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## PART – III

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### 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.

### III-10 Accounting Pronouncements

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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

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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, trademarks 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

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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

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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 method<sup>1</sup> 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) 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).

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\* 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.

### 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<sup>1</sup>, requires the disclosure of “the amount of charge for Indian Income-tax 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<sup>1</sup> 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	<u>xxxxx</u>	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

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<sup>1</sup> Now Schedule III to the Companies Act, 2013.

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

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- 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) 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 Share based 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 group<sup>1</sup> 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

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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 herein below 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 forfeited), 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.

20. The 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

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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 share based 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 'Equity settled 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 here to before is based on the fair value method. There is another method known as the 'Intrinsic Value Method' for valuation of employee share based 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 non-listed 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 cash settled 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

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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

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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 × e<sup>-0.18</sup>) and ₹.152.20 (₹ 100 × 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:

$$\text{No. of options expected to vest} = 300 \times 1,000 \times 0.97 \times 0.97 \times 0.97 = 2,73,802 \text{ options}$$

$$\text{Fair value of options expected to vest} = 2,73,802 \text{ options} \times ₹ 15 = ₹ 41,07,030$$

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	= ₹ <u>13,69,010</u>
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)

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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

1. 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.

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#### 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
<b>Compensation expense to be recognized for the year (₹)</b>	<b>6,60,000</b>	<b>1,74,000</b>	<b>4,23,000</b>

#### 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

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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 x 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		<u>Nil</u>
Expense for the year		<u>₹ 13,96,390</u>

*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		<u>₹ (13,96,390)</u>
Expense for the year		<u>₹ 13,44,535</u>

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

*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



of SARs 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 ₹ 9.00 x 1/3	=	₹ 8,21,406
Less: provision at the beginning of the year		<u>Nil</u>
Expense for the year		<u>₹ 8,21,406</u>

*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 ₹ 12.00 x 2/3	=	₹ 19,93,400
Less: provision at the beginning of the year		₹ (8,21,406)
Expense for the year		<u>₹ 11,71,994</u>

*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 ₹ 16.00	=	₹ 21,12,000
Plus: Cash paid on exercise of SARs by employees 1,20,000 SARs x ₹ 16.00	=	₹ 19,20,000
<i>Total</i>		<u>₹ 40,32,000</u>
Less: provision at the beginning of the year		<u>₹ (19,93,400)</u>
Expense for the year		<u>₹ 20,38,600</u>

*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 ₹ 21.00	=	₹ 8,82,000
Plus: Cash paid on exercise of SARs 90,000 SARs x ₹ 21.00 =		₹ 18,90,000
<i>Total</i>		<u>₹ 27,72,000</u>
Less: provision at the beginning of the year		<u>₹ (21,12,000)</u>
Expense for the year		<u>₹ 6,60,000</u>

*Year 5*

No. of SARs outstanding at the beginning of the year		42,000 SARs
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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
Plus: Cash paid on exercise of SARs 42,000 SARs x ₹ 26.00 =	₹ 10,92,000
Total	₹ 10,92,000
Less: provision at the beginning of the year	<u>₹ (8,82,000)</u>
Expense for the year	<u>₹ 2,10,000</u>

### 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	<u>Nil</u>
Expense for the year	<u>₹ 17,333</u>

Year 2

Provision required at the year-end 1,000 x ₹ 55.00 x 2/3 =	₹ 36,667
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Less: provision at the beginning of the year	₹ 17,333
Expense for the year	<u>₹ 19,334</u>
Year 3	
Provision required at the year-end 1,000 x ₹ 60.00 =	₹ 60,000
Less: provision at the beginning of the year	<u>₹ 36,667</u>
Expense for the year	<u>₹ 23,333</u>

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

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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
	Total		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	6	4,23,408
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,

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consequently, the options granted to them are expected to be forfeited.

- (c) Actual forfeitures, during the vesting period, are equal to the expected forfeitures and 900 employees have actually completed one year vesting period.
- (d) All 900 employees exercised their right to obtain shares vested in them in pursuance of the ESOP at the end of year 2.
- (e) 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 herein below.

##### 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

<b>Liabilities</b>	<b>Amount (₹)</b>
<b>Share Capital</b>	
<i>Paid-up Capital:</i>	
10,00,000 equity shares of ₹ 10 each	1,00,00,000
<b>Stock Options Outstanding Account</b>	40,50,000

<b>Reserves and Surplus</b>	
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:

<b>Particulars</b>	<b>Computations</b>
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**

<b>Liabilities</b>	<b>Amount (₹)</b>
<b>Share Capital</b>	
<i>Paid-up Capital:</i>	
12,70,000 equity shares of ₹ 10 each fully paid	1,27,00,000
(Of the above, 2,70,000 shares of ₹ 10 each have been issued to the	

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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).	
<b>Reserves and Surplus</b>	
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 (₹)	
<b>Share Capital</b>		
<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**

Liabilities	Amount (₹)
Share Capital	
<i>Paid-up Capital:</i>	

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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
<b>Reserves and Surplus</b>	
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

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)

2. 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)

3. 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 (₹)
<b>Share Capital</b>	
<i>Paid-up Capital:</i>	

10,00,000 equity shares of ₹ 10 each	1,00,00,000
<b>Stock Options Outstanding Account</b>	40,50,000
<b>Reserves and Surplus</b>	
Securities Premium Account	1,50,00,000
<b>Assets</b>	<b>Amount (₹)</b>
Investments —	
Amount recoverable from ESOP Trust	1,40,40,000
Current Assets, Loans and Advances —	

4. 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

1. 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		

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<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:</i> Amount transferred from the Stock		
Options Outstanding Account	<u>35,10,000</u>	yy.yy.yyy

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.

- (b) 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.
- (c) 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
- (d) 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.
- (e) 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 [(900 employees × 300 options × ₹ 10)/2]	(₹ 13,50,000)	(₹ 13,50,000)
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) [1,000 employees [2,85,000 × 300 options – options – (50 employees (50 employees × 300 options)] × 300 options)]	2,85,000	2,70,000
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 1<sup>st</sup> 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

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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

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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 <sup>st</sup> Quarter	2 <sup>nd</sup> Quarter	3 <sup>rd</sup> Quarter	4 <sup>th</sup> Quarter	Annual
<b>Tax Expense</b>	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 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
<b>Tax Expense</b>	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 {(₹ 400 lakhs - ₹ 100 lakhs) x 40%}. Considering the loss carryforward, the estimated average annual effective income tax rate would be 30% {(₹ 120 lakhs/₹ 400 lakhs) x 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 <sup>st</sup> Quarter	2 <sup>nd</sup> Quarter	3 <sup>rd</sup> Quarter	4 <sup>th</sup> Quarter	Annual
<b>Tax Expense</b>	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 there against. 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					100

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which tax payable.					
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)_					$\frac{15}{175} \times 100 = 8.57\%$
Tax expense for the interim period					
Current tax	(4.29)	30	(4.29)	8.57	29.99
Deferred tax	<u>(2.14)</u>	<u>15</u>	<u>(2.14)</u>	<u>4.29</u>	<u>15.01</u>
Total	<u>(6.43)</u>	<u>45</u>	<u>(6.43)</u>	<u>12.86</u>	<u>45.00</u>

- (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 there against. This will result in reversal of the					(25)

deferred tax asset in the current year.					
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: (i) Deferred tax liability on account of timing difference in depreciation (50x30/100) 15 (ii) Reversal of deferred tax asset (25x30/100) 7.5					22.5
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					
Current tax	(4.29)	30.0	(4.29)	8.57	29.99
Deferred tax	<u>(3.21)</u>	<u>22.5</u>	<u>(3.21)</u>	<u>6.43</u>	<u>22.51</u>
Total	<u>(7.50)</u>	<u>52.5</u>	<u>(7.50)</u>	<u>15.00</u>	<u>52.50</u>

- (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

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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

(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 2<sup>nd</sup> 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 =	₹ 1,750	₹ 12,500
Quarter III:		₹ 25,000	35% of ₹ 25,000 =		₹ 8,750
Quarter IV:		₹ 25,000	35% of ₹ 25,000 =		₹ 8,750
Total tax expense for the year					₹ 30,000

### GN(A) 28 (Issued 2008)

#### Guidance Note on Applicability of AS 25 to Interim Financial Results<sup>1</sup>

(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.)

##### 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:**

.....

<sup>1</sup> 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.

***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.

## **GN(A) 29 (Issued 2008)**

### **Guidance Note on Turnover in Case of Contractors<sup>1</sup>**

*(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 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

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<sup>1</sup> 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.

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’.

## GN(A) 33 (Issued 2015)

### Guidance Note on Accounting for Derivative Contracts

#### Introduction

1. In the year 2007, the Institute of Chartered Accountants of India (ICAI), issued Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement* and Accounting Standard (AS) 31, *Financial Instruments: Presentation*. Both of these Accounting Standards were to come into effect in respect of accounting periods commencing on or after April 1, 2009 and were to be recommendatory in nature for an initial period of two years. These were to become mandatory in respect of accounting periods commencing on or after April 1, 2011. Further, it was clarified, that from the date of AS 30 becoming recommendatory in nature, the following Guidance Notes on Accounting, issued by the ICAI, stood withdrawn:

- (i) Guidance Note on Guarantees & Counter Guarantees given by the Companies
- (ii) Guidance Note on Accounting for Investments in the Financial Statements of Mutual Funds
- (iii) Guidance Note on Accounting for Securitisation
- (iv) Guidance Note on Accounting for Equity Index and Equity Stock Futures and Options.

2. In March 2008, the ICAI issued an announcement that in case of derivatives, if an entity does not follow AS 30, keeping in view the principle of prudence as enunciated in Accounting Standard (AS) 1, *Disclosure of Accounting Policies*, the entity is required to provide for losses in respect of all outstanding derivative contracts at the balance sheet date by marking them to market. This announcement was applicable to financial statements for the period ending March 31, 2008, or thereafter. In case of forward contracts to which Accounting Standard (AS) 11, *The Effects of Changes in Foreign Exchange Rates (revised 2003)* applies the entity needs to fully comply with the requirements of AS 11.

3. Subsequently, in the year 2008, Accounting Standard (AS) 32, *Financial Instruments: Disclosures*, was issued by the ICAI, which was also recommendatory initially and was to become mandatory in respect of accounting periods commencing on or after April 1, 2011.

4. Owing to global financial crisis which raised issues regarding accounting treatment of financial instruments, various accounting standards setting bodies including the ICAI examined these aspects. Later, the ICAI withdrew the recommendatory as well as mandatory status of AS 30, AS 31 and AS 32 in March 2011 by means of an announcement. The announcement clarified that considering that International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement*, issued by the International Accounting Standards Board (IASB), on which AS 30 is based, was under revision by the IASB. AS 30 was not expected to be continued in its present form, i.e., was expected to be revised. Further, the status of AS 30, AS 31 and AS 32 was clarified as below:

- (i) To the extent of accounting treatments covered by any of the existing notified Accounting Standards (e.g. AS 11, AS 13 etc.), the existing Accounting Standards would continue to prevail over AS 30, AS 31 and AS 32.
- (ii) In cases where a relevant regulatory authority has prescribed specific regulatory requirements (e.g. Loan impairment, investment classification or accounting for securitisations by the RBI, etc.), the prescribed regulatory requirements would continue to prevail over AS 30, AS 31, AS 32.

- (iii) The preparers of the financial statements are encouraged to follow the principles enunciated in the accounting treatments contained in AS 30, AS 31 and AS 32 subject to (i) and (ii) above.
5. Accordingly, currently, the relevant source of guidance for accounting of foreign currency forward exchange contracts is AS 11, which is notified under the Companies (Accounting Standards) Rules, 2006. AS 11 lays down accounting principles for foreign currency transactions and foreign exchange forward contracts and in substance similar contracts. However, it does not cover all types of foreign exchange forward contracts since contracts used to hedge highly probable forecast transactions and firm commitments are outside the scope of AS 11.
6. This Guidance Note will apply to all entities that do not apply Indian Accounting Standards (Ind AS).

### Objective

7. The objective of this Guidance Note is to provide guidance on recognition, measurement, presentation and disclosure for derivative contracts so as to bring uniformity in their accounting and presentation in the financial statements. This Guidance Note also provides accounting treatment for such derivatives where the hedged item is covered under notified Accounting Standards, e.g., a commodity, an investment, etc., because except AS 11, no other notified Accounting Standard prescribes any accounting treatment for derivative accounting. This Guidance Note, however, does not cover foreign exchange forward contracts which are within the scope of AS 11. This Guidance Note is an interim measure to provide recommendatory guidance on accounting for derivative contracts and hedging activities considering the lack of mandatory guidance in this regard with a view to bring about uniformity of practice in accounting for derivative contracts by various entities.

### Scope

8. This Guidance Note covers all derivative contracts that are not covered by an existing notified Accounting Standard. Hence, it does not apply to the following:
- (i) Foreign exchange forward contracts (or other financial instruments which in substance are forward contracts covered) by AS 11.
- (ii) Derivatives that are covered by regulations specific to a sector or specified set of entities.
9. Entities such as banking, non-banking finance companies ('NBFCs'), housing finance companies and insurance entities are required to follow the accounting treatment for derivative contracts, if any, prescribed by the concerned regulators such as the Reserve Bank of India (RBI) in case of banking entities and the NBFCs, National Housing Bank (NHB) in case of housing finance companies and Insurance Regulatory and Development Authority (IRDA) in case of insurance entities. In case the concerned regulator has not prescribed any accounting treatment for derivative contracts, the recommendations contained herein should be followed.
10. This Guidance Note also provides guidance on accounting of assets covered by Accounting Standard (AS) 2, *Valuation of Inventories*, Accounting Standard (AS) 10, *Accounting for Fixed Assets*, Accounting Standard (AS) 13, *Accounting for Investments*, etc., which are designated as hedged items, since such notified Accounting Standards are silent on hedge accounting using derivative instruments for items covered by these Standards. In contrast, AS 11 provides guidance specific to foreign currency forward contracts. Accordingly, guidance for accounting for derivatives and hedging relationships which pertain to hedged items covered under such notified Accounting Standards, e.g., commodities stock, fixed assets, investments etc., is provided in this Guidance Note. However, this Guidance Note does not provide guidance on accounting for items and transactions covered in AS 11, which is a notified

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Standard. Similarly, accounting for embedded derivative contracts is not part of the scope of this Guidance Note since there are potential conflicts with the requirements of certain other notified Accounting Standards such as AS 2, AS 13 etc. Further, this Guidance Note does not deal with macro-hedging and accounting for non-derivative financial assets/liabilities which are designated as hedging instruments since its objective is to provide guidance on accounting for derivative contracts only and not hedge accounting in its entirety.

