Advanced Accounting

DEACC312

Edited by:
Dr. Nancy Saini

LOVELY
PROFESSIONAL
UNIVERSITY

Advanced Accounting

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Unit 01: AS 7:Construction Contracts

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Objectives

After studying this unit, you will be able to:

- Recognize revenue and costs of Construction contracts
- Recognizing expected losses from Construction contracts
- Disclosure practices for Construction contracts.

Introduction

The accounting method for the revenue and expenditures associated with a construction contract is described and laid out in AS 7 Construction Contract. The accounting of construction contracts in the contractors' financial statements must follow AS 7 Construction Contract. This Standard's goal is to specify how revenue and expenses related to building contracts should be treated in accounting. The dates at which the contract activity is commenced and the dates at which the activity is concluded typically fall into separate accounting periods due to the nature of the activity done in construction contracts. The allocation of contract revenue and contract costs to the accounting periods in which construction work is completed is therefore the key concern in accounting for construction contracts. When contract revenue and contract costs should be recognised as revenue and expenses in the statement of profit and loss, this Standard employs the recognition criteria outlined in the Framework for the Preparation and Presentation of Financial Statements. It also offers helpful advice on how to put these standards into practise.

1.1 Scope

The accounting for building contracts in contractors' financial statements should follow this Standard.

1.2 Definition of Construction Contract

For the construction of a single asset, such as a bridge, building, dam, pipeline, road, ship, or tunnel, a construction contract may be negotiated.

Such contracts include those for the construction of refineries and other sophisticated pieces of machinery or equipment. A construction contract may also deal with the construction of a number of assets that are closely related or interdependent in terms of their design, technology, and function or their ultimate purpose or use.

For the purposes of this Standard, "construction contracts" refer to:

(a) agreements for the provision of services directly related to the creation of the asset, such as those for project managers' and architects' services; and

(b) agreements for the destruction or restoration of assets, as well as the cleanup after their demolition.Construction contracts are formulated in a number of ways which, for the purposes ofthisStandard,areclassifiedasfixedpricecontractsandcostpluscontracts.

Some construction contracts, such as cost plus contracts with agreed-upon maximum prices, may have elements of both a fixed price contract and a cost plus contract. In these situations, a contractor must take into account all the circumstances to decide when to recognise contract revenue and expenses.

1.3 CombiningandSegmentingConstructionContracts

Each construction contract typically receives a distinct application of the standards of this Standard.

To represent the substance of a contract or group of contracts, it may be necessary in some cases to apply the Standard to each separately identifiable component of a single contract or to a group of contracts as a whole.

When a contract covers several assets, the building of each asset should be classified as a separate construction contract if:

- distinct offers have been filed for each asset;
- Each asset has been the topic of a separate discussion, and the contractor and client have had the option of accepting or rejecting the contract provision relating to each asset.
- Additionally, each asset's expenses and revenues can be determined.

When a group of contracts—whether with one customer or many—are negotiated as a single package, when they are so intricately linked that they effectively form one project with a profit margin, and when they are carried out concurrently or in a continuous sequence, they should be treated as one construction contract.

At the customer's discretion, a contract may either stipulate that an additional asset will be built, or it may be modified to do so.

When the additional asset differs significantly from the asset or assets covered by the original contract in terms of design, technology, or function, or when the price of the asset is negotiated without taking the original contract price into consideration, the construction of the additional asset should be treated as a separate construction contract.

1.4 ContractRevenue

Contract revenue should consist of the following:

a. the initial sum of revenue agreed upon in the contract; and
b. variations in contract work, claims, and incentive payments:
    - to the extent that they are likely to result in revenue; and
    - to the extent that they are able to be measured with accuracy.

The consideration received or receivable is used to calculate contract revenue. Several uncertainties that depend on how future events turn out have an impact on how contract revenue is measured. As events take place and uncertainties are cleared out, the estimates frequently need to be changed. As a result, from one period to the next, the contract revenue amount may go up or down. For instance,

1. contractor and a customer may agree to changes or claims that affect the amount of revenue under a contract in a period after the agreement of the contract;
2. cost escalation clauses may cause the revenue under a fixed price contract to increase;
3. penalties resulting from the contractor's delays in contract fulfilment could cause the amount of contract revenue to decrease; or
4. Contract revenue rises as the number of units increases when a fixed price contract includes a fixed price per unit of output.

A variation is a request by the client to alter the nature of the work to be done in accordance with the contract. Contract revenue may rise or fall as a result of a variance. Changes in the asset's specs or design as well as adjustments to the contract's duration are two examples of modifications. When both

1. it is likely that the customer will approve the variation and the amount of revenue resulting from the variation and
2. the revenue can be accurately recorded, a variation is included in contract revenue.

If certain performance standards are fulfilled or exceeded, the contractor may get additional payments known as incentive payments. For instance, a contract may stipulate that the contractor will get an incentive payment if the work is finished earlier than expected.

1. When a contract is far enough along that it is likely that the performance standards stated will be fulfilled or surpassed, and when
2. the amount of the incentive payment can be determined accurately, incentive payments are included in contract revenue.

1.5 ContractCosts

Contract costs should include the following:

1. expenses directly related to the particular contract;
2. expenses generally due to contract activity that can be allocated to the contract; and
3. any additional expenses that are expressly chargeable to the customer under the terms of the contract.

Costs that relate directly to a specific contract include:

1. site labour costs, including site supervision;
2. costs of materials used in construction;
3. depreciation of plant and equipment used on the contract;
4. Costs of transporting plant, equipment, and materials to and from the contract site;
5. costs of hiring plant and equipment;

6. costs of directly related design and technical assistance;
7. estimated costs of warranty and rectification work;
8. and claims from third parties.

Any incidental income that is not included in contract revenue, such as income from the sale of excess materials and the disposal of plant and equipment at the conclusion of the contract, may be used to offset these costs.

Any incidental income that is not included in contract revenue, such as income from the sale of excess materials and the disposal of plant and equipment at the conclusion of the contract, may be used to offset these costs.

Insurance, design and technical support costs that are not directly tied to a specific contract, construction overhead costs, and other expenses are examples of expenditures that may be attributed to contract activity in general and can be allocated to specific contracts.

Such costs are assigned using rational, systematic approaches that are consistently applied to all costs with comparable features. The distribution is determined by the average volume of construction activity. Costs for things like payroll preparation and processing are included in construction overheads. According to Accounting Standard (AS) 16, Borrowing Costs, costs that can be attributed to contract activity in general and individual contracts are also included.

Some general administrative expenditures and development costs, for which compensation is stipulated in the contract's terms, may be directly billed to the client under the terms of the agreement.

The costs of a construction contract do not include expenses that cannot be ascribed to contract work or assigned to a contract.

These expenses include

1. general administrative costs for which no reimbursement is provided in the contract;
2. selling costs;
3. costs associated with research and development for which no reimbursement is provided in the contract; and
4. depreciation of idle plant and equipment that is not used on a specific contract.

Costs associated with contracts are those incurred during the time from the time they are secured until they are fully completed.

However, if they can be reliably identified and quantified independently and it is likely that the contract will be achieved, costs that are directly related to a contract and that are incurred in securing the contract are also included as part of the contract costs.

Costs associated with securing a contract that are acknowledged as expenses in the period in which they are incurred are not counted against contract costs when the contract is eventually secured.

1.6 RecognitionofContractRevenueandExpenses

1. When the outcome of a construction contract can be estimated reliably
2. When the outcome of a construction contract can not be estimated reliably

1. When the outcome of a construction contract can be estimated reliably:

Contract income and contract costs related to the construction contract should be recorded as revenue and expenses, respectively, by reference to the state of completion of the contract activity at the reporting date, when the outcome of the construction contract can be fairly predicted. According to paragraph 35, an anticipated loss on the building contract must be immediately recorded as an expense.

When all of the following conditions are met in the event of a fixed price contract, the result of a construction contract can be reasonably estimated:

In order to compare actual contract costs incurred with prior estimates, it is necessary to meet the following criteria:

a. the total contract revenue can be measured reliably;
b. it is likely that the enterprise will benefit economically from the contract;
c. both the contract costs to complete the contract and the stage of contract completion at the reporting date can be measured reliably; and
d. the contract costs attributable to the contract can be clearly identified and measured reliably.

In the case of a cost plus contract, the outcome of a construction contract can be reliably predicted when all the prerequisites are met:

a. it is likely that the contract's economic benefits will accrue to the business;
b. and the contract costs attributable to the contract, whether or not they are specifically reimbursable, can be reliably identified and measured.

The percentage of completion approach refers to the recognition of revenue and expenses in relation to the degree of contract completion.

- This approach results in the reporting of revenue, expenses, and profit that may be linked to the percentage of work done by matching contract revenue with contract costs expended in getting to the point of completion.
- This method offers helpful data on the volume of contract activity and performance over a given time frame.
- Contract revenue is recognised as revenue in the statement of profit and loss during the accounting periods in which the work is completed according to the percentage of completion method.
- Typically, contract costs are recorded as an expense in the statement of profit and loss throughout the accounting periods during which the related work is completed.
- Any anticipated difference between total contract expenses and total contract revenue for the contract, however, is immediately recognised as an expense.
- Costs related to upcoming work on a contract may have been incurred by a contractor. If it is likely that the contract costs will be repaid, they are recorded as an asset.
- These expenses are frequently categorised as contract work in progress and represent a sum that the customer owes.
- The uncollectable amount or the amount for which recovery is no longer likely is recognised as an expense rather than as an adjustment to the amount of contract revenue when there is a question about the collectability of an amount already included in contract revenue and already recognised in the statement of profit and loss.
- After agreeing to a contract that outlines each party's enforceable rights about the asset to be built, the consideration to be traded, and the method and circumstances of settlement, an organisation is typically able to provide accurate estimates.
- The enterprise typically has to have a strong internal financial budgeting and reporting system. if the contract develops, the enterprise evaluates and, if appropriate, updates the estimates of contract revenue and contract costs. The need for such adjustments does not always mean that the contract's conclusion cannot be accurately predicted.
- A contract's progress towards completion can be assessed in a number of ways. The approach that accurately measures the work completed is used by the company. The methods may include
  a. the ratio of contract costs incurred for work completed up until the reporting date to the estimated total contract costs;

b. surveys of work performed; or

c. the physical completion of a portion of the contract work, depending on the nature of the contract.

- Customers' advances and progress payments may not always accurately reflect the work done.
- Only those contract expenses that indicate work accomplished are included in costs incurred up until the reporting date when the level of completion is defined by reference to the contract costs incurred up until the reporting date.
- Contract costs that relate to future activity on the contract, such as costs of materials delivered to a contract site or set aside for use in a contract but not yet installed, used, or applied during contract performance, are examples of contract costs that are excluded. This is true even if the materials were made specifically for the contract.
- Another example is payments made to subcontractors in advance of work done under the subcontract.

1. Whentheoutcomeofaconstructioncontractcannotbeestimatedreliably:

- Only contract costs that are incurred and are likely to be recovered should be reported as revenue; and
- Contract costs need to be recorded as an expense as soon as they are incurred.
- an anticipated loss on the building contract must be immediately recorded as an expense.

It frequently happens that the outcome of a contract cannot be accurately predicted in its early phases. Even yet, it's possible that the company will be able to recoup the costs associated with the deal. As a result, contract revenue is only recorded to the extent that costs incurred are anticipated to be recouped. No profit is recognised since a reliable forecast of the contract's conclusion is impossible. Even Nevertheless, it may be likely that overall contract expenditures will surpass total contract revenues even though the contract's conclusion cannot be reliably predicted. Any anticipated difference between the total contract costs and the total contract revenue in such circumstances is immediately recognised as an expense .

Contract costs whose recovery is unlikely are acknowledged as expenses right away.

Contracts that

1. are not fully enforceable, meaning their validity is seriously questioned;
2. are subject to the outcome of pending litigation or legislation;
3. relate to properties that are likely to be condemned or expropriated; and
4. are contracts in which the recovery of contract costs incurred may not be probable; in such cases, contract costs may need to be recognised as an expense immediately.

Revenue and expenses related to the construction contract should be recognised rather than paragraph 31 after the uncertainties that prohibited the outcome of the contract from being accurately estimated have been eliminated.

1.7 Recognising Expected Losses

The predicted loss should be reported as an expense right away when it is likely that total contract costs will exceed total contract revenue.

Whether or not work has started on the contract has no bearing on how much of a loss is incurred;

1. the amount of profits anticipated to result from other contracts that are not handled as a single construction contract in line with paragraph 8;
2. the stage of contract activity completion; or
3. the stage of contract activity.

1.8 Adjustments to Estimates

- The current estimations of contract revenue and contract costs are cumulatively subjected to the percentage of completion method each accounting quarter.
- As a result, the impact of a change in the estimated contract revenue, costs, or outcome is recorded as a change in accounting estimate (see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items, and Changes in Accounting Policies).
- The amount of revenue and expenses recorded in the statement of profit and loss for the period in which the adjustment is made as well as for subsequent periods is determined using the revised estimates.

1.9 Disclosures

The following information should be disclosed by an organisation:

- the amount of contract income recognised as revenue in the period;
- the techniques used to calculate the contract revenue recognised in the period; and
- the techniques used to identify the stage of completion of contracts that are still in progress.

For contracts that are active as of the reporting date, an organisation must provide the following information:

(a) total expenditures expended, total profits realised (less losses recognised),

(b) total advances received, and

(c) total retentions.

Retentions are portions of progress billings that are withheld until the fulfilment of requirements outlined in the contract for their payment or until flaws have been fixed.

Progress billings are charges for work completed under a contract, whether or not the customer has paid for it. Advances are sums given to the contractor prior to starting the relevant work.

The gross amount owed to consumers for contract work should be shown as a liability, while the gross amount owed to customers from the enterprise should be shown as an asset.

The gross amount due from customers for contract work is the net amount of:

- costs incurred plus recognised profits; less
- the sum of recognised losses and progress billings

for all contracts in progress for which costs incurred plus recognised profits (less recognised losses) exceeds progress billings.

According to Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date 2, an organisation must disclose any uncertainties. Contingencies could result from things like warranty expenses, fines, or potential losses.

1.10 Examples

Example on DisclosureofAccountingPolicies

1. Construction contracts with fixed prices are subject to revenue recognition using the percentage of completion approach, which compares the labour hours used up through the reporting date to the expected total work hours for each contract.
2. Costs incurred up until the reporting date are compared to the expected total costs of the contract, and the revenue from cost plus contracts is calculated by adding the recoverable costs incurred during the period and the fee obtained.

Summary

Any contract that is put into especially for the building of an asset or group of assets that are closely interconnected or interdependent in terms of their technology, design, function, or nature of its final use is referred to as a construction contract.Fixed Price Agreement is an agreement wherein the contractor consents to a set contract price. In rare circumstances, the parties may agree to include a language in the contract that addresses cost escalation. As an illustration, the parties concur to include a language in the contract allowing for price adjustments based on increases in the cost of raw materials.Cost-plus In a contract, the contractor is paid back for expenses incurred or agreed upon together with a specified proportion of those expenses.When a construction contract's result or outcome may be predicted, the contract's revenue and costs must be recognised while taking into account the contract's state of completion. Expected losses must be immediately recorded as costs.

Keywords

- **Construction contract**: A construction contract is a legal agreement that is particularly drafted for the building of a single item, a group of assets, or a mixture of assets that are closely related to one another in terms of their design, technology, function, or intended use.
- **Fixed price contract:** A construction contract with a fixed price is one in which the contractor accepts a set contract price, or set rate per unit of production, which occasionally includes cost-escalation clauses.
- **Cost plus contract**:Construction contracts known as "cost plus" reimburse the contractor for acceptable or otherwise specified expenditures in addition to a percentage of those costs or a set fee.

Self Assessment

1. … is a construction contract in which the contractor agrees to a fixed contract price.

A. fixed price contract
B. cost plus contract
C. escalation contract
D. variable price contract

2. … is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus percentage of these costs or a fixed fee.

A. fixed price contract
B. cost plus contract
C. escalation contract
D. variable price contract

3. Which of the following is wrong in regard to construction contracts under accounting standard 7 ?

A. constructioncontractsinclude contractsfortherenderingofserviceswhicharedirectlyrelatedtotheconstruction of the asset
B. constructioncontractsinclude contractsforcontractsfordestructionorrestorationofassets.
C. constructioncontracts does not include contractsforcontractsforrestorationoftheenvironmentfollowingthedemolitionofassets.
D. Someconstruction contracts may contain characteristics of both a fixed price contract and a costpluscontract

4. AS….describes and lays out the accounting treatment in respect of the revenue and costs in relation to a construction contract.

A. 7
B. 8
C. 9
D. 10

5. Which of the following is wrong in regard to combining and segmenting of construction contracts?

A. A series of contracts, whether with one or more customers, will be regarded as a single construction contract if they are all negotiated as a unit, connected together as a single project, and carried out sequentially.
B. When a contract covers the construction of more than one asset, each asset should be treated as a separate construction contract if separate proposals have been submitted for each asset, each asset has been negotiated separately, and each asset's costs and revenues can be identified separately.
C. An example of segregating would be a contract for the construction of three distinct buildings with distinct requirements on the same site may be negotiated with the contractor collectively for all structures taken together and not separately.
D. An example of combining would be the simultaneous negotiation of a contract for the construction of three similar structures (identical in every way) on a single site.

6. Which of the following is wrong in regard to recognition of revenue and cost from a contract?

A. When a construction contract's result or outcome may be predicted, the contract's revenue and costs must be recognised while taking into account the contract's state of completion.
B. Expected losses must not be immediately recorded as costs.
C. Revenue and costs are recorded in the statement of profit and loss for the accounting periods in which the job is completed under the percentage of completion technique.
D. A contractor may incur expenses related to upcoming work under a contract. If it is likely that these costs will be repaid, they are recognised as an asset.

7. Which of the following is wrong in regard to contracts completion stage?

A. . The percentage of contract costs that have been expended relative to the whole estimated cost of the contract; for instance, if the contract has a total cost of Rs. 30 lakhs and the costs have been incurred up to Rs. 15 lakhs, the stage of completion is regarded as 50% complete, or 15 lakhs / 30 lakhs.
B. Surveys of work completed; for instance, in a contract for bridge building, the site inspector may conduct a survey and provide information on the technical aspects of the project, such as the amount of work that has been finished.
C. Physical completion of a section of the contract work (for instance, if three stories of a five-story structure are finished, the stage of completion for that portion is recognised as 60%, or 3 stories/5 stories).
D. The income and cost should only be recognised to the extent of contract costs incurred whose recovery is likely when the outcome of a building contract can be predicted.

8. … is defined as those sums that are paid only after meeting the requirements outlined in the contract for payment of such sums.

A. Retention
B. Advance
C. Dispossess
D. Abondon

9. ….are sums given to the contractor prior to starting the relevant work.

A. Retention
B. Advance
C. Dispossess
D. Abondon

10. AS7 Requires contract revenue recognition at a:

A. value of the consideration received
B. value of the consideration not received
C. Requires contract revenue to be measured at fair value of the consideration received
D. Requires contract revenue to be measured at fair value of the consideration receivable

11. Which of the following is not a disclosures required under accounting standard 7?

A. Contract revenue recognized during the accounting period
B. the methods used to determine the contract revenue recognized in the period
C. The methods used to determine the stage of completion of contracts in progress
D. Contract revenue which could not be recognized during the accounting period

12. Which of the following is wrong in regard to recognition of expected losses?

A. The total number of such losses must be calculated regardless of Whether or not the contract's work has started
B. The total number of such losses must be calculated regardless of the degree of completion
C. The total number of such losses must be calculated regardless of the quantity of profits anticipated to result from other contracts that are segmented as previously described.
D. The total number of such losses must be calculated regardful of the degree of completion

13. When all of the following criteria are not required to be met in the case of a fixed price contract, for recognition of cost and revenue?

A. It is impossible to measure a contract's whole revenue with accuracy.
B. It is obvious that the organisation will gain financially from such a contract.
C. Contract costs and completion stage can both be gauged
D. For a comparison of actual costs and previous estimates, contract costs can be easily determined.

14. Which is the following is wrong for recognition of cost and revenue in case of a cost-plus contract?

A. the result can be estimated accurately
B. It is likely that the organisation will receive financial advantages from the contract.
C. outcome can-not be estimated in a reliable manner
D. Contract costs that are related to the contract are easily identifiable and quantified.

15. … This method records revenue and costs in the statement of profit and loss for the accounting periods during which the job is completed.

A. Percentage of completion method
B. cost-plus contract,
C. Fixed price contract
D. Contract work-in-progress

Answers for Self Assessment

1.	A	2.	B	3.	C	4.	A	5.	C
6.	B	7.	D	8.	A	9.	B	10.	A
11.	D	12.	D	13.	A	14.	B	15.	A

Review Questions

1. Write a note on recognition of revenue and cost from a contract.
2. Explain disclosures required in Punisher statements under accounting standard 7.
3. What is the treatment of recognition of expected losses on contracts?
4. What do you mean by combining and segmenting construction contracts?
5. What are different types of contracts?

Further Readings

- ICAI: Paper 5 advanced accounting
- https://cleartax.in/s/as-7-construction-contracts

Dr. Rupinder Katoch, Lovely Professional university

Unit 02: AS 14: Accounting for Amalgamation

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Summary

Keywords

Self Assessment

Answers for Self Assessment

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Objectives

After studying this unit, you will be able to:

- Recognize what a "Amalgamation" is and how it is recorded in accounting.
- Understand the distinction between the transferor company and the transferee corporation.
- Compute the purchase consideration using both amalgamation procedures in accordance with AS 14.
- Pass the entries necessary to shut the vendor company's books.
- Make the necessary journal entries in the purchasing business's books to include the assets and liabilities of the vendor company as well as to put additional modifications into action.

Introduction

We are seeing the emergence of new business concepts daily in the modern world. This has been a major contributor to the fierce growth in competition. Due to the nature of this intense competition, some cunning enterprises manage to thrive while others are completely wiped out. Similar to business startup techniques, there has been a significant rise in the understanding of the necessity of continuing in business despite various challenging market conditions. As a result, business-saving measures are becoming increasingly important in the business world. There may be a variety of measures to ensure the business's survival, or existing businesses may discover ways to grow market share by displacing rivals or to emerge from a financial crisis by reorganising their current capital structure, among other things. These tactics are referred to by various terms, such as "corporate marriages," "strategic alliances," "business partnerships," etc. The Accounting Standard 14 defines the identical concept (AS 14). We will gain a thorough understanding of the words, definitions, methodology, and accounting treatments connected to amalgamation in this chapter.

2.1 Meaning of Amalgamation

Amalgamation is the process of joining two or more businesses together to form a single entity or when one business completely buys out the other. As a result, the term "amalgamation" refers to two different types of activities: I the joining of two or more businesses to create a new business, or (ii) the absorbing and blending of one business into another.

As was previously mentioned, firms seek out this arrangement to benefit from a variety of benefits, including economies of scale that come with large-scale production, the avoidance of competition, increased efficiency, expansion, increased market share, etc.

In an amalgamation, there are typically two organisations involved: a vendor company, also known as a transferor, and a vendor company, also known as a transferee. We'll better comprehend the ideas if we use the examples below:

Example 1: Company C is formed by the merger of Companies A and B. This tactic is known as AMALGAMATION and involves Company A, Company B, and Company C as the transferor companies and Company C as the transferee company.

Example 2: Business B acquires Company A. (purchased). Company B is the transferee company in this instance, and Company A is the transferor company. This tactic is referred to as ABSORPTION.

Example 3: After five years of losses at Company A, a new Company B is floated to take over the struggling Business A. The transferor firm in this instance is Company A, while the transferee company is Company B. External reconstruction is the name given to this method.

2.2 Kinds ofAmalgamation

The Accounting Standard -14 (AS 14) on "Accounting for Amalgamations" has been released by the Institute of Chartered Accountants of India.

A true pooling of the assets and liabilities of the transferor and transferee companies, as well as the interests of the shareholders and the businesses of the companies, is what is meant by an amalgamation in the form of a merger. When such mergers are accounted for, it should be made sure that the resulting assets, liabilities, capital, and reserve statistics roughly total the figures of the transferor and transferee companies.

According to paragraph 3(e) of AS-14, an amalgamation in the form of a merger is one that meets each of the requirements listed below:

i. After merger, all of the transferor company's assets and liabilities transfer to the transferee company.
ii. By virtue of the amalgamation, shareholders who held at least 90% of the face value of the transferor company's equity shares before the merger—apart from the equity shares that the transferee company, its subsidiaries, or their nominees already held—become equity shareholders of the transferee company.
iii. The transferee company fully discharges the consideration for the merger owed to the equity shareholders of the transferor company who agree to become equity shareholders of the transferee company by issuing equity shares in the transferee company, with the exception of any fractional shares for which cash may be paid.
iv. The transferee company intends to continue the transferor company's operations following the merger.
v. Other than to ensure consistency in accounting practises, it is not intended to make any adjustments to the book values of the transferor business's assets and liabilities when they are included in the financial statements of the transferee company. For instance, if the transferor firm uses the weighted average technique to value its inventory, the book value

of that company's inventory will be amended by using the FIFO method (if the transferee company follows FIFO method for inventory valuation).

vi. A merger is referred to as a merger in the nature of purchase if one or more of the aforementioned prerequisites are not met.

2.3 PurchaseConsideration

We mostly follow AS 14, "Accounting for Amalgamations," when it comes to accounting for amalgamations. The phrase "purchase consideration" is defined as the "aggregate of the shares and other securities issued and the payment made in cash or other assets by the transferee company to the shareholders of the transferor company" in paragraph 3(g) of AS 14.

In plain English, it is the fee paid by the transferee company to the transferor company in exchange for assuming the transferor company's business.

The crucial thing to keep in mind is that according to AS-14, the amount paid to equity and preference shareholders is only taken into account as a portion of the purchase consideration. In light of this, it should be emphasised that the acquisition consideration does not include the amount that the transferee firm will pay directly to the holders of debentures or creditors of the transferor company. If the transferee company has not assumed a certain obligation of the transferor company, the transferor company will be released from that obligation.

The following techniques can be used to calculate the purchase consideration:

1. Lump money approach – Under this technique, the transferee firm agrees to pay the transferor company's shareholders a lump payment or fixed sum.

2. Net payment method - Under this method, the transferee business pays discrete payments to the equity and preference shareholders via cash, the issuance of shares, or debentures.

3. Net assets approach: Using this method, the acquisition consideration is determined by deducting the amount of the external liabilities (apart from share capital and reserves) that the transferee firm has assumed from the assets. According to AS 14, the value of the assets and liabilities must match the value that the two parties have agreed upon. Assets and liabilities are considered at book value if there is no agreed upon value.

The fair worth of each of its components largely determines the purchasing consideration. For instance, the value set by the statutory body may be regarded as the fair value when the consideration consists of securities. For other assets, the fair value may be calculated using the market value of the assets forfeited, or in the absence of a market value, the assets' net book value (i.e., cost less accrued depreciation) may be taken into account.

4. Share exchange or intrinsic value technique - With this approach, the purchase consideration is determined by the intrinsic worth of the transferor's or transferee's company's shares. Calculating the ratio of shares to be issued and multiplying it by intrinsic value. Divide the entire number of shares by the transferor company's total share capital.

In some cases, the purchase consideration may need to be adjusted in light of one or more potential future events. The additional payment should be factored into the purchase consideration calculation if it is probable and can be predicted fairly.

The companies may determine the acquisition consideration using any of the aforementioned approaches or a combination of the aforementioned ways.

The following examples provide explanations of the aforementioned techniques.

Example:

I On April 10, 20X1, Y Ltd. acquires control of X Ltd.

(ii) Y Ltd. releases the holders of X Ltd.'s debentures at a 10% premium by issuing 15% of its own debentures.

(iii) 14% preference shareholders: The necessary number of 15% Preference Shares of Y Ltd. (Face value: 100 apiece) are issued in order to release these shareholders of X Ltd. at a premium

of 20%.

(iv) X Ltd.'s intrinsic value per share is 20 and Y Ltd.'s intrinsic value per share is 30. On the basis of intrinsic value, Y Ltd. will issue equity shares to satisfy the equity shareholders of X Ltd. The entry should only be made at par value, though. Each equity share of Y Ltd. is valued nominally at '10'.

Do the purchase consideration calculation.

Solution

ComputationofPurchaseconsideration	*(` in'000)*	*Form*
ForPreferenceShareholdersofXLtd.	3,000	30,000 15%Preference sharesinY Ltd.
ForequityshareholdersofXLtd. (20/30 ×7,50,000) ×`10 of `10each	5,000	5,00,000Equity sharesofY Ltd.
TotalPurchaseconsideration	8,000	

2.4 Methods ofAccountingForAmalgamations

Pooling of Interest Method

If the pooling of interests technique is used, the transferee company will assume ownership of the transferor company's assets, liabilities, and reserves at their current carrying amounts unless an adjustment is necessary due to the differing accounting standards that each company adheres to.

As a result, the reserves of the financial statements of the transferee company should be adjusted to reflect the discrepancy between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company (recorded as deduction from the reserves where the capital issued is more than the capital of the transferor company).

Simply expressed, the amount to be deducted from reserves when using the pooling approach can be calculated in the following three steps:

Phase I: Issue of Equity Share Capital, Preference Share Capital, and any additional consideration provided by the Transferee Corporation in the form of cash or other assets.

Under the transferor company's records, Step II is Existing Equity Share Capital plus Existing Preference Share Capital.

Step III, Step I, and Step II equal the amount to be subtracted from the Transferee Company's reserves.

Example:

The Sun Ltd and the Moon Ltd are in the business of similar nature decided to amalgamate and a new company is formed called Star Ltd. who took over the Assets and Liabilities of both the companies. The following are the Balance Sheets.

Balance Sheet as on 31st March 2021

Liabilities	Sun Ltd. Rs.	Moon Ltd. Rs.	Assets	Sun Ltd. Rs.	Moon Ltd. Rs.
Share Capital: 7,500 Shares of Rs	75,000		Goodwill	30,000	20,000

10 each					
4,550 Shares of Rs. 10 each		45,500	Freehold Premises	10,000	
Sundry Creditors	3,000	2,000	Plant and Machinery	18,300	13,450
General Reserve	4,200		Stock	16,000	11,550
Profit & Loss A/c	800	4500	Sundry Debtors	7,500	6,000
			Cash at Bank	1,200	1,000

Assuming that Assets realize at their book values, what amount each company will get? Prepare Balance Sheet after amalgamation and journal entries in the books of Star Ltd.

Solution

Calculation of Purchase Consideration

Assets Taken over by Star Ltd.	Sun Ltd. Rs.	Moon Ltd. Rs.
Goodwill	30,000	20,000
Freehold Premises	10,000	
Plant and Machinery	18,300	13,450
Stock	16,000	11,550
Sundry Debtors	7,500	6,000
Cash at Bank	1,200	1,000
Less: Outside Liabilities taken over by Star Ltd		
Sundry Creditors	3000	2000
Purchase Consideration	80000	50000

Journal entries in the books of Star Ltd. (Transferee Company)

1. Business Purchase A/c Dr. 130000

   To Liquidator of Sun Ltd. 80000

   To Liquidator of Moon Ltd. 50000

2. Goodwill A/c Dr. 50000

   Freehold Premises A/c Dr 10000.

   Plant and Machinery A/c Dr. 31750

   Stock A/c Dr. 27550

Sundry Debtors A/c Dr 13500.

Bank A/c Dr. 2200

To Sundry Creditors A/c 5000

To Business Purchase A/c

(For Assets and Liabilities of Sun Ltd and Moon Ltd taken over) 1,30,000

3. Liquidator of Sun Ltd. Dr. 80,000

Liquidator of Moon Ltd. Dr. 50,000

To Share Capital A/c cr. 1,30,000

(For Purchase consideration paid)

Balance Sheet of Star Ltd after Amalgamation

Liabilities	Amount	Assets	Amount
Share Capital: Issued Capital 13000 Shares of Rs 10 each	1,30,000	Fixed Assets:	
		Goodwill	50000
Reserves and Surplus: Current Liabilities: Sundry Creditors	5,000	Freehold Premises	10000
		Plant and Machinery	31750
		Current Assets:	27550
		Stock	13500
		Sundry Debtors	2200
		Cash at Bank	

2.5 PurchaseMethod

Assets and Liabilities: The assets and liabilities of the transferor company should be included at their current carrying amounts, or the acquisition consideration should be assigned to specific, identifiably identifiable assets and liabilities based on their fair values at the time of merger.

The difference between the purchase consideration and the net assets transferred should be recorded as goodwill in the transferee business's financial statements whenever the purchase consideration exceeds the value of the net assets of the transferor company that the transferee company has acquired. A capital reserve should be displayed for any shortfall. Unless in cases where a somewhat longer term can be justified, goodwill should be amortised over a period of five years.

Simply expressed, the amount to be moved to capital reserve or to be recorded as goodwill in the event of the purchase method can be computed in the following three steps:

Step I: Using the formula below, determine the Net Assets amount. Outside liabilities = Total Assets – (Non-current Liabilities + Current Liabilities)

Step II: Determine the purchase consideration using one of the methods listed under Determining the purchase consideration.

Step III- (a) If Steps I and II result in a positive amount, the asset is considered a capital reserve because more was paid for it than was required to acquire it.

(b) As the price paid for acquiring the business was greater than the Net Assets, which is essentially owing to its goodwill, the amount should be recorded as Goodwill (intangible asset) if Steps I and II result in a negative sum.

Treatment of reserves

- Under the acquisition method: Only statutory reserves from the transferor company should be included in the transferee business's financial statements.

- The transferor company's general reserves and the balance of its profit and loss account are not reflected at all.
- The identity of reserves is typically not preserved in an amalgamation that takes the form of a purchase, but in the case of statutory reserves, an exception is made, and these reserves must continue to appear in the transferee company's financial statements in the same manner as they did in the transferor company's financial statements for as long as their identity must be preserved to comply with the applicable statute.
- This exception only applies to mergers where the applicable statute's requirements for recording statutory reserves in the transferee company's books have been met. The following journal entry should be made to reflect the statutory reserves of the transferor firm in the balance sheet of the transferee company.
    - Amalgamation Adjustment Reserve A/c Dr.
      To Statutory Reserves

- To bring the statutory reserves of the transferor company in, the "Amalgamation Adjustment Reserve" is deducted. This is portrayed as a deduction from the transferee company's reserves following the merger.
- The reserves and the aforementioned account are both reversed after the deadline for displaying such mandatory reserves has passed. The "Amalgamation Adjustment Reserve" must be listed separately.

2.6 Basis for Comparison between Pooling of Interest Method and Purchase Method

Meaning: Pooling of Interest Method of accounting is one in which the assets, liabilities and reserves are combined and shown at their historical values, as of the date of amalgamation. Purchase Method, is an accounting method, wherein the assets and liabilities of the transferor company are shown at their market value in the books of the transferee company, as of the date of amalgamation.

Applicability: Pooling of Interest Method of accounting is applicable on Merger. Purchase Method is applicable on Acquisition.

Assets and liabilities: in Pooling of Interest Method these Appear at book values. In Purchase Method these appear at t fair market values.

Recording: in Pooling of Interest Method, all the assets and liabilities of the companies undergoing merger are aggregated. In purchase method,only those assets and liabilities are recorded in the books of transferee company, which are taken over by it.

Reserves: in Pooling of Interest Method, The identity of transferor company's reserves is kept intact. In purchase method,The identity of the transferor company's reserves except statutory reserves is not kept intact.

Purchase Consideration: in Pooling of Interest Method difference in the amount of purchase consideration and share capital is adjusted with reserves. In purchase method,, surplus of deficit of purchase consideration over the net asset acquired, should be credited or debited, as capital reserves or goodwill

Journal entries to close vendor company's books

- Both the transferor and the transferee companies' books must receive an accounting treatment in the event of an amalgamation under one of the aforementioned approaches.
- We will now be able to comprehend how the seller has handled this section in his books.
    - Assets and liabilities are transferred to a different account known as the "Realization account" because the vendor's books will be closed upon merger.

Assets and liabilities that are settled by the vendor company rather than the vendee company are also recorded in the vendor's books exclusively.

The Realization account receives credit for the purchase consideration receivable. The accounts of equity owners and preference shareholders are debited upon receipt of the acquisition consideration. The equity shareholders' account receives the balance of the realisation account (profit or loss).

The following example helps to illustrate the vendor entries:

Example:

Purchase Consideration Method:

The following is the Balance Sheet of A Ltd. and B Ltd. as on 31st March 2021:

Liabilities	A Ltd.	B Ltd.	Assets	A Ltd.	B Ltd.
Share Capital			Sundry Assets	4,24,000	190000
Shares of Rs. 10 each	5,00,000	2,00,000	Freehold Property	1,20,000	
10% Debentures		25,000	Debtors	95,000	42,000
General Reserve		15,000	Investments	80,000	38,000
Loan	1,60,000		Bank	71,000	8000
Creditors	50,000	20,000			
Profit and Loss	80,000	18000			

The purchase consideration consists of: (i) The assumption of Assets and Liabilities of both the companies. (ii) The charge of the Debentures in B Ltd. by the issue of Rs. 30,000, 12% debentures in C Ltd. (iii) The issue at a premium of Rs. 5 per equity share of Rs. 10 each in C Ltd. (iv) For the purpose of transfer the assets were valued as under

Particulars A Ltd. Sundry Assets 5,30,000Freehold Property 1,60,000 Debtors 74,000 Investments 2,00,000 Goodwill 75,000

Particulars B Ltd. Sundry Assets 1,80,000 Freehold Property- Debtors 36,000 Investments 51,000 Goodwill 40,000

Prepare the necessary accounts in the books of A and B and journal entries in the books of C

To Business Purchase A/c 11,70,000

Solution

Calculation of Purchase Consideration

A Ltd 11,10,000-210000=910000

B ltd 3,15,000-45000=270000

Shares issued to A Ltd. Rs. 9, 00,000/15 = Rs. 60,000 shares Shares issued to B Ltd. Rs. 2, 70,000/15 = Rs. 18,000 shares

C Ltd. (Transferee Co.)

1. Business Purchase A/c Dr. 11,70,000

 To Liquidator of A Ltd. 9,00,000

 To Liquidator of B Ltd. 2,70,000

 (Purchase consideration made due)

2. Sundry Assets A/c Dr. 7,10,000

 Freehold Property A/c Dr. 1,60,000

 Debtors A/c Dr. 1,10,000

 Investments A/c Dr. 2,51,000

 Bank A/c Dr. 79,000

 Goodwill A/c Dr. 1,20,000

 To 11% Debentures A/c 30,000

 To Loan A/c 1,60,000

 To Creditors A/c 70,000

3. Liquidator of A Ltd. A/c Dr. 9,00,000

 To Equity Share Capital A/c 6,00,000

 To Securities Premium A/c (Purchase consideration paid) 3,00,000

4. Liquidator of B Ltd. A/c Dr. 2,70,000

 To Equity Share Capital A/c 1,80,000

 To Securities Premium A/c (Purchase consideration paid) 90,000

5. 11% Debentures A/c Dr. 30,000

 To 12% Debentures A/c 30,000

Ledgers in the Books of B Ltd

Realisation Account					
Date	Particular	Rs	Date	Particular	Rs
1-Apr	To Sundry Assets A/c	1,90,000			
	To Debtors A/c	42,000			20,000
	To Investments A/c	38,000			25,000
	To Bank A/c	8,000			270,000
	To Equity Shareholders A/c	37,000			

2.7 Disclosure

The names of the amalgamating companies and a general description of their line of business should be disclosed in the first financial statements that follow the merger, along with the dates that the merger became effective for accounting purposes, the method of accounting that was used to reflect the merger, and any statutory authorization information.

The initial financial statements after an amalgamation that use the pooling of interests technique shall include the extra disclosures listed below:

(a) the description of the shares issued, the number of shares issued, and the proportion of each company's equity shares exchanged in order to effect the merger;

(b) the amount of any discrepancy between the consideration and the value of the net identifiable assets acquired, and how it will be handled; and

In the first financial statements that come after an amalgamation that is accounted for using the purchase method, the following additional disclosures should be made:

(a) the consideration for the amalgamation and a description of the consideration paid or contingently payable; and

(b) the amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof, including the period of amortization of any acquired goodwill.

2.8 Amalgamation after the date of Balance Sheet

A disclosure should be made in accordance with AS 4, "Contingencies and Events Occurring After the Balance Sheet Date," but the amalgamation should not be included in the financial statements when it occurs after the balance sheet date but before the release of the financial statements of either party to the amalgamation. In some cases, the amalgamation may also disclose new information that will have an impact on the financial statements.

Summary

The accounting for amalgamation and the handling of any resulting goodwill or reserves are covered by this standard. Although certain of its standards also apply to the financial statements of other enterprises, this standard is primarily aimed at businesses. This standard does not apply to acquisitions that take place when one company (referred to as the acquiring company) buys all or a portion of the assets, or all or a portion of the shares, of another company (referred to as the acquired company), in exchange for cash payment, the issuance of shares or other securities in the acquiring company, or a combination of the two. The distinct characteristic of an acquisition is that the purchased company is kept separate and does not undergo dissolution.

Keywords

- Amalgamation: refers to a merger that complies with the requirements of the Companies Act of 1956 or any other law that might be relevant to companies.
- Transferor company: The term "transferor company" refers to a company that merges with another company.
- Transferee company: The company into which a transferor company is merged is referred to as the transferee company.
- Reserve: refers to the portion of an enterprise's earnings, revenues, or other surplus (whether capital or income) that the management has set aside for a general or specialised purpose other than a provision for depreciation.
- Consideration: The total amount of shares and other securities issued, as well as the payment made by the transferee firm to the shareholders of the transferor company in the form of cash or other assets, constitute the consideration for the merger.
- Fair value: is the sum for which an asset might be traded in an arm's length transaction between an informed, willing buyer and a knowledgeable, willing seller.
- Pooling of interest method: The goal of the pooling of interests technique of accounting for mergers is to treat the merger as though the transferee firm planned to carry on the independent businesses of the merging entities. The separate financial accounts of the merging entities are therefore aggregated with little modification.

