumstances. Such costs are often not readily measurable in monetary terms. This term is also used in a specific sense to denote the costs incurred by an enterprise in providing social amenities.

15.14 Social Benefit

The benefits or income to society resulting from operations of an enterprise in its particular circumstances. Such benefits are often not readily measurable in monetary terms.

15.15 Standard Cost

A pre-determined *cost* of an activity, operation, process or product, established as a basis for control and reporting.

15.16 Straight Line Method

The method under which the periodic charge for *depreciation* is computed by dividing the *depreciable amount* of a *depreciable asset* by the estimated number of years of its useful life.

15.17 Subscribed Share Capital

That portion of the *issued share capital* which has actually been subscribed and allotted. This includes any *bonus shares* allotted by the corporate enterprise.

15.18 Substance over Form

An accounting concept according to which the substance and not merely the legal form of transactions and events governs their accounting treatment and presentation in financial statements.

15.19 Sundry Creditor

Amount owed by an enterprise on account of goods purchased or services received or in respect of contractual obligations. Also termed as **trade creditor** or **account payable**.

15.20 Sundry Debtor

Person from whom amounts are due for goods sold or services rendered or in respect of contractual obligations. Also termed as **debtor**, **trade debtor**, **account receivable**.

15.21 Surplus

Credit balance in the *profit and loss statement* after providing for proposed appropriations, e.g., *dividend* or *reserves*.

16.01 Test Check

Examination of representative items selected from an account or record for the purpose of arriving at an opinion on the entire account or record.

16.02 Trade Creditor

See Sundry Creditor

16.03 Trade Debtor

See Sundry Debtor

16.04 Trade Discount

A reduction granted by a supplier from the list price of goods or services on business considerations other than for prompt payment.

16.05 Transfer Price

The price charged (or value assigned) to a product or service which is transferred within an enterprise from one segment/division to another.

17.01 Unclaimed Dividend

Dividend which has been declared by a corporate enterprise and a warrant or a *cheque* in respect whereof has been despatched but has not been encashed by the shareholder concerned.

17.02 Unexpired Cost

That portion of an *expenditure* whose benefit has not yet been exhausted.

17.03 Unissued Share Capital

That portion of the *authorised share capital* for which shares have not been offered for subscription.

17.04 Unpaid Dividend

Dividend which has been declared by a corporate enterprise but has not been paid, or the warrant or *cheque* in respect whereof has not been dispatched within the prescribed period.

17.05 Useful Life

Life which is either (i) the period over which a *depreciable asset* is expected to be used by the enterprise; or (ii) the number of production or similar units expected to be obtained from the use of the *asset* by the enterprise.

18.01 Value Added

The increase in value of a product or service resulting from an alteration in the form, location or availability excluding the cost of bought-out materials or services. This is also referred to as **added value**.

18.02 Value Added Statement

A statement of the value added that an enterprise has been able to generate and its distribution among those contributing to its generation. This is also referred to as **added value statement**.

GN(A) 6 (Issued 1988)**Guidance Note on Accrual Basis of Accounting****1. Introduction**

1.1 Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. "Accrual" is one of the fundamental accounting assumptions. Para 27 of the Accounting Standard on Disclosure of Accounting Policies (AS-1), issued by the Institute of Chartered Accountants of India (ICAI), provides that if fundamental accounting assumptions, viz., going concern, consistency and accrual are not followed, the fact should be disclosed.

1.2 There are three bases of accounting in use, viz., (i) accrual (ii) cash and (iii) hybrid. The Companies (Amendment) Act, 1988, has amended section 209 of the Companies Act, 1956, with effect from 15th June, 1988, making it obligatory on all companies to maintain their accounts on accrual basis and according to the double entry system of accounting. In view of this amendment all companies will now be required to keep their accounts on accrual basis of accounting, in respect of any accounting year closing on or after 15th June, 1988.

1.3 This guidance note is issued by the Research Committee of the ICAI providing guidance in respect of maintenance of accounts on the accrual basis of accounting.

2. Accrual Basis of Accounting

2.1 The term "Accrual" has been explained in the Accounting Standard on Disclosure of Accounting Policies (AS-1), as under:

"Revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate".

2.2 The Guidance Note on Terms Used in Financial Statements, issued by the Accounting Standards Board of the ICAI, explains 'Accrual Basis of Accounting' as under:

"The method of recording transactions by which revenues, costs, assets and liabilities are reflected in the accounts in the period in which they accrue. The 'Accrual Basis of Accounting' includes considerations relating to deferrals, allocations, depreciation and amortisation. This basis is also referred to as 'Mercantile Basis of Accounting'."

Accrual Basis of Accounting

2.3 Accrual basis of accounting, thus, attempts to record the financial effects of the transactions, events, and circumstances of an enterprises in the period in which they occur rather than recording them in the period(s) in which cash is received or paid by the enterprise. It recognises that the buying, producing, selling and other economic events that affect enterprise's performance often do not coincide with the cash receipts and payments of the period. The goal of accrual basis of accounting is to relate the accomplishments (measured in the form of revenue) and the efforts (measured in terms of cost) so that reported net income measures an enterprise's performance during a period instead of merely listing its cash receipts and payments. Apart from income measurement, accrual basis of accounting recognises assets, liabilities or components of revenues and expenses for amounts received or paid in cash in past, and amounts expected to be received or paid in cash in the future.

2.4 The major difference between accrual accounting and accounting based on cash receipts and outlays, is in timing of recognition of revenues, expenses, gains and losses. Cash receipts in a particular period may largely reflect the effects of activities of the enterprise in the earlier periods, while many of the cash outlays may relate to activities and efforts expected in future periods. Thus, an account showing cash receipts and cash outlays of an enterprise for a short period cannot indicate how much of the cash received is return *of* investment and how much is return *on* investment and thus cannot indicate whether or to what extent an enterprise is successful or unsuccessful.

2.5 The following are the essential features of accrual basis of accounting:

- (i) Revenue is recognised as it is earned.
- (ii) Costs are matched either against revenues so recognised or against the relevant time period to determine periodic income, and
- (iii) Costs which are not charged to income are carried forward and are kept under continuous review. Any cost that appears to have lost its utility or its power to generate future revenue is written-off as a loss.

2.6 The above features of accrual basis of accounting are discussed in the following paragraphs.

3. Revenue Recognition

3.1 The Accounting Standard on "Revenue Recognition" (AS-9) issued by ICAI deals with the bases for recognition of revenue in the statement of profit and loss of an enterprise. This standard lays down rules for recognition of revenue arising in the course of the ordinary activities of the enterprise from (i) sale of goods, (ii) rendering of services, and (iii) use of resources of the enterprise by others yielding interest, royalties and dividends.

3.2 Recognition of revenue requires that revenue is measurable and that at the time of sale or the rendering of service or the use of resources of the enterprise by others it would not be unreasonable to expect ultimate collection.

3.3 An essential criterion for the recognition of revenue is that the consideration receivable from the sale of goods, the rendering of services or from the use by others of resources of the enterprise is

reasonably determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

3.4 When recognition of revenue is postponed due to the effect of uncertainties, it is considered as revenue for the period in which it is properly recognised according to the principles discussed herein.

3.5 Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g., for escalation of price, export incentives, interest etc., revenue recognition is postponed to the extent of uncertainty involved. It is possible that the uncertainty of collection may be either in respect of the entire transaction or a part thereof. For that part in respect of which there is no uncertainty of collection, the revenue is immediately recognised and for the remaining part the recognition of revenue is postponed. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. It is necessary to disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by installments. When the uncertainty relating to collectability arises subsequent to the time of sale or the rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.

3.6 Revenue from sales or service transactions should be recognised when the requirements as to performance set out in paragraphs 3.7 and 3.8 are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection.

3.7 In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

- (i) The seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and
- (ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of goods. Thus, when such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

3.8 In a transaction involving the rendering of services, performance should be measured either under the completed service contract method or under the proportionate completion method, whichever relates the revenue to the work accomplished. Such performance should be regarded as being achieved when no significant uncertainty exists regarding the amount of the consideration that will be derived from rendering the service.

3.9 The use of resources of the enterprise by others yielding interest, royalties and dividends is recognised when no significant uncertainty as to measurability or collectability exists. The terms interest, royalties and dividends mean -

- (i) Interest - charges for the use of cash resources or amounts due to the enterprise;
- (ii) royalties - charges for the use of such assets as know-how, patents, trade marks and copyrights;
- (iii) dividends - rewards from the holding of investments in shares.

3.10 The revenues from the above sources are recognised on the following basis:

- (i) Interest accrues, in most circumstances, on the time basis determined by the amount outstanding and the rate applicable. Usually, discount or premium on debt securities held is treated as though it were accruing over the period of maturity.

- (ii) Royalties accrue in accordance with the terms of the relevant agreement and are usually recognised on that basis unless, having regard to the substance of the transactions, it is more appropriate to recognise revenue on some other systematic and rational basis.
- (iii) Dividends from investments in shares accrue when the owner's right to receive payment is established.

Similar considerations would apply where the resources of the enterprise are used by others and yield revenue such as rent.

3.11 When interest, royalties and dividends from foreign countries require exchange permission and uncertainty in remittances is anticipated, revenue recognition may need to be postponed.

3.12 The accrual basis of accounting necessitates adjustments for income received in advance as well as for outstanding income at the end of the period of accounting since the receipts during the period may not coincide with what is properly recognisable as income for the period.

4. Rules for Expense Recognition

4.1 The Guidance Note on Terms Used in Financial Statements, explains the term 'Expense' as under:

"A cost relating to the operations of an accounting period or to the revenue earned during the period or the benefits of which do not extend beyond that period".

4.2 In the accrual basis of accounting, costs are matched either against revenues or against the relevant time period to determine periodic income.

Further, costs which are not charged against income of the period are carried forward. If any particular item of cost has lost its utility or its power to generate future revenue the same is written off as an expense or a loss.

4.3 Under accrual basis of accounting, expenses are recognised by the following approaches:

(i) Identification with revenue transactions

Costs directly associated with the revenue recognised during the relevant period (in respect of which whether money has been paid or not) are considered as expenses and are charged to income for the period.

(ii) Identification with a period of time

In many cases, although some costs may have connection with the revenue for the period, the relationship is so indirect that it is impracticable to attempt to establish it. However, there is a clear identification with a period of time. Such costs are regarded as 'period costs' and are expensed in the relevant period, e.g., salaries, telephone, traveling, depreciation on office building etc.

Similarly, the costs the benefits of which do not clearly extend beyond the accounting period are also charged as expenses.

4.4 Expenses relating to a future period are accounted for as prepaid expenses even though they are paid for in the current accounting period.

Similarly, expenses of the current year, for which payment has not yet been made (outstanding expenses) are charged to the profit and loss account for the current accounting period.

4.5 The amount of a contingent loss should be provided for by a charge in the statement of profit and loss if:

- (a) it is probable that at the date of the financial statements events subsequent thereto will confirm

that (after taking into account any related probable recovery) an asset has been impaired or a liability has been incurred as at that date, and

(b) a reasonable estimate of the amount of the resulting loss can be made.

4.6 The existence of a contingent loss should be disclosed in the financial statements if either of the conditions in paragraph 4.5 is not met, unless the possibility of a loss is remote.

5. Recognition of Assets and Liabilities

5.1 As in the case of revenues and expenses which are recognised under the accrual basis of accounting, as they are earned or incurred (and not as money is received or paid), the transactions related to assets and liabilities are recognised as they occur irrespective of the actual receipts or payments.

6. Concept of Materiality

6.1 Section 209(3) of the Companies Act, 1956, requires that every company has to keep the books of account in such a manner that they give a 'true and fair' view of its state of affairs and that the books are maintained on the accrual basis of accounting.

6.2 The concept of 'true and fair' view also recognises that the concept of materiality must be given due importance in the preparation and presentation of financial statements. As explained in para 17 of Accounting Standard on 'Disclosure of Accounting Policies' (AS-1), financial statements should disclose all "material" items, i.e., items the knowledge of which might influence the decisions of the user of the financial statements.

6.3 The accrual basis of accounting does not necessarily imply that detailed calculations are required to be made in respect of even the smallest and immaterial amounts of revenue and expenditure and correlate the same on the basis of the principle of accrual. For example, it may not be improper to write off a small calculator costing ₹.100 even though it is expected to be used for more than one year.

7. Change in the Basis of Accounting

7.1 When an enterprise which was earlier following cash basis of accounting for all or any of its transactions, changes over to the accrual basis of accounting, the effect of the change should be ascertained with reference to the transactions of the previous accounting periods also, to the extent such transactions have an impact on the current financial position of the enterprise.

The fact of such change should be disclosed in the financial statements. 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. Where the effect of the change is not ascertainable, wholly or in part, the fact should be indicated. If the change has no material effect on the financial statements for the current period but is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

8. Authoritative Pronouncements of the Institute vis-a-vis Accrual Accounting

8.1 The Council of the ICAI and its various committees have issued various Guidance Notes, Statements and Accounting Standards. The accounting treatments contained in these documents are primarily based on accrual accounting. Thus, adoption of accounting treatments recommended in these documents would ensure that a company has followed accrual basis of accounting. The Appendix to this guidance note contains some special circumstances of recognition of revenue and expenses as dealt with in the aforesaid documents issued by the Institute. The Appendix also contains illustrations of situations where due to uncertainty of collection, revenue recognition may be postponed.

9. Auditor's Responsibility

9.1 Where a company has maintained its books of account in a manner that all material transactions are accounted for on accrual basis as discussed above, the auditor should state in his report that, as far as this aspect is concerned, the company has maintained proper books of account as required by law.

Where a company has not maintained its books of account in a manner that all material transactions are accounted for on accrual basis as discussed above, the auditor will have to qualify his report or give a negative opinion with regard to the following assertions:

- (a) Whether proper books of account as required by law have been kept by the company.
- (b) Whether the accounts give the information required by this Act in the manner so required and give a true and fair view of:
 - (i) in the case of the balance sheet, of the state of the company's affairs as at the end of its financial year; and
 - (ii) in the case of the profit and loss account, of the profit or loss for its financial year.

Appendix

This Appendix is illustrative only. The purpose of the Appendix is to illustrate the application of the Guidance Note on Accrual Basis of Accounting to some of the important commercial situations.

Revenue Recognition

1. Sale of Goods

(i) *Delivery is delayed at buyer's request and buyer takes title and accepts billing*

Revenue should be recognised notwithstanding that physical delivery has not been completed so long as there is every expectation that delivery will be made. However, the item must be on hand, identified and ready for delivery to the buyer at the time the sale is recognised rather than there being simply an intention to acquire or manufacture the goods in time for delivery.

(ii) *Delivered subject to conditions*

(a) *installation and inspection i.e. goods are sold subject to installation, inspection etc.*

Revenue should normally not be recognised until the customer accepts delivery and installation and inspection are complete. In some cases, however, the installation process may be so simple in nature that it may be appropriate to recognise the sale notwithstanding that installation is not yet completed (e.g. installation of a factory tested television receiver normally only requires unpacking and connecting of power and antenna.)

(b) *on approval*

Revenue should not be recognised until the goods have been formally accepted by the buyer or the buyer has done an act adopting the transaction or the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed.

(c) *guaranteed sales i.e. delivery is made giving the buyer an unlimited right of return*

Recognition of revenue in such circumstances will depend on the substance of the agreement. In the case of retail sales offering a guarantee of "money back if not completely satisfied" it may be appropriate to recognise the sale but to make a suitable provision for returns based on previous experience. In other cases, the substance of the agreement may amount to a sale on consignment, in which case it should be treated as indicated below.

(d) *Consignment sales i.e. a delivery is made whereby the recipient undertakes to sell the goods on behalf of the consignor*

Revenue should not be recognised until the goods are sold to a third party.

(e) *Cash on delivery sales*

Revenue should not be recognised until cash is received by the seller or his agent.

(iii) *Sales where the purchaser makes a series of installment payments to the seller, and the seller delivers the goods only when the final payment is received*

Revenue from such sales should not be recognised until goods are delivered. However, when experience indicates that most such sales have been consummated, revenue may be recognised when a significant deposit is received.

(iv) *Special order and shipments i.e. where payment (or partial payment) is received for goods not presently held in stock e.g. the stock is still to be manufactured or is to be delivered directly to the customer from a third party*

Revenue from such sales should not be recognised until goods are manufactured, identified and ready for delivery to the buyer by the third party.

(v) *Sale/repurchase agreements i.e. where seller concurrently agrees to repurchase the same goods at a later date*

For such transactions that are in substance a financing agreement, the resulting cash inflow is not revenue as defined and should not be recognised as revenue.

(vi) *Sales to intermediate parties i.e. where goods are sold to distributors, dealers or others for resale*

Revenue from such sales can generally be recognised if significant risks of ownership have passed, however, in some situations the buyer may in substance be an agent and in such cases the sale should be treated as a consignment sale.

(vii) *Subscriptions for publications*

Revenue received or billed should be deferred and recognised either on a straight line basis over time or, where the items delivered vary in value from period to period, revenue should be based on the sales value of the item delivered in relation to the total sales value of all items covered by the subscription.

(viii) *Installments sales*

When the consideration is receivable in installments, revenue attributable to the sales price exclusive of interest should be recognised at the date of sale. The interest element should be recognised as revenue, proportionately to the unpaid balance due to the seller.

2. Rendering of Services

(i) *Installation fees*

In cases where installation fees are other than incidental to the sale of a product, they should be recognised as revenue only when the equipment is installed and accepted by the customer.

(ii) *Advertising and Insurance Agency Commissions*

Revenue should be recognised when the service is completed. For advertising agencies, media commissions will normally be recognized when the related advertisement or commercial appears before the public and the necessary intimation is received by the agency, as opposed to production commission which will be recognised when the project is completed. Insurance agency

commissions should be recognised on the effective commencement or renewal dates of the related policies.

(iii) *Financial service commissions*

A financial service may be rendered as a single act or may be provided over a period of time. Similarly, charges for such services may be made as a single amount or in stages over the period of the service or the life of the transaction to which it relates. Such charges may be settled in full when made, or added to a loan or other account and settled in stages.

The recognition of such revenue should, therefore, have regard to:

- (a) Whether the service has been provided "once and for all" or is on a "continuing" basis;
- (b) the incidence of the costs relating to the service;
- (c) when the payment for the service will be received. In general, commissions charged for arranging or granting loan or other facilities should be recognised when a binding obligation has been entered into. Commitment, facility or loan management fees which relate to continuing obligations or services should normally be recognised over the life of the loan or facility having regard to the amount of the obligation outstanding, the nature of the services provided and the timing of the costs relating thereto.

(iv) *Admission fees*

Revenue from artistic performances, banquets and other special events should be recognised when the event takes place. When a subscription to a number of events is sold, the fee should be allocated to each event on a systematic and rational basis.

(v) *Entrance and membership fees*

Revenue recognition from these sources will depend on the nature of the services being provided. Entrance fee received is generally capitalized. If the membership fee permits only membership and all other services or products are paid for separately, or if there is a separate annual subscription, the fee should be recognised when received. If the membership fee entitles the member to services or publications to be provided during the year, it should be recognised on a systematic and rational basis having regard to the timing and nature of all services provided.

3. Uncertainty of Collection

In respect of the following items of revenue, if the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, revenue recognition is postponed to the extent of uncertainty involved :

- (i) Claim for escalation of price under a contract.
- (ii) Export incentives due from the Government or any statutory authority.
- (iii) Drawback claims, cash subsidies, benefits of Import Licenses etc. received from the Government or any statutory authority.
- (iv) Interest due or receivable on loans or other dues when the recovery of the amount is in dispute or is doubtful.
- (v) Insurance claim in respect of loss of goods or loss of profits, when the amount receivable is not certain or capable of being determined.

4. Construction Contracts*

In accounting for construction contracts in financial statements either the percentage of completion method or the completed contract method¹ may be used. When a contractor uses a particular method of accounting for a contract, then the same method should be adopted for all other contracts which meet similar criteria.

Liability for Expenditure

Gratuity

Under accrual basis of accounting it is necessary to provide for accruing liability in each accounting period.

GN(A) 7 (Issued 1989)

Guidance Note on Accounting for Depreciation in Companies¹

Introduction

1. The Council of the Institute of Chartered Accountants of India has issued Accounting Standard (AS) 6 on 'Depreciation Accounting'. This Standard lays down general principles of accounting for depreciation applicable to all entities. As such, the Standard is applicable to companies also in all matters where there are no specific requirements under the Companies Act.

AS 6 also provides that the statute governing an enterprise may provide the basis for computation of depreciation. In such a situation, the requirements of the statute have to be complied with. Thus, in case of companies, sections 205 and 350 of the Companies Act, 1956, which govern provisions regarding charge of depreciation for the purpose of payment of dividends and computation of managerial remuneration, respectively, provide the basis for computation of depreciation. The Companies (Amendment) Act, 1988, has amended section 350, as a consequence to which rates of depreciation prescribed in Income-tax Act, 1961, and the Rules made thereunder are no more relevant as the aforesaid section now provides that the rates of depreciation applicable would be those prescribed in Schedule XIV, which has been inserted in the Act. This Guidance Note on Accounting for Depreciation in Companies is issued by the Research Committee in the context of the aforesaid sections of the Act as well as the Accounting Standard.

2. The Council of the Institute and its various committees have issued, from time to time, various pronouncements on the subject of accounting for depreciation, in particular reference to the corporate sector, which are listed below:

- (a) Guidance Note on Provision for Depreciation [published in Compendium of Guidance Notes, Vol. 1 (2nd Edition)]
- (b) Statement on Provision for Depreciation in Respect of Extra or Multiple Shift Allowance [Published in Compendium of Statements and Standards on Accounting, 1st Edition]

* Accounting Standard (AS) 7, 'Construction Contracts' (revised) issued by the Institute of Chartered Accountants of India, permits the use of only percentage of completion method for accounting for construction contracts. AS 7 (revised) comes into effect in respect of all contracts entered into during accounting periods commencing on or after 1-4-2003 and is mandatory in nature.

¹ This Guidance Note also applies to various non-corporate entities to the extent it may be relevant though it has been issued specifically for companies.

- (c) Statements on Changes in the Mode of Charging Depreciation in Accounts [Published as an Appendix in the Guide to Company Audit]
- (d) Guidance Note on Accounting for Depreciation Consequent to Changes in Rates of Depreciation [Published in Compendium of Guidance Notes, Vol. II, 1st Edition]

This Guidance Note comes into effect in respect of accounting periods commencing on or after 1st April, 1989. Accordingly, the above Guidance Notes/Statements stand withdrawn from that date.

Methods of Charging Depreciation

3. Section 205 of the Companies Act, 1956, prescribes the methods of charging depreciation. The relevant extracts thereof are as follows:

"(2)...depreciation shall be provided either-

- (a) to the extent specified in section 350; or
- (b) in respect of each item of depreciable asset, for such an amount as is arrived at by dividing ninety-five percent of the original cost thereof to the company by the specified period in respect of such asset; or
- (c) on any other basis approved by the Central Government which has the effect of writing off by way of depreciation ninety-five percent of the original cost to the company of each such depreciable asset on the expiry of the specified period; or
- (d) as regards any other depreciable asset for which no rate of depreciation has been laid down by this Act or rules made thereunder, on such basis as may be approved by the Central Government by the general order published in the Official Gazette or by any special order in any particular case:

Provided that where depreciation is provided for in the manner laid down in clause (b) or clause (c), then, in the event of the depreciable asset being sold, discarded, demolished or destroyed the written down value thereof at the end of the financial year in which the asset is sold, discarded, demolished or destroyed, shall be written off in accordance with the proviso to section 350.

(5) 'Specified period' in respect of any depreciable asset shall mean the number of years at the end of which at least ninety-five per cent of the original cost of the asset to the company will have been provided for by way of depreciation if depreciation were to be calculated in accordance with the provisions of section 350."

4. Note No. 5(i) to Schedule XIV requires that depreciation method(s) used by the company shall be disclosed. Part II of Schedule VI requires that if no provision is made for depreciation, the fact that no provision has been made should be stated and the quantum of arrears of depreciation computed in accordance with section 205(2) of the Act shall be disclosed by way of a note. The Committee is of the view that the company should also disclose the method(s) by which the arrears of depreciation have been computed.

Adoption of different methods for different types of assets

5. A company may adopt more than one method of depreciation. Thus, it is permissible to follow different methods for different types of assets provided the same methods are consistently adopted from year to year in accordance with Section 205(2). Also, units in different geographical locations can follow different methods of depreciation provided the same are consistently followed.

Change in the method of providing depreciation

6. The depreciation method selected should be applied consistently from period to period. A change from one method of providing depreciation to another should be made only if the adoption of the new

method 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 preparation or presentation of the financial statements of the enterprise. When a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method would be adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency should be charged to the profit and loss account. In case the change in the method results in surplus, it is recommended that the surplus be initially transferred to the 'Appropriations' part of the profit and loss account and thence to General Reserve through the same part of the profit and loss account. Such a change should be treated as a change in accounting policy and its effects should be quantified and disclosed.

Relevant Rates of Depreciation for the Purpose of Preparation of Accounts of A Company

7. Section 205 of the Companies Act requires that no dividend shall be declared or paid by a company except out of the profits of the company arrived at after providing for depreciation in accordance with the provisions of sub-section 2 of that Section. This sub-section allows the company to provide for depreciation either in the manner specified in Section 350 of the Act or in the alternative manners specified in that sub-section itself. Part II of Schedule VI further provides that if no provision for depreciation is made, the fact that no provision has been made shall be stated and the quantum of arrears of depreciation computed in accordance with Section 205(2) of the Act shall be disclosed by way of a note.

8. A question may arise as to whether it is obligatory on a company to provide for depreciation only on the basis mentioned in Section 205(2) read with section 350 and Schedule XIV of the Act or whether these bases can be considered as indicating the minimum depreciation which must be provided by the company, insofar as the accounts of the company are concerned and insofar as it is required to exhibit a true and fair view of the state of affairs of the company as on a given date and of the profit or loss for the year.

9. The Committee is of the view that in arriving at the rates at which depreciation should be provided the company must consider the true commercial depreciation, i.e., the rate which is adequate to write off the asset over its normal working life. If the rate so arrived at is higher than the rates prescribed under Schedule XIV, then the company should provide depreciation at such higher rate but if the rate so arrived at is lower than the rate prescribed in Schedule XIV, then the company should provide depreciation at the rates prescribed in Schedule XIV, since these represent the minimum rates of depreciation to be provided. Since the determination of commercial life of an asset is a technical matter, the decision of the Board of Directors based on technological evaluation should be accepted by the auditor unless he has reason to believe that such decision results in a charge which does not represent true commercial depreciation. In case a company adopts the higher rates of depreciation as recommended above, the higher depreciation rates/lower lives of the assets must be disclosed as required in Note No. 5 of Schedule XIV to the Companies Act, 1956.

10. This view is supported by the Department of Company Affairs and it has clarified that "the rates as contained in Schedule XIV should be viewed as the *Accounting for* minimum rates, and, therefore, a company will not be permitted to charge depreciation at rates lower than those specified in the Schedule in relation to assets purchased after the date of applicability of the Schedule. If, however, on

the basis of bona fide technological evaluation, higher rates of depreciation are justified, they may be provided with proper disclosure by way of a note forming part of annual accounts"².

11. The Committee is, however, of the view that in respect of assets existing on the date of Schedule XIV coming into force, and where the company is following the Circular of the Department of Company Affairs bearing No. 1/86, dated 21st May, 1986, whereby depreciation under straight line method was worked out based on depreciation rates in force under Income-tax Act, 1961 and Rules made thereunder at the time of the acquisition of the asset, it would be permissible to the company to follow Circular no. 1/86, dated 21st May, 1986. An appropriate note will be required to be given in this regard.

12. Schedule XIV requires that where the concern has worked extra shift, the multiple or extra shift depreciation will have to be provided on the plant and machinery, wherever applicable. In this regard, various units/departments/mills/factories should be taken as separate concerns. In cases where depreciation has not been provided in respect of extra or multiple shift allowance, it will be necessary for the auditor to qualify his report accordingly.

An example of the qualification is given below:

"Depreciation in respect of extra or multiple shift allowance amounting to rupees has not been provided which is contrary to the provisions of Schedule XIV to the Companies Act. This has resulted in the profit being overstated by ₹ and plant and machinery overstated by ₹....."

13. It has been argued that the SLM rates (corresponding to the WDV rates as per Schedule XIV) can be different than those prescribed under Schedule XIV, provided the company continues to determine the rates as provided under Section 205. For instance, against the SLM rate of 11.31 (triple shift rate for general plant and machinery) prescribed in Schedule XIV, a company can charge depreciation at the rate of 10.56%. It may be mentioned that the rate of 11.31% has been determined on the basis of 8 years and 6 months or so of specified period whereas 10.56% is arrived at if 95% of the cost of the asset is divided by 9 years. It is argued that for calculating the SLM rates complete years have to be taken into account whereas the rates under Schedule XIV also take into account fractions of years.

14. The Committee is of the view that a company should provide SLM depreciation at the rates prescribed under Schedule XIV instead of holding the contention that fractions of years can be ignored. This view is supported by Department of Company Affairs, as per its Circular No. 2/89, dated March 7, 1989.

Applicability of the rates prescribed in Schedule XIV to assets existing on the date on which Schedule XIV came into force.

15. Applicability of the rates prescribed in Schedule XIV to existing assets would depend upon whether the company has been charging depreciation on its assets as per the written down value method or the straight line method.

16. Where a company has been following the written down value method of depreciation in respect of its assets, the WDV rates prescribed in Schedule XIV should be applied to the written down value as at the end of the previous financial year as per the books of the company.

17. Where a company has been following the straight line basis of depreciation in respect of its assets the position prevailing at present is discussed hereunder.

18. In January, 1985, the Department of Company Affairs issued a circular No. 1/85 dated 10.1.1985 (enclosed as Annexure II). In this Circular, the Government recognised the need for recalculating the

² Circular No. 2/89, dated March 7, 1989

specified period consequent to changes in the income-tax rates. For determining depreciation consequent upon changes in the income-tax rates it recommended the following method:

- (i) As far as recomputation of specified period is concerned, the specified period be recomputed by applying to the original cost, the revised rate of depreciation as prescribed under Income-tax Rules.
- (ii) As far as charge of depreciation is concerned, depreciation be charged by allocating the written down value as per books over the remaining part of the recomputed specified period.

19. The Department of Company Affairs issued another Circular (No. 1/86 dated 21st May, 1986, enclosed as Annexure III) wherein it re-examined its earlier Circular of 1985. The Department accordingly expressed its view that "once the 'specified period' was determined at the time of purchase of an asset in accordance with the procedure laid down under Section 205(5) read with Section 350 of the Companies Act with reference to the rates of depreciation under the Income-tax Act at that time and the amount of depreciation fixed under Section 205(2)(b) of the Companies Act, the same need not be changed subsequently consequent on changes in the rates of depreciation in the Income-tax Act." The Circular further stated that it was therefore "open to the companies to provide for depreciation under clause (b) of Section 205(2) of the Companies Act on the basis of rates of depreciation prescribed under Income-tax Act and in force at the time of acquisition/purchase of the asset."

20. In its Circular No. 2/89 dated March 7, 1989, the Department has reiterated that the companies which follow Circular No. 1/86 "may, therefore, continue to charge depreciation at the old SLM rates in respect of the already acquired assets against which depreciation has been provided in earlier years on SLM basis."

21. The Committee is of the view that where a company is following the straight line method of depreciation in respect of its assets existing on the date of Schedule XIV coming into force, it would be permissible to apply the relevant SLM rates prescribed in the said Schedule on the original cost of the assets from the year of the change of rates.

22. The Committee is accordingly of the view that where a company has been following straight line method of depreciation in respect of its assets existing on the date of Schedule XIV coming into force, the following alternative bases may be adopted for computing the depreciation charge:

- (a) Where a company follows the manner of charging depreciation recommended by the Department of Company Affairs in its Circular No. 1/85, it has to change its depreciation rates as follows:
 - (i) The specified period should be recomputed by applying to the original cost, the revised rate as prescribed in Schedule XIV;
 - (ii) depreciation charge should be calculated by allocating the unamortized value as per the books of account over the remaining part of the recomputed specified period.
- (b) A company which follows the Circular No. 1/86, can continue to charge depreciation on straight line basis at old rates in respect of assets existing on the date on which the new provisions relating to depreciation came into force.
- (c) SLM rates prescribed in Schedule XIV can be straightaway applied to the original cost of all the assets including the existing assets from the year of change of the rates.

23. A company which changes the rates of depreciation should make an appropriate disclosure in its accounts pertaining to the year in which the change is made.

Pro-Rata Depreciation

24. Note no.4 in Schedule XIV to the Companies Act, 1956, prescribes that "where, during any

financial year, any addition has been made to any asset, or where any asset has been sold, discarded, demolished or destroyed, the depreciation on such assets shall be calculated on a *pro rata* basis from the date of such addition or, as the case may be, up to the date on which such asset has been sold, discarded, demolished or destroyed". The Committee is of the view that a company may group additions and disposals in appropriate time period(s), e.g., 15 days, a month, a quarter etc., for the purpose of charging *pro rata* depreciation in respect of additions and disposals of its assets keeping in view the materiality of the amounts involved.

25. Where the financial year of a company is more/less than 12 months, a question may arise as to whether the rates of depreciation prescribed in Schedule XIV are to be applied proportionately to the duration of the financial year of the company or the said rates are to be applied as flat rates irrespective of the duration of the financial year. It may be argued that since section 205 and 350 of the Companies Act, 1956, are in relation to the financial year, the rates prescribed in Schedule XIV are applicable in respect of the financial year of the company, irrespective of its duration. The Committee is, however, of the opinion that in view of the true and fair consideration of preparation of accounts, the rates of depreciation as per Schedule XIV should be applied proportionately taking into consideration the duration of the financial year.

Depreciation on Low Value Items³

26. Prior to the enforcement of the Companies (Amendment) Act, 1988, many companies used to follow the practice of writing off low value items in the year of acquisition, since such a write off was permitted under the Income-tax Act. The limit for such a write off was ₹ 5,000/-. Schedule XIV is, however, silent on this aspect. The Committee is of the view that the concept of materiality should be kept in mind while deciding the amounts to be written off in this regard. For instance, in small companies, the total write off on this basis may be a substantial figure, it may not, therefore, be proper to charge 100% depreciation on low value items. However, in large companies, where the value of assets is very high, it may be proper to charge 100% depreciation on low value items keeping in view the concept of materiality. The Committee recommends that the accounting policy followed by the company in this regard should be disclosed appropriately in the accounts.

Computation of Managerial Remuneration — Whether SLM Rates given in Schedule can be used

27. The Department of Company Affairs, as per its circular no. 3\19\88-CL. V, dated April 13, 1989, has stated that "For the purpose of determining net profits of any financial year the amount of depreciation required to be deducted in pursuance of clause (k) of sub-section (4) of Section 349 read with Section 350 shall be the amount calculated as per the written down value method at the rate specified in Schedule XIV, on the assets as shown by the books of the Company at the end of the relevant financial year". The Committee is of the opinion that the language of Section 350 as it stands at present, does not permit the use of the Straight Line Method. The aforesaid section makes reference to 'written-down value of the assets' indicating thereby that for the purposes of computation of managerial remuneration, only the WDV method can be used as the SLM rates, by definition, are applicable only to the original cost of the assets and not to the WDV of the assets.

Charging of Depreciation in Case of Revaluation of Assets

28. A question may arise, as to whether the additional depreciation provision required in

³ This paragraph stands superseded by the 'Guidance Note on Some Important Issues Arising from the Amendments to Schedule XIV to the Companies Act, 1956', issued in August 1994.

consequence of revaluation of fixed assets can be adjusted against "Revaluation Reserve" which is created by a company by transferring the difference between the revalued figure and the book value of the fixed assets.

Depreciation is required to be provided with reference to the total value of the fixed assets as appearing in the accounts after revaluation. However, for certain statutory purposes e.g., dividends, managerial remuneration etc., only depreciation relatable to the historical cost of the fixed assets is to be provided out of the current profits of the company. In the circumstance, the additional depreciation relatable to revaluation may be adjusted against "Revaluation Reserve" by transfer to Profit and Loss Account. In other words, as per the requirements of Part II of Schedule VI to the Companies Act, the company will have to provide the depreciation on the total book value of the fixed assets (including the increased amount as a result of revaluation) in the Profit and Loss Account of the relevant period, and thereafter the company can transfer an amount equivalent to the additional depreciation from the Revaluation Reserve. Such transfer from Revaluation Reserve should be shown in the Profit and Loss Account separately and an appropriate note by way of disclosure would be desirable. Such a disclosure would appear to be in consonance with the requirement of Part I of Schedule VI to the Companies Act, prescribing disclosure of write-up in the value of fixed asset for the first five years after revaluation.

29. If a company has transferred the difference between the revalued figure and the book value of fixed assets to the "Revaluation Reserve" and has charged the additional depreciation related thereto to its Profit and Loss Account, it is possible to transfer an amount equivalent to accumulated additional depreciation from the revaluation reserve to the Profit and Loss Account or to the General Reserve provided suitable disclosure is made in the accounts as recommended in this guidance note.

30. The Revaluation Reserve is not available for payment of dividends. This view is also supported by the Companies (Declaration of Dividend out of Reserves) Rules, 1975. Similarly, accumulated losses or arrears of depreciation should not be set off against Revaluation Reserve. However, the revaluation reserve can be utilised for adjustment of the additional depreciation on the increased amount due to revaluation from year to year or on the retirement of the relevant fixed assets (as discussed in paragraphs 28 and 29 above respectively).

31. The revaluation of fixed assets is normally done in order to bring into books the replacement cost of such assets. This is a healthy trend as it recognises the importance of retaining sufficient funds through additional depreciation in the business for replacement of fixed assets. As such, it will be prudent not to charge the additional depreciation against revaluation reserve, though the charge of additional depreciation against revaluation reserve is not prohibited as discussed in paragraphs 28 and 29 above. The practice of not charging the additional depreciation against revaluation reserve would also give a more realistic appraisal of the company's operations in an inflationary situation.

GN(A) 9 (Issued 1994)

Guidance Note on Availability of Revaluation Reserve for Issue of Bonus Shares

1. In the recent past, a few private companies and closely held public companies have resorted to the practice of utilising the reserve created on revaluation of fixed assets for issue of bonus shares. This Guidance Note discusses the nature of revaluation reserve and in this context examines the question whether such reserves can be utilised for issue of bonus shares. It supplements the Guidance Note on Treatment of Reserve Created on Revaluation of Fixed Assets issued in 1982.

2. Revaluation of fixed assets is one of the issues dealt with in Accounting Standard (AS) 10 on 'Accounting for Fixed Assets', issued by the Institute of Chartered Accountants of India, which states,

inter alia, as follows:

"13.1 Sometimes financial statements that are otherwise prepared on a historical cost basis include part or all of fixed assets at a valuation in substitution for historical costs....

13.2 A commonly accepted and preferred method of restating fixed assets is by appraisal, normally undertaken by competent valuers. Other methods sometimes used are indexation and reference to current prices which when applied are cross checked periodically by appraisal method."

3. AS 10 lays down as below:

"29. When a fixed asset is revalued upwards, any accumulated depreciation existing at the date of the revaluation should not be credited to the profit and loss statement.

30. An increase in net book value arising on revaluation of fixed assets should be credited directly to owners' interests under the head of revaluation reserve, except that, to the extent that such increase is related to and not greater than a decrease arising on revaluation previously recorded as a charge to the profit and loss statement, it may be credited to the profit and loss statement. A decrease in net book value arising on revaluation of fixed asset should be charged directly to the profit and loss statement except that to the extent that such a decrease is related to an increase which was previously recorded as, credit to revaluation reserve and which has not been subsequently reversed or utilised, it may be charged directly to that account."

4. It may be noted that the excess of the revalued amount over the net book value of fixed assets, which is credited to revaluation reserve, is created as a result of a book adjustment only. The revaluation reserve does not result from an arm's length transaction; it represents an expert's perception of value. The revaluation reserve thus does not represent a realised gain.

5. Share capital represents the amount of money or money's worth received from the owners and the capitalisation of earned profits or other gains arising out of an arm's length transaction. It has, therefore, been a cardinal principle that only such profits as are earned or the relevant capital receipts (e.g. share premium), as are realised, can be capitalised.

6. In view of the above, in the opinion of the Institute of Chartered Accountants of India, bonus shares cannot be issued by capitalisation of revaluation reserve. If any company (including a private or a closely held public company) utilises revaluation reserve for issue of bonus shares, the statutory auditor of the company should qualify his audit report. An illustrative manner of the qualification is given below:

"The company has issued bonus shares for ₹ _____ (_____ equity shares of ₹._____ each) by capitalising its revaluation reserve. Accordingly, the Paid-up Equity Share Capital of the company stands increased by ₹ _____ and the revaluation reserve stands reduced by that amount. The issue of bonus shares as aforesaid is contrary to the recommendations of the Institute of Chartered Accountants of India.

Subject to the above _____".

7. The above would also apply to situations where the revaluation reserve is utilised to increase the amount paid-up on equity shares of a company.

8. In this context, it may also be noted that the Securities and Exchange Board of India (SEBI) has prohibited listed companies from issuing bonus shares out of revaluation reserves.

GN(A) 11 (Issued 1997)

Guidance Note on Accounting for Corporate Dividend Tax

1. The Finance Act, 1997, has introduced Chapter XIID on “Special Provisions Relating to Tax on Distributed Profits of Domestic Companies” [hereinafter referred to as ‘CDT’ (Corporate Dividend Tax)]. The relevant extracts of sections 115O and 115Q of the Income-tax Act, 1961, governing CDT have been reproduced in Annexure I. This Guidance Note is being issued to provide guidance on accounting for CDT.

2. The salient features of CDT are as below:

- (i) CDT is in addition to the income-tax chargeable in respect of the total income of a domestic company.
- (ii) CDT is chargeable on any amount declared, distributed or paid by such company by way of dividends (whether interim or otherwise) on or after the 1st day of June 1997.
- (iii) The dividends chargeable to CDT may be out of the current profits or accumulated profits.
- (iv) The rate of CDT is ten per cent.
- (v) CDT shall be payable even if no income-tax is payable by the domestic company on its total income.
- (vi) CDT is payable to the credit of the Central Government within 14 days of -
 - (a) declaration of any dividend,
 - (b) distribution of any dividend, or
 - (c) payment of any dividend,
 whichever is the earliest.
- (vii) CDT paid shall be treated as the final payment of tax on the dividends and no further credit therefor shall be claimed by the company or by any person in respect of the tax so paid.
- (viii) The expression ‘dividend’ shall have the same meaning as is given to ‘dividend’ in clause (22) of Section 2 but shall not include sub-clause (e) thereof. (The relevant extracts of Section 2(22) of the Income-tax Act, 1961, have been reproduced in Annexure II).

Accounting for CDT

3. According to generally accepted accounting principles, the provision for dividend is recognised in the financial statements of the year to which the dividend relates. In view of this, CDT on dividend, being directly linked to the amount of the dividend concerned, should also be reflected in the accounts of the same financial year even though the actual tax liability in respect thereof may arise in a different year.

Disclosure and Presentation of CDT In Financial Statements

4. It is noted that clause 3(vi) of Part II of Schedule VI to the Companies Act, 1956, requires the disclosure of “the amount of charge for Indian Incometax and other Indian taxation on profits, including, where practicable, with Indian income-tax any taxation imposed elsewhere to the extent of the relief, if any, from Indian income-tax and distinguishing, where practicable, between income-tax and other taxation.” It is also noted that Part II of Schedule VI only lays down the information to be disclosed in the profit and loss account. However, as a matter of convention and to improve readability, the information in the profit and loss account is generally shown in two parts, viz., the first part contains the information which is required to arrive at the figure of the current year’s profit - often referred to as ‘above the line’, and the second part which discloses, inter alia, information involving the appropriations of the current year’s profits - often referred to as ‘below the line’.

5. Since dividends are disclosed 'below the line', a question arises with regard to disclosure and presentation of CDT, as to whether the said tax should also be disclosed 'below the line' or should be disclosed along with the normal income-tax provision for the year 'above the line'.

6. The liability in respect of CDT arises only if the profits are distributed as dividends whereas the normal income-tax liability arises on the earning of the taxable profits. Since the CDT liability relates to distribution of profits as dividends which are disclosed 'below the line', it is appropriate that the liability in respect of CDT should also be disclosed 'below the line' as a separate item. It is felt that such a disclosure would give a proper picture regarding payments involved with reference to dividends.

Recommendations

7. CDT liability should be recognised in the accounts of the same financial year in which the dividend concerned is recognised.

8. CDT liability should be disclosed separately in the profit and loss account, 'below the line', as follows:

| | | |
|--------------------------------|-------|-------|
| Dividend | XXXXX | |
| Corporate Dividend Tax thereon | XXXXX | XXXXX |

9. Provision for Corporate Dividend Tax should be disclosed separately under the head 'Provisions' in the balance sheet.

Annexure I

Relevant Extracts of the Provisions under Chapter XII D of the Income Tax Act, 1961, regarding Special Provisions relating to tax on distributed profits of domestic companies.

115 O. Tax on Distributed Profits of Domestic Companies

(1) Notwithstanding anything contained in any other provision of this Act and subject to the provisions of this section, in addition to the income-tax chargeable in respect of the total income of a domestic company for any assessment year, any amount declared, distributed or paid by such company by way of dividends (whether interim or otherwise) on or after the 1st day of June, 1997, whether out of current or accumulated profits shall be charged to additional income-tax (hereafter referred to as tax on distributed profits) at the rate of ten per cent.

(1A) Notwithstanding that no income-tax is payable by a domestic company on its total income computed in accordance with the provisions of this Act, the tax on distributed profits under subsection

- (1) shall be payable by such company.
- (2) The principal officer of the domestic company and the company shall be liable to pay the tax on distributed profits to the credit of the Central Government within fourteen days from the date of -
 - (a) declaration of any dividend; or
 - (b) distribution of any dividend; or
 - (c) payment of any dividend,
 whichever is earliest.
- (3) The tax on distributed profits so paid by the company shall be treated as the final payment of tax in respect of the amount declared, distributed or paid as dividends and no further credit therefore shall be claimed by the company or by any other person in respect of the amount of tax so paid.
- (4) No deduction under any other provision of this Act shall be allowed to the company or a shareholder in respect of the amount which has been charged to tax under sub-section (1) or the tax thereon.

115 Q

Explanation — For the purposes of this Chapter, the expression “dividend” shall have the same meaning as is given to “dividend” in clause (22) of Section 2 but shall not include sub-clause (e) thereof.

Annexure II

Relevant extracts of the definition of the term dividend as per section 2(22) of the Income Tax Act, 1961.

2(22) 1“Dividend includes -

- (a) any distribution by a company of accumulated profits, whether capitalised or not, if such distribution entails the release by the company to its shareholders of all or any part of the assets of the company;
- (b) any distribution to its shareholders by a company of debentures, debenture-stock, or deposit certificates in any form, whether with or without interest, and any distribution to its preference shareholders of shares by way of bonus, to the extent to which the company possesses accumulated profits, whether capitalized or not;
- (c) any distribution made to the shareholders of a company on its liquidation, to the extent to which the distribution is attributable to the accumulated profits of the company immediately before its liquidation, whether capitalised or not;
- (d) any distribution to its shareholders by a company on the reduction of its capital, to the extent to which the company possesses accumulated profits which arose after the end of the previous year ending next before the 1st day of April, 1933, whether such accumulated profits have been capitalised or not;
- (e) but ‘dividend’ does not include -
 - (i) a distribution made in accordance with sub-clause (c) or sub-clause (d) in respect of any share issued for full cash consideration, where the holder of the share is not entitled in the event of liquidation to participate in the surplus assets;
 - (ii) any advance or loan made to a shareholder 4[or the said concern] by a company in the ordinary course of its business, where the lending of money is a substantial part of the business of the company;
 - (iii) any dividend paid by a company which is set off by the company against the whole or any part of any sum previously paid by it and treated as a dividend within the meaning of sub-clause (e), to the extent to which it is so set off.

Explanation 1. - The expression ‘accumulated profits’, wherever it occurs in this clause, shall not include capital gains arising before the 1st day of April, 1946, or after the 31st day of March, 1948, and before the 1st day of April, 1956.

Explanation 2. - The expression ‘accumulated profits’ in sub-clauses (a), (b), (d) and (e), shall include all profits of the company up to the date of distribution or payment referred to in those sub-clauses and in sub-clause (c) shall include all profits of the company up to the date of liquidation, 5[but shall not, where the liquidation is consequent on the compulsory acquisition of its undertaking by the Government or a corporation owned or controlled by the Government under any law for the time being in force, include any profits of the company prior to three successive previous years immediately preceding the previous year in which such acquisition took place].