11. This Guidance Note, thus, applies to following derivative contracts whether or not used as hedging instruments:

- (i) Foreign exchange forward contracts (or other financial instruments that are in substance forward contracts) that are hedges of highly probable forecast transactions and firm commitments (therefore outside the scope of AS 11);
- (ii) Other foreign currency derivative contracts such as cross currency interest rate swaps, foreign currency futures, options and swaps if not in the scope of AS 11;
- (iii) Other derivative contracts such as traded equity index futures, traded equity index options, traded stock futures and option contracts; and
- (iv) Commodity derivative contracts;

This list is meant to be illustrative only and is not exhaustive.

12. Examples of contracts covered within the scope of AS 11 and thus not covered within the scope of this Guidance Note include:

- Foreign currency forward or future contract entered into to hedge the payment of a monetary asset or a monetary liability recognised on balance sheet, e.g., a debtor, creditor, loan, borrowing etc.
- A currency swap contract (principal only; no interest rate element) that hedges the repayment of the principal of a foreign currency loan.

This list is meant to be illustrative only and is not exhaustive.

### Definitions

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

**Derivative:** A derivative is a financial instrument or other contract with all three of the following characteristics:

- its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the “underlying”);
- it requires no initial net investment or an initial investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
- it is settled at a future date.

**Firm Commitment:** A firm commitment is a binding agreement for the exchange of a specified quantity of resources at a specified future date or dates.

**Forecast transaction:** A forecast transaction is an uncommitted but anticipated future transaction.

**Hedging Instrument:** A hedging instrument is a designated derivative whose fair value or cash flows are expected to offset changes in the fair value or cash flows, of a designated hedged item. For the purposes of applying hedging in consolidated financial statements, the counterparty of a derivative instrument needs to be outside the consolidated group.

**Hedged Item:** A hedged item is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that (a) exposes the entity to risk of changes in fair value or future cash flows and (b) is designated as being hedged. A hedged item could also be a portfolio or group of identified assets, liabilities, firm commitments, highly probable forecast transactions or net investments in foreign operations.

**Hedge Effectiveness:** Hedge effectiveness is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.

**Hedge Ratio:** The ratio between the hedging instrument(s) and the hedged item(s) that is maintained during the course of a hedging relationship.

**The other terms which are used in the Guidance Note and are not defined above would be deemed to have the same definitions as those contained in the Framework for Preparation and Presentation of Financial Statements and Accounting Standards issued by the ICAI.**

### **Key Accounting Principles**

14. The accounting for derivatives covered by this Guidance Note is based on the following key principles:

- (i) All derivative contracts should be recognised on the balance sheet and measured at fair value.
- (ii) If any entity decides not to use hedge accounting as described in this Guidance Note, it should account for its derivatives at fair value with changes in fair value being recognised in the statement of profit and loss.
- (iii) If an entity decides to apply hedge accounting as described in this Guidance Note, it should be able to clearly identify its risk management objective, the risk that it is hedging, how it will measure the derivative instrument if its risk management objective is being met and document this adequately at the inception of the hedge relationship and on an ongoing basis.
- (iv) An entity may decide to use hedge accounting for certain derivative contracts and for derivatives not included as part of hedge accounting, it will apply the principles at (i) and (ii) above.
- (v) Adequate disclosures of accounting policies, risk management objectives and hedging activities should be made in its financial statements.

### **Synthetic Accounting not permitted**

15. This Guidance Note does not permit synthetic accounting, i.e., accounting of combining a derivative and the underlying together as a single package. For instance, if any entity has a foreign currency borrowing that it has hedged by entering into a cross currency interest rate swap, it would require the entity to recognise the loan liability separately from the cross currency interest rate swap and not treat them as a package (synthetic accounting) as INR loan. Alternatively, if any entity has borrowed in terms of INR which it swaps with foreign currency borrowing it would not treat such a loan as a foreign currency borrowing.

### **Recognition of derivatives on the balance sheet at fair value**

16. This Guidance Note requires that all derivatives are recognised on the balance sheet and measured at fair value since a derivative contract represents a contractual right or an obligation.

17. Fair value in the context of derivative contracts represents the 'exit price' i.e. the price that would be paid to transfer a liability or the price that would be received when transferring an asset to a knowledgeable, willing counterparty. The fair value would also incorporate the effect of credit risk associated with the fulfilment of future obligations. The extent and availability of collateral should be factored in while arriving at the fair value of a derivative contract.

### **Hedge Accounting**

#### ***Designation of a derivative contract as a hedging instrument***

18. An entity is permitted but not required to designate a derivative contract as a hedging instrument. Where it designates a derivative contract as a hedging instrument, it needs to, as a minimum:

- (i) identify its risk management objective;
- (ii) demonstrate how the derivative contract helps meet that risk management objective;
- (iii) specify how it plans to measure the fair value of the derivative instrument if the derivative contract is effective in meeting its risk management objective (including the relevant hedge ratio);
- (iv) document this assessment (of points (i), (ii), (v), (vi) and (vii) of this paragraph) at inception of the hedging relationship and subsequently at every reporting period;
- (v) demonstrate in cases of hedging a future cash flow that the cash flows are highly probable of occurring;
- (vi) conclude that the risk that is being hedged could impact the statement of profit and loss; and
- (vii) adequately disclose its accounting policies, risk management objectives and hedging activities (as required by this Guidance Note) in its financial statements.

19. In India, for a large number of derivative contracts that are undertaken in the Over the Counter (OTC) market, authorised dealers (generally banks) are required by the concerned regulator (e.g. the Reserve Bank of India (RBI)) to determine whether all or some of the above criteria are met before permitting an entity to enter into such a contract. The permissibility of a contract under RBI regulations, whilst persuasive, is not a sufficient condition to assert that it qualifies for hedge accounting under this Guidance Note. Certain derivative instruments that are traded on stock exchanges such as foreign exchange futures contracts or equity options / equity futures do not have such requirements and in those cases, in particular, it will be important to demonstrate compliance with the above criteria before hedge accounting can be applied.

20. In case a derivative contract is not classified as a hedging instrument because it does not meet the required criteria or an entity decides against such designation, it will be measured at fair value and changes in fair value will be recognised immediately in the statement of profit and loss.

21. It is clarified that derivatives cannot be designated for a partial term of the derivative instrument. A derivative may be used in a hedging relationship relating to a portion of a non-financial item as long as the hedged portion is clearly identifiable and capable of being measured reliably. Examples of such non-financial components include exchange (for instance London Metal Exchange) traded prices components of metal inventory and crude oil components of aviation turbine fuel.

**Need for hedge accounting**

22. Hedge accounting may be required due to accounting mismatches in:

- *Measurement* – some financial instruments (non-derivative) are not measured at fair value with changes being recognised in the statement of profit and loss whereas all derivatives, which commonly are used as hedging instruments, are measured at fair value.
- *Recognition* – unsettled or forecast transactions that may be hedged are not recognised on the balance sheet or are included in the statement of profit and loss only in a future accounting period, whereas all derivatives are recognised at inception.

23. An example of measurement mismatch is the hedge of interest rate risk on fixed rate debt instruments that are not held with the intention of trading. Another example of a measurement mismatch could be a derivative undertaken to hedge the price risk associated with recognised inventory.

24. Recognition mismatches include the hedge of a contracted or expected but not yet recognised sale, purchase or financing transaction in a foreign currency and future committed variable interest payments.

25. In order that the statement of profit and loss reflects the effect of the hedge properly, it is necessary to match the recognition of gains and losses on the hedging instrument and those on the hedged item. Matching can be achieved in principle by delaying the recording of certain gains and losses on the hedging instrument or by accelerating the recording of certain gains and losses on the hedged item in the statement of profit and loss. Both of these techniques are used while applying hedge accounting, depending on the nature of the hedging relationship.

**Types of hedge accounting**

26. This Guidance Note recognises the following three types of hedging;

- the fair value hedge accounting model is applied when hedging the risk of a fair value change of assets and liabilities already recognised in the balance sheet, or a firm commitment that is not yet recognised.
- the cash flow hedge accounting model is applied when hedging the risk of changes in highly probable future cash flows or a firm commitment in a foreign currency.
- the hedge of a net investment in a foreign operation.

***Fair value hedge accounting model***

27. A fair value hedge seeks to offset the risk of changes in the fair value of an existing asset or liability or an unrecognised firm commitment that may give rise to a gain or loss being recognised in the statement of profit and loss. A fair value hedge is a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect the statement of profit and loss.

28. When applying fair value hedge accounting, the hedging instrument is measured at fair value with changes in fair value recognised in the statement of profit and loss. The hedged item is remeasured to fair value in respect of the hedged risk even if normally it is measured at cost, e.g., a fixed rate borrowing. Any resulting adjustment to the carrying amount of the hedged item related to the hedged risk is recognised in the statement of profit and loss even if normally such a change may not be recognised, e.g., for inventory being hedged for fair value changes.

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29. The fair value changes of the hedged item and the hedging instrument will offset and result in no net impact in the statement of profit and loss except for the impact of ineffectiveness.

30. An example of a fair value hedge is the hedge of a fixed rate bond with an interest rate swap, changing the interest rate from fixed to floating. Another example is the hedge of the changes in value of inventory using commodity futures contracts.

31. The adjusted carrying amounts of the hedged assets in a fair value hedging relationship are subject to impairment testing under other applicable Accounting Standards such as Accounting Standard (AS) 28, *Impairment of Assets*, Accounting Standard (AS) 2, *Valuation of Inventories*, Accounting Standard (AS) 13, *Accounting for Investments* etc.

#### *Cash flow hedge accounting model*

32. A cash flow hedge seeks to offset certain risks of the variability of cash flows in respect of an existing asset or liability or a highly probable forecast transaction that may be reflected in the statement of profit and loss in a future period.

33. A cash flow hedge is a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction or a firm commitment in respect of foreign currency and (ii) could affect the statement of profit and loss. An example of a cash flow hedge is the hedge of future highly probable sales in a foreign currency using a forward exchange contract. Another example of a cash flow hedge is the use of a swap to change the future floating interest payments on a recognised liability to fixed rate payments.

34. Under a cash flow hedge, the hedging instrument is measured at fair value, but any gain or loss that is determined to be an effective hedge is recognised in equity, e.g., cash flow hedge reserve. This is intended to avoid volatility in the statement of profit and loss in a period when the gains and losses on the hedged item are not recognised therein.

35. In order to match the gains and losses of the hedged item and the hedging instrument in the statement of profit and loss, the changes in fair value of the hedging instrument recognised in equity must be recycled from equity and recognised in the statement of profit and loss at the same time that the impact from the hedged item is recognised (recycled) in the statement of profit and loss. The manner in which this is done depends on the nature of the hedged item:

- if the hedged forecast transaction results in a financial asset or a financial liability being recognised, the gains or losses are recycled from equity as and when the asset acquired or liability incurred affects the statement of profit and loss, e.g., when interest income or expense is recognised.
- if the hedged forecast transaction results in a non-financial asset or non-financial liability being recognised, either of the following two approaches may be applied:
- the gains or losses are recycled from equity as and when the impact of asset acquired or liability incurred affects or is recognised in the statement of profit and loss, e.g., as depreciation or cost of sales is recognised.
- the gains or losses are recycled from equity and included as a separate adjustment that is clubbed for financial statement presentation purposes with carrying amount of the asset acquired or liability incurred (referred to as the “basis adjustment”).
- in all other cases the gains or losses are recycled from equity as and when the hedged forecast transaction affects statement of profit and loss.

Note that in the first two bullets above, any gain or loss (or portions thereof) that is not expected to be recovered in future periods are recycled from equity as soon as an entity becomes aware of the fact that those amounts are not expected to be recovered.

36. An example of a forecast transaction that results in the recognition of a financial liability is a forecast issuance of a bond, which is hedged for interest rate risk using a forward-starting interest rate swap. The fair value gains or losses on the swap would be deferred in equity until the bond is issued and the swap starts, after which date they would remain in equity until amortised into the statement of profit and loss over the life of the bond.

37. The choice of the basis adjustment approach is only relevant for hedges of forecast purchases of non-financial assets such as inventory or property, plant and equipment. This approach is permitted but not required and must be applied consistently as an accounting policy choice to all cash flow hedges that result in the acquisition of a non-financial asset or non-financial liability. Any basis adjustment or accumulated balance in the hedging reserve will require to be tested at least at every reporting date for impairment. For the purposes of this impairment assessment, the basis adjustment / relevant portion of the hedging reserve may be combined with the carrying amount of the hedged item and compared to its current realisable value.

#### *Net investment hedging*

38. An investor in a non-integral operation is exposed to changes in the carrying amount of the net assets of the foreign operation (the net investment) arising from the translation of those assets into the reporting currency of the investor.

39. Principles relating to the hedge of a net investment in a foreign operation are:

- foreign exchange gains and losses on a net investment in a non-integral foreign operation are recognised directly in equity. This occurs through the translation of the non-integral foreign operation's net assets for purposes of consolidation;
- gains and losses on foreign currency derivatives used as hedging instruments are recognised directly in equity to the extent that the hedge is considered to be effective;
- the ineffective portion of the gains and losses on the hedging instruments (and any proportion not designated in the hedging relationship) is recognised in the statement of profit and loss immediately;
- any net deferred foreign currency gains and losses, i.e., arising from both the net investment and the hedging instruments are recognised in the statement of profit and loss at the time of disposal of the foreign operation.

