

Compendium of Guidance Notes

Accounting

(As on July 1, 2012)



The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

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Foreword

Accounting is a complex subject. With the increase in the size and changes in the nature of business transactions, the accounting methodologies have also evolved. In the recent years, factors such as improvements in Information Technology, growth of multinational organisations, flow of funds across borders have made significant changes in the manner businesses are conducted and in recording of the business transactions. To bring reliability in the financial statements various Accounting Standards are formulated.

At the same time while referring the Standards the users may feel need for guidance on specific issues. Accordingly, Guidance Notes on accounting have been formulated primarily to address issues arising from interpretation of Accounting Standards as well as providing guidance in areas where currently there may not be a relevant Standard in force. The Guidance Notes issued by the ICAI are designed to provide guidance to the members of the ICAI and other professionals for enhancing the quality of the services rendered by them.

I am glad that in light of growing importance of generally acceptable accounting principles in formulating a reliable system of financial reporting, the Research Committee of the ICAI is coming up with an updated edition of 'Compendium of Guidance Notes-Accounting'. It will include all guidance notes on accounting that have been issued upto July 1, 2012 and are in force as on that date may assist our members for easy reference at one place. I wish to congratulate CA. Bhavna G. Doshi, Chairperson, Research Committee, CA. Charanjot Singh Nanda, Vice-Chairman, Research Committee and its others members for bringing this updated version of 'Compendium of Guidance Notes-Accounting'.

I trust that this revised edition of the Compendium will be received with a positive response and will be immensely useful to all the users.

New Delhi
July 1, 2012

CA. Jaydeep Narendra Shah
President

Preface

In this era of rapid economic development where globe is the playground of businesses and technological advances are changing the nature and ways of doing business constantly, the business transactions are becoming more and more complex. Natural corollary of this is the challenges coming up in the task of recording and reporting these complex transactions taking place across borders.

The Institute of Chartered Accountants of India (ICAI) through its Research Committee provides guidance on wide variety of accounting issues arising in general as also in specific sectors from time to time. This is in the form of Guidance Notes on various aspects of accounting concerning application of the Accounting Standards where a subject is dealt with by an Accounting Standard and general guidance setting out principles to be applied in cases where the subject is not covered by an Accounting Standard. These Guidance Notes form an integral part of the Indian generally acceptable accounting principles and practices.

The Research Committee of ICAI, apart from developing new Guidance Notes, also undertakes the task of revising existing Guidance Notes to make them current based on the developments since its issuance. Some Guidance Notes are also withdrawn when an Accounting Standard is developed and issued on a subject covered by the Guidance Note or where the subject matter of the Guidance Note does not remain relevant or applicable due to various other developments.

The Research Committee compiles these Guidance Notes in form of a publication to facilitate users by making available all current Guidance Notes at one place. This revised edition of the 'Compendium of Guidance Notes – Accounting' contains the Guidance Notes on accounting aspects issued till and in force as on July 1, 2012.

This updated edition includes Guidance Notes issued after publication of

the previous edition in July 1, 2006. The Guidance Notes added in this publication are:

- Guidance Note on Measurement of Income Tax Expense for Interim Financial Reporting in the Context of AS 25
- Guidance Note on Accounting for Employee Share-based Payments incorporating the limited revision made by the Council
- Guidance Note on Applicability of Accounting Standard (AS) 20, Earnings Per Share
- Guidance Note on Remuneration Paid to Key Management Personnel – Whether a Related Party Transaction
- Guidance Note on Turnover in case of Contractors
- Guidance Note on Applicability of AS 25 to Interim Financial Results
- Guidance Note on Accounting for Real Estate Transactions
- Guidance Note on Accounting for Rate Regulated Activities
- Guidance Note on Accounting for Self-generated Certified Emission Reductions (CERs)
- Guidance Note on Accounting and Auditing of Political Parties

This Compendium also contains extracts of the relevant announcements of the Council regarding status of various documents issued by ICAI to the extent these relate to Guidance Notes on accounting aspects. A CD containing soft copy of this Compendium also forms part of the publication.

The development of Guidance Notes is an involved exercise and I would like to take this opportunity to acknowledge the efforts and contributions of all the persons including regulators and other bodies involved in the process of formulation of Guidance Notes from time to time. I would also like to express my sincere gratitude and thanks to CA. Jaydeep N. Shah, President, ICAI, CA. Subodh K. Agrawal, Vice-President, ICAI, CA. Charanjot Singh Nanda, Vice-Chairman, Research Committee as well as other members of the Committee and my colleagues in the Council for their invaluable suggestions and support in this initiative. I would also like to place on record substantial contribution made by the Secretary to the Committee, CA. Deepali Garg and continuous guidance provided by the Technical Director of ICAI, Dr. Avinash

Chander in the initiatives of the Committee and this publication is one such initiative.

This compendium will be a handy resource assisting all concerned with preparation and presentation of financial statements and also help users like regulators, analysts, investor and fund managers and others to appreciate emerging accounting issues in appropriate perspective.

