

## Query No. 17

**Subject:** *Amortisation of expenses incurred on various business requirements at the time of formation.*<sup>1</sup>

### A. Facts of the Case

1. A company was incorporated under the Companies Act in July, 2015 as a Government company. The company was registered with Securities and Exchange Board of India (SEBI) as an asset management company and guided by SEBI (Alternate investment Funds) Regulations, 2012. The company is primarily engaged in the business of asset management in the infrastructure sector. As on 31<sup>st</sup> March, 2016, its authorised share capital was ₹ 100 crore (10,00,000 equity shares of ₹ 1000/- each); and issued, subscribed and paid-up capital was ₹ 16 crore (1,60,000 equity shares of ₹1000 /- each).

2. During November 2015, the company incurred an expenditure of ₹ 92.92 lakh as preliminary expenses which included the following:

Registrar of Companies (ROC) fee (for authorised share capital of ₹ 100 Crore)	₹ 76, 33,920
Professional fee paid	₹ 12, 97,459
Preliminary expenses paid to lawyers and accountants	₹ 3, 61, 073
Total expenditure involved	<u>₹ 92, 92, 452</u>

3. Thus, the expenditure under the above head consists of mainly ₹ 76.33 lakh towards fee for ROC and other professional fees paid. According to the querist, the ROC fee is variable and would have been much less if the company had proposed for a lesser authorized capital. The amount was classified under 'Preliminary Expenses' and shown under 'Current Assets'.

4. The querist has stated that considering the nature of expenditure, the company decided to amortise the preliminary expenses over five years and show the unamortised expenses of ₹74.33 lakh under 'Current Assets'. An amount of ₹ 18.58 lakh was charged off (being one fifth) in the first accounts of the company during the financial year 2015-16. The reasons considered by the company for amortising the expenses are quoted below:

“The expenditure of ₹ 92.92 lakh consists mainly of fee paid to Ministry of Corporate Affairs. It is classified under 'other current assets' and not under 'Intangible Assets'. This huge expenditure would not have been incurred, had the company not issued shares with authorised capital of ₹ 100 crore. Hence, the expenditure was solely incurred in connection with issue of shares. It is also noted that under paragraph 8.7.4 in Guidance Note issued in December 2011 on the revised Schedule VI, it was suggested that there is no dispute on the treatment of share issue expenses as 'Other Current Assets' to be amortised over 5 years”.

<sup>1</sup> Opinion finalised by the Committee on 23.8.2017.

5. While conducting supplementary audit under section 143(6)(b) of the Companies Act, 2013, the government auditors from Comptroller & Auditor General of India (C&AG) opined that the above mentioned expenditure is in the nature of preliminary expenses and should be charged off in the same year of incidence.

*The preliminary comments of the Accountant General are quoted below:*

“The head includes preliminary expenses of ₹ 74, 33,962 being the expenses incurred prior to incorporation for the purpose of formation of the company. As per Accounting Standard (AS) 26, ‘Intangible Assets’ (under paragraph 56), ‘preliminary expenses incurred in establishing a legal entity such as legal and secretarial cost, expenses to open a new facility or business’ needs to be recognised as an expense when it is incurred. Omission to write off the preliminary expenses incurred prior to incorporation for the purpose of formation of the company resulted in overstatement of the head by ₹ 74,33,962.”

6. *The company contested the audit suggestion on the following grounds:*

“The expenditure of ₹ 74.34 Lakhs (unamortized portion) consists mainly of fee paid to Ministry of Corporate Affairs. It is classified under other current assets and not under intangible assets. Hence, guidelines quoted by Government auditors under AS 26 are not applicable for this asset. This huge expenditure would not have been incurred, had the company not issued shares with authorised capital of ₹ 100 Crore. The expenditure was solely incurred in connection with issue of shares.

As per paragraph 8.7.4 of the Guidance Note on Revised Schedule VI to the Companies Act, 1956, issued by the Institute of Chartered Accountants of India (ICAI), “share issue expenses, discount on shares, ancillary costs-discount-premium on borrowing, etc., being special nature items are excluded from the scope of AS 26 *Intangible Assets* (Para 5). Keeping this in view, certain companies have taken a view that it is an acceptable practice to amortize these expenses over the period of benefit, i.e., normally 3 to 5 years. The Revised Schedule VI does not deal with any accounting treatment and the same continues to be governed by the respective Accounting Standards/practices. Further, the Revised Schedule VI is clear that additional line items can be added on the face or in the notes. Keeping this in view, entity can disclose the unamortized portion of such expenses as “Unamortized expenses”, under the head “other current/ non-current assets”, depending on whether the amount will be amortized in the next 12 months or thereafter”.