GN(A) 12 (Revised 2000)

Guidance Note on Accounting Treatment for Excise Duty

Introduction

1. The Institute of Chartered Accountants of India had issued a Guidance Note on Accounting Treatment for Excise Duties in 1979. In order to bring uniformity in the accounting treatment of excise duty and inventory valuation, the Guidance Note was revised in 1988. Keeping in view further developments, viz., issuance of the revised Accounting Standard (AS) 2, "Valuation of Inventories" (which has come into effect in respect of accounting periods commencing on or after 1.4.1999 and is mandatory in nature), it has been decided to revise this Guidance Note again. This revised Guidance Note is being issued in supersession of the earlier Guidance Note issued in 1988 and is effective in respect of accounting periods beginning on or after April 1, 1999.
2. This Guidance Note recommends accounting treatment for Excise Duty in respect of excisable goods produced or manufactured by an enterprise. A separate Guidance Note on Accounting Treatment for MODVAT sets out principles for accounting for MODVAT (now renamed as 'CENVAT').
3. At the outset, this Guidance Note briefly deals with normally accepted accounting principles for inventory valuation as prescribed in revised Accounting Standard (AS) 2, "Valuation of Inventories" issued by the Institute of Chartered Accountants of India, and nature of excise duty. For details, reference should be made to revised Accounting Standard (AS) 2 and Central Excise Act, Rules, Notifications and Circulars.

Normally Accepted Accounting Principles for Inventory Valuation

4. Normally accepted accounting principles with regard to the valuation of inventories (i.e., materials or supplies to be consumed in the production process or in the rendering of services, work-in-process and finished goods), as prescribed in revised Accounting Standard (AS) 2, "Valuation of Inventories", are reproduced below:
 5. Inventories should be valued at the lower of cost and net realisable value.
 6. The cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.
 7. The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.
 8. The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour.
 9. The allocation of fixed production overheads for the purpose of their inclusion in the costs of conversion is based on the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual

level of production may be used if it approximates normal capacity. The amount of fixed production overheads allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed production overheads allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are assigned to each unit of production on the basis of the actual use of the production facilities."

"11. Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include overheads other than production overheads or the costs of designing products for specific customers in the cost of inventories."

Nature of Excise Duty

5. Excise duty is a duty on manufacture or production of excisable goods in India. Section 3 of the Central Excise Act, 1944, deals with charge of Excise Duty. This Section provides that a duty of excise on excisable goods which are produced or manufactured in India shall be levied and collected in such manner as may be prescribed. This prescription is contained in the Central Excise Rules, 1944, which provide that excise duty shall be collected at the time of removal of goods from factory premises or from approved place of storage (Rule 49). Rate of duty and tariff valuation to be applied is the one in force on that date, i.e., the date of removal (Rule 9A) and not the date of manufacture. This difference in the point of time between taxable event, viz., manufacture and that of its collection has been examined and discussed in a number of judgements. For instance, the Supreme Court in the case of Wallace Flour Mills Co. Ltd. vs. CCE [1989 (44) ELT 598] summed up the legal position as under:

"It is well settled by the scheme of the Act as clarified by several decisions that even though the taxable event is the manufacture or production of an excisable article, the duty can be levied and collected at a later stage for administrative convenience. The Scheme of the said Act read with the relevant rules framed under the Act particularly Rule 9A of the said rules, reveals that the taxable event is the fact of manufacture or production of an excisable article, the payment of duty is related to the date of removal of such article from the factory."

Supreme Court in another case, viz., CCE vs. Vazir Sultan Tobacco Co. [1996 (83) ELT 3] held as under:

"We are of the opinion that Section 3 cannot be read as shifting the levy from the stage of manufacture or production of goods to the stage of removal. The levy is and remains upon the manufacture or production alone. Only the collection part of it is shifted to the stage of removal."

6. The levy of excise duty is not restricted only to excisable goods manufactured and intended for sale. It is also leviable on excisable goods manufactured or produced in a factory for internal consumption. Such intermediate products may be used in manufacture of final products or for repairs within the factory or for use as capital goods within the factory. Excisable goods so used for captive consumption may be eligible for exemption under specific notifications issued from time to time. Finished excisable goods cleared from the place of removal may also be eligible for whole or partial duty exemption in terms of notifications issued from time to time. Such exemption, subject to specified limits, if any, may relate to a manufacturer, e.g., a small-scale industrial unit. Exemption may be goods specific, e.g., handicrafts are currently wholly exempt from duty. The exemption may also be end-use specific, e.g., goods for use by defence services. Excisable goods can be removed for export out of India either wholly without payment of duty or under bond or on payment of duty under claim for rebate of duty paid.

7. Excisable goods, after completion of their manufacturing process, are required to be kept in a storeroom or other identified place of storage in a factory till the time of their clearance. Each such storeroom or storage place is required to be declared to the Excise Authorities and approved by them. Such storeroom or storage place is generally referred to as a Bonded Storeroom. Dutiable goods are also allowed, subject to approval of Excise Authorities, to be removed without payment of duty, to a Bonded Warehouse outside factory. In such cases, excise duty is collected at the time of clearance of goods from such Bonded Warehouses.

8. Amount of excise duty forming part of the sale price of the goods is required to be indicated separately in all documents relating to assessment of duty, e.g., excise invoice used for clearance of excisable goods (Section 12A). It is, however, open to a manufacturer to recover excise duty separately or not to make a separate recovery but charge a consolidated sale price inclusive of excise duty. The incidence of excise duty is deemed to be passed on to the buyer, unless contrary is proved by the payer of excise duty (Section 12B).

Excise Duty as An Element of Cost

9. In considering the appropriate treatment of excise duty for the purpose of determination of cost for inventory valuation, it is necessary to consider whether excise duty should be considered differently from other expenses.

10. Admittedly, excise duty is an indirect tax but it cannot, for that reason alone, be treated differently from other expenses. Excise duty arises as a consequence of manufacture of excisable goods irrespective of the manner of use/disposal of goods thereafter, e.g., sale, destruction and captive consumption. It does not cease to be a levy merely because the same may be remitted by appropriate authority in case of destruction or exempted in case goods are used for further manufacture of excisable goods in the factory. Tax (other than a tax on income or sale) payable by a manufacturer is as much a cost of manufacture as any other expenditure incurred by him and it does not cease to be an expenditure merely because it is an exaction or a levy or because it is unavoidable. In fact, in a wider context, any expenditure is an imposition which a manufacturer would like to minimise.

11. Excise duty contributes to the value of the product. A "duty paid" product has a higher value than a product on which duty remains to be paid and no sale or further utilisation of excisable goods can take place unless the duty is paid. It is, therefore, a necessary expense which must be incurred if the goods are to be put in the location and condition in which they can be sold or further used in the manufacturing process.

12. Excise duty cannot, therefore, be treated differently from other expenses for the purpose of determination of cost for inventory valuation. To do so would be contrary to the basic objective of carrying forward the cost related to inventories until these are sold or consumed.

13. As stated in para 6 above, liability to excise duty arises even on excisable goods manufactured and used in further manufacturing process. In such a case, excise duty paid (if the same is not exempted) on the intermediary product becomes a manufacturing expense. Excise duty paid on such intermediary products must, therefore, be included in the valuation of work-in-process or finished goods manufactured by the subsequent processing of such products.

Provision for Unpaid Excise Duty

14. Since the point of time at which duty is collected is not necessarily the point of time at which the liability to pay the duty arises, situations will often arise when duty remains to be collected on goods which have been manufactured.

The most common of these situations arises when the goods are stored under bond, i.e., in a Bonded

Store Room, and the duty is paid when the goods are removed from such Bonded Store Room.

15. Divergent views exist as to whether provision should be made in the accounts for the liability in respect of goods which are not cleared or which are lying in bond at the balance sheet date.

16. The arguments in favour of the creation of liability are briefly summarized under:

- (a) The liability for excise duty arises at the point of time at which the manufacture is completed and it is only its collection which is deferred; and
- (b) failure to provide for the liability will result in the balance sheet not showing a true and fair view of the state of affairs of the enterprise.

17. The arguments against the creation of the liability, briefly summarised, are as under:

- (a) Though the liability for excise duty arises at the point of time at which the manufacture is completed, it gets quantified only when goods are cleared from the factory or the bonded warehouse;
- (b) the actual liability for excise duty may get modified by the time the goods are cleared from the factory or bonded warehouse;
- (c) where goods are damaged or destroyed before clearance, excise duty may be waived by the competent authority and therefore the duty may never be paid; and
- (d) failure to provide for the liability does not affect the profits or losses.

18. Since the liability for excise duty arises when the manufacture of the goods is completed, it is necessary to create a provision for liability of unpaid excise duty on stocks lying in the factory or bonded warehouse. It is true that the recovery of the duty is deferred till the goods are removed from the factory or the bonded warehouse and the exact quantification will, therefore, be at the time of removal and that estimate of duty made on balance sheet date may change on account of subsequent events, e.g., change in the rate of duty and exports under bond. But, this is true of many other items also, e.g., provision for gratuity and this cannot be an argument for not making a provision for existing liability on estimated basis.

19. The estimate of such liability can be made at the rates in force on the balance sheet date. For this purpose, other factors affecting liability should also be considered, e.g., exemptions being availed by the enterprise, pattern of sales –export, domestic etc. Thus, if a small-scale undertaking is availing the benefit of exemption allowed in a particular financial year and declares that it wishes to avail such exemption during next financial year also, excise duty liability should be calculated after taking into consideration the availability of exemption under the relevant notification. Similarly, if an enterprise is captively consuming all its production of a specific product and has been availing of exemption from payment of duty on that product, no provision for excise duty may be required in respect of non-duty paid stock of that product lying in factory or bonded warehouse. An auditor must, however, apply appropriate audit tests while verifying statements and declarations made by an enterprise in this regard.

Auditor's Responsibility

20. The auditor has a responsibility to express his opinion whether the financial statements on which he reports give a true and fair view of the operating results and state of affairs of the entity. In the case of companies, under MAOCARO, 1988, the auditor has to express an opinion whether the valuation of inventories is fair and proper in accordance with normally accepted accounting principles and is on the same basis as in the earlier years. If there is any change in the basis of valuation, the effect of such change, if material, is to be reported.

21. As explained in this Guidance Note, the liability for excise duty arises at the point of time at which

the manufacture is completed. The excise duty paid or provided on finished goods should, therefore, be included in inventory valuation. Similarly, excise duty paid on purchases (other than those subsequently recoverable by the enterprise from the taxing authorities) as well as intermediary products used for manufacture should also be included in the valuation of work-in progress or finished goods.

22. If the method of accounting for excise duty is not in accordance with the principles explained in this Guidance Note, the auditor should qualify his report. In the case of a company, reference to this qualification should also be made in the auditor's report under section 227(4A) of the Companies Act, 1956.

23. Summary of Recommendations

- (i) Excise duty should be considered as a manufacturing expense and like other manufacturing expenses be considered as an element of cost for inventory valuation.
- (ii) Where excise duty is paid on excisable goods and such goods are subsequently utilised in the manufacturing process, the duty paid on such goods, if the same is not recoverable from taxing authorities, becomes a manufacturing cost and must be included in the valuation of work-in-progress or finished goods arising from the subsequent processing of such goods.
- (iii) Where the liability for excise duty has been incurred but its collection is deferred, provision for the unpaid liability should be made.
- (iv) Excise duty cannot be treated as a period cost.
- (v) If the method of accounting for excise duty is not in accordance with the principles explained in this Guidance Note, the auditor should qualify his report.

Guidance Note on Accounting Treatment for MODVAT / CENVAT

(The following is the text of the Guidance Note on Accounting Treatment for MODVAT/CENVAT, issued by the Council of the Institute of Chartered Accountants of India.)

Introduction

1. The Guidance Note on Accounting Treatment for MODVAT was first issued in March 1988. The Guidance Note was revised in July 1995 in view of extension of MODVAT Credit Scheme to capital goods. The Guidance Note is revised again with the issuance of revised Accounting Standard (AS) 2 on 'Valuation of Inventories', which has come into effect in respect of accounting periods commencing on or after 1.4.1999 and is mandatory in nature. This revised Guidance Note is issued in supersession of the earlier Guidance Note issued in July 1995, and is effective in respect of accounting for MODVAT for accounting periods beginning on or after April 1, 1999. With the substitution of the MODVAT Credit Scheme with CENVAT Credit Scheme w.e.f. 1.4.2000, this revised Guidance Note also deals with accounting treatment in respect of the latter Scheme.

Objective

2. The objective of this Guidance Note is to provide guidance in respect of accounting for MODVAT/CENVAT credit. Salient features of MODVAT and CENVAT credit schemes are briefly set out hereinafter. Reference may be made to Central Excise Act, 1944, Central Excise Rules, 1944, Notifications and Circulars issued from time to time for details of the provisions of MODVAT/CENVAT Schemes. Guidance for accounting for excise duty is provided in the Guidance Note on Accounting Treatment for Excise Duty, which has been revised and issued separately.

Modvat Credit Scheme (Upto 31.3.2000) – Salient

Features

3. Modified Value Added Tax (MODVAT) Scheme allows instant credit of specified duties paid on specified inputs used in or in relation to manufacture of specified final excisable goods to be utilised for payment of *552 Compendium of Guidance Notes – Accounting* excise duties in respect of such goods. The Scheme covers imported goods as also those acquired indigenously. Specified duty in relation to imported goods is countervailing duty and in case of indigenous goods is excise duty, additional excise duty under Additional Duties of Excise (Textile and Textile Articles) Act, 1978 as also additional excise duty under Additional Duties of Excise (Goods of Special Importance) Act, 1957.
4. MODVAT Scheme was introduced in 1986, effective from 1.3.86, with a view to reduce the cascading effect of duties. Initially, the Schemewas restrictive in its application in that
 - (i) it applied only to limited categories of inputs and final goods;and
 - (ii) use of inputs in or in relation to manufacture of final goods was essential for utilisation of duty credit for payment of excise duties on clearance of such final goods. In other words, correlation of inputs and final goods was essential though one to one correlation of inputs was not essential.
5. Significant amendments have since been made to the MODVAT Scheme and the scope of the Scheme has been expanded considerably. Salient features of the Scheme are summarised hereinafter.
6. The Scheme applies to inputs ('Input Duty Credit Scheme') and capital goods ('Capital Goods Duty Credit Scheme').

Input Duty Credit Scheme

7. Provisions in relation to this Scheme are contained in Rules 57A to 57J of the Central Excise Rules, 1944. The Scheme covers inputs and final products classifiable under any of the headings of the Chapters of the Central Excise Tariff Act, 1985. The salient features of the Input Duty Credit Scheme are as follows:
 - (i) The Scheme is operative only when excise duty is payable on final goods. Thus, MODVAT credit cannot be availed of if the final goods are exempted from duty or are chargeable to nil rate of duty. However, the Scheme is operative in case the final goods enjoy partial exemption from duty.
 - (ii) Correlation between inputs and final goods is not required, i.e., *Accounting Treatment for MODVAT/CENVAT 553* duty credit in respect of any input brought into the factory can be utilised for payment of duty on any final product manufactured in that factory even if that input is not used in or in relation to manufacture of that final product.
 - (iii) A manufacturer is required to debit RG 23A or account current with an amount equal to 10% of the value of inputs or partially processed inputs removed from his factory for jobwork. The said amount is available as credit on return of processed/final goods to his factory from jobworkers' premises or on clearance of such processed/final goods from jobworkers' premises, if so permitted by the Commissioner, within specified time period.
The debited amount is also available for adjustment against duty payable on such inputs or partially processed inputs not received back within specified time.
 - (iv) If common inputs are used in manufacture of final products which do not attract duty liability as also those which are chargeable to duty, manufacturer (except in specified cases) is required to pay an amount equal to 8% of the price of products not chargeable to duty at the time of clearance of such products.

8. Supreme Court in a recent judgement in the case of *CCE, Pune vs. Dai Ichi Karkaria Ltd.* [1999 (112) ELT 353; decided on 11.8.99] had occasion to summarise the Scheme. Relevant extract from the decision is reproduced below:

"It is clear from these Rules, as we read them, that a manufacturer obtains credit for the excise duty paid on raw material to be used by him in the production of an excisable product immediately it makes the requisite declaration and obtains an acknowledgement thereof.

It is entitled to use the credit at any time thereafter when making payment of excise duty on the excisable product. There is no provision in the Rules which provides for a reversal of the credit by the excise authorities except where it has been illegally or irregularly taken, in which event it stands cancelled or, if utilised, has to be paid for. We are here really concerned with credit that has been validly taken, and its benefit is available to the manufacturer without any limitation in time or otherwise unless the manufacturer itself chooses not to use the raw material in its excisable product. The credit is, therefore, indefeasible. It should also be noted there is no co-relation of the raw material and the final product; that is to say, it is not as if credit can be taken only on a final product that is manufactured out of the particular raw material to which the credit is related. The credit may be taken against the excise duty on a final product manufactured on the very day that it becomes available."

Capital Goods Duty Credit Scheme

9. Provisions in relation to this Scheme are contained in Rules 57Q to 57U of the Central Excise Rules, 1944. The salient features of the Capital Goods Duty Credit Scheme are as follows:

- (i) The Scheme covers specified capital goods used in the factory of the manufacturer in relation to the production of specified final products;
- (ii) A manufacturer would not be entitled to the MODVAT credit on capital goods until the capital goods are installed or, as the case may be, used for manufacture of excisable goods, in the factory of the manufacturer;
- (iii) A manufacturer has option to:
 - (a) avail MODVAT credit in respect of duty paid on capital goods as per the Rules;
 - or
 - (b) claim depreciation on duty element under Section 32 of the Income-tax Act, 1961 or claim deduction of duty element by way of revenue expenditure under any section of the Income-tax Act, 1961, as the case may be;
- (iv) A manufacturer can claim MODVAT credit of the duty element of capital goods even if capital goods are acquired on lease, hire-purchase or loan agreement if specified duty is paid by manufacturer either directly to capital goods supplier or to the finance company before payment of first lease/hire-purchase or loan installment, as the case may be.

General

10. The general salient features relevant to Input Duty Credit Scheme and Capital Goods Duty Credit Scheme are as below:

- (i) A manufacturer is required to comply with various procedural requirements, in particular, filing of declaration, and maintenance of register of receipts, issues and balance of inputs and capital goods in Form RG-23A Part I and RG-23C Part I, respectively.

It is also required to maintain registers related to MODVAT credit in respect of inputs and capital goods in Form RG-23A Part II and RG-23C Part II, respectively.

- (ii) There is no time limit for utilisation of MODVAT credit. Government is, however, empowered to provide for lapsing of unutilised credit balances for specific products.
- (iii) Cash refund of duty credit is not allowable except in case of export of goods if the manufacturer is unable to utilise duty credit towards payment of excise duty on clearance of final goods from his factory.

Cenvat Scheme (Effective From 1.4.2000) – Salient

Features

11. Modified Value Added Tax (MODVAT) scheme has been replaced by Central Value Added Tax (CENVAT) Scheme with effect from 1.4.2000.

The same is contained in newly inserted Rules 57AA to 57AK. CENVAT Scheme, in essence, is the same as MODVAT Scheme except that it is simpler in that, the erstwhile separate schemes for inputs and capital goods are merged into one under CENVAT Scheme. The scope of the Scheme is also expanded in that all inputs (except High Speed Diesel Oil and Petrol) and specified capital goods (except equipments or appliances used in office) are covered in the Scheme.

12. Procedural simplifications have been introduced and requirement of filing declarations has been dispensed with.

13. The major difference between MODVAT and CENVAT Schemes is in relation to capital goods. The CENVAT credit in respect of capital goods received in a factory at any point of time in a given financial year is allowed to be taken only for an amount not exceeding fifty percent of the duty paid on such capital goods in the same financial year. The balance of CENVAT credit can be taken in any financial year(s) subsequent to the financial year in which the capital goods were received in the factory of the manufacturer provided capital goods are still in the possession and use of the manufacturer of final products in such subsequent year(s). The condition of possession and use is not applicable to components, spares and accessories, refactories and refractory materials and goods falling under Tariff Heading 68.02 and sub-heading 6801.10 of first Schedule of the Central Excise Tariff Act, 1985, if they are not removed without use.

14. Outstanding balances in MODVAT Credit accounts are allowed to be transferred to the CENVAT Credit accounts and utilized as per the CENVAT Scheme.

Accounting Treatment In Case Of Inputs Used In Or In Relation To Manufacture Of Final Products

15. In the light of the basic features of 'MODVAT/CENVAT' discussed above, it may be stated that MODVAT/CENVAT is a procedure whereby the manufacturer can utilise credit for specified duty on inputs against duty payable on final products. Duty credit taken on inputs is of the nature of setoff available against the payment of excise duty on the final products.

16. Specified duty paid on inputs may be debited to a separate account, e.g., MODVAT/CENVAT Credit Receivable (Inputs) Account. As and when MODVAT/CENVAT credit is actually utilised against payment of excise duty on final products, appropriate accounting entries will be required to adjust the excise duty paid out of MODVAT/CENVAT Credit Receivable (Inputs) Account to the account maintained for payment/provision for excise duty on final product. In this case, the purchase cost of the inputs would be net of the specified duty on inputs. Therefore, the inputs consumed and the inventory of inputs would be valued on the basis of purchase cost net of the specified duty on inputs. The debit balance in MODVAT/CENVAT Credit Receivable (Inputs) Account should be shown on the assets side under the head 'advances'.

An illustration of the above method is given in Annexure 'A'.

17. It may be appropriate to quote the following paragraphs nos. 6 and 7, dealing with 'cost of inventories' and 'costs of purchase', of Accounting Standard (AS) 2 (Revised) on 'Valuation of Inventories', issued by the Institute of Chartered Accountants of India.

"6. The cost of inventories should comprise all costs of purchases, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

7. The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase." Particular attention is invited to the paragraph related to 'costs of purchase', according to which, only those duties have to be included as costs of purchase which are not subsequently recoverable by the enterprise from the taxing authorities. Since the specified duty on inputs is available for setoff against the excise duty on final products, it is considered of the nature of duty recoverable from taxing authorities.

18. A question may arise as to when the 'MODVAT/CENVAT' credit should be taken if documents evidencing payment of specified duty on inputs are received later than the physical receipt of the goods. According to the accrual concept of accounting, one may account for such credit, provided one is reasonably certain of getting the said documents at a later date.

Change in Accounting Policy

19. In cases, where enterprises were accounting for MODVAT credit on inputs in accordance with the erstwhile inclusive method, i.e., the second alternative¹ recommended in the earlier edition (1995) of the Guidance Note on Accounting Treatment for MODVAT, they will have to change the method of accounting in accordance with paragraph 16 of this Guidance Note. Accordingly, such an enterprise will have to adjust the amount of opening stock in respect of the accounting periods commencing on or after April 1, 1999, in such a way so that the opening stock should appear at the amount which would have been arrived at had the method suggested in paragraph 16 of this Guidance Note been followed. This could be done by adjusting the amount of opening stock in respect of the accounting periods commencing on or after April 1, 1999, by the amount of the balance lying in the MODVAT credit availed account. Further, an amount equal to the balance of RG23A register, representing the MODVAT credit receivable in respect of the inputs purchased in the earlier years should be transferred to MODVAT Credit Receivable Account² with a corresponding adjustment in the amount of opening stock. After the aforesaid adjustments, the MODVAT Credit Receivable Account should also appear at the amount which would have been arrived at had the method suggested in paragraph 16 of this Guidance Note been followed. An example illustrating the change in accounting policy has been given as Annexure B. Appropriate disclosures as per Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, are also required to be made in the financial statements for change in accounting policy.

Accounting Treatment – Job-work

Accounting treatment in case of inputs and/or partially processed inputs sent outside the factory to job-worker for further processing

20. In a case where an enterprise removes inputs as such or in a partially processed form to a place outside the factory for the purpose of testing, repairing, refining, reconditioning or carrying out any other operations necessary for manufacture of final products, the enterprise is required to debit MODVAT Credit Register (RG 23A) or account current with an amount equal to 10% of the value of

inputs or partially processed inputs, as the case may be. The said debit is in the nature of deposit and is available for credit at the time of return of duly processed goods to the factory within the prescribed time. The said deposit is also available for adjustment against duty payment if the goods are not received back in the factory within the prescribed time limit. If this amount is debited to MODVAT Credit Register (RG 23A), the same should be accounted for as a deposit and should be debited to a separate account with appropriate nomenclature say, 'MODVAT Credit Deposit (Jobwork) Account' and credited to 'MODVAT Credit Receivable Account'. This deposit amount should be credited and 'MODVAT Credit Receivable Account' should be debited at the time of receipt of duly processed goods in the factory within the prescribed time limit or for adjustment of duty if the goods are not received back in the factory within the prescribed time limit. *This requirement of debit has been dispensed with under CENVAT Scheme.*

Accounting treatment in case of inputs received by enterprise for further processing on job-work basis

21. An enterprise may receive inputs from a principal for processing and/ or converting to final products on job work basis and may be required to avail MODVAT/CENVAT credit on such inputs and discharge duty liability on clearance of final products on behalf of the principal; the ownership of the inputs and final products continuing to be of the principal. In such cases, the enterprise should, at the time of taking MODVAT/CENVAT credit, debit an appropriate account say, 'MODVAT/CENVAT Credit Receivable Account' and the account to be credited would depend upon the terms of jobwork with the principal. If the enterprise is required to bear excise duty burden, 'Excise Duty Account' should be credited. If, on the other hand, excise duty is to be paid on the principal's account, 'Principal Account' should be credited. Similarly, in former case, excise duty paid on clearance of final products should be debited to 'Excise Duty Account' and in latter case to 'Principal Account' and credited to 'MODVAT/CENVAT Credit Receivable Account'.

Accounting Treatment For Modvat Credit In Case Of Capital Goods Used For Manufacture Of Specified Goods

22. In case an enterprise does not avail MODVAT credit on capital goods obviously no accounting treatment would be necessary. The following paragraphs apply only to those situations where an enterprise avails of MODVAT credit on capital goods.

23. Accounting Standard (AS) 10 on 'Accounting for Fixed Assets', issued by the Institute of Chartered Accountants of India, states, *inter-alia*, in para 9.1, as follows:

"The cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use; any trade discounts and rebates are deducted in arriving at the purchase price."

MODVAT credit can be considered is of the nature of a refundable tax. Therefore, MODVAT credit should be reduced from the purchase cost of capital goods concerned.

24. In view of the above, the specified duty on capital goods should be debited to separate account, e.g., MODVAT Credit Receivable (Capital Goods) Account. On actual utilisation, the account will be adjusted against excise duty on final products. Accordingly, the purchase cost of the capital goods would be net of the specified duty on capital goods. The unadjusted balance standing in the MODVAT Credit Receivable (Capital Goods) Account, if any, should be shown on the assets side under the head 'advances'.

25. MODVAT credit in respect of capital goods should be recognised in the books of account when the following conditions are satisfied:

- (i) The enterprise is entitled to the MODVAT credit as per the Rules, and
- (ii) There is a reasonable certainty that the MODVAT credit would be utilised.

Accounting Treatment For Cenvat Credit In Case Of Capital Goods

26. The nature of the CENVAT Credit in respect of capital goods is the same as that of MODVAT Credit. However, the CENVAT Credit in respect of capital goods is allowed for an amount not exceeding fifty percent of the duty paid on such capital goods in the financial year in which the goods are received in factory and the balance will be allowed in the subsequent year(s).

In case the conditions specified in para 25 above are met and the enterprise decides to take CENVAT credit, the entire amount of CENVAT Credit should be deducted from the cost of capital goods. The amount of CENVAT credit taken in the financial year, in which goods are received, should be debited to an appropriate account, say, 'CENVAT Credit Receivable (Capital Goods)

Accounting Treatment for MODVAT/CENVAT

Account' and balance may be debited to another appropriate account, say, 'CENVAT Credit Deferred Account'. In the subsequent financial year(s), when balance 'CENVAT credit is availed of, the appropriate adjustment for the same should be made, i.e., amount of CENVAT credit availed of should be credited to 'CENVAT Credit Deferred Account' with a corresponding debit to 'CENVAT Credit Receivable (Capital Goods) Account'.

Accounting Treatment Where Capital Goods Are Acquired On Lease Or Hire Purchase

27. MODVAT/CENVAT credit is available to the lessee or hirer where the capital goods have been acquired on lease or hire purchase. The accounting treatment in this regard is described hereinafter.

28. In the books of the lessor, where the financing arrangement also covers the specified duty on capital goods, the asset given on lease should be shown at purchase cost net of the specified duty on the capital goods. The specified duty on capital goods, which would be availed of as MODVAT/CENVAT credit by the lessee, should be recorded and disclosed separately as the duty recoverable from the lessee. This will not form part of 'Minimum Lease Payments' in view of the definition of the aforesaid term reproduced below from the Guidance Note on Accounting for Leases, issued by the Institute of Chartered Accountants of India:

"Minimum Lease Payments: The payments over the lease term that the lessee is or can be required to make (excluding costs for services and taxes to be paid by and be reimbursable to the lessor) together with the residual value."

Where the specified duty on capital goods does not form part of the financing arrangement and the lessee pays the duty directly to the supplier, obviously the same need not be recorded in the books of the lessor. In the books of the lessee, MODVAT/CENVAT credit receivable on the capital assets acquired on lease should be treated in the same manner as recommended in paras 24 and 26 above, except that the cost of the relevant leased capital asset and depreciation is not accounted in the books of the lessee.

29. Capital asset acquired on hire purchase should be recorded and disclosed at net cash value, i.e., cash value net of MODVAT/CENVAT credit receivable in the books of the hirer. The other accounting treatment in relation to MODVAT/CENVAT in the books of the hirer should be the same as if the asset has been acquired on outright purchase basis. The aforesaid accounting treatment, in the books of the hirer, should be made whether or not the specified duty on the capital goods forms part of the financing arrangement.

In the books of the vendor, in case the specified duty on capital goods forms part of the hire purchase arrangement and the benefit of MODVAT/CENVAT credit is available to the hirer, the vendor should book the sale in the normal course inclusive of the specified duty on the capital goods. However, where the specified duty on the capital goods does not form part of the financing arrangement and the hirer directly assumes the liability in respect thereof, the same need not be recorded in the books of the vendor.

Review of Balances In Modvat/Cenvat Credit Receivable Accounts

30. Balances in MODVAT/CENVAT Credit Receivable Accounts, pertaining to both inputs and capital goods, should be reviewed at the end of the year and if it is found that the balances of the MODVAT/CENVAT credit are not likely to be used in the normal course of business within a reasonable time, then, notwithstanding the right to carry forward such excess credit in the Excise Rules, the non-useable excess credit should be adjusted in the accounts. The consequence would be that the balances of the MODVAT/ CENVAT Credit Receivable Accounts in the financial accounts may be lower than the credit available as per the MODVAT/CENVAT Credit registers. In such a case, a reconciliation statement would have to be prepared indicating the amounts adjusted so that a track is kept for the difference between the balances and the difference between the financial accounts and the credit available as per the excise registers can be explained in subsequent years also.

31. (a) The above adjustment related to input credit should be made to the raw material or input purchase account. The effect of this would be to increase the cost of purchase and thereby to increase the cost of inputs for the purpose of accounting for consumption and valuation of closing stocks. Where it is not possible to debit or identify this excess credit to a particular lot or lots of materials purchased, such excess credit may be apportioned over the entire purchases of raw materials, components etc., entitled to MODVAT/CENVAT credit during the year on pro-rata basis.
- (b) The adjustment of excess credit related to capital goods should be made to the concerned Capital Goods Account. The excess MODVAT/ CENVAT credit, either availed or deferred, which relates to fixed assets acquired, should be added to the cost of the relevant fixed asset. For accounting purposes, depreciation on the revised unamortised depreciable amount should be provided prospectively over the residual useful life of the asset. In case the fixed asset no longer exists, the relevant amount should be written-off in the profit and loss account. To facilitate aforesaid treatment, MODVAT/CENVAT credit record should be maintained fixed asset-wise in the relevant RG Register. In relation to capital goods other than fixed assets, the accounting treatment for the excess MODVAT/CENVAT credit would be the same as stated in para 31(a) above. It is, therefore, advisable that MODVAT/CENVAT Credit Receivable (Capital Goods) Account is maintained separately for fixed assets and other capital goods.
- (c) For capital goods acquired on lease, the amount of excess MODVAT/ CENVAT credit should be written-off on a pro-rata basis along with the lease rentals.

32. Where, at any time during the year, it is revealed that the terms and conditions subject to which the benefit of MODVAT/CENVAT credit is available, have not been complied with or are not being capable of compliance, e.g., where the inputs are destroyed prior to the manufacture of final product or the relevant plant and machinery cannot be put to use for the manufacture of final product, appropriate adjustments should be made in the accounts to reverse such credit which cannot be availed of, as recommended in para 31 (a) for inputs and 31 (b) and (c) for capital goods.

Accounting Treatment for Duty Demands Paid By Debit to Modvat/Cenvat Credit Balance – Inputs And/ Or Capital Goods

33. An enterprise may choose to discharge excise duty demands made by Central Excise Department from time to time by way of debit to MODVAT/ CENVAT credit balance pertaining either to inputs or to capital goods. In that case, the duty demand so paid out of the MODVAT/CENVAT credit *564 Compendium of Guidance Notes – Accounting* balance should be debited to appropriate account, depending upon the nature of demand and credit should be given to MODVAT/CENVAT Credit Receivable Account. For example, if the duty demand pertains to excise duty on finished goods, the same should be debited to excise duty account. If, on the other hand, it pertains to disallowance of MODVAT/CENVAT credit taken on purchase of raw materials during the year, the same should be added to the cost of inputs. Appropriate adjustment in that case would have to be made while valuing inventory of inputs. If the duty demand pertains to disallowance of MODVAT/CENVAT credit in respect of purchases effected in earlier years, the accounting treatment would depend on whether the said inputs are consumed or are available in stock. If they are consumed, the disallowance should be debited to excise duty account and treated as expense of the current year. If raw materials are still lying in stock, duty demand should be added to the cost of stock of inputs.

Valuation of Inventories Of Inputs

34. The inventory of inputs should be valued at net of input duty. In other words, the specified duty paid on inputs will not form part of the cost of inventories. Balance in MODVAT/CENVAT Credit Receivable (Inputs) Account should be shown in the Balance Sheet under the head 'advances' on the assets side.

35. In some cases 'inputs' may be exempted from excise duty in the hands of the supplier, e.g., job charges are exempt from excise duty provided the prescribed procedures are observed. Small-scale suppliers who are in the exempted category may also supply the inputs free from the levy of excise duty. In such circumstances normal valuation rules in determining the cost of inventories are to be applied as these are not subject to the specified duty on inputs relief. Where purchases are made from the dealers who are not eligible under the Central Excise Rules to pass MODVAT/CENVAT credit and, therefore, cannot issue an invoice in accordance with the aforesaid Rules, the valuation should be made at the actual cost inclusive of excise duty.

36. In some cases, the same item of input can be obtained from different sources, some of them may be able to provide the required documents evidencing payment of duty while others may not be able to provide the required documents. In such cases where it is not possible for the buyer to take advantage of the MODVAT/CENVAT credit, the closing stock of inputs of such items should be valued inclusive of the specified duty on inputs. *Accounting Treatment for MODVAT/CENVAT 565 37*. If any input is used for the production of more than one final product, some of which are excisable while others are either not chargeable to excise duty or chargeable at nil rate of duty, and separate inventory of the input is not maintained, the entire inventory of inputs should be valued at net of input duty. However, if separate inventory is being maintained, the inventory of inputs useable for final products chargeable to excise duty should be valued at net of input duty and the inventory of inputs useable for final products not chargeable to duty should be valued at the actual cost inclusive of excise duty.

38. While valuing inventories of final products 4, the value of inputs should be net of the duty on inputs, that is, the purchase cost as reduced by the MODVAT/CENVAT credit.

Valuation of Inventory of Capital Goods

39. Inventories of capital goods should be valued net of MODVAT/ CENVAT credit taken on capital

goods. In other words, specified duties paid on such capital goods will not form part of their cost.

Note: For Accounting treatment of excise duty with regard to valuation of inventories, reference may be made to the Guidance Note on Accounting Treatment for Excise Duty, issued by the Institute of Chartered Accountants of India.

For the appendices given in the Guidance Note, students are advised to refer compendium of Guidance Notes –Accounting (as on July, 2006)

GN(A) 18 (Issued 2005)

Guidance Note on Accounting for Employee Share-based Payments

(The following is the text of the Guidance Note on Accounting for Employee Share-based Payments, issued by the Council of the Institute of Chartered Accountants of India.)

Introduction

1. Some employers use share-based payments as a part of remuneration package for their employees. Such payments generally take the forms of Employee Stock Option Plans (ESOPs), Employee Stock Purchase Plans (ESPPs) and stock appreciation rights. ESOPs are plans under which an enterprise grants options for a specified period to its employees to purchase its shares at a fixed or determinable price. ESPPs are plans under which the enterprise grants rights to its employees to purchase its shares at a stated price at the time of public issue or otherwise. Stock appreciation rights is a form of employee share-based payments whereby the employees become entitled to a future cash payment or shares based on the increase in the price of the shares from a specified level over a specified period. Apart from using share-based payments to compensate employees for their services, such payments are also used by an employer as an incentive to the employees to remain in its employment or to reward them for their efforts in improving its performance.

2. Recognising the need for establishing uniform sound accounting principles and practices for all types of share-based payments, the Accounting Standards Board of the Institute of Chartered Accountants of India is developing an Accounting Standard covering various types of share-based payments including employee share-based payments. However, as the formulation of the Standard is likely to take some time, the Institute has decided to bring out this Guidance Note. The Guidance Note recognises that there are two methods of accounting for employee share-based payments, viz., the fair value method and the intrinsic value method and permits as an alternative the intrinsic value method with fair value disclosures. Once the Accounting Standard dealing with Sharebased Payments comes into force, this Guidance Note will automatically stand withdrawn.

Scope

3. This Guidance Note establishes financial accounting and reporting principles for employee share-based payment plans, viz., ESOPs, ESPPs and stock appreciation rights. For the purposes of this Guidance Note, the term 'employee' includes a director of the enterprise, whether whole time or not.

4. For the purposes of this Guidance Note, a transfer of shares or stock options of an enterprise by its shareholders to its employees is also an employee share-based payment, unless the transfer is clearly for a purpose other than payment for services rendered to the enterprise. This also applies to transfers of shares or stock options of the parent of the enterprise, or shares or stock options of another enterprise in the same group¹ as the enterprise, to the employees of the enterprise.

5. For the purposes of this Guidance Note, a transaction with an employee in his/her capacity as a holder of shares of the enterprise is not an employee share-based payment. For example, if an

enterprise grants all holders of a particular class of its shares the right to acquire additional shares or stock options of the enterprise at a price that is less than the fair value of those shares or stock options, and an employee receives such a right because he/she is a holder of shares or stock options of that particular class, the granting or exercise of that right is not subject to the requirements of this Guidance Note.

6. For the purposes of this Guidance Note, a grant of shares to the employees at the time of public issue is not an employee share-based payment if the price and other terms at which the shares are offered to employees are the same or similar to those at which the shares have been offered to general investors, for example, in a public issue an enterprise grants shares to its employees as a preferential allotment while the price and other terms remain the same as those to other investors.

Definitions

7. For the purpose of this Guidance Note, the following terms are used with the meanings specified:

Employee Stock Option is a contract that gives the employees of the enterprise the right, but not the obligation, for a specified period of time to purchase or subscribe to the shares of the enterprise at a fixed or determinable price.

Employee Stock Option Plan is a plan under which the enterprise grants Employee Stock Options.

Employee Stock Purchase Plan is a plan under which the enterprise offers shares to its employees as part of a public issue or otherwise.

Equity is the residual interest in the assets of an enterprise after deducting all its liabilities.

Exercise means making of an application by the employee to the enterprise for issue of shares against the option vested in him in pursuance of the Employee Stock Option Plan.

Exercise Period is the time period after vesting within which the employee should exercise his right to apply for shares against the option vested in him in pursuance of the Employee Stock Option Plan.

Expected Life of an Option is the period of time from grant date to the date on which an option is expected to be exercised.

Exercise Price is the price payable by the employee for exercising the option granted to him in pursuance of the Employee Stock Option Plan.

Fair Value is the amount for which stock option granted or a share offered for purchase could be exchanged between knowledgeable, willing parties in an arm's length transaction.

Grant Date is the date at which the enterprise and its employees agree to the terms of an employee share-based payment plan. At grant date, the enterprise confers on the employees the right to cash or shares of the enterprise, provided the specified vesting conditions, if any, are met. If that agreement is subject to an approval process, (for example, by shareholders), grant date is the date when that approval is obtained.

Intrinsic Value is the amount by which the quoted market price of the underlying share in case of a listed enterprise or the value of the underlying

Accounting for share determined by an independent valuer in case of an unlisted enterprise, exceeds the exercise price of an option.

Market Condition is a condition upon which the exercise price, vesting or exercisability of a share or a stock option depends that is related to the market price of the shares of the enterprise, such as attaining a specified share price or a specified amount of intrinsic value of a stock option, or achieving a specified target that is based on the market price of the shares of the enterprise relative to an index

of market prices of shares of other enterprises.

Reload Feature is a feature that provides for an automatic grant of additional stock options whenever the option holder exercises previously granted options using the shares of the enterprise, rather than cash, to satisfy the exercise price.

Reload Option is a new stock option granted when a share of the enterprise is used to satisfy the exercise price of a previous stock option.

Repricing of an employee stock option means changing the existing exercise price of the option to a different price.

Stock Appreciation Rights are the rights that entitle the employees to receive cash or shares for an amount equivalent to any excess of the market value of a stated number of enterprise's shares over a stated price. The form of payment may be specified when the rights are granted or may be determined when they are exercised; in some plans, the employee may choose the form of payment.

Vest is to become entitled to receive cash or shares on satisfaction of any specified vesting conditions under an employee share-based payment plan.

Vesting Period is the period between the grant date and the date on which all the specified vesting conditions of an employee share-based payment plan are to be satisfied.

Vesting Conditions are the conditions that must be satisfied for the employee to become entitled to receive cash, or shares of the enterprise, pursuant to an employee share-based payment plan. Vesting conditions include service conditions, which require the employee to complete a specified period of service, and performance conditions, which require specified performance targets to be met (such as a specified increase in the enterprise's share price over a specified period of time).

Volatility is a measure of the amount by which a price has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. The volatility of a share price is the standard deviation of the continuously compounded rates of return on the share over a specified period.

Accounting

8. For accounting purposes, employee share-based payment plans are classified into the following categories:

- (a) *Equity-settled*: Under these plans, the employees receive shares.
- (b) *Cash-settled*: Under these plans, the employees receive cash based on the price (or value) of the enterprise's shares.
- (c) *Employee share-based payment plans with cash alternatives*: Under these plans, either the enterprise or the employee has a choice of whether the enterprise settles the payment in cash or by issue of shares.

9. A share-based payment plan falling in the above categories can be accounted for by adopting the fair value method or the intrinsic value method. The accounting treatment recommended hereinbelow is based on the fair value method. The application of the intrinsic value method is explained thereafter in paragraph 40.

Equity-Settled Employee Share-Based Payment Plans

Recognition

10. An enterprise should recognise as an expense (except where service received qualifies to be included as a part of the cost of an asset) the services received in an equity-settled employee share-based payment plan when it receives the services, with a corresponding credit to an appropriate equity

account, say, 'Stock Options Outstanding Account'. This account is transitional in nature as it gets ultimately transferred to another equity account such as share capital, securities premium account and/or general reserve as recommended in the subsequent paragraphs of this Guidance Note.

11. If the shares or stock options granted vest immediately, the employee is not required to complete a specified period of service before becoming unconditionally entitled to those instruments. In the absence of evidence to the contrary, the enterprise should presume that services rendered by the employee as consideration for the instruments have been received. In this case, on the grant date, the enterprise should recognise services received in full with a corresponding credit to the equity account.

12. If the shares or stock options granted do not vest until the employee completes a specified period of service, the enterprise should presume that the services to be rendered by the employee as consideration for those instruments will be received in the future, during the vesting period. The enterprise should account for those services as they are rendered by the employee during the vesting period, on a time proportion basis, with a corresponding credit to the equity account.

Determination of vesting period

13. A grant of shares or stock options to an employee is typically conditional on the employee remaining in the employment of the enterprise for a specified period of time. Thus, if an employee is granted stock options conditional upon completing three years' service, then the enterprise should presume that the services to be rendered by the employee as consideration for the stock options will be received in the future, over that three-year vesting period.

14. There might be performance conditions that must be satisfied, such as the enterprise achieving a specified growth in profit or a specified increase in the share price of the enterprise. Thus, if an employee is granted stock options conditional upon the achievement of a performance condition and remaining in the employment of the enterprise until that performance condition is satisfied, and the length of the vesting period varies depending on when that performance condition is satisfied, the enterprise should presume that the services to be rendered by the employee as consideration for the stock options will be received in the future, over the expected vesting period. The enterprise should estimate the length of the expected vesting period at grant date, based on the most likely outcome of the performance condition. If the performance condition is a market condition, the estimate of the length of the expected vesting period should be consistent with the assumptions used in estimating the fair value of the options granted, and should not be subsequently revised. If the performance condition is not a market condition, the enterprise should revise its estimate of the length of the vesting period, if necessary, if subsequent information indicates that the length of the vesting period differs from previous estimates.

Measurement

15. Typically, shares (under ESPPs) or stock options (under ESOPs) are granted to employees as part of their remuneration package, in addition to a cash salary and other employment benefits. Usually, it is not possible to measure directly the services received for particular components of the employee's remuneration package. It might also not be possible to measure the fair value of the total remuneration package independently, without measuring directly the fair value of the shares or stock options granted. Furthermore, shares or stock options are sometimes granted as part of a bonus arrangement, rather than as a part of basic pay, e.g., as an incentive to the employees to remain in the employment of the enterprise or to reward them for their efforts in improving the performance of the enterprise. By granting shares or stock options, in addition to other remuneration, the enterprise is paying additional remuneration to obtain additional benefits. Estimating the fair value of those additional benefits is likely to be difficult. Because of the difficulty of measuring directly the fair value of

the services received, the enterprise should measure the fair value of the employee services received by reference to the fair value of the shares or stock options granted.

Determining the fair value of shares or stock options granted

16. An enterprise should measure the fair value of shares or stock options granted at the grant date, based on market prices if available, taking into account the terms and conditions upon which those shares or stock options were granted (subject to the requirements of paragraphs 18 to 21). If market prices are not available, the enterprise should estimate the fair value of the instruments granted using a valuation technique to estimate what the price of those instruments would have been on the grant date in an arm's length transaction between knowledgeable, willing parties. The valuation technique should be consistent with generally accepted valuation methodologies for pricing financial instruments (e.g., use of an option pricing model for valuing stock options) and should incorporate all factors and assumptions that knowledgeable, willing market participants would consider in setting the price (subject to the requirements of paragraphs 18 to 21).

17. Appendix I contains further guidance on the measurement of the fair value of shares and stock options, focusing on the specific terms and conditions that are common features of a grant of shares or stock options to employees.

Treatment of vesting conditions

18. Vesting conditions, other than market conditions, should not be taken into account when estimating the fair value of the shares or stock options at the grant date. Instead, vesting conditions should be taken into account by adjusting the number of shares or stock options included in the measurement of the transaction amount so that, ultimately, the amount recognised for employee services received as consideration for the shares or stock options granted is based on the number of shares or stock options that eventually vest. Hence, on a cumulative basis, no amount is recognized for employee services received if the shares or stock options granted do not vest because of failure to satisfy a vesting condition (i.e., these are forfeited²), e.g., the employee fails to complete a specified service period, or a performance condition is not satisfied, subject to the requirements of paragraph 20.

19. To apply the requirements of paragraph 18, the enterprise should recognise an amount for the employee services received during the vesting period based on the best available estimate of the number of shares or stock options expected to vest and should revise that estimate, if necessary, if subsequent information indicates that the number of shares or stock options expected to vest differs from previous estimates. On vesting date, the enterprise should revise the estimate to equal the number of shares or stock options that ultimately vest, subject to the requirements of paragraph 20.

²The term 'forfeiture' is used to refer only to an employee's failure to earn a vested right to obtain shares or stock options because the specified vesting conditions are not satisfied.

20. Market conditions, such as a target share price upon which vesting (or exercisability) is conditioned, should be taken into account when estimating the fair value of the shares or stock options granted. Therefore, for grants of shares or stock options with market conditions, the enterprise should recognise the services received from an employee who satisfies all other vesting conditions (e.g., services received from an employee who remains in service for the specified period of service), irrespective of the fact whether that market condition is satisfied.

Treatment of a reload feature

21. For options with a reload feature, the reload feature should not be taken into account when estimating the fair value of options granted at the grant date. Instead, a reload option should be accounted for as a new option grant, if and when a reload option is subsequently granted.

After vesting date

22. On exercise of the right to obtain shares or stock options, the enterprise issues shares on receipt of the exercise price. The shares so issued should be considered to have been issued at the consideration comprising the exercise price and the corresponding amount standing to the credit of the relevant equity account (e.g., Stock Options Outstanding Account). In a situation where the right to obtain shares or stock option expires unexercised, the balance standing to the credit of the relevant equity account should be transferred to general reserve.

Appendix II contains various illustrations of the accounting for equity settled employee share-based payment plans that do not involve modifications to the terms and conditions of the grants.

Modifications to the terms and conditions on which shares or stock options were granted, including cancellations and settlements

23. An enterprise might modify the terms and conditions on which the shares or stock options were granted. For example, it might reduce the exercise price of options granted to employees (i.e., reprice the options), which increases the fair value of those options.