40. This Guidance Note does not override the principles of AS 11. However, it introduces the hedge accounting criteria for hedging of net investments.

41. When the net investment is disposed off, the cumulative amount in the foreign currency translation reserve in equity is transferred to the statement of profit and loss as an adjustment to the profit or loss on disposal of the investment. Therefore, it is necessary for an entity to keep track of the amount recognised directly in equity separately in respect of each foreign operation, in order to identify the amounts to be transferred to the statement of profit and loss on disposal.

#### **Formal documentation at inception**

42. At inception of a hedge, formal documentation of the hedge relationship must be established. The hedge documentation prepared at inception of the hedge must include a description of the following:

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- the entity's risk management objective and strategy for undertaking the hedge;
- the nature of the risk being hedged;
- clear identification of the hedged item (asset, liability or cash flows) and the hedging instrument;
- demonstrate how the derivative contract helps meet that risk management objective;
- identify how it plans to measure the derivative if the derivative contract is effective in meeting its risk management objective;
- demonstrate in cases of hedging a future cash flow that the cash flows are highly probable of occurring; and
- conclude that the risk that is being hedged could impact the statement of profit and loss.

43. This Guidance Note does not mandate a specific format for the documentation and in practice hedge documentation may vary in terms of lay-out, technology used etc. Various formats may be acceptable as long as the documentation includes the contents identified above.

44. A hedging relationship is effective if it meets all of the following requirements:

- (i) There is an economic relationship between the hedged item and the hedging instrument.
- (ii) The effect of credit risk does not dominate the value changes that result from that economic relationship.
- (iii) The hedging relationship is expected to be highly effective in achieving the stated risk management objective and the entity is in a position to reliably measure the achievement of this objective both at inception and on an ongoing basis during the tenure of the hedging relationship.

#### *Hedge effectiveness testing and measurement of ineffectiveness*

45. There is normally a single fair value measure for a hedging instrument in its entirety, and the factors that cause changes in fair value are co-dependent. Thus, a hedging relationship is designated by an entity for a hedging instrument in its entirety. The only exceptions permitted are:

- (a) separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the change in intrinsic value of an option and excluding change in its time value; and
- (b) separating the interest element and the spot price of a forward contract.

46. An entity may consider the costs associated with a hedging instrument e.g. forward premium or time value of an option contract as a period cost (for example akin to interest costs when hedging an interest bearing asset or liability) or at a point in time (for example when hedging a forecasted sale or purchase) depending on the manner of designation and how the hedged item impacts the statement of profit and loss.

47. This Guidance Note does not prescribe one single method for how hedge effectiveness testing and ineffectiveness measurement should be conducted. The appropriate method for each entity will depend on the facts and circumstances relevant to each hedging programme and be driven by the risk management objective of the entity. Entities may apply commonly used measures such as critical terms match, dollar offset or regression methods as appropriate to assess hedge effectiveness.

48. Hedge effectiveness is the extent to which changes in the fair value or the cash flows of the hedging instrument offset changes in the fair value or the cash flows of the hedged item (for example, when the hedged item is a risk component, the relevant change in fair value or cash flows of an item is

the one that is attributable to the hedged risk). Hedge ineffectiveness is the extent to which the changes in the fair value or the cash flows of the hedging instrument are greater or less than those on the hedged item. This Guidance Note does not prescribe bright line tests for effectiveness assessments but instead requires disclosure of the entity's risk management objectives and measures for assessing if these objectives are met.

49 When designating a hedging relationship, and on an ongoing basis, an entity will analyse the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term. This analysis will serve as the basis for the entity's assessment of meeting the hedge effectiveness requirements.

50. A hedging relationship will meet the hedge effectiveness requirements if:

- (i) there is an economic relationship between the hedged item and the hedging instrument.
- (ii) the effect of credit risk does not dominate the value changes that result from the economic relationship.
- (iii) the hedge ratio of the hedging relationship is the same as that resulting from the quantities of:
  - the hedged item that the entity actually hedges; and
  - the hedging instrument that the entity actually uses to hedge that quantity of hedged item; and
- (iv) the hedged item and the hedging instrument are not intentionally weighted to create hedge ineffectiveness - whether or not it is recognised - to achieve an accounting outcome that would be inconsistent with the purpose of hedge accounting.

51. An entity will assess at the inception of the hedging relationship, and on an ongoing basis, whether a hedging relationship meets the hedge effectiveness requirements. At a minimum, an entity should perform the ongoing assessment at each reporting date or upon a significant change in the circumstances affecting the hedge effectiveness requirements, whichever comes first. The assessment relates to expectations about hedge effectiveness and is therefore only forward-looking.

52. If the critical terms of the hedging instrument and the hedged item - e.g. the nominal amount, maturity and underlying - match or are closely aligned, then it may be possible to use a qualitative methodology to determine that an economic relationship exists between the hedged item and the hedging instrument.

53. If a hedging relationship ceases to meet the hedge effectiveness requirement relating to the hedge ratio but the risk management objective for that designated hedging relationship remains the same, an entity should adjust the hedge ratio of the hedging relationship so that it meets the qualifying criteria again.

54. This Guidance Note does not also prescribe a single method of how ineffectiveness measurement should be conducted other than to require an entity to consider how ineffectiveness could affect a hedging relationship and require immediate recognition of such ineffectiveness.

55. Hedge ineffectiveness is measured based on the actual performance of the hedging instrument and the hedged item, by comparing the changes in their values in currency unit amounts.

56. When measuring hedge ineffectiveness, an entity is required to consider the time value of money. Consequently, the entity determines the value of the hedged item on a present value basis and therefore the change in the value of the hedged item also includes the effect of the time value of money.

57. In certain situations, ineffectiveness is required to be recognised. These include

- in a cash flow hedge, when the forecasted hedged transaction is no longer probable of occurring;
- in a fair value hedge, when the hedging instrument is no longer considered to be an effective hedge of the hedging instrument; and
- in any hedge relationship, if the risk management objective is changed or no longer expected to be met.

The recognition of ineffectiveness does not necessarily require hedge accounting to be discontinued if the risk management objective and criteria set out by the entity for the specific hedge relationship continues to be met.

*Termination of hedge accounting / reclassification of hedge reserves*

58. An entity is not permitted to stop applying hedge accounting voluntarily unless the risk management objective of the entity, as was originally defined by the entity when first applying hedge accounting, is no longer met.

59. If an entity terminates a hedging instrument prior to its maturity / contractual term, hedge accounting is discontinued prospectively. Any amount previously recognised in the hedge reserve (in the case of cash flow or net investment hedges) is reclassified into the statement of profit and loss only in the period when the hedged item impacts earnings, e.g., when a forecasted purchase / sale actually impacts earnings or when a net investment is disposed off in the case of a net investment hedge.

60. In case of hedges of highly probable forecast transactions or commitments, if the forecasted transaction is no longer highly probable of occurring, (but still probable of occurring) then hedge accounting is discontinued prospectively but the amount recognised previously in the hedge reserve is reclassified into the statement of profit and loss only in the period when the hedged item impacts earnings (as specified in paragraph 35 of this Guidance Note). 'Probable' for the purpose of this assessment is based on whether the forecasted transaction is 'more likely than not' (or greater than 50% probability) of occurring.

61. In case of hedges of forecast transactions, if the forecasted transaction is no longer probable of occurring, then hedge accounting is discontinued and all amounts recognised in the hedge reserve are recognised immediately in the statement of profit and loss. 'Probable' for the purpose of this assessment is based on whether the forecasted transaction is 'more likely than not' (or greater than 50% probability) of occurring. Judgment may need to be exercised in situations where a forecasted transaction is delayed to determine if the delayed transaction is the one that was subject to the original hedging designation or not. This Guidance Note does not provide a bright line test in this context but recognises that judgment is required and an entity should disclose the manner in which such determinations are made in its financial statements.

**Presentation in the financial statements**

62. Derivative assets and liabilities recognised on the balance sheet at fair value should be presented as current and non-current based on the following considerations:

- Derivatives that are intended for trading or speculative purposes should be reflected as current assets and liabilities.
- Derivatives that are hedges of recognised assets or liabilities should be classified as current or non-current based on the classification of the hedged item.

- Derivatives that are hedges of forecasted transactions and firm commitments should be classified as current or non-current based on the settlement date / maturity dates of the derivative contracts.
  - Derivatives that have periodic or multiple settlements such as interest rate swaps should not be bifurcated into current and non-current elements. Their classification should be based on when a predominant portion of their cash flows are due for settlement as per their contractual terms.
63. This Guidance Note does not permit any netting off of assets and liabilities except where basis adjustment is applied under cash flow hedges and hence all the amounts presented in the financial statements should be gross amounts. Amounts recognised in the statement of profit and loss for derivatives not designated as hedges may be presented on a net basis.

### Disclosures in financial statements

64. An entity should satisfy the broader disclosure requirements by describing its overall financial risk management objectives, including its approach towards managing financial risks. Disclosures should explain what the financial risks are, how the entity manages the risk and why the entity enters into various derivative contracts to hedge the risks.

65. An entity should disclose the methodology used to arrive at the fair value of derivative contracts (whether used for hedging or not) and the extent of fair value gains/losses recognized in the statement of profit and loss and in equity.

66. The entity should disclose its risk management policies. This would include the hedging strategies used to mitigate financial risks. This may include a discussion of:

- how specific financial risks are identified, monitored and measured;
- what specific types of hedging instruments are entered into and how these instruments modify or eliminate risk; and
- details of the extent of transactions that are hedged.

67. An entity is also required to make specific disclosures about its outstanding hedge accounting relationships. The following disclosures are made separately for fair value hedges, cash flow hedges and hedges of net investments in foreign operations:

- a description of the hedge;
- a description of the financial instruments designated as hedging instruments for the hedge and their fair values at the balance sheet date;
- the nature of the risks being hedged;
- for hedges of forecast transactions, the periods in which the transactions are expected to occur, when they are expected to affect the statement of profit and loss, and a description of any forecast transactions that were originally hedged but now are no longer expected to occur. This Guidance Note does not specify the future time bands for which the disclosures should be made. Entities should decide on appropriate groupings based on the characteristics of the forecast transactions;
- if a gain or loss on derivative or non-derivative financial assets and liabilities designated as hedging instruments in cash flow hedges has been directly recognised in the hedging reserve: -
  - the amount recognised in hedge reserve during the period.
  - the amount recycled from the hedge reserve and reported in statement of profit and loss.

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- the amount recycled from hedge reserve and added to the initial measurement of the acquisition cost or other carrying amount of a non-financial asset or non-financial liability in a hedged forecast transaction.
  - a breakup of the balance in the hedge reserve between realised and unrealised components and a reconciliation of the opening balance to the closing balance for each reporting period.
68. Insofar as disclosure of derivatives designated for hedging foreign currency risks are concerned, the same should be disclosed in the Format attached as Appendix I to the Guidance Note, which also requires disclosure of all foreign exchange assets and liabilities including contingent liabilities, both hedged and unhedged.
69. The Appendix II to this Guidance Note contains examples illustrating the principles contained in this Guidance Note.

#### Transitional provisions

70. This Guidance Note applies to all derivative contracts covered by it and are outstanding on the date this Guidance Note becomes effective. Any cumulative impact (net of taxes) should be recognised in reserves as a transition adjustment and disclosed separately. An entity is not permitted to follow hedge accounting as recommended in this Guidance Note retrospectively.

#### Effective Date

71. This Guidance Note becomes applicable for accounting periods beginning on or after 1<sup>st</sup> April, 2016; its earlier application, is encouraged. From the date this Guidance Note comes into effect the following Announcements issued by the Council of the ICAI stand withdrawn:

- (i) Applicability of Accounting Standard (AS) 11 (revised 2003), *The Effects of Changes in Foreign Exchange Rates*, in respect of exchange differences arising on a forward exchange contract entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction issued on the basis of the decision of the Council at its meeting held on June 24-26, 2004.
- (ii) Disclosures regarding Derivative Instruments published in 'The Chartered Accountant', December 2005 (pp 927).
- (iii) Accounting for Derivatives published in 'The Chartered Accountant', May 2008 (pp.1945).
- (iv) Application of AS 30, *Financial Instruments: Recognition and Measurement* published in 'The Chartered Accountant', April 2011 (pp. 1575) to the extent of the guidance covered for accounting for derivatives within the scope of this Guidance Note.

#### Appendix I

#### Format for Disclosure of Foreign Currency Exposures

##### Exposures in Foreign Currency:

I. Assets	Foreign Currency	Current Year			Previous Year		
		Exchange Rate	Amount in Foreign currency	Amount in ₹	Exchange Rate	Amount in Foreign currency	Amount in ₹
Receivables (trade & other)							

Other Monetary assets (e.g. ICDs/Loans given in FC)							
<b>Total Receivables (A)</b>							
<b>Hedges by derivative contracts (B)</b>							
<b>Unhedged receivables (C=A-B)</b>							
<b>II. Liabilities</b>	<b>Foreign Currency</b>	<b>Current Year</b>			<b>Previous Year</b>		
		<b>Exchange Rate</b>	<b>Amount in Foreign currency</b>	<b>Amount in ₹</b>	<b>Exchange Rate</b>	<b>Amount in Foreign currency</b>	<b>Amount in ₹</b>
Payables (trade & other)							
Borrowings (ECB and Others)							
<b>Total Payables (D)</b>							
<b>Hedges by derivative contracts (E)</b>							
<b>Unhedged Payables (F=D-E)</b>							
<b>III. Contingent Liabilities and Commitments</b>	<b>Foreign Currency</b>	<b>Current Year</b>			<b>Previous Year</b>		
		<b>Exchange Rate</b>	<b>Amount in Foreign currency</b>	<b>Amount in ₹</b>	<b>Exchange Rate</b>	<b>Amount in Foreign currency</b>	<b>Amount in ₹</b>
Contingent Liabilities							
Commitments							
<b>Total (G)</b>							
<b>Hedges by derivative contracts (H)</b>							
<b>Unhedged Payables (I=G-H)</b>							
<b>Total unhedged FC Exposures (J=C+F+I)</b>							

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### Explanatory notes:

- Note 1:** Exposures in Assets and Liabilities to be presented currency wise.
- Note 2:** Exposure in any foreign currency(s) which are not material may be aggregated. However, any currency in which exposure is more than 10% of the total exposure should be reported separately; at least 75% of total exposure should be reported currency wise.
- Note 3:** Additional disclosures of any foreign currency exposure in an asset not hedged by an entity on the ground that the same is covered by a corresponding foreign currency exposure in a liability and vice versa, to the extent having same maturity date and the amount (known as 'natural hedge') may be made in the notes.