I look forward to suggestions for improvements to this Compendium to make it more user friendly. Also, needless to add, suggestions on subjects for consideration and development of Guidance Notes are welcomed.

New Delhi
July 1, 2012

CA. Bhavna G. Doshi
Chairperson
Research Committee

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ANNOUNCEMENTS OF THE COUNCIL REGARDING STATUS OF GUIDANCE NOTES ISSUED BY THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

I. Clarification regarding Authority Attached to Documents Issued by the Institute¹ (Relevant Extracts)

1. The Institute has, from time to time, issued 'Guidance Notes' and 'Statements' on a number of matters. With the formation of the Accounting Standards Board and the Auditing Practices Committee², 'Accounting Standards' and 'Statements on Standard Auditing Practices'³ are also being issued.

¹ Published in the December, 1985 issue of the 'The Chartered Accountant'.

² The Auditing Practices Committee of the Institute of Chartered Accountants of India was established in 1982 with, *inter alia*, the objectives of preparing the Statements on Standard Auditing Practices (SAPs), Guidance Notes on matters related to auditing, etc. At its 226th meeting held on July 2, 2002 at New Delhi, the Council of the Institute of Chartered Accountants of India approved the recommendations of the Auditing Practices Committee to strengthen the role being played by it in the growth and development of the profession of chartered accountancy in India. The Council also approved renaming of the Committee as, "Auditing and Assurance Standards Board" (AASB) with immediate effect to better reflect the activities being undertaken by the Committee. Apart from changes designed to strengthen the process for establishing auditing and assurance standards, such a move would bring about greater transparency in the working of the Auditing Practices Committee now known as the Auditing and Assurance Standards Board (AASB).

The Council also approved the renaming of the Statements on Standard Auditing Practices (SAPs) as, "Auditing and Assurance Standards" (AASs). The ICAI in 2007 issued the 'Revised Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services'. Pursuant to issuance of Revised Preface, the 'Auditing and Assurance Standards' (AAS) have been renamed as 'Engagement and Quality Control Standards'. The Engagement Standards comprise:

- Standards on Auditing (SAs) - To be applied in the audit of historical financial information.
- Standards on Review Engagements (SREs) – To be applied in the review of historical financial information.
- Standards on Assurance Engagements (SAEs) – To be applied in assurance engagements, other than audits and reviews of historical financial information.
- Standards on Related Services (SRSs) – To be applied to engagements involving application of agreed - upon procedures to information, compilation engagements, and other related services engagements, as may be specified by the ICAI.

³ *ibid.*

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2. Members have sought guidance regarding the level of authority attached to the various documents issued by the Institute and the degree of compliance required in respect thereof. This note is being issued to provide this guidance.

. . .

5. 'Guidance Notes' are primarily designed to provide guidance to members on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. Guidance Notes are recommendatory in nature. A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is satisfied that in the circumstances of the case, it may not be necessary to do so. Similarly, while discharging his attest function, a member should examine whether the recommendations in a guidance note relating to an accounting matter have been followed or not. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary.

6. There are however a few guidance notes in case of which the Council has specifically stated that they should be considered as mandatory on members while discharging their attest function. A list of these guidance notes is given below:–

- (i) Guidance Note on Treatment of Interest on Deferred Payments read along with the pronouncement of the Council, published in 'The Chartered Accountant', March 1984.⁴

⁴ The nomenclature of this document was changed by the Council of the Institute at its 133rd meeting held in April, 1988. The new nomenclature was 'Statement on Treatment of Interest on Deferred Payments'. In view of para 8 of this 'Clarification', with Accounting Standard (AS) 10 on 'Accounting for Fixed Assets', becoming mandatory in respect of accounts for periods commencing on or after 1.4.1991, the 'Statement on Treatment of Interest on Deferred Payments' stands automatically withdrawn except in the case of certain specified non-corporate entities where it stands withdrawn in respect of accounts for periods commencing on or after 1.4.1993. It may be noted that pursuant to the issuance of Accounting Standard (AS) 16 on 'Borrowing Costs', which came into effect in respect of accounting periods commencing on or after 1-4-2000, paragraph 9.2 and paragraph 20 (except the first sentence) of AS 10, relating to treatment of finance costs including interest, stand withdrawn from that date.

- (ii) Provision for Depreciation in respect of Extra or Multiple Shift Allowance, published in 'The Chartered Accountant', May 1984.⁵

. . .

II. Clarification on Status of Accounting Standards and Guidance Notes⁶

In a situation where certain matters are covered both by an Accounting Standard and a Guidance Note, issued by the Institute of Chartered Accountants of India, the Guidance Note or the relevant portion thereof will be considered as superseded from the date of the relevant Accounting Standard coming into effect, unless otherwise specified in the Accounting Standard.

Similarly, in a situation where certain matters are covered by a recommendatory Accounting Standard and subsequently, an Accounting Standard is issued which also covers those matters, the recommendatory Accounting Standard or the relevant portion thereof will be considered as superseded from the date of the new Accounting Standard coming into effect, unless otherwise specified in the new Accounting Standard.