24. The enterprise should recognise, as a minimum, the services received measured at the grant date fair value of the shares or stock options granted, unless those shares or stock options do not vest because of failure to satisfy a vesting condition (other than a market condition) that was specified at grant date. This applies irrespective of (a) any modifications to the terms and conditions on which the shares or stock options were granted, or (b) a cancellation or settlement of that grant of shares or stock options. In addition, the enterprise should recognise the effects of modifications that increase the total fair value of the employee share-based payment plan or are otherwise beneficial to the employee.

25. The requirements of paragraph 24 should be applied as follows:

- (a) If the modification increases the fair value of the shares or stock options granted (e.g., by reducing the exercise price), measured immediately before and after the modification, the enterprise should include the incremental fair value granted in the measurement of the amount recognised for services received as consideration for the shares or stock options granted. The incremental fair value granted is the difference between the fair value of the modified shares or stock options and that of the original shares or stock options, both estimated as at the date of the modification. If the modification occurs during the vesting period, the incremental fair value granted is included in the measurement of the amount recognised for services received over the period from the modification date until the date when the modified shares or stock options vest, in addition to the amount based on the grant date fair value of the original shares or stock options, which is recognized over the remainder of the original vesting period. If the modification occurs after the vesting date, the incremental fair value granted is recognised immediately, or over the vesting period if the employee is required to complete an additional period of service before becoming unconditionally entitled to those modified shares or stock options.
- (b) Similarly, if the modification increases the number of shares or stock options granted, the enterprise should include the fair value of the additional shares or stock options granted, measured at the date of the modification, in the measurement of the amount recognised for services received as consideration for the shares or stock options granted, consistent with the requirements in (a) above. For example, if the modification occurs during the vesting period, the fair value of the additional shares or stock options granted is included in the measurement of the amount recognised for services received over the period from the modification date until the date when the additional shares or stock options vest, in addition to the amount based on the grant date fair value of the shares or stock

- options originally granted, which is recognised over the remainder of the original vesting period.
- (c) If the enterprise modifies the vesting conditions in a manner that is beneficial to the employee, for example, by reducing the vesting period or by modifying or eliminating a performance condition (other than a market condition, changes to which are accounted for in accordance with (a) above), the enterprise should take the modified vesting conditions into account when applying the requirements of paragraphs 18 to 20.
26. Furthermore, to apply the requirements of paragraph 24, if the enterprise modifies the terms or conditions of the shares or stock options granted in a manner that reduces the total fair value of the employee share-based payment plan, or is not otherwise beneficial to the employee, the enterprise should nevertheless continue to account for the services received as consideration for the shares or stock options granted as if that modification had not occurred (other than a cancellation of some or all the shares or stock options granted, which should be accounted for in accordance with paragraph 27). For example:
- (a) if the modification reduces the fair value of the shares or stock options granted, measured immediately before and after the modification, the enterprise should not take into account that decrease in fair value and should continue to measure the amount recognised for services received as consideration for the shares or stock options based on the grant date fair value of the shares or stock options granted.
- (b) if the modification reduces the number of shares or stock options granted to an employee, that reduction should be accounted for as a cancellation of that portion of the grant, in accordance with the requirements of paragraph 27.
- (c) if the enterprise modifies the vesting conditions in a manner that is not beneficial to the employee, for example, by increasing the vesting period or by modifying or adding a performance condition (other than a market condition, changes to which are accounted for in accordance with (a) above), the enterprise should not take the modified vesting conditions into account when applying the requirements of paragraphs 18 to 20.
27. If the enterprise cancels or settles a grant of shares or stock options during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied):
- (a) the enterprise should account for the cancellation or settlement as an acceleration of vesting, and should therefore recognize immediately the amount that otherwise would have been recognised for services received over the remaining vesting period.
- (b) any payment made to the employee on the cancellation or settlement of the grant should be deducted from the relevant equity account (e.g., Stock Options Outstanding Account) except to the extent that the payment exceeds the fair value of the shares or stock options granted, measured at the cancellation/settlement date. Any such excess should be recognised as an expense.
- (c) if new shares or stock options are granted to the employee as replacement for the cancelled shares or stock options, the enterprise should account for the granting of replacement shares or stock options in the same way as a modification of the original grant of shares or stock options, in accordance with paragraphs 24 to 26. For the purposes of the aforesaid paragraphs, the incremental fair value granted is the difference between the fair value of the replacement shares or stock options and the net fair value of the cancelled shares or stock options, at the date the replacement shares or stock options are granted. The net fair value of the cancelled shares or stock options is their fair value, immediately before the cancellation, less the amount of any payment made to the employee on cancellation of the shares or stock options that is deducted from the relevant equity account in accordance with (b) above.

28. If an enterprise settles in cash vested shares or stock options, the payment made to the employee should be accounted for as a deduction from the relevant equity account (e.g., Stock Options Outstanding Account) except to the extent that the payment exceeds the fair value of the shares or stock options, measured at the settlement date. Any such excess should be recognised as an expense.

Appendix III contains illustrations on modifications to the terms and conditions on which stock options were granted.

Cash-Settled Employee Share-Based Payment Plans

29. An enterprise might grant rights such as stock appreciation rights to employees as part of their remuneration package, whereby the employees will become entitled to a future cash payment (rather than shares), based on the increase in the share price of the enterprise from a specified level over a specified period of time. Or an enterprise might grant to its employees a right to receive a future cash payment by granting to them a right to shares (including shares to be issued upon the exercise of stock options) that are redeemable, either mandatorily (e.g., upon cessation of employment) or at the option of the employee.

Recognition

30. An enterprise should recognise as an expense (except where service received qualifies to be included as a part of the cost of an asset) the services received in a cash-settled employee share-based payment plan when it receives the services with a corresponding increase in liability by creating a provision therefor.

31. The enterprise should recognise the services received, and the liability to pay for those services, as the employees render service. For example, some stock appreciation rights vest immediately, and the employees are therefore not required to complete a specified period of service to become entitled to the cash payment. In the absence of evidence to the contrary, the enterprise should presume that the services rendered by the employees in exchange for the stock appreciation rights have been received. Thus, the enterprise should recognise immediately the services received and a liability to pay for them. If the stock appreciation rights do not vest until the employees have completed a specified period of service, the enterprise should recognise the services received, and a liability to pay for them, as the employees render service during that period.

Measurement

32. For cash-settled employee share-based payment plan, the enterprise should measure the services received and the liability incurred at the fair value of the liability. Until the liability is settled, the enterprise should remeasure the fair value of the liability at each reporting date and at the date of the settlement, with any changes in fair value recognised in profit or loss for the period.

33. The liability should be measured, initially and at each reporting date until settled, at the fair value of the stock appreciation rights, by applying an option pricing model taking into account the terms and conditions on which the stock appreciation rights were granted, and the extent to which the employees have rendered service to date.

Appendix IV contains an illustration of a cash-settled employee share based payment plan.

Employee Share-Based Payment Plans With Cash

Alternatives

Employee share-based payment plans in which the terms of the arrangement provide the employee with a choice of settlement

34. If an enterprise has granted the employees the right to choose whether a share-based payment

plan is settled in cash or by issuing shares, the plan has two components, viz., (i) liability component, i.e., the employees' right to demand settlement in cash, and (ii) equity component, i.e., the employees' right to demand settlement in shares rather than in cash. The enterprise should first measure, on the grant date, fair value of the employee share-based payment plan presuming that all employees will exercise their option in favour of cash settlement. The fair value so arrived at should be considered as the fair value of the liability component. The enterprise should also measure the fair value of the employee share-based payment plan presuming that all employees will exercise their option in favour of equity settlement. In case the fair value under equity- settlement is greater than the fair value under cash settlement, the excess should be considered as the fair value of the equity component. Otherwise, the fair value of the equity component should be considered as zero. The fair value of the equity component should be accounted for in accordance with the recommendations in respect of 'Equity-settled employee share-based payment plan'. The fair value of the liability component should be accounted for in accordance with the recommendations in respect of 'Cash-settled employee share-based payment plan'.

35. At the date of settlement, the enterprise should remeasure the liability to its fair value. If the enterprise issues shares on settlement rather than paying cash, the amount of liability should be treated as the consideration for the shares issued.

36. If the enterprise pays in cash on settlement rather than issuing shares, that payment should be applied to settle the liability in full. By electing to receive cash on settlement, the employees forgo their right to receive shares. The enterprise should transfer any balance in the relevant equity account (e.g., Stock Options Outstanding Account) to general reserve.

Appendix V contains an illustration of an employee share-based payment plan with cash alternatives.

Employee share-based payment plans in which the terms of the arrangement provide the enterprise with a choice of settlement

37. For an employee share-based payment plan in which the terms of the arrangement provide the enterprise with the choice of whether to settle in cash or by issuing shares, the enterprise should determine whether it has a present obligation to settle in cash and account for the sharebased payment plan accordingly. The enterprise has a present obligation to settle in cash if the choice of settlement in shares has no commercial substance (e.g., because the enterprise is legally prohibited from issuing shares), or the enterprise has a past practice or a stated policy of settling in cash, or generally settles in cash whenever the employee asks for cash settlement.

38. If the enterprise has a present obligation to settle in cash, it should account for the transaction in accordance with the requirements in respect of 'Cash-settled employee share-based payment plan'.

39. If no such obligation exists, the enterprise should account for the transaction in accordance with the requirements in respect of 'Equitysettled employee share-based payment plan'. Upon settlement:

- (a) If the enterprise elects to settle in cash, the cash payment should be accounted for as a deduction from the relevant equity account (e.g., Stock Options Outstanding Account) except as noted in (c) below.
- (b) If the enterprise elects to settle by issuing shares, the balance in the relevant equity account should be treated as consideration for the shares issued except as noted in (c) below.
- (c) If the enterprise elects the settlement alternative with the higher fair value (e.g., the enterprise elects to settle in cash the amount of which is more than the fair value of the shares had the enterprise elected to settle in shares), as at the date of settlement, the enterprise should recognise an additional expense for the excess value given, i.e., the difference between the cash

paid and the fair value of the shares that would otherwise have been issued, or the difference between the fair value of the shares issued and the amount of cash that would otherwise have been paid, whichever is applicable.

Intrinsic Value Method

40. Accounting for employee share-based payment plans dealt with heretofore is based on the fair value method. There is another method known as the 'Intrinsic Value Method' for valuation of employee sharebased payment plans. Intrinsic value, in the case of a listed company, is the amount by which the quoted market price of the underlying share exceeds the exercise price of an option. For example, an option with an exercise price of ₹ 100 on an equity share whose current quoted market price is ₹ 125, has an intrinsic value of ₹ 25 per share on the date of its valuation. If the quoted market price is not available on the grant date then the share price nearest to that date is taken. In the case of a nonlisted company, since the shares are not quoted on a stock exchange, value of its shares is determined on the basis of a valuation report from an independent valuer. For accounting for employee share-based payment plans, the intrinsic value may be used, *mutatis mutandis*, in place of the fair value as described in paragraphs 10 to 39.

Examples of equity-settled employee share-based payment plan and cashsettled employee share-based payment plan, using intrinsic value method, are given in Illustration 1 of Appendix II and the Illustration in Appendix IV, respectively.

Recommendation

41. It is recommended that accounting for employee share-based payment plans should be based on the fair value approach as described in paragraphs 10 to 39. However, intrinsic value method as described in paragraph 40 is also permitted.

Graded Vesting

42. In case the options/shares granted under an employee stock option plan do not vest on one date but have graded vesting schedule, total plan should be segregated into different groups, depending upon the vesting dates. Each of such groups would be having different vesting period and expected life and, therefore, each vesting date should be considered as a separate option grant and evaluated and accounted for accordingly. For example, suppose an employee is granted 100 options which will vest @ 25 options per year at the end of the third, fourth, fifth and sixth years. In such a case, each tranche of 25 options would be evaluated and accounted for separately.

An illustration of an employee share-based payment plan having graded vesting is given in Appendix VI.

Employee Share-Based Payment Plan Administered Through A Trust

43. An enterprise may administer an employee share-based payment plan through a trust constituted for this purpose. The trust may have different kinds of arrangements, for example, the following:

- (a) The enterprise allots shares to the trust as and when the employees exercise stock options.
- (b) The enterprise provides finance to the trust for subscription to the shares issued by the enterprise at the beginning of the plan.
- (c) The enterprise provides finance to the trust to purchase shares from the market at the beginning of the plan.

44. Since the trust administers the plan on behalf of the enterprise, it is recommended that irrespective of the arrangement for issuance of the shares under the employee share-based payment plan, the enterprise should recognise in its separate financial statements the expense on account of services received from the employees in accordance with the recommendations contained in this

Guidance Note. Various aspects of accounting for employee share-based payment plan administered through a trust under the arrangements mentioned above, are illustrated in Appendix VII, for the purpose of preparation of separate financial statements.

45. For the purpose of preparation of consolidated financial statements as per Accounting Standard (AS) 21, 'Consolidated Financial Statements', issued by the Institute of Chartered Accountants of India, the trust created for the purpose of administering employee share-based compensation, should not be considered. This is because the standard requires consolidation of only those controlled enterprises which provide economic benefits to the enterprise and, accordingly, consolidation of entities, such as, gratuity trust, provident fund trust, etc., is not required. The nature of a trust established for administering employee share-based compensation plan is similar to that of a gratuity trust or a provident fund trust as it does not provide any economic benefit to the enterprise in the form of, say, any return on investment.

Earnings Per Share Implications

46. For the purpose of calculating Basic Earnings Per Share as per Accounting Standard (AS) 20, 'Earnings Per Share', shares or stock options granted pursuant to an employee share-based payment plan, including shares or options issued to an ESOP trust, should not be included in the shares outstanding till the employees have exercised their right to obtain shares or stock options, after fulfilling the requisite vesting conditions. Till such time, shares or stock options so granted should be considered as dilutive potential equity shares for the purpose of calculating Diluted Earnings Per Share. Diluted Earnings Per Share should be based on the actual number of shares or stock options granted and not yet forfeited, unless doing so would be anti-dilutive.

47. For computations required under paragraph 35 of AS 20 with regard to shares or stock options granted pursuant to an employee share-based payment plan, the assumed proceeds from the issues should include the exercise price and the unamortised compensation cost which is attributable to future services.

An example to illustrate computation of Earnings Per Share in a situation where the enterprise has granted stock options to its employees is given in Appendix VIII.

Disclosures

48. An enterprise should describe the method used to account for the employee share-based payment plans. Where an enterprise uses the intrinsic value method, it should also disclose the impact on the net results and EPS – both basic and diluted – for the accounting period, had the fair value method been used.

49. An enterprise should disclose information that enables users of the financial statements to understand the nature and extent of employee share-based payment plans that existed during the period.

50. To give effect to the principle in paragraph 49, the enterprise should disclose at least the following:

- (a) a description of each type of employee share-based payment plan that existed at any time during the period, including the general terms and conditions of each plan, such as vesting requirements, the maximum term of options granted, and the method of settlement (e.g., whether in cash or equity). An enterprise with substantially similar types of plans may aggregate this information, unless separate disclosure of each arrangement is necessary to satisfy the principle in paragraph 49.
- (b) the number and weighted average exercise prices of stock options for each of the following

groups of options:

- (i) outstanding at the beginning of the period;
 - (ii) granted during the period;
 - (iii) forfeited during the period;
 - (iv) exercised during the period;
 - (v) expired during the period;
 - (vi) outstanding at the end of the period; and
 - (vii) exercisable at the end of the period.
- (c) for stock options exercised during the period, the weighted average share price at the date of exercise. If options were exercised on a regular basis throughout the period, the enterprise may instead disclose the weighted average share price during the period.
- (d) for stock options outstanding at the end of the period, the range of exercise prices and weighted average remaining contractual life (comprising the vesting period and the exercise period). If the range of exercise prices is wide, the outstanding options should be divided into ranges that are meaningful for assessing the number and timing of additional shares that may be issued and the cash that may be received upon exercise of those options.
51. An enterprise should disclose the following information to enable users of the financial statements to understand how the fair value of shares or stock options granted, during the period, was determined:
- (a) for stock options granted during the period, the weighted average fair value of those options at the grant date and information on how that fair value was measured, including:
 - (i) the option pricing model used and the inputs to that model, including the weighted average share price, exercise price, expected volatility, option life (comprising the vesting period and the exercise period), expected dividends, the risk-free interest rate and any other inputs to the model, including the method used and the assumptions made to incorporate the effects of expected early exercise;
 - (ii) how expected volatility was determined, including an explanation of the extent to which expected volatility was based on historical volatility; and
 - (iii) whether and how any other features of the option grant were incorporated into the measurement of fair value, such as a market condition.
 - (b) for other instruments granted during the period (i.e., other than stock options), the number and weighted average fair value of those instruments at the grant date, and information on how that fair value was measured, including:
 - (i) if fair value was not measured on the basis of an observable market price, how it was determined;
 - (ii) whether and how expected dividends were incorporated into the measurement of fair value; and
 - (iii) whether and how any other features of the instruments granted were incorporated into the measurement of fair value.
 - (c) for employee share-based payment plans that were modified during the period:
 - (i) an explanation of those modifications;
 - (ii) the incremental fair value granted (as a result of those modifications); and
 - (iii) information on how the incremental fair value granted was measured, consistently with the requirements set out in (a) and (b) above, where applicable.
52. An enterprise should disclose the following information to enable users of the financial

statements to understand the effect of employee share-based payment plans on the profit or loss of the enterprise for the period and on its financial position:

- (a) the total expense recognised for the period arising from employee share-based payment plans in which the services received did not qualify for recognition as a part of the cost of an asset and hence were recognised immediately as an expense, including separate disclosure of that portion of the total expense that arises from transactions accounted for as equity-settled employee share-based payment plans;
- (b) for liabilities arising from employee share-based payment plans:
 - (i) the total carrying amount at the end of the period; and
 - (ii) the total intrinsic value at the end of the period of liabilities for which the right of the employee to cash or other assets had vested by the end of the period (e.g., vested stock appreciation rights).

Appendix IX contains illustrative disclosures.

Effective Date

53. This Guidance Note applies to employee share-based payment plans the grant date in respect of which falls on or after April 1, 2005.

Appendix I

Estimating the Fair Value of Shares or Stock Options Granted

1. The appendix discusses measurement of the fair value of shares and stock options granted, focusing on the specific terms and conditions that are common features of a grant of shares or stock options to employees. Therefore, it is not exhaustive.

Shares

2. The fair value of the shares granted should be measured at the market price of the shares of the enterprise (or an estimated value based on the valuation report of an independent valuer, if the shares of the enterprise are not publicly traded), adjusted to take into account the terms and conditions upon which the shares were granted (except for vesting conditions that are excluded from the measurement of fair value in accordance with paragraphs 18 to 20 of the text of the Guidance Note).

3. For example, if the employee is not entitled to receive dividends during the vesting period, this factor should be taken into account when estimating the fair value of the shares granted. Similarly, if the shares are subject to restrictions on transfer after vesting date, that factor should be taken into account, but only to the extent that the post-vesting restrictions affect the price that a knowledgeable, willing market participant would pay for that share. For example, if the shares are actively traded in a deep and liquid market, post-vesting transfer restrictions may have little, if any, effect on the price that a knowledgeable, willing market participant would pay for those shares. Restrictions on transfer or other restrictions that exist during the vesting period should not be taken into account when estimating the grant date fair value of the shares granted, because those restrictions stem from the existence of vesting conditions, which are accounted for in accordance with paragraphs 18 to 20 of the text of the Guidance Note.

Stock Options

4. For stock options granted to employees, in many cases market prices are not available, because the options granted are subject to terms and conditions that do not apply to traded options. If traded options with similar terms and conditions do not exist, the fair value of the options granted should be estimated by applying an option pricing model.

5. The enterprise should consider factors that knowledgeable, willing market participants would consider in selecting the option pricing model to apply. For example, many employee options have long lives, are usually exercisable during the period between vesting date and the end of the life of the option, and are often exercised early. These factors should be considered when estimating the grant date fair value of the options. For many enterprises, this might preclude the use of the Black-Scholes-Merton formula, which does not allow for the possibility of exercise before the end of the option's life (comprising the vesting period and the exercise period) and may not adequately reflect the effects of expected early exercise. It also does not allow for the possibility that expected volatility and other model inputs might vary over the option's life. However, for stock options with relatively short contractual lives (comprising the vesting period and the exercise period), or that must be exercised within a short period of time after vesting date, the factors identified above may not apply. In these instances, the Black-Scholes-Merton formula may produce a value that is substantially the same as a more flexible option pricing model.

6. All option pricing models take into account, as a minimum, the following factors:

- (a) the exercise price of the option;
- (b) the life of the option;
- (c) the current price of the underlying shares;
- (d) the expected volatility of the share price;
- (e) the dividends expected on the shares (if appropriate); and
- (f) the risk-free interest rate for the life of the option.

7. Other factors that knowledgeable, willing market participants would consider in setting the price should also be taken into account (except for vesting conditions and reload features that are excluded from the measurement of fair value in accordance with paragraphs 18 to 21 of the text of the Guidance Note).

8. For example, a stock option granted to an employee typically cannot be exercised during specified periods (e.g., during the vesting period or during periods specified, if any, by securities regulators). This factor should be taken into account if the option pricing model applied would otherwise assume that the option could be exercised at any time during its life. However, if an enterprise uses an option pricing model that values options that can be exercised only at the end of the options' life, no adjustment is required for the inability to exercise them during the vesting period (or other periods during the options' life), because the model assumes that the options cannot be exercised during those periods.

9. Similarly, another factor common to employee stock options is the possibility of early exercise of the option, for example, because the option is not freely transferable, or because the employee must exercise all vested options upon cessation of employment. The effects of expected early exercise should be taken into account, as discussed in paragraphs 16 to 21 of this Appendix.

10. Factors that a knowledgeable, willing market participant would not consider in setting the price of a stock option should not be taken into account when estimating the fair value of stock options granted. For example, for stock options granted to employees, factors that affect the value of the option from the perspective of the individual employee only are not relevant to estimating the price that would be set by a knowledgeable, willing market participant.

Inputs to option pricing models

11. In estimating the expected volatility of and dividends on the underlying shares, the objective is to approximate the expectations that would be reflected in a current market or negotiated exchange price for the option. Similarly, when estimating the effects of early exercise of employee stock options, the

objective is to approximate the expectations that an outside party with access to detailed information about employees' exercise behaviour would develop based on information available at the grant date.

12. Often, there is likely to be a range of reasonable expectations about future volatility, dividends and exercise behaviour. If so, an expected value should be calculated, by weighting each amount within the range by its associated probability of occurrence.

13. Expectations about the future are generally based on experience, modified if the future is reasonably expected to differ from the past. In some circumstances, identifiable factors may indicate that unadjusted historical experience is a relatively poor predictor of future experience. For example, if an enterprise with two distinctly different lines of business disposes of the one that was significantly less risky than the other, historical volatility may not be the best information on which to base reasonable expectations for the future.

14. In other circumstances, historical information may not be available. For example, a newly listed enterprise will have little, if any, historical data on the volatility of its share price. Unlisted and newly listed enterprises are discussed further below.

15. In summary, an enterprise should not simply base estimates of volatility, exercise behaviour and dividends on historical information without considering the extent to which the past experience is expected to be reasonably predictive of future experience.

Expected early exercise

16. Employees often exercise stock options early, for a variety of reasons. For example, employee stock options are typically nontransferable. This often causes employees to exercise their stock options early, because that is the only way for the employees to liquidate their position. Also, employees who cease employment are usually required to exercise any vested options within a short period of time, otherwise the stock options are forfeited. This factor also causes the early exercise of employee stock options. Other factors causing early exercise are risk aversion and lack of wealth diversification.

17. The means by which the effects of expected early exercise are taken into account depends upon the type of option pricing model applied. For example, expected early exercise could be taken into account by using an estimate of the expected life of the option (which, for an employee stock option, is the period of time from grant date to the date on which the option is expected to be exercised) as an input into an option pricing model (e.g., the Black-Scholes-Merton formula). Alternatively, expected early exercise could be modelled in a binomial or similar option pricing model that uses contractual life as an input.

18. Factors to consider in estimating early exercise include:

- (a) the length of the vesting period, because the stock option typically cannot be exercised until the end of the vesting period. Hence, determining the valuation implications of expected early exercise is based on the assumption that the options will vest. The implications of vesting conditions are discussed in paragraphs 18 to 20 of the text of the Guidance Note.
- (b) the average length of time similar options have remained outstanding in the past.
- (c) the price of the underlying shares. Experience may indicate that the employees tend to exercise options when the share price reaches a specified level above the exercise price.
- (d) the employee's level within the organisation. For example, experience might indicate that higher-level employees tend to exercise options later than lower-level employees (discussed further in paragraph 21 of this Appendix).
- (e) expected volatility of the underlying shares. On average, employees might tend to exercise options on highly volatile shares earlier than on shares with low volatility.

19. As noted in paragraph 17 of this Appendix, the effects of early exercise could be taken into account by using an estimate of the option's expected life as an input into an option pricing model. When estimating the expected life of stock options granted to a group of employees, the enterprise could base that estimate on an appropriately weighted average expected life for the entire employee group or on appropriately weighted average lives for subgroups of employees within the group, based on more detailed data about employees' exercise behaviour (discussed further below).

20. Separating an option grant into groups for employees with relatively homogeneous exercise behaviour is likely to be important. Option value is not a linear function of option term; value increases at a decreasing rate as the term lengthens. For example, if all other assumptions are equal, although a two-year option is worth more than a one-year option, it is not worth twice as much. That means that calculating estimated option value on the basis of a single weighted average life that includes widely differing individual lives would overstate the total fair value of the stock options granted. Separating options granted into several groups, each of which has a relatively narrow range of lives included in its weighted average life, reduces that overstatement.

21. Similar considerations apply when using a binomial or similar model. For example, the experience of an enterprise that grants options broadly to all levels of employees might indicate that top-level executives tend to hold their options longer than middle-management employees hold theirs and that lower-level employees tend to exercise their options earlier than any other group. In addition, employees who are encouraged required to hold a minimum amount of their employer's shares or stock options, might on average exercise options later than employees not subject to that provision. In those situations, separating options by groups of recipients with relatively homogeneous exercise behaviour will result in a more accurate estimate of the total fair value of the stock options granted.

Expected volatility

22. Expected volatility is a measure of the amount by which a price is expected to fluctuate during a period. The measure of volatility used in option pricing models is the annualised standard deviation of the continuously compounded rates of return on the share over a period of time. Volatility is typically expressed in annualised terms that are comparable regardless of the time period used in the calculation, for example, daily, weekly or monthly price observations.

23. The rate of return (which may be positive or negative) on a share for a period measures how much a shareholder has benefited from dividends and appreciation (or depreciation) of the share price.

24. The expected annualised volatility of a share is the range within which the continuously compounded annual rate of return is expected to fall approximately two-thirds of the time. For example, to say that a share with an expected continuously compounded rate of return of 12 per cent has a volatility of 30 per cent means that the probability that the rate of return on the share for one year will be between -18 per cent (12% - 30%) and 42 per cent (12% + 30%) is approximately two-thirds. If the share price is ₹.100 at the beginning of the year and no dividends are paid, the year-end share price would be expected to be between ₹ 83.53 ($₹.100 \times e^{-0.18}$) and ₹.152.20 ($₹ 100 \times e^{0.42}$) approximately two-thirds of the time.

25. Factors to be considered in estimating expected volatility include:

- (a) Implied volatility from traded stock options on the shares of the enterprise, or other traded instruments of the enterprise that include option features (such as convertible debt), if any.
- (b) The historical volatility of the share price over the most recent period that is generally commensurate with the expected term of the option (taking into account the remaining contractual life of the option and the effects of expected early exercise).
- (c) The length of time shares of an enterprise have been publicly traded. A newly listed enterprise

might have a high historical volatility, compared with similar enterprises that have been listed longer. Further guidance for newly listed enterprises is given in paragraph 26 of this Appendix.

- (d) The tendency of volatility to revert to its mean, i.e., its long-term average level, and other factors indicating that expected future volatility might differ from past volatility. For example, if share price of an enterprise was extraordinarily volatile for some identifiable period of time because of a failed takeover bid or a major restructuring, that period could be disregarded in computing historical average annual volatility.
- (e) Appropriate and regular intervals for price observations. The price observations should be consistent from period to period.

For example, an enterprise might use the closing price for each week or the highest price for the week, but it should not use the closing price for some weeks and the highest price for other weeks.

Newly listed enterprises

26. As noted in paragraph 25 of this Appendix, an enterprise should consider historical volatility of the share price over the most recent period that is generally commensurate with the expected option term. If a newly listed enterprise does not have sufficient information on historical volatility, it should nevertheless compute historical volatility for the longest period for which trading activity is available. It could also consider the historical volatility of similar enterprises following a comparable period in their lives. For example, an enterprise that has been listed for only one year and grants options with an average expected life of five years might consider the pattern and level of historical volatility of enterprises in the same industry for the first six years in which the shares of those enterprises were publicly traded.

Unlisted enterprises

27. An unlisted enterprise will not have historical information upon which to base an estimate of expected volatility. It will therefore have to estimate expected volatility by some other means. The enterprise could consider the historical volatility of similar listed enterprises, for which share price or option price information is available, to use as the basis for an estimate of expected volatility. Alternatively, volatility of unlisted enterprises can be taken as zero.

Expected dividends

28. Whether expected dividends should be taken into account when measuring the fair value of shares or stock options granted depends on whether the employees are entitled to dividends or dividend equivalents. For example, if employees were granted options and are entitled to dividends on the underlying shares or dividend equivalents (which might be paid in cash or applied to reduce the exercise price) between grant date and exercise date, the options granted should be valued as if no dividends will be paid on the underlying shares, i.e., the input for expected dividends should be zero. Similarly, when the grant date fair value of shares granted to employees is estimated, no adjustment is required for expected dividends if the employees are entitled to receive dividends paid during the vesting period.

29. Conversely, if the employees are not entitled to dividends or dividend equivalents during the vesting period (or before exercise, in the case of an option), the grant date valuation of the rights to shares or options should take expected dividends into account. That is to say, when the fair value of an option grant is estimated, expected dividends should be included in the application of an option pricing model. When the fair value of a share grant is estimated, that valuation should be reduced by the present value of dividends expected to be paid during the vesting period.

30. Option pricing models generally call for expected dividend yield. However, the models may be modified to use an expected dividend amount rather than a yield. An enterprise may use either its expected yield or its expected payments. If the enterprise uses the latter, it should consider its historical pattern of increases in dividends. For example, if policy of an enterprise has generally been to increase dividends by approximately 3 per cent per year, its estimated option value should not assume a fixed dividend amount throughout the option's life unless there is evidence that supports that assumption.

31. Generally, the assumption about expected dividends should be based on publicly available information. An enterprise that does not pay dividends and has no plans to do so should assume an expected dividend yield of zero. However, an emerging enterprise with no history of paying dividends might expect to begin paying dividends during the expected lives of its employee stock options. Those enterprises could use an average of their past dividend yield (zero) and the mean dividend yield of an appropriately comparable peer group.

Risk-free interest rate

32. Typically, the risk-free interest rate is the implied yield currently available on zero-coupon government issues, with a remaining term equal to the expected term of the option being valued (based on the option's remaining contractual life and taking into account the effects of expected early exercise). It may be necessary to use an appropriate substitute, if no such government issues exist or circumstances indicate that the implied yield on zero-coupon government issues is not representative of the risk free interest rate. Also, an appropriate substitute should be used if market participants would typically determine the risk-free interest rate by using that substitute, rather than the implied yield of zero-coupon government issues, when estimating the fair value of an option with a life equal to the expected term of the option being valued.

Capital structure effects

33. Typically, third parties, not the enterprise, write traded stock options. When these stock options are exercised, the writer delivers shares to the option holder. Those shares are acquired from existing shareholders. Hence the exercise of traded stock options has no dilutive effect.

34. In contrast, if stock options are written by the enterprise, new shares are issued when those stock options are exercised. Given that the shares will be issued at the exercise price rather than the current market price at the date of exercise, this actual or potential dilution might reduce the share price, so that the option holder does not make as large a gain on exercise as on exercising an otherwise similar traded option that does not dilute the share price.

35. Whether this has a significant effect on the value of the stock options granted depends on various factors, such as the number of new shares that will be issued on exercise of the options compared with the number of shares already issued. Also, if the market already expects that the option grant will take place, the market may have already factored the potential dilution into the share price at the date of grant.

36. However, the enterprise should consider whether the possible dilutive effect of the future exercise of the stock options granted might have an impact on their estimated fair value at grant date. Option pricing models can be adapted to take into account this potential dilutive effect.

Appendix II

**Equity-Settled Employee
Share-based Payment Plans**

Illustration 1 : Stock Options With Service**Condition Only****(A) Accounting during the vesting period**

At the beginning of year 1, an enterprise grants 300 options to each of its 1,000 employees. The contractual life (comprising the vesting period and the exercise period) of options granted is 6 years. The other relevant terms of the grant are as below:

| | |
|-------------------------------|---------|
| Vesting Period | 3 years |
| Exercise Period | 3 years |
| Expected Life | 5 years |
| Exercise Price | ₹ 50 |
| Market Price | ₹ 50 |
| Expected forfeitures per year | 3% |

The fair value of options, calculated using an option pricing model, is ₹ 15 per option. Actual forfeitures, during the year 1, are 5 per cent and at the end of year 1, the enterprise still expects that actual forfeitures would average 3 per cent per year over the 3-year vesting period. During the year 2, however, the management decides that the rate of forfeitures is likely to continue to increase, and the expected forfeiture rate for the entire award is changed to 6 per cent per year. It is also assumed that 840 employees have actually completed 3 years vesting period.

Suggested Accounting Treatment

Year 1

1. At the grant date, the enterprise estimates the fair value of the options expected to vest at the end of the vesting period as below:

$$\begin{aligned} &\text{No. of options expected to vest} \\ &= 300 \times 1,000 \times 0.97 \times 0.97 \times 0.97 = 2,73,802 \text{ options} \\ &\text{Fair value of options expected to vest} \\ &= 2,73,802 \text{ options} \times ₹ 15 = ₹ 41,07,030 \end{aligned}$$

2. At the balance sheet date, since the enterprise still expects actual forfeitures to average 3 per cent per year over the 3-year vesting period, no change is required in the estimates made at the grant date. The enterprise, therefore, recognises one-third of the amount estimated at (1) above (i.e., ₹ 41,07,030/3) towards the employee services received by passing the following entry:

| | | |
|-----------------------------------|-----------------|-------------|
| Employee compensation expense A/c | Dr. ₹ 13,69,010 | |
| To Stock Options Outstanding A/c | | ₹ 13,69,010 |

(Being compensation expense recognised in respect of the ESOP)

3. Credit balance in the 'Stock Options Outstanding A/c' may be disclosed in the balance sheet under a separate heading, between 'Share Capital' and 'Reserves and Surplus'.

Year 2

1. At the end of the financial year, management has changed its estimate of expected forfeiture rate

from 3 per cent to 6 per cent per year. The revised number of options expected to vest is 2,49,175 (3,00,000 x .94 x .94 x .94). Accordingly, the fair value of revised options expected to vest is ₹ 37,37,625 (2,49,175 x ₹ 15). Consequent to the change in the expected forfeitures, the expense to be recognised during the year are determined as below:

| | |
|--|---------------------|
| Revised total fair value | ₹ 37,37,625 |
| Revised cumulative expense at the end of year 2= (₹ 37,37,625 x 2/3) | =₹ 24,91,750 |
| Expense already recognised in year 1 | =₹ 13,69,010 |
| Expense to be recognised in year 2 | =₹ <u>11,22,740</u> |

2. The enterprise recognises the amount determined at (1) above (i.e., ₹ 11,22,740) towards the employee services received by passing the following entry:

| | | |
|-----------------------------------|-----------------|-------------|
| Employee compensation expense A/c | Dr. ₹ 11,22,740 | |
| To Stock Options Outstanding A/c | | ₹ 11,22,740 |

(Being compensation expense recognised in respect of the ESOP)

3. Credit balance in the 'Stock Options Outstanding A/c' may be disclosed in the balance sheet under a separate heading, between 'Share Capital' and 'Reserves and Surplus'.

Year 3

1. At the end of the financial year, the enterprise would examine its actual forfeitures and make necessary adjustments, if any, to reflect expense for the number of options that actually vested. Considering that 840 employees have completed three years vesting period, the expense to be recognised during the year is determined as below:

| | |
|---|--------------------|
| No. of options actually vested = 840 x 300 | = 2,52,000 |
| Fair value of options actually vested (₹ 2,52,000 x ₹ 15) | = ₹ 37,80,000 |
| Expense already recognised | ₹ <u>24,91,750</u> |
| Expense to be recognised in year 3 | ₹ <u>12,88,250</u> |

2. The enterprise recognises the amount determined at (1) above towards the employee services received by passing the following entry:

| | | |
|-----------------------------------|-----------------|-------------|
| Employee compensation expense A/c | Dr. ₹ 12,88,250 | |
| To Stock Options Outstanding A/c | | ₹ 12,88,250 |

(Being compensation expense recognised in respect of ESOP)

3. Credit balance in the 'Stock Options Outstanding A/c' may be disclosed in the balance sheet under a separate heading, between 'Share Capital' and 'Reserves and Surplus'.

(B) Accounting at the time of exercise/expiry of the vested options

Continuing Illustration 1(A) above, the following further facts are provided:

- 200 employees exercise their right to obtain shares vested in them in pursuance of the ESOP at the end of year 5 and 600 employees exercise their right at the end of year 6.
- Rights of 40 employees expire unexercised at the end of the contractual life of the option, i.e., at the end of year 6.
- Face value of one share of the enterprise is ₹ 10.

Suggested Accounting Treatment

- On exercise of the right to obtain shares, the enterprise issues shares to the respective

employees on receipt of the exercise price. The shares so issued are considered to have been issued on a consideration comprising the exercise price and the corresponding amount standing to the credit of the Stock Options Outstanding Account. In the present case, the exercise price is ₹ 50 per share and the amount of compensation expense recognised in the 'Stock Options Outstanding A/c' is ₹ 15 per option. The enterprise, therefore, considers the shares to be issued at a price of ₹ 65 per share.

2. The amount to be recorded in the 'Share Capital A/c' and the 'Securities Premium A/c', upon issuance of the shares, is calculated as below:

| Particulars | Exercise Date Year-end 5 | Exercise Date Year-end 6 |
|--|-----------------------------|-----------------------------|
| No. of employees exercising option | 200 | 600 |
| No. of shares issued on exercise @ 300 per employee | 60,000 | 1,80,000 |
| Exercise Price received @ ₹ 50 per share | 30,00,000 | 1,80,000 |
| Corresponding amount recognised in the 'Stock Options Outstanding A/c' @ ₹ 15 per option | 9,00,000 | 27,00,000 |
| Total Consideration | 39,00,000 | 1,17,00,000 |
| Amount to be recorded in 'Share Capital A/c' @ ₹ 10 per share | 6,00,000 | 18,00,000 |
| Amount to be recorded in 'Securities Premium A/c' @ ₹ 55 per share | 33,00,000 | 99,00,000 |
| Total | 39,00,000 | 1,17,00,000 |

3. The enterprise passes the following entries at end of year 5 and year 6, respectively, to record the shares issued to the employees upon exercise of options vested in them in pursuance of the Employee Stock Option Plan:

| | | | | |
|--------|-------------------------------|-----|-------------|-------------|
| Year 5 | Bank A/c | Dr. | ₹ 30,00,000 | |
| | Stock Options Outstanding A/c | Dr. | ₹ 9,00,000 | |
| | To Share Capital A/c | | | ₹ 6,00,000 |
| | To Securities Premium A/c | | | ₹ 33,00,000 |

(Being shares issued to the employees against the options vested in them in pursuance of the Employee Stock Option Plan)

| | | | | |
|--------|-------------------------------|-----|-------------|-------------|
| Year 6 | Bank A/c | Dr. | ₹ 90,00,000 | |
| | Stock Options Outstanding A/c | Dr. | ₹ 27,00,000 | |
| | To Share Capital A/c | | | ₹ 18,00,000 |
| | To Securities Premium A/c | | | ₹ 99,00,000 |

(Being shares issued to the employees against the options vested in them in pursuance of the Employee Stock Option Plan)

4. At the end of year 6, the balance of ₹ 1,80,000 (i.e., 40 employees x 300 options x ₹ 15 per option) standing to the credit of the Stock Options Outstanding Account, in respect of vested options expiring unexercised, is transferred to general reserve by passing the following entry:

| | | | |
|-------------------------------|-----|------------|------------|
| Stock Options Outstanding A/c | Dr. | ₹ 1,80,000 | |
| To General Reserve | | | ₹ 1,80,000 |

(Being the balance standing to the credit of the Stock Options

Outstanding Account, in respect of vested options expired unexercised, transferred to the general reserve)

(C) Intrinsic Value Method

The accounting treatment suggested in Illustrations 1(A) and 1(B) above is based on the fair value method. In case the enterprise follows the intrinsic value method instead of the fair value method, it would not recognise any compensation expense since the market price of the underlying share at the grant date is the same as the exercise price and the intrinsic value of the options is nil. However, in case the market price of the underlying share at the grant date is more than the exercise price, say, ₹ 52 per share, then the difference of ₹ 2 between the market value and the exercise price would be the intrinsic value of the option. In such a case, the enterprise would treat the said intrinsic value as compensation expense over the vesting period on the lines of Illustrations 1(A) and 1(B) above.

Illustration 2: Grant With A Performance Condition, In Which The Length Of The Vesting Period Varies

At the beginning of year 1, the enterprise grants 100 stock options to each of its 500 employees, conditional upon the employees remaining in the employment of the enterprise during the vesting period. The options will vest at the end of year 1 if the earnings of the enterprise increase by more than 18 per cent; at the end of year 2 if the earnings of the enterprise increase by more than an average of 13 per cent per year over the two-year period; and at the end of year 3 if the earnings of the enterprise increase by more than an average of 10 per cent per year over the three-year period. The fair value of the options, calculated at the grant date using an option pricing model, is ₹ 30 per option. No dividends are expected to be paid over the three-year period.

By the end of year 1, the earnings of the enterprise have increased by 14 per cent, and 30 employees have left. The enterprise expects that earnings will continue to increase at a similar rate in year 2, and, therefore, expects that the options will vest at the end of year 2. The enterprise expects, on the basis of a weighted average probability, that a further 30 employees will leave during year 2, and, therefore, expects that options will vest in 440 employees at the end of year 2.

By the end of year 2, the earnings of the enterprise have increased by only 10 per cent and, therefore, the options do not vest at the end of year 2. 28 employees have left during the year. The enterprise expects that a further 25 employees will leave during year 3, and that the earnings of the enterprise will increase by at least 6 per cent, thereby achieving the average of 10 per cent per year.

By the end of year 3, 23 employees have left and the earnings of the enterprise have increased by 8 per cent, resulting in an average increase of 10.67 per cent per year. Therefore, 419 employees received 100 shares each at the end of year 3.

Suggested Accounting Treatment

1. In the given case, the length of the vesting period varies, depending on when the performance condition is satisfied. In such a situation, as per paragraph 14 of the text of the Guidance Note, the enterprise estimates the length of the expected vesting period, based on the most likely outcome of the performance condition, and revises that estimate, if necessary, if subsequent information indicates that the length of the vesting period is likely to differ from previous estimates.

2. The enterprise determines the compensation expense to be recognised each year as below:

| Particulars | Year 1 | Year 2 | Year 3 |
|--|---------------|---------------|---------------|
| Length of the expected vesting period (at the end of the year) | 2 years | 3 years | 3 years |
| No. of employees expected to meet vesting conditions | 440 employees | 417 employees | 419 employees |

| | | | |
|--|---------------------------|-------------------------------|-----------------|
| No. of options expected to vest | 44,000 | 41,700 | 41,900 |
| Fair value of options expected to vest @ ₹ 30 per option (₹.) | 13,20,000 | 12,51,000 | 12,57,000 |
| Compensation expense accrued till the end of year (₹.) | 6,60,000 [13,20,000/2] | 8,34,000 (12,51,000 * 2/3) | 12,57,000 |
| Compensation expense recognised till the end of previous year (₹.) | Nil | 6,60,000 | 8,34,000 |
| Compensation expense to be recognized for the year (₹.) | 6,60,000 | 1,74,000 | 4,23,000 |

Illustration 3 : Grant With A Performance Condition, in Which the Number of Stock Options Varies

At the beginning of year 1, an enterprise grants stock options to each of its 100 employees working in the sales department. The stock options will vest at the end of year 3, provided that the employees remain in the employment of the enterprise, and provided that the volume of sales of a particular product increases by at least an average of 5 per cent per year. If the volume of sales of the product increases by an average of between 5 per cent and 10 per cent per year, each employee will receive 100 stock options. If the volume of sales increases by an average of between 10 per cent and 15 per cent each year, each employee will receive 200 stock options. If the volume of sales increases by an average of 15 per cent or more, each employee will receive 300 stock options.

On the grant date, the enterprise estimates that the stock options have a fair value of ₹ 20 per option. The enterprise also estimates that the volume of sales of the product will increase by an average of between 10 per cent and 15 per cent per year, and therefore expects that, for each employee who remains in service until the end of year 3, 200 stock options will vest. The enterprise also estimates, on the basis of a weighted average probability, 20 per cent of employees will leave before the end of year 3.

By the end of year 1, seven employees have left and the enterprise still expects that a total of 20 employees will leave by the end of year 3. Hence, the enterprise expects that 80 employees will remain in service for the three-year period. Product sales have increased by 12 per cent and the enterprise expects this rate of increase to continue over the next 2 years.

By the end of year 2, a further five employees have left, bringing the total to 12 to date. The enterprise now expects that only three more employees will leave during year 3, and therefore expects that a total of 15 employees will have left during the three-year period, and hence 85 employees are expected to remain. Product sales have increased by 18 per cent, resulting in an average of 15 per cent over the two years to date. The enterprise now expects that sales increase will average 15 per cent or more over the three-year period, and hence expects each sales employee to receive 300 stock options at the end of year 3.

By the end of year 3, a further two employees have left. Hence, 14 employees have left during the three-year period, and 86 employees remain. The sales of the enterprise have increased by an average of 16 per cent over the three years. Therefore, each of the 86 employees receives 300 stock options.

Suggested Accounting Treatment

Since the number of options varies depending on the outcome of a performance condition that is not a market condition, the effect of that condition (i.e., the possibility that the number of stock options might be 100, 200 or 300) is not taken into account when estimating the fair value of the stock options at

grant date. Instead, the enterprise revises the transaction amount to reflect the outcome of that performance condition, as illustrated below.

| Year | Calculation | Compensation expense for period (₹.) | Cumulative compensation expense (₹.) |
|------|--|--------------------------------------|--------------------------------------|
| 1. | 80 employees × 200 options × ₹ 20 × 1/3 | 1,06,667 | 1,06,667 |
| 2. | (85 employees × 300 options × ₹ 20 × 2/3) ₹ 1,06,667 – | 2,33,333 | 3,40,000 |
| 3. | (86 employees × 300 options × ₹ 20 × 3/3) – ₹ 3,40,000 | 1,76,000 | 5,16,000 |

Illustration 4: Grant With A Performance Condition, In Which The Exercise Price Varies

At the beginning of year 1, an enterprise grants 10,000 stock options to a senior executive, conditional upon the executive remaining in the employment of the enterprise until the end of year 3. The exercise price is ₹ 40. However, the exercise price drops to ₹ 30 if the earnings of the enterprise increase by at least an average of 10 per cent per year over the three-year period.

On the grant date, the enterprise estimates that the fair value of the stock options, with an exercise price of ₹ 30, is ₹ 16 per option. If the exercise price is ₹ 40, the enterprise estimates that the stock options have a fair value of ₹ 12 per option. During year 1, the earnings of the enterprise increased by 12 per cent, and the enterprise expects that earnings will continue to increase at this rate over the next two years. The enterprise, therefore, expects that the earnings target will be achieved, and hence the stock options will have an exercise price of ₹ 30. During year 2, the earnings of the enterprise increased by 13 per cent, and the enterprise continues to expect that the earnings target will be achieved.

During year 3, the earnings of the enterprise increased by only 3 per cent, and therefore the earnings target was not achieved. The executive completes three years' service, and therefore satisfies the service condition. Because the earnings target was not achieved, the 10,000 vested stock options have an exercise price of ₹ 40.

Suggested Accounting Treatment

Because the exercise price varies depending on the outcome of a performance condition that is not a market condition, the effect of that performance condition (i.e. the possibility that the exercise price might be ₹ 40 and the possibility that the exercise price might be ₹ 30) is not taken into account when estimating the fair value of the stock options at the grant date. Instead, the enterprise estimates the fair value of the stock options at the grant date under each scenario (i.e. exercise price of ₹ 40 and exercise price of ₹ 30) and ultimately revises the transaction amount to reflect the outcome of that performance condition, as illustrated below:

| Year | Calculation | Compensation expense for period (₹.) | Cumulative compensation expense (₹.) |
|------|--|--------------------------------------|--------------------------------------|
| 1 | 10,000 options × ₹ 16 × 1/3 | 53,333 | 53,333 |
| 2. | (10,000 options × ₹ 16 × 2/3) ₹ 53,333 | 53,334 | 1,06,667 |
| 3. | (10,000 options × ₹ 12 × 3/3) – ₹ 1,06,667 | 13,333 1, | 20,000 |

Illustration 5: Grant With A Market Condition

At the beginning of year 1, an enterprise grants 10,000 stock options to a senior executive, conditional upon the executive remaining in the employment of the enterprise until the end of year 3. However, the stock options cannot be exercised unless the share price has increased from ₹.50 at the beginning of year 1 to above ₹ 65 at the end of year 3. If the share price is above ₹ 65 at the end of year 3, the stock options can be exercised at any time during the next seven years, i.e. by the end of year 10.