Self Assessment

1. In the event of an amalgamation, …………. enters the information to eliminate any unrealized gains or losses on stock.

A. the vendor firm,

B. the purchasing company,

C. or a third party

D. None of these

2. The difference between the purchase consideration and share capital of the transferee company should be converted to …… using the "pooling of interests" approach.

A. Generalreserve.

B. Amalgamationadjustmentaccount

C. Goodwillorcapitalreserve.

D. None of these

3. At the time of amalgamation, purchase consideration excludes

A. The amount that the transferee company will pay directly to the transferor company's creditors

B. payments made by the transferee company in the form of assets to the transferor company's shareholders

C. preference shares that the transferee company issues to the transferor company's preference shareholders.

D. None of these

4. According to AS 14, the acquisition consideration is the sum that has been agreed to be paid to the following parties:

A. shareholders

B. shareholders, debenture holders, and creditors

C. shareholders and debenture holders.

D. All of these

5. If the purchasing business pays the vendor company's liquidation costs, ….. account will be debited in the purchasing company's books.

A. Goodwill

B. Account for liquidation expenses.

C. A vendor's business account.

D. None of these

6. The accounts of the amalgamated company are opened to include

A. the assets of the amalgamating company

B. the non-statutory reserves of the amalgamating company

C. the statutory reserves of the amalgamating business.

D. All of these

7. Amalgamation Adjustment Reserve is shown in the transferee company's financial accounts as

A. Other current asset.
B. Separate line item under "Reserves and Excess" with a minus sign.
C. other non-current assets.
D. Any of the above options

8. A company into which the vendor company is merged is called
A. Transferee company.
B. Transferor company.
C. Selling company.
D. Vendor

9. The difference must be recorded in the transferee company's accounts if the purchase consideration exceeds the net assets (at the agreed values) of the transferor firm.
A. Goodwill.
B. Capital Reserve.
C. Profit/loss.
D. Any of these

10. One of the conditions to be fulfilled in case of amalgamation in the nature of merger is Shareholders holding not less than …% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.
A. 80
B. 85
C. 89
D. 90

11. In case of The Pooling of Interests Method, The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company should be adjusted in
A. Reserves
B. Any item other than reserves
C. Creditors
D. Current liabilities

12. When an amalgamation is effected after the balance sheet date but before the issuance of the financial statements of either party to the amalgamation, disclosure should be made in accordance with AS ….
A. 1
B. 2
C. 3
D. 4

13. AS….Deals with accounting for amalgamation .
A. 14

B. 15
C. 16
D. 17

14. The goodwill arising on amalgamation should be amortised to income on a systematic basis over its useful life. The amortisation period should not exceed ….years unless a somewhat longer period can be justified.
A. 5
B. 6
C. 7
D. 8

15. The following statement is wrong in regard to purchase method :
A. The goodwill arising on amalgamation should not be amortised to income .
B. Any excess of the amount of the consideration over the value of the net assets of the transferor company acquired by the transferee company should be recognised in the transferee company's financial statements as goodwill arising on amalgamation.
C. If the amount of the consideration is lower than the value of the net assets acquired, the difference should be treated as Capital Reserve.
D. Where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with, statutory reserves of the transferor company should be recorded in the financial statements of the transferee company

Answers for Self Assessment

1.	B	2.	A	3.	A	4.	A	5.	A
6.	C	7.	B	8.	A	9.	A	10.	D
11.	A	12.	D	13.	A	14.	A	15.	A

Review Questions

1. What prerequisites must be met in order for an amalgamation to have the characteristics of a merger, in accordance with AS 14 on Accounting for Amalgamations?
2. Differentiate between the purchase technique of recording transactions connected to amalgamation and the pooling of interests method.
3. Explain the treatment of reserves under amalgamation
4. Explain disclosures to be made in accordance with accounting standard 14 on Accounting for Amalgamations.
5. What entries are to be passed in the box of vendor in case of amalgamation.

Further Readings

https://www.mca.gov.in/Ministry/notification/pdf/AS_14.pdf

ICAI : Paper5-Advanced accounting

Unit 03: AS 19: Leases

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Objectives

After studying this unit, you will be able to:

- Understand the criteria for lease recognition,
- Analyse whether a contract contains a lease, identifying and separating the lease and non-lease components of a contract,
- Determine the lease term, understanding the concept of lease inception and commencement, and
- Learn how to matriculate the accounting in the Lessee's books with regard to lease recognition, measurement, presentation, and disclosure requirements
- Get knowledge of accounting for sublease agreements and sale and leaseback transactions.
- Do Accounting with regard to recognition, measurement, presentation, and disclosure issues.

Introduction

The new standard for leases, Ind AS 116, was announced by the Ministry of Corporate Affairs (MCA) in a notification dated March 30, 2019. As a result of the implementation of Ind AS 116, which is completely compliant with IFRS 16, lease accounting has experienced major changes. The former Ind AS 17 has been replaced by this new standard, which will take effect for financial periods beginning on or after April 1, 2019. With distinct categorization and measurement directions for each, Ind AS 17 was based on a dual classification model of operating and financial leases. The assets and liabilities linked to the rights and duties resulting from the majority of "operation" leases were not taken into account by the dual classification approach. According to Ind

AS 116, leases are recorded using a "right-of-use approach." According to the model, a lessee has a contractual responsibility to pay the lessor on the commencement date in exchange for the right to use the underlying asset for the duration of the lease. At lease start, when the lessor first makes the underlying asset available for use by the lessee, the lessor transfers that right to utilise the underlying asset. Most leases must be recorded on the balance sheet and need additional disclosures under Ind AS 116, Leases. This is anticipated to lead to a more accurate depiction of lessees' assets and liabilities as well as increased transparency regarding the lessee's obligations and leasing activities.Therefore, the existing lessor accounting approach is not fundamentally altered by Ind AS 116.

3.1 Aim of the Standard

- This standard's goal is to guarantee that lessees and lessors supply pertinent data in a way that accurately depicts those transactions.
- Users of financial statements can evaluate the impact that leases have on an entity's financial position, financial performance, and cash flows using this information as a foundation.
- This standard requires an entity to apply the standard consistently across contracts with similar features and in similar circumstances, taking into account the terms and conditions of contracts as well as all pertinent facts and circumstances.
- Leasing is a significant method for many reporting companies to have access to real estate.
- Without transferring ownership, a leasing agreement transfers use of an asset from one party to another. Several sorts of leasing agreements are possible.
- Some agreements obviously fall under the purview of lease accounting, such as property leases that explicitly grant the right to use a building for a predetermined amount of time in exchange for payment.
- Yet, agreements that are not formal leases might still transfer the right to utilise an asset.
- Hence, it is crucial to determine which agreement incorporates a lease in order to properly assess the impact on financial position.
- Arrangements that need to be classified as leases are listed in Ind AS 116, Leases.
- The principles for the recognition, measurement, presentation, and disclosure of leases are outlined in this unit, along with how to determine which arrangements, or components within an arrangement, should be accounted for under Ind AS 116.

3.2 Coverage of the Standard

All leases, including those of right-of-use (ROU) assets in a sublease, must adhere to Ind AS 116, with the following exceptions:

1. Since it falls under the purview of Ind AS 106, "Exploration for and Evaluation of Mineral Resources," leases to explore for or utilise minerals, oil, natural gas, and comparable non-regenerative resources are permissible.
2. Since that Ind AS 41, "Agriculture," applies to biological assets owned by a lessee, there are two leases of biological assets.
3. Service concession agreements because they fall under Ind AS 115, "Revenue from "Contracts with Customers," Appendix D.
4. Intellectual property rights held by a lessee under licencing agreements for items like motion picture films, video recordings, plays, manuscripts, patents, and copyrights because they fall under the purview of Ind AS 38, "Intangible Assets," and
5. licences of intellectual property granted by a lessor because they fall under the purview of Ind AS 115, "Revenue from Contracts with Customers."

3.3 Exemptions for Recognition

1. A lessee may choose not to apply Ind AS 116's recognition requirements to the following lease types in addition to the scope exclusions mentioned above:
    - Short-term leases; and
    - Leases for which the underlying asset is of little value.
2. If a lessee decides to use the aforementioned recognition exemption, they must recognise the lease payments related to those leases as an expense either on a straight-line basis over the lease term or another systematic basis, depending on which basis best captures the pattern of the lessee's benefit.
3. The class of underlying asset to which the right of use pertains can determine the exemption for short-term leases.
4. A class of underlying assets is a collection of underlying assets that share a common type and function in the operations of an entity.
5. Consider an organisation that has rented numerous pieces of office equipment, some for less than a year and some for more than a year, but none of the leases included buy options.
6. If the entity wants to make use of the short-term lease exemption, it must do so for all leases with durations of 12 months or less, assuming that the office equipment is all regarded to be of the same class.
7. The general recognition and measurement requirements for lessees shall be followed when accounting for leases with durations longer than 12 months.
8. While choosing this option, the lessee is required to disclose certain information concerning short-term leases, both quantitatively and qualitatively.
9. All future short-term leases for a class of underlying assets must be accounted for in line with the lessee's policy after the lessee develops a policy for that class.

Example:

- Consider an organisation that has rented numerous pieces of office equipment, some for less than a year and some for more than a year, but none of the leases included buy options.
- If the entity wants to make use of the short-term lease exemption, it must do so for all leases with durations of 12 months or less, assuming that the office equipment is all regarded to be of the same class.
- The general recognition and measurement requirements for lessees shall be followed when accounting for leases with durations longer than 12 months.
- While choosing this option, the lessee is required to disclose certain information concerning short-term leases, both quantitatively and qualitatively. All future short-term leases for a class of underlying assets must be accounted for in line with the lessee's policy after the lessee develops a policy for that class.

3.4 Low-Value Asset Leases

1. Lessees have the option to choose leases where the underlying asset is of low value (i.e., low-value assets).

2. Despite the fact that Ind AS 116 does not define low-value asset leases specifically, it does outline the criteria that can be used to determine if an asset qualifies for the exemption and how to do so (s).
3. The following circumstances apply:
4. A low value underlying asset can only exist IF BOTH of the following conditions are met:
    - o Using the underlying asset alone or in conjunction with other readily available resources will benefit the lessee.
    - o The underlying asset is not extremely reliant upon or intricately linked to other assets.

Example:

The following example will help you understand this:

1. An organisation may lease a vehicle for use in its operations, and the lease also covers the use of the vehicle's tyres. The car is the sole way to use the tyres for their intended purpose, making them reliant on or very closely tied to the vehicle. The tyres would not therefore be eligible for the low-value asset exemption.
2. The general recognition and measurement requirements for lessees shall be followed when accounting for leases with durations longer than 12 months.
3. While choosing this option, the lessee is required to disclose certain information concerning short-term leases, both quantitatively and qualitatively. All future short-term leases for a class of underlying assets must be accounted for in line with the lessee's policy after the lessee develops a policy for that class.
4. As a result, every laptop is considered a low value asset, and the business has the option of applying the low value exemption to every laptop covered by the contract.

*If the nature of the underlying asset is such that, when new, the asset is normally not of low value, the lease does not qualify as a lease of a low value asset. Car leases, for instance, would not be considered leases of low-value assets because a new car is often not considered to be of low value.

Ineligible as low value assets are head leases:

It is very important to note that a head lease does not qualify as a lease of a low-value asset if the lessee sublease(s) or expects to sublease(s) an asset. This means that an intermediate lessor who sublease(s) or expects to sublease(s) an asset cannot account for a head lease as a lease of a low-value asset. (See subsection 6.1 of this lease)

3.5 How Do Leases Work?

An entity must determine if a contract is or contains a lease at the outset of the agreement. For this purpose, a lease is defined as an agreement, or a clause in an agreement, that transfers authority over the use of a specific asset for a specific amount of time in exchange for payment.

Customers and suppliers are required by Ind AS 116 to assess if a contract is or contains a lease at the time of the contract's start.

The earlier of the following dates is the inception date:

- the date of a lease agreement
- The date on which the parties agreed to the lease's main terms and conditions.

The amount of use of a specific object can be used to define "a period of time" (for e.g., the number of production units that an item of equipment will be used to produce). It encompasses any intervals of time that are not consecutive.

Asset Identified

Only when an asset has been recognised does an arrangement include a lease.

According to Ind AS 116, an identified asset may be mentioned explicitly in a contract or implicitly at the time the asset is made accessible to the client for usage.

Illustration

Customer XYZ and Supplier ABC agree to a ten-year contract for the use of rolling stock that is especially made for Customer XYZ.

The rolling stock is not appropriate for use by other customers because it is intended to convey materials for Customer XYZ's manufacturing process. Although the rolling stock isn't mentioned in the contract specifically, Supplier ABC only possesses one piece of rolling stock that is appropriate for Customer XYZ's use. According to the contract, Supplier ABC must repair or replace the rolling stock if it is not operating properly.

Whether or not an asset has been identified?

Answer:

The aforementioned rolling stock is a recognised asset.

Although the contract does not specifically mention the rolling stock (for example, by serial number), it is implied that Supplier ABC will use it to complete the contract.

Illustration:

Client XYZ and Supplier ABC agree to a ten-year contract for the use of a vehicle. The contract contains details on the car's specifications (i.e., brand, type, colour, options, etc.). The car is not yet finished when the deal is first signed.

Whether or not an asset has been identified?

Answer: The aforementioned car is a recognised asset.

Although the automobile cannot be named at the beginning of the contract, it is implicitly specified when Customer XYZ will be given access to it.

3.6 Substantive Substitution Rights

This is a crucial idea since without assessing this circumstance, it is impossible to determine whether an asset has been identified. So, even if an asset is stated, a customer does not have the right to use it if the supplier has the substantive right to replace it at any time during the usage period at the beginning of the contract.

A supplier has a SUBSTANTIAL right to replace an asset IF BOTH OF THE FOLLOWING ARE PRESENT:

1. The customer cannot stop the supplier from substituting an asset, and alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable amount of time, for example. The supplier has the PRACTICAL ABILITY to substitute alternative assets throughout the period of use.
2. If the provider used its option to replace the asset, it would profit economically (i.e., the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset).

The aforementioned terms are used to distinguish between substitution rights and rights that do not alter the nature or substance of the contract. Substitution rights result in a supplier controlling the use of an asset rather than the customer.

When analysing substitute rights, the study mainly takes the supplier's point of view into account. Examples of things to take into account include (1) transportation costs for moving one asset to a location where it can be used to fulfil the agreement or move the output from the production location to the customer, (2) production lost due to downtime from switching assets and other

disruptions to suppliers' operations, (3) excess operational costs for converting an asset that might not have produced identical output, etc.

Additionally, if the supplier has the right or obligation to substitute the asset only on or after a specific date or the happening of a specific event, the supplier's right to substitute the asset is not substantive because the supplier lacks the practical ability to substitute alternative assets during the period of use.

Based on the facts and conditions present at the beginning of the contract, an entity determines whether a supplier's right of substitution is substantive. An entity should not take into account unlikely future outcomes when creating a contract.

According to Ind AS 116, the following situations are excluded from consideration for determining whether a supplier's right of substitution is material throughout the duration of use because they were not anticipated to arise at the time the contract was signed:

The idea that a substitute right must economically benefit the supplier in order to be meaningful is new. Due to the costs involved in replacing an asset, it will frequently be obvious that the supplier would not profit from the exercise of a substitute right. The costs involved in replacing the asset may vary depending on where it is physically located. For instance, the cost of replacing an asset located at the customer's premises is typically higher than the cost of replacing a similar asset placed at the supplier's facilities. So just because a supplier determines that the cost of substitution is negligible does not mean that it would necessarily profit economically from the right of substitution.

According to Ind AS 116, a client should assume that a provider does not have a meaningful substitution right when they are unable to ascertain this information with ease. The purpose of this provision is to make it clear that a customer is not required to make an excessive effort to show that a substitute right is not meaningful. Nonetheless, providers should be equipped with enough knowledge to assess if a substitute right is genuine.

The idea that a substitute right must economically benefit the supplier in order to be meaningful is new. Due to the costs involved in replacing an asset, it will frequently be obvious that the supplier would not profit from the exercise of a substitute right. The costs involved in replacing the asset may vary depending on where it is physically located. For instance, the cost of replacing an asset located at the customer's premises is typically higher than the cost of replacing a similar asset placed at the supplier's facilities. So just because a supplier determines that the cost of substitution is negligible does not mean that it would necessarily profit economically from the right of substitution.

According to Ind AS 116, a client should assume that a provider does not have a meaningful substitution right when they are unable to ascertain this information with ease. The purpose of this provision is to make it clear that a customer is not required to make an excessive effort to show that a substitute right is not meaningful. Nonetheless, providers should be equipped with enough knowledge to assess if a substitute right is genuine.

A supplier does not have a substantive right to substitution if a contract clause only permits or mandates the substitution of alternative assets when the primary asset is not functioning as intended (such as a standard warranty provision) or when a technological upgrade is made available.

Illustration:

Case A

With a centralised data centre and the usage of a specific server, an electronic data storage provider (supplier) offers services (Server No. 10). The supplier decides at the beginning of the contract that it is allowed to and can simply substitute another server without the customer's approval during the length of use. The supplier maintains several identical servers in a single accessible area.

The supplier would also profit financially from replacing the asset with an alternative because doing so would enable the supplier to optimise the performance of its network at a very low cost. The supplier has also made it plain that it bargained this right of substitution as a crucial feature in the agreement, and the substitution right had an impact on the agreement's pricing.

Whether there is a specific asset listed and whether the substitution rights are substantive.

Solution

The provider has the practical ability to replace the server at the start of the contract and would profit financially from doing so, so the customer does not have the right to utilise the stated asset. There is therefore no known asset.

However, the customer would assume the substitution right is not substantive and come to the conclusion that there is an identified asset if they were unable to quickly determine whether the supplier had a substantive substitution right (for example, because there is not enough transparency into the supplier's operations).

Illustration

Assume the same circumstances as in Case A, with the exception that Server No. 10 is customised and the supplier lacks the practical ability to replace it for the duration of usage. Also, it's not clear whether the supplier would make money if they found a comparable alternative asset.

Whether there is a specific asset listed and whether the substitution rights are substantive.

Solution:

Because the supplier lacks the actual ability to substitute the asset and there is no proof that doing so would benefit the supplier financially, Server No. 10 would be considered an identified asset and the substitution right ineffective. In this situation, neither of the prerequisites for a substitute right are satisfied (whereas both the conditions must be met for the supplier to have a substantive substitution right). Server No. 10 will be regarded as an identified asset as a result.

Physically Distinct Identified Asset

An asset must be visibly unique to be identified. A complete asset or a piece of an asset may be a physically distinct asset. For instance, a structure is typically seen as having separate physical properties, but a level within the building may also be regarded as having such properties if it can be used independently of the other floors. Similar to this, a capacity or other portion of an asset that is not physically distinct (such as a capacity portion of a fibre optic cable) is not an identified asset unless it accounts for a substantial portion of the asset's capacity and grants the customer the ability to obtain a substantial portion of the asset's financial benefits from use.

There is no definition of "nearly all" in Ind AS 116.

The following examples can help you understand this better:

Illustration:

Client XYZ and Supplier ABC agree to a 15-year contract for the usage of five fibres in a fibre optic connection that connects Mumbai and Pune. Five of the cable's 25 fibres are designated for Client XYZ's use under the contract. Throughout the duration of the contract period, the five fibres will only be used to transmit data belonging to Client XYZ. Presume Supplier ABC lacks a significant replacement right.

Whether or not an asset has been identified?

Solution

Because they are physically distinct and specifically mentioned in the contract, the aforementioned five fibres are identifiable assets, hence the answer is yes.

Illustration: Case A

Scenario A: Customer XYZ signs a ten-year agreement with Supplier ABC to use Supplier ABC's pipeline to transport oil from India to Bangladesh. According to the agreement, Client XYZ will be entitled to use 95% of the pipeline's capacity for the duration of the contract.

Whether or not an asset has been identified?

Solution:

Indeed, the pipeline's capacity section has been designated as an asset.

While 95% of the pipeline's capacity is not physically separate from the pipeline's remaining capacity, it does constitute a significant portion of the overall pipeline's capacity, giving Customer XYZ the right to collect a significant portion of the pipeline's economic benefits.

Case B:

Consider the same circumstances as in Example A, with the exception that Customer XYZ will be permitted to utilise 65% of the pipeline's capacity over the duration of the contract.

Whether or not an asset has been identified?

Solution:

No, the pipeline's capacity section is NOT a designated asset.

Customer XYZ does not have the right to derive substantially all of the economic benefits from using the pipeline since 65% of its capacity is less than substantially all of its capacity.

3.7 Right to Control

An organisation must determine if the customer has both of the following during the time of usage in order to determine whether a contract transfers the right to regulate the use of an identified asset for a specific amount of time.

(a) The right to get almost all of the financial rewards from using the specified asset; and

(b) The right to control how the specified asset is used.

It's possible that the authority to manage how an asset is used is not always expressed in writing as a lease agreement. The right to make use of an identified asset is frequently included in a contract that appears to be a supply agreement or service agreement. Hence, to ascertain if an arrangement involves a lease, a reporting entity should take into account all of the conditions of the agreement.

In addition, the agreement includes a lease for the duration of the period during which the client has the right to govern the use of a certain asset.

Illustration:

A contract between ABC Ltd and XYZ Ltd gives ABC Ltd the sole right to utilise a certain grain storage facility for the months of May and June during a five-year term. ABC Ltd has the authority to choose which crops are stored during these months and when to remove them. For warehouse activities, XYZ Ltd offers loading and unloading services. The use of the warehouse for the other ten months of each year shall be at the discretion of XYZ Ltd.

Which party has the authority to decide how the designated asset is used throughout the usage period?

Solution:

In the aforementioned situation, ABC Ltd has the authority to decide how the warehouse will be utilised during the contractually stipulated usage periods, and as a result, has the right to govern how the specified asset is used throughout the usage period. The rights and economics of using the warehouse for the designated usage times should be the main focus of the analysis (May and June).

The choice of how much of a crop to store, as well as when to put it in and take it out of storage, during the period of usage, belongs to ABC Ltd. The economics of using the asset depend more on these rights than on the loading and unloading services provided by XYZ Ltd over the same time period. The entire economic advantage from using the asset at certain predetermined times belongs to ABC Ltd. As a result, the contract includes a lease for the time period provided.

Right to Obtain Substantially All of the Economic Benefits:

To control the use of an identified asset, a customer must have the right to obtain virtually all of the economic benefits from use of the asset throughout the period of use, i.e., the right to virtually all of the economic benefits from use of the identified asset throughout the period of use is the first criterion in the control assessment (for e.g., by having exclusive use of the asset throughout that period).

Customers may profit economically directly or indirectly (for e.g., by using, holding or subleasing the asset). Using a resource has financial advantages, including:

• any by-products (such as renewable energy credits produced through the usage of the asset), including possible cash flows deriving from these items. • the asset's principal outputs (i.e., goods or services).

• advantages of utilising the asset that might be realised from a business deal with a third party (for e.g., subleasing the asset)

An entity must take into account the economic benefits that result from using the asset within the boundaries of the customer's right to use it when determining whether the customer has the right to enjoy substantially all of the economic benefits from doing so.

For instance:

(a) if a contract limits the use of a motor vehicle to only one specific territory during the period of use, an entity only considers the economic benefits from use of the motor vehicle within that territory, not beyond; or

(b) if a contract limits the amount of miles a customer may drive in a motor vehicle during the period of use, an entity only considers the economic benefits from use of the motor vehicle for the permitted number of miles.

3.8 Accounting for Leases in the Lessor's Books

Every lease that a lessor signs must be labelled as either an operational lease or a financing lease.

If a lease substantially transfers all of the risks and rewards associated with owning the underlying asset, it is categorised as a finance lease.

If a lease does not substantially transfer all of the risks and benefits associated with ownership of the underlying asset, it is categorised as an operational lease.

Finance Lease

It is the substance of the transaction rather than the legal structure of the contract that determines whether a lease is an operating lease or a financing lease.

Examples of scenarios where a lease would typically be categorised as a finance lease, either singly or in combination, include:

(a) the lease transfers ownership of the underlying asset to the lessee by the conclusion of the lease term;

(b) The lessee has the option to buy the underlying asset at a price that is anticipated to be sufficiently below the fair value at the time the option becomes exercisable for it to be fairly certain, as of the date the option is first granted, that the option will be exercised;

(c) The underlying asset is of such a specialised nature that only the lessee can use it without significant modifications ,

(d) The lease term is for the majority of the economic life of the underlying asset even if title is not transferred (d), and

(e) at the time of inception, the present value of the lease payments equals at least substantially all of the fair value of the underlying asset.

The present value of the lease payments plus the present value of the guaranteed residual value, both discounted at the implicit lease interest rate, plus the present value of the unguaranteed residual value, less the deferred selling profit, make up the lease's net investment. (Deferred selling profit is determined by subtracting the lease receivable from the underlying asset's carrying value, net of guaranteed residual.) It should be noted that while determining whether to categorise the lease's components as current or noncurrent assets on the balance sheet, the net investment is subject to the same factors as other assets.

Interest on the lease receivable, accretion of the unguaranteed residual value, and amortisation of the deferred selling profit are all included in interest income. IRR is the rate at which interest income must be recognised in order to generate a constant periodic rate of return on the remaining net investment.

Operating Lease:

A lessor must either recognise operational lease payments as income on a straight-line basis or another organised basis. If another systematic basis is more indicative of the pattern in which the benefit from using the underlying asset is reduced, the lessor must adopt that basis instead.

Lessors are required to account for all expenditures, including depreciation, incurred in generating lease income.

The initial direct costs associated with acquiring an operating lease must be added to the carrying value of the underlying asset by the lessor and recognised as an expense throughout the course of the lease on the same timeline as lease revenue.

Operating leases' underlying assets that are subject to depreciation must follow the lessor's standard depreciation schedule for comparable assets. Depreciation must be computed by a lessor in conformity with Ind AS 16 and Ind AS 38.

To establish whether an underlying asset covered by an operating lease is impaired and to account for any impairment loss discovered, a lessor must use Ind AS 36.

Because an operational lease is not the same as a sale, a manufacturer or dealer lessor does not recognise any selling profit upon entering into the lease.

Presentation

According to the underlying asset's kind, a lessor must disclose underlying assets that are the subject of operational leases in its balance sheet.

Disclosure

In order for users of financial statements to assess the impact that leases have on the lessor's financial position, financial performance, and cash flows, lessors must disclose information in the notes that, when combined with the information in the balance sheet, statement of profit or loss, and statement of cash flows, provides a foundation.

For the reporting period, a lessor must provide the following information: (a) for finance leases, selling profit or loss, finance income on the net investment in the lease, and income related to variable lease payments not taken into account when calculating the net investment in the lease.

Illustration

Equipment with a carrying value of $136,00 and a 5-year life is leased by Lessor Y to Lessee X for a period of three years in exchange for an annual payment of $50,000 (due at the end of each year) and residual value of $50,000, which is guaranteed by X up to a loss of $30,000 per year. Implicit interest is 10%. The equipment's value at the end of the lease is $33,000. Display accounting in X's books. The implicit interest rate for lease payments is 10%. The equipment's value at the end of the lease is $33,000. Display accounting for the lease that Y's books have classed as a finance lease. Yet, the net investment in lease has an interest income rate of 19.274%.

Solution

In books of Lessee:

Implicit rate of interest: 10%

As illustrated below, the initial recognition of ROU Asset and Lease Liability is based on the present value of the payments.

Year	1	2	3	3	Present value
Payments (`)	50,000	50,000	50,000	Guaranteed 30,000	
Disc. Factor	0.909091	0.826446	0.751315	0.751315	
DCF at 10% (`)	45,454.55	41,322.31	37,565.74	22,539.44	1,46,882

LeaseLiabilityrepaymentandinterest

Year	0	1	2	3	3	3
Interest (`)		14,688.20	11,157.02	7,272.73	0	0

Payments/remission (`)		50,000	50,000	50,000	17,000 guarantee payments (50,000 – 33,000)	13,000 guarantee remissions (30,000 – 17,000)
Balance (`)	1,46,882	1,11,570.2	72,727.27	30,000	13,000	0

ROUAsset Depreciation forthe lease period

Year	0	1	2	3
Depreciation Straight line (`)		48,961	48,961	48,960
Balance (`)	1,46,882	97,921	48,960	0

A lessee must use a cost model to measure the right-of-use asset after the beginning date unless they utilise the revaluation model as it is used for the specific type of PPE.

To employ a cost model, a lessee must calculate the right-of-use asset's cost (a) adjusted for any remeasurement of the specified lease liability, (b) less any cumulative depreciation and any accrued impairment losses.

When depreciating the right-of-use asset, a lessee must follow the guidelines in Ind AS 16, Property, Plant, and Equipment (for the lease term or the useful life based on the lease condition).

	Particulars	**(Rs.)**	(Rs)
At inception	ROU Asset A/c Dr.	1,46,882	
	To, Lease Liability A/c		1,46,882
At the end of Year 1	Interest Expenses A/c Dr.	14,688	
	To, Lease Liability A/c		14,688
	Lease Liability A/c Dr.	50,000	
	To, Bank A/c		50,000
	Depreciation A/c To, ROU Asset	48,961	
			48,961
At the end of Year 2	Interest Expenses A/c	11,157	
	To, Lease Liability A/c		11,157
	Lease Liability A/c To, Bank A/c	50,000	50,000
	Depreciation A/c To, ROU Asset	48,961	48,961
At the end of Year 3	Interest Expenses A/c	7,273	
	To, Lease Liability A/c		7,273
	Lease Liability A/c To, Bank A/c	50,000	50,000
	Depreciation A/c	48,960	
	To, ROU Asset A/c		48,960
	Lease Liability A/c Dr.	30,000	
	To, Bank A/c		17,000

	(`50,000 – `33,000 = `17,000, guaranteed up to `30,000) To, P&L (liability remission) ##	13,000

PresentedintheFinancialStatements:

BalanceSheet

Particulars			ROU Asset	Lease Liability
At the end of	Year 1 (`)		97,921	1,11,570
At the end of	Year 2 (`)		48,960	72,727
At the end of	Year 3 (`)		0	0

StatementofP&L

	Interest A/c Dr.	Depreciation A/c Dr.	Guarantee remission A/c Cr.
Year 1	14,688	48,961	
Year 2	11,157	48,961	
Year 3	7,273	48,960	13,000

Summary

A lease is a contract, or a clause within a contract, that transfers the right to decide how an asset (the underlying asset) will be used for a certain amount of time in exchange for payment.

An entity evaluates whether the customer has the right to collect virtually all of the economic advantages from use of the identified asset and the right to direct usage of the identified asset during the time of use to ascertain whether the right to control has been transferred to the customer.

For leases with a period of 12 months or less and no purchase option, lessees may choose to use an approach similar to Ind AS 17 (i.e., operating lease accounting). For leases with a period of 12 months or less and no purchase option, lessees may choose to use an approach similar to Ind AS 17 (i.e., operating lease accounting). The "class of underlying asset" to which the right of use corresponds determines the availability of this option.

Keywords

Initial Direct Costs: with the exception of those incurred by a manufacturer or dealer lessor in conjunction with a finance lease, are the additional expenses incurred in order to get a lease that would not have been incurred otherwise.

Discount Rates: The present value of the lease payments, which is used to calculate the lessee's lease debt and right of use asset as well as the lessor's net investment in the lease, is calculated using discount rates.

Incremental Borrowing Rate:The interest rate that the lessee would have to pay to borrow money for an asset of a similar value to the right of use asset over a same term, with a similar security, and in a similar economic climate is known as the incremental borrowing rate.

Self Assessment

1. UnderIndAS116,thedefinition of lease is similar tothatinAS….

A. 19
B. 20
C. 21
D. 22

2. Which of the following statements is wrong about IndAS116?

A. IndAS116bringsincomprehensiveprescriptiononaccountingofmodificationsinleasecontracts
B. IndAS116hasnosuchscopeexclusion
C. Ind AS 116 does not make a distinctionbetween 'inception of lease' and'commencementof lease'
D. IndAS116eliminatestherequirementofclassificationofleasesaseitheroperatingleasesor finance leases for a lesseeand instead, introduces a singlelesseeaccountingmodelwhichrequireslesseetorecogniseassetsandliabilitiesforallleasesunlessitapplie stherecognitionexemptionapplies.

3. under Ind AS 116 tospecify that cash payments forinterest portion of lease liabilitywillbeclassifiedasactivitiesapplyingIndAS7

A. financing
B. investing
C. operating
D. none of these

4. At the commencement date, a lessee shall measure the right-of-use (ROU) of asset at ….

A. Cost
B. Market value
C. Cost or market value whichever is less
D. None of these

5. Theleasepaymentsshallbediscountedusingthe………, if that rate can be readily determined.

A. interestrateimplicitinthe lease
B. lessee'sincremental borrowing rate
C. lessor'sincremental borrowing rate
D. None of these

6. Alesseeshallapplythedepreciationrequirementsin……….,indepreciating the right-of-use asset (for the lease term or the useful life based on the lease condition).

A. IndAS16
B. IndAS17
C. IndAS18
D. IndAS19

7. Aleaseisclassifiedasaifittransferssubstantiallyalltherisksandrewardsincidentaltoowner shipof an underlying asset.

A. financelease
B. operatinglease
C. None of these
D. Both A and B

8. A lease is classified as an … if it does not transfer substantially all the risks and rewards incidentalto ownership of an underlying asset.

A. financelease
B. operatinglease
C. None of these
D. Both A and B

9. Which of these is not a feature of financial lease?
A. the lease does not transfer ownership of the underlying asset to the lessee by the end of the lease term;
B. the lessee has the option to purchase the underlying asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception date, that the option will be exercised;
C. the lease term is for the major part of the economic life of the underlying asset even if title is not transferred;
D. at the inception date, the present value of the lease payments amounts to at least substantially all of the fair value of the underlying asset; and

10. Which of these is not a feature of operating lease?
A. A lessor shall recognise lease payments from operating leases as income on either a straight-line basis or another systematic basis.
B. The lessor shall apply another systematic basis if that basis is more representative of the pattern in which benefit from the use of the underlying asset is diminished.
C. A lessor shall not recognise costs, including depreciation, incurred in earning the lease income as an expense.
D. A lessor shall add initial direct costs incurred in obtaining an operating lease to the carrying amount of the underlying asset and recognise those costs as an expense over the lease term on the same basis as the lease income.

11. Which of the following is wrong in regard to disclosures?
A. The objective of the disclosures is for lessors to disclose information in the notes that, together with the information provided in the balance sheet, statement of profit or loss and statement of cash flows,
B. The objective of the disclosures is to give a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessor.
C. A lessor shall disclose finance income on the net investment in the lease; for the reporting period for finance leases:
D. A lessor shall not disclose for operating leases, lease income, separately disclosing income relating to variable lease payments that do not depend on an index or a rate.

12. At the commencement date, the lessee shall recognise ….

A. a right-of-use asset and a lease liability.
B. Only a right-of-use asset
C. Only a lease liability.
D. None of these

13. Which of the following is wrong about Ind AS 116?

A. Standard sets out the principles for the recognition, measurement, presentation and disclosure of leases. T
B. he objective is to ensure that lessees and lessors provide relevant information in a manner that faithfully represents those transactions.
C. An entity shall consider the terms and conditions of contracts and all relevant facts and circumstances when applying this Standard.
D. An entity shall not apply this Standard consistently to contracts with similar characteristics and in similar circumstances.

14. The cost of the right-of-use of asset shall comprise following except:

A. the amount of the initial measurement of the lease liability
B. any lease payments made at or before the commencement date, less any lease incentives received;
C. any initial indirect costs incurred by the lessee; and
D. an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset

15. If the discount rate cannot be readily determined, the lessee shall use the….

A. lessee's incremental borrowing rate
B. interest rate implicit in the lease
C. lessee's decremental borrowing rate
D. interest rate explicit in the lease

Answers for Self Assessment

1.	A	2.	C	3.	A	4.	A	5.	A
6.	A	7.	A	8.	B	9.	A	10.	C
11.	D	12.	A	13.	D	14.	C	15.	A

Review Questions

1. Comment on substantive substitutions rights of lessor.
2. How right to control the use of identified asset can be established?
3. How the Lessee allocates the consideration to the lease component?
4. Explain the lease term for lease accounting under Ind AS 116?
5. What payments be included in the calculation of lease liability under Ind AS 116?

Further Readings

- ICAI: Paper 5 Advanced accounting
- Corporate accounting by Hanif and Mukherjee, MC Graw Hill India,2017
- ICMAI: Paper 18-Corporate Financial Reporting

Dr. Rupinder Katoch, Lovely Professional university

Unit 04: AS 22: Accounting for Taxes on Income

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Keywords

Self Assessment

Answers for Self Assessment

Review Questions

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Objectives

After studying this unit, you will be able to:

- Learn accountingtreatmentfortaxesonincome
- Recognize Tax expense for the period
- Measure Current tax and Deferred tax
- Disclosure practices for Deferred tax assets and liabilities

Introduction

This Standard's goal is to specify the accounting treatment for income taxes. One of the key components of an enterprise's profit and loss statement is taxes on income. According to the matching idea, taxes on income are incurred at the same time as the related revenue and expenses. Due to the fact that in some circumstances, taxable income may differ greatly from the accounting income, matching such taxes against revenue for a period presents unique challenges.There are two basic causes for the difference between taxable income and accounting income. The items that are considered revenue, costs, or deductions for tax purposes differ from those that show in the statement of profit and loss in the first place. Second, there are discrepancies between the amount related to a specific item of revenue or expense that is acknowledged in the statement of profit and loss and the corresponding amount that is acknowledged for the computation of taxable income.

4.1 Scope

- The income tax accounting should follow this standard. This includes figuring out the cost or savings associated with income taxes for a given accounting period and disclosing that amount in the financial statements.

- All domestic and international taxes that are based on taxable income are considered income taxes for the purposes of this Standard.
- This Standard does not outline when or how a business should account for taxes due on dividend distributions and other types of distributions the business makes.

4.2 Taxable Income

- Tax laws are followed while determining taxable income. In some cases, the criteria set forth by these laws for calculating taxable income are different from the ones used by the accounting standards to calculate accounting income. This distinction has the effect of making it possible for the taxable income and the accounting income to differ.
- Permanent differences and timing differences can be used to categorise disparities between taxable income and accounting income. Permanent disparities are those that start in one period and do not end later between taxable income and accounting income. For instance, there would be a permanent difference if the tax regulations only permitted a portion of an item of expenditure for calculating taxable income.
- For tax reasons, machinery purchased for business-related scientific research is fully deductible in the first year; however, the same expense would be charged to the statement of profit and loss as depreciation over the course of its useful life. Although the periods over which the depreciation is charged and the deduction is permitted may vary, the total amount of depreciation paid on the machinery for accounting purposes and the amount allowed as a deduction for tax reasons will ultimately be the same. Another instance of a timing discrepancy is when tax laws permit depreciation based on the written down value method for the purposes of calculating taxable income but do not allow it for the purposes of accounting business expenses.
- The straight line approach is used for accounting purposes.
- Subject to the application of prudent judgement, unabsorbed depreciation and losses carried forward that can be offset against future taxable income are likewise regarded as timing differences and produce deferred tax assets.

4.3 Recognition

- When calculating the period's net profit or loss, tax expenses, which include both current and deferred taxes, must be taken into account.
- Money taxes are accrued in the same period as the revenue and expenses to which they pertain and are regarded as an expense incurred by the firm in producing money. Timing differences may emerge from such matching. The financial statement's tax expense and balance sheet's deferred tax assets (subject to the prudential considerations outlined in paragraphs 15–18) or deferred tax liabilities both reflect the tax impacts of timing discrepancies.
- An item that is included in the statement of profit and loss but is not recognised as a deduction under Section 43B of the Income-tax Act of 1961 is an example of the tax impact of a timing difference that results in a deferred tax asset. When the expense is deductible under Section 43B in the next year(s), this time discrepancy will reverse. The larger charge of depreciation allowed under the Income-tax Act, 1961, compared to the depreciation disclosed in the statement of profit and loss, is an example of the tax consequence of a

timing discrepancy leading to a deferred tax liability. The difference will reverse the following years when substantially less depreciation is permitted for tax purposes.