## Appendix II

### Illustrative examples of application of Guidance Note

#### 1. Application of cash flow hedge

ABC Ltd. is an exporter of goods. In the month of July 2013, it receives the order for supply of goods to US customers in the month of January 2014 and as per the payment cycle with the customers, it expects to realise USD 100,000 in April 2014.

ABC Ltd has decided to fully hedge the sales from foreign currency risk. Immediately after getting the order, to hedge the firm commitment in foreign currency it enters into a derivative transaction with XYZ Bank, for future sale of USD 100,000 in the month of April 2014 @ ₹ 65 per USD (Spot Rate was ₹ 64.50 per USD).

For this purpose, it is assumed that the company has entered into a cash flow hedge, which is generally the case for hedging foreign currency risk.

Further, it is assumed that:

- At the time of booking of sale in January 2014, the USD rate was ₹ 61, and forward rate for delivery on April 30, 2014 was ₹ 61.20.
- On the reporting date on March 31, 2014, the USD rate was ₹ 60.50, and forward rate for delivery on April 30, 2014 was ₹ 60.60.
- At the time of realisation USD rate was ₹ 60/- on April 30, 2014.

The above transaction should be accounted in the following manner (impact of discounting of MTM of the hedging instrument has been ignored in this simplified illustration).

	ABC Limited entered to sell a forward exchange contract for USD 100,000 having ten months maturity on April 30, 2014		
	Forward Exchange Rate	65.00	
	Spot Rate as at July 01, 2013	64.50	
	No entry in the books		
Upto January 31, 2014	ABC Limited accounts the MTM effect in the books		
	Forward Contract Rate Entered	65.00	
	Forward Contract Available in the market with similar maturity	61.20	
	Forward Contract Receivable	3,80,000	
	To Cash Flow Hedge Reserve		3,80,000

January 31, 2014	ABC Limited recognises the revenue by booking an invoice for USD 100,000, having credited period of 90 days (i.e. due date – April 30, 2014) Spot rate as at January 31, 2014 Forward Contract Available in the Market with similar maturity	61.00 61.20	
	<b>Recognition of Revenue</b> Accounts Receivable To Revenue	61,00,000	61,00,000
	<b>Recognition of Hedging gain</b> Cash Flow hedge reserve To Statement of Profit & Loss	3,80,000	3,80,000
March 31, 2014	Spot Rate Forward Contract Available in the Market with similar maturity	60.50 60.60	
	<b>Restatement of Accounts Receivable</b> Forex Gain/Loss (P&L) To Accounts Receivable	50,000	50,000
	<b>MTM Effect of Forward Cover</b> Forward Contract Receivable To Forex Gain/Loss (P&L)	60,000	60,000
April 30, 2014	Spot rate <b>Realisation of Accounts Receivable</b> Bank Forex Gain/Loss (P&L) To Accounts Receivable	60.00 60,00,000 50,000	60,50,000
	<b>Maturity of Forward Contract</b> Bank To Forward Contract Receivable To Forex Gain/Loss (P&L)	5,00,000	4,40,000 60,000

## 2. Cash flow hedge of the repayment of a loan

Company X is an Indian company with annual reporting period ending on March 31 each year. On January 1, 2014, Company X borrows from a bank USD 1 million six month debt carrying a floating interest rate of three month LIBOR plus 50 basis points. As per the Company's risk management policies, it enters into a Cross Currency Interest Rate Swap (CCIRS) with a bank to swap the above floating interest bearing USD debt into a fixed interest bearing INR debt.

Since the CCIRS does not fall within the scope of AS 11 and has been entered into to hedge the exposure of currency and interest rate risk arising from the debt instrument, it would be within the scope of this Guidance Note.

According to this Guidance Note, Company X will record the following on March 31, 2014:

- (i) Translate the USD loan at closing rate and record the foreign exchange gain/ loss in the statement of profit and loss.
- (ii) Record a derivative asset/ liability based on the fair value (Mark To Market 'MTM' value) of the CCIRS with a corresponding credit/debit in Cash Flow Hedging Reserve.

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- (iii) Record the net interest expense in statement of profit and loss, i.e., the USD floating interest expense adjusted for the settlement of the interest rate swap for the period.
- (iv) Reclassify from the Cash Flow Hedging Reserve to statement of profit and loss the amount by which the hedged item, i.e., the debt has impacted the statement of profit and loss. (In this case, the amount of translation foreign exchange gain/ loss that has been recorded for the loan).

As at March 31, 2014, the Balance Sheet of Company X will carry the following items:

- Loan – Translated at the closing USD – INR conversion rate.
- Derivative asset/ liability – MTM of the CCIRS.
- Cash Flow Hedging Reserve - MTM of the CCIRS less amount reclassified to the statement of profit and loss.

#### **3a. Commodity contract – cash flow hedge of a forecasted sale with an exchange traded future**

Company Z is a producer and wholesaler of copper with annual reporting period ending on March 31 each year. On January 1, 2014, Company Z forecasts sales of 100 tonnes of copper expected to occur in September 2014. It is highly probable that the sales will occur based on historical and expected sales. In order to hedge its exposure on the variability of copper prices, Company Z enters into a 'sell' futures contract on the Commodity Exchange to sell 100 tonnes of copper (same grade) with maturity of September 30, 2014. As per its risk management policies, Company Z designates this futures contract as a cash flow hedge of highly probable forecasted sales of 100 tonnes of copper inventory in September 2014.

Since the commodity future does not fall within the scope of AS 11 and has been entered into to hedge the exposure of variability in cash flows arising from price risk, this would fall within the scope of this Guidance Note.

According to this Guidance Note, Company Z will record the following on March 31, 2014

Record a derivative asset/ liability based on the fair value (MTM) of the commodity future contract with a corresponding credit/ debit to Cash Flow Hedging Reserve.

As at March 31, 2014, the Balance Sheet of Company Z will carry the following items:

- Derivative asset/ liability – MTM of the commodity future contract.
- Cash Flow Hedging Reserve - MTM of the commodity future contract.

Assuming that the sales in future occur as expected, the MTM carried in the Cash Flow Hedging Reserve will be reclassified to the statement of profit and loss when the sales are booked in the statement of profit and loss. In this case, this will happen in September 2014, along with the maturity of the commodity futures contract. Such reclassification can be made in the sales line item in the statement of profit and loss, which potentially records the sales at the hedged price.

#### **3b. Commodity contract – fair value hedge of forecasted sales with an exchange traded future**

Continuing the above example, consider that Company Z designates the commodity futures contract as a fair value hedge of a portion of its inventory, i.e., 100 tonnes of copper. The Company documents it as a hedge of the exposure to changes in fair value of the inventory due to commodity price risk. As at March 31, 2014, the price of copper increases thereby resulting in an increase in the fair value of inventory and MTM loss on the derivative.

Since the commodity future does not fall within the scope of AS 11 and has been entered into to hedge the exposure of variability in fair values due to price risk, it would fall within the scope of this Guidance Note.

According to this Guidance Note, Company Z will record the following on March 31, 2014:

- (i) Record a derivative liability based on the fair value (MTM) of the commodity future contract with a corresponding debit to the statement of profit and loss.
- (ii) Record an increase in inventories for the change in fair value as a hedge accounting adjustment through statement of profit and loss. Accounting Standard (AS) 2, *Valuation of Inventories*, requires inventories to be carried at the lower of cost and net realisable value. Hence, this will be recorded as a separate hedge accounting adjustment distinguished from the valuation of inventories under AS 2.

As at March 31, 2014, the Balance Sheet of Company Z will carry the following items:

- Derivative asset/liability – MTM of the commodity future contract.
- Inventory – valued as per AS 2 at cost.
- Inventory hedge accounting adjustment – basis adjustment to record change in fair value.

When sales of the hedged inventory occur in the future, the hedging related fair value adjustment to inventory will be released to the statement of profit and loss and can be classified as part of 'cost of goods sold'.

#### **4. Hedging a portion of a non-financial item – Commodity future**

Company X is a producer and wholesaler of steel with annual reporting period ending on March 31 each year. On January 1, 2014, Company X forecasts sales of 200 tonnes of steel expected to occur in September 2014. It is highly probable that the sales will occur based on historical and expected sales. In order to hedge its exposure on the variability of expected cash flows from forecasted sales of steel, as per its risk management policies, Company X enters into a 'sell' futures contract on the commodity exchange for 200 tonnes of iron ore which is one of the significant components of the steel making process and significantly impacts the price of steel.

Since the commodity future does not fall within the scope of AS 11 and has been entered into to hedge the exposure of variability in cash flows arising from price risk, this would fall under the scope of this Guidance Note. This will not result into a perfect hedge since the hedged commodity, i.e., steel and the hedging instrument used, i.e., iron ore futures, are not perfectly correlated. The Guidance Note permits such designation if it is as per the company's risk management policies and strategy.

According to this Guidance Note, Company X will record the following on March 31, 2014:

Record a derivative asset/ liability based on the fair value (MTM) of the iron ore future contract with a corresponding credit/ debit to Cash Flow Hedging Reserve.

As at March 31, 2014, the Balance Sheet of Company X will carry the following items:

- Derivative asset/liability – MTM of the iron ore future contract.
- Cash Flow Hedging Reserve - MTM of the iron ore future contract.

Assuming that the sales in future occur as expected, the MTM carried in the Cash Flow Hedging Reserve will be reclassified to the statement of profit and loss when the sales are booked in the statement of profit and loss. In this case, this will happen in September 2014 along with the maturity of the commodity futures contract. Such reclassification can be made in the sales line item in the statement of profit and loss.

### 5. Exchange traded contract – Fair value hedge of investment portfolio

Company Z holds a closed portfolio of equity shares classified as long term investments under AS 13. As per its risk management policies, Company Z hedges its exposure to variability of expected fair value of the investments by entering into equity futures contract on a recognised stock exchange.

Since this derivative is outside the scope of AS 11 and is entered into to hedge a specific exposure, this would fall within the scope of this Guidance Note.

Under this Guidance Note, Company Z will record the following on March 31, 2014:

- (i) Record a derivative liability/derivative asset based on the fair value (MTM) of the equity futures contract with a corresponding debit to the statement of profit and loss.
- (ii) Record an increase/decrease in long term investments for the change in fair value as a hedge accounting adjustment through statement of profit and loss. Accounting Standard (AS) 13, *Valuation of Investments*, requires long term investments to be carried at cost. Hence this will be recorded as a separate hedge accounting adjustment distinguished from the valuation of investments under AS 13.

As at March 31, 2014, the Balance Sheet of Company Z will carry the following items:

- Derivative asset/ liability – MTM of the equity futures contract.
- Long term investments – valued as per AS 13 at cost.
- Investment hedge accounting adjustment – adjustment to record change in fair value.

### 6. Cash flow hedge accounting – forecasted sale with a forward contract

Company X is an Indian Company with annual reporting period ending on March 31 each year. On January 1, 2014, Company X forecasts sales of USD 1 million on September 30, 2014. It is highly probable that the sales will occur based on historical and expected sales. As per its risk management policies, in order to hedge the variability in cash flows arising from future sales in foreign currency, on January 1, 2014, Company X enters into a sell USD – buy INR forward contract which matures on September 30, 2014.

Since the forward contract is taken to hedge highly probable forecasted sales transaction, it does not fall within the scope of AS 11 and hence is within the scope of this Guidance Note.

According to this Guidance Note, Company X will record the following on March 31, 2014:

Record a derivative asset/liability based on the fair value (MTM) of the foreign currency forward contract with a corresponding credit/debit to Cash Flow Hedging Reserve.

As at March 31, 2014, the Balance Sheet of Company X will carry the following items:

- Derivative asset/liability – MTM of the foreign currency forward contract.
- Cash Flow Hedging Reserve – MTM of the foreign currency forward contract.

Assuming that the sales in future occur as expected, the MTM carried in the Cash Flow Hedging Reserve will be reclassified to the statement of profit and loss when the sales are booked in the statement of profit and loss. In this case, this will happen in September 30, 2014 along with the maturity of the foreign currency forward contract. Such reclassification can be made in the sales line item in the statement of profit and loss, which records the sales at the hedged rate.

## 7. Cash flow hedge accounting - forecasted sale with an option contract

Company X is an Indian Company with annual reporting period ending on March 31 each year. On January 1, 2014, Company X forecasts sales of USD 1 million on September 30, 2014. It is highly probable that the sales will occur based on historical and expected sales. As per its risk management policies, in order to hedge the variability in cash flows arising from future sales in foreign currency, on January 1, 2014 Company X enters into a sell USD – buy INR option contract which matures on September 30, 2014. The Company pays a premium to purchase this option which has a strike rate equal the then available forward exchange rate at the date when the option was purchased (often referred to as an 'At the Money' strike price option). As a result, the entire amount of the premium paid for the option is attributable to time value of the option. The Company assesses the time value of the option to be the 'cost of hedging'.

Since the option contract is taken to hedge highly probable forecasted sales transactions, it does not fall within the scope of AS 11 and hence is within the scope of this Guidance Note.

According to this Guidance Note, Company X will record the following:

On January 1, 2014 - Record an option asset on payment of option premium.