Accordingly, the company has amortised one fifth of the preliminary expenses in the first year and shown the balance unamortised amount under ‘Other current Assets’ in the balance sheet.

7. In response to the above views of the company, the government auditors opined that the fee paid is not in the nature of share issue expenses and can only be termed as preliminary expenses. Their further opinion on the issue was made on the following grounds:

“However, as per the Guidance Note on Terms Used in Financial Statements, issued by the Institute of Chartered Accountants of India (ICAI), share issue expenses means “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”. Therefore, fee paid for authorised share capital is not covered in the definition of ‘share issue expenses’. *Further, as the shares can be issued only after incorporation of the company, the Memorandum of Association fees on authorized share capital incurred in connection with the incorporation of the company are not in the nature of share issue expenses but pre-operative costs incurred for establishing the legal entity.*

Therefore, the entire amount of preliminary expenses of ₹ 92.92 lakh incurred should have been fully recognised as an expense in the statement of profit and loss”. (Emphasis supplied by the querist.)

8. The opinion of the government auditors is not acceptable to the company on the grounds quoted below:

“The preliminary expenditure under question includes mainly fees paid to Ministry of Corporate Affairs. AS 26 applicable to intangible assets is not applicable in the instant case, as the expenditure has been treated as share issue expenses, and hence classified as current assets to be amortised over a period of 5 years as stated under the paragraph 8.7.4 of Guidance Note on Revised Schedule VI to the Companies Act, 1956, issued by the Institute of Chartered Accountants of India (ICAI), issued in December 2011. It is also noted that there is no dispute on the treatment of share issue expenses as ‘Other Current Assets’ to be amortised over 5 years, but the moot point is only whether the higher ROC fees for authorized capital (during the initial setting up itself) can be classified as share issue expenses. In this regard the government auditor had quoted the Guidance Note on Terms Used in Financial Statements, issued by the ICAI (1983), Share Issue Expenses means “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”. Therefore, auditor quoted that the fee paid for Authorized Share Capital is not covered in the definition of ‘Share Issue Expense’.

It is clarified that the Guidance Note, which is non-mandatory is only clarificatory. Further, it uses the term “includes” which indicates that the definition given is not necessarily comprehensive. As regards the contention that it is a necessary expense for incorporation and therefore, part of preliminary expenses, it is clarified that such necessary expenses should be fixed and immutable and not such expenses which vary as per a scale. For instance, the company could have served its objects with a lower capital requiring lower MOA fee as per regulatory requirements, but chose to pay higher fees for higher authorised share capital with a view to capture higher credibility to its operations in the minds of probable investors to the ‘Infrastructure Fund’ proposed to be set up by the company. Therefore, such expenses display a greater

nexus to the 'share issue' rather than mandatory incorporation expenses, in our opinion.

The following submissions are also made. While releasing the above terms in 1983, the ICAI preface contained, inter alia, the following statements:

“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.”

Thus the definition was provided as guidance 33 years back and not purported to provide a comprehensive dictionary. Further, the operations of the Ministry of Corporate Affairs have taken complete changes during last decades and the accounting also involves various changes with reference to various new types of fees levied and expenses involved.

It is also submitted that the ICAI, while releasing the above terms, also stated, inter alia, as follows:

“Over a period of time, many of the terms included in the guidance note may become obsolete; connotation of many others may undergo considerable change”.

Hence, it is submitted that the above expenditure cannot be treated as intangible asset.

It is also pointed out that the Guidance Note issued in 1983 was in the context of both preliminary expenses and share issue expenses being amortised over more than one accounting period and therefore the distinction was not overly significant. However in the context of changes brought by AS 26 issued in 2002, the connotations have indeed changed, as reflected in the Guidance Note.

Further, with reference to the second part of the comment, suggesting that the fees paid to the Ministry are of the nature of pre-operative cost, it is submitted that the relevant expenses are related to the value of shares and vary accordingly. It cannot be termed as pre-operative expense. For establishing a legal entity, much lesser expenses would have been sufficient. Taking into consideration various aspects, the company decided to classify the expenditure as other current assets and amortise over a period of five years.”