- Permanent differences neither produce nor result in deferred tax assets or liabilities.
- All timing discrepancies should be recognised as deferred tax, subject to the prudent management of deferred tax assets.
- To the extent that the enterprise's gross total income is subject to the deduction during the tax holiday period in accordance with the requirements of sections 80-IA/80IB of the Income-tax Act, 1961 (hereinafter referred to as the "Act"), the deferred tax in respect of timing differences that reverse during the tax holiday period is not recognised.
- The deferred tax in relation to timing differences that reverse during the tax holiday period is not recognised in cases where sections 10A and 10B of the Act (covered under Chapter III of the Act dealing with incomes which do not form part of total income) are in effect, as long as a deduction from the total income of an enterprise is permitted during the tax holiday period in accordance with the provisions of the aforementioned sections.
- Deferred tax is recognised in the year that the timing differences first occur in relation to timing differences that change after the tax holiday period. Deferred tax assets must be recognised while exercising caution, though.
- The timing differences that originate first are deemed to reverse first for the aforementioned purposes.
- For each and every time difference, this Standard mandates the recognition of deferred tax. This is founded on the idea that all transactions that take place during a period should have their tax implications recognised in the financial statements, whether those effects are current or deferred.
- Deferred tax assets shall only be recorded and carried forward to the extent that there is a reasonable assurance that there will be enough future taxable income available against which such deferred tax assets can be realised.
- While taking into account the tax implications of time variations, caution must always be taken into account. Deferred tax assets are therefore only acknowledged and carried forward to the degree that there is a reasonable likelihood that they will be realised. This decent level of assurance would typically be attained by looking at the company's track record and making accurate predictions of future profitability.
- Deferred tax assets should only be recognised when there is a virtual certainty supported by convincing evidence that there will be enough future taxable income available against which such deferred tax assets can be realised, such as when an enterprise has unabsorbed depreciation or carry forward of losses under tax laws.
- The determination of whether there is a "virtual certainty" that there will be enough future taxable income is a matter of judgement based on persuasive evidence and will have to be assessed on a case-by-case basis. The term "virtual certainty" describes the degree of assurance that is, for all intents and purposes, regarded to be certain. Virtual certainty cannot be relied solely on performance projections, such as those seen in corporate plans. Virtual certainty requires persuasive proof and is not a matter of perception. Evidence is factual information.
- For the proof to be considered persuasive, it must be readily available at the time of the reporting in a tangible form, such as a lucrative binding export order, the cancellation of which will require the defaulting party to pay significant damages. On the other hand, a forecast of future profits made by an enterprise based on projected capital expenditures,

restructuring, etc. that was submitted even to an outside agency, such as a credit agency for obtaining loans and accepted by that agency, cannot, in isolation, be considered as convincing evidence.

- The "loss" emerging under the head "Capital gains" can only be carried forward and offset against the income coming under that head as per the Act's requirements, according to the relevant provisions of the Income-tax Act of 1961 (hereinafter referred to as the "Act").
- When a company's statement of profit and loss contains a "loss" item that, under the Act's requirements, can only be offset in the future for tax purposes against income arising under the head "Capital gains," that item is a timing difference to the extent that it is not offset in the current year but is permitted to be offset against income arising under the head "Capital gains" in subsequent years, subject to the Act's provisions. Deferred tax assets are identified and carried forward in relation to such "losses" after taking prudent judgement into account.
- Deferred tax assets are therefore only recognised and carried forward in relation to such "losses" to the extent that there is a virtual certainty, supported by convincing evidence, that there will be enough future taxable income available under the head "Capital gains" against which the loss can be offset in accordance with the Act's provisions. The facts and circumstances of each case would determine whether or not the criteria of virtual certainty is met.
- Sale of an asset generating a capital gain (eligible to set-off the capital loss in accordance with the Act) after the balance sheet date but prior to the approval of the financial statements, and binding sale agreement that will typically satisfy the test of virtual certainty, supported by convincing evidence, for the purposes of the recognition of deferred tax asset in respect of loss arising under the head "Capital gains"
- When long-term capital assets' cost indexation under the Act results in a difference between the amounts of "loss" recognised for accounting and tax purposes, the deferred tax asset is recognised and carried forward (subject to the application of caution) on the amount that can be carried forward and set-off in subsequent years in accordance with the Act's provisions.
- Unused depreciation and carried-forward losses are both strong indicators that future taxable income may not be possible. Because of this, when a business has a history of recent losses, it only recognises deferred tax assets to the extent that there are timing differences that, if reversed, will generate enough income or if there is other strong evidence that enough taxable income will be available to realise such deferred tax assets. In such cases, the type of the supporting evidence for its acknowledgment is made public.

4.4 Re-assessmentofUnrecognisedDeferredTaxAssets

- An enterprise reevaluates unrecognised deferred tax assets at each balance sheet date. To the extent that it has become reasonably certain or virtually certain, as the case may be (see paragraphs 15 to 18), that there will be enough future taxable income available against which such deferred tax assets can be realised, the enterprise recognises previously unrecognised deferred tax assets. For instance, a change in market conditions can make it more likely than not that the business would be able to produce enough taxable income in the future.
- Using the relevant tax rates and laws, current tax should be calculated as the amount anticipated to be paid to (recovered from) the taxing authorities.

- Tax rates and rules that have been passed or have been substantially passed by the balance sheet date should be used to calculate deferred tax assets and liabilities.
- Deferred tax assets and liabilities related to timing differences arising in the current period, the tax effect of which is required to be recognised under AS 22, are measured using regular tax rates rather than the tax rate under section 115JB of the Act if an enterprise expects that the timing differences arising in the current period would reverse in a period in which it may pay tax under section 115JB of the Act.
- The tax rates and adopted tax legislation are typically used to calculate deferred tax assets and liabilities. However, the government may really impose specific tax rules and rates after making certain pronouncements. Deferred tax assets and liabilities are calculated under these conditions using the recently announced tax rate and applicable tax laws.
- Deferred tax assets and liabilities are calculated using average rates when different tax rates are applied to various levels of taxable income.
- It's not a good idea to discount deferred tax assets and liabilities to their current value.
- The precise scheduling of the date of the reversal of each timing difference is necessary for the accurate computation of deferred tax assets and liabilities on a discounted basis. Such scheduling is frequently impossible or extremely complicated. Deferred tax assets and liabilities should not be required to be discounted as a result. Discounting would result in deferred tax assets and liabilities that would not be comparable between firms if it were permitted but not required. Deferred tax assets and liabilities are not required to be discounted under this Standard, nor is it permitted.

4.5 ReviewofDeferredTaxAssets

At each balance sheet date, the carrying value of deferred tax assets should be examined. When it is no longer reasonably certain or virtually certain, as the case may , that there will be enough future taxable income available against which the deferred tax asset can be realised, the enterprise should write down the carrying amount of the deferred tax asset. Any such write-down may be overturned to the extent that sufficient future taxable income becomes substantially certain or virtually certain, as applicable

4.6 PresentationandDisclosure

An enterprise should offset assets and liabilities representing current tax if theenterprise:

- ✓ hasalegallyenforceablerighttosetofftherecognisedamounts;and
- ✓ intendstosettletheassetandtheliabilityonanetbasis.

- When assets and liabilities reflecting current taxes are related to income taxes assessed under the same controlling taxation laws and those taxation laws allow the enterprise to make or receive a single net payment, the enterprise will often have a legally enforceable right to set them off.
- Deferred tax assets and liabilities should be offset by an organisation if both are related to income taxes levied under the same governing taxation laws and the organisation has a legally enforceable right to set assets against liabilities representing current tax.
- Assets and liabilities representing deferred tax for the period should be differentiated from assets and liabilities representing current tax. In the company's balance sheet, deferred tax assets and liabilities should be disclosed under a different heading from current assets and liabilities.

- For clarification, deferred tax liabilities (net of any deferred tax assets, if any, are disclosed on the face of the balance sheet separately after the head "Unsecured Loans" and deferred tax assets (net of any deferred tax liabilities, in accordance with paragraph 29), after the head "Investments."
- The notes to accounts should include a breakdown of the principal components of the relevant balances' deferred tax assets and liabilities.
- If an organisation has unabsorbed depreciation or a carryforward of losses under the tax regulations, the type of evidence used to justify the recognition of deferred tax assets should be reported.

4.7 TransitionalProvisions

- The enterprise should recognise in the financial statements any deferred tax balance that has accrued prior to the adoption of this Standard as a deferred tax asset or liability with a corresponding credit or charge to the revenue reserves, subject to the application of caution in the case of deferred tax assets. The amount so credited/charged to the revenue reserves ought to be equal to what would have happened if this Standard had been in place from the start.
- The opening balances of assets and liabilities for accounting and tax purposes are compared, and any discrepancies are established, for the purpose of calculating accumulated deferred tax in the period in which this Standard is implemented for the first time. If there are any tax repercussions from these changes, whether they are timing differences or not, they should be recorded as deferred tax assets or liabilities. For instance, the opening balance of a fixed asset is Rs.100 for accounting purposes and Rs. 60 for tax purposes in the year that an enterprise implements this Standard.
- The distinction arises from the fact that the business uses the straight line technique of depreciation for accounting reasons while using the written down value method for calculating taxable income. When depreciation for tax purposes is less than depreciation for accounting purposes in the future, the difference will be reversed. In the scenario mentioned above, deferred tax obligation of Rs.16 [(Rs.100 – Rs.60) x 40%] would be acknowledged provided that the enacted tax rate for the year is 40% and that there are no other timing inconsistencies.
- Another illustration would be a cost that was written off for accounting purposes in the year of incurrence but was later found to be deductible for tax purposes. In this instance, the asset that represents that outlay would only have a balance for taxation and not for accounting. When this expenditure is later permitted for tax purposes, the timing difference between the asset's balance for tax purposes and the balance (which is zero) for accounting purposes will reverse.

Keywords

- Accounting income (loss) is the net profit or loss for a period as shown in the profit and loss statement before subtracting income tax expense or including income tax savings.
- Taxable income (tax loss) is the amount of income (loss) for a period that is calculated in line with the tax regulations and used to assess whether income tax is due or recoverable.

- Tax expense (tax saving): The total of current tax and deferred tax charged or credited to the period's statement of profit and loss is known as tax expense (tax saving).
- Current tax: The amount of income tax that has been found to be due (recoverable) in relation to the taxable income (tax loss) for a certain period is known as current tax.
- Deferred tax: Timing differences have a tax consequence known as deferred tax.
- Timing disparities are differences that start in one period and can be reversed in one or more subsequent periods between taxable income and accounting income for that period.
- Permanent disparities: The distinctions between taxable and accounting income for a period that start in one period and do not reverse later are known as permanent disparities.

Self Assessment

1. Which standard deals with AccountingforTaxesonIncome?

A. AS22
B. As23
C. AS24
D. AS25

2. Which of the following is not a correct characteristic of permanent difference or timing difference?

A. permanent difference Cannot be reversed any subsequent period.
B. permanent difference can be reversed in one or more subsequent periods.
C. Depreciation allowed as per WDV method for computing taxable income and as per SLM method for computing accounting income is example of timing difference.
D. Donation paid in cash is disallowed in computing taxable income whereas it is allowed as expenditure while computing accounting income is an example of permanent difference

3. Which of the following is not the reason for applicability of accounting standard 22?

A. AS 22 needs to be applied when there are differences between taxable income and accounting income.
B. AS 22 needs to be applied when there are no differences between taxable income and accounting income.
C. If taxable income is greater than accounting income, then it will result in deferred tax asset.
D. And if accounting income is greater than taxable income, then it will result in deferred tax liability.

4. Which of the following is not the right difference between AS22 and IND AS 12?

A. AS 22 recognized tax effect of differences between taxable income and accounting income and IND AS 12 recognized tax effect of differences between assets and/or liabilities and their tax base.
B. AS 22 is based on profit or loss statement approach and IND AS 12 is based on balance sheet approach.
C. The types of differences on which AS 22 is applied are timing differences and permanent differences and only Permanent differences are dealt in by IND AS 12.
D. DTA is recognized only when and to the extent there is a reasonable certainty of its realization and in IND-AS 12 deductible temporary differences are recognized to theextent of the probability of taxable profits in future periods.

5. …….is the amount of income (loss) for a period that is calculated in compliance with the tax regulations and used to assess whether income tax is due or recoverable.

A. Taxableincome
B. Accounting income
C. Tax expense
D. Currenttax

6. Before subtracting income tax expense or adding income tax savings…. is the net profit or loss for a period as stated in the statement of profit and loss.

A. Taxableincome
B. Accounting income
C. Tax expense
D. Currenttax

7. …. is the total amount of current and deferred taxes that are charged or credited to the period's profit and loss statement.

A. Taxableincome
B. Accounting income
C. Tax expense
D. Currenttax

8. …. is the sum of income tax that has been judged to be due (recoverable) in relation to the taxable income or tax loss for a given period.

A. Taxableincome
B. Accounting income
C. Tax expense
D. Currenttax

9. …. is the tax ramifications of temporal variations.

A. Currenttax
B. Deferredtax
C. Timing differences
D. Permanentdifferences

10. … are disparities that start in one period that can be reversed in one or more later periods between taxable income and accounting income for that time.

A. Currenttax
B. Deferredtax
C. Timing differences
D. Permanentdifferences

11. …… are the discrepancies that start in one period and do not change later between taxable income and accounting income for a period.

A. Currenttax
B. Deferredtax

C. Timing differences
D. Permanentdifferences

12. Which of the following is not correct about timing and permanent differences ?
A. Permanent differences are those differencesbetween taxable income and accounting income which originate in one period and do notreverse subsequently.
B. Timingdifferencesarethosedifferencesbetweentaxableincomeandaccountingincome for a period that originate in one period and are capable of reversal in one or moresubsequent periods.
C. Timing differences arise because the period in which some items ofrevenueandexpensesareincludedintaxableincomedonotcoincidewiththeperiodin whichsuchitemsofrevenueandexpensesareincludedorconsideredinarrivingataccoun tingincome.
D. Timingdifferencesarethosedifferencesbetweentaxableincomeandaccountingincome for a period that originate in one period and are not capable of reversal in one or moresubsequent periods.

13. Which of the following is wrong in regard to recognition of tax expense?
A. Income taxes are accrued within the same period as the revenue and expenses to which they pertain and are regarded as an expense incurred by the business when making income.
B. Timing differences does not emerge from such matching.
C. The financial statement's tax expense and balance sheet's deferred tax or deferred tax liabilities both reflect the tax impacts of timing discrepancies.
D. An item included in the statement of profit and loss but not permitted as a deduction under Section 43B of the Income-tax Act, 1961, is an example of the tax impact of a timing difference that results in a deferred tax asset.
14. Which of the following is wrong in regard to measurement of tax?
A. Using the applicable tax rates and tax legislation, current tax should be calculated as the sum anticipated to be paid to (recovered from) the taxing authorities.
B. The tax rates and tax rules that have been passed or substantially passed by the balance sheet date should be used to calculate the deferred tax assets and liabilities.
C. The tax rates and adopted tax legislation are typically used to calculate deferred tax assets and liabilities.
D. Deferred tax assets and liabilities are calculated using different rates when different tax rates are applied to various levels of taxable income.

15. Which of the following is wrong in regard to presentation and disclosure of tax?
A. Assets and liabilities representing current tax should be offset by an organisation if it has a legally enforceable right to do so; and plans to pay the asset and liability on a net basis.
B. If a business has a legally enforceable right to set off assets against liabilities representing current tax and its deferred tax liabilities and assets both relate to income taxes assessed under the same governing tax laws, it should offset its deferred tax assets and liabilities.
C. Assets and liabilities representing deferred tax for the period should not be differentiated from assets and liabilities representing current tax.
D. In the company's balance sheet, deferred tax assets and liabilities should be disclosed under a different heading from current assets and liabilities.

Answers for Self Assessment

1.	A	2.	B	3.	C	4.	C	5.	A
6.	B	7.	C	8.	D	9.	B	10.	C
11.	D	12.	D	13.	B	14.	D	15.	C

Review Questions

1. Write a note on presentation and disclosure practices for tax.
2. Explain measurement practices for tax.
3. Briefly describe a recognition criteria for tax .
4. Discuss the applicability of accounting standard 22.
5. Discuss transitional provisions for accounting standard 22.

Further Readings

- ICAI: Paper 5 advanced accounting
- https://cleartax.in/s/as-22-accounting-on-income-taxes

Unit 05: AS 24: Discontinuing Operations

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Objectives

After studying this unit, you will be able to:

- set reporting guidelines for information regarding discontinuing operations
- generate estimates of an enterprise's cash flows, earnings-generating potential, and financial situation By separating information about operations that are ending from information about operations that are ongoing

Introduction

By separating information about ceasing operations from information about ongoing operations, this Standard aims to establish guidelines for reporting information about ceasing operations, improving the ability of users of financial statements to forecast an enterprise's cash flows, ability to generate profits, and financial position. When a business launches several businesses at once and discovers that one or more of them are unprofitable, it can halt its operations in these areas. All of these company-stopped operations are referred to as ceasing operations. However, there is one more crucial fact to be aware of: Before closing any operation, any company has already made purchases and gotten loans to operate the operation, so accurate accounting is required. When a

business stops operating, it must sell all of its assets, settle all of its debts, and then add the remaining funds to its capital or reserve.

5.1 Objective

By separating information about ceasing operations from information about ongoing operations, this Standard aims to establish guidelines for reporting information about ceasing operations, improving the ability of users of financial statements to forecast an enterprise's cash flows, ability to generate profits, and financial position.

5.2 Scope

This Standard is applicable to any enterprise operations that are being discontinued.

5.3 What is a discontinuing operation?

A discontinuing operation is one of the following:

(a) a component of an enterprise that the enterprise is

(i) disposing of substantially in its entirety, such as by selling the component in a single transaction or by demergering or spinning off ownership of the component to the enterprise's shareholders.

(ii) disposing of piecemeal, such as by selling the component's assets and settling its liabilities individually; or

(iii) terminating through abandonment.

(b) that designates a distinct principal line of business or geographic area of operations.

(c) that is distinguishable in terms of operations and financial reporting.

A discontinuing operation may be discontinued in full or in part under criterion, but only in accordance with a comprehensive strategy to end the operation as a whole.

An company may have a net gain or loss if it sells a component almost entirely. Although the actual transfer of possession and control of the discontinuing operation may take place at a later date, a legally binding sale agreement is entered into for such a discontinuance on a specific date. Additionally, payments to the seller could be made at the time of the contract, during the transfer, or over a longer period of time.

An enterprise may terminate and dispose of a component by selling its assets and paying off its liabilities piecemeal (individually or in small groups), as opposed to significantly disposing of the component in its entirety. The sale of a single asset or the payment of a single liability may have the opposite effect in the case of piecemeal disposals, even though the aggregate outcome may be a net gain or a net loss. Additionally, there is no set time when a final, legally binding sale agreement is signed. Instead, the asset sales and liability settlements might take place over a few months, or maybe even longer.

As a result, component disposal can still be ongoing at the end of a financial reporting period. The disposal must be done in accordance with a single coordinated strategy to be considered a stopping operation.

An operation may be discontinued by an enterprise without making significant asset transactions. If an operation is abandoned and meets the requirements of the definition, it is considered to be discontinuing. A change in an operation's purpose or method of execution, however, does not constitute its abandonment because the operation is still going on.

Businesses often alter the size of their workforce, close facilities, and discontinue entire product lines in reaction to market factors. Even though these kinds of terminations typically do not constitute discontinuing operations, they can nonetheless take place in connection with one.

Activities like

(a) gradual or evolutionary phasing out of a product line or class of services;

(b) discontinuing, even if relatively abruptly, several products within an ongoing line of business;

(c) shifting of some production or marketing activities for a particular line of business from one location to another; and

(d) closing

are examples of activities that do not necessarily satisfy criterion , but that may do so in combination with other circumstances.

Selling a subsidiary whose activities are similar to those of the parent or other subsidiaries is an example of consolidated financial statements.

According to Accounting Standard (AS) 17, Segment Reporting, a reportable business segment or geographic segment would typically meet criterion of the definition of a discontinuing operation , meaning it would represent a distinct major line of business or geographical area of operations. A portion of such a segment may also meet the definition's criteria .

A significant product or service line may also meet the requirements of the definition for an enterprise that operates in a single business or geographic segment and does not provide segment information.

If all of the following elements are satisfied, a component can be identified for operational and financial reporting purposes.

(a) The component's operational assets and liabilities may be directly ascribed to it;

(b) The component's revenue can be directly credited to it; and

(c) The component can be directly attributed to at least the majority of the component's operating expenses.

When a component is sold, abandoned, or otherwise disposed of, all assets, liabilities, revenue, and expenses that would otherwise be removed are considered to be directly attributable to that component. The associated interest and other finance expenses are also attributable to the component if debt is.

Discontinuing operations, as described by this Standard, should only happen occasionally. Not all rarely occurring occurrences constitute the termination of operations. Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Item s and Changes in Accounting Policies, may require separate disclosure for infrequently occurring events that do not qualify as discontinuing operations because of their size, nature, or incidence that makes them relevant to explain the performance of the enterprise for the period.

The ability of a business to continue as a going concern is not automatically called into doubt by the fact that the disposal of a component of the enterprise is categorised as a terminating operation under this Standard.

5.4 Initial Disclosure Event

The earliest of the following events, with respect to a ceasing operation, constitutes the initial disclosure event:

(a) The enterprise's board of directors or similar governing body has both

(i) approved a thorough, formal plan for the discontinuance and

(ii) made an announcement of the plan.

(b) The enterprise has entered into a binding sale agreement for the majority of the assets attributable to the discontinuing operation.

A comprehensive, formal plan for the discontinuance typically includes the following information:

(a) identification of the key assets to be sold;

(b) the expected method of sale;

(c) the anticipated time frame for sale completion;

(d) the key locations affected;

(e) the location, function, and approximate number of employees who will receive termination pay; and

(f) the estimated proceeds or salvage to be realised by sale.

The board of directors of an enterprise, or a similar governing body, is deemed to have announced a detailed, formal plan for discontinuance if it has made the plan's key components known to those who will be impacted by it, including lenders, stock exchanges, creditors, trade unions, and others, in a manner that is sufficiently specific to show that the enterprise is demonstrably committed to the discontinuance.

5.5 Recognition and Measurement

When determining when and how to recognise and measure changes in assets and liabilities as well as revenue, expenses, gains, losses, and cash flows related to a discontinuing operation, an enterprise should use the principles of recognition and measurement outlined in other Accounting Standards.

No principles for measurement and recognition are established by this Standard. Instead, it mandates that an organisation adhere to the measurement and recognition procedures outlined in other accounting standards, such as Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date2, and Accounting Standard on Impairment of Assets.

5.6 Presentation and Disclosure

Initial Disclosure

Starting with the financial statements for the period in which the initial disclosure event takes place, an entity should include the following information regarding a ceasing operation:

(a) a description of the operation(s) that are being discontinued;

(b) the geographic or business segment(s) in which it is reported in accordance with AS 17, Segment Reporting;

(c) the date and nature of the initial disclosure event;

(d) the date or period in which the discontinuance is expected to be completed if known or determinable;

(e) the carrying amounts, as of the balance sheet date, of the total assets to be sold and the total liabilities to be settled;

(f) the sums of revenue and expenses related to routine business activities attributable to the

operation ceasing during the current financial reporting period;

(g) the amount of the discontinuing operation's pre-tax profit or loss from regular operations during the current financial reporting period, as well as the income tax expense4 related thereto; and

(h) the amounts of net cash flows attributable to the operation's operating, investing, and financing activities during the current financial reporting period.

The items of assets, liabilities, revenues, expenses, gains, losses, and cash flows can only be attributed to a discontinuing operation for the purposes of presentation and disclosures required by this Standard if they will be sold, settled, reduced, or eliminated when the discontinuance is finished. Such items are not assigned to the discontinuing operation to the extent that they continue after the discontinuance has been completed. Taking the salary of the remaining employees of a closing business as an example.

Disclosures as required by Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date, are made if an initial disclosure event occurs between the balance sheet date and the date on which the financial statements for that period are approved by the corresponding approving authority in the case of a company or by the board of directors in the case of any other enterprise.

5.7 Other Disclosures

An organisation should include the following information in its financial statements whenever it disposes of assets, pays liabilities related to a ceasing business, or signs contracts for the sale of such assets or the settlement of such liabilities.

(a) the amount of the pre-tax gain or loss and income tax expense relating to any gain or loss recognised on the disposal of assets or settlement of liabilities attributable to the ending business; and

(b) the carrying amount of those net assets as of the balance sheet date, the expected timing of receipt of those cash flows, and the net selling price or range of prices (after deducting expected disposal costs) of those net assets for which the enterprise has entered into one or more binding sale agreements.

The asset sales, liability settlements, and binding sale agreements mentioned in the previous sentence may take place at the same time as the original disclosure event, within the initial disclosure event's timeframe, or at a later time.

The disclosures required by Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date, must be made if some of the assets attributable to a discontinuing operation have actually been sold or are the subject of one or more binding sale agreements entered into between the balance sheet date and the date the financial statements are approved by the corresponding approving authority in the case of a company or by the corresponding approving authority in the case of any other enterprise.

5.8 Updating the Disclosures

In addition to the disclosures in paragraphs 20 and 23, an enterprise should include a description of any significant changes in the amount or timing of cash flows related to the assets to be sold off or liabilities to be settled in its financial statements for periods following the one in which the initial disclosure event occurs.

Events and activities like a demerger or spin-off by issuing equity shares of the new firm to the enterprise's shareholders as well as legal or regulatory clearances are examples of things that would be revealed.

Financial statements should include the information mandated by paragraphs 20, 23, and 26 up to and including the period in which the cessation is completed. Even though full payments from the buyer(s) may not have been collected yet, a discontinuance is complete when the plan is either abandoned or substantially completed.

The fact, the reasons behind it, and the outcome should be revealed if a company abandons or withdraws from a plan that was previously reported as a terminating operation.

Any past impairment loss or provision that was recognised with relation to the ending activity must be reversed in order to comply with paragraph 29.

5.9 Separate Disclosure for Each Discontinuing Operation

For each ending operation, any disclosures mandated by this Standard should be provided separately.

5.10 Presentation of the Required Disclosures

All disclosures required by paragraphs on initial disclosures, Other Disclosures, Updating the Disclosures, should be included in the notes to the financial statements, with the exception of the following, which should be included on the face of the profit and loss statement:

(a) 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 (paragraph 20(g)); and

(b) the amount of the pre-tax profit or loss from ordinary activities attributable

5.11 Restatement of Prior Periods

Financial statements issued after the initial disclosure event should be restated to segregate assets, liabilities, revenue, expenses, and cash flows of continuing and discontinuing operations. Comparative information for past periods that is given in the financial statements should be restated.

5.12 Interim Financial Reports' Disclosure

In accordance with AS 25, Interim Financial Reporting, disclosures in an interim financial report relating to a discontinuing operation should be made, including:

(a) any noteworthy activities or events since the end of the most recent annual reporting period relating to a discontinuing operation; and

(b) any noteworthy changes in the amount or timing of cash flows relating to the assets to be sold or liabilities to be settled.

5.13 Illustrative Presentation and Disclosures

Illustration 1

Illustrative Disclosures

Facts of the case:

- The Delta Company is divided into three segments: the Food Division, the Beverage Division, and the Clothing Division. The Clothing Division is believed to be at odds with the Company's long-term plan. Therefore, management has decided to dissolve the Clothing Division.
- The Board of Directors of Delta Company adopted a thorough, official plan for the disposal of the Clothing Division on November 15, 20X1, and a declaration was made. The Clothing Division's net assets on that date were $90 lakhs (assets of $105 lakhs less liabilities of $15 lakhs).
- The Company determined that a pre-tax impairment loss of '20 lakhs should be recognised since the recoverable amount of the assets carried at '105 lakhs' was estimated to be '85 lakhs.
- The carrying value of the net assets for the Clothing Division as of December 31, 20Xl was '70 lakhs (assets '85 lakhs minus liabilities '15 lakhs). Between 15 November 20X1 and 31 December 20X1, when the financial statements were created, there was no additional asset impairment.
- The Company determined that a pre-tax impairment loss of '20 lakhs should be recognised since the recoverable amount of the assets carried at '105 lakhs' was estimated to be '85 lakhs.
- The carrying value of the net assets for the Clothing Division as of December 31, 20Xl was '70 lakhs (assets '85 lakhs minus liabilities '15 lakhs). Between 15 November 20X1 and 31 December 20X1, when the financial statements were created, there was no additional asset impairment.
- In addition, the selling contract requires Delta Company to fire some employees of the Clothing Division by January 31, 2023, incurring a termination fee of'30 lakhs, which must be paid by June 30, 2023. In this sense, an obligation and associated expense are also acknowledged.
- Throughout 20X2, the Company kept running its clothing division.
- The carrying value of the Clothing Division's net assets at December 31, 20X2, which are comprised of assets worth 80 lakhs and liabilities worth 35 lakhs (including a provision for anticipated termination costs of 30 lakhs), is 45 lakhs.

- Every year, as of December 31, Delta Company prepares its financial accounts. A cash flow statement is not created.The presentation and disclosures required by the Standard are presumed to be illustrated by additional figures in the financial statements that follow.

Solution

Financial Statements for 20X1

Statement of Profit and Loss for 20X1:

The following format might be used to present Delta Company's Statement of Profit and Loss for the year 20X1:

	20X1	20X0
Turnover	140	150
Operating expenses	-92	-105
Impairment loss	-20	(---)
Pre-tax profit from operating activities	28	45
Interest expense	-15	-20
Profit before tax	13	25
Profit from continuing operations before tax(see Note 5)	15	12
Income tax expense	-7	-6
Profit from continuing operations after tax	8	6
Profit (loss) from discontinuing operations before tax (see Note 5)	-2	13
Income tax expense	1	-7
Profit (loss) from discontinuing operations after tax	-1	6
Profit from operating activities after tax	7	12

- Note 5 to Delta Company's financial statements:

The Board of Directors announced an intention to sell the company's clothing division, which is also a separate segment in accordance with AS 17, Segment Reporting, on November 15, 20Xl. The sale is in line with the company's long-term plan to sell off unrelated businesses and concentrate its efforts on the production and distribution of food and beverages. The Clothing Division is currently up for sale, and the Company hopes to close the deal by the end of 20X2. The Clothing Division's carrying value of assets at the end of 20Xl was '85 lakhs (prior year '120 lakhs) and its carrying value of liabilities was '15 lakhs (previous year '20 lakhs). The revenue and costs for both continuing and ceasing operations are shown in the following statement:

	Continuing Operations (Food and Beverage Divisions)		Discontinuing Operation (Clothing Division)		Total	
	20X1	20X0	20X1	20X0	20X1	20X0
Turnover	90	80	50	70	140	150
Operating Expenses	-65	-60	-27	-45	-92	-105
Impairment Loss	----	----	-20	(---)	-20	(---)
Pre-tax profit from operating activities	25	20	3	25	28	45
Interest expense	-10	-8	-5	-12	-15	-20
Profit (loss) before tax	15	12	-2	13	13	25

Income tax expense	-7	-6	1	-7	-6	-13		
Profit (loss) from operating activities after tax				8	6	(1) 6	7	12

Summary

Discontinued operations, which are reported separately from continuing activities on the income statement, are divisions of a company's core business or product line that have been sold off or discontinued. Because it's crucial that investors can distinguish between the profits and cash flows from continuing operations and those that have ended, discontinued operations are listed separately on the income statement. This distinction is particularly helpful when two companies merge since it allows one to more clearly see which assets are being sold or folded, which helps one to predict how profitable the new entity will be. A corporation has a number of line items to report on its financial statements when activities are ceased. The business component may nevertheless produce a gain or loss in the current accounting period even though it is being shut down. Thus, the relevant income taxes are listed first, then the overall gain or loss from the discontinued operations. Due of the frequent losses associated with abandoned operations, this tax is frequently a future tax advantage. The gain or loss from discontinued activities is combined with that from ongoing operations to calculate the company's overall net income (NI).

Keywords

- Discontinued operations: In accounting, the word "discontinued operations" is used to describe a company's operations that have been discontinued. In accounting, ceased operations and continuing operations are listed separately on financial statements.
- IFRS Discontinued Operations: In accordance with the International Financial Reporting Standards (IFRS), discontinued operations must satisfy two requirements before being reported. It is specifically covered in IFRS 5. First, the questioned asset or business component must have been sold or must have been disclosed as being held for sale. Second, the component must be clearly identified as a distinct company that is ceasing operations on purpose or as a subsidiary of another component that is being held with plans to sell it soon.
- Under GAAP, discontinued operations: According to generally accepted accounting principles (GAAP), discontinued activities are handled slightly differently. In line with IFRS, a corporation may report discontinued operations under GAAP if two conditions are satisfied. First, the transaction used to close the divested business must remove its operations and cash flow from the company's overall operations in order to meet GAAP requirements. Second, according to IFRS, the ceased operation is not permitted to continue to play a substantial role in the parent company. Equity method investments cannot be categorised as being held for sale, which is another distinction.

Self Assessment

1. A reportable business segment or geographical segment is defined under AS

A. 17

B. 18

C. 19

D. 20

2. A component can be distinguished operationally and for financial reporting purposes - criterion (c) of the definition of a discontinuing operation - if all the following conditions except one are met: Which is an exception?

A. the operating assets and liabilities of the component can be directly attributed to it;

B. its revenue can be directly attributed to it;

C. at least a majority of its operating expenses can be directly attributed to it.

D. Minority of its operating expenses can be directly attributed to it.

3. Which of the following is right in regard to Initial Disclosure Event?

A. With respect to a discontinuing operation, the initial disclosure event is the occurrence of one of the following, whichever occurs earlier: the enterprise has entered into a binding sale agreement for substantially all of the assets attributable to the discontinuing operation; or the enterprise's board of directors or similar governing body has both (i) approved a detailed, formal plan for the discontinuance and (ii) made an announcement of the plan.

B. With respect to a discontinuing operation, the initial disclosure event is the occurrence of one of the following, whichever occurs later: the enterprise has entered into a binding sale agreement for substantially all of the assets attributable to the discontinuing operation; or the enterprise's board of directors or similar governing body has both (i) approved a detailed, formal plan for the discontinuance and (ii) made an announcement of the plan.

C. With respect to a discontinuing operation, the initial disclosure event is the occurrence of one of the following, whichever occurs earlier: the enterprise has entered into a binding sale agreement for only a few of the assets attributable to the discontinuing operation; or the enterprise's board of directors or similar governing body has both (i) approved a detailed, formal plan for the discontinuance and (ii) made an announcement of the plan.

D. With respect to a discontinuing operation, the initial disclosure event is the occurrence of one of the following, whichever occurs earlier: the enterprise has entered into a binding sale agreement for substantially all the assets attributable to the discontinuing operation; or the enterprise's board of directors or similar governing body has both (i) disapproved a detailed, formal plan for the discontinuance and (ii) made an announcement of the plan.

4. Under initial disclosure event, the detailed, formal plan for the discontinuance normally includes all except:

A. identification of the major assets to be disposed of;

B. the expected method of disposal;

C. the period expected to be required for completion of the disposal;

D. the location, function, and approximate number of employees who will not be compensated for terminating their services;

5. Which of the following is right in regard to Recognition and Measurement?

A. An enterprise should apply the principles of recognition and measurement that are set out in other Accounting Standards for the purpose of deciding as to when and how to recognise and measure the changes in assets and liabilities and the revenue, expenses, gains, losses and cash flows relating to a discontinuing operation.

B. This Standard AS 24 does establish recognition and measurement principles.

C. This standard AS 24 does not require that an enterprise follow recognition and measurement principles established in other Accounting Standards.

D. This standard AS 24 does not requires that an enterprise follow recognition and measurement principles established in Accounting Standard (AS) 4.

6. An enterprise should include the following information relating to a discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure event occurs except….

A. a description of the continuing operation(s);

B. the business or geographical segment(s) in which it is reported as per AS 17, Segment Reporting;

C. the date and nature of the initial disclosure event;

D. the date or period in which the discontinuance is expected to be completed if known or determinable;

7. For the purpose of presentation and disclosures required by this Standard, which of the following is wrong?

A. The items of assets, liabilities, revenues, expenses, gains, losses, and cash flows can be attributed to a discontinuing operation only if they will be disposed of, settled, reduced, or eliminated when the discontinuance is completed.

B. The items of assets, liabilities, revenues, expenses, gains, losses, and cash flows can be attributed to a discontinuing operation only if they will be disposed of, settled, reduced, or eliminated when the discontinuance is initiated.

C. To the extent that such items continue after completion of the discontinuance, they are not allocated to the discontinuing operation. For example, salary of the continuing staff of a discontinuing operation.

D. If an initial disclosure event occurs between the balance sheet date and the date on which the financial statements for that period are approved by the board of directors in the case of a company or by the corresponding approving authority in the case of any other enterprise, disclosures as required by Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date, are made.

8. Which of the following is wrong in regard to Other Disclosures?

A. When an enterprise disposes of assets or settles liabilities attributable to a discontinuing operation or enters into binding agreements for the sale of such assets or the settlement of such liabilities, it should not include, in its financial statements, the following information when the events occur:for any gain or loss that is recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation, (i) the amount of the pre-tax gain or loss and (ii) income tax expense relating to the gain or loss;

B. When an enterprise disposes of assets or settles liabilities attributable to a discontinuing operation or enters into binding agreements for the sale of such assets or the settlement of such liabilities, it should include, in its financial statements, the following information when the events occur the net selling price or range of prices (which is after deducting expected disposal costs) of those net assets for which the enterprise has entered into one or more binding sale agreements, the expected timing of receipt of those cash flows and the carrying amount of those net assets on the balance sheet date.

C. The asset disposals, liability settlements, and binding sale agreements referred to in the preceding paragraph may occur concurrently with the initial disclosure event, or in the period in which the initial disclosure event occurs, or in a later period.

D. If some of the assets attributable to a discontinuing operation have actually been sold or are the subject of one or more binding sale agreements entered into between the balance sheet date and the date on which the financial statements are approved by the board of directors in case of a company or by the corresponding approving authority in the case of any other enterprise, the disclosures required by Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date, are made.

9. Which the following is wrong in regard to updating the Disclosures?

A. An enterprise should include, in its financial statements, for periods subsequent to the one in which the initial disclosure event occurs, a description of any significant changes in the amount or timing of cash flows relating to the assets to be disposed or liabilities to be settled and the events causing those changes.

B. Examples of events and activities that would be disclosed include the nature and terms of binding sale agreements for the assets, a demerger or spin-off by issuing equity shares of the new company to the enterprise's shareholders, and legal or regulatory approvals.

C. disclosure of the effect doers not include reversal of any prior impairment loss5or provision that was recognised with respect to the discontinuing operation.

D. If an enterprise abandons or withdraws from a plan that was previously reported as a discontinuing operation, that fact, reasons therefor and its effect should be disclosed.

10. Which of the following is wrong in regard to Separate Disclosure for Each Discontinuing Operation and Presentation of the Required Disclosures

A. Any disclosures required by this Standard should be presented separately for each discontinuing operation

B. 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 (paragraph 20 (g)) should be shown on the face of the statement of profit and loss; and

C. the amount of the pre-tax gain or loss recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation (paragraph 23 (a)) should be shown on the face of the statement of profit and loss.

D. All the disclosures required by paragraphs on initial disclosures, Other Disclosures, Updating the Disclosures, should be presented on the face of the statement of profit and loss.

11. Which of the following is wrong in regard to Disclosure in Interim Financial Reports?

A. Disclosures in an interim financial report in respect of a discontinuing operation should be made in accordance with AS 25.

B. Disclosures in an interim financial report in respect of a discontinuing operation should be made in accordance with AS 26.

C. Disclosures in an interim financial report in respect of a discontinuing operation should be made in accordance with AS 27.

D. Disclosures in an interim financial report in respect of a discontinuing operation should be made in accordance with AS 28.

12. Which standard deals with discontinuing operations?

A. AS24

B. AS13

C. AS12

D. AS14

13. AS 24 was issued in..

A. 2001

B. 2002

C. 2003

D. 2004

14. Accounting Standard is not mandatory for non-corporate entities falling in Level …...

A. II

B. III

C. IV

D. V

15. The requirements related to cash flow statement contained in this Standard are applicable where an

A. enterprise prepares and presents a cash flow statement

B. enterprise does not prepares and presents a cash flow statement

C. enterprise prepares and presents an income statement

D. enterprise does not prepares and presents an income statement

Answers for Self Assessment

1.	A	2.	D	3.	A	4.	D	5.	A
6.	A	7.	B	8.	A	9.	C	10.	D
11.	A	12.	A	13.	B	14.	B	15.	A

Review Questions

1. Explain initial disclosure event under AS 24.
2. Explain disclosures required under AS 24.
3. How the prior period items are restated?
4. How discontinued operation under AS24 differ from IFRS treatment?
5. What is recognition and measurement criteria under AS 24?

Further Readings

ICAI: Paper 5 advanced accounting

Web Links

- https://corporatefinanceinstitute.com/resources/accounting/discontinued-operations/
- https://www.investopedia.com/terms/d/discontinued-operations.asp
- https://cleartax.in/s/as-24-discontinuing-operations

Dr. Rupinder Katoch, Lovely Professional university

Unit 06: AS 29: Provisions, Contingent Liabilities and Contingent Assets

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Objectives

After studying this unit, you will be able to:

- Recognize provisions, contingent liabilities, and contingent assets
- Measure provisions, contingent liabilities, and contingent assets
- Disclosure practices for provisions, contingent liabilities, and contingent assets

Introduction

This Standard's goal is to make sure that the proper recognition criteria and measurement bases are used for provisions and contingent liabilities, and that the notes to the financial statements contain enough information to help readers understand the nature, timing, and amount of these liabilities. This Standard also aims to establish suitable accounting for contingent assets. The Standard was released for the first time in 2003. The Standard has been updated by the Ministry of Corporate Affairs, Government of India, and is applicable to businesses that follow the Companies (Accounting Standards) Rules, 2006, and should be used for the preparation of accounts for accounting periods starting on or after the date of notification. The notification was issued on March 30, 2016, and it is relevant for businesses that follow these rules. The Standard was updated by the Council of the ICAI for entities other than corporations in 2016 and is now required for accounting periods starting on or after April 1, 2017 (see Announcement XLV).

6.1 Scope

1. In dealing with contingent assets, this Standard should be used, with the following exceptions:

(a) those originating from financial instruments2 that are carried at fair value;

(b) those resulting from executory contracts, unless the contract is onerous;

Explanation:

(i) An "onerous contract" is one in which the inescapable costs of upholding the contract's commitments outweigh the anticipated financial gains. Therefore, in order for a contract to be considered onerous, the inevitable costs of upholding its obligations must be greater than the projected financial gains. The least expensive way to end a contract would cost less than its avoidable costs, which are the higher of its avoidable costs and any compensation or penalties for breaching it.