On March 31, 2014 - Record changes in fair value of the option asset based on the MTM of the foreign currency option contract with a corresponding credit/ debit to Cash Flow Hedging Reserve. This amount includes both the time value and the intrinsic value, if any, of the option contract on that date.

As at March 31, 2014, the Balance Sheet of Company X will carry the following items:

- Derivative asset/liability – MTM of the foreign currency option contract.
- Cash Flow Hedging Reserve - MTM of the foreign currency option contract.

Assuming that the sales in future occur as expected, the MTM carried in the Cash Flow Hedging Reserve will be reclassified to the statement of profit and loss when the sales are booked in the statement of profit and loss. In this case, this will happen on September 30, 2014, along with the maturity of the foreign currency option contract. Such reclassification can be made in the sales line item in the statement of profit and loss, which records the sales at the hedged rate.

## 8. Cash flow hedge accounting – hedging the repayment of foreign currency debt with an option contract

Company X is an Indian Company with annual reporting period ending on March 31 each year. On January 1, 2014, Company X has USD 1 million of foreign currency debt that it needs to repay on September 30, 2014. As per its risk management policies, in order to hedge the variability in cash flows arising from the repayment of this debt in foreign currency, on January 1, 2014 Company X enters into a buy USD – sell INR option contract which matures on September 30, 2014. The Company pays a premium to purchase this option which has a strike rate equal the then available forward exchange rate at the date when the option was purchased (often referred to as an 'At the Money' strike price option). As a result the entire amount of the premium paid for the option is attributable to time value of the option. The Company assesses the time value of the option to be the 'cost of hedging'.

The option contract is outside the scope of AS 11 and hence is within the scope of this Guidance Note.

According to this Guidance Note, Company X will record the following:

On January 1, 2014 - Record an option asset on payment of option premium.

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On March 31, 2014 - Record changes in fair value of the option asset based on the MTM of the foreign currency option contract with a corresponding credit/debit to Cash Flow Hedging Reserve. This amount includes both the time value and the intrinsic value, if any, of the option contract on that date.

In addition,

- Company X will also reclassify from the Cash Flow Hedge Reserve, a proportionate amount of the option premium paid as a 'cost of hedging' type adjustment into the statement of profit or loss; and
- To the extent that there is intrinsic value in the option contract that offsets the translation gain/loss on the foreign currency debt, Company will additionally reclassify such amounts to the statement of profit or loss.

As at March 31, 2014, the Balance Sheet of Company X will carry the following items:

- Derivative asset/ liability – MTM of the foreign currency option contract.
- Cash Flow Hedging Reserve - MTM of the foreign currency option contract adjusted for the 'cost of hedging' reclassification and the intrinsic value reclassification, if any.

On September 30, 2014, in addition to the above treatment, the debt will be repaid at the spot rate, the option settled or expires worthless (as the case may be) and any balance in the cash flow hedge reserve will be reclassified to the statement of profit and loss for the period ended on that date.

### **GN (A) 34 (Issued May 15, 2015)**

### **Guidance Note on Accounting for Expenditure on Corporate Social Responsibility Activities**

(The Council of the Institute of Chartered Accountants of India (ICAI) has issued this **Guidance Note on Accounting for Expenditure on Corporate Social Responsibility Activities** which comes into effect from the date of its issuance.)

#### **Introduction**

1. Section 135 of the Companies Act, 2013 (the Act), requires the Board of Directors of every company having a net worth of Rupees 500 crore or more, or turnover of Rupees 1,000 crore or more or a net profit of Rupees 5 crore or more, during any financial year, to ensure that the company spends in every financial year at least 2% of the average net profits of the company made during the three immediately preceding financial years on Corporate Social Responsibility (CSR) in pursuance of its policy in this regard. The Act requires such companies to constitute a Corporate Social Responsibility Committee which shall formulate and recommend to the Board a Corporate Social Responsibility Policy which shall indicate the CSR activities to be undertaken by the company as specified in Schedule VII to the Act.

#### **Objective**

2. The objective of this Guidance Note is to provide guidance on recognition, measurement, presentation and disclosure of expenditure on activities relating to corporate social responsibility.

#### **Scope**

3. What constitutes CSR activities is specified in Schedule VII to the Act. Reference is also invited to the circular issued by the Ministry of Corporate Affairs (MCA) No. 21/2014 and Notification dated October 24, 2014. Accordingly, the Guidance Note does not deal with identification of activities that

constitute CSR activities but only provides guidance on accounting for expenditure on CSR activities in line with the requirements of the generally accepted accounting principles including the applicable Accounting Standards.

### Definitions

4. For the purpose of this Guidance Note, the definitions mentioned at sl. nos. (a) to (f) are reproduced from the Companies Act, 2013, and the Companies (Corporate Social Responsibility Policy) Rules, 2014 and in the event of any change in the Act or the Rules made thereunder, these definitions shall stand automatically revised/modified to that extent:

- (a) *Any financial year*: “Any financial year” referred under sub-section (1) of Section 135 of the Act read with Rule 3(2) of Companies CSR Rule, 2014, implies ‘any of the three preceding financial years’. (Clarification vide MCA General Circular No. 21/2014)
- (b) *Average Net Profit*: “Average Net Profit” is the amount as calculated in accordance with the provisions of Section 198 of the Companies Act, 2013.
- (c) *Financial Year*: “Financial Year”, in relation to any company or body corporate, means the period ending on the 31st day of March every year, and where it has been incorporated on or after the 1st day of January of a year, the period ending on the 31st day of March of the following year, in respect whereof financial statement of the company or body corporate is made up:

Provided that on an application made by a company or body corporate, which is a holding company or a subsidiary of a company incorporated outside India and is required to follow a different financial year for consolidation of its accounts outside India, the Tribunal may, if it is satisfied, allow any period as its financial year, whether or not that period is a year:

Provided further that a company or body corporate, existing on the commencement of this Act, shall, within a period of two years from such commencement, align its financial year as per the provisions of this clause;

- (d) *Net Profit*: “Net Profit” means the net profit of a company as per its financial statement prepared in accordance with the applicable provisions of the Act, but shall not include the following, namely:-
  - (i) any profit arising from any overseas branch or branches of the company, whether operated as a separate company or otherwise; and
  - (ii) any dividend received from other companies in India, which are covered under and complying with the provisions of section 135 of the Act:

Provided that net profit in respect of a financial year for which the relevant financial statements were prepared in accordance with the provisions of the Companies Act, 1956, (1 of 1956) shall not be required to be re-calculated in accordance with the provisions of the Act:

Provided further that in case of a foreign company covered under these rules, net profit means the net profit of such company as per profit and loss account prepared in terms of clause (a) of sub-section (1) of section 381 read with section 198 of the Act.

- (e) *Net worth*: “Net worth” means the aggregate value of the paid-up share capital and all reserves created out of the profits and securities premium account, after deducting the aggregate value of the accumulated losses, deferred expenditure and miscellaneous expenditure not written off, as per the audited balance sheet, but does not include reserves created out of revaluation of assets, write-back of depreciation and amalgamation;

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- (f) *Turnover*: “Turnover” means the aggregate value of the realisation of amount made from the sale, supply or distribution of goods or on account of services rendered, or both, by the company during a financial year;
- (g) *Spend* : The term ‘spend’ in accounting parlance generally means the liabilities incurred during the relevant accounting period.

5. Rule 4 of the Companies (Corporate Social Responsibility Policy) Rules, 2014, requires that the CSR activities that shall be undertaken by the companies for the purpose of Section 135 of the Act shall exclude activities undertaken in pursuance of its ‘normal course of business’. The Rules also specify that CSR projects or programmes or activities that benefit only the employees of the company and their families shall not be considered as CSR activities in accordance with the requirements of the Act. Such programmes or projects or activities, that are carried out as a pre-condition for setting up a business, or as part of a contractual obligation undertaken by the company or in accordance with any other Act, or as a part of the requirement in this regard by the relevant authorities cannot be considered as a CSR activity within the meaning of the Act. Similarly, the requirements under relevant regulations or otherwise prescribed by the concerned regulators as a necessary part of running of the business, would be considered to be the activities undertaken in the ‘normal course of business’ of the company and, therefore, would not be considered CSR activities.

#### **Recognition and Measurement of CSR Expenditure in Financial Statements *Whether Provision for Unspent Amount required to be created?***

6. Section 135 (5) of the Companies Act, 2013, requires that the Board of every eligible company, “shall ensure that the company spends, in every financial year, at least 2% of the average net profits of the company made during the three immediately preceding financial years, in pursuance of its Corporate Social Responsibility Policy”. A proviso to this Section states that “if the company fails to spend such amount, the Board shall, in its report ... specify the reasons for not spending the amount”.

7. Further, Rule 8(1) of the Companies (Corporate Social Responsibility Policy) Rules, 2014, prescribes that the Board Report of a company under these Rules shall include an Annual Report on CSR, containing particulars specified in the Annexure to the said Rules, which provide a format in this regard.

8. The above provisions of the Act clearly lay down that the expenditure on CSR activities is to be disclosed only in the Board’s Report in accordance with the Rules made thereunder. In view of this, no provision for the amount which is not spent, i.e., any shortfall in the amount that was expected to be spent as per the provisions of the Act on CSR activities and the amount actually spent at the end of a reporting period, may be made in the financial statements. The proviso to section 135 (5) of the Act, makes it clear that if the specified amount is not spent by the company during the year, the Directors’ Report should disclose the reasons for not spending the amount. However, if a company has already undertaken certain CSR activity for which a liability has been incurred by entering into a contractual obligation, then in accordance with the generally accepted principles of accounting, a provision for the amount representing the extent to which the CSR activity was completed during the year, needs to be recognised in the financial statements.

9. Where a company spends more than that required under law, a question arises as to whether the excess amount ‘spent’ can be carried forward to be adjusted against amounts to be spent on CSR activities in future period. Since ‘2% of average net profits of immediately preceding three years’ is the minimum amount which is required to be spent under section 135 (5) of the Act, the excess amount cannot be carried forward for set off against the CSR expenditure required to be spent in future.

### ***Other Considerations in Recognition and Measurement***

10. A company may decide to undertake its CSR activities approved by the CSR Committee with a view to discharge its CSR obligation as arising under section 135 of the Act in the following three ways:

- (a) making a contribution to the funds as specified in Schedule VII to the Act; or
- (b) through a registered trust or a registered society or a company established under section 8 of the Act (or section 25 of the Companies Act, 1956) by the company, either singly or along with its holding or subsidiary or associate company or along with any other company or holding or subsidiary or associate company of such other company, or otherwise; or
- (c) in any other way in accordance with the Companies (Corporate Social Responsibility Policy) Rules, 2014, e.g. on its own

11. In case a contribution is made to a fund specified in Schedule VII to the Act, the same would be treated as an expense for the year and charged to the statement of profit and loss. In case the amount is spent in the manner as specified in paragraph 10 (b) above the same will also be treated as expense for the year by charging off to the statement of profit and loss. The accounting for expenditure incurred by the company otherwise e.g. on its own would be accounted for in accordance with the principles of accounting as explained hereinafter.

### ***CSR activities carried out by the company covered under paragraph 10 (c)***

12. In cases, where an expenditure of revenue nature is incurred on any of the activities mentioned in Schedule VII to the Act by the company on its own, the same should be charged as an expense to the statement of profit and loss. In case the expenditure incurred by the company is of such nature which may give rise to an 'asset', a question may arise as to whether such an 'asset' should be recognised by the company in its balance sheet. In this context, it would be relevant to note the definition of the term 'asset' as per the Framework for Preparation and Presentation of Financial Statements issued by the Institute of Chartered Accountants of India. As per the Framework, an 'asset' is a "resource controlled by an enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise". Hence, in cases where the control of the 'asset' is transferred by the company, e.g., a school building is transferred to a Gram Panchayat for running and maintaining the school, it should not be recognised as 'asset' in its books and such expenditure would need to be charged to the statement of profit and loss as and when incurred. In other cases, where the company retains the control of the 'asset' then it would need to be examined whether any future economic benefits accrue to the company. Invariably future economic benefits from a 'CSR asset' would not flow to the company as any surplus from CSR cannot be included by the company in business profits in view of Rule 6(2) of the Companies (Corporate Social Responsibility Policy) Rules, 2014.

13. In some cases, a company may supply goods manufactured by it or render services as CSR activities. In such cases, the expenditure incurred should be recognised when the control on the goods manufactured by it is transferred or the allowable services are rendered by the employees. The goods manufactured by the company should be valued in accordance with the principles prescribed in Accounting Standard (AS) 2, *Valuation of Inventories*. The services rendered should be measured at cost. Indirect taxes (like excise duty, service tax, VAT or other applicable taxes) on the goods and services so contributed will also form part of the CSR expenditure.

14. Where a company receives a grant from others for carrying out CSR activities, the CSR expenditure should be measured net of the grant.

**Recognition of Income Earned from CSR Projects/ Programmes or During the Course of Conduct of CSR Activities**

15. Rule 6 (2) of the Companies (Corporate Social Responsibility Policy) Rules, 2014, requires that “the surplus arising out of the CSR projects or programs or activities shall not form part of the business profit of a company”. The term ‘surplus’ ordinarily means excess of income over expenditure pertaining to an entity or an activity. Thus, in respect of a CSR project or programme or activity, it needs to be determined whether any surplus is arising therefrom. A question would arise as to whether such surplus should be recognised in the statement of profit and loss of the company. It may be noted that paragraph 5 of Accounting Standard (AS) 5, *Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies*, inter alia, requires that all items of income which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise. As to whether the surplus from CSR activities can be considered as ‘income’, the *Framework for Preparation and Presentation of Financial Statements* issued by the Institute of Chartered Accountants of India, defines ‘income’ as “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”. Since the surplus arising from CSR activities is not arising from a transaction with the owners, it would be considered as ‘income’ for accounting purposes. In view of the aforesaid requirement any surplus arising out of CSR project or programme or activities shall be recognised in the statement of profit and loss and since this surplus cannot be a part of business profits of the company, the same should immediately be recognised as liability for CSR expenditure in the balance sheet and recognised as a charge to the statement of profit and loss. Accordingly, such surplus would not form part of the minimum ‘2% of the average net profits of the company made during the three immediately preceding financial years in pursuance of its Corporate Social Responsibility Policy’.