In a situation where certain matters are covered by a mandatory Accounting Standard and subsequently, an Accounting Standard is issued which also covers those matters, the earlier Accounting Standard or the relevant portion thereof will be considered as superseded from the date of the new Accounting Standard becoming mandatory, unless otherwise specified in the new Accounting Standard.

⁵ The nomenclature of this document was changed by the Council of the Institute at its 133rd meeting held in April, 1988. The new nomenclature was 'Statement on Provision for Depreciation in respect of Extra or Multiple Shift Allowance'. This statement has been withdrawn in respect of accounting periods commencing on or after 1.4.1989, as per the Guidance Note on Accounting for Depreciation in Companies, issued in pursuance of amendments in the Companies Act, 1956, through Companies (Amendment) Act, 1988.

⁶ Published in 'The Chartered Accountant', April 2002 (page 1242).

GN(A) 3 (Issued 1982)

Guidance Note on Treatment of Reserve Created on Revaluation of Fixed Assets*

Foreword

The accounting treatment of reserve created on revaluation of fixed assets has been widely debated in the accounting circles in the past. Of late, the matter has assumed considerable importance in view of the fact that many companies have resorted to major revaluation of fixed assets as a partial accounting response to inflation.

Considering the practical importance of the subject, the Research Committee made an in-depth study of the various issues involved and issued an exposure draft on the subject in August, 1981 for public comments. The encouraging response received by the Committee from members in the form of comments on the exposure draft itself gave an indication of the need for guidance on this subject. Based on these comments and after discussions on the subject with an eminent counsel, the Committee has now finalised this Guidance Note, which I trust will be useful to the members both in industry and in practice.

I also trust that the conclusions arrived at after detailed consideration of various aspects would go a long way in bringing about the desired level of uniformity in the accounting treatment of reserve created on revaluation of fixed assets.

New Delhi
April 30, 1982

A. C. Chakraborti
Chairman
Research Committee

* For accounting treatment of revaluation reserves in amalgamations, see Accounting Standard (AS) 14, 'Accounting for Amalgamations'.

GN(A) 3 (Issued 1982)

Guidance Note on Treatment of Reserve Created on Revaluation of Fixed Assets

1. In the preparation of the financial statements of a company, various fixed assets are stated on the basis of their historical cost. Sometimes, in order to bring into the Balance Sheet their replacement cost, a company revalues its fixed assets on the basis of a valuation made by competent valuers. When the value of fixed assets is written up in the books of account of a company on revaluation, a corresponding credit is given to the Revaluation Reserve. Such reserve represents the difference between the estimated present market values and the book values of the fixed assets. When such reserve is created, a question arises about its nature and the manner in which it can be utilised. This guidance note deals with accounting treatment of the reserve created on revaluation of fixed assets (herein referred to as "Revaluation Reserve").
2. Part I of Schedule VI to the Companies Act, 1956 provide that every company shall classify its fixed assets under convenient heads and show under each head the original cost, additions/deductions and the total depreciation provided upto the end of each accounting period. When a company revalues its fixed assets, it is necessary for the company to show separately the date of revaluation and, for a period of five years thereafter, the amount of increase made.
3. When a company revalues its fixed assets, depreciation should be provided on the basis of the revalued figures.
4. A view has been expressed in some quarters that, for measurement of profits, revenue is deemed to have arisen when it is actually collected or when a justifiable claim to collect it arises (e.g. credit sale) or when there is knowledge and evidence that it is capable of being collected if a sale were to be made (i.e. prevailing market price). According to this view, this principle will apply equally to current and fixed assets and, therefore, when fixed assets are written up to their present value, the corresponding Revaluation Reserve cannot be considered as an unrealised reserve. It is, therefore, argued that past accumulated losses as well as depreciation for the year or

Treatment of Reserve Created on Revaluation of Fixed Assets

arrears of depreciation for earlier years which are required to be provided under Section 205 of the Companies Act can be written off or adjusted against such Revaluation Reserve.

5. There is a contrary view that such Revaluation Reserve is created as a result of a book adjustment only and, therefore, such a reserve is an unrealised reserve which is not available for distribution as dividends. When accounts are prepared on the basis of historical cost, measurement of profits can be made by comparing the cost of the assets at the beginning and at the end of the accounting period. As such there is no justification for taking credit for unrealised gains because the increase in market value may be due to various extraneous factors such as fall in the purchasing power of currency or other factors not related to the operations of the company. So far as fixed assets are concerned, these are held for the use in the business and not for sale in the normal course of business. In the circumstance, the difference between the market value and the book value does not represent realised gain and cannot be treated as such in the books of account.

6. Section 205 of the Companies Act provides that a company can declare or pay dividend only out of its profits. The profits for this purpose are to be arrived at after providing for depreciation. If dividend is to be declared out of the profits of any earlier year or years, it is necessary that such profits should be arrived at after providing for depreciation for the respective years.