(ii) If a company has an onerous contract, the current duty under the contract is acknowledged and measured as a provision in accordance with this Standard. Illustration+ 10 of Illustration C, which is appended to the Standard, shows how the aforementioned explanation is applied in practise. (c) Those resulting from contracts with policyholders in insurance operations; (d) Those covered by another Accounting Standard. 2. Financial instruments that are not carried at fair value (including guarantees) are subject to this Standard.

(c) Those resulting from contracts with policyholders in insurance operations;

(d) Those covered by another Accounting Standard.

2. Financial instruments that are not carried at fair value (including guarantees) are subject to this Standard.

3. Executory contracts are agreements wherein neither party has complied with any of its responsibilities or when both parties have complied with some but not all of their obligations. Executory contracts are exempt from this Standard unless they are burdensome.

4. Other than those resulting from contracts with policyholders, this Standard applies to provisions, contingent liabilities, and contingent assets of insurance firms.

5. An company applies that Accounting Standard rather than this Standard where another Accounting Standard addresses a particular category of provision, contingent liability, or contingent asset.

6. When an enterprise provides assurances in exchange for a charge, for example, some amounts classified as provisions may be related to the recognition of revenue. The recognition of revenue is not a topic covered by this Standard. The income Recognition Standard (AS9) specifies the conditions under which income is recognised and offers helpful advice on how to apply the recognition criteria. The requirements of AS 9 are not changed by this Standard.

7. According to this Standard, provisions are obligations that can only be quantified with a significant amount of guesswork. The term "provision" is frequently used to refer to elements that affect the carrying amounts of assets, such as depreciation, asset impairment, and questionable loans; these items are not covered by this Standard.

8. Other Accounting Standards define whether expenses or assets should be considered when making financial decisions. This Standard does not address these problems. As a result, capitalization of the expenses recognised when a provision is made is neither prohibited nor required by this Standard.

9. The rules for restructuring—including ceasing operations—are covered by this Standard. When a restructure satisfies the criteria for a discontinued operation, AS 24, discontinued Operations, mandates further disclosures.

6.2 Recognition

Provisions

a. A provision should be recognised when an enterprise has a present obligation as a result of a past event,

b. it is likely that an outflow of resources encapsulating economic benefits will be necessary to settle the obligation,

c. and a reliable estimate of the obligation's amount can be made. No provision should be recognised if these prerequisites are not satisfied.

Present Obligation

It will be obvious in almost all situations whether a previous event gave birth to a present obligation.

Rarely, such as in a legal proceeding, it may be contested as to whether particular events have actually taken place or whether they have led to a present duty.

In such a situation, a company evaluates whether a present obligation exists at the balance sheet date by considering all relevant information, such as, for instance, expert opinions.

Any further evidence made available by occurrences after the balance sheet date is taken into consideration.

Based on such evidence, the enterprise (if the recognition criteria are met) recognises a provision where it is more likely than not that a present obligation exists at the balance sheet date, and discloses a contingent liability where it is more likely that no such obligation exists at the balance sheet date, unless the likelihood of an outflow of resources entailing economic benefits is remote.

Past Event

An obligating event is a previous occurrence that results in a current obligation. An occurrence must be an obligating event in order for the firm to have no practical alternative to satisfying the obligation it has caused.

Financial statements discuss an enterprise's financial situation as of the end of the reporting period, not as it might be in the future.

As a result, no provision is made for expenses that will be incurred in the future in order to function.

Liabilities that exist as of the balance sheet date are the only ones that are recognised in an enterprise's balance sheet.

Only those duties resulting from past events that exist independently of a company's future acts (i.e., how its business will be conducted in the future) are recognised as provisions.

Examples of such responsibilities are fines or clean-up expenses for unintentional environmental damage, both of which would result in an outflow of funds that would represent financial gains in a settlement independent of the enterprise's future activities.

Similar to that, a business recognises a provision for an oil installation's decommissioning costs to the extent that it must make good on previously done damage.

On the other hand, an organisation may need to invest in order to function in a specific way in the future due to commercial pressures or legal restrictions (for instance, by installing smoke filters in a specific sort of plant).

The company has no present commitment for that future expense and no provision is made since it can avoid the future expense through its future actions, such as changing its way of operation.

There is always a recipient of the responsibility in a contract. However, it is not required to be aware of the party's name; in fact, the obligation may be owed to the whole public.

It will frequently be impossible to know for sure whether a law will be passed until it is.

Probable Outflow of Resources Embodying Economic Benefits

- A liability must have both a present requirement and the likelihood of an outflow of resources that would result in economic gains in order to satisfy the obligation before it can be recognised.
- A resource outflow or other event is considered probable for the purposes of this Standard4 if it is more likely than not to occur, that is, if the likelihood that it will happen is higher than the likelihood that it won't.
- Unless the likelihood of an outflow of resources entailing economic benefits is remote, a firm discloses a contingent responsibility when it is not likely that a present obligation exists.
- Consideration of the class of obligations as a whole helps estimate the likelihood that an outflow will be necessary in settlement where there are numerous similar obligations (such as product warranties or similar contracts).

- Even while there may not be much of an outflow for any given item, it may still be likely that some outflow of resources will be required to pay off the entire class of commitments. If the other recognition conditions are satisfied, the provision is recognised in that situation.

Reliable Estimate of the Obligation

Using estimations is a crucial step in creating financial statements, and doing so does not compromise their dependability.

This is especially true for provisions, which by definition require more estimation than the majority of other things.

A business will typically be able to identify a variety of potential outcomes and, as a result, can create a reliable estimate of the obligation to utilise when recognising a provision.

A responsibility arises that cannot be recognised in the extremely unusual circumstance where no accurate assessment can be produced. That liability is declared as a contingent liability.

Contingent Liabilities

A company shouldn't acknowledge a contingent liability.

A contingent liability is disclosed, as required by paragraph 68, unless it is highly unlikely that resources will be used to generate economic benefits.

The portion of an obligation that is expected to be satisfied by other parties is treated as a contingent liability when a business is jointly and severally liable for it. Except in the incredibly rare instances when no accurate estimate can be achieved, the enterprise recognises a provision for the portion of the obligation for which an outflow of resources embodying economic advantages is likely.

It's possible for contingent liabilities to take a turn for the unexpected. They are therefore regularly evaluated to ascertain if it is likely that resources containing economic advantages will be released. A provision is recognised in accordance with preceeding paragraphs in the financial statements of the period in which the change in probability occurs if it becomes likely that an outflow of future economic benefits will be necessary for an item previously dealt with as a contingent liability (except in the extremely rare situations where no reliable estimate can be made).

Contingent Assets

A contingent asset should not be recognised by an organisation. 31. Unexpected or other unexpected circumstances that raise the likelihood of an inflow of financial benefits to the firm typically give rise to contingent assets. As an illustration, consider a legal claim that a business is pursuing with no guarantee of success.

Contingent assets are not included in financial statements since doing so could cause income that may never materialise to be reported. The associated asset is not a contingent asset, though, and it should be recognised when the realisation of income is almost guaranteed.

The financial accounts don't mention a contingent asset. Where an inflow of economic benefits is likely, it is often mentioned in the report of the authorising authority (the Board of Directors in the case of a corporation, or the analogous approving body in the case of any other enterprise).

Contingent assets are continuously evaluated, and if an inflow of economic advantages is almost expected to occur, the asset and the associated income are recognised in the financial statements of the period in which the change happens.

Measurement

Best estimate

At the time of the balance sheet date, the amount recorded as a provision should represent the best estimate of the cost necessary to pay the present obligation. Except in cases of decommissioning, restoration, and similar liabilities that are recognised as costs of Property, Plant, and Equipment, the amount of a provision should not be discounted to its current value.

The discount rate (or rates) should be pre-tax rates that take into account both the liability's particular risks and current market estimates of the time worth of money. Risks that have been taken into account in future cash flow predictions should not be reflected in the discount rate(s).

The statement of profit and loss should include periodic unwinding of discounts.

Estimates of the results and financial impact are made by the company's management based on their judgement, experience with previous transactions, and, occasionally, reports from outside specialists. Any further evidence made available by occurrences after the balance sheet date is taken into consideration.

The provision is calculated before taxes, and AS 22, Accounting for Taxes on Income, deals with the provision's tax ramifications and adjustments.

Risk and Uncertainties

The best estimate of a provision should take into account the risks and uncertainty that inevitability accompany many occurrences and circumstances.

Risk is a term used to describe result variability. The level at which an obligation is measured may increase as a result of a risk adjustment.

Making decisions in uncertain situations requires caution to avoid overstating assets or income and understating liabilities or expenses.

Uncertainty does not, however, excuse the addition of excessive provisions or the purposeful overestimation of liabilities.

- For instance, if the expected costs of a particularly unfavourable event are calculated prudently, that outcome is not then purposefully viewed as more likely than it is.
- A provision should not be overstated as a result of duplicate adjustments for risk and uncertainty.

Future Events

Where there is sufficient credible evidence that a future occurrence will occur, the amount of a provision should be adjusted to account for that possibility.

Future occurrences that are anticipated may be especially significant when determining provisions. For instance, a business might think that upcoming technological advancements will lower the expense of cleaning up a site once it has served its purpose.

The amount recognised takes into account all available information regarding the technology that will be accessible at the time of the clean-up and reflects a fair expectation of technically competent, objective observers.

As a result, it is reasonable to include things like anticipated cost savings from expanded application experience or the anticipated cost of using existing technology for a larger or more involved clean-up operation than has previously been done.

An organisation does not, however, plan on the creation of an entirely new technique for cleanup unless it is sufficiently supported by unbiased data.

while there is sufficient objective information that the law is almost expected to be passed, the impact of potential new legislation is considered while assessing an existing requirement.

It is typically impossible to pinpoint a single instance that will serve as adequate, objective proof in every situation due to the multiplicity of conditions that happen in practise.

Evidence is needed to show both what the proposed legislation will need and whether it is almost guaranteed to be passed and put into effect when the time comes.

In many circumstances, the new legislation won't be effective until there is adequate objective evidence.

Expected Disposal of Assets

Gains from anticipated asset sales shouldn't be considered when calculating a provision.

Even if the anticipated disposal of assets is directly related to the incident giving rise to the provision, gains on those sales are not taken into account when calculating a provision.

Instead, at the time designated by the Accounting Standard addressing the relevant assets, a company recognises gains on planned asset disposals.

Reimbursements

The reimbursement should be recognised when, and only when, it is virtually certain that payment will be obtained if the enterprise resolves the obligation.

In this case, some or all of the expenditure needed to settle a provision is expected to be reimbursed by another party. The reimbursement needs to be handled as a different asset.

The reimbursement amount should not be greater than the provision amount.

The expense associated with a provision may be reflected in the statement of profit and loss net of the amount recognised for a reimbursement.

An organisation may occasionally be able to rely on another party to cover all or a portion of the costs associated with resolving a provision (for instance, through insurance agreements, indemnification provisions, or supplier warranties). The other party has the option of paying the money immediately or reimbursing the firm for any sums already paid.

In the majority of situations, the business will continue to be liable for the full amount in issue, meaning that it would be required to pay the full sum if the third party failed to make the payment for whatever reason.

When it is almost certain that payment will be received if the enterprise resolves the responsibility, a provision is recorded for the full amount of the liability and a separate asset for the expected reimbursement is recognised.

In some circumstances, if the third party doesn't pay, the business won't be held responsible for the charges in question. In this scenario, neither the enterprise nor the provision are responsible for those expenses. A liability for which an entity is jointly and severally liable is a contingent liability to the extent that it is anticipated that the other parties will pay the obligation. Changes in Provisions

Provisions should be reviewed at each balance sheet date and adjusted to reflect current best estimate. The provision should be changed if it is no longer likely that resources containing economic advantages would be expended in order to satisfy the obligation.

6.3 Use of Provisions

- Only expenses for which a provision was initially recognised shall be covered by it.
- Only costs associated with the original provision are subtracted from it.
- The impact of two distinct events would be hidden if expenditures were adjusted against a provision that was first identified for another purpose.

6.4 Application of Recognition and Measurement Rules

Future operating losses shouldn't be accounted for with provisions.

Future operating losses don't fit the definition of an obligation or the basic requirements for recognition of provisions.

The likelihood of future operational losses is a sign that some of the operation's assets may be damaged.

According to Accounting Standard (AS) 28, Impairment of Assets, a company evaluates these assets for impairment.

6.5 Restructuring

The following instances could be considered restructuring-related events:

(a) the sale or discontinuation of a business line;

(b) the closing of business locations in a nation or region or the transfer of business operations from one nation or region to another;

(c) changes to the management structure, such as the removal of a layer of management; and

(d) fundamental reorganisations that materially alter the nature and focus of the enterprise's operations.

Only when the recognition requirements for provisions outlined in paragraph 14 are satisfied is a provision for restructuring costs recognised.

Until the firm commits to the sale, that is, until a legally binding sale agreement is in place, no duty to sell an operation emerges.

Before the business commits to the sale, that is, until there is a legally binding sale agreement, no duty to sell an operation occurs.

Until a buyer has been found and a legally binding selling agreement has been signed, an enterprise cannot commit to the sale. The firm will be free to change its decision until a legally binding sale agreement is in place, and it may even be forced to choose another course of action if a buyer cannot be located at an agreeable price.

According to Accounting Standard (AS) 28, Impairment of Assets, when the sale of an operation is contemplated as part of a restructuring, the operation's assets are assessed for impairment.

A restructuring provision should only cover direct costs associated with the restructuring, which are costs that are

(a) inevitably associated with the restructuring and

(b) unrelated to the enterprise's continued operations.

A restructuring provision does not cover expenses for marketing, investing in new technologies and distribution networks, or relocating or retraining current employees.

These costs are related to how the firm will operate in the future and are not obligations for reorganisation as of the balance sheet date. These costs are recorded in the same way as if they had not resulted from a restructuring.

A provision does not take into account identifiable projected operating losses through the date of a reorganisation.

Gains on the anticipated sale of assets are not considered for calculating a restructuring provision, even if the sale of assets is envisaged as part of the restructuring.

6.6 Disclosure

Following should all be disclosed for each class of provision.

- The carrying amount at the start and end of the period,
- any additional provisions made during the period, including increases to existing provisions, amounts used (i.e., incurred and charged against the provision) during the period, and
- unused amounts reversed during the period

For each category of provision, an entity should provide the following information:

- a brief explanation of the obligation's nature,
- the anticipated timing of any associated economic benefit outflows,
- and a statement of any associated uncertainties.

- An enterprise should report the key assumptions it made about future occurrences, when necessary to provide adequate information.
- It should also declare the amount of any expected reimbursement and the value of any asset that has been recognised in support of that reimbursement.

An enterprise should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practical, an estimate of its financial impact, an indication of the uncertainties relating to any outflow, and the possibility of any reimbursement. This is true even if the likelihood of any outflow in settlement is remote.

Example 1: Warranties

A producer provides guarantees to customers who buy its products at the point of sale. According to the conditions of the sales contract, the manufacturer agrees to correct any manufacturing flaws that are discovered within three years of the date of the sale, either through repair or replacement. According to prior experience, it is probable—that is, more likely than not—that some claims will be made in reliance on the warranties.

A prior obligating event that resulted in a current obligation is the selling of the product with a warranty. This event created the obligation.

A resource outflow that represents financial gains in settlement is probable for all warranties combined.

Conclusion: The best estimate of the costs of making good on products sold prior to the balance sheet date is recognised as a provision.

Illustration 2: Contaminated Land - Virtually Certain Enactment of Legislation

Because there is no law regulating cleanup, an oil sector company that has been damaging land for years does not clean it up after causing contamination. As of March 31, 2005, it is almost a certain that legislation requiring the cleanup of already-polluted land will be passed soon after the year's conclusion.

Due to the near inevitability of legislation demanding cleanup, the contamination of the property was the obligating event that led to the current responsibility.

A resource outflow that results in settlement advantages is probable.

Conclusion: The best estimate of the costs associated with the clean-up is recognised with a provision.

Example 3: An offshore oilfield

An organisation manages an offshore oilfield where its licence agreement mandates that it take down the oil rig and rehabilitate the seabed after production is finished. The dismantling of the oil rig and repair of the damage caused by its construction account for 90% of total expenditures, and oil extraction costs account for 10%. The rig has been built but no oil has been extracted as of the balance sheet date.

An duty to remove the oil rig and restore the seabed is created by the building of the oil rig, which is an obligatory event and the cause of the current obligation. However, there is no need to repair the harm that oil extraction may create as of the balance sheet date.

A resource outflow that results in settlement advantages is probable.

Conclusion: The best estimate of 90% of the actual expenses associated with removing the oil rig and repairing any damage it caused is accepted as a provision The price of the oil rig includes these expenses. As soon as oil is extracted, the 10% of costs that result from its extraction are recognised as liabilities.

Example 4: Refunds Procedure

A retail establishment has a policy of returning purchases made by unhappy consumers, although having no legal responsibility to do so. The company's refund policy is well known.

Present obligation as a result of past obligating event - The sale of the goods is the obligating event that results in an obligation since obligations also come from custom, customary commercial practise, and the desire to uphold good business relations or act fairly.

A percentage of the items are likely to be returned for a refund, constituting an outflow of resources representing economic gains in settlement.

Conclusion - A provision is recognised for the best estimate of the costs of refunds

Example 5: The Need for Smoke Filters Under Law

A company must install smoke filters in its factories by September 30, 2005, per new legislation. The smoke filters have not been installed by the company.

(a) On March 31, 2005, the date of the balance statement.

The absence of an obligating event prevents any obligation from existing, whether it is for the expense of installing smoke filters or for fines imposed by the law.

Conclusion: The expense of installing the smoke filters is not recognised.

(b) As of 31 March 2006, the balance sheet date

Due to the absence of an obligating event (the installation of the filters), there is no obligation for the expenditures associated with fitting smoke filters at this time. However, since the obligating event (the non-compliant operation of the factory) has already occurred, there may be a legal responsibility to pay fines or penalties.

An outflow of funds encapsulating financial gains in settlement - Determining the likelihood that a non-compliant activity will be subject to fines and penalties depends on the specifics of the law and the rigour of the enforcement regime.

Conclusion: No funding is acknowledged for the expenditures associated with installing smoke filters. The best estimate of any fines and penalties that are more likely than not to be levied is, however, recognised (see paragraphs 14 and 16–18).

Example 6: Retraining of Staff Due to Income Tax System Changes

The income tax system has undergone a number of adjustments from the government. A company in the financial services industry will need to retrain a sizable number of its administrative and sales staff as a result of these developments in order to maintain compliance with financial services regulation. No staff members have undergone retraining as of the balance sheet date.

There is no obligation because there has been no obligating event (retraining), hence there is no present responsibility resulting from a prior obligating event.

Conclusion:, no provision is recognised.

Example 7: A Single Guarantee

Enterprise A provides a guarantee for some of Enterprise B's borrowings over the 2004–2005 period, during which time Enterprise B's financial situation is stable. Enterprise B's financial situation worsens throughout 2005–2006, and on September 30, 2005, Enterprise B enters liquidation.

(a) On March 31, 2005

- Past obligating event that resulted in the present obligation - The obligation is created when the guarantee is given, which is the obligating event.
- An outflow of resources containing economic advantages in settlement - As of the end of March 2005, no such outflow of benefits was likely.

Conclusion: No provision is recognized. Unless the likelihood of any outflow is deemed remote, the guarantee is declared as a contingent liability.

(b) On March 31, 2006.

- The providing of the assurance is the obligating event that results in the creation of the legal obligation that exists today.

- An outflow of resources entailing economic benefits in settlement - As of the end of March 2006, it is likely that the obligation will need to be settled with an outflow of resources entailing economic benefits.

In order to account for the best estimate of the duty, a provision is recognised.

Illustration 8: A legal situation

- Ten persons passed away during a wedding in 2004–2005; it's possible that food poisoning from the company's products contributed to their deaths.
- The business is sued in order to recover damages, but it contests responsibility.
- The enterprise's solicitors advise that it is likely that the enterprise will not be found responsible up until the date of approval of the financial accounts for the year ending March 31, 2005.
- However, the enterprise's solicitors advise that it is likely that the enterprise will be found accountable when the enterprise prepares the financial statements for the year ending on March 31, 2006, due to developments in the case.

(a) **on March 31, 2005**

There is no present obligation resulting from a historical incident that was obligating, according to the evidence that was available at the time the financial statements were authorised.

Conclusion: No provision is recognised the concept of "present obligation"). Unless the likelihood of any outflow is deemed remote, the item is stated as a contingent obligation.

(b) On March 31, 2006.

A past obligating incident has resulted in a contemporary obligation, according to the evidence that is available.

A resource outflow that results in settlement advantages is probable.

Conclusion: The amount to satisfy the obligation is accepted as a provision for the best estimate.

Summary

The goal of AS 29 is to make sure that the proper recognition criteria and measurement bases are used for provisions and contingent liabilities, and that the notes to the financial statements contain enough information to allow readers to comprehend the nature, timing, and amount of those liabilities. The provisions, contingent liabilities, and contingent assets deriving from financial instruments (not carried at fair value) and insurance enterprises (other than those emanating from contracts with policyholders) are accounted for in accordance with this standard. The provisions/liabilities resulting from implementing controls and those covered by any other accounting standard will not be subject to the standard.

Keywords

- A provision is a liability that can only be quantified with a high degree of guesswork.
- A liability is a current duty of the business that was caused by a past incident and whose resolution is anticipated to cause the business to expend resources that will bring about financial gains.
- An obligating event is one that generates an obligation such that the enterprise has no practical way to avoid fulfilling the obligation.
- A contingent asset is a potential asset resulting from past events that will only be confirmed by the occurrence or non-occurrence of one or more unpredictable future events that are not entirely under the control of the company.

Self Assessment

1. ….. Is a potential asset that results from previous actions, the existence of which will only be determined by the occurrence or non-occurrence of one or more unpredictable future actions that are not entirely under the control of the organisation.

A. A Contingent asset

B. Present obligation

C. Possible obligation

D. A Restructuring

2. … is a project that is planned and managed by management that significantly alters either the nature or the scope of the business that an enterprise engages in.

A. A Contingent asset

B. Present obligation

C. Possible obligation

D. A Restructuring

3. A potential obligation resulting from previous events, the existence of which will only be established by the occurrence or non-occurrence of one or more unpredictable future events outside the enterprise's complete control…

A. A Contingent asset

B. A Contingent liability

C. Provision

D. A Restructuring

4. … is an occurrence that generates a liability and leaves an organisation with no viable alternative to paying the liability.

A. A Contingent asset

B. A Contingent liability

C. Provision

D. Obligating event

5. …. is a liability that can only be quantified with a high degree of assumption.

A. Provision

B. Obligating event

C. Contingent liability

D. Contingent asset

6. Which of the following is wrong in regard to contingent liabilities ?

A. Unless the likelihood of an outflow of resources including economic advantages is remote, a contingent liability must be stated as required by paragraph 68.

B. The portion of an obligation for which a business is jointly and severally liable that is anticipated to be satisfied by third parties is referred to as a contingent liability.

C. In order to establish whether an outflow of resources encapsulating economic benefits has become likely, contingent liabilities are continuously assessed.

D. They may not grow in ways that were not previously anticipated.

7. Which of the following is wrong in regard to contingent assets?

A. An enterprise should recognise a contingent asset.

B. Contingent assets usually arise from unplanned or other unexpected events

C. A contingent asset is not disclosed in the financial statements.

D. It is usually disclosed in the report of the approving where an inflow of economic benefits is probable.

8. Which of the following is wrong in regard to measurement of provisions?

A. The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date.

B. The amount of a provision should not be discounted to its present value

C. The estimates of outcome and financial effect are determined by the judgment of the management of the enterprise,

D. The provision is measured after tax

9. Which of the following is wrong in regard to risk and uncertainties?

A. Risk describes stability of outcome.

B. uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities.

C. Care is needed to avoid duplicating adjustments for risk and uncertainty with consequent overstatement of a provision.

D. Caution is needed in making judgments under conditions of uncertainty, so that income or assets are not overstated and expenses or liabilities are not understated.

10. Which of the following is wrong in regard to future events?

A. Expected future events may be particularly important in measuring provisions.

B. it is appropriate to include, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out.

C. However, an enterprise does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence.

D. The effect of possible new legislation is taken into consideration in measuring an existing obligation when sufficient objective evidence exists that the legislation is virtually uncertain to be enacted.

11. Which of the following is wrong in regard to Expected Disposal of Assets

A. Gains from the expected disposal of assets should not be taken into account in measuring a provision

B. Gains from the expected disposal of assets should be taken into account in measuring a provision

C. Gains on the expected disposal of assets are not taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision.

D. an enterprise recognises gains on expected disposals of assets at the time specified by the Accounting Standard dealing with the assets concerned.

12. Which of the following is wrong in regard to Reimbursements

A. the reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation.

B. The reimbursement should not be treated as a separate asset.

C. The amount recognised for the reimbursement should not exceed the amount of the provision.

D. In the statement of profit and loss, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.

13. Which of the following is wrong in regard to Changes in Provisions?

A. Provisions should be reviewed at each balance sheet date

B. Provisions should not be reviewed at each balance sheet date

C. Provisions should be adjusted to reflect the current best estimate.

D. . If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.

14. Which of the following is wrong in regard to Restructuring?

A. A provision for restructuring costs is recognised only when the recognition criteria for provisions are met.

B. No obligation arises for the sale of an operation until the enterprise is committed to the sale, i.e., there is a binding sale agreement.

C. A restructuring provision should include only the direct expenditures arising from the restructuring

D. A restructuring provision includes costs as retraining or relocating continuing staff

15. Which of the following is wrong in regard to Disclosure

A. An enterprise should disclose the carrying amount at the beginning and end of the period;

B. An enterprise should disclose additional provisions made in the period, including increases to existing provisions

C. An enterprise should disclose amounts used (i.e. incurred and charged against the provision) during the period; and

D. An enterprise should not disclose unused amounts reversed during the period.

Answers for Self Assessment

1.	A	2.	D	3.	B	4.	D	5.	A
6.	D	7.	A	8.	D	9.	A	10.	D
11.	B	12.	B	13.	B	14.	D	15.	D

Review Questions

1) Define contingent assets .
2) What disclosures should be made by an enterprise for each class of provision?

3) What does a restructuring provision incorporate?
4) What is the provision and contingent liability as for AS 29 ?
5) What is the aim of AS 29?

Further Readings

- https://www.vskills.in/certification/tutorial/as-29-provisions-contingent-liabilities-and-contingent-assets/
- ICAI: Paper 5 advanced accounting- https://cleartax.in/s/as-29-provisions-contingent-liabilities-assets

Unit 07: Employee Stock Option Plan

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Objectives

After studying this unit, you will be able to:

- Recognize the significance of and the need for employee stock option plans.
- Recognize how Employee Stock Option Programs are addressed in Guideline Note on Accounting for Share-Based Compensation.

Introduction

ESOP refers to a programme wherein the employer gives a worker the option—rather than the obligation—to apply for business shares at a predetermined price. At the time frame provided, the employee may use this right. According to Section 2(37) of the Companies Act of 2013, "employee stock option" means the option granted to a company's full-time directors, executives, or employees, giving them the advantage or right to purchase or subscribe to the securities offered by the firm at a future date at a predetermined price. Employee Stock Purchase Scheme (ESPS) denotes a programme in which the business provides shares to employees as part of a public offering or in other ways. All share-based programmes, including ESOPs, are subject to the accounting standards outlined in the Guidance Note on Accounting for Share-Based Payments. Unlisted businesses, especially start-up businesses, frequently provide share-based remuneration since they cannot afford to pay their staff large salaries but are prepared to partake in the company's future success. A number of businesses also give vendors and other non-employees share-based compensation. Therefore, it is crucial that the financial accounts recognise the cost associated with these. According to Accounting Standard 20, unless workers have exercised their entitlement to obtain shares or stock options, stock options granted in accordance with an employee share-based payment plan shall not be counted among the shares outstanding.

7.1 Meaning of ESOP

- Under the ESOP plan, the company offers stock options to its employees. Employee stock options are a type of benefit plan that allows corporate employees to subscribe to or buy company shares for a set length of time at a predetermined price.
- According to the Companies Act of 2013, if a company with a share capital ever proposes to increase its subscribed capital by the issuance of additional shares, those shares may be offered to employees under a plan of employee stock options, subject to a special resolution passed by the company and subject to any conditions that may be prescribed.
- The Employee Stock Option Scheme (ESOS), Employee Stock Purchase Scheme (ESPS), Stock Appreciation Rights Scheme (SRS), General Employee Benefits Scheme (GEBS), and Retirement Benefit Scheme are covered by the SEBI (Share Based Employee Benefits) Regulations, 2014 (applicable for listed companies), which includes provisions regarding accounting policies, pricing, disclosures, administration, and implementation of various schemes (RBS). The Regulations demand compliance with the disclosure requirements set forth in the Guidance Note on Accounting for Share-Based Payments as well as any other accounting standards that may be periodically required by the ICAI.

7.2 A Share-Based Payment Transaction

It is "a transaction in which the enterprise:

(a) receives goods or services in a share-based payment arrangement from the supplier of those goods or services (including an employee), or

(b) incurs an obligation to settle the transaction in a share-based payment arrangement when another group enterprise receives those goods or services.

Those businesses that are exempt from the requirement to use Indian Accounting Standards must account for ESOPs in accordance with the Guideline Note on Accounting for Share-Based Payments1 (2020).

The Guidance Note's requirements apply to employee stock option plans with award dates that are on or after 1 April 2021.

This Guideline Note is not needed to be applied by a company to equity instruments that are not fully vested as of 1 April 2021 under employee stock option schemes.

Although the Guidance Note's scope is not limited to transactions with workers, for the purposes of this chapter, our discussion is limited to those involving employees exclusively.

The Guidance Note may be referred to as the Guidance Note henceforth.

7.3 Why are ESOPs used?

- Linking personal wealth creation to organisational creation is one of the goals.
- Other goals include attracting, rewarding, and motivating people during the start-up and growth phases.
- Boost employee ownership culture;
- Reduce cash costs;
- Market pays, not the Company;
- May be especially crucial for start-up companies that are cash-strapped;
- Useful tool in cash crunch - In case of economic slowdown, organisations can incentivize employees by issuing ESOPs.

Unlisted businesses, and start-up businesses in particular, frequently provide share-based remuneration since they cannot afford to pay their staff large salaries but are prepared to partake in the future success of the business. Therefore, it is crucial that the expense associated with these stock option schemes is recorded in the financial accounts.

7.4 What does the Company Consider While Offering ESOPs to Employees?

- Opportunity Cost
- Current and Prospective Contribution
- Loyalty, Performance, and Designation

The benefits that the company and the employees receive from the Employee Stock Option Plan are as follows:

1. Stock options give employees a chance to take part in and contribute to the expansion of the business.
2. Stock options help employees build wealth over the long run.
3. They are crucial tools for luring in, keeping, and inspiring the greatest talent the business has to offer.

7.5 Provisions of Guidance Note on Accounting for Share-Based Payments

Scope of the Guidance Note establishes financial accounting and reporting principles for ESOPs. For the purposes of this Guidance Note, the term 'employee' includes a director of the enterprise, whether whole time or not.

The Guidance Note must be applied to all employee share based plans, including:

(a) equity-settled share-based payment transactions;

(b) cash-settled share-based payment transactions; and

(c) transactions where either the enterprise or the supplier of goods or services can choose whether the transaction is to be equity- settled or cash-settled.

This guidance note covers employee stock option programmes between group companies. Among a group of businesses, it is normal for one of the members to have the responsibility to settle an employee stock option plan if services are delivered to another member of the group (often the parent) (typically a subsidiary). Although it is not a direct party to the arrangement between its parent and its employee, the enterprise receiving the services, the enterprise settling the transaction, and the group as a whole are all covered by this guidance note. In light of the foregoing, this Guideline Note mandates that an entity account for a transaction in which it:

When one company in the same group (or a shareholder of any group enterprise) receives goods or services, the other company in the same group (or shareholder of any group enterprise) either: • has an obligation to settle the employee stock option plan; or • has an obligation to settle the employee stock option plan when the other company in the same group receives services, unless the transaction's primary goal is something other than the payment of services provided to the enterprise receiving them.

A transaction with an employee acting in his or her role as a holder of company shares is not considered an employee stock option plan for the purposes of this guidance note.

Example:

If a company gives all holders of a certain class of shares the opportunity to purchase more shares or stock options at a discount from the shares' or options' fair market value, and the holder is given such a right

The granting or exercise of such right shall not be subject to the provisions of this Guidance Note to the extent that such person is a holder of shares or stock options of that particular class.

7.6 Executive Summary of the Guidance Note on Accounting forEmployee Share-based Payments

- The Accounting Standards Board of the Institute is creating an Accounting Standard that will cover all types of share-based payments, including employee share-based payments, in recognition of the need to establish consistent, sound accounting principles and practises for all types of share-based payments. However, the Institute has chosen to provide this Guidance Note because it is expected that the Standard's formulation will take some time. This Guidance Note will automatically expire once the Share-based Payments Accounting Standard enters into force.
- The rules of financial accounting and reporting are established in this guidance note for employee share-based payment programmes, including stock appreciation rights, employee stock purchase plans, and employee stock option plans. The term "employee" as used in this Guideline Note includes an enterprise director, whether they are full-time or not.
- Employee share-based payment arrangements are divided into the following groups for accounting purposes:
    - Equity-settled plans: They provide employees with shares as payment.
    - Cash-settled: In accordance with these plans, employees get cash payments based on the share price (or value) of the company.
    - Payment arrangements based on employee shares that include cash alternatives: In accordance with these arrangements, the choice of how the business settles the payment—in cash or by issuing shares—remains with either the employer or the employee.

Either the fair value technique or the intrinsic value method can be used to account for an employee share-based payment plan that fits into one of the aforementioned categories. The fair value method serves as the foundation for the accounting procedure suggested below. After that, in paragraph 15, the application of the intrinsic value technique is discussed.

7.7 Equity-Settled Employee Share-Based Payment Plans

Recognition

1. The services received from an equity-settled employee should be recognised by the company as an expense (unless the service qualifies to be included as a part of the cost of an asset). When it obtains the services, it will use a share-based payment plan, and a corresponding credit will be made to the relevant equity account, such as the "Stock Options Outstanding Account." This account is temporary in nature since, as suggested in this guidance note, it will eventually be transferred to another equity account, such as share capital, securities premium account, and/or general reserve.
2. The employee is not obliged to finish a particular amount of service before becoming unconditionally entitled to the shares or stock options provided if they vest right away. The business should assume that the services provided by the employee in exchange for the instruments have been received if there is no proof to the contrary. In this situation, the

business should recognise the entire value of the services received on the grant date by making a commensurate credit to the equity account.

3. The enterprise should assume that the services to be provided by the employee in exchange for such instruments will be received in the future, during the vesting period, if the shares or stock options awarded do not vest until the employee completes a specific period of service. The business should credit the equity account for such services as they are provided by the employee during the vesting term, on a time proportion basis.

Measurement

1. If market prices are available, an organisation should use them to determine the fair value of shares or stock options awarded at the grant date while also taking the terms and circumstances into account. If market prices are unavailable, the organisation should estimate the fair value of the granted instruments using a valuation method to determine what the cost of those instruments would have been on the grant date in a transaction between competent, willing parties conducted at arm's length.
2. Use of an option pricing model for the valuation of stock options, for example, is consistent with generally accepted valuation methodologies for pricing financial instruments. The valuation technique should also include all the assumptions and factors that knowledgeable, willing market participants would take into account when determining the price.
3. For determining the fair value of options at the grant date, vesting criteria other than market circumstances shouldn't be taken into consideration. Instead, vesting conditions should be considered by adjusting the number of shares or stock options included in the measurement of the transaction amount so that, in the end, the amount recognised for employee services is based on the number of shares or stock options that have been granted cumulatively. If the shares or stock options granted do not satisfy a vesting condition (i.e., these), no amount is recognised for employee services received.
4. The best estimate of the number of shares or stock options expected to vest should be used by the enterprise to determine how much should be recognised for employee services provided during the vesting period. If additional information becomes available that changes the number of shares or stock options expected to vest, the enterprise should revise its estimate as necessary. The company should update the estimate on vesting date to reflect the actual number of shares or stock options that vest.
5. For determining the fair value of the given shares or stock options, market factors like the target share price upon which vesting (or exercisability) is conditioned should be taken into consideration.

After vesting date

When a stock option or the right to purchase shares is exercised, the company issues shares in exchange for payment of the exercise price.

The exercise price and the accompanying amount to the credit of the applicable equity account should be considered the consideration for the shares that were issued (e.g., Stock Options Outstanding Account).

When a stock option or the right to purchase shares expires without being exercised, the sum to the credit of the applicable equity account should be moved to general reserve.

Cash-Settled Employee Share-Based Payment Plans

The enterprise should measure the services obtained and the obligation incurred at the liability's fair value for cash-settled employee share-based payment arrangements.

Every reporting date and the date of settlement must be used to reassess the fair value of the liability until it is settled, with any changes in value being recorded in the period's profit or loss.

Employee Share-Based Payment Plans With Cash Alternatives

For employee share-based payment plans where the terms of the agreement give either the company or the employee a choice as to whether the company settles the transaction in cash or by issuing shares, the company must account for the transaction, or the parts of the transaction, as a cash-settled share-based payment plan if, and to the extent that, the company has incurred a liability to settle in cash (or other assets), or as a share-settled payment plan.

Intrinsic Value Method

- The fair value method is used to account for employee share-based payment plans discussed thus far.
- For the purpose of valuing employee share-based payment arrangements, there is another approach known as the "Intrinsic Value Approach."
- The margin by which the quoted market price of the underlying share exceeds the exercise price of an option is known as intrinsic value in the context of a listed corporation.
- As a non-listed company's shares are not traded on a stock market, the value of its shares is established using a valuation report from a third party appraiser.
- The intrinsic value may be utilised, mutatis mutandis, in place of the fair value for the purposes of accounting for employee share-based payment arrangements.

Recommendation

- It is advised that the fair value method, which is discussed in paragraphs 5 to 14, be used to account for employee share-based payment arrangements.
- But, the provided intrinsic value method is equally acceptable.
- A business that uses the intrinsic value method must disclose fair value.

7.8 Other Aspects Dealt With in The Guidance Note

In addition to the aforementioned, the Guidance Note covers a number of other important aspects of employee share-based payment plans, such as performance requirements, changes to the terms and conditions of the grant of shares or stock options, the reload feature, graded vesting, earnings-per-share implications, accounting for employee share-based payments administered through a trust, etc.

The Guidance Note also suggests mandating thorough disclosure rules.

The appendices of the Guidance Note offer in-depth guidance on how to estimate the fair value of shares and stock options, including how to use different inputs for option-pricing models and examples to show how various guidelines indicated in the Guidance Note can be applied.

Summary

The prevailing opinion that it is a good idea for corporate governance to promote significant long-term ownership stakes by senior management in order to align their financial interests with those of shareholders is encouraging this trend, which accounts for a significant portion of the total remuneration package for senior personnel in a number of countries. These programmes typically

take the shape of stock appreciation rights, employee stock purchase plans, and employee stock option plans (ESOPs) (SARs).

ESOPs are arrangements wherein a business offers its employees the chance to purchase the company's shares at a set or determinable price for a predetermined amount of time. One benefit of ESOPs as compensation is that the company need not incur any monetary costs.

Keywords

- Share-based payment arrangement:: an agreement between a company (or another group enterprise) and any shareholder of any group enterprise that entitles the other party (including an employee) to receive: (a) Cash or other assets of the company for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the company or another group enterprise, or (b) Equity instruments (including shares or share options) of the company or another group enterprise.
- Volatility is a measurement of the degree to which a price has historically fluctuated or is anticipated to fluctuate in the future. The standard deviation of the continuously compounded rates of return on a share over a certain period is the volatility of a share price.
- Equity: The remaining stake in a company's assets after all liabilities have been paid off.
- Exercise refers to the counterparty submitting an application for the issuance of equity instruments (such as shares or share options) in exchange for the option that has become vested under an employee stock option plan.
- A share option: is a contract that grants the holder the right, but not the duty, to purchase company shares for a set length of time at a set price.
- The exercise period: is the window of time following vesting during which the counterparty must apply for equity instruments (such as shares or share options) in exchange for the option that has become exercisable under the employee stock option plan.
- Intrinsic value: The difference between the fair value of the shares that the counterparty has the right to receive or subscribe to, whether conditionally or unconditionally, and the price (if any) that the counterparty is (or will be) compelled to pay for those shares is known as intrinsic value. For instance, a share option on a share with a fair value of 20 and an exercise price of 15 has an intrinsic value of 5.
- A share option is a contract that grants the holder the right, but not the duty, to purchase company shares for a set length of time at a set price.
- Grant date: which occurs when the company and the employee have a mutual understanding of the terms and conditions of the agreement, is the time when the company and the employee agree to an employee stock option plan. If the stipulated vesting criteria, if any, are satisfied, the enterprise grants the counterparty the right to cash, other assets, or equity instruments of the firm at the grant date. Grant date is the day on which the agreement receives approval from any parties, including shareholders if the agreement is subject to shareholder approval.
- Measurement date: For the purposes of this guidance note, the measurement date is the time at which the fair value of the given equity instruments is calculated. The grant date is used as the measuring date for transactions involving workers.
- Stock appreciation right:: The right to receive cash or stock in exchange for any excess of the market value of a specified number of company shares over a specified price is known as a stock appreciation right.