## **B. Query**

9. Under this background, the company has sought the opinion of the Expert Advisory Committee of the ICAI as to whether under the given circumstances, the company can amortise the expenses, mainly relating to fee paid to the Ministry of Corporate Affairs and incidental legal fee, professional fee etc. paid at the time of formation.

## **C. Points considered by the Committee**

10. The Committee notes that the basic issue raised in the query relates to whether the company can amortise the expenses, mainly relating to fee paid to the Ministry of Corporate Affairs and incidental legal fee, professional fee etc. paid in connection with authorized capital at the time of formation of the company. Accordingly, the Committee has examined only this issue and has not examined any other issue arising from the Facts of the Case, such as, accounting for expenses incurred on allotment and other share issue expenses, etc. Further, the opinion of the Committee expressed, hereinafter, is only from accounting point of view and not from legal viewpoint. The Committee also wishes to point out that since financial year 2015-16 has been referred to by the querist in the extant case, the opinion expressed hereinafter, is in the context of Accounting Standards, notified under the Companies (Accounting Standards) Rules, 2006 and not in the context of Indian Accounting Standards (Ind ASs).

11. The Committee has first analysed that which expenses can be termed as 'share issue expenses'. In this respect, the Committee notes paragraph 5 of Accounting Standard (AS) 26, 'Intangible Assets', notified under the Companies (Accounting Standards) Rules, 2006 (as reproduced in paragraph 4 above), which states that this Standard does not apply to accounting for share issue expenses. The term 'share issue expenses', however, has not been defined in AS 26. The Committee further notes that the term has been defined in the Guidance Note on Terms Used in Financial Statements which provides as under:

“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.”

From the above, the Committee notes that although this definition is an inclusive definition but it specifically states that share issue expenses are costs incurred in *connection with the issue and allotment of shares*.

12. The Committee notes that the querist has argued that the expenditure of ₹ 92.92 lakh mainly includes ₹ 76.33 lakh towards fee for ROC and other professional fees paid and the ROC fees being variable, would have been much less if the company had proposed for a lesser authorized capital. Hence, the expenditure was solely incurred in connection with issue of shares.

The Committee is of the view that registration of authorised share capital is a necessary step to set a limit for the paid up capital of a company at any given point of time and cannot be termed as 'share issue expense'. Issuance of shares is a separate independent process subsequent to the registration of authorised capital and the same can be done at a later stage as well.

13. As regards accounting for the expenses incurred on ROC Fees, Professional fees and preliminary expenses paid to lawyers, the Committee notes the following paragraphs of AS 26:

**“6.2 An asset is a resource:**

- (a) controlled by an enterprise as a result of past events; and**
- (b) from which future economic benefits are expected to flow to the enterprise.”**

“56. In some cases, expenditure is incurred to provide future economic benefits to an enterprise, but no intangible asset or other asset is acquired or created that can be recognised. In these cases, the expenditure is recognised as an expense when it is incurred. For example, expenditure on research is always recognised as an expense when it is incurred (see paragraph 41). Examples of other expenditure that is recognised as an expense when it is incurred include:

- (a) expenditure on start-up activities (start-up costs), unless this expenditure is included in the cost of an item of fixed asset under AS 10. Start-up costs may consist of preliminary expenses incurred in establishing a legal entity such as legal and secretarial costs, expenditure to open a new facility or business (pre-opening costs) ...”

From the above paragraphs of AS 26, the Committee notes that if expenditure does not result into acquisition of an asset, it should be recognised as an expense as and when incurred. The Committee also notes that the amount spent towards ROC Fees, professional fees and legal expenses paid to lawyers, does not give rise to any *resource controlled* by the enterprise. In fact, such expenses are in the nature of start-up costs/preliminary expenses, which are only related to incorporation of the company and set a limit for the issued/paid-up capital of the company which does not ensure any flow of funds to the company. Accordingly, it does not meet the definition of an asset (either an intangible or current asset), as reproduced above. Thus, the amount aggregating to ₹ 92.92 lakh incurred towards ROC Fees, professional fees and legal expenses should be recognised as expense in the statement of profit and loss as per the requirements of paragraph 56 of AS 26.

#### **D. Opinion**

14. On the basis of the above, the Committee is of the opinion that the expenditure incurred by the company relating to fee paid to the Ministry of Corporate Affairs and incidental legal fee, professional fee etc. paid at the time of formation cannot be considered as share issue expenses and should be treated as expense and charged off in the statement of profit and loss, as discussed in paragraphs 12 and 13 above.