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

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

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

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

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

10. If a company has transferred the difference between the revalued figure and the book value of fixed assets to the "Revaluation Reserve" and has charged the additional depreciation related thereto to its Profit and Loss Account, it is possible to transfer an amount equivalent to accumulated additional depreciation from the revaluation reserve to the Profit and Loss

Treatment of Reserve Created on Revaluation of Fixed Assets

Account or to the General Reserve as the circumstances may permit, provided suitable disclosure is made in the accounts as recommended in this guidance note.

11. The Revaluation Reserve is not available for payment of dividends. This view is also supported by the Companies (Declaration of Dividend out of Reserves) Rules, 1975. Similarly, accumulated losses or arrears of depreciation should not be set off against Revaluation Reserve. However, the revaluation reserve can be utilised for adjustment of the additional depreciation on the increased amount due to revaluation from year to year or on the retirement of the relevant fixed assets (as discussed in paras 9 and 10 above respectively).

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

GN(A) 5 (Issued 1983)

Guidance Note on Terms Used in Financial Statements

Foreword

This guidance note, 'Terms used in Financial Statements', fulfils a long-felt need for guidance to both preparers as well as users of financial statements regarding the general usage of various terms used therein.

In the present-day context, financial statements of an enterprise are intended to serve the information needs of a wide variety of interest groups, some of which may not possess the knowledge of accounting and its terminology. While such users may quite appreciate those terms which are used in the financial statements in their generic sense, many other words or phrases which have a special connotation in accounting may mean little or nothing to them. The problem is further accentuated by the fact that there is considerable divergence in the usage of various terms. Thus, it is obvious that for achieving effective communication through financial statements, the terms should be used therein consistently and uniformly to the extent possible so that they are understood by the users in the same sense in which they are used by the preparers. Recognising that adequate literature is not available on this subject, the Accounting Standards Board has formulated this guidance note.

I trust, the guidance note would go a long way in improving the quality of financial statements as well as their appreciation by the users.

New Delhi
August 16, 1983

Ashok Kumbhat
President

Preface

Financial statements provide vital information on operational performance and financial position of the reporting entities and, thus, are indispensable aids to rational economic decision-making by such diverse range of interest-groups as the existing and potential investors, private lenders, banks and financial institutions, and various governmental agencies. It is therefore important that efforts are made to make the financial statements as effective a means of communication as possible. This requires, *inter alia*, that the terms used in financial statements should be consistently and uniformly followed. The present guidance note, 'Terms used in Financial Statements', clarifies these terms with a view to facilitate their broad and basic understanding as well as to promote consistency and uniformity in their usage.

The guidance note does not purport to be a rigid dictionary of accounting nor has any attempt been made to describe the accounting methods and procedures.

The process of formulating this guidance note was naturally long. The basic draft was prepared by a Study Group at Calcutta under the able leadership of Shri P.M. Narielvala. The draft was subsequently reviewed by the Technical Directorate of the Institute and after appropriate revisions by the Accounting Standards Board, it was circulated to various bodies representing industry, trade and commerce, banks and financial institutions, etc. for their comments. The revised draft has now been finalised on the basis of a large number of comments received.

The Accounting Standards Board must express its deep gratitude to the members of Calcutta Study Group for their dedicated and sincere efforts in preparing the basic draft of this guidance note. The Board is also grateful to all those bodies and individuals who provided incisive comments on the draft guidance note.

In preparing this guidance note, the Accounting Standards Board has drawn upon the terminology bulletins of professional accountancy bodies in other countries, particularly those in the U.K., U.S.A., Canada and Australia. These publications have been of great assistance to us.

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Over a period of time, many of the terms included in the guidance note may become obsolete; connotation of many others may undergo considerable change; and many new terms may need inclusion herein. It is therefore proposed to review the guidance note periodically. Suggestions in this regard would be most welcome.

I trust, the guidance note would be found useful by all those who are concerned with the financial statements.

New Delhi
August 16, 1983

A.C. Chakrabortti
Chairman
Accounting Standards Board

GN(A) 5 (Issued 1983)

Guidance Note on Terms Used in Financial Statements

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

Introduction

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

6. The definitions of the terms in this guidance note do not spell out the accounting procedure and are not prescriptive of a course of action.

General Definitions

1.01 Absorption Costing

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

1.02 Acceptance

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

1.03 Account Receivable

See **Sundry Debtor**

1.04 Accounting Policies

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

1.05 Accrual

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

1.06 Accrual Basis of Accounting

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

The terms given in italics have been defined elsewhere in this guidance note.

1.07 Accrued Asset

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

1.08 Accrued Expense

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

1.09 Accrued Liability

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

1.10 Accrued Revenue

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

1.11 Accumulated Depletion

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

1.12 Accumulated Depreciation

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

1.13 Actual Cost

See **Cost**

1.14 Ad-valorem

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

1.15 Added Value

See **Value Added**

1.16 Added Value Statement

See **Value Added Statement**

1.17 Advance

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

1.18 Amortisable Amount

See **Amortisation**

1.19 Amortisation

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

1.20 Amortised Value

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

1.21 Annual Report

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

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Directors. It also includes other information voluntarily provided e.g., *value added statement*, graphs, charts, etc.