- Vest: To vest is to acquire rights. A vesting event occurs under an employee stock option plan when the employee's rights to cash, other assets, or equity instruments of the company is no longer contingent upon the satisfaction of any vesting criteria.
- Vesting period: The vesting period is the time frame in which an employee stock option plan's specified vesting conditions must all be met.
- expected life of the option : The time between the grant date and the anticipated exercise date of an option is known as the expected life of the option.
- The exercise price: is the amount that the counterparty must pay in order to exercise the option that has been granted to them under the employee stock option plan.
- Fair Value : is the sum for which an asset, a liability, or an equity instrument provided may be swapped in a transaction between knowledgeable, willing parties acting at arm's length.

Self Assessment

1. Employee stock option programmes are categorised as

A. Equity settled and cash settled for accounting purposes.

B. The liability and cash settlements.

C. Employee stock option plans with cash alternatives as well as equity- and cash-settled settlements.

D. None of these

2. The price (if any) the counterparty is (or will be required to pay for the shares is……of the shares to which the counterparty has the (conditional or unconditional) right to subscribe or which it has the right to receive.

A. the Exercise Price

B. the Intrinsic Value

C. the Fair Value

D. None of these

3. What sum would employee stock option programmes be required to recognise?

A. The fair market value of the services received

B. The agreed-upon sum

C. The fair market value of the equity instruments issued.

D. None of these

4. In accordance with the Guideline Note on Accounting for Share-Based Payments, an organisation must recognise an amount for the services provided by employees

A. throughout the vesting period based on the most accurate projection of the number of stock options that would eventually vest.

B. Immediately.

C. proportionately during the vesting term.

D. none of these

5. Which approach is suggested by the Guideline Note on Accounting for Share-Based Payments for the valuation of Employee Stock Option Plans?

A. Intrinsic Value.

B. Reasonable value .
C. Both (a) and (b).
D. None of these

6. ….. implies the period on the completion of which the said portion can be exercised. Vesting percentage refers to that portion of total options granted, which the employee will be eligible to exercise.
A. Vesting period
B. Grant
C. exercise period
D. none of these

7. …..is the eligibility of a particular employee for the grant of stock options is based on his role and performance
A. Vesting period
B. Grant
C. exercise period
D. none of these

8. The activity of converting the options granted to an employee into shares by paying the required exercise price is known as the…
A. Vesting period
B. Grant
C. exercise period
D. Exercise

9. …. is the date on which the Company allots the shares
A. Vesting period
B. Grant
C. exercise period
D. Effective date of exercise

10. …. has two components – Vesting percentage and vesting period
A. Vesting
B. Grant
C. exercise period
D. Effective date of exercise

11. …. gives the employees the choice to purchase the shares of the company on the fulfillment of the conditions mentioned in the ESOP plan at the price decided at the time of grant of options.
A. 'Option' in stock options
B. Grant
C. exercise period
D. Effective date of exercise

12. ……is the difference between the fair value of the shares to which thecounterpartyhasthe(conditionalorunconditional)righttosubscribe,andtheprice(ifany)thecounterpartyis(orwillbe)requiredtopayforthoseshares.

A. Intrinsic Value
B. FairValue
C. Exercise Price
D. None of these

13. ……...of an Option is the period of time from grant date to the date onwhichanoptionisexpectedtobeexercised.

A. Expected Life
B. GrantDate
C. Measurement date
D. None of these

14. …. is the date at which the fair value of the equity instrumentsgranted is measured for the purposes of this Guidance Note.

A. Expected Life
B. GrantDate
C. Measurement date
D. None of these

15. ….istheamountforwhichanassetcouldbeexchanged,aliabilitysettled,oranequityinstrument grantedcouldbeexchanged,betweenknowledgeable,willingpartiesinanarm'slengthtransaction.

A. Intrinsic Value
B. FairValue
C. Exercise Price
D. None of these

Answers for Self Assessment

1.	C	2.	B	3.	C	4.	A	5.	B
6.	A	7.	B	8.	D	9.	D	10.	A
11.	A	12.	A	13.	A	14.	C	15.	B

Review Questions

1. Explain the importance of employee stock options in the modern times.
2. Define the main terms associated with employee stock options .
3. What is the difference between grant date and exercise date .
4. Explain the provisions of guidelines note on accounting treatment of employees stock option plans .
5. What advantages accrued to both company and employees from employees stock auction plans?

Further Readings

- ICAI: Paper 5 advanced accounting
- ICSI: Paper 5 Corporate and Management Accounting
- http://www.esopindia.com/Images/pdf/Accounting/GuidanceNoteonAccountingforEmployeeShare.pdf

Unit 08:Types of Payment plans

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Objectives

After studying this unit, you will be able to:

- Read about how Employee Stock Option Programs are treated in accounting.

Introduction

Either the fair value technique or the intrinsic value method may be used to account for an employee stock option plan that falls within the purview of this guidance note. The Guideline Note suggests that accounting for share-based payment schemes be based on the fair value methodology, which is the basis for the accounting technique suggested below. When the services are provided, an organisation must acknowledge them in an employee stock option plan. If the services were provided under an employee stock option plan with an equity settlement, the company must record a matching increase in equity; otherwise, it must record a liability. This transitional account, which results from an increase in equity in an equity-settled employee stock option plan, will eventually be moved to another equity account, such as share capital, a securities premium account, or general reserve, in accordance with this Guidance Note. Employee stock option plan services that do not meet the criteria to be recognised as assets must be recorded as expenses.

8.1 Equity-Settled Employee Stock Option Plan

For employee stock option plans with equity settlement, the company must assess the services received and the resulting increase in equity immediately at the fair value of the services received, unless it is impossible to estimate the fair value of the services. The firm must measure the fair

value of the services received and the resulting increase in equity indirectly by comparison to the fair value of the equity instruments granted if it is unable to do so.

The firm shall evaluate the fair value of the employee services received by reference to the fair value of the equity instruments granted because it is impossible to directly quantify the fair value of the services received.

The counterparty is not obliged to fulfil a specific period of service before becoming unconditionally entitled to those equity instruments if the equity instruments granted vest immediately. The firm shall assume that services provided by the counterparty in exchange for the equity instruments have been received in the absence of proof to the contrary. In this scenario, the firm must fully recognise the services acquired on the award date and boost equity in proportion.

The company should assume that the services to be provided by the counterparty as compensation for those instruments will be received in the future, during the vesting period, if the equity instruments granted do not vest until the counterparty completes a specific term of service. The business should credit the equity account for such services as they are provided by the employee during the vesting term, on a time proportion basis. For instance:

(a) The company shall assume that the services to be provided by the employee in exchange for the share options during the three-year vesting period if an employee is granted share options contingent upon completing three years of service.

(b) If an employee is granted share options subject to the fulfilment of a performance condition and continues to work for the company until that condition is met, and the vesting period's length varies depending on when that performance condition is met, the company must assume that the employee will provide the share options' consideration in the future, over the anticipated vesting period. Based on the most likely result of the performance condition, the organisation shall estimate the duration of the anticipated vesting period at grant date.

The estimated duration of the anticipated vesting term must be consistent with the assumptions made when estimating the fair value of the granted options and cannot be changed later if the performance condition is a market condition. If new information shows that the length of the vesting term differs from earlier estimates and the performance requirement is not a market condition, the enterprise must update its estimate of the vesting period's duration, if necessary.

The enterprise should recognise an amount for the employee services received during the vesting period based on the best estimate of the number of shares or stock options expected to vest and should revise that estimate, if necessary, if new information indicates that the number of shares or stock options expected to vest differs from previous estimates in order to comply with the Guidance Note's requirements for employee stock option plans. The company should update the estimate on vesting date to reflect the actual number of shares or stock options that vest.

For determining the fair value of the shares or stock options given, market factors like a target share price upon which vesting (or the right to exercise) is conditioned should be taken into account. When a stock option or the right to purchase shares is exercised, the company issues the shares in exchange for payment of the exercise price. The exercise price and the accompanying amount to the credit of the applicable equity account should be considered the consideration for the shares that were issued (e.g., Stock Options Outstanding Account). The balance to the credit of the applicable equity account should be transferred to general reserve in the event that the right to purchase shares or a stock option expires without being exercised.

8.2 VestingConditionsandNon-VestingConditions

An employee stock option plan's vesting requirement establishes whether the enterprise receives the services that allow the counterparty to receive money, other assets, or equity instruments of the enterprise. Service or performance requirements make up a vesting condition.

Market Condition is a performance requirement that affects the exercise price, vesting, or exercisability of an equity instrument and is linked to the market price (or value) of the enterprise's equity instruments (or the equity instruments of another enterprise in the same group), such as

(a) achieving a specified share price or an amount of share option intrinsic value; or

(b) achieving a specified target that is based on the market price (or value).

A market condition (also known as a service condition) mandates that the counterparty fulfil a predetermined amount of service; the service requirement may be explicit or implicit.

The term "performance condition" refers to a vesting requirement that calls for both

(a) the counterparty to finish a predetermined period of service (also known as a "service condition"); the service requirement may be explicit or implicit; and

(b) specific performance target(s) to be met while the counterparty is providing the service required in the performance condition (a).

The time frame for achieving the performance target(s):

(a) shall not go beyond the service period; and

(b) may begin prior to the service period, provided that the performance target's start date does not substantially precede the service period's start date.

A performance target may be related to the performance of the company as a whole or to a specific area (or group), such a division or a specific employee.

Treatment for Vesting Issues

A grant of equity instruments may be subject to certain vesting requirements being met. For instance, an employee's receipt of shares or share options is often contingent upon their continued employment with the company for a predetermined amount of time. There may be performance requirements that must be met, like the company attaining a specific increase in earnings or a specific increase in share price.

When determining the fair value of the shares or share options at the measurement date, vesting factors other than market conditions are not to be taken into consideration. Instead, the number of equity instruments included in the measurement of the transaction amount shall be adjusted to account for vesting conditions such that, ultimately, the amount recognised for services received in consideration for the equity instruments granted shall be based on the number of equity instruments that ultimately vest.

Therefore, subject to the requirements in relation to market conditions listed below, no amount is recognised on a cumulative basis for services received if the equity instruments granted do not vest because a vesting condition, such as the counterparty failing to complete a specified service period, or a performance condition, is not satisfied.

For the purposes of implementing the aforementioned requirements, the enterprise shall recognise an amount for the services received during the vesting period based on the best estimate of the number of equity instruments expected to vest and shall revise that estimate, if necessary, if new information indicates that the number of equity instruments expected to vest differs from earlier estimates. Subject to the conditions in regard to market conditions listed below, the firm shall modify the estimate at vesting date to equal the number of equity instruments that finally vested.

When determining the fair value of the equity instruments provided, market factors, such as the target share price upon which vesting (or exercisability) is conditioned, must be taken into consideration. As a result, regardless of whether the market condition is met, the enterprise must recognise services from counterparties who satisfy all other vesting requirements (such as services from employees who continue to work for the required amount of time) for grants of equity instruments subject to market conditions.

8.3 TreatmentofNon-VestingConditions

- Similar to this, a company must consider every non-vesting condition when determining the grant equity instruments' fair value.
- Consequently, for grants of equity instruments with non-vesting conditions, the enterprise shall recognise the services received from a counterparty that satisfies all non-market vesting conditions (for example, services received from an employee who continues to work

for the required period of service), regardless of whether those non-vesting conditions are satisfied.

Treatmentafterthevestingdate

- The enterprise shall not subsequently change the total equity beyond the vesting date after recognising the services received in accordance with the guidance note's requirements and a commensurate increase in equity.
- For instance, if the vested equity instruments are later forfeited or, in the case of share options, the options are not exercised, the firm shall not afterwards reverse the amount recognised for services obtained from an employee.
- This condition does not, however, prevent the business from recognising a transfer within equity, that is, a transfer from one equity component to another.

8.4 Graded Vesting

- The whole plan should be divided into distinct groups depending on the vesting dates if the options/shares awarded under a share-based payment arrangement do not veg on the same date but instead have a graded vesting schedule.
- Consider the following scenario: Assume an employee receives 100 options, 25 of which will vest annually at the conclusion of the third, fourth, fifth, and sixth years. Each tranche of the 25 alternatives in this scenario would be assessed and recorded separately.
- Accounting Treatment: Because each of these groups would have a different expected life and vesting duration, each vesting date should be treated as a new option grant and recorded as such.

If an accurate estimate of the fair value of the equity instruments cannot be made

The enterprise shall instead:

(a) measure the equity instruments at their intrinsic value, initially at the date the counterparty renders service and subsequently at the end of each reporting period and at the date of final settlement, with any change in intrinsic value recognised in profit or loss. This procedure should only be used in rare circumstances where the enterprise may be unable to reliably estimate the fair value of the equity instruments granted at the measurement date. The employee stock option plan is finally settled for a grant of share options when the options are exercised, forfeited (for example, upon termination of employment), or expire (for example, at the end of the option's life).

(b) based on the number of stock instruments that eventually vest or (where applicable) are ultimately exercised, recognise the services obtained.

If new information shows that the number of share options expected to vest differs from earlier projections, the enterprise will update that estimate as necessary. The company must update the estimate on the day of vesting to reflect the amount of stock instruments that actually became vested. If the share options are later forfeited or expire at the end of the share option's life after the vesting date, the company must reverse the amount recognised for services rendered.

Changes to the terms and conditions under which equity instruments were issued, such as cancellations and settlements

- The terms and conditions under which the shares or stock options were given may be changed by the business. For instance, it might lower the exercise price of employee stock options (i.e., reprice the options), raising their fair value.
- Unless the granted equity instruments do not vest due to failure to satisfy a vesting condition (other than a market condition) that was specified at grant date, the enterprise shall recognise, at a minimum, the services received measured at the grant date fair value of the granted equity instruments.
- This is true even if the terms and conditions under which the equity instruments were given were changed, or if the grant of equity instruments was cancelled or settled. The business must also take into account changes that benefit the employee in some other way or raise the share-based payment arrangement's overall fair value.
- Other than a grant forfeited when the vesting conditions are not met, if an equity instrument grant is cancelled or resolved within the vesting period:
- In order to account for the cancellation or settlement as an acceleration of vesting, the organisation must immediately recognise the amount that would have otherwise been recognised for services provided throughout the balance of the vesting period.
- Unless the payment exceeds the fair market value of the equity instruments granted, as determined at the repurchase date, any payment made to the employee on the cancellation or settlement of the grant shall be accounted for as the repurchase of an equity interest, i.e., as a deduction from equity. Any such surplus must be recorded as a cost.
- Nonetheless, the company must premeasure the fair value of the obligation at the time of cancellation or settlement if the employee stock option plan had liability components. Any settlement payment for the component of obligation must be recorded as an extinguishment of liability.
- The enterprise must account for the granting of replacement equity instruments in the same way as a modification of the initial grant of equity instruments if new equity instruments are granted to the employee and, on the date those new equity instruments are granted, the enterprise identifies the new equity instruments granted as replacement equity instruments for the cancelled equity instruments.
- The difference between the net fair value of the cancelled equity instruments and the fair value of the replacement equity instruments at the time the replacement equity instruments are awarded is known as the additional fair value granted. The amount of any payment made to the employee upon cancellation of the equity instruments that is accounted for as a deduction from equity in accordance with (b) above is deducted from the net fair value of the cancelled equity instruments, which is their fair value immediately prior to the cancellation. The firm must account for newly awarded equity instruments as a new grant of equity instruments if it fails to designate the newly granted equity instruments as replacement equity instruments for the cancelled equity instruments.

8.5 Cash-Settled Employee Stock Option Plans

- The company must measure the services received and the liability incurred for cash-settled employee stock option programmes at the liability's fair value.
- Every reporting period until the liability is settled, the enterprise must premeasure the liability's fair value, with any changes in fair value being included in the period's profit or loss.

- As an illustration, a company can include share appreciation rights in an employee's compensation package, entitling them to a future cash payout (instead of an equity instrument) based on the increase in the company's share price from a specific level over a specific time period.
- Another possibility is for an organisation to give its employees the right to redeemable shares (including shares that will be granted upon the exercise of share options) at their discretion or mandatory (such as upon termination of employment).

8.6 Plans for Employee Stock Options With Cash Payouts

If the terms of an employee stock option plan give either the company or the counterparty the option to settle a transaction in cash (or other assets) or by issuing equity instruments, the company must account for that transaction, or any of its components, as a cash settled share-based payment transaction if it has incurred a liability to settle in cash or by issuing equity instruments.

Plans for employee stock options where the agreement's terms give the counterparty a choice of Settling

The plan has two components:

- a debt component (the counterparty's right to demand payment in cash) and
- an equity component (the counterparty's right to demand settlement in equity instruments rather than in cash) if an enterprise has given the counterparty the choice of whether a stock option plan is settled in cash or by issuing equity instruments.
- Taking into account the terms and conditions under which the rights to cash or equity instruments were issued, the firm must determine the fair value of the employee stock option plan at the measurement date.

In these situations, the fair value of the equity component is zero, making the employee stock option plan's fair value equal to that of the debt component.

In contrast, if the fair values of the settlement alternatives diverge, the equity component's fair value will typically be higher than zero, in which case the employee stock option plan's fair value will be higher than the debt component's fair value.

Employee stock option plans in which the terms of the arrangement provide the enterprise with a choice of settlement

The firm must decide whether it has a present obligation to settle in cash for an employee stock option plan where the provisions of the agreement give the option to settle in cash or by issuing equity instruments, and then account for the employee stock option plan accordingly. If the enterprise has a past practise or a stated policy of settling in cash, or if the enterprise typically settles in cash whenever the counterparty requests cash settlement, then the enterprise has a present obligation to settle in cash if the option of settling in equity instruments has no commercial substance (for example, because the enterprise is legally prohibited from issuing shares).

For instance, a company may have historically followed a policy of awarding ex gratia cash compensation for partially vested share options to all employees who were regarded to be "good" leavers or all "good" leavers with a specific level of seniority. For the purposes of this Guidance Note, such a plan may be considered cash-settled to the extent that such "good" leavers are anticipated within the vesting term.

If the business is currently obligated to settle in cash, it must account for the transaction in accordance with the rules that apply to employee stock option plans that are obligated to settle in cash. If no such responsibility exists, the company must account for the transaction in accordance with the rules governing employee stock option programmes with equity settlement.

8.7 Plans for Employee Stock Options Among Group Companies

The enterprise receiving the services shall measure the services received as either an equity-settled or a cash-settled employee stock option plan by evaluating (a) the nature of the awards granted, and (b) its own rights and obligations in its separate or individual financial statements for employee stock option plans among group enterprises.

The amount acknowledged by the business that is receiving the services may not be the same as the amount acknowledged by the consolidated group or another business within the group for the purpose of settling the employee stock option plan.

Whether (a) the awards issued are its own equity instruments or (b) the company has no duty to settle the employee stock option plan, the enterprise receiving the services shall measure the services as an equity-settled employee stock option plan.

Only changes in non-market vesting circumstances will trigger a subsequent remeasurement of such an equity-settled employee stock option plan by the company. In all other cases, the company receiving the services must treat them like a plan for cash-settled employee stock options.

Only if an employee stock option plan is paid in the company's own equity instruments will the settlement be recognised as an equity-settled employee stock option plan by the enterprise when another enterprise in the group obtains the services. If not, the transaction will be recognised as an employee stock option plan with a cash settlement.

8.8 ValuationMethods–Esops

The Guidance Note suggests that the fair value approach be used to account for employee stock option schemes. Yet, the intrinsic value approach is also acceptable.

Programs for employee stock options that are managed by a trust

The administration of an employee stock option plan by an organisation may be done through a trust created for this purpose. The trust may have a variety of agreements, such as the following:

(a) When employees exercise their stock options, the company distributes shares to the trust.

(b) The business provides funding to the trust so that it can purchase the shares it issued at the start of the plan.

(c) At the start of the plan, the firm lends money to the trust to enable it to buy shares on the market.

The enterprise should recognise the expense on account of services received from the employees in its separate financial statements, in accordance with the recommendations contained in this Guidance Note, regardless of the arrangement for issuance of the shares under the employee stock option plan, as the trust administers the plan on behalf of the company.

8.9 Disclosures

An organisation needs to explain how employee stock option programmes are accounted for.

An organization's financial statements should at least include the following information:

(a) A description of each type of employee stock option plan that was in place at any point during the reporting period, including a summary of the key terms and conditions of such plan, such as vesting requirements, the maximum duration of options issued, and the settlement procedure (e.g., whether in cash or equity). This information may be combined by a business with plans that are essentially identical to one another.

(b) the quantity of stock options and their weighted average exercise prices for each of the following sets of options:

- those that were granted during the period,
- those that were granted during the period, and

- those that were forfeited during the period.
- outstanding at the conclusion of the term; and
- exercisable at the end of the period.
- exercised during the period;
- expired during the period.

(c) the weighted average share price on the exercise date for stock options that were executed during the time period. The business may instead provide the period's weighted average share price if options were regularly exercised during it.

(d) the range of exercise prices and weighted average remaining contractual life for stock options that were still exercisable at the end of the period (comprising the vesting period and the exercise period). The amount of outstanding options should be separated into meaningful ranges for determining the quantity and time of additional shares that may be issued, as well as the potential cash obtained upon exercising those options, if the range of exercise prices is wide.

Example:

On April 1, 2016, RK Ltd. granted 1000 options with a 2.5-year vesting period for Rs. 40 (the nominal value of Rs. 10 per option). One year was the longest possible exercise duration. 200 unvested options expired and 600 were exercised on October 1 of this year. The remaining 200 options expired on October 30, 2019, at the end of the exercise period.

Make the required journal entries.

Solution

JOURNAL In the Books of RK Ltd.

2016 April 1: Deferred Employee Compensation Expense A/c Dr. 80,000

To Employee Stock Options Outstanding A/c 80,000

(Being grant of 1,000 options at a discount of Rs. 80, i.e., Rs. 120 - Rs.40)

2017 March 31: Employee Compensation Expense A/c Dr. 32,000

To Deferred Employee Compensation Expense A/c 32,000

(Being amortization of Deferred Compensation, i.e., Rs. 80,000 / 2.5)

2018 March 31: Employee Compensation Expense A/c Dr. 32,000

To Deferred Employee Compensation Expense A/c 32,000

(Being amortization of Deferred Compensation, i.e., Rs. 80,000 / 2.5)

2018 Oct 1: Employee Stock Options Outstanding A/c Dr. 16,000

To Employee Compensation Expense A/c [(200 * Rs.80) * 2/2.5] 12800

To Deferred Employee Compensation Expense A/c 3200

[(200 * Rs.80) * 0.5/2.5]

(Being reversal of compensation accounting on lapse of 200 unvested options)

2018 Oct 1: Employee Compensation Expense A/c Dr. 12800

To Deferred Employee Compensation Expense A/c 12800

(Being amortization of Deferred Compensation) (800*80*0.5/2.5)

2018 Oct 1 Bank A/c (600 *40) Dr. 24,000

Employee Stock Options Outstanding A/c Dr. [Rs. 600 * (Rs. 120 - Rs. 40)] 48,000

To Equity Share Capital A/c (600 * 10) 6,000

To Securities Premium A/c [Rs.600 *(Rs. 120 - Rs. 10)] 60,000

(Being excise of 600 options at an excise price of Rs. 20 each and an accounting value of Rs. 60 each)

2019 Oct. 30: Employee Stock Options Outstanding A/c Dr. 16,000

To Employee Compensation Expense A/c 16,000

(Being reversal of compensation accounting on lapse of 200 vested options at the end of the excise period i.e., Rs.200 * 80)

Issue of Employee Stock Options by Unlisted Public Company as per provisions of Companies Act

As per provisions of Sec 62(1)(b) of Companies Act, 2013, "where at any time a company having a share capital proposes to increase its subscribed capital by the issue of further shares, such shares shall be offered to employees under a scheme of employees' stock option, subject to special resolution passed by the company and subject to such conditions as may be prescribed."

The 2014 Businesses (Share Capital and Debentures) Rules should be read in conjunction with the aforementioned rule. See Rule 12. According to the aforementioned Regulation, a firm that is not publicly traded may not grant its employees stock options unless it satisfies the standards given below, specifically:-

1. Sanction via Special Resolution:

The company's shareholders authorised the Workers Stock Option Plan by voting in favour of a special resolution. Workers who are eligible for ESOPs include: The term "employee" has the following meanings for the purposes of the aforementioned statement: (a) a company permanent employee who has worked in India or outside of India; (b) a company director, but not an independent director; or (c) an employee as defined in 1(a) or (b) above of a subsidiary, in India or outside of India, or of a holding company of the company.

Excludes - I an employee who is a promoter or a member of the promoter group; or (ii) a director who personally solicits business from the company either by himself, through his relatives, or through anyone else in corporate.

or indirectly, owns more than 10% of the company's outstanding equity shares.

2. Information included in the explanation attached to the notice of adoption of the resolution The following disclosures must be made by the corporation in the explanatory statement attached to the notice of the resolution's passage:

   (a) the total number of stock options to be granted;

   (b) the designation of employee classes eligible to participate in the ESOP;

   (c) the evaluation procedure for determining an employee's eligibility to participate in the ESOP;

   (d) the requirements of vesting and the period of vesting;

   (e) the maximum period within which the options shall be vested;

   (f) the exercise price or the formula for determining the same;

   (g) the exercise period and process of exercise;

   (h) the lock-in period, if any;

   I the maximum number of options to be granted to each employee collectively;

   (j) the method the company will use to value its options;

(k) the circumstances under which an employee's vested options may lapse, such as in the event of termination for misconduct; and

(l) the specified time period within which the employee must exercise the vested options in the event of a proposed termination of employment or resignation.

3. Pricing: Companies giving their employees stock options under the Employees Stock Option Scheme are entitled to choose the exercise price in accordance with any applicable accounting regulations.

4. Approval of shareholders by separate resolution: If the company wants to give options to employees of a subsidiary or holding company, or if it wants to give specific employees options that are equal to or greater than 1% of the company's issued capital at the time of the option grant, it must first obtain the approval of shareholders via a separate resolution.

(5) (a) By special resolution, the firm may change the provisions of the ESOP that have not yet been exercised by the employees.

(b) The notification for enacting a special resolution for changing the parameters of an ESOP must include all relevant information about the change, including its purpose as well as the specifics of the employees who will benefit from it.

(6) Minimum vesting period:

(a) At least a year must pass between the time an option is granted and when it becomes fully vested.

The period during which the options granted by the merging or amalgamating company were held by him shall be adjusted against the minimum vesting period required if the company grants options under its Employees Stock Option Scheme in place of options held by the same person under Employees Stock Option Scheme in another company that has merged or amalgamated with the first mentioned company (i.e., 1 year)

(b) Lock-in period for shares issued upon option exercise: The company is allowed to determine the lock-in period for the shares issued upon option exercise.

(c) Right to dividends: Until shares are issued upon option exercise, employees do not have the right to vote, receive dividends, or in any other way benefit from being a shareholder with respect to options granted to them.

(7) Forfeiture/Refund of Amount Paid By Employees Under ESOP: The Amount Payable By Employees At The Time Of Option Grant - (a) May Be Forfeited By The Company If The Employees Do Not Exercise The Option Within The Exercise Period; Or (b) May Be Refunded To The Employees If The Options Are Not Vested Due To Non-fulfillment Of Conditions Associated With Option Vesting As Per The Employees Stock Option Scheme

(a) Employees are not permitted to transfer their option.

(b) The employees' option may not be pledged, hypothecated, mortgaged, encumbered in any other way, or otherwise alienated.

(c) Except as provided in subsection (d), only the employees to whom the option has been given are eligible to exercise it.

(d) In the event that an employee passes away while still working, all choices granted to him up until that point will pass to the employee's legitimate heirs or designees.

(e) If an employee becomes permanently disabled while still employed, any options granted to him as of the date of his permanent disability will become his property on that day.

(f) All unvested options in the employee as of the date of resignation or termination of service must expire. However, according to the terms and circumstances under the plan providing such options as approved by the Board, the employee may exercise the options granted to him that were vested within the time period prescribed in this regard.

(8)Disclosures in Board of Directors Report : The Board of Directors, shall, inter alia, disclose in the Directors' Report for the year, the following details of the Employees Stock Option Scheme:

(a) options granted;

(b) options vested;

(c) options exercised;

(d) the total number of shares arising as a result of exercise of option;

(e) options lapsed;

(f) the exercise price;

(g) variation of terms of options;

(h) money realized by exercise of options;

(i) total number of options in force;

(j) employee wise details of options granted to;-

(i) key managerial personnel;

(ii) any other employee who receives a grant of options in any one year of option amounting to five percent or more of options granted during that year.

(iii) listed all workers who, in any one year, received options worth at least 1% of the company's issued capital (excluding outstanding warrants and conversions) at the time of grant;

(09) Register of Employee Stock Options:

(i) The company must keep a Register of Employee Stock Options in Form No. SH.6 and must immediately enter the information regarding options issued in accordance with clause (b) of sub-section (1) of Section 62.

(ii) The Register of Employee Stock Options must be kept at the company's registered office or another location determined by the Board.

(iii) The company secretary of the company or any other individual designated by the Board for this purpose must certify the entries in the register.

According to Rule 12(11), the Employees Stock Option Plan must be granted in line with the Securities and Exchange Board of India's regulations in cases where the company's equity shares are listed on a reputable stock market. on behalf of. The former SEBI Employee Stock Option Scheme and Employee Stock Purchase Scheme Guidelines (applicable for listed businesses) 1999 have been replaced by the SEBI (Share Based Employee Benefits) Regulations, 2014, released on October 28, 2014 (effective from the even date).

Summary

Employee share-based payments are compensation based on the cost or market value of the shares. Directors, senior executives, and many other employees frequently get compensation in the form of share plans and share option plans. The practise of entrepreneurs giving their employees ownership stakes in the business is known as an employee stock ownership plan, or ESOP.The enterprise should measure the services obtained and the obligation incurred at the liability's fair value for cash-settled employee share-based payment arrangements. Each reporting date and the date of settlement must be used to reassess the liability's fair value until it is settled, with any changes in fair value being included in the period's profit or loss.

Keywords

Employees' stock option: According to Section 2(37) of the Companies Act of 2013, a "employees' stock option" is an option granted to a company's directors, officers, or employees, or, if any, to a holding company or subsidiary company, giving them the benefit or right to purchase, or to subscribe for, the company's shares at a future date at a fixed price.

Forfeiture/ Refund of amount paid by employees under ESOP: If the option is not exercised by the employees during the exercise term, the company may forfeit the amount paid by the employees at the time of option grant and refund it to them.

Self Assessment

1. (i) Date of grant of option 1st April, 2013 (ii) Vesting period 3 years (iii) Number of options granted 1,250 shares (iv) Market price of the share ~ 200 per share (v) Exercise price ~ 80 per share (v) Nominal value ~ 10 (v) Exercise period 1 year Assume that there was no change in the number of employees during the vesting period. Calculate Intrinsic value of each option

A. 100
B. 120
C. 200
D. 80

2. (i) Date of grant of option 1st April, 2013 (ii) Vesting period 3 years (iii) Number of options granted 1,250 shares (iv) Market price of the share ~ 200 per share (v) Exercise price ~ 80 per share (v) Nominal value ~ 10 (v) Exercise period 1 year Assume that there was no change in the number of employees during the vesting period. Calculate total value of options.

A. 1,00,000
B. 1,50,000
C. 2,00,000
D. 2,10,000

3. (i) Date of grant of option 1st April, 2013 (ii) Vesting period 3 years (iii) Number of options granted 1,250 shares (iv) Market price of the share ~ 200 per share (v) Exercise price ~ 80 per share (v) Nominal value ~ 10 (v) Exercise period 1 year Assume that there was no change in the number of employees during the vesting period. You are required to calculate the amount to be recognised as expense in 2013-14.

A. 50,000
B. 1,50,000
C. 2,00,000
D. 2,10,000

4. (i) Date of grant of option 1st April, 2013 (ii) Vesting period 3 years (iii) Number of options granted 1,250 shares (iv) Market price of the share ~ 200 per share (v) Exercise price ~ 80 per share (v) Nominal value ~ 10 (v) Exercise period 1 year Assume that there was no change in the number of employees during the vesting period. You are required to calculate the amount to be recognised as expense in 2014-15.

A. 50,000
B. 1,50,000
C. 2,00,000
D. 2,10,000

5. i) Date of grant of option 1st April, 2013 (ii) Vesting period 3 years (iii) Number of options granted 1,250 shares (iv) Market price of the share ~ 200 per share (v) Exercise price ~ 80 per share (v) Nominal value ~ 10 (v) Exercise period 1 year Assume that there was no change in the number of employees during the vesting period. You are required to calculate the amount to be recognised as expense in 2015-16.

A. 50,000
B. 1,50,000

C. 2,00,000
D. 2,10,000

6. i) Date of grant of option 1st April, 2013 (ii) Vesting period 3 years (iii) Number of options granted 1,250 shares (iv) Market price of the share ~ 200 per share (v) Exercise price ~ 80 per share (v) Nominal value ~ 10 (v) Exercise period 1 year Assume that there was no change in the number of employees during the vesting period. Number of years expired in F.Y. 2013-14

A. 1
B. 2
C. 3
D. 4

7. i) Date of grant of option 1st April, 2013 (ii) Vesting period 3 years (iii) Number of options granted 1,250 shares (iv) Market price of the share ~ 200 per share (v) Exercise price ~ 80 per share (v) Nominal value ~ 10 (v) Exercise period 1 year Assume that there was no change in the number of employees during the vesting period. Number of years expired in F.Y. 2014-15

A. 1
B. 2
C. 3
D. 4

8. i) Date of grant of option 1st April, 2013 (ii) Vesting period 3 years (iii) Number of options granted 1,250 shares (iv) Market price of the share ~ 200 per share (v) Exercise price ~ 80 per share (v) Nominal value ~ 10 (v) Exercise period 1 year Assume that there was no change in the number of employees during the vesting period. Number of years expired in F.Y. 2015-16

A. 1
B. 2
C. 3
D. 4

9. i) Date of grant of option 1st April, 2013 (ii) Vesting period 3 years (iii) Number of options granted 1,250 shares (iv) Market price of the share ~ 200 per share (v) Exercise price ~ 80 per share (v) Nominal value ~ 10 (v) Exercise period 1 year Assume that there was no change in the number of employees during the vesting period. For FY 2014-15, Cumulative expenses after the expiry of 2 years:

A. 100,000
B. 1,50,000
C. 2,00,000
D. 2,10,000

10. i) Date of grant of option 1st April, 2013 (ii) Vesting period 3 years (iii) Number of options granted 1,250 shares (iv) Market price of the share ~ 200 per share (v) Exercise price ~ 80 per share (v) Nominal value ~ 10 (v) Exercise period 1 year Assume that there was no change in

the number of employees during the vesting period. For FY 2015-16, Cumulative expenses after the expiry of 3 years:

A. 100,000
B. 1,50,000
C. 2,00,000
D. 2,10,000

11. Employees at HK receive 45,000 options free of charge. Each grant is based on the requirement that the recipients have worked for HK for at least three years. The corporation calculated that each share option had a fair value of 15 on the issuance date. According to HK's estimation, one-third of the workforce will depart the company during the three-year timeframe, forfeiting their share option rights. Everything went as planned. You must determine the sums that must be recorded as expenses in first year.

A. 100,000
B. 1,50,000
C. 2,00,000
D. 2,10,000

12. Employees at HK receive 45,000 options free of charge. Each grant is based on the requirement that the recipients have worked for HK for at least three years. The corporation calculated that each share option had a fair value of 15 on the issuance date. According to HK's estimation, one-third of the workforce will depart the company during the three-year timeframe, forfeiting their share option rights. Everything went as planned. You must determine the sums that must be recorded as expenses in second year.

A. 100,000
B. 1,50,000
C. 2,00,000
D. 2,10,000

13. Employees at HK receive 45,000 options free of charge. Each grant is based on the requirement that the recipients have worked for HK for at least three years. The corporation calculated that each share option had a fair value of 15 on the issuance date. According to HK's estimation, one-third of the workforce will depart the company during the three-year timeframe, forfeiting their share option rights. Everything went as planned. You must determine the sums that must be recorded as expenses in third year.

A. 100,000
B. 1,50,000
C. 2,00,000
D. 2,10,000

14. Employees at HK receive 45,000 options free of charge. Each grant is based on the requirement that the recipients have worked for HK for at least three years. The corporation calculated that each share option had a fair value of 15 on the issuance date. According to HK's estimation, one-third of the workforce will depart the company during the three-year timeframe, forfeiting their share option rights. Everything went as planned. You must determine Cumulative expense after the expiry of 2 years

A. 100,000
B. 1,50,000
C. 2,00,000
D. 3,00,000

15. Employees at HK receive 45,000 options free of charge. Each grant is based on the requirement that the recipients have worked for HK for at least three years. The corporation calculated that each share option had a fair value of 15 on the issuance date. According to HK's estimation, one-third of the workforce will depart the company during the three-year timeframe, forfeiting their share option rights. Everything went as planned. You must determine Cumulative expense after the expiry of 3 years

A. 100,000
B. 1,50,000
C. 2,00,000
D. 4,50,000

Answers for Self Assessment

1.	A	2.	B	3.	A	4.	A	5.	A
6.	A	7.	B	8.	C	9.	A	10.	B
11.	B	12.	B	13.	B	14.	D	15.	D

Review Questions

1. By Employee Stock Option Scheme (ESOS), what do you mean?
2. State SEBI ESOS guidelines.
3. What does Vesting Period mean?
4. Describe the Employee Stock Buying Plan (ESPS)
5. Explain accounting treatment of esop.

Further Readings

- ICAI: Paper 5 advanced accounting
- ICSI: Paper 5 Corporate and Management Accounting
- http://www.esopindia.com/Images/pdf/Accounting/GuidanceNoteonAccountingforEmployeeShare.pdf
- Corporate accounting by Hanif and Mukherjee. 2nd ed, McGraw Hill Education (India) Private Limited

Dr. Rupinder Katoch, Lovely Professional university

Unit 09: Accounting for Buy Back of Securities

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Objectives

After studying this unit, you will be able to:

- Study the regulations of the Companies Act relating the buy-back of securities
- Comprehend the meaning of the term "buy-back of securities" and its accounting treatment.

Introduction

The term "buy back shares" or "other specified securities" refers to the company purchasing its own shares or other specified securities from the holder and cancelling them. Sections 68, 69, and 70 of the Companies Act of 2013 and Rule 17 of the Companies (Share Capital and Debentures) Amendment Regulations of 2016 deal with share buybacks. Under certain restrictions, the firms are permitted to repurchase their own shares and other designated securities. Also, SEBI has published some norms governing the buy-back of shares for listed businesses.A business must cancel the shares it has purchased back while doing so. As a result, the company's share capital decreases as a result of share buybacks. A firm is not permitted to invest in its own stock. If a firm has enough cash, it may elect to repurchase its own shares.

9.1 Advantages of Buy-Back of Shares

(a) to boost earnings per share if there is no dilution of the company's profits as the share buybacks lower the number of outstanding shares.

(b) to increase promoters' ownership because shares that are repurchased are cancelled.

(c) to deter other parties from making hostile bids to acquire the business because the buyback will enhance the promoters' ownership.

(d) to maintain the share price on the stock markets when, in the view of firm management, the share price is less than its value, particularly in a down market.

(e) to distribute extra cash to shareholders when the business is not in need of it.

9.2 Applicability of Sections

- A business may, under certain circumstances, purchase its own shares or other securities under Section 68 of the Companies Act, 2013.
- Section 69 of the Companies Act of 2013 addresses the accounting treatment of buyback proceeds. In some situations.
- Section 70 of the 2013 Companies Act sets restrictions on share buybacks.

9.3 Buy-Back Sources Include

- Free reserves
- Securities premium account
- The proceeds of any shares or other specified securities.

The proceeds of an earlier offering of the same class of shares cannot be used for a buyback, though.

Conditions For Buy Back

- The company's articles of association (AOA), or, in the absence of a provision, the AOA, must be changed, must authorise the buyback of shares.
- Pass Board Resolution if the shares to be repurchased total a. Up to 10% of Paid-Up Capital + Free Reserves + Securities Premium. b. Pass Extraordinary Resolution with up to 25% of Paid-Up Capital, Free Reserves, and Securities Premium.
- The buy-back should not exceed 25% of the company's total paid-up capital and free reserves.
- The buy-back of equity shares cannot total more than 25% of the company's paid-up equity capital in any given fiscal year.
- After the buyback, the debt-to-equity ratio shouldn't drop below 2:1.
- The shares as well as the designated securities must be paid in full.
- For listed shares and other securities, the company must adhere to the SEBI regulations.
- The buy-back must be finished within a year of the day the Special Resolution or Board Resolution, as applicable, was passed.
- The shares must be physically destroyed within seven days of the buy-conclusion. back's
- Apart from the issuance of bonus shares, ESOPs, sweat equity, and the conversion of debt/preference shares into equity, no new issues may be made within six months following the buy-back.
- After an offer is made public to shareholders, it cannot be withdrawn.

9.4 Limitations on Buy-Back

Limitations on Buy-Back: Section 70 of the Companies Act of 2013 states that a company may not buy back its securities or other specified securities either directly or indirectly if :

- through any subsidiary company including its own subsidiary companies;
- through any investment company or group of investment companies; or
- If there is any default in payment of deposits or interest due, redemption of debentures/preference shares or payment of dividend.
- When Company has defaulted in filing of Annual Return, declaration of dividend & financial statement

9.5 Requirement for Audited and Unaudited Accounts

The audited account used to calculate the buyback must be no older than six months from the offer document's issue date.

The calculations with regard to the buy back shall be based on unaudited accounts not older than six months from the date of the offer document and subject to restricted review by the company's auditors where the audited accounts are older than that period.