16. Item 5 (A)(k) of the General Instructions for Preparation of Statement of Profit and Loss under Schedule III to the Companies Act, 2013, requires that in case of companies covered under Section 135, the amount of expenditure incurred on ‘Corporate Social Responsibility Activities’ shall be disclosed by way of a note to the statement of profit and loss. From the perspective of better financial reporting and still be in line with the requirements of Schedule III in this regard, it is recommended that all expenditure on CSR activities, that qualify to be recognised as expense in accordance with paragraphs 10-14 above should be recognised as a separate line item as ‘CSR expenditure’ in the statement of profit and loss. Further, the relevant note should disclose the break-up of various heads of expenses included in the line item ‘CSR expenditure’.

17. The notes to accounts relating to CSR expenditure should also contain the following:

- (a) Gross amount required to be spent by the company during the year.
- (b) Amount spent during the year on:

		In cash	Yet to be paid in cash	Total
(i)	Construction/acquisition of any asset			
(ii)	On purposes other than (i) above			

The above disclosure, to the extent relevant, may also be made in the notes to the cash flow statement, where applicable.

- (c) Details of related party transactions, e.g., contribution to a trust controlled by the company in relation to CSR expenditure as per Accounting Standard (AS) 18, *Related Party Disclosures*.

- (d) Where a provision is made in accordance with paragraph 8 above the same should be presented as per the requirements of Schedule III to the Companies Act, 2013. Further, movements in the provision during the year should be shown separately.

## Appendix 1

### Section 135 of the Companies Act, 2013-Corporate Social Responsibility

- (1) Every company having net worth of rupees five hundred crore or more, or turnover of rupees one thousand crore or more or a net profit of rupees five crore or more during any financial year shall constitute a Corporate Social Responsibility Committee of the Board consisting of three or more directors, out of which at least one director shall be an independent director.
- (2) The Board's report under sub-section (3) of Section 134 shall disclose the composition of the Corporate Social Responsibility Committee.
- (3) The Corporate Social Responsibility Committee shall,
- (a) formulate and recommend to the Board, a Corporate Social Responsibility Policy which shall indicate the activities to be undertaken by the company as specified in Schedule VII;
  - (b) recommend the amount of expenditure to be incurred on the activities referred to in clause (a); and
  - (c) monitor the Corporate Social Responsibility Policy of the company from time to time.
- (4) The Board of every company referred to in sub-section (1) shall,
- (a) after taking into account the recommendations made by the Corporate Social Responsibility Committee, approve the Corporate Social Responsibility Policy for the company and disclose contents of such Policy in its report and also place it on the company's website, if any, in such manner as may be prescribed; and
  - (b) ensure that the activities as are included in Corporate Social Responsibility Policy of the company are undertaken by the company.
- (5) The Board of every company referred to in sub-section (1), shall ensure that the company spends, in every financial year, at least two per cent. of the average net profits of the company made during the three immediately preceding financial years, in pursuance of its Corporate Social Responsibility Policy:

Provided that the company shall give preference to the local area and areas around it where it operates, for spending the amount earmarked for Corporate Social Responsibility activities:

Provided further that if the company fails to spend such amount, the Board shall, in its report made under clause (o) of sub-section (3) of Section 134, specify the reasons for not spending the amount.

Explanation.—For the purposes of this section “average net profit” shall be calculated in accordance with the provisions of Section 198.

## Appendix 2

### Section 198 of the Companies Act , 2013 – Calculation of Profits

- (1) In computing the net profits of a company in any financial year for the purpose of section 197,—
- (a) credit shall be given for the sums specified in sub-section (2), and credit shall not be given for those specified in sub-section (3); and

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- (b) the sums specified in sub-section (4) shall be deducted, and those specified in sub-section (5) shall not be deducted.
- (2) In making the computation aforesaid, credit shall be given for the bounties and subsidies received from any Government, or any public authority constituted or authorised in this behalf, by any Government, unless and except in so far as the Central Government otherwise directs.
- (3) In making the computation aforesaid, credit shall not be given for the following sums, namely:—
- (a) profits, by way of premium on shares or debentures of the company, which are issued or sold by the company;
  - (b) profits on sales by the company of forfeited shares;
  - (c) profits of a capital nature including profits from the sale of the undertaking or any of the undertakings of the company or of any part thereof;
  - (d) profits from the sale of any immovable property or fixed assets of a capital nature comprised in the undertaking or any of the undertakings of the company, unless the business of the company consists, whether wholly or partly, of buying and selling any such property or assets:  
Provided that where the amount for which any fixed asset is sold exceeds the written-down value thereof, credit shall be given for so much of the excess as is not higher than the difference between the original cost of that fixed asset and its written-down value;
  - (e) any change in carrying amount of an asset or of a liability recognised in equity reserves including surplus in profit and loss account on measurement of the asset or the liability at fair value.
- (4) In making the computation aforesaid, the following sums shall be deducted, namely:—
- (a) all the usual working charges;
  - (b) directors' remuneration;
  - (c) bonus or commission paid or payable to any member of the company's staff, or to any engineer, technician or person employed or engaged by the company, whether on a whole-time or on a part-time basis;
  - (d) any tax notified by the Central Government as being in the nature of a tax on excess or abnormal profits;
  - (e) any tax on business profits imposed for special reasons or in special circumstances and notified by the Central Government in this behalf;
  - (f) interest on debentures issued by the company;
  - (g) interest on mortgages executed by the company and on loans and advances secured by a charge on its fixed or floating assets;
  - (h) interest on unsecured loans and advances;
  - (i) expenses on repairs, whether to immovable or to movable property, provided the repairs are not of a capital nature;
  - (j) outgoings inclusive of contributions made under section 181;
  - (k) depreciation to the extent specified in section 123;
  - (l) the excess of expenditure over income, which had arisen in computing the net profits in accordance with this section in any year which begins at or after the commencement of this Act, in so far as such excess has not been deducted in any subsequent year preceding the year in respect of which the net profits have to be ascertained;

- (m) any compensation or damages to be paid in virtue of any legal liability including a liability arising from a breach of contract;
  - (n) any sum paid by way of insurance against the risk of meeting any liability such as is referred to in clause (m);
  - (o) debts considered bad and written off or adjusted during the year of account.
- (5) In making the computation aforesaid, the following sums shall not be deducted, namely:—
- (a) income-tax and super-tax payable by the company under the Income-tax Act, 1961, or any other tax on the income of the company not falling under clauses (d) and (e) of sub-section (4);
  - (b) any compensation, damages or payments made voluntarily, that is to say, otherwise than in virtue of a liability such as is referred to in clause (m) of sub-section (4);
  - (c) loss of a capital nature including loss on sale of the undertaking or any of the undertakings of the company or of any part thereof not including any excess of the written-down value of any asset which is sold, discarded, demolished or destroyed over its sale proceeds or its scrap value;
  - (d) any change in carrying amount of an asset or of a liability recognised in equity reserves including surplus in profit and loss account on measurement of the asset or the liability at fair value.

### Appendix 3

#### Schedule VII to the Companies Act, 2013

##### (See sections 135)

Activities which may be included by companies in their Corporate Social Responsibility Policies  
Activities relating to:—

- (i) eradicating hunger, poverty and malnutrition, promoting health care including preventive health care and sanitation<sup>2</sup> including contribution to the Swach Bharat Kosh set-up by the Central Government for the promotion of sanitation and making available safe drinking water;
- (ii) promoting education, including special education and employment enhancing vocation skills especially among children, women, elderly and the differently abled and livelihood enhancement projects;
- (iii) promoting gender equality, empowering women, setting up homes and hostels for women and orphans; setting up old age homes, day care centres and such other facilities for senior citizens and measures for reducing inequalities faced by socially and economically backward groups;
- (iv) ensuring environmental sustainability, ecological balance, protection of flora and fauna, animal welfare, agroforestry, conservation of natural resources and maintaining quality of soil, air and water<sup>3</sup> including contribution to the Clean Ganga Fund set-up by the Central Government for rejuvenation of river Ganga;
- (v) protection of national heritage, art and culture including restoration of buildings and sites of historical importance and works of art; setting up public libraries; promotion and development of traditional arts and handicrafts;
- (vi) measures for the benefit of armed forces veteran, war widows and their dependents;

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<sup>2</sup> Inserted vide Notification G.S.R. 741 (E) dated 24.10.2014

<sup>3</sup> Inserted vide Notification G.S.R. 741 (E) dated 24.10.2014

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- (vii) training to promote rural sports nationally recognised sports, Paralympic sports and Olympic sports;
- (viii) contribution to the Prime Minister's National Relief Fund or any other fund set up by the Central Government for socio-economic development and relief and welfare of the Scheduled Castes, the Scheduled Tribes, other backward classes, minorities and women;
- (ix) contributions or funds provided to technology incubators located within academic institutions which are approved by the Central Government;
- (x) rural development projects;
- (xi) <sup>4</sup>slum area development

Explanation.—For the purposes of this item, the term 'slum area' shall mean any area declared as such by the Central Government or any State Government or any other competent authority under any law for the time being in force.

#### Appendix 4

### Rules for CSR under Section 135 of Chapter IX (after incorporating Amendments upto May, 2015)

New Delhi, dated 27th February, 2014

G.S.R. 129 (E).- In exercise of the powers conferred under section 135 and sub-sections (1) and (2) of section 469 of the Companies Act, 2013 (18 of 2013), the Central Government hereby makes the following rules, namely: -

1. **Short title and commencement. –**

- (1) These rules may be called the Companies (Corporate Social Responsibility Policy) Rules, 2014;
- (2) They shall come into force on the 1st day of April, 2014.

2. **Definitions.-**

- (1) In these rules, unless the context otherwise requires;
  - (a) "Act" means the Companies Act, 2013;
  - (b) "Annexure" means the Annexure appended to these rules;
  - (c) "Corporate Social Responsibility (CSR)" means and includes but is not limited to:-
    - (i) Projects or programs relating to activities specified in Schedule VII to the Act; or
    - (ii) Projects or programs relating to activities undertaken by the board of directors of a company (Board) in pursuance of recommendations of the CSR Committee of the Board as per declared CSR Policy of the company subject to the condition that such policy will cover subjects enumerated in Schedule VII of the Act.
  - (d) "CSR Committee" means the Corporate Social Responsibility Committee of the Board referred to in section 135 of the Act;

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<sup>4</sup> Inserted vide Notification G.S.R 568 (E) dated 06.08.2014

- (e) "CSR Policy" relates to the activities to be undertaken by the company as specified in Schedule VII to the Act and the expenditure thereon, excluding activities undertaken in pursuance of normal course of business of a company;
- (f) "Net profit" means the net profit of a company as per its financial statement prepared in accordance with the applicable provisions of the Act, but shall not include the following, namely :-
  - (i) any profit arising from any overseas branch or branches of the company, whether operated as a separate company or otherwise; and
  - (ii) any dividend received from other companies in India, which are covered under and complying with the provisions of section 135 of the Act:

Provided that net profit in respect of a financial year for which the relevant financial statements were prepared in accordance with the provisions of the Companies Act, 1956, (1 of 1956) shall not be required to be re-calculated in accordance with the provisions of the Act:

Provided further that in case of a foreign company covered under these rules, net profit means the net profit of such company as per profit and loss account prepared in terms of clause (a) of sub-section (1) of section 381 read with section 198 of the Act.

- (2) Words and expressions used and not defined in these rules but defined in the Act shall have the same meanings respectively assigned to them in the Act.

### 3. Corporate Social Responsibility. -

- (1) Every company including its holding or subsidiary, and a foreign company defined under clause (42) of section 2 of the Act having its branch office or project office in India, which fulfills the criteria specified in sub-section (1) of section 135 of the Act shall comply with the provisions of section 135 of the Act and these rules:

Provided that net worth, turnover or net profit of a foreign company of the Act shall be computed in accordance with balance sheet and profit and loss account of such company prepared in accordance with the provisions of clause (a) of sub-section (1) of section 381 and section 198 of the Act.

- (2) Every company which ceases to be a company covered under sub-section (1) of section 135 of the Act for three consecutive financial years shall not be required to -
  - (a) constitute a CSR Committee; and
  - (b) comply with the provisions contained in sub-section (2) to (5) of the said section, till such time it meets the criteria specified in sub-section (1) of section 135

### 4. CSR Activities.-

- (1) The CSR activities shall be undertaken by the company, as per its stated CSR Policy, as projects or programs or activities (either new or ongoing), excluding activities undertaken in pursuance of its normal course of business.
- (2) The Board of a company may decide to undertake its CSR activities approved by the CSR Committee, through a registered trust or a registered society or a company established under Section 8 of the Act by the company, either singly or alongwith its holding or subsidiary or associate company, or alongwith any other company or holding or subsidiary or associate company of such other company, or otherwise:<sup>5</sup>

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<sup>5</sup> Substituted vide Amendment in Rules, G.S.R. 43 (E), dated 19.01.2015

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Provided that-

- (i) if such trust, society or company is not established by the company either singly or alongwith its holding or subsidiary or associate company, or alongwith any other company or holding or subsidiary or associate company of such other company<sup>6</sup>, it shall have an established track record of three years in undertaking similar programs or projects.
- (ii) the company has specified the project or programs to be undertaken through these entities, the modalities of utilization of funds on such projects and programs and the monitoring and reporting mechanism.
- (3) A company may also collaborate with other companies for undertaking projects or programs or CSR activities in such a manner that the CSR Committees of respective companies are in a position to report separately on such projects or programs in accordance with these rules.
- (4) Subject to provisions of sub-section (5) of section 135 of the Act, the CSR projects or programs or activities undertaken in India only shall amount to CSR expenditure.
- (5) The CSR projects or programs or activities that benefit only the employees of the company and their families shall not be considered as CSR activities in accordance with section 135 of the Act.
- (6) Companies may build CSR capacities of their own personnel as well as those of their Implementing agencies through Institutions with established track records of at least three financial years but such expenditure <sup>7</sup>including expenditure on administrative overheads, shall not exceed five percent of total CSR expenditure of the company in one financial year.
- (7) Contribution of any amount directly or indirectly to any political party under section 182 of the Act, shall not be considered as CSR activity.