1.22 Appropriation Account

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

1.23 Assets

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

1.24 Auditor's Report

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

1.25 Authorised Share Capital

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

1.26 Average Cost

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

2.01 Bad Debts

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

2.02 Balance Sheet

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

2.03 Bill of Exchange

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

2.04 Bond

See **Debenture**

2.05 Bonus Shares

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

2.06 Book Value

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

3.01 Call

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

3.02 Called-up Share Capital

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

3.03 Capital

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

3.04 Capital Assets

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

3.05 Capital Commitment

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

3.06 Capital Employed

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

3.07 Capital Loss

See **Capital Profit**

3.08 Capital Profit

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

3.09 Capital Redemption Reserve

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

3.10 Capital Reserve

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

3.11 Capital Work-in-progress

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

3.12 Cash Basis of Accounting

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

3.13 Cash Discount

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

3.14 Cash Profit

The *net profit* as increased by non-cash costs, such as *depreciation*,

amortisation, etc. When the result of the computation is negative, it is termed as **cash loss**.

3.15 Changes in Financial Position, Statement of

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

3.16 Charge

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

3.17 Cheque

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

3.18 Collateral Security

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

3.19 Contingency

A condition or situation, the ultimate outcome of which, *gain* or *loss*, will be known or determined only on the occurrence or non-occurrence of one or more uncertain future events.

3.20 Contingent Asset

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

3.21 Contingent Liability

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

3.22 Contra Account

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

3.23 Cost

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

3.24 Cost of Purchase

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

3.25 Cost-plus Contract

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

3.26 Cost of Goods Sold

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

3.27 Cost of Sales

Cost of goods sold plus selling and administrative expenses.

3.28 Conversion Cost

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

3.29 Convertible Bond

See **Convertible Debenture**

3.30 Convertible Debenture

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

3.31 Creditor

See **Sundry Creditor**

3.32 Cumulative Dividend

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

3.33 Cumulative Preference Shares

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

3.34 Current Assets

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

3.35 Current Liability

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

4.01 Debenture

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

4.02 Debenture Redemption Reserve

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

4.03 Debtor

See **Sundry Debtor**

4.04 Deferral

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

4.05 Deferred Expenditure

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

4.06 Deferred Revenue

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

4.07 Deferred Revenue Expenditure

See **Deferred Expenditure**

4.08 Deficiency

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

4.09 Deficit

The debit balance in the *profit and loss statement*.

4.10 Depletion

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

4.11 Depreciable Amount

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

4.12 Depreciable Asset

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

4.13 Depreciation

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

4.14 Depreciation Method

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

4.15 Depreciation Rate

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

4.16 Development Allowance Reserve

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

4.17 Development Rebate Reserve

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

4.18 Diminishing Balance Method

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

4.19 Direct Cost

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

4.20 Direct Costing

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

4.21 Discount

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

4.22 Dividend

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

4.23 Dividend Equalisation Reserve

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

5.01 Earnings Per Share

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

5.02 Entity Concept

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

5.03 Equity Share

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

5.04 Expenditure

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

5.05 Expense

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

5.06 Expired Cost

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

5.07 Extraordinary Item

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

6.01 Fair Market Value

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

6.02 Fictitious Asset

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

6.03 First Charge

A *charge* having priority over other charges.

6.04 First In, First Out (FIFO)

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

6.05 Fixed Asset

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

6.06 Fixed Cost

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

6.07 Fixed Deposit

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

6.08 Fixed or Specific Charge

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

6.09 Floating Charge

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

6.10 Foreign Currency, Translation of

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

6.11 Foreign Currency Conversion

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

6.12 Forfeited Share

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

6.13 Free Reserve

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

6.14 Functional Classification

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

6.15 Fund

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

6.16 Fundamental Accounting Assumptions

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

6.17 Funds Flow Statement

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

7.01 Gain

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

7.02 General Reserve

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

7.03 Going Concern Assumption

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

7.04 Goodwill

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

7.05 Gross Margin or Gross Profit

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

7.06 Gross Sales

See **Sales Turnover**

7.07 Gross Turnover

See **Sales Turnover**

8.01 Income

See **Revenue**

8.02 Income and Expenditure Statement

A financial statement, often prepared by non-profit making enterprises like clubs, associations etc. to present their *revenues* and *expenses* for an accounting period and to show the excess of *revenues* over *expenses* (or vice versa) for that period. It is similar to profit and loss statement and is also called **revenue and expense statement**.

8.03 Intangible Asset

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

8.04 Internal Audit

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

8.05 Internal Check

A system of allocation of responsibility, division of work, and methods of recording transactions, whereby the work of an employee or group of employees is checked continuously by correlating it with the work of others.

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An essential feature is that no one employee or group of employees has exclusive control over any transaction or group of transactions.