The enterprise applies a binomial option pricing model, which takes into account the possibility that the share price will exceed ₹ 65 at the end of year 3 (and hence the stock options become exercisable) and the possibility that the share price will not exceed ₹ 65 at the end of year 3 (and hence the options will not become exercisable). It estimates the fair value of the stock options with this market condition to be ₹ 24 per option.

Suggested Accounting Treatment

Because paragraph 20 of the text of the Guidance Note requires the enterprise to recognise the services received from an employee who satisfies all other vesting conditions (e.g., services received from an employee who remains in service for the specified service period), irrespective of whether that market condition is satisfied, it makes no difference whether the share price target is achieved. The possibility that the share price target might not be achieved has already been taken into account when estimating the fair value of the stock options at the grant date. Therefore, if the enterprise expects the executive to complete the three-year service period, and the executive does so, the enterprise recognises the following amounts in years 1, 2 and 3:

| Year | Calculation | Compensation expense for period (₹.) | Cumulative compensation expense (₹.) |
|------|--|--------------------------------------|--------------------------------------|
| 1. | 10,000 options × ₹ 24 × 1/3 | 80,000 | 80,000 |
| 2. | (10,000 options × ₹ 24 × 2/3) – ₹ 80,000 | 80,000 | 1,60,000 |
| 3. | (10,000 options × ₹ 24) – ₹ 1,60,000 | 80,000 | 2,40,000 |

As noted above, these amounts are recognised irrespective of the outcome of the market condition. However, if the executive left during year 2 (or year 3), the amount recognised during year 1 (and year 2) would be reversed in year 2 (or year 3). This is because the service condition, in contrast to the market condition, was not taken into account when estimating the fair value of the stock options at grant date. Instead, the service condition is taken into account by adjusting the transaction amount to be based on the number of shares or stock options that ultimately vest, in accordance with paragraphs 18 and 19 of the text of the Guidance Note.

Illustration 6: Grant with A Market Condition, in Which the Length of the Vesting Period Varies

At the beginning of year 1, an enterprise grants 10,000 stock options with a ten-year life to each of ten senior executives. The stock options will vest and become exercisable immediately if and when the share price of the enterprise increases from ₹ 50 to ₹ 70, provided that the executive remains in service until the share price target is achieved.

The enterprise applies a binomial option pricing model, which takes into account the possibility that the share price target will be achieved during the ten-year life of the options, and the possibility that the target will not be achieved. The enterprise estimates that the fair value of the stock options at grant date is ₹ 25 per option. From the option pricing model, the enterprise determines that the mode of the distribution of possible vesting dates is five years. In other words, of all the possible outcomes, the

most likely outcome of the market condition is that the share price target will be achieved at the end of year 5. Therefore, the enterprise estimates that the expected vesting period is five years. The enterprise also estimates that two executives will have left by the end of year 5, and therefore expects that 80,000 stock options (10,000 stock options x 8 executives) will vest at the end of year 5.

Throughout years 1-4, the enterprise continues to estimate that a total of two executives will leave by the end of year 5. However, in total three executives leave, one in each of years 3, 4 and 5. The share price target is achieved at the end of year 6. Another executive leaves during year 6, before the share price target is achieved.

Suggested Accounting Treatment

Paragraph 14 of the text of the Guidance Note requires the enterprise to recognise the services received over the expected vesting period, as estimated at grant date, and also requires the enterprise not to revise that estimate. Therefore, the enterprise recognises the services received from the executives over years 1 to 5. Hence, the transaction amount is ultimately based on 70,000 stock options (10,000 stock options × 7 executives who remain in service at the end of year 5). Although another executive left during year 6, no adjustment is made, because the executive had already completed the expected vesting period of 5 years. Therefore, the enterprise recognises the following amounts in years 1-5:

| Year | Calculation | Compensation expense for period (₹.) | Cumulative compensation expense (₹.) |
|------|---|--------------------------------------|--------------------------------------|
| 1 | 80,000 options × ₹ 25 × 1/5 | 4,00,000 | 4,00,000 |
| 2. | (80,000 options × ₹ 25 × 2/5) – ₹ 4,00,000 | 4,00,000 | 8,00,000 |
| 3. | (80,000 options × ₹ 25 × 3/5) – ₹ 8,00,000 | 4,00,000 | 12,00,000 |
| 4. | 4 (80,000 options × ₹ 25 × 4/5) – ₹ 12,00,000 | 4,00,000 | 16,00,000 |
| 5. | (70,000 options × ₹ 25) – ₹ 16,00,000 | 1,50,000 | 17,50,000 |

Illustration 7: Employee Share Purchase Plan

An enterprise offers all its 1,000 employees the opportunity to participate in an employee stock purchase plan. The employees have two weeks to decide whether to accept the offer. Under the terms of the plan, the employees are entitled to purchase a maximum of 100 shares each. The purchase price will be 20 per cent less than the market price of the shares of the enterprise at the date the offer is accepted, and the purchase price must be paid immediately upon acceptance of the offer. All shares purchased must be held in trust for the employees, and cannot be sold for five years. The employee is not permitted to withdraw from the plan during that period. For example, if the employee ceases employment during the five-year period, the shares must nevertheless remain in the plan until the end of the five-year period. Any dividends paid during the five-year period will be held in trust for the employees until the end of the five-year period.

In total, 800 employees accept the offer and each employee purchases, on average, 80 shares, i.e., the employees purchase a total of 64,000 shares. The weighted-average market price of the shares at the purchase date is ₹ 30 per share, and the weighted-average purchase price is ₹.24 per shares.

Suggested Accounting Treatment

Paragraph 15 of the text of the Guidance Note provides that the enterprise should measure the fair value of the employee services received by reference to the fair value of the shares or stock options

granted. To apply this requirement, it is necessary first to determine the type of instrument granted to the employees. Although the plan is described as an employee stock purchase plan (ESPP), some ESPPs include option features and are therefore, in effect, stock option plans. For example, an ESPP might include a 'lookback feature', whereby the employee is able to purchase shares at a discount, and choose whether the discount is applied to the share price of the enterprise at the date of grant or its share price at the date of purchase. Or an ESPP might specify the purchase price, and then allow the employees a significant period of time to decide whether to participate in the plan. Another example of an option feature is an ESPP that permits the participating employees to cancel their participation before or at the end of a specified period and obtain a refund of amounts previously paid into the plan.

However, in this example, the plan includes no option features. The discount is applied to the share price at the purchase date, and the employees are not permitted to withdraw from the plan.

Another factor to consider is the effect of post-vesting transfer restrictions, if any. Paragraph 3 of the Appendix I to the Guidance Note states that, if shares are subject to restrictions on transfer after vesting date, that factor should be taken into account when estimating the fair value of those shares, but only to the extent that the post-vesting restrictions affect the price that a knowledgeable, willing market participant would pay for that share. For example, if the shares are actively traded in a deep and liquid market, post-vesting transfer restrictions may have little, if any, effect on the price that a knowledgeable, willing market participant would pay for those shares. In this example, the shares are vested when purchased, but cannot be sold for five years after the date of purchase. Therefore, the enterprise should consider the valuation effect of the five-year post-vesting transfer restriction. This entails using a valuation technique to estimate what the price of the restricted share would have been on the purchase date in an arm's length transaction between knowledgeable, willing parties. Suppose that, in this example, the enterprise estimates that the fair value of each restricted share is ₹ 28. In this case, the fair value of the instruments granted is ₹ 4 per share (being the fair value of the restricted share of ₹ 28 less the purchase price of ₹ 24). Because 64,000 shares were purchased, the total fair value of the instruments granted is ₹ 2,56,000.

In this example, there is no vesting period. Therefore, in accordance with paragraph 11 of the text of the Guidance Note, the enterprise should recognise an expense of ₹ 2,56,000 immediately.

Appendix III

Modifications to the Term and Conditions of Equity-Settled Employee Share-based Payment Plans

Illustration 1: Grant of Stock Options that are Subsequently Repriced

At the beginning of year 1, an enterprise grants 100 stock options to each of its 500 employees. The grant is conditional upon the employee remaining in service over the next three years. The enterprise estimates that the fair value of each option is ₹ 15. On the basis of a weighted average probability, the enterprise estimates that 100 employees will leave during the three-year period and therefore forfeit their rights to the stock options.

Suppose that 40 employees leave during year 1. Also suppose that by the end of year 1, the share price of the enterprise has dropped, and the enterprise reprices its stock options, and that the repriced stock options vest at the end of year 3. The enterprise estimates that a further 70 employees will leave during years 2 and 3, and hence the total expected employee departures over the three-year vesting period is 110 employees. During year 2, a further 35 employees leave, and the enterprise estimates that a further 30 employees will leave during year 3, to bring the total expected employee departures over the three-year vesting period to 105 employees. During year 3, a total of 28 employees leave, and

hence a total of 103 employees ceased employment during the vesting period. For the remaining 397 employees, the stock options vested at the end of year 3.

The enterprise estimates that, at the date of repricing, the fair value of each of the original stock options granted (i.e., before taking into account the repricing) is ₹ 5 and that the fair value of each repriced stock option is ₹ 8.

Suggested Accounting Treatment

Paragraph 24 of the text of the Guidance Note requires the enterprise to recognise the effects of modifications that increase the total fair value of the employee share-based payment plans or are otherwise beneficial to the employee. If the modification increases the fair value of the shares or stock options granted (e.g., by reducing the exercise price), measured immediately before and after the modification, paragraph 25(a) of the text of this Guidance Note requires the enterprise to include the incremental fair value granted (i.e., the difference between the fair value of the modified instrument and that of the original instrument, both estimated as at the date of the modification) in the measurement of the amount recognised for services received as consideration for the instruments granted. If the modification occurs during the vesting period, the incremental fair value granted is included in the measurement of the amount recognised for services received over the period from the modification date until the date when the modified instruments vest, in addition to the amount based on the grant date fair value of the original instruments, which is recognised over the remainder of the original vesting period.

The incremental value is ₹ 3 per stock option (₹ 8 – ₹ 5). This amount is recognised over the remaining two years of the vesting period, along with remuneration expense based on the original option value of ₹ 15.

The amounts recognised towards employees services received in years 1-3 are as follows:

| Year | Calculation | Compensation expense for period (₹.) | Cumulative compensation expense (₹.) |
|------|---|--------------------------------------|--------------------------------------|
| 1 | $(500 - 110) \text{ employees} \times 100 \text{ options} \times ₹ 15 \times 1/3$ | 1,95,000 | 1,95,000 |
| 2. | $(500 - 105) \text{ employees} \times 100 \text{ options} \times (₹ 15 \times 2/3 + ₹ 3 \times 1/2) - ₹ 1,95,000$ | 2,59,250 | 4,54,250 |
| 3. | $(500 - 103) \text{ employees} \times 100 \text{ options} \times (₹ 15 + ₹ 3) - ₹ 4,54,250$ | 2,60,350 | 7,14,600 |

Illustration 2: Grant of Stock Options with A Vesting Condition that is Subsequently Modified

At the beginning of year 1, the enterprise grants 1,000 stock options to each member of its sales team, conditional upon the employees remaining in the employment of the enterprise for three years, and the team selling more than 50,000 units of a particular product over the three-year period. The fair value of the stock options is ₹ 15 per option at the date of grant.

During year 2, the enterprise increases the sales target to 1,00,000 units. By the end of year 3, the enterprise has sold 55,000 units, and the stock options do not vest. Twelve members of the sales team have remained in service for the three-year period.

Suggested Accounting Treatment

Paragraph 19 of the text of the Guidance Note requires, for a performance condition that is not a market condition, the enterprise to recognise the services received during the vesting period based on the best available estimate of the number of shares or stock options expected to vest and to revise that

estimate, if necessary, if subsequent information indicates that the number of shares or stock options expected to vest differs from previous estimates. On vesting date, the enterprise revises the estimate to equal the number of instruments that ultimately vested. However, paragraph 24 of the text of the Guidance Note requires, irrespective of any modifications to the terms and conditions on which the instruments were granted, or a cancellation or settlement of that grant of instruments, the enterprise to recognise, as a minimum, the services received, measured at the grant date fair value of the instruments granted, unless those instruments do not vest because of failure to satisfy a vesting condition (other than a market condition) that was specified at grant date. Furthermore, paragraph 26(c) of the text of this Guidance Note specifies that, if the enterprise modifies the vesting conditions in a manner that is not beneficial to the employee, the enterprise does not take the modified vesting conditions into account when applying the requirements of paragraphs 18 to 20 of the text of the Guidance Note.

Therefore, because the modification to the performance condition made it less likely that the stock options will vest, which was not beneficial to the employee, the enterprise takes no account of the modified performance condition when recognising the services received. Instead, it continues to recognise the services received over the three-year period based on the original vesting conditions. Hence, the enterprise ultimately recognizes cumulative remuneration expense of ₹ 1,80,000 over the three-year period (12 employees × 1,000 options × ₹ 15).

The same result would have occurred if, instead of modifying the performance target, the enterprise had increased the number of years of service required for the stock options to vest from three years to ten years. Because such a modification would make it less likely that the options will vest, which would not be beneficial to the employees, the enterprise would take no account of the modified service condition when recognising the services received. Instead, it would recognise the services received from the twelve employees who remained in service over the original three-year vesting period.

Appendix IV

Cash-Settled Employee Share-based Payment Plans

Continuing, Illustration 1(A) of Appendix II, suppose the enterprise has granted stock appreciation rights (SARs) to its employees, instead of the options whereby the enterprise pays cash to the employees equal to the intrinsic value of the SARs as on the exercise date. The SARs are granted on the condition that the employees remain in its employment for the next three years. The contractual life [comprising the vesting period (3 years) and the exercise period (2 years)] of SARs is 5 years.

The other facts of the Illustration are the same as those in Illustration 1(A) of Appendix II. However, it is also assumed that at the end of year 3, 400 employees exercise their SARs, another 300 employees exercise their SARs at the end of year 4 and the remaining 140 employees exercise their SARs at the end of year 5.

The enterprise estimates the fair value of the SARs at the end of each year in which a liability exists and the intrinsic value of the SARs at the end of years 3, 4 and 5. The values estimated by the enterprise are as below:

| Year | Fair Value | Intrinsic Value |
|------|------------|-----------------|
| 1 | ₹ 15.30 | |
| 2 | ₹ 16.50 | |
| 3 | ₹ 19.20 | ₹ 16.00 |
| 4 | ₹ 21.30 | ₹ 21.00 |
| 5 | | ₹ 26.00 |

Suggested Accounting Treatment

1. The expense to be recognised each year in respect of SARs are determined as below:

Year 1

| | | |
|---|---|---------------|
| No. of SARs expected to vest (as per the original estimate) | | |
| 1,000 x 300 x 0.97 x 0.97 x 0.97 | = | 2,73,802 SARs |
| Provision required at the year-end | | |
| 2,73,802 SARs x ₹ 15.30 x 1/3 | = | ₹ 13,96,390 |
| Less: provision at the beginning of the year | | Nil |
| Expense for the year | | ₹ 13,96,390 |

Year 2

| | | |
|--|---|---------------|
| No. of SARs expected to vest (as per the revised estimate) | | |
| 1,000 x 300 x 0.94 x 0.94 x 0.94 | = | 2,49,175 SARs |
| Provision required at the year-end | | |
| 2,49,175 SARs x ₹ 16.50 x 2/3 | = | ₹ 27,40,925 |
| Less: provision at the beginning of the year | | ₹ (13,96,390) |
| Expense for the year | | ₹ 13,44,535 |

Year 3

| | | |
|---|---|---------------|
| No. of SARs actually vested | | |
| 840 employees x 300 SARs | | 2,52,000 SARs |
| No. of SARs exercised at the year-end | | |
| 400 employees x 300 SARs | | 1,20,000 SARs |
| No. of SARs outstanding at the year-end | | 1,32,000 SARs |
| Provision required in respect of SARs outstanding at the year-end | | |
| 1,32,000 SARs x ₹ 19.20 | = | ₹ 25,34,400 |
| Plus: Cash paid on exercise of SARs by employees | | |
| 1,20,000 SARs x ₹ 16.00 | = | ₹ 19,20,000 |

| | | |
|--|--|---------------|
| <i>Total</i> | | ₹ 44,54,400 |
| Less: provision at the beginning of the year | | ₹ (27,40,925) |
| Expense for the year | | ₹ 17,13,475 |

Year 4

| | | |
|---|---|---------------|
| No. of SARs outstanding at the beginning of the year | | 1,32,000 SARs |
| No. of SARs exercised at the year-end | | |
| 300 employees x 300 SARs | | 90,000 SARs |
| No. of SARs outstanding at the year-end | | 42,000 SARs |
| Provision required in respect of SARs outstanding at the year-end | | |
| 42,000 SARs x ₹ 21.30 | = | ₹ 8,94,600 |

| | | |
|---|---|---------------|
| <i>Plus:</i> Cash paid on exercise of SARs | | |
| 90,000 SARs x ₹ 21.00 | = | ₹.18,90,000 |
| <i>Total</i> | | ₹ 27,84,600 |
| <i>Less:</i> provision at the beginning of the year | | ₹ (25,34,400) |
| Expense for the year | | ₹ 2,50,200 |

Year 5

| | |
|---|-------------|
| No. of SARs outstanding at the beginning of the year | 42,000 SARs |
| No. of SARs exercised at the year-end | |
| 140 employees x 300 SARs | 42,000 SARs |
| No. of SARs outstanding at the year-end | Nil |
| Provision required in respect of SARs outstanding at the year-end | Nil |

| | | |
|---|---|--------------|
| <i>Plus:</i> Cash paid on exercise of SARs | | |
| 42,000 SARs x ₹ 26.00 | = | ₹.10,92,000 |
| <i>Total</i> | | ₹ 10,92,000 |
| <i>Less:</i> provision at the beginning of the year | | ₹ (8,94,600) |
| Expense for the year | | ₹ 1,97,400 |

2. The enterprise passes the following entry, in each of the years, to recognise the compensation expense determined as above:

| | |
|--------------------------------------|-----------|
| Employee compensation expense A/c | Dr. _____ |
| To Provision for payment of SARs A/c | _____ |

(Being compensation expense recognised in respect of SARs)

3. The enterprise passes the following entry, in the years 3, 4 and 5, to record the cash paid on exercise of SARs:

| | |
|-----------------------------------|-----------|
| Provision for payment of SARs A/c | Dr. _____ |
| To Bank A/c | _____ |

(Being cash paid on exercise of SARs)

4. Balance in the 'Provision for payment of SARs Account', outstanding at year-end, is disclosed in the balance sheet, as a provision under the heading 'Current Liabilities and Provisions'.

Intrinsic Value Method

The accounting treatment suggested above is based on the fair value method. In case the enterprise has followed the intrinsic value method instead of the fair value method, it would make all the computations suggested above on the basis of intrinsic value of SARs on the respective dates instead of the fair value. To illustrate, suppose the intrinsic value of SARs at the grant date is ₹ 6 per right. The intrinsic values of the SARs on the subsequent dates are as below:

| Year | Intrinsic Value |
|------|-----------------|
| 1 | ₹ 9.00 |

V-84 Financial Reporting

| | |
|---|---------|
| 2 | ₹ 12.00 |
| 3 | ₹ 16.00 |
| 4 | ₹ 21.00 |
| 5 | ₹ 26.00 |

In the above case, the enterprise would determine the expense to be recognised each year in respect of SARs as below:

Year 1

No. of SARs expected to vest (as per the original estimate)

$$1,000 \times 300 \times 0.97 \times 0.97 \times 0.97 = 2,73,802 \text{ SARs}$$

Provision required at the year-end

$$2,73,802 \text{ SARs} \times ₹ 9.00 \times 1/3 = ₹ 8,21,406$$

Less: provision at the beginning of the year Nil

$$\text{Expense for the year} = ₹ 8,21,406$$

Year 2

No. of SARs expected to vest (as per the revised estimate)

$$1,000 \times 300 \times 0.94 \times 0.94 \times 0.94 = 2,49,175 \text{ SARs}$$

Provision required at the year-end

$$2,49,175 \text{ SARs} \times ₹ 12.00 \times 2/3 = ₹ 19,93,400$$

Less: provision at the beginning of the year

$$₹ (8,21,406)$$

Expense for the year

$$₹ 11,71,994$$

Year 3

No. of SARs actually vested

$$840 \text{ employees} \times 300 \text{ SARs} = 2,52,000 \text{ SARs}$$

No. of SARs exercised at the year-end

$$400 \text{ employees} \times 300 \text{ SARs} = 1,20,000 \text{ SARs}$$

No. of SARs outstanding at the year-end

$$1,32,000 \text{ SARs}$$

Provision required in respect of SARs outstanding at the year-end

$$1,32,000 \text{ SARs} \times ₹ 16.00 = ₹ 21,12,000$$

Plus: Cash paid on exercise of SARs by employees

$$1,20,000 \text{ SARs} \times ₹ 16.00 = ₹ 19,20,000$$

Total

$$₹ 40,32,000$$

Accounting for Employee Share-based Payments 337

Less: provision at the beginning of the year

$$₹ (19,93,400)$$

Expense for the year

$$₹ 20,38,600$$

| | |
|--|---------------|
| <i>Year 4</i> | |
| No. of SARs outstanding at the beginning of the year | 1,32,000 SAR₹ |
| No. of SARs exercised at the year-end 300 employees x 300 SARs | 90,000 SARs |
| No. of SARs outstanding at the year-end | 42,000 SARs |
| Provision required in respect of SARs outstanding at the year-end 42,000 SARs x ₹ 21.00 | = ₹ 8,82,000 |
| <i>Plus:</i> Cash paid on exercise of SARs 90,000 SARs x ₹ 21.00 = | ₹ 18,90,000 |
| <i>Total</i> | ₹ 27,72,000 |
| <i>Less:</i> provision at the beginning of the year | ₹ (21,12,000) |
| Expense for the year | ₹ 6,60,000 |
| <i>Year 5</i> | |
| No. of SARs outstanding at the beginning of the year | 42,000 SARs |
| No. of SARs exercised at the year-end 140 employees x 300 SARs | 42,000 SARs |
| No. of SARs outstanding at the year-end | Nil |
| Provision required in respect of SARs outstanding at the year-end | Nil |
| <i>Plus:</i> Cash paid on exercise of SARs 42,000 SARs x ₹ 26.00 = | ₹ 10,92,000 |
| <i>Total</i> | ₹ 10,92,000 |
| <i>Less:</i> provision at the beginning of the year | ₹ (8,82,000) |
| Expense for the year | ₹ 2,10,000 |

Appendix V

Employee Share-based Payment Plan with Cash Alternatives

Illustration : An enterprise grants to an employee the right to choose either a cash payment equal to the value of 1,000 shares, or 1,200 shares. The grant is conditional upon the completion of three years' service. If the employee chooses the equity alternative, the shares must be held for three years after vesting date. The face value of shares is ₹ 10 per share.

At grant date, the fair value of the shares of the enterprise (without considering post-vesting restrictions) is ₹ 50 per share. At the end of years 1, 2 and 3, the said fair value is ₹ 52, ₹ 55 and ₹ 60 per share respectively. The enterprise does not expect to pay dividends in the next three years. After taking into account the effects of the post-vesting transfer restrictions, the enterprise estimates that the grant date fair value of the equity alternative is ₹ 48 per share.

At the end of year 3, the employee chooses:

Scenario 1: The cash alternative

Scenario 2: The equity alternative

Suggested Accounting Treatment

1. The employee share-based payment plan granted by the enterprise has two components, viz., (i) a liability component, i.e., the employees' right to demand settlement in cash, and (ii) an equity component, i.e., the employees' right to demand settlement in shares rather than in cash. The enterprise measures, on the grant date, the fair value of two components as below:

| | |
|---------------------------------------|----------|
| Fair value under equity settlement | |
| 1,200 shares x ₹ 48 = | ₹ 57,600 |
| Fair value under cash settlement | |
| 1,000 shares x ₹ 50 = | ₹ 50,000 |
| Fair value of the equity component | |
| (₹ 57,600 – ₹ 50,000) = | ₹ 7,600 |
| Fair value of the liability component | ₹ 50,000 |

2. The enterprise calculates the expense to be recognised in respect of the liability component at the end of each year as below:

Year 1

| | |
|--|----------|
| Provision required at the year-end | |
| 1,000 x ₹ 52.00 x 1/3 = | ₹ 17,333 |
| Less: provision at the beginning of the year | Nil |
| Expense for the year | ₹ 17,333 |

Year 2

| | |
|--|----------|
| Provision required at the year-end | |
| 1,000 x ₹ 55.00 x 2/3 = | ₹ 36,667 |
| Less: provision at the beginning of the year | ₹ 17,333 |
| Expense for the year | ₹ 19,334 |

Year 3

| | |
|--|----------|
| Provision required at the year-end | |
| 1,000 x ₹ 60.00 = | ₹ 60,000 |
| Less: provision at the beginning of the year | ₹ 36,667 |
| Expense for the year | ₹ 23,333 |

3. The expense to be recognised in respect of the equity component at the end of each year is one third of the fair value (₹ 7,600) determined at (1) above.

4. The enterprise passes the following entry at the end of each of the years to recognise compensation expense towards liability component determined at (2) above:

| | | |
|---|-----------|-------|
| Employee compensation expense A/c | Dr. _____ | |
| To Provision for liability component of employee share-based payment plan | | _____ |

(Being compensation expense recognised in respect of liability component of employee share-based payment plan with cash alternative)

5. The enterprise passes the following entry at the end of each of the year to recognise compensation expense towards equity component determined at (3) above:

| | |
|-----------------------------------|-----------|
| Employee compensation expense A/c | Dr. _____ |
| To Stock Options Outstanding A/c | _____ |

(Being compensation expense recognised in respect of equity component of employee share-based payment plan with cash alternative)

6. Provision for liability component of employee share-based payment plan, outstanding at year-end, is disclosed in the balance sheet, as a provision under the heading 'Current Liabilities and Provisions'. Credit balance in the 'Stock Options Outstanding A/c' is disclosed under a separate heading, between 'Share Capital' and 'Reserves and Surplus'.

7. The enterprise passes the following entry on the settlement of the employee share-based payment plan with cash alternative:

Scenario 1: The cash alternative

| | |
|--|--------------|
| Provision for liability component of employee share-based payment plan | Dr. ₹ 60,000 |
| To Bank A/c | ₹ 60,000 |

(Being cash paid on exercise of cash alternative under the employee share-based payment plan)

| | |
|-------------------------------|-------------|
| Stock Options Outstanding A/c | Dr. ₹ 7,600 |
| To General Reserve | ₹ 7,600 |

(Being the balance standing to the credit of the Stock Options Outstanding Account transferred to the general reserve upon exercise of cash alternative)

Scenario 2: The equity alternative

| | |
|--|--------------|
| Stock Options Outstanding A/c | Dr. ₹ 7,600 |
| Provision for liability component of employee share-based payment plan | Dr. ₹ 60,000 |
| To Share Capital A/c (1,000 shares x ₹ 10) | ₹ 10,000 |
| To Securities Premium A/c | ₹ 57,600 |

(Being shares issued on exercise of equity alternative under the employee share-based payment plan)

Appendix VI

Graded Vesting

Continuing Illustration 1(A) of Appendix II, suppose that the options granted vest according to a graded schedule of 25 per cent at the end of the year 1, 25 per cent at the end of the year 2, and the remaining 50 per cent at the end of the year 3. The expected lives of the options that vest at the end of the year 1, 2 and 3 are 2.5 years, 4 years and 5 years respectively. The fair values of these options, computed based on their respective expected lives, are ₹ 10, ₹ 13 and ₹ 15 per option, respectively. It is also assumed that expected forfeiture rate is 3% per year and does not change during the vesting period.

Suggested Accounting Treatment

1. Since the options granted have a graded vesting schedule, the enterprise segregates the total

plan into different groups, depending upon the vesting dates and treats each of these groups as a separate plan.

2. The enterprise determines the number of options expected to vest under each group as below:

Vesting Date (Year-end) Options expected to vest

1 300 options x 1,000 employees x 25% x 0.97 = 72,750 options

2 300 options x 1,000 employees x 25% x 0.97 x .97= 70,568 options

3 300 options x 1,000 employees x 50% x 0.97

x .97 x .97 =1,36,901 options

Total options expected to vest 2,80,219 options

3. Total compensation expense for the options expected to vest is determined as follows:

| Vesting Date (Year-end) | Expected Vesting (No. of Options) | Value per Option (₹.) | Compensation Expense (₹.) |
|-------------------------|-----------------------------------|-----------------------|---------------------------|
| 1 | 72,750 | 10 | 7,27,500 |
| 2 | 70,568 | 13 | 9,17,384 |
| 3 | 1,36,901 | 15 | 20,53,515 |
| | <i>Total</i> | | 36,98,399 |

4. Compensation expense, determined as above, is recognised over the respective vesting periods. Thus, the compensation expense of ₹ 7,27,500 attributable to 72,750 options that vest at the end year 1, is allocated to the year 1. The expense of ₹ 9,17,384 attributable to the 70,568 options that vest at the end of year 2 is allocated over their 2-year vesting period (year 1 and year 2). The expense of ₹ 20,53,515 attributable to the 1,36,901 options that vest at the end of year 3 is allocated over their 3-year vesting period (year 1, year 2 and year 3). Total compensation expense of ₹ 36,98,399, determined at the grant date, is attributed to the years 1, 2 and 3 as below:

| Vesting Date (End of year) | Cost to be recognised | | |
|----------------------------|-----------------------|------------------|-----------------|
| | Year 1 | Year 2 | Year 3 |
| 1 | 7,27,500 | | |
| 2 | 4,58,692 | 4,58,692 | |
| 3 | <u>6,84,505</u> | <u>6,84,505</u> | <u>6,84,505</u> |
| Cost for the year | <u>18,70,697</u> | <u>11,43,197</u> | <u>6,84,505</u> |
| Cumulative cost | 18,70,697 | 30,13,894 | 36,98,399 |

Intrinsic Value Method

The accounting treatment suggested above is based on the fair value method. In case the enterprise has followed the intrinsic value method instead of the fair value method, it would make computations suggested above on the basis of intrinsic value of options at the grant date (which would be the same for all groups) instead of the fair value. To illustrate, suppose the intrinsic value of the option at the grant date is ₹ 6 per option. In such a case, total compensation expense for the options expected to vest would be

| Vesting Date (End of year) | Expected Vesting (No. of Options) | Value per Option (₹.) | Compensation Expense (₹.) |
|----------------------------|-----------------------------------|-----------------------|---------------------------|
| 1 | 72,750 | 6 | 4,36,500 |

| | | | |
|---|--------------|-----|-----------|
| 2 | 70,568 | 64, | 23,408 |
| 3 | 1,36,901 | 6 | 8,21,406 |
| | <i>Total</i> | | 16,81,314 |

Total compensation expense of ₹ 16,81,314, determined at the grant date, would be attributed to the years 1, 2 and 3 as below:

| Vesting Date (End of year) | Cost to be recognised | | |
|-------------------------------|-----------------------|-----------------|-----------------|
| | Year 1 | Year 2 | Year 3 |
| 1 | 4,36,500 | | |
| 2 | 2,11,704 | 2,11,704 | |
| 3 | <u>2,73,802</u> | <u>2,73,802</u> | <u>2,73,802</u> |
| Cost for the year | <u>9,22,006</u> | <u>4,85,506</u> | <u>2,73,802</u> |
| Cumulative cost | 9,22,006 | 14,07,512 | 16,81,314 |

Appendix VII

Accounting for Employee Share-based Payment Plans Administered Through a Trust

Illustration 1: Enterprise Allots Shares To The Esop Trust As And When The Employees Exercise Stock Options

At the beginning of year 1, an enterprise grants 300 stock options to each of its 1,000 employees, conditional upon the employees remaining in the employment of the enterprise for one year. The fair value of the stock options, at the date of grant, is ₹ 15 per option and the exercise price is ₹ 50 per share. The options can be exercised in one year after the date of vesting. The other relevant terms of the grant and assumptions are as below:

- The grant is administered by an ESOP trust appointed by the enterprise. According to the terms of appointment, the enterprise agrees to allot shares to the ESOP trust as and when the stock options are exercised by the employees.
- The number of employees expected to complete one year vesting period, at the beginning of the plan, is 900, i.e., 100 employees are expected to leave during the vesting period and, consequently, the options granted to them are expected to be forfeited.
- Actual forfeitures, during the vesting period, are equal to the expected forfeitures and 900 employees have actually completed one year vesting period.
- All 900 employees exercised their right to obtain shares vested in them in pursuance of the ESOP at the end of year 2.
- Apart from the shares allotted to the trust, the enterprise has 10,00,000 shares of ₹ 10 each outstanding at the end of year 1. The said shares were issued at a premium of ₹ 15 per share. The full amount of premium received on issue of shares is still standing to the credit of the Securities Premium Account. The enterprise has not made any change in the share capital upto the end of year 2, except that arising from transactions with the employees pursuant to the Employee Stock Option Plan.

Suggested Accounting Treatment

The accounting treatment, in this case, would be the same as explained in the case where the enterprise itself is administering the Employee Stock Option Plan (ESOP) although the enterprise issues shares to the ESOP Trust instead of issuing shares to the employees directly. The accounting

treatment in this case is explained hereinbelow.

Year 1

1. At the grant date, the enterprise estimates the fair value of the options expected to vest at the end of the vesting period as below:

No. of options expected to vest

$$(1,000 - 100) \text{ employees} \times 300 \text{ options} = 2,70,000 \text{ options}$$

Fair value of options expected to vest

$$2,70,000 \text{ options} \times ₹ 15 = ₹ 40,50,000$$

2. At the end of the financial year, the enterprise examines its actual forfeitures and makes necessary adjustments, if any, to reflect expense for the number of options that actually vested. Considering that actual forfeitures, during the vesting period, are equal to the expected forfeitures and 900 employees have actually completed one year vesting period, the enterprise recognises the fair value of options expected to vest (estimated at 1 above) towards the employee services received by passing the following entry:

Employee compensation expense A/c Dr. ₹ 40,50,000

To Stock Options Outstanding A/c ₹ 40,50,000

(Being compensation expense recognised in respect of the ESOP)

3. Credit balance in the 'Stock Options Outstanding Account' is disclosed in the balance sheet under a separate heading, between 'Share Capital' and 'Reserves and Surplus', as below:

Extracts from the Balance Sheet

| Liabilities | Amount (₹) |
|--|-------------|
| Share Capital | |
| <i>Paid-up Capital:</i> | |
| 10,00,000 equity shares of ₹ 10 each | 1,00,00,000 |
| Stock Options Outstanding Account | 40,50,000 |
| Reserves and Surplus | |
| Securities Premium A/c (10,00,000 shares x ₹ 15) | 1,50,00,000 |

Year 2

1. On exercise of the right to obtain shares by the employees, the enterprise allots shares to the ESOP Trust for issuance to the employees. The shares so issued are considered to have been issued on a consideration comprising the exercise price and the fair value of the options. In the present case, the exercise price is ₹ 50 per share and the fair value of the options is ₹ 15 per option. The enterprise, therefore, considers the shares to be issued at a price of ₹ 65 per share.

2. The amount to be recorded in the 'Share Capital Account' and the 'Securities Premium Account', upon issuance of the shares, is calculated as below:

| Particulars | Computations |
|---|--------------|
| No. of employees exercising option | 900 |
| No. of shares issued on exercise @ 300 per employee | 2,70,000 |
| Exercise Price @ ₹ 50 per share | 1,35,00,000 |

| | |
|---|-------------|
| Fair value of options @ ₹ 15 per option | 40,50,000 |
| <i>Total Consideration</i> | 1,75,50,000 |
| Amount to be recorded in 'Share Capital A/c' @ ₹ 10 per share | 27,00,000 |
| Amount to be recorded in 'Securities Premium A/c' @ ₹ 55 per share | 1,48,50,000 |
| <i>Total</i> | 1,75,50,000 |

3. The ESOP Trust receives exercise price from the employees exercising the options vested in them in pursuance of the Employee Stock Option Plan. The Trust passes on the exercise price so received to the enterprise for issuance of shares to the employees. The enterprise allots shares to the ESOP Trust for issuance to the employees exercising the options vested in them in pursuance of the Employee Stock Option Plan. To recognise the transaction, the following entry is passed:

| | |
|-----------------------------------|---------------|
| Bank A/c Dr. | ₹ 1,35,00,000 |
| Stock Options Outstanding A/c Dr. | ₹ 40,50,000 |
| To Share Capital A/c | ₹ 27,00,000 |
| To Securities Premium A/c | ₹ 1,48,50,000 |

(Being shares allotted to the ESOP Trust for issuance to the employees against the options vested in them in pursuance of the Employee Stock Option Plan)

4. The Share Capital Account and the Securities Premium Account are disclosed in the balance sheet as below:

Extracts from the Balance Sheet

| Liabilities | Amount (₹.) |
|---|-------------|
| Share Capital | |
| <i>Paid-up Capital:</i> | |
| 12,70,000 equity shares of ₹ 10 each fully paid (Of the above, 2,70,000 shares of ₹ 10 each have been issued to the employees pursuant to an Employee Share-based Payment Plan. The issue price of the share was ₹ 65 per share out of which ₹ 15 per share were received in the form of employee services over a period of one year). | 1,27,00,000 |
| Reserves and Surplus | |
| Securities Premium A/c | 2,98,50,000 |

Computation of Earnings Per Share

For the purpose of calculating Basic EPS, stock options granted pursuant to the employee share-based payment plan would not be included in the shares outstanding till the employees have exercised their right to obtain shares, after fulfilling the requisite vesting conditions. Till such time, stock options so granted would be considered as dilutive potential equity shares for the purpose of calculating Diluted EPS.

Illustration 2: Enterprise Provides Finance to the ESOP Trust for Subscription to Shares Issued by the Enterprise at the Beginning of the Plan

Continuing Illustration 1 above, suppose the enterprise provides finance, at the grant date, to the ESOP trust for subscription to the shares of the enterprise equivalent to the number of shares expected to vest. With the help of finance provided by the enterprise, the trust subscribes to the shares offered by the enterprise at a cash price of ₹ 50 per share, at the beginning of the plan. The Trust would issue shares to the employees as and when they exercise the right vested in them in pursuance of the Employee Stock Option Plan (ESOP). The other facts of the case are the same as in Illustration 1.

Suggested Accounting Treatment

The computations of employee compensation expense, amount to be recognised in the Share Capital Account and the Securities Premium Account, etc., would be the same as that in Illustration 1 above.

Year 1

1. The enterprise passes the following entry to record provision of finance [₹ 1,35,00,000 (i.e., 2,70,000 shares x ₹ 50)] to the ESOP trust:

| | | | |
|--|-----|---------------|---------------|
| Amount recoverable from ESOP Trust A/c | Dr. | ₹ 1,35,00,000 | |
| To Bank A/c | | | ₹ 1,35,00,000 |

(Being finance provided to the ESOP trust for subscription of shares)

2. The enterprise passes the following entry to record the allotment of 2,70,000 shares to the ESOP Trust at ₹ 65 per share [comprising the exercise price (₹ 50) and the fair value of options (₹ 15)]:

| | | | |
|--|-----|---------------|---------------|
| Bank A/c | Dr. | ₹ 1,35,00,000 | |
| Amount recoverable from ESOP Trust A/c | Dr. | ₹ 40,50,000 | |
| To Share Capital A/c | | | ₹ 27,00,000 |
| To Securities Premium A/c | | | ₹ 1,48,50,000 |

(Being shares allotted to the ESOP Trust in respect of the Employee Stock Option Plan)

3. The enterprise passes the following entry to recognise the employee services received during the year:

| | | | |
|-----------------------------------|-----|-------------|-------------|
| Employee compensation expense A/c | Dr. | ₹ 40,50,000 | |
| To Stock Options Outstanding A/c | | | ₹ 40,50,000 |

(Being compensation expense recognised in respect of the ESOP)

4. The Share Capital Account, the Securities Premium Account, credit balance in the 'Stock Options Outstanding Account' and debit balance in the 'Amount recoverable from ESOP Trust Account' are disclosed in the balance sheet as below:

Extracts from the Balance Sheet

| Liabilities | Amount (₹) | |
|--|-------------|-------------|
| Share Capital | | |
| <i>Paid-up Capital:</i> | | |
| 12,70,000 equity shares of ₹ 10 each | 1,27,00,000 | |
| Less: Amount recoverable from ESOP Trust (face value of 2,70,000 share allotted to the Trust) | 27,00,000 | 1,00,00,000 |
| Stock Options Outstanding Account | 40,50,000 | |

| | | |
|---|-------------|-------------|
| Reserves and Surplus | | |
| Securities Premium Account | 2,98,50,000 | |
| Less: Amount recoverable from ESOP Trust (Premium on 2,70,000 share allotted to the Trust) | 1,48,50,000 | 1,50,00,000 |

5. Apart from other required disclosures, the enterprise gives a suitable note in the Notes to Accounts to explain the transaction and the nature of deduction of the 'Amount recoverable from ESOP Trust' made from the 'Share Capital' and the 'Securities Premium Account'.

Year 2

1. On exercise of the right to obtain shares, the ESOP trust issues shares to the respective employees after receiving the exercise price of ₹ 50 per share. The ESOP Trust passes on the exercise price received on issue of shares to the enterprise. The enterprise passes the following entry to record the receipt of the exercise price:

| | | | |
|----------|-----|---|---------------|
| Bank A/c | Dr. | ₹ 1,35,00,000 | |
| | | To Amount recoverable from ESOP Trust A/c | ₹ 1,35,00,000 |

(Being amount received from the ESOP Trust against finance provided to it at the beginning of the Employee Stock Option Plan)

2. The enterprise transfers the balance standing to the credit of the 'Stock Options Outstanding Account' to the 'Amount recoverable from ESOP Trust Account' by passing the following entry:

| | | | |
|-------------------------------|-----|---|-------------|
| Stock Options Outstanding A/c | Dr. | ₹ 40,50,000 | |
| | | To Amount recoverable from ESOP Trust A/c | ₹ 40,50,000 |

(Being consideration for shares issued to the employees received in the form of employee services adjusted against the relevant account)

3. The Share Capital Account and the Securities Premium Account are disclosed in the balance sheet as below:

Extracts from the Balance Sheet

| <i>Liabilities</i> | <i>Amount (₹.)</i> |
|---|--------------------|
| Share Capital | |
| <i>Paid-up Capital:</i> | |
| 12,70,000 equity shares of ₹ 10 each fully paid (Of the above, 2,70,000 shares of ₹ 10 each have been issued to the employees (through ESOP Trust) pursuant to an Employee Share-based Payment Plan. The issue price of the share was ₹ 65 per share out of which ₹ 15 per share were received in the form of employee services over a period of one year). | 1,27,00,000 |
| Reserves and Surplus | |
| Securities Premium Account | 2,98,50,000 |

Computation of Earnings Per Share

For the purpose of calculating Basic EPS, shares allotted to the ESOP Trust pursuant to the employee share-based payment plan would not be included in the shares outstanding till the employees have exercised their right to obtain shares, after fulfilling the requisite vesting conditions. Till such time, the shares so allotted would be considered as dilutive potential equity shares for the purpose of calculating Diluted EPS.

Illustration 3: Enterprise Provides Finance To The Esop Trust To Purchase Shares From The Market At The Beginning Of The Plan

Continuing Illustration 2 above, suppose the enterprise does not issue fresh shares to the ESOP Trust. Instead, it provides finance, at the grant date, to the trust to purchase shares of the enterprise from the market, equivalent to the number of shares expected to vest. With the help of finance provided by the enterprise, the ESOP Trust purchases 2,70,000 shares from the market @ ₹ 52 per share at the beginning of the plan. The other facts remain the same as in Illustration 2 above.

Suggested Accounting Treatment

Year 1

- The enterprise passes the following entry to record provision of finance [₹ 1,40,40,000 (i.e., 2,70,000 shares x ₹ 52)] to the ESOP trust:

| | | |
|--|-----|---------------|
| Amount recoverable from ESOP Trust A/c | Dr. | ₹ 1,40,40,000 |
| To Bank A/c | | ₹ 1,40,40,000 |

(Being finance provided to the ESOP trust for purchase of shares in respect of the ESOP)

- The enterprise passes the following entry at the end of the year to recognise the employee services received during the year:

| | | |
|-----------------------------------|-----|-------------|
| Employee compensation expense A/c | Dr. | ₹ 40,50,000 |
| To Stock Options Outstanding A/c | | ₹ 40,50,000 |

(Being compensation expense recognised in respect of the ESOP)

- Credit balance in the 'Stock Options Outstanding Account' is disclosed on the liability side of the balance sheet under a separate heading, between 'Share Capital' and 'Reserves and Surplus'. Debit balance in the 'Amount recoverable from ESOP Trust Account' is disclosed on the asset side under a separate heading, between the 'Investments' and the 'Current Assets, Loans and Advances'. On this basis, the relevant extracts of the balance sheet appear as below:

Extracts from the Balance Sheet

| Liabilities | Amount (₹.) |
|--|--------------------|
| Share Capital | |
| <i>Paid-up Capital:</i> | |
| 10,00,000 equity shares of ₹ 10 each | 1,00,00,000 |
| Stock Options Outstanding Account | 40,50,000 |
| Reserves and Surplus | |
| Securities Premium Account | 1,50,00,000 |
| Assets | Amount (₹.) |
| Investments — | |
| Amount recoverable from ESOP Trust | 1,40,40,000 |
| Current Assets, Loans and Advances — | |

- Apart from the other required disclosures, the enterprise gives a suitable note in the 'Notes to Accounts' to explain the transaction and the nature of the 'Amount recoverable from ESOP Trust'.

Year 2

- On exercise of the right to obtain shares by the employees, the ESOP trust issues shares to the

respective employees after receiving the exercise price. The exercise price so received is passed on to the enterprise.

The amount received, in this manner, is ₹ 1,35,00,000 (i.e., 900 employees x 300 options x ₹ 50). The enterprise passes the following entry to record the receipt of the exercise price:

| | | |
|---|-------------------|---------------|
| Bank A/c | Dr. ₹ 1,35,00,000 | |
| To Amount recoverable from ESOP Trust A/c | | ₹ 1,35,00,000 |

(Being amount received from the ESOP trust against the finance provided to it in respect of the Employee Stock Option Plan)

2. The enterprise transfers an amount equivalent to the difference between the cost of shares to the ESOP Trust and the exercise price from the 'Stock Options Outstanding Account' to the 'Amount recoverable from ESOP Trust Account'. In the present case, there is a difference of ₹ 2 per share (i.e., ₹ 52 – ₹ 50) between the cost of shares and the exercise price. The number of shares issued to the employees is 2,70,000. The enterprise, accordingly, transfers an amount of ₹ 5,40,000 from the 'Stock Options Outstanding Account' to the 'Amount recoverable from ESOP Trust Account' by passing the following entry:

| | | |
|---|----------------|------------|
| Stock Options Outstanding A/c | Dr. ₹ 5,40,000 | |
| To Amount recoverable from ESOP Trust A/c | | ₹ 5,40,000 |

(Being the difference between the cost of shares to the ESOP Trust and the exercise price adjusted)

3. The balance of ₹ 35,10,000 (i.e., ₹ 40,50,000 – ₹ 5,40,000)

standing to the credit of the 'Stock Options Outstanding Account' is transferred to the 'General Reserve' by passing the following entry:

| | | |
|-------------------------------|-----------------|-------------|
| Stock Options Outstanding A/c | Dr. ₹ 35,10,000 | |
| To General Reserve | | ₹ 35,10,000 |

(Being balance in the 'Stock Options Outstanding Account' transferred to the 'General Reserve', at the end of the Employee Stock Option Plan)

4. The Share Capital Account, the Securities Premium Account and the General Reserve are disclosed in the balance sheet as below:

Extracts from the Balance Sheet

| Liabilities | Amount (₹.) | |
|---|------------------|------------------|
| Share Capital | | |
| <i>Paid-up Capital:</i> | | |
| 10,00,000 equity shares of ₹ 10 each fully paid | 1,00,00,000 | |
| Reserves and Surplus | | |
| Securities Premium Account | 1,50,00,000 | |
| General Reserve | xx,xx,xxx | |
| <i>Add: Amount transferred from the Stock Options Outstanding Account</i> | <u>35,10,000</u> | <u>yy,yy,yyy</u> |

5. The enterprise gives a suitable note in the 'Notes to Accounts' to explain the nature of the addition of ₹ 35,10,000 made in the 'General Reserve'.