#### 5. CSR Committees.-

1. The companies mentioned in the rule 3 shall constitute CSR Committee as under:-
  - (i) an unlisted public company or a private company covered under sub-section (1) of section 135 which is not required to appoint an independent director pursuant to subsection (4) of section 149 of the Act, shall have its CSR Committee without such director;
  - (ii) a private company having only two directors on its Board shall constitute its CSR Committee with two such directors;
  - (iii) with respect to a foreign company covered under these rules, the CSR Committee shall comprise of at least two persons of which one person shall be as specified under clause (d) of sub-section (1) of section 380 of the Act and another person shall be nominated by the foreign company.
- (2) The CSR Committee shall institute a transparent monitoring mechanism for implementation of the CSR projects or programs or activities undertaken by the company.

#### 6. CSR Policy.-

- (1) The CSR Policy of the company shall, inter-alia, include the following, namely -
  - (a) a list of CSR projects or programs which a company plans to undertake falling within the purview of the Schedule VII of the Act, specifying modalities of execution of such project or programs and implementation schedules for the same; and

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<sup>6</sup> Substituted vide Amendment in Rules, G.S.R. 43 (E), dated 19.01.2015

<sup>7</sup> Inserted vide Amendment in Rules, G.S.R. 644 (E), dated 12.09.2014

(b) monitoring process of such projects or programs:

Provided that the CSR activities does not include the activities undertaken in pursuance of normal course of business of a company.

Provided further that the Board of Directors shall ensure that activities included by a company in its Corporate Social Responsibility Policy are related to the activities included in Schedule VII of the Act.

(2) The CSR Policy of the company shall specify that the surplus arising out of the CSR projects or programs or activities shall not form part of the business profit of a company.

7. **CSR Expenditure-** CSR expenditure shall include all expenditure including contribution to corpus, for projects or programs relating to CSR activities approved by the Board on the recommendation of its CSR Committee, but does not include any expenditure on an item not in conformity or not in line with activities which fall within the purview of Schedule VII of the Act.

**8. CSR Reporting-**

(1) The Board's Report of a company covered under these rules pertaining to a financial year commencing on or after the 1st day of April, 2014 shall include an annual report on CSR containing particulars specified in Annexure.

(2) In case of a foreign company, the balance sheet filed under sub-clause (b) of sub-section (1) of section 381 shall contain an Annexure regarding report on CSR.

**9. Display of CSR activities on its website -**

The Board of Directors of the company shall, after taking into account the recommendations of CSR Committee, approve the CSR Policy for the company and disclose contents of such policy in its report and the same shall be displayed on the company's website, if any, as per the particulars specified in the Annexure.

**ANNEXURE**

**FORMAT FOR THE ANNUAL REPORT ON CSR ACTIVITIES TO BE INCLUDED IN THE BOARD'S REPORT**

1. A brief outline of the company's CSR policy, including overview of projects or programs proposed to be undertaken and a reference to the web-link to the CSR policy and projects or programs.
2. The Composition of the CSR Committee.
3. Average net profit of the company for last three financial years.
4. Prescribed CSR Expenditure (two per cent. Of the amount as in item 3 above)
5. Details of CSR spent during the financial year.
  - (a) Total amount to be spent for the financial year;
  - (b) Amount unspent, if any;

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(c) Manner in which the amount spent during the financial year is detailed below.

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
S. No.	CSR Project or activity identified	Sector in which the Project is covered	Projects or programs (1) Local area or other (2) Specify the State and district where projects or programs was undertaken	Amount outlay (budget) project or programs wise	Amount spent on the projects or programs <b>Sub -heads:</b>  (1) Direct expenditure on projects or programs.  2.Overheads:	Cumulative expenditure upto to the reporting period	Amount spent: Direct or through implementing agency
1							
2							
3							
	<b>TOTAL</b>						

\*Give details of implementing agency:

6. In case the company has failed to spend the two per cent of the average net profit of the last three financial years or any part thereof, the company shall provide the reasons for not spending the amount in its Board report.
7. A responsibility statement of the CSR Committee that the implementation and monitoring of CSR Policy, is in compliance with CSR objectives and Policy of the company.

Sd/- (Chief Executive Officer or Managing Director or Director)	Sd/- (Chairman Committee)	CSR	Sd/- (Person specified under clause (d) of sub-section (1) of section 380 of the Act) (wherever applicable)
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## Guidance Note on the Schedule III to the Companies Act, 2013

### 1. Introduction

1.1 Schedule III to the Companies Act, 2013 ('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) had issued a revised form of Schedule VI on February 28, 2011 and this has formed the basis for the Schedule III of Companies Act, 2013. As per the Act and rules / notifications

thereunder, the Schedule applies to all companies for the Financial Statements to be prepared for the financial year commencing on or after April 1, 2014.

**1.2** The requirements of the Schedule III however, do not apply to companies as referred to in the proviso to Section 129(1) 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 Statement of Profit and Loss 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 1 (4) of the Companies Act states that the Companies Act will apply to electricity companies, to the extent it is not inconsistent with the provisions of the Electricity Act. Keeping this in view, Schedule III 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 Schedule III. 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 Section 133 of the Companies Act, 2013 read together with Paragraph 7 of the Companies (Accounts) Rules, 2014 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 Schedule III.

**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. S.O. 902 (E) dated 26<sup>th</sup> March, 2015, the Schedule III is applicable for the Balance Sheet and Statement of Profit and Loss to be prepared for the financial year commencing on or after April 1, 2014.

**3.2.** Early adoption of the Schedule III is not permitted since Schedule VI is a statutory format.

**3.3.** The Schedule III 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 Schedule III. Thus for the Financial Statements prepared for the year 2014-15(1<sup>st</sup>April 2014to 31<sup>st</sup> March 2015), corresponding amounts need to be given for the financial year 2013-14.

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**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 Schedule III 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 also going forward conform to that used in the company's most recent annual Financial Statements, i.e., the Schedule III of Companies Act, 2013.

**3.7.** The format of Balance Sheet currently prescribed under Clause 41 to the Listing Agreement is also based the format of Balance Sheet in the Schedule III.

**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 Schedule III. 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 Schedule III 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 5<sup>th</sup>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 31<sup>st</sup>March 2012, they would prepare only in the new format as prescribed by the Schedule VI of the Companies Act, 1956'. In the absence of similar clarification with regard to use of Revised Schedule VI vis-à-vis, for the periods after 31<sup>st</sup> March 2012, the Schedule III format will have to be adhered to, which is anyway, similar to the Revised Schedule VI format under Companies Act 1956 for standalone financials except for an additional disclosure requirement with respect to Corporate Social Responsibility Expenditure.

## **4. Summary of Schedule III**

### **4.1. Main principles**

**4.1.1.** The Schedule III 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 Schedule III, the requirements of the Act and/ or the notified Accounting Standards will prevail over the Schedule.

**4.1.2.** The Schedule III 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.** The terms used in the Schedule III 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.

**4.1.4.** 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.

**4.1.5.** 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, but was introduced in the Revised Schedule VI itself.

**4.1.6.** 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 (brought in by Revised Schedule VI onwards)**

**4.2.1.** The Schedule III (and earlier, 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 Statement of Profit and Loss 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.

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**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 Schedule III (and earlier, 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 Schedule III (and earlier, the Revised Schedule VI), other commitments also need to be disclosed.

**4.2.12.** The Schedule III (and earlier, 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, 2015 (CARO).

**4.2.13.** The Schedule III (and earlier, the Revised Schedule VI) introduced 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 (brought in by Revised Schedule VI and added to by Schedule III)**

**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 Schedule III (and earlier 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 Schedule III (and earlier 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 Schedule III (and earlier 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.

**4.3.8.** Schedule III has brought in an additional requirement under additional information to be provided requiring companies to disclose amount of expenditure incurred on corporate social responsibility activities.

**4.4. Disclosures no longer required (brought in by Revised Schedule VI)**

The Schedule III (and earlier 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 Schedule III (and earlier Revised Schedule VI).

**5. Structure of the Schedule III**

The Structure of Schedule III 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

VI. General Instructions for the Preparation of Consolidated Financial Statements

**6. General Instructions to The Schedule III**

**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 Schedule III (and earlier, 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 Schedule III (and earlier, the Revised Schedule VI).

**6.3.** The Schedule III 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 interse, in the Financial Statements or statements forming part thereof, the same shall be made and the requirements of Schedule III 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 Schedule III 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 Schedule III 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 Schedule III, requirements of the Accounting Standards would prevail over the Schedule III 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 interse. 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 Schedule III), while the remaining line-items may be included under the latter heading.

**6.5.** Para 2 of the General Instructions to the Schedule III 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 Schedule III.

**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 Schedule III. 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 Schedule III.

**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 Sub Section (3) of Section 182 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 Schedule III, 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 Schedule III.

**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 Schedule III (and earlier, 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 Schedule III 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 recognized in the Financial Statements also emanate from the Accounting Standards, such as, disclosures required under AS9 *Revenue*

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*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 *AS29 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 Schedule III (and earlier, 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 Schedule III (and earlier, 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 Schedule III (and earlier, 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	Schedule III (and earlier, the Revised Schedule VI)
<ul style="list-style-type: none"> <li>• <b>Turnover &lt;Rs. 100 Crores</b> – Round off to the nearest hundreds, thousands or decimal thereof</li> <li>• Turnover Rs. 100 to Rs. 500 Crores- Round off to the nearest hundreds, thousands, lakhs or millions or decimal thereof</li> <li>• Turnover &gt;Rs. 500 Crores- Round off to the nearest hundreds, thousands, lakhs, millions or crores, or decimal thereof.</li> </ul>	<ul style="list-style-type: none"> <li>• <b>Turnover &lt;Rs. 100 Crores</b> - Round off to the nearest hundreds, thousands, <b>lakhs or millions</b> or decimal thereof.</li> <li>• <b>Turnover &gt;Rs. 100 Crores</b> - Round off to the nearest lakhs, millions or <b>crores</b>, or decimal thereof</li> </ul>

**6.15.** The instructions also clarify that the terms used in the Schedule III shall be as per the applicable Accounting Standards. For example, the term 'related parties' used at several places in the Schedule III 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 Schedule III 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 Amortization 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 Schedule III 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 Schedule III 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

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- (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 Schedule III 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 upto 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 Schedule III, 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 non-current liabilities will be governed by the criteria laid down in the Schedule III. 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

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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 Schedule III.

**7.4.** The Schedule III requires Investments to be classified as Current and Non-Current. However, *AS13 ‘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 Schedule III, “Non-current” Investment has to be determined with respect to the Balance Sheet date.

**7.4.2.** Though the Schedule III 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 Schedule III. The portion of long-term investment as per *AS13* which is expected to be realized within twelve months from the Balance Sheet date needs to be shown as Current investment under the Schedule III.

#### **7.5. Settlement of a liability by issuing of equity**

**7.5.1.** The Schedule III 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 Schedule III.

7.6 As per the classification in the Schedule III 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 Schedule III 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 Schedule III 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,

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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 Schedule III, calls unpaid are to be disclosed separately as per the Schedule III.

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 Schedule III, 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, non-cumulative, 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 upto the ultimate holding company

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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 Schedule III.

- (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.

**8.1.2. Reserves and Surplus**

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. The term "Capital Reserve" has not been defined under the Schedule III. 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 Schedule III does not have the requirement of

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“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 55 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 69 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 Schedule III 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 71 of the Act where a company issues debentures, 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 Schedule III 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'. Under the Schedule III, 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.

**8.1.2.11**As per Schedule III, a reserve specifically represented by earmarked investments shall be termed as a 'fund'

**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 Note 6 of General Instructions for preparation of Balance sheet 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;

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- 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 50 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 Schedule III, 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 Schedule III may be used as long-term liability for the above disclosure. Also, the phrase “term loan” has not been defined in the Schedule III. Term loans normally have a fixed or pre-determined maturity period or a repayment schedule.

**8.3.1.8.** As referred to in para 72 of 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” (The same guidance is relevant for this item as per CARO 2015 also). 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.

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**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 sub-classified as secured and unsecured giving the nature of the security for the secured position.

**8.3.1.11** The Schedule III 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 Schedule III 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 Schedule III 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 Schedule III. 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 Schedule III.

**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 Schedule III, 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

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employee benefit obligations, their classification as current and non-current liability will be governed by the criteria laid down in the Schedule III. 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;

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- (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(I) of Part I of the Schedule III.

- (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 AS14 *Accounting for Amalgamations* and AS10 *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 AS11 *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 AS11 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 Schedule III has introduced office equipment as a separate line item while dropping items like, livestock, 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.

AS10 *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 Schedule III 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 Schedule III only for five years. However, details required by AS10 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.

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### 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 Schedule III.

- (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 Schedule III, 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 Schedule III, 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 Schedule III 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 AS13 *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 Schedule III, this amount should be disclosed separately in the notes. However, as per AS13 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 non-current investments should also be separately disclosed to comply with the specific disclosure requirement in Schedule III.

### 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 Schedule III 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 Schedule III 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 Schedule III. 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 Schedule III 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.

**8.7.2.10** Any application money paid towards securities, where security has not been allotted on the date of the Balance Sheet shall be disclosed as a separate line item. If the amount is material, details about the allotment since made or when the allotment is expected to be completed may also be disclosed.

In case the investment is of current investment in nature, such share application money shall be accordingly, disclosed under current investments.