1) Call a meeting of the company's board of directors;

2) Notice of General Meeting:

Send notice of the general meeting at which the special resolution will be adopted along with an explanation that includes the information required to be disclosed under Section 68(3)(a) through (e) and Rule 17(1)(a) through (n) of the Companies (Share Capital and Debentures) Rules, 2014. The notice must also include information on all relevant facts, the need for the buyback, the class of the securities intended to be bought back, and any other relevant information.

3) Submitting form MGT-14 to the Registrar of Companies to notify them (within 30 days) that the EGM passed a special resolution that altered the AOA.

4) Letter of Offer (Form SH-8): Prior to the buy-back of shares, the company must submit a Letter of Offer in electronic form SH-8 to the Registrar of Companies. The Letter of Offer must be sent to the shareholders immediately following submission to the Registrar of Companies, while also complying with the requirements of Sub-rule 10 of Rule 17 of The Companies (Share Capital and Debentures) Rules, 2014.

5) Offer Period: The buyback offer must be made within 30 days of the letter of offer's shipment and must be made for a minimum of 15 days. If all members agree, the period may be less than 15 days.

6) Declaration of Solvency (Form SH-9): The company must file a declaration of solvency in e-Form SH-9 with the Registrar of Companies together with the letter of offer and a verified affidavit to ensure its solvency for at least a year after the buy-back is complete.

7) Acceptance of Offer: In the event that the number of shares provided by the shareholders exceeds the total number of shares that the firm is willing to buy back, the acceptance per shareholder shall be based on a pro rata share of the total shares offered for purchase.

8) Separate Bank Account: Immediately upon the buy-back offer's termination, the corporation must open a separate bank account and deposit the full amount that is owed as consideration for the shares offered for purchase therein.

9) Verification: The shares or other securities lodged shall be deemed to be accepted unless a communication of rejection is made within twenty-one (21) days (21) from the date of closure of the offer. The company shall complete the verifications of the offers received within fifteen days from the date of closure of the offer.

10) Payment: Within 7 days on the day the offers were verified.

11) Extinguishment of Shares: Within seven days of the buy-conclusion, back's a company must extinguish and physically destroy any shares that were purchased.

12) Register of Buy-Backs (Form SH-10): The Company is required to keep a record of the shares that have been purchased back in Form SH-10, which will be attached to Form SH-11.

13) Return of Buy-Back (Form SH-11): Submit the Return of Buy-Back (Form SH-11) along with the Compliance Certificate (Form SH-15), all of which must be signed by two directors, one of whom must be the Managing Director, if any.

We must submit the following MCA electronic forms related to buybacks:

E-Form MGT-14

E-Form SH-8,

‘E-Form SH-9, and

E-Form SH-11

are among the forms.

Additional Documents Necessary For Share Buyback

SH 10-Description of shares or other specified securities bought back Buyback

Notice of EGM with Explanatory

Certified Copy of Board Resolution

Affidavit as Declaration of Solvency

Audited Financial Details of the Last Three Years

Auditors Report as Certificate of Declaration Details of Promoters of the Company Specifics relating to Holders of Securities Bought BackLiabilities (is not more than six months old from the date of offer document)

In this section an attempt is to discuss the compliance aspect of share buybacks, which will aid you in understanding the relevant rules.

Summary

A share purchase or buyback is another name for it. when a company buys its own outstanding shares to reduce the amount of shares that are traded publicly. Companies repurchase shares for a variety of purposes, including to increase the value of the available shares by reducing supply or prevent other owners from gaining control. Businesses will be able to invest in themselves through buybacks. The percentage of shares owned by investors rises as the number of outstanding shares on the market decreases. A company might undertake a buyback if it believes that its shares are being undervalued in order to reward investors.

Keywords

- "Specified Securities" includes stock options granted to workers as well as any other securities the Central Government may from time to time notify;
- "Free reserves" refers to those reserves that, according to a company's most recent audited balance sheet, are available for dividend distribution:

Illustration1:

The following balance sheet particulars, as of March 31, 2020, are provided by M Ltd:

Authorized, Issued and Subscribed Capital:

3,00,000 Equity shares of Rs10 each fully paid up Rs.3000,000

Reserves and Surplus	
Capital reserve	100
Revenue reserve	4,300
Securities premium	400
Profit and Loss account	1,500
Total	6,300

The business decided to buy back 20% of its shares at a price of $15 per share. It sold its investments worth 30 lakhs for 28 lakhs in order to achieve this.

You must provide the needed Journal entries.

Solution

	Particulars		Dr.	Cr.
1	Bank A/c	Dr.	2,800	
	Profit and Loss A/c	Dr.	200	
	To Investment A/c			3,000
	(Being investment sold for the purpose of buy-back of Equity Shares)			
2	Equity share capital A/c	Dr.	750	
	Premium payable on buy-back	Dr.	375	
	To Equity shares buy-back A/c			1125
	(Being the amount due on buy-back of equity shares)			
3	Equity shares buy-back A/c	Dr.	1125	
	To Bank A/c			1125
	(Being payment made for buy-back of equity shares)			
4	Securities Premium A/c	Dr.	375	
	To Premium payable on buy-back			375
	(Being premium payable on buy-back charged from Securities premium)			
5	Revenue reserve A/c	Dr.	750	
	To Capital Redemption Reserve A/c			750
	(Being creation of capital redemption reserve to the extent of the equity shares bought back)			

Illustration 2:

Authorized, issued and subscribed share capital:	
10% Redeemable preference shares of Rs 100 each, fully paid up	175
Equity shares of Rs 10 each, fully paid up	20
Total	195

Reserves and Surplus	
Capital reserve	10
Securities premium	30
Revenue reserves	260
Total	300

On April 1st, 20X1, the company redeemed preference shares. Also, it repurchased 40 lakh equity shares at rs.10 each for Rs. 40 each.

	Particulars		Dr.	Cr.
1st April, 20X1	12% Preference share capital A/c	Dr.	175	
	To Preference shareholders A/c			175
	(Being preference share capital account transferred to shareholders account)			
	Preference shareholders A/c	Dr.	175	
	To Bank A/c			175
	(Being payment made to shareholders)			
	Shares buy-back A/c	Dr.	20	
	To Bank A/c			20
	(Being 50 lakhs equity shares bought back @ ` 50 per share)			
	Equity share capital A/c (40 lakhs x ` 10)	Dr.	4	
	Securities premium A/c (40 lakhs x ` 40)	Dr.	16	
	To Shares buy-back A/c			20
	(Being cancellation of shares bought back)			
	Revenue Reserve A/c	Dr.	79	
	To Capital Redemption Reserve A/c (75+4)			79
	(Being creation of capital redemption reserve to the extent of the face value of preference shares redeemed and equity shares bought back)			

Liability side of Balance Sheet of Anu Ltd as at 1.4.20X1 (Rs. In crores)

Particulars			Notes	`
		Equity and Liabilities		
1		Shareholders' funds		
	A	Share capital	1	16
	B	Reserves and Surplus	2	284
2		Current liabilities		
	A	Trade Payables		40
		Total		340

Notes:

No.	Particulars		`
1	Share Capital		
	Authorized, issued and subscribed share capital		
	160 lakhs Equity shares of Rs10 each fully paid		16
	Total		16
2	Reserves and Surplus		
	Capital reserve		10
	Capital redemption reserve		79

	Securities premium	30	
	Less: Utilization for buy-back of shares	-16	14
	Revenue Reserve	260	
	Less: transfer to Capital redemption reserve	-79	181
	Total		284

Self Assessment

1. In accordance with Section 68(1) of the Companies Act, the business may not purchase back more than

A. 25% of its entire paid-up capital and free reserves.

B. 20% of the company's free reserves and total paid-up capital.

C. 15% of the company's total paid-up capital and free reserves

D. 35% of the company's total paid-up capital and free reserves

2. Companies have the option to repurchase their own stock using

A. proceeds from the sale of any shares,

B. free reserves, and the premium on securities.

C. Both A and B

D. None of above

3. An amount equal to the nominal value of the shares purchased must be transferred to the

A. Revenue redemption reserve when a firm buys its own shares using free reserves.

B. capital redemption reserve.

C. Reserve for buybacks

D. None of these

4. Preference shareholders do not have the ability to vote on any of the following resolutions:

A. those that directly impact the rights affixed to their preference shares.

B. for reducing their overall ownership position in the company by joining a private equity arrangement to obtain further funds.

C. To get remuneration.

D. None of these

5. If the dividend on their share remains unpaid for …. year, preference shareholders shall have the opportunity to vote on all motions.

A. 1

B. 2

C. 3

D. 4

6. A difference in the class of equity shares may be created for

A. The right to vote.

B. Dividend.

C. Both A and B

D. None of these

7. Which one of the following assertions is true, please?
A. The buy-back represents more than 25% of the company's total paid-up capital and free reserves.
B. A company is not permitted to repurchase partially paid shares.
C. The buy-back of equity shares in any fiscal year may not exceed 25% of the fiscal year's total paid-up equity capital.
D. All are untrue

8. The premium (the difference between the buy-back price and par value) should be deducted from
A. Free reserves.
B. Security premium.
C. Both A and B
D. None of these

9. Share buybacks have several benefits, including
A. Motivating competitors to make hostile takeover offers.
B. Reduce promoter holdings because the shares that are repurchased are cancelled.
C. Prevent others from making aggressive bids to acquire the business because the buyback will increase the promoters' ownership.
D. None of these

10. A business may, under certain circumstances, purchase its own shares or other securities under Section ….of the Companies Act, 2013.
A. 68
B. 69
C. 70
D. 71

11. Section …. of the Companies Act of 2013 addresses the accounting treatment of buyback proceeds.
A. 68
B. 69
C. 70
D. 71

12. In some situations, Section… of the 2013 Companies Act sets restrictions on share buybacks.
A. 68
B. 69
C. 70
D. 71

13. Debt-equity ratio should not fall below …. after buy-back.
A. 2:1
B. 2:3

C. 1;3

D. 1:4

14. After the buy-back is over, the shares must be physically destroyed within … days.

A. 7

B. 8

C. 9

D. 10

15. Except for the issuance of bonus shares, ESOPs, sweat equity, and the conversion of debt/preference shares into equity, no further issues are permitted within …. months of the buy-back.

A. 5

B. 6

C. 7

D. 8

Answers for Self Assessment

1.	A	2.	B	3.	B	4.	B	5.	A
6.	C	7.	B	8.	C	9.	C	10.	A
11.	B	12.	C	13.	A	14.	A	15.	B

Review Questions

1. What do you mean by buy back of equity shares.
2. What prerequisites must a joint stock company meet in order to repurchase its equity shares under the 2013 Companies Act? Briefly describe.
3. What benefits do equity share buybacks under the 2013 Companies Act offer? Briefly describe.
4. What requirements must be met legally in order to repurchase equity shares under the 2013 Companies Act? Briefly describe.
5. Write a note on section 68, section 69, and section 70 in regard to buy back of shares under 2013 Companies Act.

Further Readings

- https://taxguru.in/company-law/buy-shares-companies-act-2013.html#:~:text=Conditions%20of%20Buy%2Dback%3A,then%20first%20alter%20the%20AOA.&text=a.,b.
- ICAI: Paper 5 advanced accounting

Unit 10: Provision Relating to Buyback

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Objectives

After studying this unit, you will be able to:

- Understand the Buyback Methods
- Understand the provisions relating to accounting treatments for buyback

Introduction

A share purchase or buyback is another name for it. when a company buys its own outstanding shares to reduce the amount of shares that are traded publicly. Companies repurchase shares for a variety of purposes, including to increase the value of the available shares by reducing supply or prevent other owners from gaining control. Businesses will be able to invest in themselves through buybacks. The percentage of shares owned by investors rises as the number of outstanding shares on the market decreases. A company might undertake a buyback if it believes that its shares are being undervalued in order to reward investors. The share repurchase reduces the number of outstanding shares, increasing the value of each share as a proportion of the firm. Thus, if the Price-to-Earnings ratio (P/E) declines or the stock price rises, the stock's Earnings Per Share (EPS) increases. A buyback shows investors that the company has enough cash on hand to cover crises, reducing the likelihood of financial difficulties.

10.1 Restrictions on Purchase by Company or giving of Loans by it for Purchase of its Shares [Section 67]

1. No company limited by shares or by guarantee with a share capital may purchase its own shares unless the resulting share capital reduction is carried out in accordance with the provisions of this Act.
2. No public company shall provide any financial assistance, directly or indirectly, whether through a loan, guarantee, the provision of security, or otherwise, for the purpose of, or in connection with, a subscription made or to be made, by any person, for any shares of the company or in its holding company.
3. Nothing in subsection (2) shall apply to:

- a banking company lending money in the normal course of its business;
- a company providing money in accordance with a plan approved by the company through a special resolution and in compliance with any requirements that may be prescribed, for the purchase of, or subscription for, fully paid-up shares in the company or its holding company, if the purchase of, or subscription for, the shares held by, the company.
- giving loans to employees of a company, excluding directors and key managerial personnel, for an amount not to exceed their salary or wages for a period of six months in order to enable them to buy or subscribe for fully paid up shares in the company or its holding company to be held by them through beneficial ownership.

With the caveat that disclosures on voting rights not directly exercised by workers in regard to shares to which the scheme relates shall be made in the Board's report in accordance with any applicable regulations.

4. Nothing in this section shall limit a company's ability to redeem any preference shares it has issued in accordance with this Act or a prior company law.
5. A company that violates the terms of this section is subject to a fine that must not be less than one lakh rupees but may reach twenty-five lakh rupees, and any officers who are in default are subject to imprisonment for a term that may reach three years and a fine that must not be less than one lakh rupees but may reach twenty-five lakh rupees.

10.2 Power of Company to Purchase its Own Securities [Section 68]

1. A company may buy its own shares or other specified securities (referred to as a "buyback") out of

a. its free reserves

b. the securities premium account

c. the proceeds of the issue of any shares or other specified securities, notwithstanding anything contained in this Act, but subject to the provisions of sub-section (2).

However, no buy-back of any kind of shares or other specified securities shall be made out of the proceeds of an initial public offering.

2. No corporation is allowed to buy back its own shares or other specified securities under subsection (1) unless:

a. the buy-back is permitted under the company's articles; or

b. a special resolution has been approved by the company's general meeting.

The following conditions must be met in order for this clause to apply:

(i) the buy-back must represent 10% or less of the company's total paid-up equity capital and free reserves; and

(ii) the buy-back must have been permitted by the Board by a resolution adopted at its meeting.

c. the buy-back is twenty-five percent or less of the company's paid-up capital and free reserves; provided, however, that the reference to twenty-five percent in this clause shall be construed with respect to the company's total paid-up equity capital in that financial year for equity share buy-backs; and

d. the ratio of the company's total secured and unsecured debts after the buy-back is not more than twice the paid-up capital.

e. all the shares or other specified securities for buy-back are fully paid-up;

f. The purchase of shares or other specified securities listed on any recognised stock exchange complies with the rules established in this regard by the Securities and Exchange Board;

g. The purchase of shares or other specified securities other than those mentioned in clause (f) complies with any rules that may be established.

With the caveat that no offer of buy-back under this subsection may be made within a year starting from the day that the previous offer of buy-back, if any, was closed.

3. A detailed explanation of all relevant facts,

a. the necessity for the buy-back,

b. the class of shares or securities intended to be purchased under the buy-back,

c. the amount to be invested under the buy-back, and

d. the deadline for buy-back completion

must all be included in the notice of the meeting at which the special resolution is proposed to be passed under clause (b) of subsection (2).

4. Each buy-back must be completed within a year of the special resolution's passage or, as applicable, the Board resolution enacted in accordance with sub-section (2) clause (b).

5. The buy-back described in subsection (1) may be made

a. proportionately from current shareholders or security holders;

b. on the open market; or

c. by purchasing the securities given to workers of the company under a stock option or sweat equity programme.

6. When a company plans to buy back its own shares or other specified securities under this section as the result of a special resolution, it must first file with the Registrar and the SEBI a declaration of solvency signed by at least two directors, one of whom must be the managing director, if any, in the form that may be prescribed and supported by an affidavit stating that the Board of Directors of the company has conducted a thorough investigation.

With the caveat that a company whose shares are not listed on any reputable stock exchange shall not file a declaration of solvency with the Securities and Exchange Board.

7. Within seven days of the last date the buy-back was completed, a corporation that buys back its own shares or other specified securities must extinguish and physically destroy the shares or securities.

8. When a company completes a buyback of its shares or other specified securities under this section, it may not issue the same kind of shares or other securities again for six months, including the allocation of new shares under clause (a) of sub-section (1) of section 62 or other specified securities, unless it is a bonus issue or in order to fulfil ongoing obligations, such as the conversion of warrants, stock option plans, sweat equity.

9. When a company buys back its shares or other specified securities under this section, it is required to keep a record of the shares or securities purchased, the consideration paid for the shares or securities purchased back, the date the shares or securities were cancelled, the date the shares or securities were physically destroyed, and any other information that may be required.

10. A company must file a return with the Registrar and the Securities and Exchange Board with the necessary information regarding the buyback within thirty days of the completion of the buyback under this section.

With the exception that a firm whose shares are not listed on any recognised stock exchange shall not file any return with the Securities and Exchange Board.

11. For the purposes of clause (f) of sub-section (2), a company that fails to comply with the provisions of this section or any Securities and Exchange Board regulation will be subject to a fine that cannot be less than one lakh rupees but may not exceed three lakh rupees, and any officers who fail to comply will face up to three years in prison or a fine that cannot be less than one lakh rupees.

12. Disclosure requirements for the buyback of shares or other securities in the explanation statement that will be attached to the notice of the general meeting

13. The following disclosures must be included in the explanatory statement that will be attached to the notice of the general meeting in accordance with Section 102 about the buyback of shares or other securities by private companies and unlisted public companies:

a. the purpose of the buy-back,

b. the class of shares or other securities intended to be purchased under the buy-back,

c. the number of securities the company proposes to buy-back,

d. the method to be used for the buy-back, and

e. the price at which the buy-back of shares or other securities shall be made.

f. The date of the board meeting at which the proposal for buy-back was approved by the board of directors of the company.

g. the methodology used to determine the buy-back price;

h. the maximum amount to be paid for the buy-back and the funding sources that would be used to finance the buy-back;

i. the deadline for the buyback's completion;

- the total number of equity shares purchased or sold by those mentioned in clause (i) during the twelve months prior to the date of the board meeting at which the buy-back was approved and from that date until the date of the notice convening the general meeting; and
- the total number of equity shares purchased or sold by those mentioned in clause (i) during the period of twelve months prior to the date of the board meeting at which the buy-back was approved, the date of the general meeting;
- the maximum and minimum price at which the purchases and sales mentioned in item (ii) were made;

k. If the individuals listed in sub-clause (i) of clause (j) intend to tender their shares for buyback:

- the number of shares proposed to be tendered;
- the specifics of their transactions and holdings for the twelve months prior to the date the buyback was approved by the board, including information on the number of shares acquired, the price, and the date of acquisition;

l. a declaration that there are no outstanding defaults regarding the repayment of deposits, interest payments on deposits, the redemption of debentures or the payment of interest on debentures, the redemption of preferred shares or the payment of dividends due to shareholders, or the repayment of any term loans or the payment of interest on term loans to any financial institution or banking company;

m. a statement stating that the Board of Directors has thoroughly investigated the company's affairs and future prospects and has come to the following conclusions:

- there will be no circumstances that would make it possible for the company to be found unable to pay its debts immediately after the date the general meeting is called;
- regarding its prospects for the year immediately after that date, that the company will be able to meet its liabilities as and when they become due and will not be declared insolvent within a year of that date, taking into account their intentions regarding the management of the company's business during that year as well as the amount and nature of the financial resources they believe will be available to the company during that year; and
- The liabilities (including potential and contingent liabilities) have been considered by the directors as if the company were being wound up in accordance with the 2013 Companies Act.

n. report from the company's auditors to the board of directors stating that

- they have looked into the company's financial situation;

- the amount of the permissible capital payment for the securities in question is, in their opinion, properly determined;
- the audited accounts used to calculate the buyback are not older than six months from the date of the offer document; and
- the board of directors has considered the audited accounts.
- The company, considering its current condition of affairs, will not be rendered insolvent within a year of that date, and the Board of Directors has made the opinion stated in subsection (m) on reasonable grounds.

o. Buy-Back Is Prohibited in Certain Situations [Section 70]

p. No company shall, directly or indirectly purchase its own shares or other specified securities:

- through any subsidiary company, including its own subsidiary companies;
- through any investment company or group of investment companies; or
- if a default is made by the company in repayment of deposits accepted before or after the commencement of this Act, interest payment thereon, redemption of debentures or preference shares, or payment of dividend to any shareholder, or repayment of any term loan or interest payable thereon to any financial institution or banking company.

No company shall, directly or indirectly: (a) purchase its own shares or other specified securities, If the default is corrected and three years have passed after it ceased to exist, provided that the buy-back is not forbidden.

10.3 Accounting for Buy-Back

Section 68

This Section permits a company to repurchase its shares or other specified securities using any of the following funds:

1. free reserves,

2. securities premium account, or

3. proceeds from the sale of any shares or other specified securities, such as stock options granted to employees.

However, no shares may be repurchased using the proceeds of a prior issuance of the same class of shares. The buy-back of all shares or other specified securities must be fully paid up, according to this Section.

When a company buys its own shares using free reserves, as per Section 69, then the capital redemption reserve account will receive a transfer of funds equivalent to the nominal value of the shares so purchased, with the balance sheet disclosing the specifics of the transfer.

Determination of the buy-back quantum. Section 68 of the 2013 Company Act

The least number of shares arrived is used to calculate the maximum number of shares to be bought back by running the following tests:

(1) The outstanding share test;

(2) the resource test; and

(3) the debt-to-equity ratio test.

(1) Share Outstanding test:

(a) Ascertain the number of shares

(b) 25% of the number of shares is eligible for buy back with the approval of shareholders.

(2) Resource test:

(a) Ascertain sharehooders fund (Capital + Free Reserves)

(b) No. of shares held for buyback =Shareholders funds/Buy back price

Free Reserve includes Securities Premium, General Reserve, Revenue Reserves, Profit & Loss A/c (Cr. Balance) excludes Revaluation Reserve, any other specific reserves

Accounting — Buy back of Shares

1. Shares held for buy-back

Equity Share Capital A/c Dr.

Premium on Buyback A/c Dr.

To Equity Shareholders A/c or Shares bought back A/c

2. Adjustment of premium on buyback

Securities Premium A/c Dr.

General Reserve A/c Dr.

To Premium on Buyback A/c

3. Transfering reserves to the extent of capital redeemed Reserves A/c Dr.

Profit Loss A/c Dr.

To Capital Redemption Reserve

4. On buy-back of shares

Equity Shareholders A/c Dr. or Shares bought back A/c Dr.

To Bank A/c

Example 1

Buy back at par.

- X Co. Ltd. buys back 2,00,000 of its own equity shares at par.
- In addition to general reserve, the company has sufficient profits that are available for dividends.
- No new shares are issued for this purpose.
- The shares have been paid in full. Journalise the transactions.

In the Books of X Co. Ltd. Journal Entries

Date Particulars Debit Credit

Equity Share Capital A/c Dr.

To Bank A/c

(Buying-back 2,00,000 equity shares of rs. 10 each, at par) 20,00,000

20,00,000

General Reserve A/c Dr.

To Capital Redemption Reserve A/c

(Transfer of nominal value of shares bought back) 20,00,000

20,00,000

Example 2;

(Where shares are partially paid up)

- By special resolution, the BCG Co. Ltd. decided to repurchase 2,00,000 of its equity shares with a face value of $10 apiece, of which $8 had already been paid in full.
- The company's general reserve amount was $50,000, and
- no additional shares were issued.
- Journalize the transactions.

BCG Co. Ltd.

Date Particulars Debit Credit

Equity Share Final Call A/c Dr.

To Equity Share Capital A/c

(Final call of Rs.2 per share due on 2,00,000 equity shares as per Board resolution)4,00,000

4,00,000

Bank A/c Dr.

To Equity Share Final Call A/c

(Final call money on 2,00,000 shares received) 4,00,000

4,00,000

Equity Share Capital A/c Dr.

To Equity Shareholders A/c

(Amount due to equity shareholders transferred to their account for Buy Back) 20,00,000

20,00,000

Equity Shareholders A/c Dr.

To Bank A/c

(Payment to shareholders towards buy-back) 20,00,000

20,00,000

General Reserve A/c Dr.

To Capital Redemption Reserve A/c (Transfer of nominal value of shares Bought-back 20,00,000

20,00,000

Example 3:

(Where shares are bought-back at a premium)

- Beta Co. Ltd.'s share capital is made up of
- 25,000 fully called preference shares for $100 each and
- one million equity shares worth $10 each.
- Its securities premium account now has a balance of $40,000 and a
- $7,000,000 general reserve.
- The business decides to repurchase 20,000 equity shares at a price of $12 each.
- Pass the necessary journal entries.

In the Books of Beta Co. Ltd. Journal Entries

Date Particulars Debit Credit

Equity Share Capital A/c

Securities Premium A/c

To Equity Shareholders A/c

(Amount due to equity shareholders for buying-back of 20,000 equity shares) 2,00,000

40,000

2,40,000

Equity Shareholders A/c

To Bank A/c

(Payment to shareholders on account of buy-back) 2,40,000

2,40,000

General Reserve A/c

To Capital Redemption Reserve A/c (Transfer of nominal amount of equity shares Bought-back.) 2,00,000

2,00,000

Example 4:

Where shares are bought-back at a discount

- The PTC Co. Ltd. has a share capital of $ 15,00,000.
- This capital is made up of 50,000 8% preference shares worth $ 10 each and 1,000,000 equity shares worth $ 10 each
- both of which have been fully called up and paid up.
- The company's general reserve is sufficient for it to meet the requirements of the share buyback's legal requirements.
- 20% of its equity share capital will be bought back for $9 per share.
- Enter the transactions in the business's books.

Solution: Journal Entries in the Books PTC Co. Ltd.

Date Particulars Debit Credit

Equity Share Capital A/c

To Equity Shareholders A/c

To Capital Reserve A/c

(Amount due to equity shareholders for buy-back of 20,000 shares @ rs. 9) 2,00,000

1,80,000

20,000

Equity Shareholders A/c

To Bank A/c

(Payment to equity shareholders the amount due to them) 1,80,000

1,80,000

General Reserve A/c

To Capital Redemption Reserve A/c (Transfer of nominal amount of shares bought-back) 2,00,000

2,00,000

Example 5:

Fresh issue of shares for purposes of buy-back

A paid-up equity share capital of Rs. 20,00,000 in 2,00,000 shares of '10 each is held by Alpha Co. Ltd.

It decided to repurchase 50,000 equity shares for $15 each.

It issued 20,000 12% preference shares of $10 each, par, payable with application for this purpose.

The corporation has $250,000 in its securities premium account and $110,000 in its general reserve account to its credit.

The business made use of the general reserve.

Solution

In the Books of Alpha Co. Ltd.

Date Particulars Debit Credit

Bank A/c

To Preference Share Application A/c

(Application money on 20,000 preference shares at Rs. 10 each) 2,00,000

2,00,000

Preference Share Application A/c

To Preference Share Capital A/c

(Transfer of application money to preference share capital account on shares being allotted) 2,00,000

2,00,000

Equity Share Capital A/c

Securities Premium A/c

To Equity Shareholders A/c

(Amount due to equity shareholders consequent upon buy-back of 50,000 Shares at Rs. 15) 5,00,000

2,50,000

7,50,000

Equity Shareholders A/c

To Bank A/c (Payment to equity shareholders for amount due to them) 7,50,000

7,50,000

General Reserve A/c

To Capital Redemption Reserve A/c (Transfer of the nominal value of shares bought back.) 3,00,000

3,00,000

Summary

Share buy-backs are the exact reverse of share issues. Just as shares may be issued at par, at a premium, even buy-back may be at par, at a premium or at a discount. The Amended Companies Act's Section 68 serves as the foundation for accounting for buy-backs. This Section not only enables a firm to repurchase or redeem its equity shares, but it also details the sources from which such an action must be carried out.

Keywords

- Buy back of shares: it means purchase of its own shares by a company
- Securities Premium Account: includes premium on issue of shares, debentures, bonds or other financial instrument.
- Free Reserves: The Companies Act of 1956 does not define the term "free reserves" in any particular way. In several parts where a definition was necessary, there were references to free reserves. For example, free reserves were defined in section 372A of the Companies Act of 1956 for a specific purpose. In accordance with section 2(43) of the Companies Act of 2013, "Free reserves" are defined as reserves that, based on a company's most recent audited balance sheet, are available for distribution as dividend:assuming that—
  - o any sum showing unrealized gains, notional gains, or asset revaluation, whether it is displayed as a reserve or not; or
  - o Free reserve is not to be recognised as a change in the carrying amount of an asset or a liability that has been recognised in equity, including any excess in the profit and loss account following the measurement of the asset or the liability at fair value.

Self Assessment

1. Which of the following are not available for buy-back of shares?

A. Capital redemption reserve

B. Debenture redemption reserve

C. Share forfeited account

D. Securities Premium Account

2. Which of the following is not an advantage of buyback of shares?

A. To increase promoters holding as the shares which are bought back are cancelled.

B. To increase earnings per share if there is no dilution in company's earnings as the buy-back of shares reduces the outstanding number of shares.

C. To support the share price on the stock exchanges when the share price, in the opinion of the company management, is less than its worth, especially in the depressed market.

D. To be used as a tool for insider trading.

3. Section 68 of the Companies Act, 2013 allows a company to buy its own shares and other specified securities out of following except:

A. Free reserves; or

B. the securities premium account; or

C. the proceeds of any shares or other specified securities.

D. out of the proceeds of an earlier issue of the same kind of shares or same kind of other securities.

4. According to section 69 of the Companies Act, 2013, where buy-back is done out of free reserves or securities premium account, then an amount equal to the nominal value of shares bought back must be transferred to

A. Capital Redemption Reserve Account

B. Capital Reserve Account

C. Debenture redemption reserve

D. Share forfeited account

5. As per section 55, Capital Redemption Reserve Account can be used

A. only for issue of fully paid bonus shares.

B. only for issue of partly paid bonus shares.

C. Not for issue of fully paid bonus shares.

D. only for issue of fully paid debebtures.

6. Which of the following is wrong in regard to free reserves?

A. The expression "free reserves" was not specifically defined under the Companies Act, 1956.

B. According to section 2(43) of the Companies Act, 2013, "Free reserves" means such reserves which, as per the latest audited balance sheet of a company, are available for distribution as dividend

C. under the Companies Act, 2013 it is defined in generic sense

D. for the purposes of section 68, "free reserves" does not include securities premium account.

7. Which of the following is wrong in regard to Meaning of "Proceeds of any shares or other specified securities"

A. As per section 68 of the Companies Act, 2013, buy-back of shares and other specified securities can be made out of the proceeds of earlier issue of other kind of shares or other kind of specified securities made for the purpose of buy-back of shares

B. preference shares may be issued for buy-back of equity shares; and equity shares may be issued for buy-back of preference shares

C. When shares are issued at par, proceeds mean par value of the shares issued.

D. When shares are issued at premium, the proceeds in this case mean the premium value of the shares issued

8. Every buy back must be completed within … months from the date of passing of the special resolution or resolution passed by the Board.

A. 11

B. 12

C. 13

D. 14

9. Which of the following is not a method of buyback?

A. from the existing shareholders or security holders on a proportionate basis;

B. from the existing shareholders or security holders on a unbalanced basis;

C. from the open market,

D. by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.

10. Where a company completes a buy-back of its shares or other specified securities, it must not make further issue of same kind of shares or other specified securities within a period of … months

A. 6

B. 7

C. 8

D. 9

11. After the completion of buy-back, the company has to file a return in the prescribe form with the Registrar (and also with SEBI in case of a listed company) within .. days of such completion.

A. 30

B. 40

C. 50

D. 60

12. Under this method the company buys-back shares through the stock exchange at the prevailing market price till it purchases the pre-determined number of shares it had originally decided to buy-back and the market price does not exceed the pre-determined maximum price for buy-back.

A. Open Market through Stock Exchange

B. Open Market through Book-building process

C. buy-back through negotiated deals

D. buy-back through spot transactions

13. In this method, a company makes an offer to buy-back a specified number of shares to the shareholders at a specified price range, say Rs. 40 to Rs. 45 per share.

A. Open Market through Stock Exchange

B. Open Market through Book-building process

C. buy-back through negotiated deals

D. buy-back through spot transactions

14. Under this method, the shareholders are invited to make a bid quoting a price within the price range and the number of shares offered for buy-back.

A. Open Market through Stock Exchange

B. Open Market through Book-building process

C. buy-back through negotiated deals

D. buy-back through spot transactions

15. Under this method, no buy-back of any kind of shares or other specified securities shall be made out of the proceeds of an earlier issue of the same kind of shares or same kind of specified securities.

A. Open Market through Stock Exchange

B. Open Market through Book-building process

C. buy-back through negotiated deals

D. buy-back through spot transactions

Answers for Self Assessment

1.	D	2.	D	3.	D	4.	A	5.	A
6.	D	7.	D	8.	B	9.	B	10.	A
11.	A	12.	A	13.	B	14.	B	15.	B

Review Questions

1. In what cases, Buyback is prohibited?
2. What are the different sources of buy-back?
3. What is the Accounting treatment of buy-back of shares?
4. What is the difference between reserves and free reserves?
5. Which reserves amongst others, are not available for buy-back of shares?

Further Readings

ICAI: Paper 5 advanced accounting

ICMAI: Paper 12 - COMPANY ACCOUNTS & AUDIT

Web Links

https://taxguru.in/company-law/buy-shares-companies-act-2013.html#:~:text=Conditions%20of%20Buy%2Dback%3A,then%20first%20alter%20the%20AOA.&text=a.,b.

https://www.taxmann.com/post/blog/what-is-a-share-buyback/#9999

Unit 11: Liquidation of Companies

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Summary

Keywords

Self Assessment

Answers for Self Assessment

Review Questions

Further Readings

Objectives

After studying this unit, you will be able to:

- Recognize the meaning of winding up and its variations.
- Compile your Statement of Affairs in accordance with the Act's format requirements.
- Create a Deficiency Account and be able to identify the causes of the Deficiency.
- Differentiate between overriding preferential payments and preferential payments with preference.
- Decide on the sequence in which all debts should be paid.
- Create the final statement of accounts for the liquidator.

Introduction

A company is created by legislation, yet that same law can also end it. The process through which a company's affairs are removed out of the directors' hands is known as winding up or liquidation. Its directors typically pass away. The administrator is chosen as a "Liquidator."

A company's assets are realised by a liquidator, who also pays out the company's debts. After paying off the company's debts, any remaining funds are divided among the shareholders. Regardless matter whether the company is solvent or bankrupt, this technique may be used.

11.1 DefinitionofWindingUP

According to Section 2 (94A) of the Companies Act of 2013, "winding up" refers to either liquidation under this Act or winding up under the Insolvency and Bankruptcy Code of 2016, depending on the circumstances.

Winding Up Contains

1. Dissolution under the 2013 Companies AcTt
2. In the 2016 Insolvency and Bankruptcy Act, liquidation

11.2 WindingUPByTribunal

The provisions of Part I should apply to the winding up of a company by the Tribunal under this Act, in accordance with section 270.

Conditions under Which a Corporation May Be Wound Up by a Tribunal:

(a) The company has decided to request that the Tribunal dissolve the company. The business must adopt a particular resolution.

b) The company's actions have been detrimental to India's sovereignty and integrity, the state's security, cordial relations with other countries, public order, morality, or decency.

(c) The Registrar or any other person designated by the Central Government by notification pursuant to this Act may submit a tribunal application. The Tribunal believes that it is appropriate to wind up the company because its affairs have been managed fraudulently, it was founded for fraudulent and illegal purposes, or those involved in its formation or management have engaged in fraud, mismanagement, or misconduct in connection therewith. (d) The business failed to file its annual reports or financial statements with the Registrar for the five fiscal years that came before them.

(d) The Tribunal believes that winding up the corporation would be just and equitable.

11.3 PetitiontoWindUP

A petition for winding up may be submitted to the tribunal by:

- The Company
- Any Contributory or Contributories The registrar
- Any person authorized by Central Government in that behalf
- In case affairs of the company have been conducted in a Fraudulent manner, by the Central Government or a State Government

PetitionbyContributory

A contributory should be qualified to file a petition for the winding up of a company if:

The shares of which he is a contributory were either issued to him, held by him for at least six months in the 18 months prior to the winding up, registered in his name, or passed to him through the death of a previous holder.

Contributory may submit a petition while omitting the following things:

- He could be the owner of fully paid-up shares,
- the company could be completely devoid of assets, and
- there might not be any surplus assets left over after liabilities are paid.

Petition by Registrar

- Except for the reasons listed in the section, the Registrar should be permitted to submit a petition for winding up under section 271.
- Before presenting a petition, the Registrar must first have the Central Government's approval.
- The Central Government must wait until the enterprise has had a reasonable opportunity to make arguments before granting its sanction.

PetitionbyCompany

Only if a statement of affairs in the form and in the manner specified by the Tribunal will be submitted with a petition for winding up filed by the firm.

Without affecting any other rules, a copy of the petition filed under this section shall also be filed with the Registrar, who should thereafter offer his opinions to the Tribunal within 60 days of receiving the petition.

11.4 Voluntary Winding**UP**

- Let's talk about the voluntary winding up of a corporation after learning about the mandatory winding up of a company.
- Due to section 255 of the Insolvency & Bankruptcy Code, 2016 and section 59 covered under Chapter V of the Insolvency & Bankruptcy Code, 2016, which was notified on 01.04.2017, provisions under the Companies Act, 2013 relating to voluntary winding up stand deleted.
- As a result, the provisions of the Companies Act are valid until March 31, 2017, and the Insolvency and Bankruptcy Code of 2016 takes effect on April 1.

11.5 2016 Insolvency and Bankruptcy Code Provisions

(1) Under the terms of Chapter V- Voluntary liquidation of corporate persons of the Insolvency and Bankruptcy Code of 2016, a corporate person who chooses to dissolve itself voluntarily and has not committed any default may commence voluntary liquidation procedures.

(2) The voluntary liquidation of a corporate person must adhere to the circumstances and formalities that the Board may specify.

(3) The following requirements must be met before voluntary liquidation proceedings of a corporate person registered as a company can proceed:

(a) a declaration from a majority of the company's directors, verified by an affidavit, stating that—

> (i) they have conducted a thorough investigation into the company's affairs and have come to the conclusion that either the company has no debts or that it will be able to pay those debts in full from the proceeds of assets to be sold in the voluntary
>
> (ii) No one is being defrauded as a result of the company's liquidation;

(b) The declaration under subsection (a) must be accompanied by the papers listed below:

> (i) the company's audited financial statements and record of business operations for the past two years, or for the time since its establishment, whichever comes later;
>
> (ii) a report of the company's assets' valuation, if any, prepared by an accredited valuer;

(c) Within four weeks of a declaration made under clause

(a), there must be one of the following:

(i) a special resolution of the company's members in a general meeting requiring the company to be liquidated voluntarily and appointing an insolvency professional to serve as the liquidator; or

(ii) a resolution of the company's members in a general meeting requiring the company to be liquidated voluntarily due to the passing of the period of its duration, if any,

If the company has any outstanding debts, within seven days of the resolution being enacted under section (c), creditors representing two-thirds of the total debt of the company must approve it.

(4) Within seven days of the resolution or the subsequent approval by the creditors, as applicable, the company shall notify the Registrar of Companies and the Board about the decision to liquidate the company pursuant to subsection (3).

(5) The voluntary liquidation procedures for a company are assumed to have begun on the date the resolution under sub-clause (c) of sub-section (3) was passed, subject to the consent of the creditors under subsection (3).

(6) Subject to any required modifications, the provisions of sections 35 to 53 of Part III (Procedure for Liquidation) and Chapter VII (Offenses and Penalties) must apply to voluntary liquidation procedures for corporate persons.

(7) The liquidator must request the dissolution of the corporate person from the adjudicating authority when the corporate person's affairs have been fully wound up and its assets fully liquidated.

(8) In response to a request submitted by the liquidator in accordance with subsection (7), the adjudicating authority shall issue an order dissolving the corporate debtor as of the date of the order.

(9) The authority with which the corporate person is registered must receive a copy of an order made under to subsection (8) within fourteen days of the order's date.

11.6 Liquidator’sStatementofAccount

The Company Liquidator should keep proper books in the way that may be prescribed in the event of a Compulsory Wind-Up, and he should cause entries or minutes to be made of meeting proceedings and other issues that may be prescribed.

Any creditor or contributor may examine any of these books directly or through an agent, subject to the Tribunal's control.

Receipts are listed in the following sequence when creating the liquidator's statement of account:

(a) The stipulated order includes the amount that was realised from assets.

(b) Only the surplus from assets that have been specifically committed in favour of creditors are recorded as "surplus from securities."

(c) If the available funds are insufficient to cover creditors' and preference shareholders' claims in the case of partially paid up shares, the equity shareholders should be called upon to contribute the appropriate sum (up to the amount of uncalled capital). In order to pay creditors, preference owners would be asked to contribute (up to the amount still owing on the shares).

Payments are made in the following order, which is also shown:

(a) Legal charges;

(b) Liquidator’s expenses;

(c) Debenture holders (including interest up to the date of winding up if the company is insolvent and to the date of payment if it is solvent);

(d) Creditors:

- (i) Preferential (in actual practice, preferential creditors are paid before debenture holders having a floating charge);
- (ii) Unsecured creditors;

(e) Preferential shareholders (Arrears of dividends on cumulative preference shares should be paid up to the date of commencement of winding up); and

(f) Equity shareholders.