Computation of Earnings Per Share

In this case, the enterprise does not issue any new shares either at the beginning of the Employee Stock Option Plan or on exercise of stock options by the employees. Instead, the ESOP Trust purchases the shares from the market at the beginning of the plan and the employees exercising

options vested in them are granted shares out of the shares so purchased. The shares purchased by the Trust represent the shares that have already been issued by the enterprise and the same should continue to be included in the shares outstanding for the purpose of calculating Basic EPS as would have been done prior to the purchase of the shares by the Trust. Since the exercise of stock options granted under the plan does not result into any fresh issue of shares, the stock options granted would not be considered as dilutive potential equity shares for the purpose of calculating Diluted EPS.

Appendix VIII

Computation of Earnings Per Share

Illustration : At the beginning of year 1, an enterprise grants 300 stock options to each of its 1,000 employees, conditional upon the employees remaining in the employment of the enterprise for two years. The fair value of the stock options, at the date of grant, is ₹ 10 per option and the exercise price is ₹ 50 per share. The other relevant terms of the grant and assumptions are as below:

- The number of employees expected to complete two years vesting period, at the beginning of the plan, is 900. 50 employees are expected to leave during the each of the year 1 and year 2 and, consequently, the options granted to them are expected to be forfeited.
- Actual forfeitures, during the vesting period, are equal to the expected forfeitures and 900 employees have actually completed two-years vesting period.
- The profit of the enterprise for the year 1 and year 2, before amortisation of compensation cost on account of ESOPs, is ₹ 25,00,000 and ₹ 28,00,000 respectively.
- The fair value of shares for these years was ₹ 57 and ₹.60 respectively.
- The enterprise has 5,00,000 shares of ₹ 10 each outstanding at the end of year 1 and year 2.

Compute the Basic and Diluted EPS, ignoring tax impacts, for the year 1 and year 2.

Suggested Computations

- The stock options granted to employees are not included in the shares outstanding till the employees have exercised their right to obtain shares or stock options, after fulfilling the requisite vesting conditions. Till such time, the stock options so granted are considered as dilutive potential equity shares for the purpose of calculating Diluted EPS. At the end of each year, computations of diluted EPS are based on the actual number of options granted and not yet forfeited.
- For calculating diluted EPS, no adjustment is made to the net profit attributable to equity shareholders as there are no expense or income that would result from conversion of ESOPs to the equity shares.
- For calculating diluted EPS, the enterprise assumes the exercise of dilutive options. The assumed proceeds from these issues are considered to have been received from the issue of shares at fair value. The difference between the number of shares issuable and the number of shares that would have been issued at fair value are treated as an issue of equity shares for no consideration
- As per paragraph 47 of this Guidance Note, the assumed proceeds to be included for computation, mentioned at (c) above, include (i) the exercise price; and (ii) the unamortized compensation cost related to these ESOPs, attributable to future services.
- The enterprise calculates the basic and diluted EPS as below:

| Particulars | Year 1 | Year 2 |
|---|---------------|---------------|
| Net profit before amortisation of ESOP cost | | |
| | ₹ 25,00,000 | ₹ 28,00,000 |
| Less: Amortisation of ESOP cost | (₹ 13,50,000) | (₹ 13,50,000) |

| | | |
|---|------------------------|-------------|
| [(900 employees × 300 options × ₹ 10)/2] | | |
| Net profit attributable to equity shareholders | ₹ 11,50,000 | ₹ 14,50,000 |
| Number of shares outstanding | 5,00,000 | 5,00,000 |
| Basic EPS | ₹ 2.30 | ₹ 2.90 |
| Number of options outstanding (Options granted less actual forfeitures) | 2,85,000 | 2,70,000 |
| [1,000 employees [2,85,000 × 300 options – options – (50 employees (50 employees × 300 options)] × 300 options)] | | |
| Unamortised compensation cost per option | ₹ 5 [₹ 10 – ₹ 10/2] | ₹ 0 |
| Number of dilutive potential equity shares [2,85,000 – [2,70,000 – ((2,85,000 * 50) / (2,70,000 + (2,85,000 * 50)/60)] * 5)/57] | 10,000 | 45,000 |
| No. of equity shares used to compute diluted earnings per share | 5,10,000 | 5,45,000 |
| Diluted EPS | ₹ 2.255 | ₹ 2.66 |

Appendix IX

Illustrative Disclosures

An example has been given in this appendix to illustrate the disclosure requirements in paragraphs 49 to 52 of the text of the Guidance Note. The students are advised to refer this appendix from the compendium of Guidance Notes.

GN(A) 22 (Issued 2006)**Guidance Note on Accounting for Credit Available in respect of Minimum Alternative Tax under the Income-tax Act, 1961**

(The following is the text of the Guidance Note on Accounting for Credit Available in Respect of Minimum Alternative Tax Under the Income-tax Act, 1961, issued by the Council of the Institute of Chartered Accountants of India.)

Introduction

1. The Finance Act, 1997, introduced section 115JAA in the Income-tax Act, 1961 (hereinafter referred to as the 'Act') providing for tax credit in respect of MAT paid under section 115JA (hereinafter referred to as 'MAT credit') which could be carried forward for set-off for five succeeding years in accordance with the provisions of the Act. Section 115JA was inserted by the Finance Act, 1996, w.e.f. 1.4.1997. The said section provided for payment of Minimum Alternative Tax (hereinafter referred to as 'MAT') by certain companies, where the total income, as computed under the Income-tax Act, 1961, in respect of any previous year relevant to the assessment year commencing on or after 1st day of April, 1997, but before the 1st day of April, 2001, was less than 30% of its book profit. In such a case, the total income of the company chargeable to tax for the relevant previous year was deemed to be an amount equal to thirty per cent of its book profit.

2. The Finance Act, 2000, w.e.f. 1.4.2001, introduced section 115JB according to which a company is liable to pay MAT under the provisions of the said section in respect of any previous year relevant to the assessment year commencing on or after the 1st day of April, 2001. The MAT under this section is

payable where the normal income-tax payable by such company in the previous year is less than 7.5 per cent (10 per cent proposed by the Finance Bill, 2006) of its book profit which is deemed to be the total income of the company. Such company is liable to pay income-tax at the rate of 7.5 per cent (10 per cent proposed by the Finance Bill, 2006) of its book profit.

The Finance Act, 2005, inserted sub-section (1A) to section 115JAA, to grant tax credit in respect of MAT paid under section 115JB of the Act with effect from assessment year 2006-07.

3. The salient features of MAT credit under section 115JAA as applicable, in respect of tax paid under sections 115JA and 115JB, are as below:

- (a) A company, which has paid MAT, would be allowed credit in respect thereof.
- (b) The amount of MAT credit would be equal to the excess of MAT over normal income-tax for the assessment year for which MAT is paid.
- (c) No interest is allowable on such credit.
- (d) The MAT credit so determined can be carried forward for set-off for five succeeding assessment years from the year in which MAT credit becomes allowable. The Finance Bill, 2006, has proposed that credit in respect of MAT paid under section 115JB can be carried forward upto seven succeeding assessment years (hereinafter referred to as the 'specified period').
- (e) The amount of MAT credit can be set-off only in the year in which the company is liable to pay tax as per the normal provisions of the Act and such tax is in excess of MAT for that year.
- (f) The amount of set-off would be to the extent of excess of normal income-tax over the amount of MAT calculated as if section 115JB had been applied for that assessment year for which the set-off is being allowed.

Accounting Treatment

Whether MAT credit is a deferred tax asset

4. An issue has been raised whether the MAT credit can be considered as a deferred tax asset within the meaning of Accounting Standard (AS) 22, Accounting for Taxes on Income, issued by the Institute of Chartered Accountants of India. In this context, the following definitions given in AS 22 are noted:

"Timing differences are the differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods."

"Accounting income (loss) is the net profit or loss for a period, as reported in the statement of profit and loss, before deducting income tax expense or adding income tax saving."

"Taxable income (tax loss) is the amount of the income (loss) for a period, determined in accordance with the tax laws, based upon which income tax payable (recoverable) is determined."

5. From the above, it is noted that payment of MAT, does not by itself, result in any timing difference since it does not give rise to any difference between the accounting income and the taxable income which are arrived at before adjusting the tax expense, namely, MAT. In other words, under AS 22, deferred tax asset and deferred tax liability arise on account of differences in the items of income and expenses credited or charged in the profit and loss account as compared to the items of income that are taxed or items of expense that are allowed as deduction, for the purposes of the Act. Thus, deferred tax assets and deferred tax liabilities do not arise on account of the amount of the tax expense itself. In view of this, it is not appropriate to consider MAT credit as a deferred tax asset for the purposes of AS 22.

Whether MAT credit can be considered as an 'asset'

6. Although MAT credit is not a deferred tax asset under AS 22 as discussed above, yet it gives rise to expected future economic benefit in the form of adjustment of future income tax liability arising within the specified period. A question, therefore, arises whether the MAT credit can be considered as an 'asset' and in case it can be considered as an asset whether it should be so recognised in the financial statements.

7. The Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India, defines the term 'asset' as follows:

"An *asset* is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise."

8. MAT paid in a year in respect of which the credit is allowed during the specified period under the Act is a resource controlled by the company as a result of past event, namely, the payment of MAT. MAT credit has expected future economic benefits in the form of its adjustment against the discharge of the normal tax liability if the same arises during the specified period.

Accordingly, MAT credit is an 'asset'.

9. According to the Framework, once an item meets the definition of the term 'asset', it has to meet the criteria for recognition of an asset so that it may be recognised as such in the financial statements. Paragraph 88 of the Framework provides the following criteria for recognition of an asset:

"88. An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably."

10. In order to decide when it is 'probable' that the future economic benefits associated with the asset will flow to the enterprise, paragraph 84 of the Framework, *inter alia*, provides as below:

"84. The concept of probability is used in the recognition criteria to refer to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the enterprise. The concept is in keeping with the uncertainty that characterises the environment in which an enterprise operates. Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence available when the financial statements are prepared."

11. The concept of probability as contemplated in paragraph 84 of the Framework relates to both items of assets and liabilities and, therefore, the degree of uncertainty for recognition of assets and liabilities may vary keeping in view the consideration of 'prudence'. Accordingly, while for recognition of a liability the degree of uncertainty to be considered 'probable' can be 'more likely than not' (as in paragraph 22 of Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets') for recognition of an asset, in appropriate conditions, the degree may have to be higher than that. Thus, for the purpose of consideration of the probability of expected future economic benefits in respect of MAT credit, the fact that a company is paying MAT and not the normal income tax, provides a *prima facie* evidence that normal income tax liability may not arise within the specified period to avail MAT credit. In view of this, MAT credit should be recognised as an asset only when and to the extent there is convincing evidence that the company will pay normal income tax during the specified period. Such evidence may exist, for example, where a company has, in the current year, a deferred tax liability because its depreciation for the income-tax purposes is higher than the depreciation for accounting purposes, but from the next year onwards, the depreciation for accounting purposes would be higher than the depreciation for income-tax purposes, thereby resulting in the reversal of the deferred tax liability to an extent that the company becomes liable to pay normal income tax.

12. Where MAT credit is recognised as an asset in accordance with paragraph 11 above, the same should be reviewed at each balance sheet date. A company should write down the carrying amount of the MAT credit asset to the extent there is no longer a convincing evidence to the effect that the company will pay normal income tax during the specified period.

Presentation of MAT credit in the financial statements

Balance Sheet

13. Where a company recognises MAT credit as an asset on the basis of the considerations specified in paragraph 11 above, the same should be presented under the head 'Loans and Advances' since, there being a convincing evidence of realisation of the asset, it is of the nature of a pre-paid tax which would be adjusted against the normal income tax during the specified period. The asset may be reflected as 'MAT credit entitlement'.

14. In the year of set-off of credit, the amount of credit availed should be shown as a deduction from the 'Provision for Taxation' on the liabilities side of the balance sheet. The unavailed amount of MAT credit entitlement, if any, should continue to be presented under the head 'Loans and Advances' if it continues to meet the considerations stated in paragraph 11 above.

Profit and Loss Account

15. According to paragraph 6 of Accounting Standards Interpretation (ASI) 'Accounting for Taxes on Income in the context of Section 115JB of the Income-tax Act, 1961', issued by the Institute of Chartered Accountants of India, MAT is the current tax. Accordingly, the tax expense arising on account of payment of MAT should be charged at the gross amount, in the normal way, to the profit and loss account in the year of payment of MAT. In the year in which the MAT credit becomes eligible to be recognised as an asset in accordance with the recommendations contained in this Guidance Note, the said asset should be created by way of a credit to the profit and loss account and presented as a separate line item therein.

GN(A) 24 (Issued 2006)

Guidance Note on Measurement of Income Tax Expense for Interim Financial Reporting in the Context of AS 25

(The following is the text of the Guidance Note on Measurement of Income-tax Expense for Interim Financial Reporting in the context of AS 25, issued by the Council of the Institute of Chartered Accountants of India.)

1. Accounting Standard (AS) 25, 'Interim Financial Reporting', issued by the Council of the Institute of Chartered Accountants of India (ICAI), prescribes the minimum content of an interim financial report and the principles for recognition and measurement in complete or condensed financial statements for an interim period. AS 25 became mandatory in respect of accounting periods commencing on or after 1st April, 2002. In accordance with the Accounting Standards Interpretation (ASI) 27, 'Applicability of AS 25 to Interim Financial Results', the recognition and measurement principles laid down in AS 25 should be applied for recognition and measurement of items contained in the interim financial results presented under Clause 41 of the Listing Agreement entered into between stock exchanges and the listed enterprises. This Guidance Note deals with the measurement of income tax expense for the purpose of inclusion in the interim financial reports.
2. The general principles for recognition and measurement have been laid down in AS 25 as below:

“27. An enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. However, the frequency of an enterprise’s reporting (annual, half-yearly, or quarterly) should not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes should be made on a year-to-date basis.

28. Requiring that an enterprise apply the same accounting policies in its interim financial statements as in its annual financial statements may seem to suggest that interim period measurements are made as if each interim period stands alone as an independent reporting period. However, by providing that the frequency of an enterprise’s reporting should not affect the measurement of its annual results, paragraph 27 acknowledges that an interim period is a part of a financial year. Year-to-date measurements may involve changes in estimates of amounts reported in prior interim periods of the current financial year. But the principles for recognising assets, liabilities, income, and expenses for interim periods are the same as in annual financial statements.”
3. Paragraph 29(c) of AS 25 illustrates the application of the general principles for recognition and measurement of tax expense in interim periods, as below:

“29.....

 - (c) income tax expense is recognized in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year. Amounts accrued for income tax expense in one interim period may have to be adjusted in a subsequent interim period of that financial year if the estimate of the annual income tax rate changes.”
4. Appendix 3 to AS 25 illustrates the general recognition and measurement principles for the preparation of interim financial reports. Paragraphs 8 to 16 of the Appendix provide guidance on the computation of income-tax expense for the interim period, which are reproduced in Appendix A to this Guidance Note for ready reference. Paragraph 8 of the Appendix states as below:

“8. Interim period income tax expense is accrued using the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate applied to the pre-tax income of the interim period.”
5. The various steps involved in the measurement of income tax expense for the purpose of interim financial reports are as below:
 - (i) An enterprise will first have to estimate its annual accounting income. For this purpose, an enterprise would have to take into account all probable events and transactions that are expected to occur during the financial year. Such an estimate would involve, e.g., estimating on prudent basis, the depreciation on expected expenditure on acquisition of fixed assets, profits from sale of fixed assets/investments, etc. Such future events and transactions should be taken into account only if there is a reasonable certainty that the same would take place during the financial year.
 - (ii) The enterprise should next estimate its tax liability for the financial year. For this purpose, the enterprise will have to estimate taxable income for the year. By applying the enacted or the substantively enacted tax rate on the taxable income, an estimate of the current tax for the year is arrived at. The estimates of tax liability would have to be based on the estimated deductions, allowances, etc., that would be available to the enterprise, provided there is a reasonable certainty for the same. The enterprise would also have to estimate the deferred tax assets/liabilities by applying the principles of Accounting Standard (AS) 22, ‘Accounting for Taxes

on Income', issued by the Institute of Chartered Accountants of India. Special considerations may have to be applied in certain cases as below:

- (a) Where brought forward losses exist from the previous financial year (when deferred tax asset was not recognised on considerations of prudence as per AS 22): In such a situation, for estimating the current tax liability, the brought forward losses would have to be deducted from the estimated annual accounting income as explained in paragraph 16 of Appendix 3 to AS 25 (reproduced in Appendix A to this Guidance Note). Since such carried forward losses will get set-off during the year, these would not have any tax consequence in future periods.
 - (b) Where brought forward losses exist (when deferred tax asset was recognised on the considerations of prudence as per AS 22): In such a situation, current tax would be computed in the same manner as explained in (a) above. However, in the determination of deferred tax, the tax expense arising from the reversal of the deferred tax asset recognised previously, to the extent of reversal of deferred tax asset in the current year, would also be considered.
 - (iii) The enterprise would now have to calculate the weighted average annual effective tax rate. This tax rate would be determined by dividing the estimated tax expense as arrived at step (ii) above by the estimated annual accounting income as arrived at step (i) above. Where different tax rates are applicable to different portions of the estimated annual accounting income, e.g., normal tax rate and a different tax rate for capital gains, the weighted average annual effective tax rate would have to be calculated separately for such portions of estimated annual accounting income.
 - (iv) The weighted average annual effective tax rate arrived at step (iii) would be applied to the accounting income for the interim period for determining the income tax expense to be recognised in the interim financial reports.
6. Accounting for interim period income-tax expense as suggested above is based on the approach prescribed in AS 25 that the interim period is part of the whole accounting year (often referred to as the 'integral approach') and, therefore, the said expense should be worked out on the basis of the estimated weighted average annual effective income-tax rate. According to this approach, the said rate is determined on the basis of the taxable income for the whole year, and applied to the accounting income for the interim period in order to determine the amount of tax expense for that interim period. This is in contrast to accounting for certain other expenses such as depreciation which is based on the approach prescribed in AS 25 that the interim period should be considered on stand-alone basis (often referred to as the 'discrete approach') because expenses such as depreciation are worked out on the basis of the period for which a fixed asset was available for use. The aforesaid treatments are, however, consistent with the requirement contained in paragraph 27 of AS 25 that an enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements.
 7. Appendix B contains examples of computing weighted average annual effective tax rate.

APPENDIX A

EXTRACTS FROM APPENDIX 3 TO ACCOUNTING STANDARD (AS) 25, INTERIM FINANCIAL REPORTING

Measuring Income Tax Expense for Interim Period

8. Interim period income tax expense is accrued using the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate applied to the pre-tax income of the interim period.
9. This is consistent with the basic concept set out in paragraph 27 that the same accounting recognition and measurement principles should be applied in an interim financial report as are applied in annual financial statements. Income taxes are assessed on an annual basis. Therefore, interim period income tax expense is calculated by applying, to an interim period's pre-tax income, the tax rate that would be applicable to expected total annual earnings, that is, the estimated average effective annual income tax rate. That estimated average annual income tax rate would reflect the tax rate structure expected to be applicable to the full year's earnings including enacted or substantively enacted changes in the income tax rates scheduled to take effect later in the financial year. The estimated average annual income tax rate would be re-estimated on a year-to-date basis, consistent with paragraph 27 of this Statement. Paragraph 16(d) requires disclosure of a significant change in estimate.
10. To the extent practicable, a separate estimated average annual effective income tax rate is determined for each governing taxation law and applied individually to the interim period pre-tax income under such laws. Similarly, if different income tax rates apply to different categories of income (such as capital gains or income earned in particular industries), to the extent practicable a separate rate is applied to each individual category of interim period pre-tax income. While that degree of precision is desirable, it may not be achievable in all cases, and a weighted average of rates across such governing taxation laws or across categories of income is used if it is a reasonable approximation of the effect of using more specific rates.
11. As illustration, an enterprise reports quarterly, earns ₹ 150 lakhs pre-tax profit in the first quarter but expects to incur losses of ₹ 50 lakhs in each of the three remaining quarters (thus having zero income for the year), and is governed by taxation laws according to which its estimated average annual income tax rate is expected to be 35 per cent. The following table shows the amount of income tax expense that is reported in each quarter:

(Amount in ₹ lakhs)

| | 1 st Quarter | 2 nd Quarter | 3 rd Quarter | 4 th Quarter | Annual |
|-------------|----------------------------|----------------------------|----------------------------|----------------------------|--------|
| Tax Expense | 52.5 | (17.5) | (17.5) | (17.5) | 0 |

Difference in Financial Reporting Year and Tax Year

12. If the financial reporting year and the income tax year differ, income tax expense for the interim periods of that financial reporting year is measured using separate weighted average estimated effective tax rates for each of the income tax years applied to the portion of pre-tax income earned in each of those income tax years.
13. To illustrate, an enterprise's financial reporting year ends 30 September and it reports quarterly. Its year as per taxation laws ends 31 March. For the financial year that begins 1 October, Year 1 ends 30 September of Year 2, the enterprise earns ₹ 100 lakhs pre-tax each quarter. The

V-104 Financial Reporting

estimated weighted average annual income tax rate is 30 per cent in Year 1 and 40 per cent in Year 2.

(Amount in ₹ lakhs)

| | Quarter Ending 31 Dec. Year 1 | Quarter Ending 31 Mar. Year 1 | Quarter Ending 30 June Year 2 | Quarter Ending 30 Sep. Year 2 | Year Ending 30 Sep. Year 2 |
|-------------|--|--|--|--|-------------------------------------|
| Tax Expense | 30 | 30 | 40 | 40 | 140 |

Tax Deductions/Exemptions

14. Tax statutes may provide deductions/exemptions in computation of income for determining tax payable. Anticipated tax benefits of this type for the full year are generally reflected in computing the estimated annual effective income tax rate, because these deductions/exemptions are calculated on an annual basis under the usual provisions of tax statutes. On the other hand, tax benefits that relate to a one-time event are recognised in computing income tax expense in that interim period, in the same way that special tax rates applicable to particular categories of income are not blended into a single effective annual tax rate.

Tax Loss Carry forwards

15. A deferred tax asset should be recognised in respect of carry forward tax losses to the extent that it is virtually certain, supported by convincing evidence, that future taxable income will be available against which the deferred tax assets can be realised. The criteria are to be applied at the end of each interim period and, if they are met, the effect of the tax loss carry forward is reflected in the computation of the estimated average annual effective income tax rate.
16. To illustrate, an enterprise that reports quarterly has an operating loss carryforward of ₹ 100 lakhs for income tax purposes at the start of the current financial year for which a deferred tax asset has not been recognised. The enterprise earns ₹ 100 lakhs in the first quarter of the current year and expects to earn ₹ 100 lakhs in each of the three remaining quarters. Excluding the loss carryforward, the estimated average annual income tax rate is expected to be 40 per cent. The estimated payment of the annual tax on ₹ 400 lakhs of earnings for the current year would be ₹ 120 lakhs $\{(\text{₹ } 400 \text{ lakhs} - \text{₹ } 100 \text{ lakhs}) \times 40\%$. Considering the loss carryforward, the estimated average annual effective income tax rate would be 30% $\{(\text{₹ } 120 \text{ lakhs}/\text{₹ } 400 \text{ lakhs}) \times 100\}$. This average annual effective income tax rate would be applied to earnings of each quarter. Accordingly, tax expense would be as follows:

(Amount in ₹ lakhs)

| | 1 st Quarter | 2 nd Quarter | 3 rd Quarter | 4 th Quarter | Annual |
|-------------|----------------------------|----------------------------|----------------------------|----------------------------|--------|
| Tax Expense | 30.00 | 30. | 30.00 | 30.00 | 120.00 |

Appendix B

Examples of Computation of Weighted Average Annual Effective Tax Rate

Example 1: *When deferred tax asset was not recognised for carried forward losses from earlier accounting periods.*

| | QUARTER I ₹ | QUARTER II ₹ | QUARTER III ₹ | QUARTER IV ₹ | Total ₹ |
|---|-------------------|--------------------|---------------------|--------------------|---------------------------------------|
| Estimated Pre-tax Income (after considering estimated depreciation on the probable acquisition of fixed assets during the year) | (25) | 175 | (25) | 50 | 175 |
| Carried forward losses from earlier accounting periods, the deferred tax asset in respect of which was not recognised as it did not meet the requirements of prudence laid down in AS 22. During this year, in view of the expected taxable income, this loss is expected to be set off thereagainst. Therefore, it will not have any tax effect on future periods. | | | | | (25) |
| Additional estimated depreciation as per tax laws as compared to the accounting depreciation after considering depreciation on probable capital expenditure on acquisition of fixed assets during the year. | | | | | (50) |
| Estimated taxable income on which tax payable. | | | | | 100 |
| Applicable tax rate (say) | | | | | 30% |
| Estimated current tax expense for the year. | | | | | 30 |
| Estimated deferred tax expense for the year (50x30/100) | | | | | 15 |
| Weighted Average Annual Effective Tax Rate (current tax) | | | | | $\frac{30}{175} \times 100 = 17.14\%$ |
| Weighted Average Annual Effective Tax Rate (deferred tax) | | | | | $\frac{15}{175} \times 100$ |

V-106 Financial Reporting

| | | | | | |
|------------------------------------|---------------|-----------|---------------|--------------|--------------|
| | | | | | =8.57% |
| Tax expense for the interim period | (4.29) | 30 | (4.29) | 8.57 | 29.99 |
| Current tax | <u>(2.14)</u> | <u>15</u> | <u>(2.14)</u> | <u>4.29</u> | <u>15.01</u> |
| Deferred tax | (6.43) | <u>45</u> | (6.43) | <u>12.86</u> | <u>45.00</u> |
| Total | | | | | |

- (a) The above calculation needs to be done for every interim period for which recognition and measurement of tax expense is required.
- (b) It is presumed that there are no other differences between accounting income and taxable income.

Example 2: *When deferred tax asset was recognised for carried forward losses from earlier accounting periods.*

| | QUARTER I ₹ | QUARTER II ₹ | QUARTER III ₹ | QUARTER IV ₹ | Total ₹ |
|--|-------------------|--------------------|---------------------|--------------------|------------|
| Estimated Pre-tax Income (after considering estimated depreciation on the probable acquisition of fixed assets during the year) | (25) | 175 | (25) | 50 | 175 |
| Carried forward losses from earlier accounting periods, the deferred tax asset in respect of which was recognised on the basis of considerations of AS 22. During this year, in view of the expected taxable income, this loss is expected to be set off thereagainst. This will result in reversal of the deferred tax asset in the current year. | | | | | (25) |
| Additional estimated depreciation as per tax laws as compared to the accounting depreciation after considering depreciation on probable capital expenditure on acquisition of fixed assets during the year. | | | | | (50) |
| Estimated taxable income on which tax payable. | | | | | 100 |
| Applicable tax rate (say) | | | | | 30% |
| Estimated current tax expense | | | | | 30 |

| | | | | | |
|---|---------------|-------------|---------------|--------------|---|
| for the year. | | | | | |
| Estimated deferred tax expense for the year: | | | | | 22.5 |
| (i) Deferred tax liability on account of timing difference in depreciation (50x30/100) 15 | | | | | |
| (ii) Reversal of deferred tax asset (25x30/100) 7.5 | | | | | |
| Weighted Average Annual Effective Tax Rate (Current tax) | | | | | $\frac{30}{175} \times 100 = 17.14\%$ |
| Weighted Average Annual Effective Tax Rate (Deferred tax) | | | | | $\frac{22.5}{175} \times 100 = 12.86\%$ |
| Tax expense for the interim period | (4.29) | 30.0 | (4.29) | 8.57 | 29.99 |
| Current tax | <u>(3.21)</u> | <u>22.5</u> | <u>(3.21)</u> | <u>6.43</u> | <u>22.51</u> |
| Deferred tax | <u>(7.50)</u> | <u>52.5</u> | <u>(7.50)</u> | <u>15.00</u> | <u>52.50</u> |
| Total | | | | | |

- (a) The above calculation needs to be done for every interim period for which recognition and measurement of tax expense is required.
- (b) It is presumed that there are no other differences between accounting income and taxable income.

Example 3: When progressive rates of tax are applicable

Under the Indian tax system, the tax rates for corporates and firms are not progressive (i.e., based on levels of income), but are flat rates. Therefore, the tax rate to be applied in the interim period would be the normal rate applicable to the entity. However, the calculation of weighted average annual effective tax rate can be illustrated as below where the tax rates are progressive:

Estimated annual income ₹.1 lakh

Assumed Tax Rates:

On first ₹ 40,000 30%

On the balance income 40%

Tax expense: 30% of ₹ 40,000 + 40% of ₹ 60,000 = ₹ 36,000

Weighted average annual effective tax rate = $\frac{36,000}{1,00,000} \times 100 = 36\%$

Supposing the estimated income of each quarter is ₹ 25,000, the tax expense of ₹ 9,000 (36% of ₹ 25,000) would be recognised in each of the quarterly financial reports.

Example 4: When different rates of tax are applicable to different portions of the estimated annual accounting income (refer para 5(iii))

Estimated annual income ₹ 1 lakh

V-108 Financial Reporting

(inclusive of Estimated Capital Gains (earned in Quarter II) ₹ 20,000

Assumed Tax Rates:

On Capital Gains 10%

On other income:

First ₹ 40,000 30%

Balance income 40%

Assuming there is no difference between the estimated taxable income and the estimated accounting income,

Tax Expense:

On Capital Gains portion of annual income:

10% of ₹ 20,000 ₹ 2,000

On other income: 30% of ₹ 40,000 + 40% of ₹.40,000 ₹.28,000

Total: ₹.30,000

Weighted Average Annual Effective Tax Rate:

On Capital Gains portion of annual income: $\frac{2,000}{20,000} \times 100 = 10\%$

On other income: $\frac{28,000}{80,000} \times 100 = 35\%$

Supposing the estimated income of each quarter is ₹.25,000, when income of ₹.25,000 for 2nd Quarter includes capital gains of ₹.20,000, the tax expense for each quarter will be calculated as below:

| | | Income | Tax Expense | | |
|--------------------------------|----------------|----------|-------------------|----------------|-----------------|
| Quarter I: | | ₹ 25,000 | 35% of ₹ 25,000 = | ₹ 8,750 | |
| Quarter II: | Capital Gains: | ₹ 20,000 | 10% of ₹ 20,000 = | ₹ 2,000 | |
| | Other: | ₹ 5,000 | 35% of ₹ 5,000 = | <u>₹ 1,750</u> | ₹.12,500 |
| Quarter III: | | ₹ 25,000 | 35% of ₹ 25,000 = | | ₹ 8,750 |
| Quarter IV: | | ₹ 25,000 | 35% of ₹ 25,000 = | | <u>₹ 8,750</u> |
| Total tax expense for the year | | | | | <u>₹ 30,000</u> |

Guidance Note on Remuneration paid to Key Management Personnel - Whether a Related Party Transaction¹

(The following is the text of the 'Guidance Note on Remuneration paid to key management personnel – whether a related party transaction' issued by the Council of the Institute of Chartered Accountants of India. Pursuant to the issuance of this Guidance Note, Accounting Standards Interpretation (ASI) 23, 'Remuneration paid to key management personnel – whether a related party transaction (Re. AS 18)', stands withdrawn.)

Introduction

1. This Guidance Note deals with the issue whether remuneration paid to key management personnel is a related party transaction. Another related issue dealt by this Guidance Note is whether remuneration paid to non-executive directors on the Board of Directors is a related party transaction.
2. Accounting Standard (AS) 18, *Related Party Disclosures*, defines "related party transaction" as "**a transfer of resources or obligations between related parties, regardless of whether or not a price is charged.**" Further, paragraph 24 of AS 18 provides as under:

"The following are examples of the related party transactions in respect of which disclosures may be made by a reporting enterprise:

 - purchases or sales of goods (finished or unfinished);
 - purchases or sales of fixed assets;
 - rendering or receiving of services;
 - agency arrangements;
 - leasing or hire purchase arrangements;
 - transfer of research and development;
 - licence agreements;
 - finance (including loans and equity contributions in cash or in kind);
 - guarantees and collaterals; and
 - management contracts including for deputation of employees."
3. As per the definition of the expression 'related party transaction', the transaction should be between related parties to qualify as a related party transaction. Since key management personnel are related parties under AS 18, remuneration paid to key management personnel is a related party transaction requiring disclosures under AS 18. Further, in case non-executive directors on the Board of Directors are not related parties, remuneration paid to them is not considered a related party transaction.

Recommendation

Remuneration paid to key management personnel should be considered as a related party transaction requiring disclosures under AS 18. In case non-executive directors on the Board of Directors are not related parties, remuneration paid to them should not be considered a related party transaction.

¹ This Guidance Note was earlier issued as Accounting Standards Interpretation (ASI) 23, 'Remuneration paid to key management personnel - whether a related party transaction (Re. AS 18)' by the Institute of Chartered Accountants of India (ICAI). While the Accounting Standards notified by the Central Government under the Companies (Accounting Standards) Rules, 2006, have incorporated the 'Consensus' part of various ASIs issued by the ICAI, ASI 23 has not been so incorporated as it was felt that it is primarily clarificatory in nature. The Council of the ICAI, has accordingly, decided to withdraw ASI 23, and issue the same as a Guidance Note as it provides appropriate guidance on the subject.

Guidance Note on Applicability of Accounting Standard (AS) 20, Earnings Per Share¹

(The following is the text of the 'Guidance Note on the Applicability of Accounting Standard (AS) 20, Earnings Per Share', issued by the Council of the Institute of Chartered Accountants of India. Pursuant to the issuance of this Guidance Note, Accounting Standards Interpretation (ASI) 12 – 'Applicability of AS 20 (Re. AS 20)', stands withdrawn.)

Introduction

1. This Guidance Note deals with the issue whether companies which are required to give information under Part IV of Schedule VI to the Companies Act, 1956, should calculate and disclose earnings per share in accordance with Accounting Standard (AS) 20, *Earnings Per Share*.
2. AS 20 came into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory in nature, from that date, in respect of enterprises whose equity shares or potential equity shares are listed on a recognised stock exchange in India. AS 20 does not mandate an enterprise, which has neither equity shares nor potential equity shares which are so listed, to calculate and disclose earnings per share, but, if that enterprise discloses earnings per share for complying with the requirements of any statute or otherwise, it should calculate and disclose earnings per share in accordance with AS 20.

Recommendation

3. Since Part IV of Schedule VI to the Companies Act, 1956, requires, among other things, disclosure of earnings per share, every company which provides information under Part IV of Schedule VI to the Companies Act, 1956, should calculate and disclose earnings per share in accordance with AS 20, whether or not its equity shares or potential equity shares are listed on a recognised stock exchange in India.

Guidance Note on Applicability of AS 25 To Interim Financial Results⁴

(The following is the text of the 'Guidance Note on Applicability of AS 25 to Interim Financial Results', issued by the Council of the Institute of Chartered Accountants of India. Pursuant to the issuance of this Guidance Note, Accounting Standards Interpretation (ASI) 27 - 'Applicability of AS 25 to Interim Financial Results (Re. AS 25)', stands withdrawn.)

¹ This Guidance Note was earlier issued as Accounting Standards Interpretation (ASI) 12, 'Applicability of AS 20 (Re. AS 20)' by the Institute of Chartered Accountants of India (ICAI). While the Accounting Standards notified by the Central Government under the Companies (Accounting Standards) Rules, 2006, have incorporated the 'Consensus' part of various ASIs issued by the ICAI, ASI 12 has not been so incorporated as it was felt that it is primarily clarificatory in nature. The Council of the ICAI, has accordingly, decided to withdraw ASI 12, and issue the same as a Guidance Note as it provides appropriate guidance on the subject.

⁴ This Guidance Note was earlier issued as Accounting Standards Interpretation (ASI) 27, 'Applicability of AS 25 to Interim Financial Results (Re. AS 25)' by the Institute of Chartered Accountants of India (ICAI). While the Accounting Standards notified by the Central Government under the Companies (Accounting Standards) Rules, 2006, have incorporated the 'Consensus' part of various ASIs issued by ICAI, ASI 27 has not been so incorporated as it was felt that it was not relevant to the requirements of the Companies Act, 1956. The Council of the ICAI, accordingly, has decided to withdraw ASI 27 and issue the same as a Guidance Note as it provides appropriate guidance on the subject.

Introduction

1. This Guidance Note deals with the issue whether Accounting Standard (AS) 25, *Interim Financial Reporting*, is applicable to interim financial results presented by an enterprise pursuant to the requirements of a statute/regulator, for example, quarterly financial results presented under Clause 41 of the Listing Agreement entered into between Stock Exchanges and the listed enterprises.
2. Accounting Standard (AS) 25, *Interim Financial Reporting*, issued by the Council of the Institute of Chartered Accountants of India, came into effect in respect of accounting periods commencing on or after 1-4-2002. If any enterprise is required or elects to prepare and present an interim financial report, it should comply with this Standard (applicability paragraph).
3. AS 25 further provides as follows:

"1. This Statement does not mandate which enterprises should be required to present interim financial reports, how frequently, or how soon after the end of an interim period. If an enterprise is required or elects to prepare and present an interim financial report, it should comply with this Statement.

2. A statute governing an enterprise or a regulator may require an enterprise to prepare and present certain information at an interim date which may be different in form and/or content as required by this Statement. In such a case, the recognition and measurement principles as laid down in this Statement are applied in respect of such information, unless otherwise specified in the statute or by the regulator."

"4. The following terms are used in this Statement with the meanings specified:

.....
***Interim financial report** means a financial report containing either a complete set of financial statements or a set of condensed financial statements (as described in this Statement) for an interim period."*

Recommendation

4. The presentation and disclosure requirements contained in AS 25 should be applied only if an enterprise prepares and presents an 'interim financial report' as defined in AS 25. Accordingly, presentation and disclosure requirements contained in AS 25 are not required to be applied in respect of interim financial results (which do not meet the definition of 'interim financial report' as per AS 25) presented by an enterprise. For example, quarterly financial results presented under Clause 41 of the Listing Agreement entered into between Stock Exchanges and the listed enterprises do not meet the definition of 'interim financial report' as per AS 25. However, the recognition and measurement principles laid down in AS 25 should be applied for recognition and measurement of items contained in such interim financial results.

Guidance Note on Turnover in Case of Contractors¹

(The following is the text of the 'Guidance Note on Turnover in case of Contractors', issued by the Council of the Institute of Chartered Accountants of India. Pursuant to the issuance of this Guidance

¹ This Guidance Note was earlier issued as Accounting Standards Interpretation (ASI) 29, 'Turnover in case of Contractors (Re. AS 7)' by the Institute of Chartered Accountants of India (ICAI). While the Accounting Standards notified by the Central Government under the Companies (Accounting Standards) Rules, 2006, have incorporated the 'Consensus' part of various ASIs issued by the ICAI, ASI 29 has not been so incorporated as it was felt that it is primarily clarificatory in nature. The Council of the ICAI, has accordingly, decided to withdraw ASI 29, and issue the same as a Guidance Note as it provides appropriate guidance on the subject.

Note, Accounting Standards Interpretation (ASI) 29 – ‘Turnover in case of Contractors (Re. AS 7); stands withdrawn.)

Introduction

1. This Guidance Note deals with the issue whether the revenue recognised in the financial statements of contractors as per the requirements of Accounting Standard (AS) 7, *Construction Contracts* (revised 2002), can be considered as ‘turnover’.
2. AS 7 (revised 2002) deals, *inter alia*, with revenue recognition in respect of construction contracts in the financial statements of contractors. It requires recognition of revenue by reference to the stage of completion of a contract (referred to as ‘percentage of completion method’). This method results in reporting of revenue which can be attributed to the proportion of work completed. Under this method, contract revenue is recognised as revenue in the statement of profit and loss in the accounting period in which the work is performed.
3. The paragraph dealing with the ‘Objective’ of AS 7 (revised 2002) provides as follows:

“Objective

The objective of this Statement is to prescribe the accounting treatment of revenue and costs associated with construction contracts. Because of the nature of the activity undertaken in construction contracts, the date at which the contract activity is entered into and the date when the activity is completed usually fall into different accounting periods. Therefore, the primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which construction work is performed. This Statement uses the recognition criteria established in the Framework for the Preparation and Presentation of Financial Statements to determine when contract revenue and contract costs should be recognised as revenue and expenses in the statement of profit and loss. It also provides practical guidance on the application of these criteria.”

From the above, it may be noted that AS 7 (revised 2002) deals, *inter alia*, with the allocation of contract revenue to the accounting periods in which construction work is performed.

4. Further, paragraphs 21 and 31 of AS 7 (revised 2002) provide as follows:
“21. When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date. An expected loss on the construction contract should be recognised as an expense immediately in accordance with paragraph 35.”
“31. When the outcome of a construction contract cannot be estimated reliably:
 - (a) *revenue should be recognised only to the extent of contract costs incurred of which recovery is probable; and*
 - (b) *contract costs should be recognised as an expense in the period in which they are incurred.*

An expected loss on the construction contract should be recognised as an expense immediately in accordance with paragraph 35.”

From the above, it may be noted that the recognition of revenue as per AS 7 (revised 2002) may be inclusive of profit (as per paragraph 21 reproduced above) or exclusive of profit (as per paragraph 31 reproduced above) depending on whether the outcome of the construction contract can be estimated reliably or not. When the outcome of the construction contract can be estimated

reliably, the revenue is recognised inclusive of profit and when the same cannot be estimated reliably, it is recognised exclusive of profit. However, in either case it is considered as revenue as per AS 7 (revised 2002).

5. 'Revenue' is a wider term. For example, within the meaning of Accounting Standard (AS) 9, *Revenue Recognition*, the term 'revenue' includes revenue from sales transactions, rendering of services and from the use by others of enterprise resources yielding interest, royalties and dividends. The term 'turnover' is used in relation to the source of revenue that arises from the principal revenue generating activity of an enterprise. In case of a contractor, the construction activity is its principal revenue generating activity. Hence, the revenue recognised in the statement of profit and loss of a contractor in accordance with the principles laid down in AS 7 (revised 2002), by whatever nomenclature described in the financial statements, is considered as 'turnover'.

Recommendation

6. The amount of contract revenue recognised as revenue in the statement of profit and loss as per the requirements of AS 7 (revised 2002), should be considered as 'turnover'.

Guidance Note on Revised Schedule-VI to the Companies Act, 1956

1. Introduction

1.1 Schedule VI to the Companies Act, 1956 ('the Act') provides the manner in which every company registered under the Act shall prepare its Balance Sheet, Statement of Profit and Loss and notes thereto. In the light of various economic and regulatory reforms that have taken place for companies over the last several years, there was a need for enhancing the disclosure requirements under the Old Schedule VI to the Act and harmonizing and synchronizing them with the notified Accounting Standards as applicable ('AS'/Accounting Standard(s)'). Accordingly, the Ministry of Corporate Affairs (MCA) has issued a revised form of Schedule VI on February 28, 2011. The relevant notification along with the Revised Schedule VI to the Act. As per the relevant notifications, the Schedule applies to all companies for the Financial Statements to be prepared for the financial year commencing on or after April 1, 2011.

1.2 The requirements of the Revised Schedule VI however, do not apply to companies as referred to in the proviso to Section 211 (1) and Section 211 (2) of the Act, i.e., any insurance or banking company, or any company engaged in the generation or supply of electricity or to any other class of company for which a form of Balance Sheet and Profit and Loss account has been specified in or under any other Act governing such class of company.

1.3 It may be clarified that for companies engaged in the generation and supply of electricity, however, neither the Electricity Act, 2003, nor the rules framed thereunder, prescribe any specific format for presentation of Financial Statements by an electricity company. Section 616(c) of the Companies Act states that the Companies Act will apply to electricity companies, to the extent it is not contrary to the requirements of the Electricity Act. Keeping this in view, Revised Schedule VI may be followed by such companies till the time any other format is prescribed by the relevant statute.

2. Objective and Scope

2.1. The objective of this Guidance Note is to provide guidance in the preparation and presentation of Financial Statements of companies in accordance with various aspects of the Revised Schedule VI. However, it does not provide guidance on disclosure requirements under Accounting Standards, other pronouncements of the Institute of Chartered Accountants of India (ICAI), other statutes, etc.

2.2. In preparing this Guidance Note, reference has been made to the Accounting Standards notified

under the Companies (Accounting Standards) Rules, 2006 (as amended), other Accounting Standards issued by the ICAI (yet to be notified under the Act) and various other pronouncements of the ICAI. The primary focus of the Guidance Note has been to lay down broad guidelines to deal with practical issues that may arise in the implementation of the Revised Schedule VI.

2.3. As per the clarification issued by ICAI regarding the authority attached to the Documents Issued by ICAI, "*Guidance Notes' are primarily designed to provide guidance to members on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. Guidance Notes are recommendatory in nature. A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is satisfied that in the circumstances of the case, it may not be necessary to do so. Similarly, while discharging his attest function, a member should examine whether the recommendations in a guidance note relating to an accounting matter have been followed or not. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary.*"

3. Applicability

3.1. As per the Government Notification no. F.No.2/6/2008-C.L-V dated 30-3-2011, the Revised Schedule VI is applicable for the Balance Sheet and Profit and Loss Account to be prepared for the financial year commencing on or after April 1, 2011.

3.2. Early adoption of the Revised Schedule VI is not permitted since Schedule VI is a statutory format.

3.3. The Revised Schedule VI requires that except in the case of the first Financial Statements laid before the company after incorporation, the corresponding amounts for the immediately preceding period are to be disclosed in the Financial Statements including the Notes to Accounts. Accordingly, corresponding information will have to be presented starting from the first year of application of the Revised Schedule VI. Thus for the Financial Statements prepared for the year 2011-12 (1st April 2011 to 31st March 2012), corresponding amounts need to be given for the financial year 2010-11.

3.4. ICAI had earlier issued the Statement on the Amendments to Schedule VI to the Companies Act, 1956 in March 1976 (as amended). Wherever guidance provided in this publication is different from the guidance in the aforesaid Statement, this Guidance Note will prevail.

3.5. Applicability of the Revised Schedule VI format to interim Financial Statements prepared by companies in the first year of application of the Schedule:

Relevant paragraphs of *AS-25 Interim Financial Reporting* are quoted below:

"10. If an enterprise prepares and presents a complete set of Financial Statements in its interim financial report, the form and content of those statements should conform to the requirements as applicable to annual complete set of Financial Statements.

11. If an enterprise prepares and presents a set of condensed Financial Statements in its interim financial report, those condensed statements should include, at a minimum, each of the headings and sub-headings that were included in its most recent annual Financial Statements and the selected explanatory notes as required by this Statement. Additional line items or notes should be included if their omission would make the condensed interim Financial Statements misleading."

3.6. Accordingly, if a company is presenting condensed interim Financial Statements, its format should conform to that used in the company's most recent annual Financial Statements, i.e., the Old Schedule VI. However, if it presents a complete set of Financial Statements, it should use the Revised Schedule

VI, i.e., the new format applicable to annual Financial Statements.

3.7. The format of Balance Sheet currently prescribed under Clause 41 to the Listing Agreement based on the Old Schedule VI is inconsistent with the format of Balance Sheet in the Revised Schedule VI. Till Clause 41 is revised, this issue to be addressed by companies as explained below :

3.7.1. Clauses 41(l)(ea) and 41(l)(eaa) to the Listing Agreement regarding presentation of Balance Sheet items in half-yearly and annual audited results, respectively states as under:

“(ea) As a part of its audited or unaudited financial results for the half-year, the company shall also submit by way of a note, a statement of assets and liabilities as at the end of the half-year.

“(eaa) However, when a company opts to submit un-audited financial results for the last quarter of the financial year, it shall, submit a statement of assets and liabilities as at the end of the financial year only along with the audited financial results for the entire financial year, as soon as they are approved by the Board.”

3.7.2. Further, Clause 41(V)(h) regarding format of Balance Sheet items states as under:

“(h) Disclosure of Balance Sheet items as per items (ea) shall be in the format specified in Annexure IX drawn from Schedule VI of the Companies Act, or its equivalent formats in other statutes, as applicable.”

Based on the above:

- (a) **For Half yearly results:** Though the requirement in clause 41(V)(h) makes a reference to the Schedule VI for the presentation of Balance Sheet items, in case of half-yearly results of a company, it has prescribed a specific format for the purpose. Hence, till the time a new format is prescribed by the Securities and Exchange Board of India (SEBI) under Clause 41, companies will have to continue to present their half-yearly Balance Sheets based on the format currently specified by the SEBI.
- (b) **For Annual audited yearly results:** Clause 41(V) (h) does not refer to any format for the purposes of annual statement of assets and liabilities. Since companies have to prepare their annual Financial Statements in the Revised Schedule VI format, companies should use the same format of Revised Schedule VI for submission to stock exchanges as well.

3.8. The formats of the Balance Sheet and Statement of Profit and Loss prescribed under the SEBI (Issue of Capital & Disclosure Requirements) Regulations 2009 ('ICDR Regulations') is inconsistent with the format of the Balance Sheet/ Statement of Profit and Loss in the Revised Schedule VI. However, the formats of Balance Sheet and Statement of Profit and Loss under ICDR Regulations are "illustrative formats". Accordingly, to make the data comparable and meaningful for users, companies should use the Revised Schedule VI format to present the restated financial information for inclusion in the offer document. Consequently, among other things, this will involve classification of assets and liabilities into current and non-current for earlier years presented as well.