8.06 Internal Control

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

8.07 Interim Report

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

8.08 Inventory

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

8.09 Investment

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

8.10 Investments

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

8.11 Investment Allowance Reserve

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

8.12 Issued Share Capital

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

9.01 Last In, First Out (LIFO)

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

9.02 Liability

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

9.03 Lien

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

9.04 Long-term Liability

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

9.05 Loss

See **Profit**

10.01 Materiality

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

10.02 Mercantile Basis of Accounting

See **Accrual Basis of Accounting**

10.03 Mortgage

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

11.01 Net Assets

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

11.02 Net Fixed Assets

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

11.03 Net Loss

See **Net Profit**

11.04 Net Profit

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

11.05 Net Realisable Value

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

11.06 Net Sales

See **Sales Turnover**

11.07 Net Turnover

See **Sales Turnover**

11.08 Net Worth

See **Net Assets**

11.09 Nominal Share Capital

See **Authorised Share Capital**

12.01 Obsolescence

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

12.02 Operating Profit

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

13.01 Paid-up Share Capital

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

13.02 Pari Passu Charge

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

13.03 Pledge

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

13.04 Preference Share Capital

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

13.05 Preferential Payment

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

13.06 Preliminary Expenses

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

13.07 Pre-paid Expense

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

13.08 Prime Cost

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

13.09 Prior Period Item

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

13.10 Profit

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

13.11 Profit and Loss Statement

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

13.12 Promissory Note

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

13.13 Propriety Concept

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

13.14 Provision

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

13.15 Provision for Doubtful Debts

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

13.16 Prudence

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

13.17 Public Deposits

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

14.01 Redeemable Preference Share

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

14.02 Redemption

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

14.03 Reduction of Capital

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

14.04 Reserve

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

14.05 Revaluation Reserve

A *reserve* created on the revaluation of *assets* or *net assets* of an

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enterprise represented by the surplus of the estimated replacement cost or estimated market values over the *book values* thereof.

14.06 Revenue

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

14.07 Revenue and Expense Statement

See **Income and Expenditure Statement**

14.08 Revenue Reserve

Any *reserve* other than a *capital reserve*.

14.09 Right Share

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

15.01 Sales Turnover

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

15.02 Secured Loan

Loan secured wholly or partly against an *asset*.

15.03 Self-Insurance

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

15.04 Share Capital

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

15.05 Share Discount

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

15.06 Shareholders' Equity

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

15.07 Shareholders' Funds

See **Net Assets**

15.08 Share Issue Expenses

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

15.09 Share Premium

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

15.10 Short-term Liability

See **Current Liability**

15.11 Sinking Fund

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

15.12 Social Cost Benefit Analysis

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

15.13 Social Cost

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

15.14 Social Benefit

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

15.15 Standard Cost

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

15.16 Straight Line Method

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

15.17 Subscribed Share Capital

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

15.18 Substance over Form

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

15.19 Sundry Creditor

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

15.20 Sundry Debtor

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

15.21 Surplus

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

16.01 Test Check

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

16.02 Trade Creditor

See **Sundry Creditor**

16.03 Trade Debtor

See **Sundry Debtor**

16.04 Trade Discount

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

16.05 Transfer Price

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

17.01 Unclaimed Dividend

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

17.02 Unexpired Cost

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

17.03 Unissued Share Capital

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

17.04 Unpaid Dividend

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

17.05 Useful Life

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

18.01 Value Added

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

18.02 Value Added Statement

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

18.03 Variable Cost

That *cost* which varies directly, or nearly directly, with the volume of activity.

19.01 Wasting Asset

Natural resource which is subject to *depletion* through the process of extraction or use e.g. mines, quarries.

19.02 Weighted Average Cost

See **Average Cost**

19.03 Working Capital

The funds available for conducting day-to-day operations of an enterprise. Also represented by the excess of *current assets* over *current liabilities* including short-term loans.

19.04 Work in Process

Work in Process includes all materials which have undergone manufacturing or processing operations, but upon which further operations are necessary before the product is ready for sale.

19.05 Written Down Value Method (W.D.V.)

See **Diminishing Balance Method**

GN(A) 6 (Issued 1988)

Guidance Note on Accrual Basis of Accounting

Foreword

The controls to which the corporate system is subject to change from time to time. In the past couple of decades, there has been an increasing use of the corporate system for the purpose of converting into readily transferable form of ownership of large and complex business enterprises. This evolution has brought about changes in company legislation which have led to the creation of new controls, including reconsideration of accounting procedures. As a result of this development, the presentation of fairest possible periodic net income and the financial position has assumed considerable importance not only for the investors but also for the other interest groups such as creditors, government and the general public. These changes have manifested in the form of a recent amendment in the Indian Companies Act, whereby all companies are now required to maintain their accounts on accrual basis of accounting — a basis of accounting which has long been heralded as the most scientific in the accounting literature.

Since the introduction of the relevant Bill in the Parliament, a need was being felt for a document which could provide guidance on the conceptual and practical aspects of accrual basis of accounting. I am indeed happy to note that the Research Committee rose to the occasion and has brought out this Guidance Note on Accrual Basis of Accounting, soon after the enactment of the Amendment Act.

I am confident that this Guidance Note will be useful to our members in industry and in practice, as well as to those who are otherwise concerned.