11.7 Beginning of Winding Up By Tribunal

The winding up of the company should be deemed to have started at the time the resolution was passed, and unless the Tribunal, on proof of fraud or mistake, thinks fit to direct otherwise, all proceedings in the voluntary winding up should be deemed to have been validly taken. This is true where, prior to the presentation of a petition for the winding up of a company by the Tribunal, a resolution for voluntary winding up has been passed by the company.

In all other circumstances, the Tribunal's winding up of a firm should be considered to have started when the petition for the winding up was presented.

Elimination of Certain Time from the Calculation of the Limitation Period

The period from the date the winding up of the company began to the period of one year immediately following the date of the winding up order should be excluded when calculating the period of limitation specified for any suit or application filed in the name and on behalf of a company that is being wound up by the Tribunal, regardless of anything in the Limitation Act of 1963 or in any other law currently in effect.

11.8 StatementofAffairs

A petition brought by the company for winding up before the Tribunal will only be granted if it is accompanied by a statement of affairs in the form and in the way that may be stipulated, according to Section 272(5) of the Companies Act, 2013, which applies in cases of winding up by Tribunal.

According to Section 274(1), when a petition for winding up is filed before the Tribunal by someone other than the company, the Tribunal shall, if satisfied that a prima facie case for winding up of the company is made out, direct the company by an order to file its objections and a statement of its affairs within thirty days of the order in the form and in the manner that may be prescribed.

In an emergency or under unusual circumstances, the Tribunal may grant a longer thirty-day window.

The following are the general guidelines on which the Statement of Affairs is prepared:

(1) Incorporate non-fixed charge assets at the value they are anticipated to realise. Remember to include calls in arrears but not uncalled capital, advise your students.

(2) Take into account any assets that have a fixed fee. The anticipated revenue would be compared to the amount owed to the impacted creditor. Any extra money should be added to the other column. Unsecured creditors are to be increased by a deficit, which is the difference between what is due to them and what may be realised from the asset.(3) All creditors have access to the total of the assets listed in point (1) and any surplus from the assets listed in point (2). (except secured creditors already covered by specifically mortgaged assets).

(4) The following must be subtracted one by one from the total amount of available assets:

- I Preferential creditors; (ii) Debentures with a floating charge; and (iii) Unsecured creditors.

There would be a deficit with respect to creditors if the balance is negative; otherwise, there would be a surplus.

Add the total paid-up capital (which includes information about each class of shares) to get the deficiency (or surplus) as it relates to members figure.

Note: Eight lists should be accompanied with a statement of affairs:

List A This list must contain all the details of any description of property that is neither formally promised nor mentioned in any other list.

List B Assets specifically pledged and completely or partially secured creditor claims.

Priority creditors for rates, taxes, salaries, and other debts are included in List C.

List D: Holders of debentures with floating charges.

Unsecured creditors are on List E.

List F: Shareholders with preference.

Owners of equity are listed in List G.

Deficiency or excess account, list H.

11.9 DeficiencyAccount

When information is provided for the creation of an account to explain the deficiency or excess, the official liquidator will specify a date for a period of time (minimum three years) to commence on that date. Either there would be a reserve on that day or there would be a deficit or debit balance in the profit and loss account because assets would be more than capital plus liabilities. Two sections make up the Deficiency account:

1. The first section begins with the deficit (as of the specified date) and includes all items that raise the deficit (or reduces surplus such as losses, dividends etc.).

2. The second section includes all profits and begins with the surplus as of the specified date.

There would be a deficit to the extent of the difference if the total of the first part was higher than the total of the second, and a surplus if the total of the second part was higher than the total of the first.

11.10 OverridingPreferentialPayments

In the event of a company's dissolution, the following debts must be paid before any others, in accordance with Section 326:

Workmen's dues, and if a secured creditor has realised a secured asset, the amount of the workmen's portion of that secured creditor's security (if payable under the law), whichever is less, pari passu with the workmen's dues:

Example:

A secured creditor of a company's security is worth $100,000. The workmen's dues total $1,000,000 in total. The sum owed by the business to its secured creditors is $3,000,000. The sum of the debts owed to secured creditors plus the amount of workmen's compensation is $4,000,000. Hence, the workmen's portion of the security is worth '25,000, or one-fourth of the security's value.

11.11 PreferentialCreditors

In a winding up, all other debts that are governed by section 326's rules shall be paid in order of priority.

- Government Taxes: Any revenues, taxes, cess, and rates that are owed by the corporation to the Central Government, a State Government, or a local authority as of the relevant date and that have accrued during the twelve months immediately prior to that day;
- Salary and Wages: All wages or salary, including wages payable for time or piece work and salary earned wholly or partially by way of commission of any employee in respect of services rendered to the company and due for a period not exceeding four months within the twelve months immediately preceding the relevant date, subject to the condition that the amount payable under this clause to any workman should not exceed that which may be notified;
- Holiday Remuneration: Upon the termination of an employee's employment prior to, or by the issuance of a winding-up order, or, as the case may be, the dissolution of the company, all accrued holiday remuneration shall become payable to such employee or, in the event of his death, to any other person claiming under him;
- Contribution under the Employees' State Insurance Act: All amounts due in relation to contributions payable during the period of twelve months immediately prior to the

relevant date by the company as the employer of individuals under the Employees' State Insurance Act, 1948, or any other law then in effect, unless the company is being wound up voluntarily merely for the purposes of reconstruction or amalgamation with another company;

- Compensation for death or disablement: Unless the company has, at the time of winding up, rights that can be transferred to and vested in the workers under a contract with any insurer as is mentioned in section 14 of the Workmen's Compensation Act of 1923, all amounts due in respect of any compensation or liability for compensation under the said Act in respect of the death or disablement of any employee of the company are as follows:
  - When a compensation under the said Act is paid weekly, the amount payable under this provision should be interpreted as the lump sum for which the employer could redeem the weekly payment, if redeemable, if an application has been submitted under the said Act;
- PF, Pension Fund, or Gratuity Fund: All amounts payable to any employee from the Provident Fund, Pension Fund, Gratuity Fund, or any other Employee Welfare Fund managed by the Company; and
- Costs of Investigation: Insofar as they are reimbursable by the company, the costs of any investigation conducted in accordance with Sections 213 and 216. When an employee of a corporation receives an advance payment from someone else for the purpose of covering wages, salaries, or earned vacation time. When it comes to the money that has been advanced and paid up to the amount, the person who made the advance should have priority. Due to the payment being paid, the amount for which the employee or another person in his right would have been entitled to precedence in the winding up has been decreased.
- Costs of Investigation: Insofar as they are reimbursable by the company, the costs of any investigation conducted in accordance with Sections 213 and 216. When an employee of a corporation receives an advance payment from someone else for the purpose of covering wages, salaries, or earned vacation time. When it comes to the money that has been advanced and paid up to the amount, the person who made the advance should have priority. Due to the payment being paid, the amount for which the employee or another person in his right would have been entitled to precedence in the winding up has been decreased.
- The debts listed in this section should:
  - rank equally among themselves and be paid in full;
  - have priority over the claims of holders of debentures under any floating charge established by the company insofar as the assets of the company available for payment to general creditors are insufficient to meet them; and
  - be paid in accordance with this priority out of any property co
- The assets should be used to pay off the debts under this section as soon as possible, with the exception of any money that may be required to cover the costs and expenditures of winding up the business.
- The debts to which priority is given under this section should be a first charge on the goods or effects so strained on or the proceeds of their sale in the event that a landlord or other person distrains or has distrained on any goods or effects of the company within three months prior to the date of a winding up order.

- The debts to which priority is given under this section should be a first charge on the goods or effects so distrained on or the proceeds of their sale in the event that a landlord or other person distrains or has distrained on any goods or effects of the company within three months prior to the date of a winding up order. Provided, however, that the landlord or other person should have the same rights as a creditor with respect to any money paid under any such charge.
- Any compensation for a period of vacation or time off work for medical reasons resulting from illness or another valid reason shall be deemed to constitute pay in respect of services provided to the Company during such period.
- Accrued Holiday Remuneration: Includes, in relation to any person, all sums that are payable on account of the remuneration that would ordinarily have become payable to him in respect of a period of holiday had his employment with the company continued until he became entitled to be allowed the holiday, under the terms of either his employment contract or the provisions of any law, including any order made or direction given thereunder;

11.12 A floating charge's effects [Section 332]

The amount of any cash paid to the company at the time of and in consideration for or subsequent to the creation of the charge, along with interest on that amount, should be excluded from the validity of any floating charge on the undertaking or property of the company created within the 12 months immediately prior to the commencement of the winding up, unless it is proven that the company immediately after the creation of the charge was solvent.

11.13 B List Contributories

(a) Persons: Shareholders who had transferred Partially Paid Shares within a year of the date of winding up (otherwise than by operation of law or by death) may be required to pay a sum to settle any Creditors that existed at the time of the transfer of shares. They are referred to as B List Contributors.

(b) Their responsibility is limited to the sum that was left over after the shares were transferred. They are only obligated to pay the share's full face value when called upon to do so. The B List Contributory can be called on to pay a maximum of '40 only if shares with a Face Value of 100 were paid up '60, for instance.

(c) Conditions: The liability of B List Contributors will only become a problem if (a) the liquidator's available assets are insufficient to fulfil the liabilities, or (b) the current shareholders fail to pay the liquidation the sum owed on the shares.

11.14 The "Liquidator's Statement of Account

The "Liquidator's Statement of Account" is the statement the liquidator creates in the event of a voluntary winding up that details cash receipts and payments. The statement is known as the "Official Liquidator's Final Account" in the event of a compulsory winding up. The following details should be kept in mind when preparing the statement of accounts:

(i) The defined order of liquidity includes assets.

(ii) Only the surplus from assets specifically charged in the direction of creditors, if any, is recognised as "Surplus from Securities."

(iii) The net outcome of transactions entered on the revenue side, with profits added and losses subtracted.

(iv) The cost of execution, or the price of collecting debts, as well as payments made to redeem securities are subtracted from the total receipts.

(v) The following order is followed while making payments:

- Legal Charges;
- Liquidator's Remuneration;
- Liquidation Expenses;
- Debenture holders (including interest up to the date of winding up if the company is insolvent and to the date of payment if it is solvent);
- Creditors;
- Preferential (in actual practice, preferential creditors are paid before debenture holders having a floating charge). Unsecured creditors, shareholders for dividends declared but not yet paid;
- Preference shareholders; and
- Equity shareholders.

(vi) Up until the date of winding up, dividend arrears on cumulative preference shares must be paid.

(vii) If shares are partially paid, it should be determined if any money needs to be called up on those shares.

First, in the event that the amount required is insufficient to satisfy the creditors' claims of the preference shareholders, the equity owners shall be called up to pay the requisite sum (up to the amount of uncalled capital). In order to pay off creditors, preference owners would be asked to contribute (up to the amount still left on the shares).

(viii) The amount of the loss incurred by each class of shareholders, or the amount that cannot be reimbursed, shall be inversely proportional to the share's nominal value. The loss per share has a nominal value of 100, and one group of shareholders paid 80 for each share while another group paid 60. In this situation, an appropriate adjustment will need to be made in cash; either the second set contributes 20 first or the first set is paid 20 first.

Illustration:

KK *Ltd.istobeliquidated.Thefollowingbalanceshave been pulled outasat1st April2021fromits records:*

	Rs.
2,00,000 equity shares of ` 10 each	*20,00,000*
Secured debentures (on land and buildings)	*9,00,000*
Unsecured loans	*30,00,000*
Trade creditors	*35,00,000*
Land and Building	*5,00,000*
Other Property, plant and Equipment	*20,00,000*
Current assets	*45,00,000*
Profit and Loss A/c (Dr. balance)	*20,00,000*
Contingent liabilities are :	
For bills discounted	*1,00,000*

For excise duty demands	*1,00,000*

Realisable value of assets:

Land & Buildings	*12,00,000*
Other Property, plant and Equipment	*28,00,000*
Current assets	*34,00,000*

Prepare statement of affairs .

Solution

StatementofAffairsof
K K Ltd.(inLiquidation)on1st April2021

	Estimated Realisable value
Assets not specifically pledged (As per list A):	
Other Property, plant and Equipment	2800000
Current assets	3400000
Assets not specifically pledged (As per List A)	6200000

Assets specifically pledged (As per List B)					
	Estimated realisable value	*Due to secured creditors*	*Deficiency*	*Surplus*	
	`	`	`	`	
Land & Buildings	12,00,000	900000		3,00,000	
	Estimated total assets available to unsecured creditors				6500000
	Summary of Gross Assets				
	Gross realisable value of assets specifically pledged			12,00,000	
	Other assets			6200000	-
	Gross Assets			74,00,000	-
Gross liabilities `	**Liabilities**				

	Secured Creditors (as per list B) to the extent to which claims are estimated to be covered by assets				
9,00,000	Specifically pledged				
1,00,000	Preferential creditors (as per list C)	1,00,000			
	Unsecured creditors (as per list E):	6,400,000			
30,00,000	Unsecured Loans	30,00,000			
35,00,000	Trade creditors	35,00,000			
1,00,000	Contingent Liability on Bills Discounted	1,00,000			
76,00,000	Estimated deficiency as regards creditors	2,00,000			
	(7600,000—74,00,000)				
	2,00,000 Equity Shares of ` 10 each: (as per list G)	20,00,000			
	Estimated deficiency as regards members	22,00,000			

Summary

In the event that the firm is wound up, a statement known as a Statement of Affairs is prepared. A deficit account, also known as a deficit or debit balance in the profit and loss account, is created when capital plus liabilities exceed assets. In accordance with section 529(1), overriding preference payments are those that must be given for the workman's fees and debts secured to secured creditors (c). Priority must be given to paying preferential creditors over unsecured creditors and debtors with floating charges.• The "Liquidator's Statement of Account" is the document the liquidator prepares in the event of a voluntary winding up to demonstrate cash receipts and payments. Shareholders who transferred partially paid shares within a year of the date of winding up may be required to pay a sum (not to exceed the amount not called up when the shares were transferred) to settle any debts that were owed on the transfer date.

Keywords

Workmen: Workmen refers to a company's employees who qualify as workers under Section 2(s) of the Industrial Disputes Act of 1947;

Workmen dues: refers to a company and refers to the total of the following amounts owed by the company to its workers:

Workmen portion: The amount that bears to the value of the security the same proportion as the amount of the workmen's dues bears to the total of the amount of the workmen's dues and the amount of the debts due to the secured creditors is referred to as the "workmen portion" (c) in regards to the security of any secured creditor of a company.

Self Assessment

1. In case the company has made a default in filing with the Registrar its financial statements or annual returns for immediately preceding ………consecutive financial

years, it may be Wound Up by Tribunal.

A. 1
B. 2
C. 4
D. 5

2. In the case of a petition by a Contributory, the Shares in respect of which he is a Contributory were either originally allotted to him, have been held by him for at least ….. months in the 18 months prior to the start of the winding up and registered in his name, or have been transferred to him through the demise of a previous holder.

A. 2
B. 4
C. 6
D. 8

3. In the event that a petition is filed by a company, a copy of the petition must also be submitted to the Registrar, who must then provide his or her opinion to the Tribunal within ….. days after receiving the petition, without regard to any other regulations.

A. 60
B. 70
C. 80
D. 90

4. Due to section ….. of the Insolvency & Bankruptcy Code, 2016 and section 59 covered under Chapter V of the Insolvency & Bankruptcy Code, 2016, which was notified on 01.04.2017, provisions under the Companies Act, 2013 relating to voluntary winding up stand deleted.

A. 255
B. 256
C. 257
D. 267

5. corporate person registered as a company must meet the following requirements in order to initiate voluntary liquidation proceedings, namely: a declaration from the majority of the company's directors, which must be supported by an affidavit, must be submitted with the company's audited financial statements and record of business operations for the past …..years, or for the time since it was founded, whichever comes later;

A. 2
B. 3
C. 4
D. 5

6. With relation to the declaration mentioned in question 5, within... weeks of the declaration, the company's members must pass a special resolution at a general meeting directing the business to voluntarily dissolve and appointing an insolvency practitioner to serve as the liquidator:

A. 4
B. 5
C. 6
D. 8

7. With relation to declaration as stated in question #6 , provided that the company owes any debt to any person, creditorsrepresenting …..in value of the debt of the company shallapprove the resolution.

A. 2/3

B. 1/3

C. ¼

D. 1/5

8. If the corporation has a debt to anyone, creditors representing. 2/3 in value of the debt must support the resolution with regard to the declaration made in question #6, within ….daysofsuchresolution.

A. 5

B. 6

C. 7

D. 8

9. 9. Continuing from question 8, the firm must notify the Board and the Registrar of Companies within …. days of the resolution to liquidate the company or, in some cases, the creditors' acceptance of the resolution.

A. 6

B. 7

C. 8

D. 9

10. In the event of VOLUNTARY WINDING UP, the authority with which the corporate person is registered must receive a copy of the adjudicating authority's order under subsection (8) within …. days of the order's date.

A. 12

B. 13

C. 14

D. 15

11. Which statement is ready to be given before the Tribunal in the event that the Tribunal decides to wind up the company?

A. Statement of affairs.

B. Statement of assets and liabilities.

C. Statement of deficiency.

D. None of these

12. Which of the following parties will be given preferential treatment?

A. Government taxation.

B. Trade creditors

C. Unsecured loans

D. None of these

13. The B List Contributory may be called on to pay ……. if Shares with a Face Value of'100 were paid up '70.
A. A maximum of'30
B. Maximumof`70only.
C. Maximumof100only.
D. None of These

14. B's responsibility List Contributions will only materialise if
A. the liquidator's current assets are insufficient to cover the liabilities.
B. The Liquidator is not paid by the existing shareholders the sum owed on the shares.
C. both (a) and (b).
D. none of these

15. which of the following statement is wrong in regard to winding up of companies ?
A. Overriding preferential payments are the payments to be made for the workman's dues and debts secured to secured creditors to the extent they rank under section 529(1).
B. A deficit account is created when capital plus liabilities are below assets, resulting in a deficit or debit balance in the profit and loss account (c).
C. In the event of a voluntary winding up, the account generated by the liquidator outlining cash collections and payments is referred to as the "Liquidator's Statement of Account."
D. Preferential creditors are required to be paid in priority to unsecured creditors or creditors with a floating charge.

Answers for Self Assessment

1.	D	2.	C	3.	A	4.	A	5.	A
6.	A	7.	A	8.	C	9.	B	10.	C
11.	A	12.	A	13.	A	14.	C	15.	B

Review Questions

1. What is the difference between liquidation and winding up.
2. Explain the procedure of winding up by tribunal
3. Explain the procedure of voluntary winding up,
4. How statement of affairs and deficiency account is prepared in case of liquidation of companies?
5. Explain overriding preferential payments treatments section 326,
6. Who are preferential creditors and how they are treated at the tile of liquidation?
7. Explain the preparation of liquidators' final statement of account?

Further Readings

- ICAI: Paper 5 Advanced accounting
- Corporate accounting by Hanif and Mukherjee, MC Graw Hill India,2017

Unit 12: Banking Companies

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12.7 Maintenance of Assets in India

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Objectives

After studying this unit, you will be able to:

- Understand the types of commercial banks
- Identify the functions of commercial banks
- Recognize the licensing requirements of commercial banks
- Appreciate the reserve requirements of commercial banks

Introduction

Cash and credit are managed by the banking sector of a nation. Banks are the institutional organisations that accept deposits, extend credit to individuals and businesses, and are crucial to a nation's ability to sustain its economic standing. Most nations maintain rigorous regulation of banks due to their significance to the economy. The Reserve Bank of India (RBI) is the top banking organisation in India and controls the nation's monetary policy.

12.1 Classification of Banks

The four categories into which banks are divided are:

- Commercial Banks
- Small Finance Banks
- Payments Banks
- Co-operative Banks

Public sector banks, private sector banks, foreign banks, and Regional Rural Banks (RRB) are additional categories for commercial banks. Contrarily, there are two categories for cooperative

banks: urban and rural. A payments bank is another relatively recent addition to the system in addition to these.

Commercial Banks

- These are subject to regulation under the Banking Regulation Act of 1949, and they operate with a profit-making strategy.
- They primarily take deposits and lend money to individuals, businesses, and the government.
- Commercial banks can be categorised as follows:

Public Sector Banks	Private Sector Banks
Foreign Banks	Regional Rural Banks

Public sector banks

- These are the nationalised banks, which conduct more than 75% of the nation's banking transactions.
- The government is the largest shareholder in these institutions.
- SBI is the largest public sector bank in India by volume, and as of April 1, 2017, it had merged with five of its partner banks to place it among the top 50 banks in the world.

Bank of Maharashtra	Indian Bank
Bank of Baroda	Punjab & Sind Bank
Bank of India	Punjab National Bank
Canara Bank	State Bank of India
Central Bank of India	Union Bank of India
Indian Overseas Bank	UCO Bank

Private sector banks:

- These include banks where private shareholders hold a significant portion of the stock or stake.
- All of the banking laws and guidelines established by the RBI will also apply to banks in the private sector.
- The list of Indian private sector banks is provided below.

Axis Bank	IndusInd Bank
Bandhan Bank	Jammu and Kashmir Bank
City Union Bank	Karnataka Bank
Dhanlaxmi Bank	Kotak Mahindra Bank
DCB Bank	Karur Vysya Bank
Federal Bank	CSB Bank Ltd.
HDFC Bank	Nainital Bank

ICICI Bank	RBL Bank
IDFC Bank	South Indian Bank
IDBI Bank	Tamilnad Mercantile Bank
YES Bank	

Foreign Banks:

- A foreign bank is a private company that has its headquarters outside of India and conducts business there.
- These banks are required to abide by the laws of both their home country and the nation in where they are doing business.
- The list of foreign banks with operations in India is provided below. –
    - Astralia and New Zealand Banking Group Ltd.
    - DBS Bank India Limited
    - SBM Bank (India) Limited
    - Bank of Bahrain & Kuwait BSCAB Bank Ltd.
    - Sonali Bank Ltd.
    - Bank of Nova Scotia
    - Industrial & Commercial Bank of China Ltd.
    - BNP Paribas
    - Credit Agricole Corporate & Investment Bank
    - SocieteGenerale
    - Deutsche BankHSBC Bank
    - PT Bank Maybank Indonesia
    - TBK
    - Mizuho Bank Ltd.
    - Sumitomo Mitsui Banking Corporation
    - MUFG Bank, Ltd.
    - Cooperatieve Rabobank U.A.
    - Doha Bank Q.P.S.C
    - Qatar National Bank (Q.P.S.C.)
    - JSC VTB Bank
    - Sberbank
    - United Overseas Bank Ltd
    - FirstRand Bank Ltd
    - Shinhan Bank
    - Woori Bank
    - KEB Hana Bank
    - Industrial Bank of Korea
    - Bank of Ceylon
    - Credit Suisse A.G
    - CTBC Bank Co., Ltd.
    - Krung Thai Bank Public Co. Ltd.
    - Abu Dhabi Commercial Bank Ltd
    - .Mashreq Bank PSC
    - First Abu Dhabi Bank PJSC

- o Emirates Bank NBD
- o Barclays Bank Plc.
- o Standard Chartered Bank
- o Bank of China
- o American Express Banking Corporation
- o Bank of America
- o Citibank
- o J.P. Morgan Chase Bank N.A.
- o Kookmin Bank

Regional Rural Banks

These are also scheduled commercial banks, but their primary goal when they were founded was to help out economically disadvantaged groups in society, such as agricultural labourers, small business owners, and marginal farmers. In different Indian states, they typically operate at the regional level and occasionally have branches in particular cities. Additionally crucial duties performed by RRBs are:

- supplying rural and semi-urban areas with banking and financial services
- Governmental activities like paying MGNREGA workers' wages and distributing pensions are examples.
- Debit cards, credit cards, and locker facilities are examples of para-banking amenities

Small Finance Banks

- This country's specialised banking market aims to bring financial inclusion to societal groups that are underserved by other banks.
- Microindustries, small and marginal farmers, unorganised sector entities, and tiny business units are the principal clients of small finance institutions.
- These are supervised by the regulations of the RBI Act of 1934 and FEMA, and they are licenced under Section 22 of the Banking Regulation Act of 1949.

AU Small Finance Bank Ltd.	Jana Small Finance Bank Ltd.
Capital Small Finance Bank Ltd.	North East Small Finance Bank Ltd.
ESAF Small Finance Bank Ltd.	Suryoday Small Finance Bank Ltd.
Equitas Small Finance Bank Ltd.	Utkarsh Small Finance Bank Ltd.
Fincare Small Finance Bank Ltd.	Ujjivan Small Finance Bank Ltd.
Shivalik Small Finance Bank Ltd.	**Unity Small Finance Bank Ltd.**

Payment banks

- This is a very recent bank model in the Indian banking sector.
- It can accept a restricted deposit and was conceptualised by the RBI.
- There is now a Rs. 1 lakh per customer cap on the amount.
- Additionally, they provide services like debit cards, ATM cards, online banking, and mobile banking.

Cooperative banks

- Cooperative banks are governed by an elected management committee and licenced under the Cooperative Societies Act of 1912.
- These operate on a no-profit, no-loss basis and mostly support urban self-employed individuals, small businesses, and industries.
- They mostly fund agriculture-based enterprises in rural areas, such as farming, raising livestock, and hatcheries.

Urban Co-operative Banks	State Co-operative Banks

Urban Co-operative Banks

- The main cooperative banks found in urban and semi-urban areas are referred to as urban cooperative banks.
- These banks mainly provided small loans to consumers and companies based around neighbourhoods and workplace communities.
- According to the RBI, there were 2,104 Urban Co-operative Banks as of March 31, 2003, of which 56 were scheduled banks.
- Five states—Andhra Pradesh, Gujarat, Karnataka, Maharashtra, and Tamil Nadu—comprise almost 79% of these.

State Cooperative Banks

- A State Cooperative Bank is a union of the State's central cooperative bank, which guards the state's cooperative banking system.
- Scheduled and Non-Scheduled Banks are further two ways to categorise banks.
- Every person needs to confirm if their savings or deposit account is held with a Scheduled Bank or a Non-Scheduled Bank.
- Scheduled Banks are included in the Deposit Insurance and Credit Guarantee Corporation's (DICGC) depositor insurance programme, which is advantageous for all account holders with savings and fixed/recurring deposit accounts.
- Bank deposits up to Rs 1 lakh, including fixed, savings, current, and recurring deposits, are protected under the DICGC in the case of bank collapse for each depositor per bank.

Scheduled Banks

- The Reserve Bank of India Act, 1934's Second Schedule applies to scheduled banks. The following requirements must be met by the bank in order to be considered a scheduled bank:
- A bank meets the requirements for the schedule bank category if its paid-up capital is Rs. 5 lakh or more.
- A bank must demonstrate to the central bank that its operations do not jeopardise the interests of its depositors.
- Instead of being a sole proprietorship or partnership, a bank should be a corporation.

Non-Scheduled Banks

Local area banks that are not included in the Reserve Bank of India's Second Schedule are referred to as non-scheduled banks.

The cash reserve requirement must also be maintained by Non-Scheduled Banks, not with the RBI.

12.2 Registration of a Company Under the Provisions of the Companies Act

The applicant must be a "Company" established in accordance with The Companies Act, 1956, which is the first and most important prerequisite for the foundation of a banking company in India. In India, everyone who wants to launch a banking company must establish a separate legal corporation that is unrelated to the owner. Section 7 of the Act specifies the steps to take while forming a company. Every firm must register with the company registrar by submitting an application and the necessary paperwork, such as a Memorandum of Agreement and an Articles of Association. A certificate of registration will be issued under Section 7(1) if the registrar finds all of the documents to be satisfactory.

The following important documents are needed to start a company:

Memorandum of Association (MoA):

- The MoA's framing is the first stage in the process of forming a corporation.
- It is a company's most crucial document and is frequently referred to as the Constitution of the Company. According to Section 4 of the MoA, a MoA consists of five sections, which are listed in Tables A through Table E in Schedule 1 of the Act.
- Various clauses are included in it, including the name clause, capital clause, liability clause, object clause, etc.
- This document mostly addresses a company's external issues. It should be mentioned that every company's MoA is accessible as a public document on the Ministry of Corporate Affairs' website.

Article of Association (AoA):

- After the MoA, the AoA is the most crucial document. This document, which is often referred to as the by-laws of a company, deals with internal corporate affairs.
- The regulations relating to AoA are covered in Section 5 of the Act, which specifies that the AoA of a corporation must include information about the regulation and management of the firm as well as all other things deemed essential to its operation.
- Similar to MoA, the AoA of a corporation is composed of five parts, which are listed in Schedule 1's Tables F through J.

RBI's Regulations

According to the RBI's standards, the promoters of a banking company that has been in operation for more than 15 years are permitted to increase the share cap to 15%. Additionally, the RBI may raise this ceiling from 15% to 26% in accordance with a recent recommendation from The PK Mohanty Committee.

12.3 Capital Requirements

Legislative requirements

Every banking company must maintain the minimum capital requirements as outlined in Section 11 of The Banking Regulation Act in order to do banking activity. These requirements are explained below. Based on the location of the company's incorporation, the act has categorised the capital needs.

Section	Place of	Capital Required

	Incorporation	
11(2)	Banking Company Incorporated Outside India (Foreign Banking Company)	*If business is in the city of Bombay or Calcutta:* amount of its paid up capital shall not be below **twenty lakhs rupees.**
		If no business in the city of Bombay or Calcutta: amount of its paid up capital shall not be below **fifteen lakhs rupees.**
11(3)	Banking Company is Incorporated in India	*1. If it has place of business in more than one state:* **five lakhs rupee** and if such a place is *Bombay or Calcutta* then **ten lakh rupees.**
		2. If it has place of business in more than one state none of which is situated in Bombay or Calcutta: **One Lakh rupees** in respect of the principal place of business + **Ten Thousand rupees** for each place where its business is situated in same district, + **Twenty five thousand rupees** of each place of business situated elsewhere in the state other than in the district.
		3. If it has a place of business in one state, one or more of which is situated in Bombay or Calcutta: **Five lakh rupees + twenty five thousand rupees** for each place outside Bombay and Calcutta.

Furthermore, no Indian-incorporated banking firm shall be required to maintain a paid-up capital requirement in excess of 10 lakh rupees.

The aforementioned sum must be deposited with the Reserve Bank of India and kept there, whether in cash or an unencumbered recognised security in any form.

These are merely the minimum capital and reserve requirements set down by law. However, in reality, the Reserve Bank of India sets the requirements for approving a new banking venture in India. The recommendations of the RBI must be followed in order to maintain the capital requirements for the foundation of a new banking firm.

12.4 Licensing of Banking Companies

- According to Section 22 of the Act, no banking company is allowed to conduct banking activity in India unless it has a licence that was given on the Reserve Bank's behalf.
- Only after the RBI is confident that all the requirements have been met will such a licence be granted.
- Since banking is the foundation of the Indian economy, it is crucial that no dishonest component be added to this banking sector if India is to execute banking business smoothly.
- In order to prevent any negative elements from participating in the Indian financial sector, licencing is required.
- Before beginning its banking operations in India, every company wishing to do so must submit a written application to the Reserve Bank of India.
- Before obtaining a licence, the Reserve Bank is obliged by Section 22(3) to satisfy the conditions listed below:
- That the company will be able to pay its current and prospective depositors; That the company's affairs won't be run in a way that hurts the banking industry;

Termination of Licence:

- Section 22(4) lists the circumstances in which the RBI may terminate a banking business:

If the company stops operating as a bank; If the company doesn't adhere to the requirements outlined in the Act.

Opening New Branches or Moving an Established Business Location

According to Section 23 of the Act, no banking company is permitted to open a new location without first seeking approval from the RBI, and banks are also not permitted to shift their current location without first obtaining authorization from the RBI.

12.5 Reserve Funds

Every bank is obligated to transfer an amount to the Reserve Funds each year equal to 20% of its profit for that year in accordance with the terms of Section 17 of the Act.

12.6 Cash Reserve

According to the rules of Section 18 of the Act, every banking business is required to keep 3% of its demand and time obligations in deposit with the RBI at all times. Any decision made in this regard by the reserve bank shall be final and not subject to review.

12.7 Maintenance of Assets in India

Every banking company is required to keep assets in India that are equal to 20% of its demand and time liabilities under the terms of Section 24 of the Act. The act also specifies which asset must be used to hold such a sum; these assets are either gold, unencumbered securities, or approved securities.

Summary

The Indian economy has been based on banking ever since independence. The strong banking sector in our country is the foundation for its future success. Additionally, the Indian banking sector has recently experienced sustained rise in demand. This significantly expanding market size of the sector clearly signals its growth potential, and establishing a banking company can be quite profitable. Contrary to unregulated marketplaces, however, the establishment of a banking company necessitates knowledge of a number of legal difficulties. In light of this, the current article covers and explains the numerous issues related to the establishment of a banking company in India. Currently, there are only 34 banking companies in existence, of which 12 are public sector banks and the remaining 22 are private sector banks. According to statistics, India's banking sector contributes 7.7% of the country's GDP and has a market of about 105 trillion rupees. Despite all of these facts, 20% of Indians do not have a bank account, a statistic that amply demonstrates the banking sector's potential for expansion.In conclusion, it can be said that the Banking Regulation Act of 1949 and the employee-issued guidelines both outline the steps for the foundation of a banking firm in India. In India, the process for establishing a banking corporation is stiff and complicated. The Banking Regulation Act of 1949 and the terms of both laws must be kept in mind when founding a banking firm. In addition to these two pieces of legislation, the RBI's guidelines must also be taken into account.

Keywords

Private sector banks: These include banks in which major stake or equity is held by private shareholders

Public sector banks: These are the nationalised banks and account for more than 75 per cent of the total banking business in the country.

Self Assessment

1. Section 22(3) states that the Reserve Bank is required to be satisfied with the following conditions except ….before granting license:

A. That the company will be in a stance to pay its present and future depositors;

B. That the affairs of the company are conducted in a manner which is detrimental to the banking business;

C. That the management structure of the company is not prejudice to public interest;

D. That the company has adequate capital as prescribed under the statute and prescribed by RBI;

2. As per the provisions of Section 17 of the Act, every bank is required to transfer, each year, an amount equivalent to …% of its profit for that year to the Reserve Funds

A. 20

B. 30

C. 40

D. 50

3. As per the provisions of Section 18 of the Act, every banking company needs to maintain, at all time, an amount in cast with the RBI which is equivalent to ..% of its demand and time liabilities.

A. 3

B. 4

C. 5

D. 6

4. As per the provisions of Section 24 of the Act, every banking company is required to maintain assets in India which are equivalent to ….% of its demand and time liabilities.

A. 20

B. 25

C. 30

D. 35

5. While forming a banking company the provisions of both the Companies Act, 1956 and ….has to be kept in mind, in addition to these two legislations the Guidelines issued by the RBI has also to be considered.

A. The Banking Regulation Act

B. LLP act

C. Partnership Act

D. Contract Act

6. As per the provisions of Section …… of the Act, no banking company is allowed to open a new place of business without obtaining prior permission of the RBI, and neither the banks can transfer their existing place of business without prior permission of the RBI

A. 12

B. 23

C. 35

D. 46

7. Section …… states the situations where the RBI is entitled to cancel a banking business

A. 21(2)

B. 22(4)

C. 23(1)

D. 24(2)

8. According to the RBI's standards, the promoters of a banking company that has been in operation for more than 15 years are permitted to increase the share cap to …%.

A. 12

B. 13

C. 14

D. 15

9. According to Section 12 of the Banking Regulation Act, 1949, no banking company is allowed to carry on its business unless its subscribed capital is not less than ….of its authorized capital;

A. one-half

B. one-third

C. one-fourth

D. one-fifth

10. According to Section 12 of the Banking Regulation Act, 1949, no banking company is allowed to carry on its business unless its paid-up capital is not less than … of the subscribed capital;

A. one-half

B. one-third

C. one-fourth

D. one-fifth

11. According to Section 12 of the Banking Regulation Act, 1949, no banking company is allowed to carry on its business unless No person holding shares in a banking company shall have voting rights of above …% of total voting rights of all the shareholders;

A. 10

B. 11

C. 12

D. 15

12. Recently, in November 2020, a panel led by P.K. Mohanty has recommended RBI to increase the minimum initial capital requirements for licensing of a new banking firm to ….Crore Rupees for universal bank

A. 1000

B. 2000

C. 3000

D. 4000

13. Recently, in November 2020, a panel led by P.K. Mohanty has recommended RBI to increase the minimum initial capital requirements for licensing of a new banking firm to ….Crore Rupees for Small finance banks.

A. 200
B. 300
C. 400
D. 500

14. Bank of Baroda is an example of …
A. Public Sector Banks
B. Private Sector Banks
C. Foreign Banks
D. Regional Rural Banks

15. Axis bank is an example of….
A. Public Sector Banks
B. Private Sector Banks
C. Foreign Banks
D. Regional Rural Banks

Answers for Self Assessment

1.	B	2.	A	3.	A	4.	A	5.	B
6.	B	7.	B	8.	D	9.	A	10.	A
11.	A	12.	A	13.	B	14.	A	15.	B

Review Questions

1. Write a note on reserve requirements of banking company.
2. Write a note on licensing requirements of banking company.
3. Explain registration formalities for opening banking company.
4. Write a note on business or banking?
5. What are the capital requirements for a banking company?

Further Readings

https://blog.ipleaders.in/formation-banking-company-india/

https://www.paisabazaar.com/banking/

Dr. Rupinder Katoch, Lovely Professional university

Unit 13: Financial Statements of Banking Companies

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Summary

Keywords

Self Assessment

Answers for Self Assessment

Review Questions

Further Readings

Objectives

After studying this unit, you will be able to:

- Recognise the key elements of a bank's accounting procedure.
- Recognise the objectives of and procedures used by a bank in maintaining all detailed accounts in subsidiary books and major books.
- Make a note of all the other registers, departmental journals, and memo books that a bank typically keeps.
- Become familiar with the quarterly, yearly, and monthly returns that banks submit to the RBI.
- Recognise the Banking Regulation Act's Form A for Balance Sheet and Form B for Profit and Loss Statement formats for bank financial statements.
- Introduction

Introduction

A commerce or manufacturing company's bookkeeping system and a banking company's are very unlike. A bank has a lot of different kinds of accounts for its clients. Customers' accounts must be kept up-to-date and checked frequently to prevent payments from being made into their accounts that are greater than the balance that is to their credit or checks from being returned because the account balance was entered incorrectly. Many other mercantile businesses keep their main ledger

and subsidiary ledgers for debtors, creditors, etc. after the books of primary entry (also known as day books) have been updated. A bank must record every transaction as soon as it occurs in its ledgers since it cannot afford to disregard them, especially those pertaining to its customers' accounts. Day books are given comparatively less weight in bank accounting. These are just seen as a means to an end, which is to maintain accurate detailed ledgers, to consistently balance the trial balance, and to maintain the accuracy of all control accounts. Currently, Core Banking Solutions (CBS) is used by the most, if not all, of the banks for their accounting. With CBS, all accounts are held on sizable servers, and posting is instantaneous via vouchers, debit cards, internet banking, etc.

13.1 The primary Traits of a Bank's Bookkeeping System

- Posting of vouchers - A voucher is just a loose leaf from a journal or cash book where transactions are recorded as they happen. Instead of posting from the books of prime entry, entries are made directly from vouchers in the personal ledger.
- Voucher summary sheets: Daily voucher entries are summarised on summary sheets, and their sums are posted to the control accounts in the general ledger.
- Daily trial balance - The daily trial balance for the general ledger is retrieved and approved.
- Continuous checks– All entries in the detailed personal ledgers and summary sheets are continuously audited by individuals other than the individuals who produced the entries. Most clerical errors are found before the start of the next day thanks to the use of a sizable force of such checks.
- Control Accounts - In accordance with general ledger control accounts, a trial balance of the detailed personal ledgers is created on a regular basis, often every two weeks.
- Double voucher system: Two vouchers—one credit voucher and one debit voucher—are created for any transaction that doesn't include cash.

13.2 Ledger Posting System Using the Slip (or Voucher)

- When a cheque is handed to the bank for payment, the bank must make sure that customer (depositors) ledger accounts are current so that it may decide right once whether to honour or dishonour the cheque. Therefore, it is essential that bank transactions are instantly recorded or updated electronically.
- Slip system of ledger posting is used for this purpose. Under this technique, instead of using subsidiary books or journals, entries are made directly from various slips into the (personal) accounts of customers in the ledger, and then a Day Book is typed up. The Day Book is then compared with entries made in the consumers' accounts. In this manner, the daybook entry and posting to the ledger accounts can be completed concurrently without wasting any time. Another name for a slip is a voucher.
- Generally speaking, pay-in slips, checks, or withdrawal forms are the three sorts of slips used in bank bookkeeping.
- Because customers fill out these slips, bank personnel save a lot of time and labour as a result.

Pay-in-slip:

- To deposit money with a bank, a customer must complete a printed pay-in-slip form and hand it to the bank's "receiving cashier" along with cash.
- There are two elements to the pay-in-slip form. 'Counterfoil' refers to the area on the left side of the pay-in slip.
- The receiving cashier returns it once he has received and counted the money.

- The receiving cashier's signature is on the counterfoil, which is also properly inked with the bank's rubber stamp.
- The pay-in-slip serves as a confirmation of the customer's deposit with the bank.
-
- The remainder of the pay-in slip, or its right-hand side, stays with the bank for recording in the cash book before being given to the "personal accounts ledger keeper" to credit the customer's ledger account.
- However, thanks to the development of banking through computerization, checks can now be deposited by simply writing the depositor's account number on the reverse of the check.
- The same applies to using ATMs (Automatic Teller Machines) to deposit cash. The deposited checks and ATM deposit slips are the records used for entry in such circumstances.