Attention is also invited to the General Circular no 62/2011 dated 5th September 2011 issued by the Ministry of Company Affairs which clarifies that "the presentation of Financial Statements for the limited purpose of IPO/FPO during the financial year 2011-12 may be made in the format of the pre-revised Schedule VI under the Companies Act, 1956. However, for period beyond 31st March 2012, they would prepare only in the new format as prescribed by the present Schedule VI of the Companies Act, 1956'.

4. Summary of Revised Schedule VI

4.1. Main principles

4.1.1. The Revised Schedule VI requires that if compliance with the requirements of the Act and / or the notified Accounting Standards requires a change in the treatment or disclosure in the Financial Statements as compared to that provided in the Revised Schedule VI, the requirements of the Act and / or the notified Accounting Standards will prevail over the Schedule.

4.1.2. The Revised Schedule VI clarifies that the requirements mentioned therein for disclosure on the face of the Financial Statements or in the notes are minimum requirements. Line items, sub-line items and sub-totals can be presented as an addition or substitution on the face of the Financial Statements when such presentation is relevant for understanding of the company's financial position and /or performance.

4.1.3. In the Old Schedule VI, break-up of amounts disclosed in the main Balance Sheet and Profit and Loss Account was given in the Schedules. Additional information was furnished in the Notes to Account. The Revised Schedule VI has eliminated the concept of 'Schedule' and such information is now to be furnished in the Notes to Accounts.

4.1.4. The terms used in the Revised Schedule VI will carry the meaning as defined by the applicable Accounting Standards. For example, the terms such as 'associate', 'related parties', etc. will have the same meaning as defined in Accounting Standards notified under Companies (Accounting Standards) Rules, 2006.

4.1.5. In preparing the Financial Statements including the Notes to Accounts, a balance will have to be maintained between providing excessive detail that may not assist users of Financial Statements and not providing important information as a result of too much aggregation.

4.1.6. All items of assets and liabilities are to be bifurcated between current and non-current portions and presented separately on the face of the Balance Sheet. Such classification was not required by the Old Schedule VI.

4.1.7. There is an explicit requirement to use the same unit of measurement uniformly throughout the Financial Statements and notes thereon. Moreover, rounding off requirements (where opted for) have been changed to eliminate the option of presenting figures in terms of hundreds and thousands if turnover exceeds 100 crores.

4.2. Major changes related to the Balance sheet

4.2.1. The Revised Schedule VI prescribes only the vertical format for presentation of Financial Statements. Thus, a company will now not have an option to use horizontal format for the presentation of Financial Statements as prescribed in Old Schedule VI.

4.2.2. Current and non-current classification has been introduced for presentation of assets and liabilities in the Balance Sheet. The application of this classification will require assets and liabilities to be segregated into their current and non-current portions. For instance, current maturities of a long-term borrowing will have to be classified under the head "Other current liabilities."

4.2.3. Number of shares held by each shareholder holding more than 5 percent shares in the company now needs to be disclosed. In the absence of any specific indication of the date of holding, such information should be based on shares held as on the Balance Sheet date.

4.2.4. Details pertaining to aggregate number and class of shares allotted for consideration other than cash, bonus shares and shares bought back will need to be disclosed only for a period of five years immediately preceding the Balance Sheet date including the current year.

4.2.5. Any debit balance in the Statement of Profit and Loss will be disclosed under the head "Reserves and surplus." Earlier, any debit balance in Profit and Loss Account carried forward after deduction from uncommitted reserves was required to be shown as the last item on the Assets side of the Balance Sheet.

4.2.6. Specific disclosures are prescribed for Share Application money. The application money not exceeding the capital offered for issuance and to the extent not refundable will be shown separately on the face of the Balance Sheet. The amount in excess of subscription or if the requirements of minimum subscription are not met will be shown under "Other current liabilities."

4.2.7. The term "sundry debtors" has been replaced with the term "trade receivables." 'Trade receivables' are defined as dues arising only from goods sold or services rendered in the normal course of business. Hence, amounts due on account of other contractual obligations can no longer be included in the trade receivables.

4.2.8. The Old Schedule VI required separate presentation of debtors outstanding for a period exceeding six months based on date on which the bill/invoice was raised whereas, the Revised Schedule VI requires separate disclosure of trade receivables outstanding for a period exceeding six months from the date the bill/invoice is due for payment.

4.2.9. "Capital advances" are specifically required to be presented separately under the head "Loans & advances" rather than including elsewhere.

4.2.10. Tangible assets under lease are required to be separately specified under each class of asset. In the absence of any further clarification, the term "under lease" should be taken to mean assets given on operating lease in the case of lessor and assets held under finance lease in the case of lessee.

4.2.11. In the Old Schedule VI, details of only capital commitments were required to be disclosed. Under the Revised Schedule VI, other commitments also need to be disclosed.

4.2.12. The Revised Schedule VI requires disclosure of all defaults in repayment of loans and interest to be specified in each case. Earlier, no such disclosure was required in the Financial Statements. However, disclosures pertaining to defaults in repayment of dues to a financial institution, bank and debenture holders continue to be required in the report under Companies (Auditor's Report) Order, 2003 (CARO).

4.2.13. The Revised Schedule VI introduces a number of other additional disclosures. Some examples are:

- (a) Rights, preferences and restrictions attaching to each class of shares, including restrictions on the distribution of dividends and the repayment of capital;
- (b) Terms of repayment of long-term loans;
- (c) In each class of investment, details regarding names of the bodies corporate in whom investments have been made, indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities, and the nature and extent of the investment made in each such body corporate (showing separately partly-paid investments);
- (d) Aggregate provision for diminution in value of investments separately for current and long-term investments;
- (e) Stock-in-trade held for trading purposes, separately from other finished goods.

4.3. Main changes related to Statement of Profit and Loss

4.3.1. The name has been changed to "Statement of Profit and Loss" as against 'Profit and Loss Account' as contained in the Old Schedule VI.

4.3.2. Unlike the Old Schedule VI, the Revised Schedule VI lays down a format for the presentation of Statement of Profit and Loss. This format of Statement of Profit and Loss does not mention any appropriation item on its face. Further, the Revised Schedule VI format prescribes such 'below the line' adjustments to be presented under "Reserves and Surplus" in the Balance Sheet.

4.3.3. In addition to specific disclosures prescribed in the Statement of Profit and Loss, any item of income or expense which exceeds one percent of the revenue from operations or Rs. 100,000 (earlier 1 % of total revenue or Rs. 5,000), whichever is higher, needs to be disclosed separately.

4.3.4. The Old Schedule VI required the parent company to recognize dividends declared by subsidiary companies even after the date of the Balance Sheet if they were pertaining to the period ending on or before the Balance Sheet date. Such requirement no longer exists in the Revised Schedule VI. Accordingly, as per *AS-9 Revenue Recognition*, dividends should be recognized as income only when the right to receive dividends is established as on the Balance Sheet date.

4.3.5. In respect of companies other than finance companies, revenue from operations need to be disclosed separately as revenue from (a) sale of products, (b) sale of services and (c) other operating revenues.

4.3.6. Net exchange gain/loss on foreign currency borrowings to the extent considered as an adjustment to interest cost needs to be disclosed separately as finance cost.

4.3.7. Break-up in terms of quantitative disclosures for significant items of Statement of Profit and Loss, such as raw material consumption, stocks, purchases and sales have been simplified and replaced with the disclosure of "broad heads" only. The broad heads need to be decided based on considerations of materiality and presentation of true and fair view of the Financial Statements.

4.4. Disclosures no longer required

The Revised Schedule VI has removed a number of disclosure requirements that were not considered relevant in the present day context. Examples include:

- (a) Disclosures relating to managerial remuneration and computation of net profits for calculation of commission;
- (b) Information relating to licensed capacity, installed capacity and actual production;
- (c) Information on investments purchased and sold during the year;
- (d) Investments, sundry debtors and loans & advances pertaining to companies under the same management;
- (e) Maximum amounts due on account of loans and advances from directors or officers of the company;
- (f) Commission, brokerage and non-trade discounts

However, there are certain disclosures such as value of imports calculated on CIF basis, earnings/expenditure in foreign currency, etc. that still continue in the Revised Schedule VI.

5. Structure of the Revised Schedule VI

The Structure of Revised Schedule VI is as under:

I. General Instructions

II. Part I – Form of Balance Sheet

III. General Instructions for Preparation of Balance Sheet

IV. Part II – Form of Statement of Profit and Loss

V. General Instructions for Preparation of Statement of Profit and Loss

6. General Instructions to The Revised Schedule VI

6.1. The General Instructions lay down the broad principles and guidelines for preparation and presentation of Financial Statements.

6.2. As laid down in the Preface to the Statements of Accounting Standards issued by ICAI, if a particular Accounting Standard is found to be not in conformity with law, the provisions of the said law will prevail and the Financial Statements should be prepared in conformity with such law. Accordingly, by virtue of this principle, disclosure requirements of the Old Schedule VI were considered to prevail over Accounting Standards. However, since the Revised Schedule VI gives overriding status to the requirements of the Accounting Standards and other requirements of the Act, such principle of law overriding the Accounting Standards is inapplicable in the context of the Revised Schedule VI.

6.3. The Revised Schedule VI requires that if compliance with the requirements of the Act including applicable Accounting Standards require any change in the treatment or disclosure including addition, amendment, substitution or deletion in the head/sub-head or any changes inter se, in the Financial Statements or statements forming part thereof, the same shall be made and the requirements of Revised Schedule VI shall stand modified accordingly.

6.4. Implications of all instructions mentioned above can be illustrated by means of the following example. One of the line items to be presented on the face of the Balance Sheet under Current assets is "Cash and cash equivalents". The break-up of these items required to be presented by the Revised Schedule VI comprises of items such as Balances with banks held as margin money or security against borrowings, guarantees, etc. and bank deposits with more than 12 months maturity. According to *AS-3 Cash Flow Statements*, Cash is defined to include cash on hand and demand deposits with banks. Cash Equivalents are defined as short term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value. The Standard further explains that an investment normally qualifies as a cash equivalent only when it has a short maturity of three months or less from the date of acquisition. Hence, normally, deposits with original maturity of three months or less only should be classified as cash equivalents. Further, bank balances held as margin money or security against borrowings are neither in the nature of demand deposits, nor readily available for use by the company, and accordingly, do not meet the aforesaid definition of cash equivalents. Thus, this is an apparent conflict between the requirements of the Revised Schedule VI and the Accounting Standards with respect to which items should form part of Cash and cash equivalents. As laid down in the General Instructions, Para 1 of Revised Schedule VI, requirements of the Accounting Standards would prevail over the Revised Schedule VI and the company should make necessary modifications in the Financial Statements which may include addition, amendment, substitution or deletion in the head/sub-head or any other changes inter se. Accordingly, the conflict should be resolved by changing the caption "*Cash and cash equivalents*" to "*Cash and bank balances*," which may have two sub-headings, viz., "*Cash and cash equivalents*" and "*Other bank balances*." The former should include only the items that constitute Cash and cash equivalents defined in accordance with AS 3 (and not the Revised Schedule VI), while the remaining line-items may be included under the latter heading.

6.5. Para 2 of the General Instructions to the Revised Schedule VI states that the disclosure requirements of the Schedule are in addition to and not in substitution of the disclosure requirements

specified in the notified Accounting Standards. They further clarify that the additional disclosures specified in the Accounting Standards shall be made in the Notes to Accounts or by way of an additional statement unless required to be disclosed on the face of the Financial Statements. All other disclosures required by the Act are also required to be made in the Notes to Accounts in addition to the requirements set out in the Revised Schedule VI.

6.6. An example to illustrate the above point is the specific disclosure required by *AS-24 Discontinuing Operations* on the face of the Statement of Profit and Loss which has not been incorporated in the Revised Schedule VI. The disclosure pertains to the amount of pre-tax gain or loss recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation. Accordingly, such disclosures specifically required by the Accounting Standard on the face of either the Statement of Profit and Loss or Balance Sheet will have to be so made even if not forming part of the formats prescribed under the Revised Schedule VI.

6.7. All the other disclosures required by the Accounting Standards will continue to be made in the Financial Statements. Further, the disclosures required by the Act will continue to be made in the Notes to Accounts. An example of this is the separate disclosure required by Section 293A of the Act for donations made to political parties. Such disclosures would be made in the Notes.

6.8. Though not specifically required by the Revised Schedule VI, disclosures mandated by other Acts or legal requirements will have to be made in the Financial Statements. For example, The Micro, Small and Medium Enterprises Development (MSMED) Act, 2006 requires specified disclosures to be made in the annual Financial Statements of the buyer wherever such Financial Statements are required to be audited under any law. Accordingly, such disclosures will have to be made in the buyer company's annual Financial Statements.

6.9. The above principle would apply to disclosures required by other legal requirements as well such as, disclosures required under Clause 32 to the Listing Agreement, etc. A further extension of the above principle also means that specific disclosures required by various pronouncements of regulatory bodies such as the ICAI announcement for disclosures on derivatives and unhedged foreign currency exposures, and other disclosure requirements prescribed by various ICAI Guidance Notes, such as Guidance Note on Employee Share-based Payments, etc. should continue to be made in the Financial Statements in addition to the disclosures specified by the Revised Schedule VI.

6.10. In the Old Schedule VI, break-up of amounts disclosed on the face of the Balance Sheet and Profit and Loss Account was required to be given in the Schedules. Additional information was required to be furnished in the Notes to Account. The Revised Schedule VI requires all information relating to each item on the face of the Balance Sheet and Statement of Profit and Loss to be cross-referenced to the Notes to Accounts. The manner of such cross-referencing to various other informations contained in the Financial Statements has also been changed to "Note No." as compared to "Schedule No." in the Old Schedule VI. Hence, the same is suggestive of a change in the old format of presentation from Schedules and Notes to Accounts to the new format of only Notes to Accounts. The instructions state that the Notes to Accounts should provide where required, narrative descriptions or disaggregations of items recognized in those statements. Hence, presentation of all narrative descriptions and disaggregations should preferably be presented in the form of Notes to Accounts rather than in the form of Schedules. Such style of presentation is also in line with the manner of presentation of Financial Statements followed by companies internationally and would facilitate comparability of Financial Statements.

6.11. Para 3 of the General Instructions of the Revised Schedule VI also states that the Notes to Accounts should also contain information about items that do not qualify for recognition in Financial Statements. These disclosures normally refer to items such as Contingent Liabilities and Commitments

which do not get recognised in the Financial Statements. These have been dealt with later in this Guidance Note. Some of the other disclosures relating to items that are not recognised in the Financial Statements also emanate from the Accounting Standards, such as, disclosures required under *AS 9 Revenue Recognition* on circumstances in which revenue recognition is to be postponed pending the resolution of significant uncertainties. Contingent Assets, however, are not to be disclosed in the Financial Statements as per *AS 29 Provisions, Contingent Liabilities and Contingent Assets*.

6.12. The General Instructions also lay down the principle that in preparing Financial Statements including Notes to Accounts, a balance shall be maintained between providing excessive detail that may not assist users of Financial Statements and not providing important information as a result of too much aggregation. Compliance with this requirement is a matter of professional judgement and may vary on a case to case basis based on facts and circumstances. However, it is necessary to strike a balance between overburdening Financial Statements with excessive detail that may not assist users of Financial Statements and obscuring important information as a result of too much aggregation. For example, a company should not obscure important information by including it among a large amount of insignificant detail or in a way that it obscures important differences between individual transactions or associated risks.

6.13. The Revised Schedule VI has specifically introduced a new requirement of using the same unit of measurement uniformly across the Financial Statements. Such requirement should be taken to imply that all figures disclosed in the Financial Statements including Notes to Accounts should be of the same denomination.

6.14. The Revised Schedule VI has also introduced new rounding off requirements as compared to the Old Schedule VI. The new requirement does not prescribe the option to present figures in terms of hundreds and thousands if the turnover equals or exceeds Rs. 100 crores. Rather, they allow rounding off in crores, which was earlier permitted only when the turnover equaled or exceeded five hundred crores rupees. Similarly, where turnover is below Rs. 100 crore, the Revised Schedule VI gives an option to present figures in lakhs and millions as well, which did not exist earlier. However, it is not compulsory to apply rounding off and a company can continue to disclose full figures. But, if the same is applied, the rounding off requirement should be complied with.

| Old Schedule VI | Revised Schedule VI |
|--|---|
| <ul style="list-style-type: none"> • Turnover < Rs. 100 Crores – Round off to the nearest hundreds, thousands or decimal thereof • Turnover Rs. 100 to Rs. 500 Crores - Round off to the nearest hundreds, thousands, lakhs or millions or decimal thereof • Turnover > Rs. 500 Crores Round off to the nearest hundreds, thousands, lakhs, millions or crores, or decimal thereof. | <ul style="list-style-type: none"> • Turnover < Rs. 100 Crores - Round off to the nearest hundreds, thousands, lakhs or millions or decimal thereof. • Turnover > Rs. 100 Crores Round off to the nearest lakhs, millions or crores, or decimal thereof |

6.15. The instructions also clarify that the terms used in the Revised Schedule VI shall be as per the applicable Accounting Standards. For example, the term 'related parties' used at several places in the Revised

Schedule VI should be interpreted based on the definition given in *AS-18 Related Party Disclosures*.

6.16. The Notes to the General Instructions re-clarify that the Revised Schedule VI sets out the minimum requirements for disclosure in the Financial Statements including notes. It states that line

items, sub-line items and sub-totals shall be presented as an addition or substitution on the face of the Balance Sheet and Statement of Profit and Loss when such presentation is relevant to an understanding of the company's financial position or performance or to cater to industry/sector-specific disclosure requirements, apart from, when required for compliance with amendments to the Act or the Accounting Standards.

The application of the above requirement is a matter of professional judgement. The following examples illustrate this requirement. Earnings before Interest, Tax, Depreciation and Amortisation is often an important measure of financial performance of the company relevant to the various users of Financial Statements and stakeholders of the company. Hence, a company may choose to present the same as an additional line item on the face of the Statement of Profit and Loss. The method of computation adopted by companies for presenting such measures should be followed consistently over the years. Further, companies should also disclose the policy followed in the measurement of such line items.

6.17. Similarly, users and stakeholders often want to know the liquidity position of the company. To highlight the same, a company may choose to present additional sub-totals of Current assets and Current liabilities on the face of the Balance Sheet.

6.18. One example of addition or substitution of line items, sub-line items and sub-totals to cater to industry-specific disclosure requirements can be noted from Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007. The Directions prescribe that every non-banking finance company is required to separately disclose in its Balance Sheet the provisions made under the Directions without netting them from the income or against the value of assets. Though not specifically required by the Schedule, such addition or substitution of line items can be made in the notes forming part of the Financial Statements as well.

7. General Instructions For Preparation of Balance Sheet : Notes 1 To 5

7.1. Current/Non-current assets and liabilities:

The Revised Schedule VI requires all items in the Balance Sheet to be classified as either Current or Non-current and be reflected as such. Notes 1 to 3 of the Revised Schedule VI define Current Asset, Operating Cycle and Current Liability as below:

7.1.1. "An asset shall be classified as current when it satisfies any of the following criteria:

- (a) it is expected to be realized in, or is intended for sale or consumption in, the company's normal operating cycle;
- (b) it is held primarily for the purpose of being traded;
- (c) it is expected to be realized within twelve months after the reporting date; or
- (d) it is Cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

All other assets shall be classified as non-current."

7.1.2. "An operating cycle is the time between the acquisition of assets for processing and their realization in Cash or cash equivalents. Where the normal operating cycle cannot be identified, it is assumed to have a duration of twelve months."

7.1.3. "A liability shall be classified as current when it satisfies any of the following criteria:

- (a) it is expected to be settled in the company's normal operating cycle;
- (b) it is held primarily for the purpose of being traded;

- (c) it is due to be settled within twelve months after the reporting date; or
- (d) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

All other liabilities shall be classified as non-current.”

7.1.4. The Revised Schedule VI defines “current assets” and “current liabilities”, with the non-current category being the residual. It is therefore necessary that the balance pertaining to each item of assets and liabilities contained in the Balance Sheet be split into its current and non-current portions and be classified accordingly as on the reporting date.

7.1.5. Based on the definition, current assets include assets such as raw material and stores which are intended for consumption or sale in the course of the company's normal operating cycle. Items of inventory which may be consumed or realized within the company's normal operating cycle should be classified as current even if the same are not expected to be so consumed or realized within twelve months after the reporting date. Current assets would also include assets held primarily for the purpose of being traded such as inventory of finished goods. They would also include trade receivables which are expected to be realized within twelve months from the reporting date and Cash and cash equivalents which are not under any restriction of use.

7.1.6. Similarly, current liabilities would include items such as trade payables, employee salaries and other operating costs that are expected to be settled in the company's normal operating cycle or due to be settled within twelve months from the reporting date. It is pertinent to note that such operating liabilities are normally part of the working capital of the company used in the company's normal operating cycle and hence, should be classified as current even if they are due to be settled more than twelve months after the end of the reporting date.

7.1.7. Further, any liability, pertaining to which the company does not have an unconditional right to defer its settlement for at least twelve months after the Balance Sheet/reporting date, will have to be classified as current.

7.1.8. The application of this criterion could be critical to the Financial Statements of a company and requires careful evaluation of the various terms and conditions of a loan liability. To illustrate, let us understand how this requirement will apply to the following example:

Company X has taken a five year loan. The loan contains certain debt covenants, e.g., filing of quarterly information, failing which the bank can recall the loan and demand repayment thereof. The company has not filed such information in the last quarter; as a result of which the bank has the right to recall the loan. However, based on the past experience and/or based on the discussions with the bank the management believes that default is minor and the bank will not demand the repayment of loan. According to the definition of Current Liability, what is important is, whether a borrower has an unconditional right at the Balance Sheet date to defer the settlement

irrespective of the nature of default and whether or not a bank can exercise its right to recall the loan. If the borrower does not have such right, the classification would be “current.” It is pertinent to note that as per the terms and conditions of the aforesaid loan, the loan was not repayable on demand from day one. The loan became repayable on demand only on default in the debt covenant and bank has not demanded the repayment of loan up to the date of approval of the accounts. In the Indian context, the criteria of a loan becoming repayable on demand on breach of a covenant, is generally added in the terms and conditions as a matter of abundant caution. Also, banks generally do not demand repayment of loans on such minor defaults of debt covenants. Therefore, in such situations, the companies

generally continue to repay the loan as per its original terms and conditions. Hence, considering that the practical implications of such minor breach are negligible in the Indian scenario, an entity could continue to classify the loan as "non-current" as on the Balance Sheet date since the loan is not actually demanded by the bank at any time prior to the date on which the Financial Statements are approved. However, in case a bank has recalled the loan before the date of approval of the accounts on breach of a loan covenant that occurred before the year-end, the loan will have to be classified as current. Further, the above situation should not be confused with a loan which is repayable on demand from day one. For such loans, even if the lender does not demand repayment of the loan at any time, the same would have to be continued to be classified as "current".

7.2. The term "Operating Cycle" is defined as the time between the acquisition of assets for processing and their realization in Cash or cash equivalents. A company's normal operating cycle may be longer than twelve months e.g. companies manufacturing wines, etc. However, where the normal operating cycle cannot be identified, it is assumed to have a duration of twelve months.

7.2.1. Where a company is engaged in running multiple businesses, the operating cycle could be different for each line of business. Such a company will have to classify all the assets and liabilities of the respective businesses into current and non-current, depending upon the operating cycles for the respective businesses.

Let us consider the following other examples:

1. A company has excess finished goods inventory that it does not expect to realize within the company's operating cycle of fifteen months. Since such finished goods inventory is held primarily for the purpose of being traded, the same should be classified as "current".
2. A company has sold 10,000 tonnes of steel to its customer. The sale contract provides for a normal credit period of three months. The company's operating cycle is six months. However, the company does not expect to receive the payment within twelve months from the reporting date. Therefore, the same should be classified as "Non-Current" in the Balance Sheet. In case, the company expects to realize the amount upto 12 months from the Balance Sheet date (though beyond operating cycle), the same should be classified as "current".

7.3. For the purpose of Revised Schedule VI, a company also needs to classify its employee benefit obligations as current and non-current categories. While *AS-15 Employee Benefits* governs the measurement of various employee benefit obligations, their classification as current and noncurrent liabilities will be governed by the criteria laid down in the Revised Schedule VI. In accordance with these criteria, a liability is classified as "current" if a company does not have an unconditional right as on the Balance Sheet date to defer its settlement for twelve months after the reporting date. Each company will need to apply these criteria to its specific facts and circumstances and decide an appropriate classification of its employee benefit obligations. Given below is an illustrative example on application of these criteria in a simple situation:

- (a) Liability toward bonus, etc., payable within one year from the Balance Sheet date is classified as "current".
- (b) In case of accumulated leave outstanding as on the reporting date, the employees have already earned the right to avail the leave and they are normally entitled to avail the leave at any time during the year. To the extent, the employee has unconditional right to avail the leave, the same needs to be classified as "current" even though the same is measured as 'other long-term employee benefit' as per *AS-15*. However, whether the right to defer the employee's leave is available unconditionally with the company needs to be evaluated on a case to case basis – based on the terms of Employee Contract and Leave Policy, Employer's right to postpone/deny

the leave, restriction to avail leave in the next year for a maximum number of days, etc. In case of such complexities the amount of Non-current and Current portions of leave obligation should normally be determined by a qualified Actuary.

- (c) Regarding funded post-employment benefit obligations, amount due for payment to the fund created for this purpose within twelve months is treated as “current” liability. Regarding the unfunded post-employment benefit obligations, a company will have settlement obligation at the Balance Sheet date or within twelve months for employees such as those who have already resigned or are expected to resign (which is factored for actuarial valuation) or are due for retirement within the next twelve months from the Balance Sheet date. Thus, the amount of obligation attributable to these employees is a “current” liability. The remaining amount attributable to other employees, who are likely to continue in the services for more than a year, is classified as “non-current” liability. Normally the actuary should determine the amount of current & non-current liability for unfunded post-employment benefit obligation based on the definition of Current and Non-current assets and liabilities in the Revised Schedule VI.

7.4. The Revised Schedule VI requires Investments to be classified as Current and Non-Current. However, *AS 13 ‘Accounting for Investments’* requires to classify Investments as Current and Long-Term. As per *AS 13*, current investment is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made. A long-term investment is an investment other than a current investment.

7.4.1. Accordingly, as per *AS-13*, the assessment of whether an Investment is “Long-term” has to be made with respect to the date of Investment whereas, as per the Revised Schedule VI, “Non-current” Investment has to be determined with respect to the Balance Sheet date.

7.4.2. Though the Revised Schedule VI clarifies that the Accounting Standards would prevail over itself in case of any inconsistency between the two, it is pertinent to note that AS-13 does not lay down presentation norms, though it requires disclosures to be made for Current and Long-term Investments. Accordingly, presentation of all investments in the Balance Sheet should be made based on Current/Non-current classification as defined in the Revised Schedule VI. The portion of long-term investment as per *AS 13* which is expected to be realized within twelve months from the Balance Sheet date needs to be shown as Current investment under the Revised Schedule VI.

7.5. Settlement of a liability by issuing of equity

7.5.1. The Revised Schedule VI clarifies that, “the terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification”. A consequence of this is that if the conversion option in convertible debt is exercisable by the holder at any time, the liability cannot be classified as “current” if the maturity for cash settlement is greater than one year. A question therefore arises as to how does the aforesaid requirement affect the classification of items for say,

- a) convertible debt where the conversion option lies with the issuer, or b) mandatorily convertible debt instrument.

7.5.2. Based on the specific exemption granted only to those cases where the conversion option is with the counterparty, the same should not be extended to other cases where such option lies with the issuer or is a mandatorily convertible instrument. For all such cases, conversion of a liability into equity should be considered as a means of settlement of the liability as defined in the Framework For the Preparation and Presentation of Financial Statements issued by ICAI. Accordingly, the timing of such settlement would also decide the classification of such liability in terms of Current or Non-current as defined in the Revised Schedule VI.

7.6 As per the classification in the Revised Schedule VI and in line with the ICAI's earlier announcement with regard to the presentation and classification of net Deferred Tax asset or liability, the same should always be classified as "non-current".

8. Part I: Form of Balance Sheet and Note 6 to General Instructions for Preparation of Balance Sheet

As per the Framework for The Preparation and Presentation of Financial Statements, asset, liability and equity are defined as follows:

An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.

A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

Equity is the residual interest in the assets of the enterprise after deducting all its liabilities.

I. Equity and Liabilities

8.1. Shareholders' Funds

Under this head, following line items are to be disclosed:

- Share Capital;
- Reserves and Surplus;
- Money received against share warrants.

8.1.1. Share capital

8.1.1.1. Notes to the General Instructions require a company to disclose in the Notes to Accounts line items/sub-line items referred to in Notes 6A to 6Q. Clauses (a) to (l) of Note 6 A deal with disclosures for Share Capital and such disclosures are required for each class of share capital (different classes of preference shares to be treated separately).

8.1.1.2. As per ICAI Guidance Note on Terms Used in Financial Statements, 'Capital' refers "*to the amount invested in an enterprise by its owners e.g. paid-up share capital in a corporate enterprise. It is also used to refer to the interest of owners in the assets of an enterprise.*"

8.1.1.3. The said Guidance Note defines 'Share Capital' as the "*aggregate amount of money paid or credited as paid on the shares and/or stocks of a corporate enterprise.*"

8.1.1.4. In respect of disclosure requirements for Share Capital, the Revised Schedule VI states that "different classes of preference share capital to be treated separately". A question arises whether the preference shares should be presented as share capital only or does it mean that a company compulsorily needs to decide whether preference shares are liability or equity based on its economic substance using *AS 31 Financial Instruments: Presentation* principles and present the same accordingly. The Revised Schedule VI deals only with presentation and disclosure requirements. Accounting for various items is governed by the applicable Accounting Standards. However, since Accounting Standards *AS 30 Financial Instruments: Recognition and Measurement*, *AS 31* and *AS 32 Financial Instruments: Disclosures* are yet to be notified and Section 85(1) of the Act refers to Preference Shares as a kind of share capital, Preference Shares will have to be classified as Share Capital.

8.1.1.5. Presently, in the Indian context, generally, there are two kinds of share capital namely - Equity and Preference. Within Equity/Preference Share Capital, there could be different classes of shares, say, Equity Shares with or without voting rights, Compulsorily Convertible Preference Shares,

Optionally Convertible Preference Shares, etc. If the preference shares are to be disclosed under the head 'Share Capital', until the same are actually redeemed, they should continue to be shown under the head 'Share Capital'. Preference shares of which redemption is overdue should continue to be disclosed under the head 'Share Capital'.

8.1.1.6. Clause (a) of Note 6A - the number and amount of shares authorized :

As per the Guidance Note on Terms Used in Financial Statements 'Authorised Share Capital' means *"the number and par value, of each class of shares that an enterprise may issue in accordance with its instrument of incorporation. This is sometimes referred to as nominal share capital."*

8.1.1.7. Clause (b) of Note 6A - the number of shares issued, subscribed and fully paid, and subscribed but not fully paid :

The disclosure is for shares:

- Issued;
- Subscribed and fully paid;
- Subscribed but not fully paid.

Though the disclosure is only for the number of shares, to make the disclosure relevant to understanding the company's share capital, even the amount for each category should be disclosed. Issued shares are those which are offered for subscription within the authorised limit. It is possible that all shares offered are not subscribed to and to the extent of unsubscribed portion, there will be difference between shares issued and subscribed. As per the Guidance Note on Terms Used in Financial Statements, the expression 'Subscribed Share Capital' is *"that portion of the issued share capital which has actually been subscribed and allotted. This includes any bonus shares issued to the shareholders."*

Though there is no requirement to disclose the amount per share called, if shares are not fully called, it would be appropriate to state the amount per share called. As per the definition contained in the Guidance Note on Terms Used in Financial Statements, the expression 'Paid-up Share Capital' is *"that part of the subscribed share capital for which consideration in cash or otherwise has been received. This includes bonus shares allotted by the corporate enterprise."* As per the Old Schedule VI, debit balance on the allotment or call account is presented in the Balance Sheet not as an asset but by way of deduction from Called-up Capital. However, as required by Clause (k) of Note 6A of the Revised Schedule VI, calls unpaid are to be disclosed separately as per the Revised Schedule VI.

However, the unpaid amount towards shares subscribed by the subscribers of the Memorandum of Association should be considered as 'subscribed and paid-up capital' in the Balance Sheet and the debts due from the subscriber should be appropriately disclosed as an asset in the balance sheet.

8.1.1.8. Clause (c) of Note 6A – par value per share :

Par value per share is the face value of a share as indicated in the Capital Clause of the Memorandum of Association of a company. It is also referred to as '*face value*' per share. In the case of a company having share capital, (unless the company is an unlimited company), the Memorandum shall also state the amount of share capital with which the company is registered and their division thereof into shares of fixed amount as required under clause (a) to the sub-section (4) of section 13 of the Act. In the case of a company limited by guarantee, Memorandum shall state that each member undertakes to contribute to the assets of the company in the event of winding-up while he is a member or within one year after he ceases to be a member, for payment of debts and liabilities of the company, as the case may be. There is no specific mention for the disclosure by companies limited by guarantee and having

share capital, and companies limited by guarantee and not having share capital. Such companies need to consider the requirement so as to disclose the amount each member undertakes to contribute as per their Memorandum of Association.

8.1.1.9. Clause (d) of Note 6A - a reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period :

As per the Revised Schedule VI, opening number of shares outstanding, shares issued, shares bought back, other movements, etc. during the year and closing number of outstanding shares should be shown. Though the requirement is only for a reconciliation of the number of shares, as given for the disclosure of issued, subscribed capital, etc. [Clause (b) of Note 6A] above, to make the disclosure relevant for understanding the company's share capital, the reconciliation is to be given even for the amount of share capital. Reconciliation for the comparative previous period is also to be given. Further, the above reconciliation should be disclosed separately for both Equity and Preference Shares and for each class of share capital within Equity and Preference Shares.

8.1.1.10. Clause (e) of Note 6A - the rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital.

As per the Guidance Note on Terms Used in Financial Statement, the expression 'Preference Share Capital' means *"that part of the share capital of a corporate enterprise which enjoys preferential rights in respect of payments of fixed dividend and repayment of capital. Preference shares may also have full or partial participating rights in surplus profits or surplus capital."* The rights, preferences and restrictions attached to shares are based on the classes of shares, terms of issue, etc., whether equity or preference. In respect of Equity Share Capital, it may be with voting rights or with differential voting rights as to dividend, voting or otherwise in accordance with such rules and subject to such conditions as may be prescribed under Companies (Issue of Share Capital with Differential Voting Rights) Rules, 2001. In respect of Preference shares, the rights include (a) as respects dividend, a preferential right to be paid a fixed amount or at a fixed rate and, (b) as respects capital, a preferential right of repayment of amount of capital on winding up. Further, Preference shares can be cumulative, noncumulative, redeemable, convertible, non-convertible etc. All such rights, preferences and restrictions attached to each class of preference shares, terms of redemption, etc. have to be disclosed separately.

8.1.1.11. Clause (f) of Note 6A - shares in respect of each class in the company held by its holding company or its ultimate holding company including shares held by or by subsidiaries or associates of the holding company or the ultimate holding company in aggregate :

The requirement is to disclose shares of the company held by -

- Its holding company;
- Its ultimate holding company;
- Subsidiaries of its holding company;
- Subsidiaries of its ultimate holding company;
- Associates of its holding company; and
- Associates of its ultimate holding company.

Aggregation should be done for each of the above categories.

The terms 'subsidiary', 'holding company' and 'associate' should be understood as defined under AS-21, *Consolidated Financial Statements* and AS-18, *Related Party Disclosures*. Based on the aforesaid definitions, for the purposes of the above disclosures, shares held by the entire chain of subsidiaries and associates starting from the holding company and ending right up to the ultimate holding company

would have to be disclosed. Further, all the above disclosures need to be made separately for each class of shares, both within Equity and Preference Shares.

8.1.1.12. Clause (g) of Note 6A -shares in the company held by each shareholder holding more than 5 percent shares specifying the number of shares held :

In the absence of any specific indication of the date of holding, the date for computing such percentage should be taken as the Balance Sheet date. For example, if during the year, any shareholder held more than 5% Equity shares but does not hold as much at the Balance Sheet date, disclosure is not required. Though it is not specified as to whether the disclosure is required for each class of shares or not, companies should disclose the shareholding for each class of shares, both within Equity and Preference Shares. Accordingly, such percentage should be computed separately for each class of shares outstanding within Equity and Preference Shares. This information should also be given for the comparative previous period.

8.1.1.13. Clause (h) of Note 6A - shares reserved for issue under options and contracts/commitments for the sale of shares/ disinvestment, including the terms and amounts :

Shares under options generally arise under promoters or collaboration agreements, loan agreements or debenture deeds (including convertible debentures), agreement to convert preference shares into equity shares, ESOPs or contracts for supply of capital goods, etc. The disclosure would be required for the number of shares, amounts and other terms for shares so reserved. Such options are in respect of unissued portion of share capital.

8.1.1.14. Clause (i) of Note 6A – For the period of five years immediately preceding the date as at which the Balance Sheet is prepared : (a) Aggregate number and class of shares allotted as fully paid up pursuant to contract(s) without payment being received in cash. (b) Aggregate number and class of shares allotted as fully paid up by way of bonus shares. (c) Aggregate number and class of shares bought back.

- (a) Aggregate number and class of shares allotted as fully paid up pursuant to contract(s) without payment being received in cash.

The following allotments are considered as shares allotted for payment being received in cash and not as without payment being received in cash and accordingly, the same are not to be disclosed under this Clause:

- (i) If the subscription amount is adjusted against a *bona fide* debt payable in money at once by the company;
- (ii) Conversion of loan into shares in the event of *default* in repayment.
- (b) Aggregate number and class of shares allotted as fully paid up by way of bonus shares.

As per the Guidance Note on Terms Used in Financial Statements 'Bonus shares' are defined as shares allotted by capitalisation of the reserves or surplus of a corporate enterprise. The requirement of disclosing the source of bonus shares is omitted in the Revised Schedule VI.

- (c) Aggregate number and class of shares bought back.

The total number of shares bought back for each class of shares needs to be disclosed.

All the above details pertaining to aggregate number and class of shares allotted for consideration other than cash, bonus shares and shares bought back need to be disclosed only if such event has occurred during a period of five years immediately preceding the Balance Sheet date. Since disclosure is for the aggregate number of shares, it is not necessary to give the year-wise break-up of the shares allotted or bought back, but the aggregate number for the last five financial years needs to be disclosed.

8.1.1.15. Clause (j) of Note 6A - Terms of any securities convertible into equity/preference shares issued along with the earliest date of conversion in descending order starting from the farthest such date:

This disclosure would cover securities, such as Convertible Preference Shares, Convertible Debentures/bonds, etc. – optionally or otherwise into equity.

Under this Clause, disclosure is required for any security, when it is either convertible into equity or preference shares. In this case, terms of such securities and the earliest date of conversion are required to be disclosed. If there are more than one date of conversion, disclosure is to be made in the descending order of conversion. If the option can be exercised in different periods then earlier date in that period is to be considered. In case of compulsorily convertible securities, where conversion is done in fixed tranches, all the dates of conversion have to be considered. Terms of convertible securities are required to be disclosed under this Clause. However, in case of Convertible debentures/bonds, etc., for the purpose of simplification, reference may also be made to the terms disclosed under the note on Long-term borrowings where these are required to be classified in the Balance Sheet, rather than disclosing the same again under this clause.

8.1.1.16. Clause (k) of Note 6(A) - Calls unpaid (showing aggregate value of calls unpaid by directors and officers):

A separate disclosure is required for the aggregate value of calls unpaid by directors and also officers of the company. The Old Schedule VI required disclosures of calls due by directors only. The total calls unpaid should be disclosed. The terms 'director' and 'officer' should be interpreted based on the definitions in the Act.

Note 6(B) of the General Instructions deals with the disclosures of "Reserves and Surplus" in the Notes to Accounts and the classification thereof under the various types of reserves.

8.1.2.1. Reserve:

The Guidance Note on Terms Used in Financial Statements defines the term 'Reserve' as *"the portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability."* 'Reserves' should be distinguished from 'provisions'. For this purpose, reference may be made to the definition of the expression 'provision' in *AS-29 Provisions, Contingent Liabilities and Contingent Assets*.

As per *AS-29*, a 'provision' is *"a liability which can be measured only by using a substantial degree of estimation"*. A 'liability' is *"a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits."* 'Present obligation' – *"an obligation is a present obligation if, based on the evidence available, its existence at the Balance Sheet date is considered probable, i.e., more likely than not."*

8.1.2.2. Capital Reserves :

It is necessary to make a distinction between capital reserves and revenue reserves in the accounts. A revenue reserve is a reserve which is available for distribution through the Statement of Profit and Loss. The term "Capital Reserve" has not been defined under the Revised Schedule VI. However, as per the Guidance Note on Terms Used in Financial Statements, the expression 'capital reserve' is defined as *"a reserve of a corporate enterprise which is not available for distribution as dividend"*. Though the Revised Schedule VI does not have the requirement of *"transferring capital profit on reissue of forfeited shares to capital reserve"*, since profit on re-issue of forfeited shares is basically profit of a capital nature and, hence, it should be credited to capital reserve.

8.1.2.3. Capital Redemption Reserve :

Under the Act, Capital Redemption Reserve is required to be created in the following two situations:

- a) Under the provisions of Section 80 of the Act, where the redemption of preference shares is out of profits, an amount equal to nominal value of shares redeemed is to be transferred to a reserve called 'capital redemption reserve'.
- b) Under Section 77AA of the Act, if the buy-back of shares is out of free reserves, the nominal value of the shares so purchased is required to be transferred to capital redemption reserve from distributable profit.

8.1.2.4. Securities Premium Reserve :

The Guidance Note of Terms Used in Financial Statements defines 'Share Premium' as *"the excess of the issue price of shares over their face value."* Though the terminology used in the Revised Schedule VI is 'Securities Premium Reserve' the nomenclature as per the Act is "Securities Premium Account". Accordingly, the terminology of the Act should be used.

8.1.2.5. Debenture Redemption Reserve :

According to Section 117C of the Act where a company issues debentures after the commencement of this Act, it is required to create a debenture redemption reserve for the redemption of such debentures. The company is required to credit adequate amounts, from out of its profits every year to debenture redemption reserve, until such debentures are redeemed.

On redemption of the debentures for which the reserve is created, the amounts no longer necessary to be retained in this account need to be transferred to the General Reserve.

8.1.2.6. Revaluation Reserve :

As per the Guidance Note of Terms Used in Financial Statements, 'Revaluation reserve' is *'a reserve created on the revaluation of assets or net assets of an enterprise represented by the surplus of the estimated replacement cost or estimated market values over the book values thereof.'*

Accordingly, if a company has carried out revaluation of its assets, the corresponding amount would be disclosed as "Revaluation Reserve"

8.1.2.7. Share Options Outstanding Account :

Presently, as per the Guidance Note on Accounting for Employee Share-based Payments, Stock Options Outstanding Account is shown as a separate line-item. The Revised Schedule VI requires this item to be shown as a part of 'Reserve and Surplus'.

8.1.2.8. Other Reserves (specify the nature and purpose of reserve and the amount in respect thereof) :

Every other reserve which is not covered in the paragraphs 8.1.2.2 to 8.1.2.7 is to be reflected as 'Other Reserves'. However, since the nature, purpose and the amount are to be shown, each reserve is to be shown separately. This would include reserves to be created under other statutes like Tonnage Tax Reserve to be created under the Income Tax Act, 1961.

8.1.2.9. Surplus i.e. balance in Statement of Profit and Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves, etc.

Appropriations to the profit for the year (including carried forward balance) is to be presented under the main head 'Reserves and Surplus'. Unlike the current prevalent practice, under the Revised Schedule VI, the Statement of Profit and Loss will no longer reflect any appropriations, like dividends transferred to Reserves, bonus shares, etc.

Please also refer to the discussion in Para 10.9 below.

8.1.2.10. Additions and deductions since the last Balance Sheet to be shown under each of the specified heads:

This requires the company to disclose the movement in each of the reserves and surplus since the last Balance Sheet.

Please refer to Para 10.9 of this Guidance note.

1. **8.1.2.11** As per Revised Schedule VI, a reserve specifically represented by earmarked investments shall be termed as a 'fund'

2. **8.1.2.12 Debit balance in the Statement of Profit and Loss and in Reserves and Surplus:**

Debit balance in the Statement of Profit and Loss which would arise in case of accumulated losses, is to be shown as a negative figure under the head 'Surplus'. The aggregate amount of the balance of 'Reserves and Surplus', is to be shown after adjusting negative balance of surplus, if any. If the net result is negative, the negative figure is to be shown under the head 'Reserves and Surplus'.

8.1.3. Money received against Share Warrants

Generally, in case of listed companies, share warrants are issued to promoters and others in terms of the Guidelines for preferential issues viz., SEBI (Issue of Capital and Disclosure Requirements), Guidelines, 2009. AS 20 *Earning Per Share* notified under the Companies (Accounting Standards) Rules, 2006 defines 'share warrants' as "financial instruments which give the holder the right to acquire equity shares". Thus, effectively, share warrants are nothing but the amount which would ultimately form part of the Shareholders' funds. Since shares are yet to be allotted against the same, these are not reflected as part of Share Capital but as a separate line-item – 'Money received against share warrants.'

8.2. Share Application Money pending allotment

8.2.1. Share Application money pending allotment is to be disclosed as a separate line item on the face of Balance Sheet between "Shareholders' Funds" and "Non-current Liabilities". Share application money not exceeding the issued capital and to the extent not refundable is to be disclosed under this line item. If the company's issued capital is more than the authorized capital and approval of increase in authorized capital is pending, the amount of share application money received over and above the authorized capital should be shown under the head "Other Current Liabilities".

8.2.2. Clause (g) of Notes 6G lists various circumstances and specifies the information to be disclosed in respect of share application money. However, amount shown as 'share application money pending allotment' will not include share application money to the extent refundable. For example, the amount in excess of issued capital, or where minimum subscription requirement is not met. Such amount will have to be shown separately under 'Other Current Liabilities'.

8.2.3. Various disclosure requirements pertaining to Share Application Money are as follows:

- terms and conditions;
- number of shares proposed to be issued;
- the amount of premium, if any;
- the period before which shares are to be allotted;
- whether the company has sufficient authorized share capital to cover the share capital amount on allotment of shares out of share application money;

- Interest accrued on amount due for refund;
- The period for which the share application money has been pending beyond the period for allotment as mentioned in the share application form along with the reasons for such share application money being pending.

The above disclosures should be made in respect of amounts classified under both Equity as well as Current Liabilities, wherever applicable.

8.2.4. As per power given under section 92 of the Act, a company, if so authorized by its Articles, may accept from any member the whole or a part of the amount remaining unpaid on any shares held by him, although no part of that amount has been called up. The shareholder who has paid the money in advance is not a creditor for the amount so paid as advance, as the same cannot be demanded for repayment and the company cannot pay him back unless Articles so provide. The amount of calls paid in advance does not form part of the paid-up capital. The Department of Company Affairs has clarified that it is better to show "Calls in Advance" under the head "Current Liabilities and Provisions" (Letter No. 8/16(1)/61-PR, dated 9.5.1961). Thus, under the Revised Schedule VI, calls paid in advance are to be reflected under "Other Current Liabilities". The amount of interest which may accrue on such advance should also be reflected as a liability.

8.2.5. "Share application money pending allotment" is required to be shown as a separate line item on the face of the Balance Sheet after Shareholders' Funds. However, under "Other current liabilities" there is a statement that Share application money not exceeding the issued capital and to the extent not refundable shall be shown under the head Equity. The two requirements appear to be conflicting. However, from the format as set out in the Schedule, it appears that the Regulator's intention is to specifically highlight the amount of Share application money pending allotment, though they may be, in substance, in nature of Equity. Accordingly, the equity element should continue to be disclosed on the face of the Balance Sheet as a separate line item, rather than as a component of Shareholders' Funds.

8.3. Non-current liabilities

A liability shall be classified as current when it satisfies any of the following criteria:

- (a) it is expected to be settled in the company's normal operating cycle;
- (b) it is held primarily for the purpose of being traded;
- (c) it is due to be settled within twelve months after the reporting date; or
- (d) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

All other liabilities shall be classified as non-current.

Based on the above definitions, on the face of the Balance Sheet, the following items shall be disclosed under non-current liabilities.

- Long-term borrowings;
- Deferred tax liabilities (Net);
- Other Long-term liabilities;
- Long-term provisions.

8.3.1. Long-term borrowings:

8.3.1.1. Long-term borrowings shall be classified as:

- (a) Bonds/debentures;
- (b) Term loans;
 - from banks;
 - from other parties;
- (c) Deferred payment liabilities;
- (d) Deposits;
- (e) Loans and advances from related parties;
- (f) Long term maturities of finance lease obligations;
- (g) Other loans and advances (specify nature).

8.3.1.2. Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

8.3.1.3. Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed. The word "others" used in the phrase "directors or others" would mean any person or entity other than a director. Therefore, this is not restricted to mean only related parties. However, in the normal course, a person or entity guaranteeing a loan of a company will generally be associated with the company in some manner.