September 16, 1988

S.K.Dasgupta
President

Preface

The Companies (Amendment) Act, 1988, amended section 209 of the Companies Act, 1956, requiring all companies to maintain their accounts on accrual basis of accounting. Thus, by placing this basis of accounting on the statute book, the law has recognised that proper income measurement, which represents true economic performance of an entity, can be achieved if efforts and accomplishment's of an enterprise are matched - the prime objective of accrual basis of accounting. However, prior to the enactment of the said amendment, as well as subsequent to that also, some misgivings about the application of this basis of accounting have been expressed in certain quarters. It was therefore imperative that some guidance was required for proper understanding of the concept of accrual and its applicability in practice. The Institute of Chartered Accountants of India being the premier accounting body in the country, assumed this responsibility through its Research Committee. The result is this Guidance Note on Accrual Basis of Accounting.

The Guidance Note at the outset explains the concept of accrual as a basis of accounting, particularly, in comparison with the cash basis of accounting. It also deals generally with the matters of recognition of revenue and expenses, assets and liabilities. A section of the Guidance Note is devoted to the concept of materiality vis-a-vis accrual basis of accounting. It also provides guidance to the auditor in case a company has not maintained its accounts on accrual basis. Finally, in the Appendix, illustrations highlighting application of the principles explained in the Guidance Note to certain important commercial situations have been included.

I am indeed indebted to Shri P.N. Shah, past President of the Institute and a member of this Research Committee, who spared his invaluable time in giving this Guidance Note its final shape and form. I am also grateful to other members of the Research Committee for extending full support in bringing out this Guidance Note in a short time.

I hope this Guidance Note will prove to be of immense help to our members in industry as well as to those in practice in discharging their responsibilities.

September 16, 1988

A. H. Dalal
Chairman
Research Committee

GN(A) 6 (Issued 1988)

Guidance Note on Accrual Basis of Accounting

1. Introduction

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

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

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

2. Accrual Basis of Accounting

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

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

Accrual Basis of Accounting

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

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

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

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

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

- (i) Revenue is recognised as it is earned.
- (ii) Costs are matched either against revenues so recognised or

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against the relevant time period to determine periodic income, and

- (iii) Costs which are not charged to income are carried forward and are kept under continuous review. Any cost that appears to have lost its utility or its power to generate future revenue is written-off as a loss.

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

3. Revenue Recognition

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

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

3.3 An essential criterion for the recognition of revenue is that the consideration receivable from the sale of goods, the rendering of services or from the use by others of resources of the enterprise is reasonably determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

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

3.5 Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g., for escalation of price, export incentives, interest etc., revenue recognition is postponed to the extent of uncertainty involved. It is possible that the uncertainty of collection may be either in respect of the entire transaction or a part thereof. For that part in respect of which there is no uncertainty of collection, the revenue is immediately recognised and for the remaining part the recognition of revenue is postponed. In such cases, it may be appropriate to recognise revenue only

Accrual Basis of Accounting

when it is reasonably certain that the ultimate collection will be made. It is necessary to disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by installments. When the uncertainty relating to collectability arises subsequent to the time of sale or the rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.

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

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

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

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

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

- (i) interest - charges for the use of cash resources or amounts due to the enterprise;

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- (ii) royalties - charges for the use of such assets as know-how, patents, trade marks and copyrights;
- (iii) dividends - rewards from the holding of investments in shares.

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

- (i) Interest accrues, in most circumstances, on the time basis determined by the amount outstanding and the rate applicable. Usually, discount or premium on debt securities held is treated as though it were accruing over the period of maturity.
- (ii) Royalties accrue in accordance with the terms of the relevant agreement and are usually recognised on that basis unless, having regard to the substance of the transactions, it is more appropriate to recognise revenue on some other systematic and rational basis.
- (iii) Dividends from investments in shares accrue when the owner's right to receive payment is established.

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

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

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

4. Rules for Expense Recognition

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

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

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4.2 In the accrual basis of accounting, costs are matched either against revenues or against the relevant time period to determine periodic income. Further, costs which are not charged against income of the period are carried forward. If any particular item of cost has lost its utility or its power to generate future revenue the same is written off as an expense or a loss.

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

(i) *Identification with revenue transactions*

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

(ii) *Identification with a period of time*

In many cases, although some costs may have connection with the revenue for the period, the relationship is so indirect that it is impracticable to attempt to establish it. However, there is a clear identification with a period of time. Such costs are regarded as 'period costs' and are expensed in the relevant period, e.g., salaries, telephone, traveling, depreciation on office building etc. Similarly, the costs the benefits of which do not clearly extend beyond the accounting period are also charged as expenses.

4.4 Expenses relating to a future period are accounted for as prepaid expenses even though they are paid for in the current accounting period. Similarly, expenses of the current year, for which payment has not yet been made (outstanding expenses) are charged to the profit and loss account for the current accounting period.

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

- (a) it is probable that at the date of the financial statements events subsequent thereto will confirm that (after taking into account any related probable recovery) an asset has been impaired or a liability has been incurred as at that date, and
- (b) a reasonable estimate of the amount of the resulting loss can be made.