### **8.7.3 Long-term loans & advances**

- (i) Long-term loans and advances shall be classified as:

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- (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 Schedule III, Capital Advances are not to 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 Schedule III 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 Schedule III 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 Schedule III does not deal with any accounting treatment and the same continues to be governed by the respective Accounting Standards/practices. Further, the Schedule III 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 Schedule III, 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 Schedule III 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

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- (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 Schedule III 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 Schedule III, 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 Schedule III (and earlier, 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.

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The term "cash and bank balances" in the Old Schedule VI is replaced with 'Cash and cash equivalents' in the Schedule III.

**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, unamortized 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.

**8.8.7.2A** 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 Schedule III 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 Schedule III. 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 Schedule III 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 Schedule III, 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 Schedule III. 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 Schedule III, 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 Schedule III 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.

**8.8.7.9** The Schedule III 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. 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. AS13 *Accounting for Investments* requires current investments to be valued at lower of cost and fair value. AS2 *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 III. Hence, a diligent application of the requirements of Accounting Standards and Schedule III 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 sub clause (ii) of clause (40) of section 2 of the Companies Act, 2013 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 Schedule III

**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 Schedule III, 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".

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**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, 2013, or Schedule III. 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:

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- (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 Schedule III (and earlier, 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.

**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 AS13 "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 Schedule III 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'.

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- 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.

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**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.

**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 Schedule III. 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) (l) 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 Schedule III. 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) (l) 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

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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	<u>(XX)</u>
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** AS22 "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 AS20 *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 AS20.

## **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 AS11. 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 para9.6.5 [Note 3(c) of Schedule III].

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### 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 (m) of Note 5 (i) ]

The term 'Prior period Items' is not defined in Schedule III. 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 Schedule III 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	Gross income derived from services rendered under broad heads
Company that falls under more than one category	It will be sufficient compliance with 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 Schedule III 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 Schedule III 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
<b>Raw materials</b>	
Raw material A	XX (YY)
Raw material B	XX (YY)
Others	XX (YY)
<b>Total</b>	<b>XX</b> <b>(YY)</b>

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Particulars	Purchases
<b>Goods purchased</b>	
Traded item A	XX (YY)
Traded item B	XX (YY)
Others	XX (YY)
<b>Total</b>	<b>XX</b> <b>(YY)</b>

Particulars	Sales values	Closing Inventory	Opening Inventory
<b>Manufactured goods</b>			
Finished goods A	XX (YY)	<u>XX</u>	<u>XX</u>
Finished goods B	XX (YY)	XX	XX
Others	XX (YY)	XX	XX
<b>Total</b>	<b>XX</b> <b>(YY)</b>	<b>XX</b>	<b>XX</b>
<b>Traded goods</b>			
Traded goods A	XX (YY)	XX	XX
Traded goods B	XX (YY)	XX	XX
Others	XX (YY)	XX	XX
<b>Total</b>	<b>XX</b> <b>(YY)</b>	<b>XX</b>	<b>XX</b>

Particulars	WIP
<b>Work in Progress</b>	
Goods A WIP	XX (YY)
Goods B WIP	XX

	(YY)
Others	XX (YY)
<b>Total</b>	<b>XX</b> (YY)

**10.8.2 Trading company**

Particulars	Purchase	Sales
<b>Traded goods</b>		
Traded goods A	XX (YY)	XX (YY)
Traded goods B	XX (YY)	XX (YY)
Others	XX (YY)	XX (YY)
<b>Total</b>	<b>XX</b> (YY)	<b>XX</b> (YY)

**10.8.3 Service Company**

Particulars	Amount
<b>Services rendered</b>	
Service A	XX (YY)
Service B	XX (YY)
Others	XX (YY)
<b>Total</b>	<b>XX</b> (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)]**

**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, 2013 or any other applicable statute e.g.

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Income Tax Act, 1961, or RBI Act, 1932, etc. Further, profits may also be appropriated to free reserves as deemed appropriate by the management.

**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.

**10.13 Clause (k) of Note 5(i) requires disclosure for 'expenditure incurred on corporate social responsibility activities'.**

This new requirement introduced by the Companies Act 2013 is that the companies which are covered under Section 135 are required to disclose the amount of expenditure incurred on corporate social responsibility activities. The Guidance Note on Accounting for Expenditure on Corporate Social Responsibility Activities issued may be referred to for disclosure requirements, which are essentially as under:

- a) From the perspective of better financial reporting and in line with the requirements of Schedule III in this regard, it is recommended that all expenditure on CSR activities, that qualify to be recognised as expense should be recognised as a separate line item as 'CSR expenditure' in the statement of profit and loss. Further, the relevant note should disclose the break-up of various heads of expenses included in the line item 'CSR expenditure'.
- b) The notes to accounts relating to CSR expenditure should also contain the following:
  - (1) Gross amount required to be spent by the company during the year.
  - (2) Amount spent during the year on:

In cash	Yet to be paid in cash	Total
(i) Construction/acquisition of any asset		
(ii) On purposes other than (i) above		

The above disclosure, to the extent relevant, may also be made in the notes to the cash flow statement, where applicable.

- (c) Details of related party transactions, e.g., contribution to a trust controlled by the company in relation to CSR expenditure as per Accounting Standard (AS) 18, Related Party Disclosures.
- (d) Where a provision is made in accordance with paragraph 8 above the same should be presented as per the requirements of Schedule III to the Companies Act, 2013. Further, movements in the provision during the year should be shown separately.

## 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 para9.5.1.3 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 para9.5.1.2 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

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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 Schedule III. 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 Schedule III, 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 Schedule III 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

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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 Note5(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 Schedule III. 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.

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**11.3.11** As regards spare parts, the substantive requirement of Schedule III (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 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 [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 thereof.

## 13 Consolidated Financial Statements

The Companies Act 2013 has mandated that the companies which have one or more subsidiaries / associates (which as per the Act includes joint ventures) are required to prepare Consolidated Financial Statements, except under certain circumstances exempted under the Act and Rules.

The companies are expected to prepare the standalone financial statements and in addition prepare the consolidated financial statements also.

Schedule III provides for general instructions in regard to the preparation of consolidated financial statements. This is a new addition brought in under Companies Act 2013.

### 13.1. General requirement

Where the company is required to prepare consolidated financial statements, the company shall *mutatis mutandis* follow the requirements of Schedule III for the standalone financial statements. This means that all the reporting requirements of the Schedule III need to be aggregated and reported for the group as a whole in the consolidated financial statements.

This would also indicate the need to obtain such information for all the subsidiaries / associates of the consolidated financial statements, including where such subsidiaries / associates are not audited under the Companies Act 2013.

However, due note has to be taken of the fact that the Schedule III itself states that the provisions of the schedule are to be followed *mutatis mutandis* to a consolidated financial statement. MCA has also clarified vide General Circular No. 39 / 2014 dated 14<sup>th</sup> October 2014 that Schedule III to the Act read

with the applicable Accounting Standards does not envisage that a company while preparing its CFS merely repeats the disclosures made by it under stand-alone accounts being consolidated. Accordingly, the company would need to give all disclosures relevant for CFS only.

In this context, the requirements of Schedule III shall apply to a CFS, subject to the following exemptions / modifications based on the relevance to the CFS:

Schedule III Requirement	Applicability to CFS (if left blank, is applicable, as it is)
Share capital – authorized, issued, subscribed and paid up	It is adequate to present paid up capital and any calls in arrears Note: It has no relevance in the CFS context.
Capital reserve or goodwill arising on consolidation	Needs to be shown as a separate line item on the face of the Balance Sheet Note: IFRS / Ind AS does not require this to be stated separately. However, as per AS, differing treatment is given to goodwill arising on amalgamation and goodwill arising on consolidation and even SEBI format requires this to be separately disclosed.
<p>(a) 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.</p> <p>(b) 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</p> <p>(c) 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</p> <p>(d) Where in respect of an issue</p>	On all these items, disclosure can be limited to those which are material to the CFS; materiality could be considered at 10% of the respective balance sheet item

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<p>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</p> <p>Note: This item is required to be disclosed even if it is exempted as per AS- 21 by keeping it here, as it is only reinforcing the regulatory requirement for reporting – what is required by AS 21 cannot override regulatory requirements</p>	
<p>Application money received for allotment of securities and due for refund and interest accrued thereon. Share application money includes advances towards allotment of share capital. The terms and conditions including the number of shares proposed to be issued, the amount of premium, if any, and the period before which shares shall be allotted shall be disclosed. It shall also be disclosed whether the company has sufficient authorized capital to cover the share capital amount resulting from allotment of shares out of such share application money. Further, the period for which the share application money has been pending beyond the period for allotment as mentioned in the document inviting application for shares along with the reason for such share application money being pending shall be disclosed. Share application money not exceeding the issued capital and to the extent not refundable shall be</p>	<p>Separate notes should be given for such monies due outside the group in respect of entities which are consolidated.</p>

<p>shown under the head Equity and share application money to the extent refundable i.e., the amount in excess of subscription or in case the requirements of minimum subscription are not met, shall be separately shown under 'Other current liabilities'</p>	
<p>Requirement to disclose excise duty separately</p>	<p>To be disclosed where such information is available for the entities consolidated.</p> <p>Note: Though AS 9 states excise to be shown separately, where subsidiaries are not disclosing it, it would not be practical and also no benefit is derived by disclosure of this.</p>
<p>(a) Payments to the auditor 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</p> <p>(b) In case of Companies covered under section 135, amount of expenditure incurred on corporate social responsibility activities</p> <p>(c) Raw materials under broad heads</p> <p>(d) goods purchased under broad heads</p> <p>(e) In the case of trading companies, purchases in respect of goods traded in by the company under broad heads</p> <p>(f) In the case of companies rendering or supplying services, gross income derived from services rendered or supplied under broad heads</p> <p>(g) In the case of a company, which falls under more than one of the categories</p>	<p>Not relevant at CFS level and hence, may be dispensed with</p>

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<p>mentioned in (a), (b) and (c) above, it shall be sufficient compliance with the requirements herein if purchases, sales and consumption of raw material and the gross income from services rendered is shown under broad heads</p>	
<p>(h) In the case of other companies, gross income derived under broad heads</p> <p>(i) In the case of all concerns having works in progress, works-in-progress under broad heads</p> <p>(j) Value of imports calculated on C.I.F basis by the company during the financial year in respect of</p> <ul style="list-style-type: none"><li>(i) Raw materials</li><li>(ii) Components and spare parts</li><li>(iii) Capital goods</li></ul> <p>(k) Expenditure in foreign currency during the financial year on account of royalty, know-how, professional and consultation fees, interest, and other matters</p> <p>(l) 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</p>	<p>Not relevant at CFS level and hence, may be dispensed with</p>
<p>(m) The amount remitted during the year in foreign currencies on account of dividends with a</p>	<p>Not relevant at CFS level and hence, may be dispensed with</p>

<p>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</p> <p>(n) Earnings in foreign exchange classified under the following heads, namely:</p> <p>(i) Export of goods calculated on F.O.B. basis</p> <p>(ii) Royalty, know-how, professional and consultation fees</p> <p>(iii) Interest and dividend</p> <p>(iv) Other income, indicating the nature thereof</p>	
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### 13.2. Accounting Standards

The Consolidated Financial Statements shall also disclose the information as required under the various accounting standards applicable.

### 13.3. Minority Interest

Profit or loss attributable to “minority interest” shall be shown as an allocation for the period in the statement of profit and loss.

In the Balance Sheet, “minority interest” shall be presented within equity separately from equity of the owners of the parent.

### 13.4. Additional information on the entities included in the consolidated financial statements

Schedule III requires specific disclosure of additional information on the entities which are included in the consolidated financial statement in the following format.

Name of the entity in	Net Assets i.e., total assets minus total liabilities		Share in profit or loss	
	As % of Consolidated net assets	Amount	As % of Consolidated profit or loss	Amount
1	2	3	4	5
Parent				
Subsidiaries				
Indian				
1				
2				

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3				
...				
.....				
Foreign				
1				
2				
3				
...				
.....				
Minority interest in all subsidiaries Associates (Investment as per equity method)				
Indian				
1				
2				
3				
...				
...				
Foreign				
1				
2				
3				
...				
.....				
Joint Ventures (as per proportionate consolidation/ Investment as per equity method)				
1				
2				
3				
...				
.....				
Foreign				
1				

2				
3				
...				
.....				
TOTAL				

In this context, it needs to be considered that in order to ensure that the total can be matched with the reported profits and net assets in the consolidated financial statements, the inter company eliminations needs to be adjusted to the respective entities which are part of the consolidated financial statements. This would require management to take judgements as to which entity the profit element and inter company balances are to be adjusted from in providing for an entity wise break up of net profits and net assets.

### 13.5. Entities not consolidated

Entities which are not covered in the consolidated financial statement, whether subsidiaries, associates or joint ventures are to be listed in the consolidated financial statement along with the reasons for not consolidating such entities. This requirement is also in line with the requirements of the accounting standard on consolidated financial statements.

### 13.6 Comparative figures

Schedule III states that except for the first financial statements prepared by a company after incorporation, presentation of comparative amounts is mandatory. Schedule III however, clarifies that in case of any conflict between Accounting Standards and Schedule III, Accounting Standards will prevail over the requirements of Schedule III. The transitional provisions of AS 21 exempt presentation of comparative numbers in the first set of consolidated financial statements prepared, even by an existing group. Hence, an existing group preparing consolidated financial statements for the first time under AS 21, need not present comparative information.

### 13.7 Definition of terms relevant for consolidation

The terms "Control", "Subsidiary" and "Associate" are defined very differently in the Companies Act as compared to definition in Accounting Standards. Rule 6 of the Companies (Accounts) Rules however states that consolidated financial statements shall be prepared in accordance with the provisions of Schedule III of the Act and the applicable accounting standards. Accordingly, for removal of all doubts it is hereby clarified that for the purposes of preparing consolidated financial statements, the definitions of the above terms as given in Accounting Standards should be followed.

**Note:** Schedule III to the Companies Act, 2013 is annexed at the end of Module-I.