8.3.1.4. Bonds/debentures (along with the rate of interest and particulars of redemption or conversion, as the case may be) shall be stated in descending order of maturity or conversion, starting from farthest redemption or conversion date, as the case may be. Where bonds/debentures are redeemable by installments, the date of maturity for this purpose must be reckoned as the date on which the first installment becomes due.

8.3.1.5. Particulars of any redeemed bonds/ debentures which the company has power to reissue shall be disclosed.

8.3.1.6. Period and amount of continuing default as on the Balance Sheet date in repayment of loans and interest shall be specified separately in each case.

8.3.1.7. The phrase "long-term" has not been defined. However, the definition of 'non-current liability' in the Revised Schedule VI may be used as long-term liability for the above disclosure. Also, the phrase "term loan" has not been defined in the Revised Schedule VI. Term loans normally have a fixed or pre-determined maturity period or a repayment schedule.

8.3.1.8. As referred to in the 2005 edition of the ICAI Statement on Companies (Auditor's Report) Order, 2003 (CARO) in the banking industry, for example, loans with repayment period beyond thirty six months are usually known as "term loans". Cash credit, overdraft and call money accounts/ deposit are, therefore, not covered by the expression "terms loans". Term loans are generally provided by banks and financial institutions for acquisition of capital assets which then become the security for the loan, i.e., end use of funds is normally fixed.

8.3.1.9. Deferred payment liabilities would include any liability for which payment is to be made on deferred credit terms. E.g. deferred sales tax liability, deferred payment for acquisition of fixed assets etc.

8.3.1.10. The current maturities of all long-term borrowings will be disclosed under 'other current

liabilities' and not under long-term borrowings and short-term borrowings. Hence, it is possible that the same bonds / debentures / term loans may be bifurcated under both long-term borrowings as well as under other current liabilities. Further, long-term borrowings are to be subclassified as secured and unsecured giving the nature of the security for the secured position.

8.3.1.11 The Revised Schedule VI also stipulates that the nature of security shall be specified separately in each case. A blanket disclosure of different securities covering all loans classified under the same head such as 'All Term loans from banks' will not suffice. However, where one security is given for multiple loans, the same may be clubbed together for disclosure purposes with adequate details or cross referencing.

8.3.1.12 The disclosure about the nature of security should also cover the type of asset given as security e.g. inventories, plant and machinery, land and building, etc. This is because the extent to which loan is secured may vary with the nature of asset against which it is secured.

8.3.1.13 When promoters, other shareholders or any third party have given any personal security for any borrowing, such as shares or other assets held by them, disclosure should be made thereof, though such security does not result in the classification of such borrowing as secured.

8.3.1.14 The Revised Schedule VI requires that under the head "Borrowings," period and amount of "continuing default (in case of long-term borrowing) and default (in case of short-term borrowing) as on the Balance Sheet date in repayment of loans and interest shall be specified separately in each case". The word "loan" has been used in a more generic sense. Hence, the disclosures relating to default should be made for all items listed under the category of borrowings such as bonds/ debentures, deposits, deferred payment liabilities, finance lease obligations, etc. and not only to items classified as "loans" such as term loans, or loans and advances ,etc.

8.3.1.15 Also, a company need not disclose information for defaults other than in respect of repayment of loan and interest, e.g., compliance with debt covenants. The Revised Schedule VI requires specific disclosures only for default in repayment of loans and interest and not for other defaults.

8.3.1.16 Though two different terms, viz., continuing default (in case of long-term borrowing) and default (in case of short-term borrowing) have been used, the requirement should be taken to disclose default "as on the Balance Sheet date" in both the cases. Pursuant to this requirement, details of any default in repayment of loan and interest existing as on the Balance Sheet date needs to be separately disclosed. Any default that had occurred during the year and was subsequently made good before the end of the year does not need to be disclosed.

8.3.1.17 Terms of repayment of term loans and other loans shall be disclosed. The term 'other loans' is used in general sense and should be interpreted to mean all categories listed under the heading 'Long-term borrowings' as per Revised Schedule VI. Disclosure of terms of repayment should be made preferably for each loan unless the repayment terms of individual loans within a category are similar, in which case, they may be aggregated.

8.3.1.18 Disclosure of repayment terms should include the period of maturity with respect to the Balance Sheet date, number and amount of instalments due, the applicable rate of interest and other significant relevant terms if any.

8.3.1.19 Deposits classified under Borrowings would include deposits accepted from public and inter corporate deposits which are in the nature of borrowings.

8.3.1.20 Loans and advances from related parties are required to be disclosed. Advances under this head should include those advances which are in the nature of loans.

8.4. Other Long-term liabilities

This should be classified into:

- a) Trade payables; and
- b) Others.

8.4.1 A payable shall be classified as 'trade payable' if it is in respect of amount due on account of goods purchased or services received in the normal course of business. As per the Old Schedule VI, the term 'sundry creditors' included amounts due in respect of goods purchased or services received or in respect of other contractual obligations as well. Hence, amounts due under contractual obligations can no longer be included within Trade payables. Such items may include dues payables in respect of statutory obligations like contribution to provident fund, purchase of fixed assets, contractually reimbursable expenses, interest accrued on trade payables, etc. Such payables should be classified as "others" and each such item should be disclosed nature-wise. However, Acceptances should be disclosed as part of trade payables in terms of the Revised Schedule VI.

8.4.2 The Micro, Small and Medium Enterprises Development (MSMED) Act, 2006 however, requires specified disclosures to be made in the annual Financial Statements of the buyer wherever such Financial Statements are required to be audited under any law. Though not specifically required by the Revised Schedule VI, such disclosures will still be required to be made in the annual Financial Statements.

8.4.3 The following disclosures are required under Sec 22 of MSMED Act 2006 under the Chapter on Delayed Payments to Micro and Small Enterprises:

- (a) the principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier as at the end of accounting year;
- (b) the amount of interest paid by the buyer under MSMED Act, 2006 along with the amounts of the payment made to the supplier beyond the appointed day during each accounting year;
- (c) the amount of interest due and payable for the period (where the principal has been paid but interest under the MSMED Act, 2006 not paid);
- (d) the amount of interest accrued and remaining unpaid at the end of accounting year; and
- (e) the amount of further interest due and payable even in the succeeding year, until such date when the interest dues as above are actually paid to the small enterprise, for the purpose of disallowance as a deductible expenditure under section 23.

The terms "appointed day", "buyer", "enterprise", "micro enterprise", "small enterprise" and "supplier", shall be as defined under clauses (b), (d), (e), (h), (m) and (n) respectively of section 2 of the Micro, Small and Medium Enterprises Development Act, 2006.

8.5. Long-Term Provisions

8.5.1 This should be classified into provision for employee benefits and others specifying the nature. Provision for employee benefits should be bifurcated into long-term (non-current) and other current and the long-term portion is disclosed under this para. All long-term provisions, other than those related to employee benefits should be disclosed separately based on their nature. Such items would include Provision for warranties etc. While AS-15 *Employee Benefits* governs the measurement of various employee benefit obligations, their classification as current and non-current liability will be governed by the criteria laid down in the Revised Schedule VI. Accordingly, a liability is classified as current if a company does not have an unconditional right as on the Balance Sheet date to defer its settlement for 12 months after the reporting date. Each company will need to apply these criteria to its specific facts

and circumstances and decide an appropriate classification for its employee benefit obligations.

8.6. Current Liabilities

This should be classified on the face of the Balance Sheet as follows:

- Short-term borrowings;
- Trade payables;
- Other current liabilities;
- Short-term provisions.

8.6.1. Short-term borrowings

8.6.1.1. (i) Short-term borrowings shall be classified as:

(a) Loans repayable on demand

- from banks;
- from other parties.

(b) Loans and advances from related parties;

(c) Deposits;

(d) Other loans and advances (specify nature).

- (ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.
- (iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.
- (iv) Period and amount of default as on the Balance Sheet date in repayment of loans and interest shall be specified separately in each case.

8.6.1.2 Loans payable on demand should be treated as part of short-term borrowings. Short-term borrowings will include all loans within a period of 12 months from the date of the loan. In the case of short-term borrowings, all defaults existing as at the date of the Balance Sheet should be disclosed (item-wise). Current maturity of long-term borrowings should not be classified as short-term borrowing. They have to be classified under Other current liabilities. Guidance on disclosure on various matters under this Para should also be drawn, to the extent possible, from the guidance given under Long-term borrowings.

8.6.2. Trade payables

Guidance on disclosure under this clause should be drawn from the guidance given under Other Long-term borrowings to the extent applicable.

8.6.3. Other current liabilities

The amounts shall be classified as:

- (a) Current maturities of long-term debt;
- (b) Current maturities of finance lease obligations;
- (c) Interest accrued but not due on borrowings;
- (d) Interest accrued and due on borrowings;
- (e) Income received in advance;

- (f) Unpaid dividends;
- (g) Application money received for allotment of securities and due for refund and interest accrued thereon;
- (h) Unpaid matured deposits and interest accrued thereon;
- (i) Unpaid matured debentures and interest accrued thereon;
- (j) Other payables (specify nature).

The portion of long term debts / lease obligations, which is due for payments within twelve months of the reporting date is required to be classified under "Other current liabilities" while the balance amount should be classified under Long-term borrowings.

Trade Deposits and Security Deposits which are not in the nature of borrowings should be classified separately under Other Non-current/Current liabilities. Other Payables may be in the nature of statutory dues such as Withholding taxes, Service Tax, VAT, Excise Duty etc.

8.6.4. Short-term provisions

The amounts shall be classified as:

- (a) Provision for employee benefits;
- (b) Others (specify nature).

Others would include all provisions other than provisions for employee benefits such as Provision for dividend, Provision for taxation, Provision for warranties, etc. These amounts should be disclosed separately specifying nature thereof.

II. Assets

8.7. Non-current assets Definition and Presentation

An asset shall be classified as 'current' when it satisfies any of the following criteria:

- (a) it is expected to be realized in, or is intended for sale or consumption in the company's normal operating cycle;
- (b) it is held primarily for the purpose of being traded;
- (c) it is expected to be realized within twelve months after the reporting date; or
- (d) it is Cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

All other assets shall be classified as 'non-current'. Based on the above definition, on the face of the Balance Sheet, the following items shall be disclosed under non-current assets: -

- (a) Fixed Assets
 - (i) Tangible assets;
 - (ii) Intangible assets;
 - (iii) Capital work-in-progress;
 - (iv) Intangible assets under development
- (b) Non-current investments
- (c) Deferred tax assets (net)
- (d) Long-term loans and advances

(e) Other non-current assets

8.7.1 Fixed Assets

Fixed assets are classified as:

| S. No. | Particulars | Relevant Accounting Standards as notified under Companies (Accounting Standards) Rules, 2006 |
|--------|-------------------------------------|--|
| 1. | Tangible assets | AS 10, AS 6 |
| 2. | Intangible assets | AS 26 |
| 3. | Capital work-in-progress | AS 10 |
| 4. | Intangible assets under development | AS 26 |

8.7.1.1 Tangible Assets

The company shall disclose the following in the Notes to Accounts as per 6(l) of Part I of the Revised Schedule VI.

(i) Classification shall be given as:

- (a) Land;
- (b) Buildings;
- (c) Plant and Equipment;
- (d) Furniture and Fixtures;
- (e) Vehicles;
- (f) Office equipment;
- (g) Others (specify nature).

(ii) Assets under lease shall be separately specified under each class of asset.

The term "under lease" should be taken to mean assets given on operating lease in the case of lessor and assets held under finance lease in the case of lessee. Further, leasehold improvements should continue to be shown as a separate asset class.

(iii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related depreciation and impairment losses/reversals shall be disclosed separately.

All acquisitions, whether by way of an asset acquisition or through a business combination are to be disclosed as part of the reconciliation in the note on Fixed Assets. Acquisitions through 'Business Combinations' need to be disclosed separately for each class of assets. Similarly, though not specifically required, it is advisable that asset disposals through demergers, etc. may also be disclosed separately for each class of assets.

The term "business combination" has not been defined in the Act or the Accounting Standards as notified under the Companies (Accounting Standards) Rules, 2006. However, related concepts have been enumerated in AS 14 *Accounting for Amalgamations* and AS 10 *Accounting for Fixed Assets*. Accordingly, such terminology should be interpreted to mean an amalgamation or acquisition or any other mode of restructuring of a set of assets and/or a group of assets and liabilities constituting a business.

Other adjustments should include items such as capitalization of exchange differences where such option has been exercised by the Company as per AS 11 *The Effects of Changes in Foreign Exchange Rates* and/or adjustments on account of exchange fluctuations for fixed assets in case of non-integral operations as per AS 11 and/or borrowing costs capitalised in accordance with AS 16 *Borrowing Costs*. Such adjustments should be disclosed separately for each class of assets.

Since reconciliation of gross and net carrying amounts of fixed assets is required, the corresponding depreciation/amortization for each class of asset should be disclosed in terms of Opening Accumulated Depreciation, Depreciation/amortization for the year, Deductions/Other adjustments and Closing Accumulated Depreciation/Amortization. Similar disclosures should also be made for Impairment, if any, as applicable.

- (iv) Where any amounts have been written-off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every Balance Sheet subsequent to date of such write-off or addition shall show the reduced or increased figures, as applicable. Disclosure by way of a note would also be required to show the amount of the reduction or increase, as applicable, together with the date thereof for the first five years subsequent to the date of such reduction or increase.

The Revised Schedule VI has introduced office equipment as a separate line item while dropping items like, live stock, railway sidings, etc. However, if the said items exist, the same should be disclosed separate asset class specifying nature thereof.

The Revised Schedule does not prescribe any particular classification/ presentation for leasehold land. AS 19 *Leases*, excludes land leases from its scope. The accounting treatment for leasehold land should be continued with as is being currently followed under the prevailing Indian generally accepted accounting principles and practices. Accordingly, Leasehold land should also continue to be presented as a separate asset class under Tangible Assets. Also, Freehold land should continue to be presented as a separate asset class.

AS 10 *Accounting for Fixed Assets* also requires a company to disclose details such as gross book value of revalued assets, method adopted to compute revalued amounts, nature of indices used, year of appraisal, involvement of external valuer as long as the concerned assets are held by the enterprise.

The Revised Schedule VI is clear that the disclosure requirements of the Accounting Standards are in addition to disclosures required under the Schedule. Also, in case of any conflict, the Accounting Standards will prevail over the Schedule. Keeping this in view, companies should make disclosures required by the Revised Schedule VI only for five years. However, details required by AS 10 will have to be given as long as the asset is held by the company.

However, it may be noted that, AS 26 *Intangible Assets* does not permit revaluation of intangible assets.

8.7.1.2 Intangible assets

The company shall disclose the following in the Notes to Accounts as per 6(J) of Part I of the Revised Schedule VI.

- (i) Classification shall be given as:
- (a) Goodwill;
 - (b) Brands /trademarks;
 - (c) Computer software;
 - (d) Mastheads and publishing titles;

- (e) Mining rights;
 - (f) Copyrights, and patents and other intellectual property rights, services and operating rights;
 - (g) Recipes, formulae, models, designs and prototypes;
 - (h) Licenses and franchise;
 - (i) Others (specify nature).
- (ii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related amortization and impairment losses/reversals shall be disclosed separately.
- (iii) Where sums have been written-off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every Balance Sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase, as applicable, together with the date thereof for the first five years subsequent to the date of such reduction or increase.

Classification of intangible assets (as listed above) has been introduced under the Revised Schedule VI, which did not exist earlier.

The guidance given above on Tangible Assets, to the extent applicable, is also to be used for Intangible Assets.

8.7.1.3 Capital work-in-progress

As per the Revised Schedule VI, capital advances should be included under Long-term loans and advances and hence, cannot be included under capital work-in-progress.

8.7.1.4 Intangible assets under development

Intangible assets under development should be disclosed under this head provided they can be recognised based on the criteria laid down in AS 26 *Intangible Assets*.

8.7.2 Non-current investments

- (i) Non-current investments shall be classified as trade investments and other investments and further classified as:
- (a) Investment property;
 - (b) Investments in Equity Instruments;
 - (c) Investments in preference shares;
 - (d) Investments in Government or trust securities;
 - (e) Investments in debentures or bonds;
 - (f) Investments in Mutual Funds;
 - (g) Investments in partnership firms;
 - (h) Other non-current investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate (indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities) in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of

the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

- (ii) Investments carried at other than at cost should be separately stated specifying the basis for valuation thereof.
- (iii) The following shall also be disclosed:
 - (a) Aggregate amount of quoted investments and market value thereof;
 - (b) Aggregate amount of unquoted investments;
 - (c) Aggregate provision for diminution in value of investments

If a debenture is to be redeemed partly within 12 months and balance after 12 months, the amount to be redeemed within 12 months should be disclosed as current and balance should be shown as non-current.

8.7.2.1 Trade Investment

Note 6(K)(i) of Part I requires that non-current investments shall be classified as "trade investment" and "other investments". The term "trade investments" is defined neither in Revised Schedule VI nor in Accounting Standards.

The term "trade investment" is, however, normally understood as an investment made by a company in shares or debentures of another company, to promote the trade or business of the first company.

8.7.2.2 Investment property

As per AS 13 *Accounting for Investments*, an investment property is an investment in land or buildings that are not intended to be occupied substantially for use by, or in the operations of, the investing enterprise.

8.7.2.3 Aggregate provision for diminution in value

As per the Revised Schedule VI, this amount should be disclosed separately in the notes. However, as per AS 13 all long-term (non-current) investments are required to be carried at cost. However, when there is a decline, other than temporary, in the value of a long-term investment, the carrying amount is reduced to recognize the decline. Accordingly, the value of each long-term investment should be carried at cost less provision for other than temporary diminution in the value thereof. It is recommended to disclose the amount of provision netted-off for each long-term investment.

However, the aggregate amount of provision made in respect of all noncurrent investments should also be separately disclosed to comply with the specific disclosure requirement in Revised Schedule VI.

8.7.2.4 Controlled special purpose entities

Under investments, there is also a requirement to disclose the names of bodies corporate, including separate disclosure of investments in "controlled special purpose entities" in addition to subsidiaries, etc. The expression "controlled special purpose entities" however, has not been defined either in the Act or in the Revised Schedule VI or in the Accounting Standards. Accordingly, no disclosures would be additionally required to be made under this caption. If and when such terminology is explained/introduced in the applicable Accounting Standards, the disclosure requirement would become applicable.

8.7.2.5 Basis of valuation

The Revised Schedule VI requires disclosure of the "basis of valuation" of non-current investments which are carried at other than cost. However, what should be understood by such terminology has not been clarified. The term 'basis of valuation' was not used in the Old Schedule VI. Hence, the same may

be interpreted in the following ways:

One view is that basis of valuation would mean the market value, or valuation by independent valuers, valuation based on the investee's assets and results, or valuation based on expected cash flows from the investment, or management estimate, etc. Hence, for all investments carried at other than cost, the basis of valuation for each individual investment should be disclosed.

The other view is that, disclosure for basis of valuation should be either of:

- At cost;
- At cost less provision for other than temporary diminution;
- Lower of cost and fair value.

However, making disclosures in line with the latter view would be sufficient compliance with the disclosure requirements.

8.7.2.6 Quoted investments

The term quoted investments has not been defined in the Revised Schedule VI. The expression "quoted investment", as defined in the Old Schedule VI, means an investment as respects which there has been granted a quotation or permission to deal on a recognized stock exchange, and the expression "unquoted investment" shall be construed accordingly.

8.7.2.7 Under each sub-classification of Investments, there is a requirement to disclose details of investments including names of the bodies corporate and the nature and extent of the investment in each such body corporate. The term "nature and extent" should be interpreted to mean the number and face value of shares. There is also a requirement to disclose partly-paid shares. However, it is advisable to clearly disclose whether investments are fully paid or partly paid.

8.7.2.8 Disclosure relating to partnership firms in which the company has invested, etc. (under Current and Non-current Investments in the Balance Sheet)

A company, as a juridical person, can enter into partnership. The Revised Schedule VI provides for certain disclosures where the company is a partner in partnership firms.

In the Balance Sheet, under the sub-heading "Current Investments" and "Non-current Investments", separate disclosure is to be made of any investment in the capital of partnership firm by the company. In addition, in the Notes to Accounts separate disclosure is required with regard to the names of the firms, along with the names of all their partners, total capital and the shares of each partner.

The disclosure in the Balance Sheet relating to the value of the investment in the capital of a partnership firm as the amount to be disclosed as on the date of the Balance Sheet can give rise to certain issues, the same are discussed in the following paragraphs.

- (a) In case of a change in the constitution of the firm during the year, the names of the other partners should be disclosed by reference to the position existing as on the date of the company's Balance Sheet.
- (b) The total capital of the firm to be disclosed should be with reference to the amount of the capital on the date of the company's Balance Sheet.

If it is not practicable to draw up the Financial Statements of the partnership upto such date and, are drawn up to different reporting dates, drawing analogy from AS-21 and AS-27, adjustments should be made for the effects of significant transactions or other events that occur between those dates and the date of the parent's Financial Statements. In any case, the difference between reporting dates should not be more than six months. In such cases, the difference in

reporting dates should be disclosed.

- (c) For disclosure of the share of each partner it is suggested to disclose share of each partner in the profits of the firm rather than the share in the capital since, ordinarily, the expression "share of each partner" is understood in this sense. Moreover, disclosure is already required of the total capital of the firm as well as of the company's share in that capital. The share of each partner should be disclosed as at the date of the company's Balance Sheet
- (d) The Statement of investments attached to the Balance Sheet is required to disclose, *inter alia*, the total capital of the partnership firm in which the company is a partner. Where such a partnership firm has separate accounts for partner's capital, drawings or current, loans to or from partners, etc., disclosure must be made with regard to the total of the capital accounts alone, since this is what constitutes the capital of the partnership firm. Where, however, such accounts have not been segregated, or where the partnership deed provides that the capital of each partner is to be calculated by reference to the net amount at his credit after merging all the accounts, the disclosure relating to the partnership capital must be made on the basis of the total effect of such accounts taken together.

Separate disclosure is required by reference to each partnership firm in which the company is a partner. The disclosure must be made along with the name of each such firm and must then indicate the total capital of each firm, the names of all the partners in each firm and the respective shares of each partner in the firm.

8.7.2.9 A limited liability partnership is a body corporate and not a partnership firm as envisaged under the Partnership Act, 1932. Hence, disclosures pertaining to Investments in partnership firms will not include investments in limited liability partnerships. The investments in limited liability partnerships will be disclosed separately under other investments. Also, other disclosures prescribed for Investment in partnership firms, need not be made for investments in limited liability partnerships.

8.7.3 Long-term loans & advances

- (i) Long-term loans and advances shall be classified as:
 - (a) Capital Advances;
 - (b) Security Deposits;
 - (c) Loans and advances to related parties (giving details thereof);
 - (d) Other loans and advances (specify nature).
- (ii) The above shall also be separately sub-classified as:
 - (a) Secured, considered good;
 - (b) Unsecured, considered good;
 - (c) Doubtful.
- (iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.
- (iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other persons or amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

Under the Revised Schedule VI, Capital Advances are not be classified under Capital Work in Progress, since they are specifically to be disclosed under this para.

Capital advances are advances given for procurement of fixed assets which are non-current assets. Typically, companies do not expect to realize them in cash. Rather, over the period, these get converted into fixed assets which, by nature, are non-current assets. Hence, capital advances should be treated as non-current assets irrespective of when the fixed assets are expected to be received and should not be classified as Short-Term/Current.

Details of loans and advances to related parties need to be disclosed. Since the Revised Schedule VI states that the terms used therein should be interpreted based on applicable the Accounting Standards, the term "details" should be interpreted to understand the disclosure requirements contained in AS 18 *Related Party Disclosure*. Accordingly, making disclosures beyond the requirements of AS-18 would not be necessary.

Other loans and advances should include all other items in the nature of advances recoverable in cash or kind such as Prepaid expenses, Advance tax, CENVAT credit receivable, VAT credit receivable, Service tax credit receivable, etc. which are not expected to be realized within the next twelve months or operating cycle whichever is longer, from the Balance Sheet date.

Each item of loans and advances should be further sub-classified as a) Secured, considered good, b) Unsecured, considered good and c) Doubtful. Further, the amount of allowance for bad and doubtful loans and advances is required to be disclosed separately under the "relevant heads". Therefore, the amount of such allowance also should be disclosed separately for each category of loans and advances.

8.7.4 Other non-current assets

Other non-current assets shall be classified as:

- (i) Long term Trade Receivables (including trade receivables on deferred credit terms);
- (ii) Others (specify nature)

Long term Trade Receivables, shall be sub-classified as:

- (i)
 - (a) Secured, considered good;
 - (b) Unsecured considered good;
 - (c) Doubtful
- (ii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.
- (iii) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

A receivable shall be classified as 'trade receivable' if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business. Whereas as per the Old Schedule VI, the term 'sundry debtors' included amounts due in respect of goods sold or services rendered or in respect of other contractual obligations as well. Hence, amounts due under contractual obligations cannot be included within Trade Receivables. Such items may include dues in respect of insurance claims, sale of fixed assets, contractually reimbursable expenses, interest accrued on trade receivables, etc. Such receivables should be classified as "others" and each such item should be disclosed nature-wise.

Guidance in respect of above items may also be drawn from the guidance given in respect of Long-term loans & advances to the extent applicable.

The Revised Schedule VI does not contain any specific disclosure requirement for the unamortized

portion of expense items such as share issue expenses, ancillary borrowing costs and discount or premium relating to borrowings. The Old Schedule VI required these items to be included under the head "Miscellaneous Expenditure."

As per AS 16 *Borrowing Costs* ancillary borrowing costs and discount or premium relating to borrowings could be amortized over the loan period. Further, share issue expenses, discount on shares, ancillary costs-discount-premium on borrowing, etc., being special nature items are excluded from the scope of AS 26 *Intangible Assets* (Para 5). Keeping this in view, certain companies have taken a view that it is an acceptable practice to amortize these expenses over the period of benefit, i.e., normally 3 to 5 years. The Revised Schedule VI does not deal with any accounting treatment and the same continues to be governed by the respective Accounting Standards/practices. Further, the Revised Schedule VI is clear that additional line items can be added on the face or in the notes. Keeping this in view, entity can disclose the unamortized portion of such expenses as "Unamortized expenses", under the head "other current/ non-current assets", depending on whether the amount will be amortized in the next 12 months or thereafter.

8.8 Current assets

As per the Revised Schedule VI, all items of assets and liabilities are to be bifurcated between current and non-current portions. In some cases, the items presented under the "non-current" head of the Balance Sheet do not have a corresponding "current" head especially for Assets. For example: Security Deposits have been shown under "Long-term loans & advances", however, the same is not reflected under the "short-term loans & advances". Since Revised Schedule VI permits the use of additional line items, in such cases the current portion should be classified under the Short-term category of the respective balance as a separate line item and other relevant disclosures e.g. doubtful amount, related provision etc. should be made.

8.8.1 Current investments

- (i) Current investments shall be classified as:
 - (a) Investments in Equity Instruments;
 - (b) Investment in Preference Shares
 - (c) Investments in government or trust securities;
 - (d) Investments in debentures or bonds;
 - (e) Investments in Mutual Funds;
 - (f) Investments in partnership firms
 - (g) Other investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate (indicating separately whether such bodies are

(i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities) in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

- (ii) The following shall also be disclosed:
 - (a) The basis of valuation of individual investments
 - (b) Aggregate amount of quoted investments and market value thereof;

- (c) Aggregate amount of unquoted investments;
- (d) Aggregate provision made for diminution in value of investments.

Guidance in respect of above items may be drawn from the guidance given in respect of Non-current investments to the extent applicable.

Based on these criteria, if a debenture is to be redeemed partly within twelve months and balance after twelve months, the amount to be redeemed within twelve months should be disclosed as current and balance should be shown as non-current.

Additionally, the Revised Schedule VI also require basis of valuation of individual investment. It is pertinent to note that there is no requirement to classify investments into trade & non-trade in respect of current investments.

The aggregate provision for diminution in the value of current investments that needs to be separately disclosed is the amount written down based on the measurement principles of Current Investments as per AS-13 on a cumulative basis, though such write-down is not actually a 'provision' as per the Standard.

8.8.2 Inventories

- (i) Inventories shall be classified as:
 - (a) Raw materials;
 - (b) Work-in-progress;
 - (c) Finished goods;
 - (d) Stock-in-trade (in respect of goods acquired for trading);
 - (e) Stores and spares;
 - (f) Loose tools;
 - (g) Others (specify nature).
- (ii) Goods-in-transit shall be disclosed under the relevant sub-head of inventories.
- (iii) Mode of valuation shall be stated.

As per the Revised Schedule VI, goods in transit should be included under relevant heads with suitable disclosure. Further, mode of valuation for each class of inventories should be disclosed.

The heading Finished goods should comprise of all finished goods other than those acquired for trading purposes.

8.8.3 Trade Receivables (current)

- (i) Aggregate amount of Trade Receivables outstanding for a period exceeding six months from the date they are due for payment should be separately stated.
- (ii) Trade receivables shall be sub-classified as:
 - (a) Secured, considered good;
 - (b) Unsecured considered good;
 - (c) Doubtful.
- (iii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.
- (iv) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any

director is a partner or a director or a member should be separately stated.

A trade receivable will be treated as current, if it is likely to be realized within twelve months from the date of Balance Sheet or operating cycle of the business.

The Old Schedule VI required separate presentation of debtors (i) outstanding for a period exceeding six months (i.e., based on billing date) and (ii) other debtors. However, the Revised Schedule VI requires separate disclosure of "Trade Receivables outstanding for a period exceeding six months from the date they became due for payment" only for the current portion of trade receivables.

Where no due date is specifically agreed upon, normal credit period allowed by the company should be taken into consideration for computing the due date which may vary depending upon the nature of goods or services sold and the type of customers, etc.

All other guidance given under Long-term Trade Receivables to the extent applicable are applicable here also.

8.8.4 Cash and cash equivalents

- (i) Cash and cash equivalents shall be classified as:
 - (a) Balances with banks;
 - (b) Cheques, drafts on hand;
 - (c) Cash on hand;
 - (d) Others (specify nature).
- (ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.
- (iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.
- (iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.
- (v) Bank deposits with more than twelve months maturity shall be disclosed separately.

The term "cash and bank balances" in the Old Schedule VI is replaced with 'Cash and cash equivalents' in the Revised Schedule VI.

Please also refer to the earlier discussion under the section on General Instructions in para 6.4 for classification of items under this head.

"Other bank balances" would comprise of items such as balances with banks to the extent of held as margin money or security against borrowings etc, and bank deposits with more than three months maturity. Banks deposits with more than more than twelve months maturity will also need to be separately disclosed under the sub-head 'Other bank balances'. The non-current portion of each of the above balances will have to be classified under the head "Other Non-current assets" with separate disclosure thereof.

8.8.5 Short-term loans & Advances

- (i) Short-term loans and advances shall be classified as:
 - (a) Loans and advances to related parties (giving details thereof);
 - (b) Others (specify nature).
- (ii) The above shall also be sub-classified as:
 - (a) Secured, considered good;
 - (b) Unsecured, considered good;

- (c) Doubtful.
- (iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.
- (iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other person or amounts due by firms or private companies respectively in which any director is a partner or a director or a member shall be separately stated.

The guidance for disclosures under this head should be drawn from guidance given for items comprised within Long-term Loans and Advances.

8.8.6 Other current assets (specify nature)

This is an all-inclusive heading, which incorporates current assets that do not fit into any other asset categories e.g. unbilled Revenue, unamortised premium on forward contracts etc.

In case any amount classified under this category is doubtful, it is advisable that such doubtful amount as well as any provision made there against should be separately disclosed.

8.8.7 Contingent liabilities and commitments

- (i) Contingent liabilities shall be classified as:
 - (a) Claims against the company not acknowledged as debt;
 - (b) Guarantees;
 - (c) Other money for which the company is contingently liable
- (ii) Commitments shall be classified as:
 - (a) Estimated amount of contracts remaining to be executed on capital account and not provided for;
 - (b) Uncalled liability on shares and other investments partly paid
 - (c) Other commitments (specify nature).

8.8.7.1 The provisions of AS-29 *Provisions, Contingent Liabilities and Contingent Assets*, will be applied for determining contingent liabilities.

8.8.7.2 A contingent liability in respect of guarantees arises when a company issues guarantees to another person on behalf of a third party e.g. when it undertakes to guarantee the loan given to a subsidiary or to another company or gives a guarantee that another company will perform its contractual obligations. However, where a company undertakes to perform its own obligations, and for this purpose issues, what is called a "guarantee", it does not represent a contingent liability and it is misleading to show such items as contingent liabilities in the Balance Sheet. For various reasons, it is customary for guarantees to be issued by Bankers e.g. for payment of insurance premia, deferred payments to foreign suppliers, letters of credit, etc. For this purpose, the company issues a "counter-guarantee" to its Bankers. Such "counter-guarantee" is not really a guarantee at all, but is an undertaking to perform what is in any event the obligation of the company, namely, to pay the insurance premia when demanded or to make deferred payments when due. Hence, such performance guarantees and counter-guarantees should not be disclosed as contingent liabilities.

8.8.7.3 The Revised Schedule VI also requires disclosures pertaining to various commitments such as Capital commitments not provided for and Uncalled liability on shares. It also requires disclosures pertaining to 'Other commitments', with specification of nature thereof, which was not required by the Old Schedule VI.

8.8.7.4 The word 'commitment' has not been defined in the Revised Schedule VI. The Guidance Note on Terms Used in Financial Statements issued by ICAI defines 'Capital Commitment' as future liability for capital expenditure in respect of which contracts have been made. Hence, drawing inference from such definition, the term 'commitment' would simply imply future liability for contractual expenditure. Accordingly, the term 'Other commitments' would include all expenditure related contractual commitments apart from capital commitments such as commitments arising from long-term contracts for purchase of raw material, employee contracts, lease commitments, etc. The scope of such terminology is very wide and may include contractual commitments for purchase of inventory, services, investments, sales, employee contracts, etc. However, to give disclosure of all contractual commitments would be contrary to the overarching principle under General Instructions that "a balance shall be maintained between providing excessive detail that may not assist users of Financial Statements and not providing important information as a result of too much aggregation."

8.8.7.5 Disclosures relating to lease commitments for non-cancellable leases are required to be disclosed by *AS-19 Leases*.

8.8.7.6 Accordingly, the disclosures required to be made for 'other commitments' should include only those non-cancellable contractual commitments (i.e. cancellation of which will result in a penalty disproportionate to the benefits involved) based on the professional judgement of the management which are material and relevant in understanding the Financial Statements of the company and impact the decision making of the users of Financial Statements.

Examples may include commitments in the nature of buy-back arrangements, commitments to fund subsidiaries and associates, non-disposal of investments in subsidiaries and undertakings, derivative related commitments, etc.

8.8.7.7 The Revised Schedule VI requires disclosure of the amount of dividends proposed to be distributed to equity and preference shareholders for the period and the related amount per share to be disclosed separately. It also requires separate disclosure of the arrears of fixed cumulative dividends on preference shares. The Old Schedule VI specifically required proposed dividend to be disclosed under the head "Provisions." In the Revised Schedule VI, this needs to be disclosed in the notes. Hence, a question that arises is as to whether this means that proposed dividend is not required to be provided for when applying the Revised Schedule VI. *AS-4 Contingencies and Events Occurring After the Balance Sheet date* requires that dividends stated to be in respect of the period covered by the Financial Statements, which are proposed or declared by the enterprise after the Balance Sheet date but before approval of the Financial Statements, should be adjusted. Keeping this in view and the fact that the Accounting Standards override the Revised Schedule VI, companies will have to continue to create a provision for dividends in respect of the period covered by the Financial Statements and disclose the same as a provision in the Balance Sheet, unless *AS-4* is revised. Hence, the disclosure to be made in the notes is over and above the disclosures pertaining to a) the appropriation items to be disclosed under Reserves and Surplus and b) Provisions in the Balance Sheet.

8.8.7.8 The Revised Schedule VI requires that where in respect of an issue of securities made for a specific purpose, the whole or part of the amount has not been used for the specific purpose at the Balance Sheet date, there shall be indicated by way of note how such unutilized amounts have been used or invested. Such a requirement existed in the Old Schedule VI as well.

8.8.7.9 The Revised Schedule VI also states that if, in the opinion of the Board, any of the assets other than fixed assets and non-current investments do not have a value on realization in the ordinary course of business at least equal to the amount at which they are stated, the fact that the Board is of that opinion, shall be stated. A similar requirement existed in the Old Schedule VI as well. It is difficult to contemplate a situation where any asset other than fixed assets and non-current investments has a

realizable value that is lower than its carrying value, and the same is not given effect to in the books of account, since Accounting Standards do not permit the same. AS 13 *Accounting for Investments* requires current investments to be valued at lower of cost and fair value. AS 2 *Valuation of Inventories* also requires inventories to be valued at the lower of cost and net realizable value. Further, Allowance for bad and doubtful debts is required to be shown as a deduction from both Long-term loans & advances and Other Non-current assets as well as Trade Receivables and Short-term loans and advances as per Schedule VI. Hence, a diligent application of the requirements of Accounting Standards and Schedule VI will normally not leave any scope for making any additional disclosures in this regard.

9. Part II – Statement of Profit and Loss

Part II deals with disclosures relating to the Statement of Profit and Loss. The format prescribed is the vertical form wherein disclosure for revenues and expenses is in various line items. Part II of the Schedule contains items I to XVI which lists items of Revenue, Expenses and Profit / (Loss). "General Instructions for Preparation of Statement of Profit and Loss" govern the other disclosure and presentation.

As per the Guidance Note 'Terms Used in Financial Statements', the phrase 'Profit and Loss statement' is defined as "*the Financial Statement which presents the revenues and expenses of an enterprise for an accounting period and shows the excess of revenues over expenses (or vice versa) It is also known as profit and loss account.*"

As per Note 1 to "General Instructions for Preparation of Statement of Profit and Loss", the provisions of this part also apply to the income and expenditure account referred to in section 210(2) of the Companies Act, 1956 in the same manner as they apply to a Statement of Profit and Loss.

The specific format laid down for presentation of various items of Income and Expenses in the Statement of Profit and Loss indicates that expenses should be aggregated based on their nature. Accordingly, functional classification of expenses is prohibited.

As per the Framework For The Preparation and Presentation Of Financial Statements, Income and expenses are defined as follows:

- (a) *Income* is increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.
- (b) *Expenses* are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

9.1 Revenue from operations:

The aggregate of Revenue from operations needs to be disclosed on the face of the Statement of Profit and Loss as per Revised Schedule VI

9.1.1 Note 2(A) to General Instructions for the Preparation of Statement of Profit and Loss require that in respect of a company other than a finance company, Revenue from operations is to be separately disclosed in the notes, showing revenue from:

- (a) Sale of products
- (b) Sale of services
- (c) Other operating revenues

(d) Less: Excise duty

9.1.2 As per AS-9 "*Revenue Recognition*", the above disclosure in respect of Excise Duty needs to be shown on the face of the Statement of Profit and Loss. Since Accounting Standards override Revised Schedule VI, the presentation in respect of excise duty will have to be made on the face of the Statement of Profit and Loss. In doing so, a company may choose to present the elements of revenue from sale of products, sale of services and other operating revenues also on the face of the Statement of Profit and Loss instead of the Notes.

9.1.3 Indirect taxes such as Sales tax, Service tax, Purchase tax etc. are generally collected from the customer on behalf of the government in majority of the cases. However, this may not hold true in all cases and it is possible that a company may be acting as principal rather than as an agent in collecting these taxes. Whether revenue should be presented gross or net of taxes should depend on whether the company is acting as a principal and hence responsible for paying tax on its own account or, whether it is acting as an agent i.e. simply collecting and paying tax on behalf of government authorities. In the former case, revenue should also be grossed up for the tax billed to the customer and the tax payable should be shown as an expense. However, in cases, where a company collects tax only as an intermediary, revenue should be presented net of taxes.

9.1.4 However, as per the Guidance Note on Value Added Tax, "Value Added Tax (VAT) is collected from the customers on behalf of the VAT authorities and, therefore, its collection from the customers is not an economic benefit for the enterprise and it does not result in any increase in the equity of the enterprise". Accordingly, VAT should not be recorded as Revenue of the enterprise. At the same time, the payment of VAT should not be treated as an expense in the Financial Statements of the company.

9.1.5 Further, as per the definition of Revenue in the Guidance Note on Terms Used in Financial Statement, "It excludes amounts collected on behalf of third parties such as certain taxes". The Guidance Note on VAT further states, "Where the enterprise has not charged VAT separately but has made a composite charge, it should segregate the portion of sales which is attributable to tax and should credit the same to 'VAT Payable Account' at periodic intervals".

9.1.6 For non-finance companies, revenue from operations needs to be disclosed separately as revenue from

- (a) sale of products,
- (b) sale of services and
- (c) other operating revenues.

It is important to understand what is meant by the term "other operating revenues" and which items should be classified under this head vis-à-vis under the head "Other Income".

9.1.7 The term "other operating revenue" is not defined. This would include Revenue arising from a company's operating activities, i.e., either its principal or ancillary revenue-generating activities, but which is not revenue arising from the sale of products or rendering of services. Whether a particular income constitutes "other operating revenue" or "other income" is to be decided based on the facts of each case and detailed understanding of the company's activities. The classification of income would also depend on the purpose for which the particular asset is acquired or held. For instance, a group engaged in manufacture and sale of industrial and consumer products also has one real estate arm. If the real estate arm is continuously engaged in leasing of real estate properties, the rent arising from leasing of real estate is likely to be "other operating revenue". On the other hand, consider a consumer products company which owns a 10 storied building. The company currently does not need one floor for its own use and has given the same temporarily on rent. In that case, lease rent is not an "other

operating revenue”; rather, it should be treated as “other income”.

9.1.8 To take other examples, sale of Fixed Assets is not an operating activity of a company, and hence, profit on sale of fixed assets should be classified as other income and not other operating revenue. On the other hand, sale of manufacturing scrap arising from operations for a manufacturing company should be treated as other operating revenue since the same arises on account of the company’s main operating activity.

9.1.9 Net foreign exchange gain should be classified as Other Income. This is because such gain or loss arises purely on account of fluctuation in exchange rates and not on account of sale of products or services rendered, unless the business of the company is to deal in foreign exchange.

9.1.10 As per Note 2(A) to General Instructions for Preparation of Statement of Profit and loss, in respect of a finance company, revenue from operations shall include revenue from

- (a) Interest; and
- (b) Other financial services

Revenue under each of the above heads is to be disclosed separately by way of Notes to Accounts to the extent applicable.

9.1.11 The term finance company is not defined under the Companies Act, 1956, or Revised Schedule VI. Hence, the same should be taken to include all companies carrying on activities which are in the nature of “business of non-banking financial institution” as defined under section 451(f) of the Reserve Bank of India Act, 1935.

The relevant extract is reproduced below:

(a) “business of a non-banking financial institution” means carrying on of the business of a financial institution referred to in clause (c) and includes business of a non-banking financial company referred to in clause (f);

(c) “financial institution” means any non-banking institution which carries on as its business or part of its business any of the following activities, namely:–

- (i) the financing, whether by way of making loans or advances or otherwise, of any activity other than its own;
- (ii) the acquisition of shares, stock, bonds, debentures or securities issued by a Government or local authority or other marketable securities of a like nature;
- (iii) letting or delivering of any goods to a hirer under a hire-purchase agreement as defined in clause (c) of section 2 of the Hire-Purchase Act, 1972;
- (iv) the carrying on of any class of insurance business;
- (v) managing, conducting or supervising, as foreman, agent or in any other capacity, of chits or kuries as defined in any law which is for the time being in force in any State, or any business, which is similar thereto;
- (vi) collecting, for any purpose or under any scheme or arrangement by whatever name called, monies in lumpsum or otherwise, by way of subscriptions or by sale of units, or other instruments or in any other manner and awarding prizes or gifts, whether in cash or kind, or disbursing monies in any other way, to persons from whom monies are collected or to any other person, but does not include any institution, which carries on as its principal business,–

- (a) agricultural operations; or

- (aa) industrial activity; or
- (b) the purchase or sale of any goods (other than securities) or the providing of any services; or
- (c) the purchase, construction or sale of immovable property, so however, that no portion of the income of the institution is derived from the financing of purchases, constructions or sales of immovable property by other persons;

Explanation.– For the purposes of this clause, “industrial activity” means any activity specified in sub-clauses (i) to (xviii) of clause (c) of section 2 of the Industrial Development Bank of India Act, 1964;

- (f) “non-banking financial company” means–
 - (i) a financial institution which is a company;
 - (ii) a non-banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;
 - (iii) such other non-banking institution or class of such institutions, as the bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify;

9.1.12 Accordingly, applying the aforesaid definition, the term “finance company” would cover all NBFCs - Asset Finance companies, Investment companies, Leasing and Hire Purchase companies, Loan companies, Infra Finance companies, Core Investment companies, Micro-finance companies, etc. Further, Housing Finance Companies regulated by National Housing Bank should also be considered as a finance company.

9.2 Other income:

The aggregate of ‘Other income’ is to be disclosed on face of the Statement of Profit and Loss.

9.2.1 As per Note 4 to General Instructions for the preparation of Statement of Profit and Loss ‘Other Income shall be classified as:

- (a) Interest Income (in case of a company other than a finance company);
- (b) Dividend Income;
- (c) Net gain / loss on sale of investments;
- (d) Other non-operating income (net of expenses directly attributable to such income).

9.2.2 All kinds of interest income for a company other than a finance company should be disclosed under this head such as interest on fixed deposits, interest from customers on amounts overdue, etc.

9.2.3 Clause (a) of Note 5 (vii) requires a separate disclosure for Dividends from subsidiary companies. The Old Schedule VI specifically required parent companies to recognise dividend declared by subsidiary companies even if declared after the Balance Sheet date if they are related to the period covered by the Financial Statements. The Revised Schedule VI does not prescribe any such accounting requirement. Accordingly, dividend income from subsidiary companies should be recognized in accordance with AS-9, i.e. only when they have a right to receive the same on or before the Balance Sheet date. Normally, the right to receive is established only when the dividend is approved by the shareholders at the Annual General Meeting of the investee company. In the first year of application of Revised Schedule VI, dividend income recognised in the immediately preceding year based on the aforesaid requirements of Old Schedule VI should not be derecognized for the

comparatives presented.

To recognize dividend based on the right to receive would constitute a change in accounting policy which should be applied prospectively. Dividend approved by the shareholders of the subsidiary in the current year but already recognised by the holding company in the previous year's Financial Statements as per Old Schedule VI should not be again recognised in the first year of application of Revised Schedule VI. Necessary disclosures as per AS 5 *Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies* pertaining to change in accounting policy should be made in the Notes to Accounts.

9.2.4 Other income items such as interest income, dividend income and net gain on sale of investments should be disclosed separately for Current as well as Long-term Investments as required by AS 13 *"Accounting for Investments"*. If it is a net loss the same should be classified under expenses.

9.2.5 For other non-operating income, income should be disclosed under this head net off expenses directly attributable to such income. However, the expenses so netted off should be separately disclosed.

9.3 Share of profits/losses in a Partnership firm

9.3.1 Though, there is no specific requirement in the Revised Schedule VI to disclose profit or losses on investments in a partnership firm as was required by the Old Schedule VI, the same should be disclosed as discussed as under.

9.3.2 Share of profit or loss in a partnership firm accrues the moment the same is computed and credited or debited to the Capital/Current/any other account of the company in the books of the partnership firm. Hence, the same should be accordingly accounted for in the books of the company.

9.3.3 Separate disclosure of profits or losses from partnership firms should be made. In a case where the company was a partner during the year but is not a partner at the end of the year, the disclosure should be made for the period during which the company was a partner.

9.3.4 The company's share of the profits or losses of the partnership firm should be calculated by reference to the company's own accounting year. The Financial Statements of the partnership for computing the share of profits and losses should be drawn up to the same reporting date. If it is not practicable to draw up the Financial Statements of the partnership upto such date and, are drawn up to a different reporting date, drawing analogy from AS-21 and AS-27, adjustments should be made for the effects of significant transactions or other events that occur between that date and the date of the parent's Financial Statements. In any case, the difference between reporting dates should not be more than six months. In such cases, the difference in reporting dates should be disclosed.

9.3.5 In case the year ending of the company and of the firm fall on different dates, the Financial Statements of the company should also contain a note to indicate that the accounting period of the partnership firm in respect of which the profits or losses have been accounted for in the company's books.

9.3.6 If however, a partnership firm happens to be in the nature of a Jointly Controlled Operation as defined in AS-27, the share of incomes, expenses, assets or liabilities will have to be accounted for in the Standalone Financial Statements as prescribed in AS-27.

9.3.7 In case the partnership firm is a Subsidiary under AS-21, Associate under AS-23 or Jointly Controlled Entity/Jointly Controlled Operation under AS-27, in the Consolidated Financial Statements, the share of profit/loss from the firm should be accounted for in terms of the applicable Accounting Standard as stated above.

9.3.8 The aforesaid principles should also be applied to accounting for the share of profits and losses in

an Association of Persons (AOP).