Withdrawal slip or cheque

- When a customer withdraws money from the bank, he must fill out a withdrawal slip or write a cheque and give it to the cashier who will then make the payment after verifying the customer's signature and the sufficiency of the amount in his ledger account.
- The ledger keeper debits the customer's account while the paying cashier credits the cash account.
- Nowadays, just before making the payment, the cashier himself may debit the customer's account in the computer-based ledger.

Dockets:

- The bank staff occasionally creates slips for ledger account entries for which there aren't original vouchers.
- For instance, when the interest is due, the loan department of a bank creates vouchers.
- The term "docket" refers to this slip or coupon.

Reasons for which the Slip System is Required

The following factors make a slip system necessary:

- Up-to-Date, Accurate Accounts: The bank is required to keep its clients' accounts current and accurate since they may present a cheque or withdrawal slip at any moment during normal business hours.
- Work Division: Because there are so many bank transactions, the slip system enables the simultaneous division of posting tasks among numerous bank employees.
- Workflow Is Smooth: There are no hiccups in the accounting work flow.

Pay in slips are no longer utilised in many banks today, as was already indicated, as a result of the banking industry's complete computerization.

13.3 Principal Books of Accounts

General Ledger:

- The profit and loss account, various asset accounts, and accounts from all personal ledgers are all included in the general ledger.
- The general ledger's accounts are organised in such a way that a balance sheet may be easily created from them.

- One aspect of bank accounting is the existence of certain additional accounts known as contra accounts.
- These are maintained in order to maintain control over acts that do not directly affect the bank's position, such as opening letters of credit, receiving or sending invoices for collection, making guarantees, etc.

Profit and loss ledger –

- Some banks have separate books for the particular accounts and one account for profit and loss in the general ledger.
- Each revenue or expense head has its own column in these columnar books. For debits and credits, other banks have separate ledgers.
- These books are delivered via coupons. The Profit and Loss Account in the General Ledger is updated with the sum of posted debits and credits.
- In certain banks, the general ledger is where the revenue accounts are also stored, but in other banks, the general ledger is where the broad revenue headings are held and the subsidiary ledgers are where the specifics are kept.
- For management purposes, the account heads in the bank's published Profit and Loss Account are less detailed than those in the Profit and Loss ledgers.
- For instance, the basic income, dearness allowance, and numerous other allowances will all have their own accounts, which are combined in the final accounts.
- Similar to this, several accounts for general expenses, interest collected, paid, etc. are kept separately in the Profit and Loss ledgers.

13.4 Subsidiary Books

Personal Ledgers:

- A bank keeps distinct ledgers for various kinds of accounts. There are distinct ledgers, for instance, for current accounts, fixed deposits (which are frequently further categorised by the length of the deposit), cash certificates, loans, overdrafts, etc.
- These ledgers, as was already indicated, are posted straight from vouchers, and voucher summary sheets are created for each ledger for all the vouchers entered in a given day.
- The individuals who don't write the ledgers are responsible for creating the voucher summary sheets in the department where the transaction was initiated.
- After that, they are verified against the vouchers by various individuals who are typically unrelated to the process of recording ledgers on the voucher summary sheets.

Bill Registers –

- Information about various bills is recorded in separate registers with appropriate columns.
- For instance, serial data is daily entered in distinct registers for bills purchased, bills received for collection, bills sent out for collection, etc.
- When bills are bought or sold at a discount, party-specific information is also recorded in the standard ledger format.
- In order to prevent party limits from being exceeded, this is done.
- The original papers are referred to while making entries in these registers.
- Each register receives a voucher with the total value of the transactions for that day.
- The Day Book has been updated with this voucher.
- The original entry for a bill in the register is crossed out when it is realised or returned.

- Such realisations or refunds are summarised daily in separate registers, and the sums are added to vouchers that are posted in the Day Book.
- When it comes to invoices that are due for payment, contra vouchers that reflect both sides of the transaction are created at the time of the initial entry, and this is reversed when the money is actually received.
- Usually twice a month, outstanding entries are summed up and their total is compared to the balance of the corresponding control accounts in the General Ledger.

13.5 Subsidiary Registers

For different kinds of transactions, there exist several registries. Depending on the specific requirements of each bank, their number, volume, and details will vary. There will be registers, for instance, for the following transactions:

- Demand Drafts, Telegraphic Transfers and Mail Transfers issued on Branches and Agencies.
- Demand drafts, Telegraphic Transfers and Mail Transfers received from Branches and Agencies.
- Letters of Credit.
- Letters of Guarantee.

Original papers that are also daily summarised on vouchers are used to make entries into these registers. The Day Book is updated with these vouchers.

Outstanding entries are regularly summed up, and their total is agreed upon in the general ledger with the control heads.

13.6 Memorandum Books

In addition to the books described above, the bank's many departments are required to keep a variety of memo books to aid in their work. Below are descriptions of a few of the significant books:-

1. Cash Department

a. Receiving Cashiers' cash book

b. Paying Cashiers' cash book

c. Main cash book

d. Cash Balance book

Other than the cashiers, someone else keeps track of the main Cash Book. Each cashier maintains a different cash book.

Cash is always received with a pay-in slip or other equivalent document. The chief cashier then confirms the cashier's entry in his book.

The Main Cash Book writer makes an entry in his books after receiving the pay-in slip.

The counter-foil of the slip is then returned to the customer once the cash book checker has verified the entry with the slip, and the foil is sent to the necessary department for entry into the ledger.

A voucher is created using the foil. A check or other document (such as a traveler's check, demand draught, pay order, etc.) is paid against in cash after it has been properly passed and recorded in the relevant ledger account. The original forms of checks, demand draughts, pay orders, etc., are utilised as vouchers.

2. Banks' Quick Payment System

- Banks implement several methods to provide speedy delivery of cash payments and other services to its consumers.

- The teller system is the most common one. In accordance with this approach, the tellers maintain cash, ledger cards, and the sample signature cards of each client in regard to current and savings bank accounts.
- A teller is permitted to accept payments up to a set limit, say, $10,000. When the cheque is received, he checks it, submits it for payment, puts it on the ledger card and then pays the customer.
- Cash put in these accounts is also received by the teller.

3. Outward Clearing:

i. A clearing check received book is used for inputting customer checks received for clearing during outward clearing

ii. A bank-by-bank listing of the aforementioned checks, one copy of which is provided to the clearing house with the checks. The vouchers (pay-in slip foil) are examined, and they are listed in the Clearing Cheque Received Book. The appropriate departments receive the vouchers after which the accounts of the consumers are instantly credited. The record is reversed if any checks are returned unpaid. Drawings are typically not permitted against clearing checks deposited on the same day, but the manager may frequently make an exception for long-standing clients.

4. Internal clearing:

- Cheques are compared to the lists that come with them.
- They are then dispersed to other departments, and a memo book is used to record how many checks were provided to each department.
- The number of the checks is independently agreed upon with the Memo Book before they are passed and recorded into ledgers.
- Any checks that are determined to be unpayable are sent back to the clearing house.
- The checks themselves act as receipts.

5. Departments of Loans and Overdrafts

- Keeps track of shares and other securities held on each customer's behalf.
- Summary Securities Books that list information on Government Securities, Individual Company Shares, etc.
- Godown registers kept by the bank's godown keeper.
- A price register that displays the wholesale cost of the goods bailed out by the bank.
- Register for Overdraft Sanctions.
- Delivery Order books.
- Storage books.

6. Deposits Division

- Registers for opening and closing accounts.
- The Rate Register for Fixed Deposits provides analysis of deposits based on rates.
- Due Date Calendar.
- A sample autograph book.

7. Department of establishment

- Salary and related registers, including those for attendance, leave, overtime, etc.
- A list of all fixed assets, such as furniture, fixtures, cars, and other vehicles.
- Registers for stationery.
- Register for old records.

8. General

- Signature book of bank's officers.
- Private Telegraphic Code and Cyphers.

13.7 Statistical Books

Different banks maintain statistical data according to their specific needs. For instance, there might be books for keeping track of the following information:

i. average balance in loans and advances, etc.;

ii. deposits received and amounts paid out each month in the various departments;

iii. number of checks paid; and

iv. the total amount of collected checks, invoices, and other items.

The list of accounting records retained by a bank is not all-inclusive.

13.8 Accounts for profit and loss and balance sheets

New Revised Formats The Third Schedule

(See Section 29) Form 'A'

Form of Balance Sheet

Balance Sheet of (here enter name of the Banking company)

Balance Sheet as on 31st March (Year)

(000's)

Schedule As on 31.3.... As on 31.3......

(Current year) (Previous year)

Capital & Liabilities

Capital 1

Reserve & Surplus 2

Deposits 3

Borrowings 4

Other liabilities and provisions 5

Total

Assets

Cash and balances with

Reserve Bank of India 6

Balance with banks and Money 7 call and short notice

Investments 8

Advances 9

Fixed Assets 10

Other Assets 11

Total

Contingent liabilities Bills for collection 12

Refer Annexure I for detailed break-up of the Balance Sheet schedules at the end of chapter

Form 'B'

Form of Profit & Loss Account for the year ended 31st March('000)

Schedule Year ended

As on 31.3....

(Current year) (Previous year)

I. Income

Interest earned 13

Other income 14

Total

II. Expenditure

Interest expended15

Operating expenses 16

Provisions and contingencies

Total

III. Profit/Loss

Net profit/loss (—) for the year Profit/Loss (—) brought forward Total

IV. Appropriations

Transfer to statutory reserves Transfer to other reserves

Transfer to Government/Proposed dividends

Balance carried over to balance sheet

Total

See Annexure II for a detailed explanation of the schedules for the profit and loss accounts at the end of the chapter. Additionally, Annexure III has a thorough summary of the directions provided by RBI for assembling financial statements.

The Banking Regulations Act of 1949 only specifies Schedules 1 through 16. Any additional schedule created by a banking business that is not listed in the Third Schedule of the Banking Regulations Act, 1949, is only done so that their financial statements can be understood better. As a result, banks may also create Schedule 17 for Notes on Accounts and Schedule 18 for Disclosure of Accounting Policies in addition to the 16 schedules listed above.

Notes

1. Capital adequacy ratio

The minimum capital charge for open exchange positions mandated by the Exchange Control Department of the "notional risk assets" should be converted by multiplying it by 12.5 (the reciprocal of the minimum capital to risk-weighted assets ratio of 8%), and adding the resulting figure to the weighted assets, compiled for credit risk purposes, in order to arrive at the denominator.

2. Capital adequacy ratio – Tier I Capital

The minimum capital charge for open exchange positions mandated by the Exchange Control Department of the RBI should be used as the numerator, and the denominator should be determined by converting it into "notional risk assets" by multiplying it by 25 (the reciprocal of the minimum capital to risk-weighted assets ratio of 4%), and then adding the resulting figure to the weighted assets, compiled for credit risk purposes.

3. **Capital adequacy ratio-Tier II Capital Amount of subordinated debt raised as Tier II capital:**The balance sheet and Schedule 5's "Other Liabilities and Provisions" section should also include explanations for this item.

4. Percentage of net NPAs to net advances:

Net NPAs are calculated as gross NPAs less (balance in Interest Suspense Account, ECGC claims received and held for adjustment, part payment received and held in Suspense Account, and provisions maintained for Non-Performing Assets).

5. Movements in NPAs:

The opening balances of NPAs at the beginning of the year (after deducting provisions held, interest suspense account, ECGC claims received, and part payments received and kept in suspense account), reductions/additions to the NPAs during the year, and the balances at the end of the year should all be disclosed. The financial statements of banking businesses include these disclosures on both a Gross NPA level and a Net NPA basis.

6. The total amount of provisions made for NPA, for decline in investment value, and for tax for the year:

These provisions should add up to the total of the sum retained under "Provisions and income-contingencies" in the profit and loss account, along with any additional provisions and contingencies.

7. Pattern of investment securities' maturities:

For the purpose of disclosing the maturity pattern, banks adhere to the maturity buckets outlined in the standards for the Assets-Liability Management System.

8. Pattern of loan and advance maturities:

Banks can disclose the maturity pattern by using the maturity buckets listed in the Assets-Liability Management System standards.

9. Assets and liabilities in foreign currencies:

The maturity profile of the bank's foreign currency liabilities should be provided with regard to this item.

10. Accounts Restructured for Corporate Debut:

The following information regarding corporate debt restructuring initiatives made throughout the year should be disclosed by banks under "Notes on Accounts" in their published annual balance sheets.

a. The total amount of loan assets undergoing CDR restructuring.

b. [(a) = (b)+(c) +(d)]

c. The quantity of common assets susceptible to CDR.

d. The quantity of subpar assets that are subject to CDR.

e. The quantity of questionable assets subject to CDR.

All accounts restructured or rescheduled throughout the year are subject to the disclosures in the Notes on Account to the Balance Sheet regarding such accounts. While banks should make sure they adhere to the minimum specified disclosures, they are free to make additional disclosures.

13.9 Disclosure of Accounting Policies

The banks should disclose the accounting policies pertaining to their key operational areas at one location along with notes on accounting in their financial statements in order to bring the true financial position of banks into sharp focus and enable the users of financial statements to study and have a meaningful comparison of their positions. By requiring thorough disclosures in line with global best practises, the RBI has periodically taken a number of initiatives to improve the openness in bank operations. Beginning with the fiscal year ending in March 2010, the RBI has mandated the insertion of the following extra disclosures in the "Notes to accounts" in the bank balance sheets:

The following topics are covered in further detail:

(i) Concentration of Deposits, Advanced, Exposures, and NPAs;

(ii) Sector-specific NPAs;

(iii) Movement of NPAs;

(iv) Overseas Assets, NPAs, and Revenue; and

(v) Off-Balance Sheet SPVs Sponsored by Banks.

Summary

Numerous books have been mandated by various laws for banks to keep in order to preserve accurate records of the various transactions that a banking institution does. Primary books are those that aid in the creation of financial statements for organisations. Secondary books consist of Current Account, Fixed Deposits, Loans, etc.: It consists of Schedule 3 information, such as demand deposits from banks and other financial institutions, term deposits, deposits made in India and abroad, etc. Bills to be Paid: Party-specific information is available. It must be stated in Balance Sheet Form A.

Keywords

- Working funds: are the total assets (less any accumulated losses, if any) as of the balance sheet date. These are typically timely reported together with CRR/SLR returns.
- Operating profit: means total income minus expenses plus operating expenses etc.
- Business (deposits plus advances) per employee: As of the balance sheet date, this equals the fortnightly average of deposits (apart from interbank deposits) and advances divided by the number of workers.

Self Assessment

1. When a customer withdraws money from the bank, he has to fill-up or write a

A. Withdrawal slip or cheque

B. Pay-in-slip

C. Dockets

D. None of these

2. slips for making entries in the ledger accounts for which there are no original vouchers:

A. Withdrawal slip or cheque

B. Pay-in-slip

C. Dockets

D. None of these

3. …..contains accounts of all personal ledgers, the profit and loss account and different asset accounts

A. The General ledger

B. Profit and loss ledger

C. Personal Ledgers

D. Bill Registers

4. Separate ledgers are maintained by a bank for different types of accounts….

A. The General ledger

B. Profit and loss ledger

C. Personal Ledgers

D. Bill Registers

5. Details of different types of bills are kept in separate registers which have suitable columns..

A. The General ledger

B. Profit and loss ledger

C. Personal Ledgers

D. Bill Registers

6. Demand Drafts are part of ……

A. Subsidiary Registers

B. Profit and loss ledger

C. Personal Ledgers

D. Bill Registers

7. Letters of Credit are part of ….

A. Subsidiary Registers

B. Profit and loss ledger

C. Personal Ledgers

D. Bill Registers

8. Main cash book is part of…

A. Subsidiary Registers

B. Memorandum books

C. Personal Ledgers

D. Bill Registers

9. Receiving Cashiers' cash book is part of

A. Subsidiary Registers

B. Memorandum books

C. Personal Ledgers

D. Bill Registers

10. Registers for shares and other securities held on behalf of each customer is part of..

A. Subsidiary Registers

B. Memorandum books

C. Personal Ledgers

D. Bill Registers

11. Account Opening & Closing registers is part of..

A. Subsidiary Registers

B. Memorandum books

C. Personal Ledgers

D. Bill Registers

12. Stationery registers is part of…

A. Subsidiary Registers

B. Memorandum books

C. Personal Ledgers

D. Bill Registers

13. Letters of Guarantee is a part of…

A. Subsidiary Registers

B. Profit and loss ledger

C. Personal Ledgers

D. Bill Registers

14. Telegraphic Transfers and Mail Transfers are part of

A. Memorandum books

B. Personal Ledgers

C. Bill Registers

D. Subsidiary Registers

15. A Clearing Cheque Received Book is part of

A. Subsidiary Registers
B. Memorandum books
C. Personal Ledgers
D. Bill Registers

Answers for Self Assessment

1.	A	2.	C	3.	A	4.	C	5.	D
6.	A	7.	A	8.	B	9.	B	10.	B
11.	B	12.	B	13.	A	14.	D	15.	B

Review Questions

1. Which additional disclosures in the "Notes to accounts" in the bank balance sheets have been mandated by RBI from the fiscal year ending in March 2010,
2. Write a note on the main features of banks bookkeeping system?
3. What are the principal books of accounts in a banking company?
4. Given account of memorandum books.
5. Given account of statistical books in banking company.

Further Readings

ICAI: paper 5 Advanced Accounting

ICMAI: Paper 10: Corporate Accounting And Auditing (Caa)

Web Links

https://bank.caknowledge.com/books-maintained-banking-companies/

Unit 14: Non-Banking Financial Companies

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Summary

Keywords

Self Assessment

Answers for Self Assessment

Review Questions

Further Readings

Objectives

After studying this unit, you will be able to:

- Understand the concept of NBFC
- Apply the provisions relating to NBFC accounting.

Introduction

The banks, investment intermediaries (such as mutual funds, hedge funds, pension funds, etc.), risk transfer entities (such as insurance companies), information and analysis providers (such as rating agencies, financial advisers, etc.), investment banks, and portfolio managers make up the financial sector of any economy. Other than banks, all of the aforementioned financial intermediaries are collectively referred to as Non-Banking Financial Institutions. Non-Banking Financial Companies (NBFCs), which offer a variety of financial services, are an essential component of the Indian financial system. With financial innovation, NBFC activities have recently undergone a range of adjustments. The Indian Companies Act, 2013, is used to originally incorporate the NBFC, which is then given a Certificate of Incorporation by the RBI.

14.1 Concept of Non-Banking Financial Company (NBFC)

- Non-Banking Finance Corporation (NBFC) is a financial company that does not fall under the legal definition of a bank but engages in operations that are comparable to those of a bank, such as lending money and making investments, even though it lacks a banking licence.

- A non-banking financial company is defined as follows in Section 45I(f) of the RBI Act, 1934: I a financial institution that is a company; (ii) a non-banking institution that is a company and that conducts its primary business in accepting deposits under any scheme or arrangement or in any other way, or in lending in any way; (iii) any other non-banking institution or class of institutions that the Bank may, with the prior approval of the Central Government
- A company that is registered under the Companies Act of 2013 and engaged in the business of making loans and advances, acquiring shares, stocks, bonds, debentures, securities issued by local or federal governments, or other marketable securities of a like nature, is known as a non-banking financial company (NBFC), lease, hire-purchase, insurance industry, and chit business
- However, such a company does not include any institution whose main line of business is one of the following:
    - Purchase, sale, or provision of any good or service, including the sale, purchase, or building of immovable property (other than securities).
- Moreover, a non-banking financial firm is a corporate entity whose primary activity is the receipt of deposits under any scheme or arrangement, whether in a single payment or in installments, through contributions or in any other method (called a Residuary non-banking company).

14.2 Classification of Non- Banking Financial Companies (NBFCs)

A. On the basis of Liability Structure

B. On the basis of nature of primary activities performed

A. On the basis of Liability Structure

Deposit taking NBFCs (referred to as NBFCs-D):

These NBFCs must adhere to regulations for asset liability management (ALM) discipline, exposure rules (including limitations on exposure to investments in land, buildings, and unquoted shares), capital adequacy norms, liquid assets maintenance criteria, and reporting requirements.

Non-Deposit taking NBFCs (referred to as NBFCs-ND):

NBFCs-ND were only lightly regulated up until 2006. However, since 2007, NBFCs-ND are now designated as Systemically Important Non-Deposit Taking NBFCs if their assets are Rs. 100 crore or above (NBFCs-ND-SI).

- The current threshold for establishing systemic significance for NBFCs-ND (non-deposit taking NBFCs) has been reduced in light of the general increase in growth of the NBFC industry. As a result, from this point forward, the NBFCs-ND-SI shall be those NBFCs-ND with asset sizes of "500 crore and above as per the most recent audited balance sheet.
- In light of the new threshold limit for systemic significance, the NBFCs-ND will now be divided into two major categories:
- There are two types of NBFCs: NBFCs-ND (those with assets under 500 crore) and NBFCs-ND-SI (those with assets beyond 500 crore).
- The prudential regulations, which include capital adequacy standards, exposure guidelines, and reporting requirements, are now applicable to NBFCs and ND-SIs. At various times, the Asset Liability-Management (ALM) reporting and disclosure standards have also been made relevant to them.
- NB: NBFCs that are a part of a corporate group or that are formed by a common group of promoters won't be considered separately. To evaluate if a consolidation comes within the asset sizes of the aforementioned two categories, NBFCs-ND and NBFCs-ND-SI, the total assets of

NBFCs in a group, including deposit taking NBFCs, will be added together. Statutory Auditors would have to certify the asset size of all the NBFCs in the Group in order to serve this function.

B. On the basis of nature of primary activities performed

1. An asset finance company is a business that finances the physical assets that support productive/economic and general purpose assets as its primary activity.

2. A leasing firm is a business that primarily engages in the financing of such activities or the lease of equipment.

3. An investment company is any corporation whose primary activity is the purchase of securities.

4. A loan company is any business that, as a financial institution, engages in the lending of money—whether through loans, advances, or other means—for purposes other than its own, excluding asset financing companies.

5. An infrastructure finance company is a business that specialises in funding the purchase or building of various types of infrastructure facilities.

6. Infrastructure Debt Fund is a business that has been registered as an NBFC to help finance long-term debt for infrastructure projects.

7. A venture capital company is any corporation whose primary activity is the provision of seed financing to new business enterprises.

8. NBFC-Factor is a non-deposit taking NBFC with factoring as its main line of business.

9. A new bank can be established by promoters or promoter groups via the NBFC- Non-Operative Financial Holding Company (NOFHC), a financial institution. It is a wholly-owned Non-Operative Financial Holding Company (NOFHC), and to the degree permitted by the relevant regulatory requirements, it will hold the bank as well as all other financial services companies regulated by the RBI or other financial sector regulators.

14.3 NBFC Accounting Guidelines

Accounting-related difficulties include asset classification, Income Recognition Criteria, Accounting of Investments, and Provisioning Requirements. The "Systemically Important Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2015" and "Non-Systemically Important Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2015" in the RBI Directions provide more information on these.

RBI has mandated that income recognition be based on generally accepted accounting principles; however, insofar as they are not in conflict with any of these Directions, Accounting Standards and Guidance Notes issued by the Institute of Chartered Accountants of India (referred to in these Directions as "ICAI" shall be followed.

Income Recognition

Regardless of how they are classified, NBFCs must use recognised accounting methods to recognise income.

- Only when the income is actually realised, including any interest, discounts, hire fees, lease rentals, or other charges on NPA, is it recognised. Any income that was recognised prior to the asset losing performance and remained unrealized must be reversed.
- In addition, RBI mandates that income recognised prior to an asset being an NPA be reversed in the fiscal year in which such an asset becomes an NPA. Income like interest, discounts, or any other charges on NPAs must only be recognised when actually realised.
- Unless the business has declared the dividend in AGM and the firm's right to receive the same has been proven, in which case it can be reported on an accrual basis, NBFCs are

required to recognise revenue from dividends on shares of corporate bodies and units of mutual funds on a cash basis.

- Income from corporate bonds, debentures, and government securities/bonds may be taken into account on an accrual basis as long as it is paid on time and is not delinquent.
- Revenue from corporate or public sector undertaking securities may be recorded on an accrual basis as long as the central government has guaranteed both the interest payment and the repayment of the security.

14.4 Principles for accounting of Investment

- Since investing is one of the main operations of NBFCs, the RBI mandates the board of directors to develop and implement the company's investment policy.
- The Board of the Company should include the criteria for classification of investments into current and long-term in the investment policy. The investments in securities shall be classified into current and long-term at the time of making each investment.
- At the time of each investment, the investments must be divided into current and long-term investments.
- There cannot thereafter be an ad hoc transfer of investments between classes. If necessary, an interclass transfer should be made at the beginning of the semester, either on April 1 or October 1, and with the Board's consent.
- The investments will be moved scrip-by-scrip, at book value or market value, whichever is lower, from current to long-term investments or vice versa;
- Each scrip's depreciation, if any, must be fully compensated for, and any appreciation must be disregarded. Moreover, even when transferring between classes of securities, the depreciation in one security may not be offset by the appreciation in another security.

14.5 Valuation of Investments

Together with numerous valuation standards for quoted and unquoted current investments, the instructions state that long-term investments should be evaluated in accordance with ICAI Accounting Standards.

It mandates that quoted current investments be divided into the following categories: equity shares, preference shares, debentures and bonds, government securities, including treasury bills, mutual fund units, and others.

Each defined category shall be valued at the lower of aggregate cost or aggregate market value. The investments in each category will be taken into account scrip-by-scrip for this purpose, with the cost and market value for all assets in each category being combined. The net depreciation must be accounted for or charged to the profit and loss account if the category's total market value is less than its whole cost. The net appreciation shall not be taken into account if the category's total market value exceeds its total cost. Investment depreciation in one category cannot be offset by appreciation in a different area.

Unquoted equity shares that are current investments must be valued at break-up value or cost, whichever is lower. Yet according to the RBI Guidelines, if it is deemed essential, fair value for the share break-up value may be changed. "Breakup value" is the equity capital and reserves divided by the number of equity shares of the investee company, after deducting intangible assets and revaluation reserves. Such shares shall be valued at one rupee only if the investee company's balance sheet is not available for two years.

Unquoted preference shares that are current investments must be valued at face value or cost, whichever is lower.

Government-guaranteed bonds and investments in unquoted government securities must be valued at carrying cost.

Unquoted investments in mutual fund units that take the form of current investments must be evaluated at the net asset value that the mutual fund has disclosed for each specific plan.

A commercial paper's carrying cost value shall be used.

A long-term investment must be valued in conformity with the ICAI-issued Accounting Standard.

For the purposes of income recognition and asset classification, unquoted debentures must be considered as term loans or another sort of credit facilities, depending on their tenor.

Buying and selling government securities

Using their CSGL or demat accounts, non-banking financial companies must engage in government securities: With the caveat that no non-banking financial company shall engage in any physical transaction involving government securities through any broker.

14.6 Balance Sheet And Profit And Loss Account Preparation

Every non-banking financial institution is required to annually prepare its balance sheet and profit and loss statement as of March 31. When a non-banking financial firm wants to extend the date of its balance sheet in accordance with the terms of the Companies Act, it must first obtain Reserve Bank of India approval before doing so.

Furthermore, the non-banking financial firm must provide the Bank with a proforma balance statement (unaudited) as of March 31 of the year and the statutory returns due on that date, even in situations where the Bank and the Registrar of Companies provide extensions of time. Every non-banking financial organisation must complete its balance sheet within three months of the date it relates to. The information in Schedule III, Division III, shall be annexed to the balance sheet required by the Companies Act of 2013 for each non-banking financial firm.

Information on the Balance Sheet

Some disclosure guidelines for the balance sheet are outlined in the instructions.

Disclosure of provisions made without netting them off against earnings or asset value. The provisions must be clearly identified as I Provisions for Bad and Doubtful Debts; and (ii) Provisions for Investment Depreciation under separate categories of account.

The general provisions and loss reserves retained shall not be appropriated for the payment of provisions. The profit and loss account shall be debited for provisions. Without making an adjustment against the provisions, the excess of provisions, if any, kept under the headings general provisions and loss reserves may be written back.

Without making an adjustment against the provisions, the excess of provisions, if any, kept under the headings general provisions and loss reserves may be written back.

Every non-banking financial company is required to include the information in Division III of Schedule III, as modified on and with effect from 01-04-2021, as an attachment to its balance sheet required by the Companies Act of 2013, which was passed in 2013.

Only systemically important non-deposit taking non-banking financial companies are subject to the following disclosure requirements: Capital to Risk Assets Ratio (CRAR); Exposure to Real Estate Sector, both Direct and Indirect; Maturity Pattern of Assets and Liabilities.

Moreover, RBI specifies the formats for the aforementioned disclosures. By the Ministry of Corporate Affairs Division III was added to Schedule III by notification dated October 11th, 2018 for NBFCs whose financial statements were prepared in accordance with the Companies (Indian Accounting Standards) Regulation, 2015. Further changes to Schedule III for NBFC are contained in Notice dated March 24, 2021, to take effect on April 1, 2021.

Division III outlines the minimal standards for disclosure and offers a framework for the balance sheet and statement of profit and loss.

The following must be disclosed by an NBFC in the Notes under the heading "Loans":

Purchased and discounted invoices, loans that are repayable immediately, and lerm Loans\s(iv) Leasing\s(v) factoring\s(vi) Others

NBFCs must declare Statutory Reserve specifically in Other Reserve as part of Other Equity. Conditions or constraints for distribution from the Statutory Reserve should be further disclosed.

Items of Revenue from Operations and Other Comprehensive Income must be presented on the face of the profit and loss statement rather than in the notes. Every Other Income or Other Expense item that exceeds 1% of the total Income should be noted in addition to the disclosure of all Material Items in Financial Statements.

The format of Balance Sheet and Statement of Profit and Loss of the NBFC as per Division III is shown below.

Assets

Financial assets

(a) Cash and cash equivalents

(b) Bank Balance other than included in (a) above

(c) Derivative financial instruments

(d) Receivables

(I) Trade Receivables

(II) Other Receivables

(e) 1oans

(f) Investments

(g) Other Financial assets (to be specified)

Non -Financial assets

(a) Inventories

(b) CurrentTax Assets (Net)

(c) Deferred Tax Assets (Net)

(d) Investment Property

(e) Biological assets other than bearer plants

(f) Property, Plant and Equipment

(g) Capital work-in-progress

(h) Intangible assets under development

(i) Goodwill

(j) Other Intangible assets

(k) Other non-financial assets (to be specified)

Total Assets

Liabilities and Equity

Liabilities

Financial Liabilities

(a) Derivative financial instruments

(b) Payables

(I) Trade Payables

(i) total outstanding dues of micro enterprises and small enterprises

(ii) total outstanding dues of creditors other than micro enterprises and small enterprises

(II) Other Payables

(i) total outstanding dues of micro enterprises and small enterprises

(ii) total outstanding dues of creditors other than micro enterprises and small enterprises

(c) Debt Securities

(d) Borrowings (Other than Debt Securities)

(e) Deposits

(f) Subordinated Liabilities

(g) Other financial liabilities (to be specified)

Non-financialLiabilities

(a) Currenttaxliabilities (Net)

(b) Provisions

(c) Deferred tax liabilities (Net)

(d) Other non-financial liabilities (to be specified)

Equity

(a) Equity Share capital

(b) Other Equity

Total Liabilities and Equity

Part II - Statement of Profit and Loss Revenue from Operations

(i) Interest Income

(ii) Dividend Income

(iii) Rental Income

(iv) Fees and commission Income

(v) Net gain on fair value changes

(vi) Net gain on derecognition of financial instruments under amortised cost category

(vii) Sale of products(including Excise Duty)

(viii) Sale of services

(ix) Others (to be specified)

(I) Total Revenue from operations

(II) Other Income (to be specified)

(III) Total Income (l+ll)

Expenses

(i) Finance Costs

(ii) Fees and commission expense

(iii)Net loss on fair value changes

(iv)Net loss on derecognition of financial instruments under amortised cost category

(v) Impairment on financial instruments

(vi) Cost of materials consumed

(vii) Purchases of Stock -in -trade

(viii) Changes in Inventories of finished goods, stock -in - trade and work -in - progress

(ix) Fmployee Benefits Expenses

(x) [Depreciation , amortization and impairment

(xi) Others expenses (to be specified)

(IV) Total Expenses (IV)

(V) Profit / (loss) betore exceptional items and tax (III - IV)

(VI) Exceptional items

(VII) Profit/(loss) before tax (V -VI)

(VIII) Tax Expense:

(1) Current Tax

(2) Deferred Tax

(IX) Profit / (loss) for the period from continuing operations (VII -VIII)

(X) Profit/floss) from discontinued operations

(XI) Tax Expense of discontinued operations

(XII) Profit/(loss) from discontinued operations(After tax) (X -XI)

(XIII) Profit/(loss) for the period (IX+XII)

(XIV) Other Comprehensive Income

(A) (i) Items that will not be reclassified to profit or loss (specify items and amounts)

(ii) Income tax relating to items that will not be reclassified to profit or loss

Subtotal (A)

(B) (i) Items that will be reclassified to profit or loss (specify items and amounts)

(ii) Income tax relating to items that will be reclassified to profit or loss

Subtotal (B)

Other Comprehensive Income (A + B)

(XV) Total Comprehensive Income for the period (XIII+XIV) (Comprising Profit (Loss) and other

Comprehensive) Income for the period)

(XVI) Earnings per equity share (for continuing operations)

Basic (`)

Diluted (`)

(XVII) Earnings per equity share (for discontinued operations)

Basic (`)

Diluted (`)

(XVIII) Earnings per equity share (for continuing and discontinued operations)

Basic (`)

Diluted (`)

14.7 Provision Requirements for NBFCs as RBI Regulations

Provision against sub-standard assets, doubtful assets and loss assets

Every NBFC is required to make provisions against substandard assets, doubtful assets, and loss assets as described herein after taking into account the lag between an account becoming non-performing and being recognised as such, realising the security, and the erosion over time in the value of the security charged:

On loans, advances and other credit facilities including bills purchased and discounted

On loss assets:

For assets on lease and hire-purchase

The RBI Guidelines state that the following provisions must be made for assets that are leased or purchased under hire-purchase agreements:

The total dues (overdue and future instalments combined) for hire purchase assets, less (a) any finance charges that are carried forward as unmatured finance charges and (b) the depreciated value of the underlying asset, shall be used to cover any costs.

Extra provision for leased and hire-purchased assets: Additional provision for such assets shall be provided as follows:

(a) Where hire charges or lease rentals are overdue upto 12 months Nil

(b) Where hire charges or lease rentals are overdue for more than 12 months but upto 24 months 10 per cent of the net book value

(c) Where hire charges or lease rentals are overdue for more than 24 months but upto 36 months 40 per cent of the net book value

(d) Where hire charges or lease rentals are overdue for more than 36 months but upto 48 months 70 per cent of the net book value

(e) Where hire charges or lease rentals are overdue for more than 48 months 100 per cent of the net book value

14.8 Provision against Standard Assets

According to the "Non-Systemically Important Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2015," each Non-Banking Financial Company is required to set aside 0.25 percent of its outstanding balance in standard assets, which are not taken into account when calculating net non-performing assets (NPAs).

Every Non-Banking Financial Company is required to make provisions for standard assets at 0.25 percent by the end of March 2015, 0.30 percent by the end of March 2016, 0.35 percent by the end of March 2017, and 0.40 percent by the end of March 2018 and thereafter, of the outstanding, which shall not be reckoned for arriving, in accordance with the "Systemically Important Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions As a result, the provision for standard assets for all NBFCs-D and NBFCs-ND has now been raised to 0.40%.

The following timelines are provided for the phase-in of compliance with the new standard:

0.30% by the end of March 2016

0.35% by the end of March 2017

0.40% by the end of March 2018.

The provision for standard assets does not have to be subtracted from gross advances; instead, it must be listed separately in the balance sheet as "Contingent Provisions against Standard Assets."

Summary

Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 (now the Companies Act, 2013) that engages in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, and chit business but excludes institutions whose primary business is that of agriculture activity, industrial activity, or other similar businesses. The NBS-7 must be filed on a quarterly basis because it is a quarterly return. This quarterly statement of risk-weighted assets, risk asset ratio, and statement of capital funds, among other things, must be filed by every NBFC-ND-SI. Monthly Return on NBFCs-ND-SI Important Financial Parameters. Asset Liability Management (ALM) results in: Statement of structural liquidity in format ALM [NBS-ALM2] and Statement of short-term dynamic liquidity in format ALM [NBS-ALM1] are both published monthly. Statement of Interest Rate Sensitivity, format ALM-[NBS-ALM3], every six months. ALM-YRLY stands for Annual Return for Asset Liability Mismatch Statement. Branch Info come back. Non-Deposit Taking NBFCs (NDNBs) with assets between Rs. 50 crore and Rs. 100 crore are required to disclose quarterly the basic information about their business, including their name, address, profit or loss statement, and NOF (Net Owned Profit) during the previous three years.

Keywords

Deposit taking NBFCs: These NBFCs must adhere to regulations for asset liability management (ALM) discipline, exposure rules (including limitations on exposure to investments in land, buildings, and unquoted shares), capital adequacy norms, liquid assets maintenance criteria, and reporting requirements.

Non-Deposit taking NBFCs: NBFCs-ND were only lightly regulated up until 2006. NBFCs-ND, on the other hand, are now categorised as Systemically Important Non-Deposit Taking NBFCs (NBFCs-ND-SI) as of 2007. However, since 2007, NBFCs-ND are now designated as Systemically Important Non-Deposit Taking NBFCs if their assets are at least Rs. 100 crore.

Self Assessment

1. Since 2007, NBFCs-ND with assets of `Rs. …..crores and above are being classified as Systemically Important Non-Deposit taking NBFCs (NBFCs-ND-SI).

A. 100

B. 200

C. 300

D. 400

2. … is a company which carries on as its principal business the financing of physical assets supporting productive/economic and general purpose assets
3. Asset Finance company
4. Leasing company
5. Investment company
6. Loan company

3. … a company which carries on as its principal business, the business of leasing of equipments or the financing of such activity

A. Asset Finance company

B. Leasing company

C. Investment company

D. Loan company

4. …. means any company which carries on as its principle business the acquisition of securities

A. Asset Finance company

B. Leasing company

C. Investment company

D. Loan company

5. … means any company which is a financial institution carrying on as its principal business the providing of finance whether by making loans or advances or otherwise for any activity other than its own but does not include an Asset Finance Company.

A. Leasing company

B. Investment company

C. Loan company

D. Asset Finance company

6. ….. Infrastructure finance company is a company which carries on as its principle business, the financing of the acquisition or construction of infrastructure facilities of various kinds.

A. Leasing company

B. Investment company

C. Loan company

D. Infrastructure finance company

7. …….means any company which carries on as its principle business the providing of start-up capital to new business ventures

A. Venture capital company

B. Leasing company

C. Investment company

D. Loan company

8. … is a non-deposit taking NBFC engaged in the principal business of factoring.

A. Venture capital company

B. Leasing company

C. Investment company

D. NBFC-Factor

9. … is financial institution through which promoter / promoter groups will be permitted to set up a new bank .It's a wholly-owned Non-Operative Financial Holding Company (NOFHC) which will hold the bank as well as all other financial services companies regulated by RBI or other financial sector regulators, to the extent permissible under the applicable regulatory prescriptions.

A. Venture capital company

B. Leasing company

C. Investment company

D. NBFC- Non-Operative Financial Holding Company

10. In terms of Section 45 IA of the RBI Act, 1934, no NBFC can commence or carry on business of a non- banking financial institution without having a Net Owned Funds (NOF) of `Rs. … lakhs.

A. 25

B. 30

C. 50

D. 70

11. The requirement of NOF has been increased to Rs…. lakhs for all new companies w.e.f. April 21. 1999 vide RBI Notification No. DNBS.132 CGM (VSNM) - 99 dated April 21, 1999.

A. 200

B. 300

C. 400

D. 500

12. But now all NBFCs are compulsorily required to attain a minimum Net Owned Fund (NOF) of rs…. crore by the end of March 2017

A. 1

B. 2

C. 3

D. 4

13. Sub standard asset is one an asset which has been classified as non-performing asset for a period not exceeding … months;

A. 18

B. 19

C. 20

D. 21

14. a non-performing asset (NPA) means:an asset, in respect of which, interest has remained overdue for a period of …months or more;

A. 6

B. 7

C. 8

D. 9

15. a non-performing asset (NPA) means any dues on account of sale of assets or services rendered or reimbursement of expenses incurred, which remained overdue for a period of … months or more;

A. 6

B. 7

C. 8

D. 9

Answers for Self Assessment

1.	A	2.	A	3.	B	4.	C	5.	C
6.	D	7.	A	8.	D	9.	D	10.	A
11.	A	12.	B	13.	A	14.	A	15.	A

Review Questions

1. What are the counting guidelines for NPFCs?
2. What are the Prudential norms for NPFCs?
3. What is the asset classification for NPFC?
4. What are non performing assets?
5. What are the principles for accounting of investments in NPFCs?

Further Readings

https://icmai.in/upload/Students/Syllabus2022/Final_Stdy_Mtrl/P18.pdf

https://taxguru.in/rbi/general-understanding-requirements-nbfc-carrying-nbfc-busines.html

LOVELY PROFESSIONAL UNIVERSITY
Jalandhar-Delhi G.T. Road (NH-1)
Phagwara, Punjab (India)-144411
For Enquiry: +91-1824-521360
Fax.: +91-1824-506111
Email: odl@lpu.co.in