9.4 Share of profits/losses in a Limited Liability Partnership (LLP)

9.4.1 A Limited Liability Partnership, as per the LLP Act, is a body corporate and the share of profit/loss in the LLP does not accrue to the partners till the same is transferred to the Partners' Capital/Current Account as per the terms of the LLP Agreement. Accordingly, the share of profit/loss should be accounted in the books of the company as and when the same is credited/ debited to the Partners' Capital Account.

9.4.2 Depending upon the terms of agreement between the Partners, the LLP may be a Subsidiary under AS-21, Associate under AS-23 or Jointly Controlled Entity under AS-27. Hence, accounting in respect of the same in the Consolidated Financial Statements would be governed by the applicable Accounting Standards.

9.5 Expenses

The aggregate of the following expenses are to be disclosed on the face of the Statement of Profit and Loss:

- Cost of materials consumed
- Purchases of Stock-in-Trade
- Changes in inventories of finished goods, work in progress and stock in trade
- Employee benefits expense
- Finance costs
- Depreciation and amortization expense
- Other expenses

9.5.1 Cost of materials consumed

9.5.1.1 This disclosure is applicable for manufacturing companies. Materials consumed would consist of raw materials, packing materials (where classified by the company as raw materials) and other materials such as purchased intermediates and components which are 'consumed' in the manufacturing activities of the company. Where packing materials are not classified as raw materials the consumption thereof should be disclosed separately. However, intermediates and components which are internally manufactured are to be excluded from the classification:

9.5.1.2 For purpose of classification of inventories, internally manufactured components may be disclosed as below:

- i. where such components are sold without further processing they are to be disclosed as 'finished products'.
- ii. where such components are sold only after further processing, the better course is to disclose them as 'work-in-progress' but they may also be disclosed as 'manufactured components' subject to further processing or with such other suitable description as 'semi-finished products' or 'intermediate products'.
- iii. where such components are sometimes sold without further processing and sometimes after further processing it is better to disclose them as 'manufactured components'.

9.5.1.3 For the purpose of interpreting the requirement to classify the raw materials, some guidance may be necessary with regard to the question as to what constitutes raw materials. According to the strict dictionary connotation of this term, raw materials would include only materials obtained in the

state of nature. Such a definition would, however, be unrealistic in context of this requirement because it would exclude even a basic material such as steel. Generally speaking, the term "raw materials" would include materials which physically enter into the composition of the finished product. Materials, such as stores, fuel, spare parts etc, which do not enter physically into the composition of the finished product, would therefore, be excluded from the purview of the term "raw materials".

9.5.1.4 The requirement is silent with regard to containers and packaging materials. It is, therefore, open to question whether such materials constitute a category of "raw materials" for the purpose of the classification. The matter should be decided in the light of the facts and circumstances of each case, the nature of the containers and packaging materials, their relative value in comparison to the raw materials consumed, and other similar considerations. Where, however, packaging materials, because of their nature are included in raw materials it is preferable to show the description as "raw materials including packaging materials consumed".

9.5.1.5 Since in case of a company which falls under the category of manufacturing or manufacturing and trading company, disclosure is required with regard to raw materials consumed, care should be taken to ensure that the figures relate to actual consumption rather than "derived consumption". The latter figure is ordinarily obtained by deducting the closing inventory from the total of the opening inventory and purchases, but this figure may not always represent a fair indication of actual consumption because it might conceal losses and wastages. On the other hand, if the figure of actual consumption can be compiled from issue records or other similar data, it is likely to be more accurate. Where this is not possible, the derived figure of consumption may be shown and it is left to the company, according to the circumstances of each case, to determine whether any footnote is required to indicate that the consumption disclosed is on the basis of derived figures rather than actual records of issue.

9.5.1.6 Where the consumption is disclosed on the basis of actual records of issue, a further question arises with regard to the treatment of shortages, losses and wastages. In most manufacturing companies, these are inevitable. It is, therefore, suggested that the company should itself establish reasonable norms of acceptable margins. Any shortages, losses or wastages which are within these norms may be regarded as an ordinary incidence of the manufacturing process and may, therefore, be included in the figure of consumption. On the other hand, any shortages, losses or wastages which are beyond the permitted margin or when they are known to have occurred otherwise than in the manufacturing process, should not be included in the consumption figures. Whether or not such abnormal variations need to be separately disclosed in the accounts would depend upon the facts and circumstances of each case. The General Instructions for Preparation of Statement of Profit and Loss does not require any specific disclosures.

9.5.1.7 In the case of industries where there are several processes, materials may move from process to process, so that the finished product of one department constitutes the raw materials of the next. Since the disclosure requirement provides only for disclosure of raw material under broad heads and goods purchased under broad heads and also having regard to the fact that the consumption of raw materials for production of such intermediates would have to be accounted as raw materials consumed, it follows that internal transfers from one department to another should be disregarded in determining the consumption figures to be disclosed. .

9.5.2 Purchases of Stock in Trade

Stock-in-trade refers to goods purchased normally with the intention to resell or trade in. In case, any semi-finished goods/materials are purchased with an intention of doing further processing activities on the same, the same should be included in 'cost of materials consumed' rather than under this item.

9.5.3 Changes in inventories of finished goods, work-in-progress and stock-in-trade

This requires disclosure of difference between opening and closing inventories of finished goods, work-in-progress and stock-in-trade. The difference should be disclosed separately for finished goods, work in progress and stock in trade.

9.5.4 Employee benefits expense [Note 5(i)(a)]

This requires disclosure of the following details:

9.5.4.1 Salaries and wages

The aggregate amounts paid/payable by the company for payment of salaries and wages are to be disclosed here. Expenses on account of bonus, leave encashment, compensation and other similar payments also need to be disclosed here. Where a separate fund is maintained for Gratuity payouts, contribution to Gratuity fund should be disclosed under the sub-head Contribution to provident and other funds.

The term employee should be deemed to include directors who are either in whole-time or part-time employment of the company. It will exclude those directors who attend only Board meetings and are not under a contract of service with the company. Those who act as consultants or advisers without involving the relationship of master and servant with the company should also be excluded. A distinction should be made between persons engaged under a contract of service and those engaged under a contract for services. Only the former are to be included in the computation. Whether part-time employees are to be included would depend on the facts and circumstances of each case - the basic criterion being whether they are employed under a contract of service or a contract for services.

9.5.4.2 Contribution to provident and other funds

The aggregate amounts paid/payable by a company on account of contributions to provident fund and other funds like Gratuity fund, Superannuation fund, etc. are to be disclosed here.

Contributions for such funds for contract labour may also be separately disclosed here. However, penalties and other similar amounts paid to the statutory authorities are not strictly in the nature of 'contribution' and should not be disclosed here.

9.5.4.3 Expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP)

The amount of expense under this head should be determined in accordance with the Guidance Note on Accounting for Employee Share based Payments and/or the SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999, as applicable. All disclosures required by the aforesaid Guidance Note should be made here.

9.5.4.4 Staff welfare expense

The total expenditure on Staff welfare is to be disclosed herein.

9.5.5 As per Note 3 of to the General Instructions for the Preparation of the Statement of Profit and Loss, disclosure of Finance costs is to be bifurcated under the following:

- (A) Interest expense
 - (B) Other borrowing costs
 - (C) Applicable net gain/loss on foreign currency transactions and translation
- A) Interest expense

This would cover interest paid on borrowings from banks and others, on debentures, bonds or similar

instruments etc. Finance charges on finance leases are in the nature of interest expense and hence should also be classified as interest expense. In the absence of any bifurcation required for interest paid on fixed period loans and other borrowings as required under the Old Schedule VI, the same need not be given.

B) Other borrowing costs

Other borrowing costs would include commitment charges, loan processing charges, guarantee charges, loan facilitation charges, discounts/premium on borrowings, other ancillary costs incurred in connection with borrowings, or amortization of such costs, etc.

C) Applicable net gain/loss on foreign currency transactions and translation

As per Para 4(e) of AS-16, borrowing costs also include exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs. Any such exchange differences would need to be disclosed under this head.

9.5.6 Depreciation and amortization expense [Note 5(i) (b)]

A company has to disclose depreciation provided on fixed assets and amortization of intangible assets under this head.

9.5.7 Other Expenses

All other expenses not classified under other heads will be classified here. For this purpose, any item of expenditure which exceeds one percent of the revenue from operations or `Rs. 1,00,000, whichever is higher (as against the requirement of Old Schedule VI of 1 percent of total revenue or Rs. 5,000 whichever is higher), needs to be disclosed separately.

Further Note 5(vi) requires a separate disclosure of each of the following items, which will also be classified under 'Other expenses'

- Consumption of stores and spare parts;
- Power and fuel;
- Rent;
- Repairs to buildings;
- Repairs to machinery;
- Insurance;
- Rates and taxes, excluding taxes on income;
- Miscellaneous expenses.

9.6 Exceptional items

The term 'Exceptional items' is not defined in Revised Schedule VI. However, AS-5 "*Net Profit or Loss for the period, Prior period items and changes in Accounting Policies*" has a reference to such items in Paras 12, 13 and 14.

"Para 12: 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.

Para 13: Although the items of income and expense described in paragraph 12 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 notes to

the Financial Statements.

Para 14: Circumstances which may give rise to the separate disclosure of items of income and expense in accordance with paragraph 12 include: 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; and*
- ✓ *other reversals of provisions.*

In case the company has more than one such item of income / expense of the above nature, the aggregate of such items should be disclosed on the face of the Statement of Profit and Loss. Details of the all individual items should be disclosed in the Notes. [Note 5 (i) (k) to the General Instructions for preparation of the Statement of Profit and Loss]

9.7 Extraordinary items

The term 'Extraordinary items' is not defined in Revised Schedule VI. However, AS 5 "*Net Profit or Loss for the period, Prior period items and changes in Accounting Policies*" at para 4.2 defines 'extraordinary items' as: '*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. Further para 8 of AS-5 discusses about the disclosure of extraordinary items as below:*

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 case the company has more than one such item of income / expense of the above nature, the aggregate of such items should be disclosed on the face of the Statement of Profit and Loss. Details of the all individual items should be disclosed in the Notes. [Note 5 (i) (k) to the General Instructions for Preparation of the Statement of Profit and Loss].

9.8 Tax expense:

This is to be disclosed on the face of the Statement to Profit and Loss and bifurcated into:

- (1) Current tax and
- (2) Deferred tax

9.8.1 Current tax

9.8.1.1 The term 'Current tax' has been defined under AS-22 "Accounting for Taxes" on Income as the amount of income tax determined to be payable (recoverable) in respect of the taxable income (tax loss) for a period. Hence, details of all taxes on income payable under the applicable taxation laws should be disclosed here.

9.8.1.2 Presentation for Minimum Alternate Tax (MAT) credit should be made as prescribed by the ICAI Guidance Note on "Accounting for Credit Available in Respect of Minimum Alternative tax under the Income-tax Act, 1961". The relevant portion is as under:

"Profit and Loss Account:

15. According to paragraph 6 of Accounting Standards Interpretation (ASI) 6, 'Accounting for Taxes on Income in the context of Section 115JB of the Income-tax Act, 1961', issued by the Institute of Chartered Accountants of India, MAT is the current tax. Accordingly, the tax expense arising on account of payment of MAT should be charged at the gross amount, in the normal way, to the profit and loss account in the year of payment of MAT. In the year in which the MAT credit becomes eligible to be recognised as an asset in accordance with the recommendations contained in this Guidance Note, the said asset should be created by way of a credit to the profit and loss account and presented as a separate line item therein."

The Disclosure in this regard should be made as under :

| | |
|-------------------------------|------|
| Current tax (MAT) | XX |
| Less : MAT credit entitlement | (XX) |
| Net Current tax | XX |

9.8.1.3 Any interest on shortfall in payment of advance income-tax is in the nature of finance cost and hence should not be clubbed with the Current tax. The same should be classified as Interest expense under finance costs. However, such amount should be separately disclosed.

9.8.1.4 Any penalties levied under Income tax laws should not be classified as Current tax. Penalties which are compensatory in nature should be treated as interest and disclosed in the manner explained above. Other tax penalties should be classified under Other expenses.

9.8.1.5 Wealth tax payable by a company on assets liable for wealth tax should not be included within current tax since the same is not a tax on income. Accordingly, wealth tax should be included in Rates and taxes under other expenses.

9.8.1.6 Excess/Short provision of tax relating to earlier years should be separately disclosed.

9.8.2 Deferred tax

9.8.2.1 Any charge/credit for deferred taxes needs to be disclosed separately on the face of the Statement of Profit and Loss.

9.8.2.2 AS 22 "Accounting for Taxes on Income" defines 'Deferred tax' as the tax effect of timing differences.

Timing differences are defined as "differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods."

9.9 Profit / (loss) for the period from Discontinuing operations

9.9.1 The term 'Discontinuing operations' is defined in AS 24 "Discontinuing operations" as a component of an enterprise:

- a. that the enterprise, pursuant to a single plan, is:
 - (i) disposing of substantially in its entirety, such as by selling the component in a single transaction or by demerger or spin-off of ownership of the component to the enterprise's shareholders; or
 - (ii) disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually; or
 - (iii) terminating through abandonment; and
- b. that represents a separate major line of business or geographical area of operations; and

c. *that can be distinguished operationally and for financial reporting purposes.*

9.9.2 Profit or loss from Discontinuing Operations needs to be separately disclosed on the face of Statement of Profit and Loss. This disclosure is in line with the disclosure requirement of AS-24 Para 32(a) which requires the amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto to be disclosed on the face of the Statement of Profit and Loss.

9.9.3 Further, AS-24 Para 32(b) requires the following disclosure to be made on the face of the Statement of Profit and Loss as well:

“(b) the amount of the pre-tax gain or loss recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation.”

Accordingly, such disclosures for discontinuing operations should be made wherever applicable.

9.10 Tax expense of discontinuing operations

In case there are any taxes payable / tax credits available on profits / losses of discontinuing operations, the same needs to be disclosed as a separate line item on the Statement of Profit and Loss.

9.11 Earnings per equity share

Computation of Basic and Diluted Earnings Per Share should be made in accordance with AS 20 *Earnings Per Share*. It is pertinent to note that the nominal value of equity shares should be disclosed along with the Earnings Per Share figures as required by AS 20.

10 Other additional information to be disclosed by way of Notes to Statement of Profit and Loss

Besides the above disclosures, Para 5 of the General instructions for Preparation of Statement of Profit and Loss also require disclosure on the following items:

10.1 Adjustments to the carrying amount of investments [Clause (h) of Note 5(i)]

In case there are any adjustments to carrying amount of investments pursuant to diminution in value of the investment (or reversal thereof) in conformity with AS 13 *Accounting for Investments*, the same should be disclosed here.

10.2 Net gain or loss on foreign currency translation (other than considered as finance cost) Clause (i) of Note 5(i)

Any gains / losses on account of foreign exchange fluctuations are to be disclosed separately as per AS 11. Thus net exchange loss should be classified under Other expenses and the amount so included should be separately disclosed. Under this head, exchange differences to the extent classified as borrowing costs as per Para 4(e) of AS-16 should not be disclosed. Refer para 9.5.5 [Note 3(c) of Revised Schedule VI].

10.3 Payments to the auditor [Clause (j) of Note 5(i)]

Payments covered here should be for payments made to the firm of auditor(s). Expenses incurred towards such auditor's remuneration should be disclosed under each of the following sub-heads as follows:

As :

- (a) Auditor,
- (b) For taxation matters,

- (c) For company law matters,
- (d) For management services,
- (e) For other services,
- (f) For reimbursement of expenses;

10.4 Prior period items [Clause (l) of Note 5 (i)]

The term 'Prior period Items' is not defined in Revised Schedule VI. AS 5 "*Net Profit or Loss for the period, Prior period items and changes in Accounting Policies*", in para 4.3 defines 'Prior period items' as "*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*".

10.5 The Revised Schedule VI requires the following additional information to be given by way of notes:

| Nature of company | Disclosures required |
|---|--|
| Manufacturing companies | Raw materials under broad heads Goods purchased under broad heads |
| Trading companies | Purchases of goods traded under broad heads |
| Companies rendering or supplying services Company that falls under | Gross income derived from services rendered under broad heads It will be sufficient compliance with more than one category the requirements, if purchases, sales and consumption of raw material and the gross income from services rendered are shown under broad heads. |

10.6 The disclosure requirements to be made for the above in the Financial Statements are discussed as under:

The disclosures required as above are not very clear and give rise to the following questions:

- (a) Whether a company is required to disclose quantitative details or not?
- (b) Whether a manufacturing company will disclose purchase, sale or consumption of raw materials?
- (c) What is meant by "good purchased" in case of manufacturing companies?
- (d) While there is a requirement to disclose gross income in case of a service company and sales in case of a company falling under more than one category, there is no clear requirement to disclose sales for a manufacturing or a trading company.
- (e) With regard to a company falling under more than one category different interpretations seem possible. One interpretation is that it should disclose purchase, sale and consumption for raw material. The other interpretation is that purchase relates to traded goods, sale relates to all goods sold (both manufactured goods and traded goods) and for raw material, only consumption needs to be disclosed.

10.7 Since the Revised Schedule VI gives a note stating that "Broad heads shall be decided taking into

account the concept of materiality and presentation of true and fair view of Financial Statements”, a company may consider the following in deciding the disclosures required:

- (a) Apparently, there is no need to give quantitative details for any of the items.
- (b) Considering the ambiguity and on a conservative interpretation, a manufacturing company may disclose the following under broad heads:
 - (i) Consumption of major items of raw materials (including other items classified as raw material such as intermediates/ components/packing material)
 - (ii) Goods purchased for trading (if any)
 - (iii) Though the Revised Schedule VI does not specifically require, it is also suggested to disclose major items of opening and closing stock. However, it is not mandatory.
 - (iv) Considering the requirement to disclose gross income in case of a service company and sales in case of a company falling in more than one category, disclosure of sales of finished goods should also be made under broad heads.
- (c) The term “broad heads” may be interpreted to mean broad categories of raw materials, goods purchased, etc. These categories should be decided based on the nature of each business and other facts and circumstances. Normally, 10 percent of total value of sales/services, purchases of trading goods and consumption of raw material is considered as an acceptable threshold for determination of broad heads. Any other threshold can also be considered taking into account the concept of materiality and presentation of true and fair view of Financial Statements.
- (d) Similar principle may be followed to decide disclosure requirement in other cases.

10.8 Based on the above perspectives, given below is a suggested format for making this disclosure:

10.8.1 Manufacturing company (Amount in ₹)

| Particulars | Consumption |
|----------------------|--------------------------|
| Raw materials | |
| Raw material A | XX (YY) |
| Raw material B | XX (YY) |
| Others | XX (YY) |
| Total | XX (YY) |

| Particulars | Purchases |
|-----------------------|------------|
| Good purchased | |
| Traded item A | XX (YY) |
| Traded item B | XX |

| | |
|--------------|--------------------|
| | (YY) |
| Others | XX (YY) |
| Total | XX (YY) |

| Particulars | Sales values | Closing Inventory | Opening Inventory |
|---------------------------|----------------|-------------------|-------------------|
| Manufactured goods | | | |
| Finished goods A | XX (YY) | XX | XX |
| Finished goods B | XX (YY) | XX | XX |
| Others | XX (YY) | XX | XX |
| Total | XX (YY) | XX | XX |
| Traded goods | | | |
| Traded goods A | XX (YY) | XX | XX |
| Traded goods B | XX (YY) | XX | XX |
| Others | XX (YY) | XX | XX |
| Total | XX (YY) | XX | XX |

| Particulars | WIP |
|-------------------------|--------------------|
| Work in Progress | |
| Goods A WIP | XX (YY) |
| Goods B WIP | XX (YY) |
| Others | XX (YY) |
| Total | XX (YY) |

10.8.2 Trading company

| Particulars | Purchase | Sales |
|----------------|----------------|----------------|
| Traded goods | | |
| Traded goods A | XX (YY) | XX (YY) |
| Traded goods B | XX (YY) | XX (YY) |
| Others | XX (YY) | XX (YY) |
| Total | XX (YY) | XX (YY) |

10.8.3 Service Company

| Particulars | Amount |
|-------------------|--------------------|
| Services rendered | |
| Service A | XX (YY) |
| Service B | XX (YY) |
| Others | XX (YY) |
| Total | XX (YY) |

Note : Figures in brackets represent previous year figures.

A company falling under more than one category will make the above disclosures, to the extent relevant.

10.9 The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserve [Clause (a) of Note 5(iv)]

1. **10.9.1** Disclosure is required for amounts set aside or proposed to be set aside to reserves out of the profits for the period. The said transfers can be in terms of the applicable statute under which the Financial Statements are prepared i.e., the Companies Act, 1956 or any other applicable statute e.g. Income Tax Act, 1961, or RBI Act, 1932, etc. Further, profits may also be appropriated to free reserves as deemed appropriate by the management.

2. **10.9.2** The transfer to reserves as above should, however, not include provisions made to meet any specific liability, contingency or commitment known to exist at the date as on which the Balance Sheet is made up.

10.10 The aggregate, if material, of any amounts withdrawn from such reserves [Clause (b) of Note 5 (iv)]:

In case the company has made any withdrawals from any reserves created in terms of Clause (a) of

Note 5(iv) above, the same is to be disclosed separately.

It may be noted that such setting aside as well as withdrawal from reserves is to be disclosed under applicable Line item of Reserves and Surplus, and not under the Statement of Profit and Loss since the same is an appropriation of profits and not a charge against revenue.

10.11 The aggregate, if material, of the amounts set aside to provisions made for meeting specific liabilities, contingencies or commitments and amounts withdrawn from such provisions, as no longer required [Clause (a) of Note 5(v) and Clause (b) of Note 5(v)]

The amounts in respect of the items under this requirement should be separately disclosed as a charge to the Statement of Profit and Loss. Provisions no longer required should be credited to the Statement of Profit and Loss.

10.12 Clause (b) of Note 5(vii) requires disclosure for 'Provisions for losses of subsidiary companies'.

However, as per AS-13, a provision in respect of losses made by subsidiary companies is made only when the same results in an other than temporary diminution in the value of investments in the subsidiary. Accordingly, the aforesaid disclosure should be made separately only where such a provision has been made in respect of the investment in such loss-making subsidiary.

11 Other Disclosures

The Statement of Profit and Loss shall also contain by way of a note the following information, namely:-

(a) Value of imports calculated on C.I.F basis by the company during the financial year in respect of –

- I. Raw materials;
- II. Components and spare parts;
- III. Capital goods;

(b) Expenditure in foreign currency during the financial year on account of royalty, know-how, professional and consultation fees, interest, and other matters;

(c) Total value if all imported raw materials, spare parts and components consumed during the financial year and the total value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption;

(d) The amount remitted during the year in foreign currencies on account of dividends with a specific mention of the total number of non-resident shareholders, the total number of shares held by them on which the dividends were due and the year to which the dividends related;

(e) Earnings in foreign exchange classified under the following heads, namely:-

- Export of goods calculated on F.O.B. basis;
- Royalty, know-how, professional and consultation fees;
- Interest and dividend;
- Other income, indicating the nature thereof

11.1 Value of imports calculated on C.I.F. basis by the company during the financial year [Clause (a) of Note 5(viii)]

The above disclosure is to be given in respect of – Raw materials; Components and spare parts; Capital goods.

11.1.1 One of the requirements of disclosure as a note to the Statement of Profit and Loss is the value

of imports of raw materials calculated on C.I.F. basis. The manner in which the term "raw materials" should be interpreted for this purpose, is as discussed in para 9.5.1.3 of this Guidance Note.

11.1.2 Disclosure is also required to be made as to the value of imports of components and spare parts and capital goods respectively. The term "components" may be interpreted in the same manner as the term "intermediates or components" in connection with the requirement, discussed earlier in para 9.5.1.2 of this Guidance Note, to disclose the consumption of purchased components or intermediates. The term "spare parts" would ordinarily relate to spare parts for plant and machinery and other capital equipment. The total value of imports of components and spare parts may be disclosed in the aggregate. It may be appropriate to sub-classify the value of imports between components and spare parts respectively since the nature of these two items is not entirely similar. Such separate classification however, is not a mandatory requirement of the Revised Schedule VI. However, wherever the records for raw materials and components are maintained together, the information required under this clause pertaining to components can be presented collectively with raw materials.

11.1.3 As regards "capital goods", disclosure would be involved in respect of imported plant and machinery, furniture and fixtures, transport equipment, intangible assets and other types of expenditure which is treated as capital expenditure in the books of account. It is undoubtedly anomalous to disclose the value of imports of capital goods by way of a note on the Statement of Profit and Loss, since by the very definition, capital assets do not form part of the Statement of Profit and Loss. However, since this is the specific requirement of the Revised Schedule VI, it would have to be complied as such. Since this disclosure is required for the Statement of Profit and Loss, it would not be advisable to disclose the imports of capital goods by way of a note on Fixed Assets- Tangible Assets or Capital work-in-progress, even though it would be more appropriate to do so.

11.1.4 It is significant that this requirement covers only imported spare parts. It apparently does not apply to goods imported for sale, imported stores, etc. However, the practice followed by most companies is that imported stores are being clubbed with imported spare parts for the purposes of this disclosure. This is probably due to the practical difficulty involved in separating stores from spare parts. Hence, where it is not possible to segregate the two owing to practical difficulties, the total value of imports of stores and spare parts may be shown against a caption which clearly indicates that the value shown relates to both the stores as well as the spare parts.

11.1.5 The disclosure in respect of imports of the foregoing items is to be made on accrual basis. This is because disclosure is required in respect of the value of imports "during the financial year". Consequently, if the particular item has been imported during the accounting year, it should be disclosed as such, even though the payment is not made in that year.

11.1.6 It is also to be noted that the disclosure under this requirement relates to the imports as such. It is not linked with the consumption of the material or utilization of capital goods.

11.1.7 While a subsequent requirement relates to expenditure in foreign currency for designated items, the requirement presently under discussion is not linked with any particular expenditure in foreign currency or local currency. Consequently, the value of imports of raw materials, components and spare parts and capital goods is to be disclosed irrespective of whether or not such imports have resulted in an expenditure in foreign currency. It is possible that imports may have been arranged on Rupee payment terms without involving any foreign currency expenditure but even so, the value of the imports would have to be suitably disclosed.

11.1.8 Disclosure should be made in Indian currency. Where the imports involve foreign currency expenditure, the amount to be disclosed would be the corresponding Rupee value of the imports as translated in the books of account on normal principles relating to the translation of foreign currencies.

11.1.9 The value of the imports is to be calculated on C.I.F. basis – that is inclusive of cost, insurance and freight. It is possible that the imported materials may have been shipped by an Indian carrier and the insurance may have been arranged with an Indian insurer, so that, really, there is no element of import of services with regard to the insurance and freight. Even so, the Revised Schedule VI requires the value of the imports to be disclosed on a C.I.F. basis, and while this may be anomalous in the types of situations indicated above, the requirement should ordinarily be complied with. If for any reason, there is some practical difficulty in disclosing the value of the imports on C.I.F. basis, a footnote should be appended to the statement indicating the precise method by which the value of imports has been arrived at. For example, it may be stated that, because of practical difficulties in disclosing the value of imports on C.I.F. basis, such disclosure has been made on F.O.B. basis. Without attempting to particularize the various circumstances under which it may be difficult to disclose the value of imports on a C.I.F. basis, one example may be cited. A company may have standing arrangements with a shipping line or with an insurer so that all imports are covered through such a standing arrangement. In that case, it may be difficult to allocate the insurance or freight to each specific shipment. Similarly, if a company is a self insurer, or if it owns its own fleet of ships, disclosure of the value of imports cannot be made on a C.I.F. basis. In situations of this kind the matter should be covered by a suitable explanatory note but otherwise, wherever possible, the value of imports should be disclosed on a C.I.F. basis. It may be noted that the requirement to disclose the value on a C.I.F. basis relates to the method of computation of the value, rather than the terms of the import contract. It is not to be implied that this method of valuation is restricted to a case where the import contract is itself on a C.I.F. basis.

11.1.10 Disclosure is required with regard to the value of imports “by the company”. This implies that only direct imports by the company are involved in the disclosure. If the company purchases imported materials in the open market, no disclosure would be necessary under this requirement. Similarly, if the company canalized its imports through another agency such as the State Trading Corporation, no disclosure would be required, since it is the latter agency which is the importing entity. On the other hand, if a company purchases import entitlements and thereafter imports materials on the basis of those entitlements, the value of such imports would need to be disclosed, since they are the imports of the company, irrespective of the manner in which the company procured the import entitlements. Within this rather broad statement of the case, it is apprehended that practical difficulties may arise in determining whether or not a particular import has been made “by the company”.

11.1.11 For the purpose of this requirement, only direct imports are to be taken into consideration. Imported materials purchased locally, and imports canalized through other sources, need not be disclosed. While this distinction may be clear in the large majority of cases, problems may arise in individual cases. In particular, in the case of indirect imports, care should be taken to determine whether the source from which the imports have been obtained represent an agency or an independent principal. If a company has appointed a person or a company as its agent for the purpose of securing the import of raw materials, etc., the imports through such agent must be regarded as the company's imports, and the value of such imports should be disclosed pursuant to the requirement under this Note. On the other hand, if another person or company has already imported the materials and the company in question merely purchases such imported materials, on a principal to principal basis, (except in cases where importing the materials is done under specific requisition resulting in substance agent-principal relationship) the value of such imports should be ignored by the latter company, and included by the former.

11.1.12 The value of imports should also include goods which are in transit on the Balance Sheet date, provided significant risks and rewards of ownership in those goods have already passed to the purchasing company. For the purpose of determining whether or not the property has passed, reference may be made to the terms of the import contract, and recognized legal principles, relating to

this matter. Conversely, goods-in-transit at the beginning of the year should be excluded on a similar basis so that they do not form part of the value of the current year's imports or succeeding year's for the purpose of the same disclosure relating to the value of imports.

11.1.13 Since the requirement is to disclose the value of imports during the accounting year, it may be necessary to determine when the significant risks and rewards of ownership to the goods has passed from the overseas exporter to the Indian importer in accordance with the well recognized legal principles relating to this matter, irrespective of the fact whether or not the goods have been physically received.

11.1.14 A particular problem may, however, arise in the case of import of capital goods where delivery is to be made in installments through part shipments from time to time. The contract may provide for the total value of the entire shipment and it may, therefore, be difficult to determine the separate value of the part shipments received during the accounting year. Since the disclosure which is required is in respect of imports during the accounting year, it may be necessary to estimate, on a reasonable basis, the separate value of part shipments. If such estimates are reasonable, no objection needs be taken thereto.

11.1.15 It follows from this that, in appropriate cases, the disclosure would include the value of goods in transit at the end of the year if the significant risks and rewards of ownership in such goods has already passed to the Indian importer. Conversely, it may be necessary to exclude the value of the opening inventory in transit if the title to such inventory had already passed to the Indian importer prior to the end of the previous year.

11.1.16 For the purpose of working out the C.I.F. value of imports, it may be necessary to make approximations in suitable cases. For example, a company may be actually importing materials on the basis of F.O.B. contracts so that the values directly available from its records would be those relating to F.O.B. terms. In such cases, a standard formula may be applied in order to convert the F.O.B. values to C.I.F. For example, the company's accountant may calculate that a loading of, say, eleven per cent on the F.O.B. values is ordinarily adequate and correct in order to convert the F.O.B. values to C.I.F. If such approximations are reasonable, no objection should ordinarily be taken thereto.

11.2 Expenditure in foreign currency during the financial year [Clause (b) of Note 5(viii)]

The above is to be disclosed for expenditure incurred on account of royalty, know-how, professional and consultation fees, interest and other matters;

11.2.1 In addition to the requirement discussed earlier relating to the disclosure of the value imported materials, and the disclosure relating to the consumption of imported materials as compared to indigenous materials, there is also a further requirement to disclose expenditure in foreign currency on account of royalty, know-how, professional consultation fees, interest, and other matters.

11.2.2 In this particular case, the disclosure is to be made with regard to the expenditure in foreign currency. Consequently, if no foreign currency expenditure is involved, no disclosure would be required, even though the specific services covered by this requirement have been imported free of cost or against Rupee payment or against any other method of payment or adjustment not involving the expenditure of foreign currency. Although the disclosure is required to be made with regard to items involving expenditure in foreign currency, the amount to be disclosed would be the Indian Rupee amount. It should be noted that every company is required to follow accrual system of accounting and the requirement refers to 'expenditure', the disclosure should be on the basis of the expenditure incurred and recorded in the books of account and not on the basis of remittance. The appropriate Rupee figure can be obtained by converting the foreign exchange figure through the application of a rate of exchange which is suitable for that purpose, having regard to normal principles of foreign

currency translation/conversion in accounts. If so desired, the foreign currency figure may also be given as additional information but this cannot be regarded as mandatory.

11.2.3 While the requirement relating to the disclosure of imports clearly specifies the different heads under which the disclosure is to be made, and while the requirement relating to foreign exchange earnings also similarly indicates the specific heads under which the disclosure is to be classified, there is no such requirement with regard to the disclosure of expenditure in foreign currency. It is true that the specific items in respect of which such disclosure is to be made have been indicated, but this does not by itself imply that the disclosure is to be classified with reference to those items. At the same time, since such classification should not be difficult, it is advisable to classify the foreign currency expenditure between royalty, know-how, professional consultation fees, interest and other matters. In other words, the classification as between these items is certainly desirable but is probably not mandatory, having regard to the precise terms of the Revised Schedule VI. It may also be noted that under old Schedule VI, for the same requirement, the practice has been to classify between different heads and disclose.

11.2.4 The various items specified above do not call for any particular comments since they are expressed through well understood terms. The residual item relating to "other matters" appears to be sufficiently exhaustive so as to cover any items for which foreign currency expenditure is involved. It is necessary to point out that disclosure is required with regard to "other matters" rather than with regard to "other similar matters". Consequently, it would not be reasonable to infer that disclosure is limited to items of a nature similar to royalty, know-how, professional consultation fees and interest. At the same time, however, it would be unreasonable to suggest that disclosure should be made once again with regard to the expenditure involved in foreign currency for an item whose import value has already been disclosed in response to the earlier requirement. Ordinarily, the requirement presently under discussion relates to expenditure on intangible items rather than on the import of tangible goods. However, if any foreign currency expenditure on the import of tangible goods has not been disclosed pursuant to the earlier requirements, it would need to be disclosed under this requirement. For example, foreign currency expenditure on the import of stores may not have been disclosed on the basis that the earlier requirement necessitates disclosure only with regard to the value of imports of "components and spare parts". In that case, the foreign currency expenditure involved in the import of stores would need to be disclosed under the requirement presently under discussion since this requirement covers "expenditure in foreign currency" on account of royalty, know-how, professional consultation fees, interest and *other matters*. Disclosure would also be involved under this requirement of any foreign currency expenditure in the payment of taxes in an overseas country on income earned in that country in a case where the payment of such taxes involves actual remittance from India. Where, however, the payment of taxes in the overseas country is made through deduction at source rather than by actual remittance from India, the method of disclosure has been suggested in a subsequent paragraph of this Note dealing with foreign exchange earnings where it has been recommended that foreign exchange earnings received subject to deduction of tax at source should be disclosed both gross and net.

11.2.5 The disclosure of expenditure in foreign currency is to be made on accrual basis since all the items in the Statement of Profit and Loss are stated on an accrual basis.

11.2.6 A further question which needs to be resolved is whether the disclosure is to be made of the gross amount of the expenditure, or of the net amount after tax deduction at source, in a case where such deduction is involved. So far as the company is concerned the gross expenditure is the amount of expenditure incurred in foreign currency even though a part of it may have been paid in Rupees to the Government to meet the statutory obligation of deducting tax at source. Deduction of tax at source by itself is not the finality of the matter and is merely a preliminary stage towards settlement of tax liability

of the non-resident. Ultimately, on assessment of the non-resident, the full amount of tax deducted at source may have to be refunded. In view of this, the preferable course seems to be to disclose the gross expenditure that has been incurred by the company.

11.2.7 Disclosure is to be limited only to those cases where the company itself incurs a foreign currency expenditure. Where an expenditure involves foreign currency but the original payment by the company itself is in Rupees, no disclosure is necessary. For instance, if a company has borrowed a loan from a Government agency and incurs expenditure in payment of interest on that loan, the company may be aware that the interest paid by it to the Government agency in Rupees will ultimately be remitted by the Government agency to a foreign lender. However, since the company itself does not incur any foreign currency expenditure, no disclosure is required in its accounts.

11.3 Total value of all imported raw materials, spare parts and components consumed during the financial year and the total value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption; [Clause (c) of Note 5(viii)]

11.3.1 Apart from the disclosure relating to the C.I.F. value of imports, separate disclosure is also required with reference to the value of imported raw materials, spare parts and components consumed during the accounting year. There is no guidance, for the purpose of this requirement, as to the manner in which the imported materials are to be evaluated i.e., C.I.F. basis or F.O.B. basis or any other basis. Even though the value of materials imported by the company itself is required to be stated on a C.I.F. basis, it does not follow that this basis is necessarily appropriate to the disclosure of the value of imported materials consumed. In the latter case, it would be more appropriate to make the disclosure on the basis of the actual cost to the company of the imported materials which have been consumed, since it is this cost which enters into the company's accounts. Consequently, the value of imported materials consumed should include not only their cost but also incidental expenses directly related to the purchase of such materials.

There is another reason for this suggestion and that is based on the fact that the value imported materials consumed is required to be compared with the value of indigenous materials consumed. Moreover, in the company's accounts, the total figure shown for consumption of materials (inclusive of indigenous and imported materials) would ordinarily be based on the value inclusive of the cost of such materials and various incidental charges. Therefore, in order to facilitate correlation with the total amount shown for consumption of materials in the Statement of Profit and Loss account as well as in order to facilitate comparison between the value of indigenous consumption and imported consumption, it is desirable that the value of imported materials consumed should be stated on a similar and consistent basis by including the cost of such materials and various incidental charges.

11.3.2 On the face of it, it would appear that this requirement duplicates the earlier requirement relating to the disclosure of the value of imports of raw materials, components and spare parts. However, there is a difference. The earlier requirement relates to the disclosure of the value of imports *per se* irrespective of whether or not the materials imported have been consumed in the company's operations. The latter requirement, on the other hand relates only to the value of the imported materials consumed in the company's operation.

11.3.3 As in the case of earlier requirement, it is not relevant to consider whether or not the imported materials which have been consumed have necessitated an expenditure in foreign currency. Even if no foreign currency expenditure is involved, the value of consumption of imported materials is still required to be disclosed.

11.3.4 The disclosure is to be made in Indian currency by applying normal methods for the translation

of foreign currencies where the original expenditure was incurred in a foreign currency.

11.3.5 A question may arise whether to include the consumption of locally purchased materials of foreign origin. Apart from the difficulties of ascertaining which locally purchased materials are of imported origin, it is logical to interpret this requirement as requiring disclosure only of materials imported directly or indirectly by the company. This would include materials imported directly by the company as well as indirect imports made to be company's knowledge or at its request through canalizing agents such as the State Trading Corporation.

11.3.6 It is not entirely clear whether the requirement herein implies that the value of imported raw materials, spare parts and components should be separately disclosed for each of these three items, or whether a composite disclosure for all the three items taken together is sufficient. The latter part of this clause states that "the percentage of each to the total consumption" is also to be disclosed. This may be taken to imply that the consumption is to be shown separately for raw materials, spare parts and components respectively. However, wherever the records for raw materials and components are maintained together, the information required under this clause can be presented collectively.

11.3.7 While raw materials are undoubtedly consumed in the course of operations, this term is hardly appropriate to spare parts and components. Spare parts may be utilized for repairs and maintenance or for other similar purposes, and components may be assembled into the finished product. In either case, the spare parts and components can hardly be said to have been "consumed". However, without going into the semantics relating to the word "consumed", the intention appears to be reasonably clear and disclosure may, therefore, be made on the basis of indicating the value of imported spare parts and components utilized in the company's operations.

11.3.8 In addition to disclosing the value of imported raw materials spare parts and components consumed during the accounting year, disclosure is also required with regard to the value of indigenous raw materials, spare parts and components similarly consumed during that year. In both cases, the value of the consumption should be determined on the same identical basis, so that like is compared with like. Thereafter, it is also required that the relative percentages of consumption value in respect of imported items and indigenous items should be stated as a percentage of total consumption for each of the categories of raw materials, spare parts and components respectively.

11.3.9 Care should be taken to ensure that the total consumption agrees with the figures in the Statement of Profit and Loss. In the case of consumption of raw materials, the separate figures for such consumption is generally disclosed in one figure in the Statement of Profit and Loss, in which case, the total consumption classified as between imported and indigenous should agree with this figure. Sometimes, however, the total consumption of raw materials is not shown as one figure in the Statement of Profit and Loss. Instead, a note is given indicating the consumption of raw materials shown under more than one head of account. In that case, care should be taken to ensure that the total figure for consumption of raw materials analysed as between imported and indigenous agrees with the total consumption shown in the Statement of Profit and Loss inclusive of the figure of consumption charged to other heads of account.

11.3.10 The term "spare parts" for the purpose of the foregoing requirements would refer to spares for plant and machinery and other items of a similar nature or intended for a similar purpose. This term would not ordinarily include stores. The term "stores" refers to materials and supplies which assist the manufacturing process but which do not directly enter into the furnished product. It is a term of wider import than "spare parts" and ordinarily, the term "stores" would include "spare parts". Since the present requirement is limited to spare parts, it would appear to be unnecessary to disclose the separate figures relating to the consumption of stores – imported and indigenous. It is somewhat curious that disclosure should be required with regard to spare parts and not with regard to stores, but

this is nevertheless, the logical interpretation of the words used in the relevant clause. Where the segregation between stores and spare parts is not possible owing to practical difficulties, the value of consumption of imported and indigenous stores and spare parts may be shown against a caption which clearly indicates that the value shown relates to both stores and spare parts.

11.3.11 As regards spare parts, the substantive requirement of Revised Schedule VI (Other expenses para 9.5.7) requires a composite figure to be disclosed in respect of consumption of stores and spare parts, whereas the analysis here is required only in respect of consumption of spare parts. Consequently, the total figure analysed for consumption of spare parts may not agree directly with the figure disclosed in the Statement of Profit and Loss for consumption of stores and spare parts, unless in the Statement of Profit and Loss, these two figures are separately itemized. In any case, however, a reconciliation statement should be kept on the company's working paper files to indicate that the figures have been agreed.

11.3.12 As regards components, the clause does not indicate clearly whether the classification of imported and indigenous components is to be restricted to purchased components, or whether it would also include components manufactured internally. Normally, imported components would in any case be restricted to those which are purchased, with the possible exception of a rare case in which components are fabricated outside India by a branch or department of the same company and are then shipped to India for incorporation into the finished product. Ignoring such an exception, it would appear that if imported components are to be restricted to those which are purchased, indigenous components would also have to be similarly restricted, otherwise the comparison would be vitiated. Consequently, it is suggested that this requirement may be interpreted in a manner whereby the classification of components between imported and indigenous would be limited to purchased components, ignoring any components which are manufactured internally.

11.3.13 Under some systems accounting, the consumption is originally charged in the accounts on the basis of standard or pre-determined rates. Periodically, an adjustment is made in the total consumption account in order to accord with the actual rates at which relevant materials may have been purchased. A problem may arise with reference to the classification of the total net debit or credit for such price adjustment as between imported and indigenous consumption. The most obvious method of solving this difficulty – which should be acceptable in most cases – is to allot the total debit or credit adjustment between imported and indigenous consumption, in the same ratio as the figure for imported and indigenous consumption prior to such debit or credit adjustment. A similar procedure may also be followed in the case of any other special debit or credit adjustments which are entered in the consumption accounts to reflect adjustments to the total consumption figure. On a slightly different context, a similar problem arises where the same item is partly purchased locally and partly imported and stocks are not physically kept separately. In such cases, it appears to be permissible to assume that consumption is on a pro-rata basis, e.g., in the ratio of opening stock plus purchase.

11.4 Total amount remitted during the year in foreign currencies on account of dividends with a specific mention of the total number of nonresident shareholders, the total number of shares held by them on which the dividends were due and the year to which the dividends related [Clause (d) of Note 5(viii)];

11.4.1 The requirement is to the disclosure with regard to the amount remitted to non-resident shareholders on account of dividends. This disclosure is to be made with reference to the amount remitted during the accounting year in foreign currencies. Consequently, if the dividend has been paid to a non-resident shareholder in Indian Rupees, disclosure would not appear to be necessary. Also, if a non-resident shareholder has indicated that all dividends payable to him are to be deposited in a Rupee account with his bankers in India, and if such deposit is actually made on the basis of the necessary

sanctions from the Reserve Bank of India, no disclosure would be required because such a deposit does not constitute any payment in foreign currency. It is possible that the non-resident shareholder may ultimately arrange for foreign currency remittances out of his Rupee bank account but this would be no concern of the company which pays the dividends into his Rupee bank account. However, by way of additional information, deposits regarding such dividends paid in the bank account may be given, indicating the fact.

11.4.2 As in the case of other disclosure relating to imports, exports, foreign exchange expenditure and earnings, etc. the amount to be disclosed in respect of foreign currency dividends is to be stated in Indian Rupees. If so desired, additional information may be furnished with regard to the foreign currency equivalent to the dividend, which has been remitted, but the basic requirement is to disclose the rupee amount. Disclosure of the foreign currency equivalent is not mandatory.

11.4.3 Since disclosure is required with regard to the "amount remitted during the year", it would appear that the information is to be furnished in the year of actual payment of dividend rather than in the year in which the dividend is proposed or declared. In other words, the disclosure should be made on a cash basis, contrary to the fact that the other disclosures are to be made on accrual basis.

11.4.4 In addition to the disclosure relating to the amount of dividends remitted in foreign currency, further disclosure is also required with regard to the number of non-resident shareholders to whom the dividends were remitted, the number of shares held by them, and the year to which the dividends relate. These requirements should not be difficult to comply with and no particular problem is likely to be encountered.

11.4.5 A question may arise as to whether or not any information is to be furnished with regard to the number of non-resident shareholders and the number of shares held by them, in particular year in which no dividend has been remitted to the non-resident shareholders. The answer is in negative, since, as already indicated earlier, the information relating to the number of non-resident shareholders and the number of shares held by them is intended to be linked to the basic information relating to the dividends remitted to non-resident shareholders.

11.5 Earnings in Foreign exchange [Clause (e) of Note 5 (viii)]

11.5.1 Foreign exchange earnings have to be classified under the following heads:-

- (i) export of goods calculated on F.O.B. basis;
- (ii) royalty, know-how, professional and consultation fees;
- (iii) interest and dividends; and
- (iv) other income (indicating the nature thereof).

11.5.2 In this case also, as in the case of disclosure relating to foreign currency expenditure, the question arises as to whether foreign currency earnings have to be disclosed on a cash basis or on an accrual basis. The considerations relating to this aspect of the matter are similar to those discussed earlier in connection with the requirement relating to the disclosure of foreign currency expenditure. Since the Statement of Profit and Loss is prepared on an accrual basis, it may be suggested that foreign currency earnings should also be disclosed on a similar basis.

11.5.3 Since, foreign exchange earnings are to be disclosed on an accrual basis, the subsequent receipt of foreign exchange in a later year should be ignored, as otherwise the same earnings would be disclosed twice.

11.5.4 A further question which arises is whether the foreign exchange earnings should be disclosed gross of tax or whether they should be disclosed net of any tax deducted at source in the overseas

country in which earnings have arisen. One way of looking at the matter is that the actual amount of earnings is the amount received after deduction of overseas tax at source, where such deduction is involved. On the other hand, the tax which is deducted at source in the overseas country is available by way of credit against the tax payable in that country. But for this credit, actual or constructive remittance may be involved from India to the overseas country for the purpose of meeting the tax liability in that country. It is, therefore, suggested that the more appropriate basis of disclosure would be gross of tax with a mention of the net of tax earnings and tax deducted at source. A further advantage of this method of disclosure is that the amount which is so disclosed would agree with the financial accounts, since, in the books of accounts kept in India, the gross amount of the foreign exchange earnings would be credited to revenue, while the tax deducted at source would be debited to an appropriate account relating to payment of taxes.

11.5.5 While the requirement relating to the disclosure of imports requires the "value of imports" to be disclosed, the disclosure of exports requires the "earnings from export of goods" to be disclosed. It would probably have been more consistent if the relevant clause had required the value of exports to be disclosed, rather than the earnings.

11.5.6 Considerations that apply in determining whether a purchase is an import by the company will also apply in determining whether sales is an export by the company. Any sales made direct by the company through an agent to any overseas buyer is an export by the company. However, goods sold to any canalizing agent like the State Trading Corporation for export is not the company's export.

12 Multiple Activity Companies

Where a company has multiple activities e.g. both manufacturing and trading

i.e. it falls under more than one category, it should comply with the various disclosure requirements relating to each of its classified activities. For instance, in respect of its manufacturing activities, such a company should comply with the requirements relating to a manufacturing company, whereas in respect of its trading or service activities, it should comply with the requirements relating to those categories of companies. However, in case of complexities in segregating the required information it would be sufficient compliance if the information is disclosed with respect to main activities with a suitable disclosure explaining the reasons therefore.