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

5. Recognition of Assets and Liabilities

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

6. Concept of Materiality

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

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

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

7. Change in the Basis of Accounting

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

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

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

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

9. Auditor's Responsibility

9.1 Where a company has maintained its books of account in a manner that all material transactions are accounted for on accrual basis as discussed above, the auditor should state in his report that, as far as this aspect is concerned, the company has maintained proper books of account as required by law. Where a company has not maintained its books of account in a manner that all material transactions are accounted for on accrual basis as discussed above, the auditor will have to qualify his report or give a negative opinion with regard to the following assertions:

- (a) Whether proper books of account as required by law have been kept by the company.
- (b) Whether the accounts give the information required by this Act in the manner so required and give a true and fair view of:

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- (i) in the case of the balance sheet, of the state of the company's affairs as at the end of its financial year; and
- (ii) in the case of the profit and loss account, of the profit or loss for its financial year.

Appendix

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

Revenue Recognition

1. Sale of Goods

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

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

- (ii) *Delivered subject to conditions*

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

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

- (b) *on approval*

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

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

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

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

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

- (e) *Cash on delivery sales*

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

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

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

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

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

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

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

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

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

- (vii) *Subscriptions for publications*

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

- (viii) *Installments sales*

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

2. Rendering of Services

- (i) *Installation fees*

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

- (ii) *Advertising and Insurance Agency Commissions*

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

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project is completed. Insurance agency commissions should be recognised on the effective commencement or renewal dates of the related policies.

(iii) Financial service commissions

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

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

(iv) Admission fees

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

(v) Entrance and membership fees

Revenue recognition from these sources will depend on the nature of the services being provided. Entrance fee received is generally capitalised. If the membership fee permits only membership and all other services or products are paid for separately, or if there is a separate annual subscription, the fee should be recognised when received. If the membership fee entitles the member to services or

publications to be provided during the year, it should be recognised on a systematic and rational basis having regard to the timing and nature of all services provided.

3. Uncertainty of collection

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

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

4. Construction contracts

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

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

Liability for Expenditure

Gratuity

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

GN(A) 7 (Issued 1989)

Guidance Note on Accounting for Depreciation in Companies

Foreword

The subject of accounting for depreciation has always been a matter of crucial importance for the purpose of true and fair determination of the operating results of an entity and the depiction of its financial position through its profit and loss account and the balance sheet, respectively. In the case of companies, some new issues have arisen in this regard because of recent amendments in the relevant provisions of the Companies Act, in particular, delinking of depreciation rates for the purpose of the provisions of the Companies Act from the rates prescribed under the Income-tax Act, 1961, by introduction of new Schedule XIV in the Companies Act. Though Schedule VI to the Companies Act, 1956, requires only a disclosure of depreciation not provided, it is obvious that depreciation has to be provided in all cases so that the accounts give a true and fair view.

With a view to provide an authoritative position of the Institute on the issues arising out of the said amendments in this regard and to consolidate and revise the existing pronouncements on the subject of accounting for depreciation, in particular reference to the companies, issued by the Institute and its various Committees, the Research Committee of the Institute has brought out this Guidance Note on Accounting for Depreciation in Companies.

I hope that this endeavour of the Research Committee will go a long way in providing guidance to the members - in industry as well in practice - in the performance of their day-to-day duties.

New Delhi
September 13, 1989

K.G. Somani
President

Preface

The Council of the Institute and its various Committees had issued, from time to time, various statements/guidance notes on the subject of accounting for depreciation, with particular reference to companies. By virtue of the amendment in Section 350 of the Companies Act, 1956, through the Companies (Amendment) Act, 1988, the rates of depreciation prescribed in Income-tax Act, 1961 and the rules made thereunder are no longer relevant for the purposes of the Companies Act as the aforesaid section now prescribes that the rates of depreciation applicable would be those prescribed in the newly inserted Schedule XIV to the Companies Act. Since the amendment has repercussions, inter alia, on the accounting for depreciation in companies, the Research Committee of the Institute considered it imperative that the erstwhile pronouncements on the subject should be revised and incorporated at one place for the convenience of the users.

This Guidance Note on Accounting for Depreciation in Companies, accordingly, comprehensively deals with various aspects of accounting for depreciation, such as, methods of charging depreciation (including change in the method of providing depreciation), relevant rates of depreciation for the purpose of preparation of accounts of a company with particular reference to Schedule XIV, pro-rata computation of depreciation, depreciation on low value items, charge of depreciation in case of revaluation of assets and other matters arising on account of amendments in the Companies Act, 1956.

I am confident that this guidance note will immensely benefit our members in industry as well as in professional practice in effective discharge of their responsibilities.

New Delhi
September 14, 1989

N. P. Sarda
Chairman
Research Committee

GN(A) 7 (Issued 1989)

Guidance Note on Accounting for Depreciation in Companies¹

Introduction

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

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

- (a) Guidance Note on Provision for Depreciation [published in Compendium of Guidance Notes, Vol. 1 (2nd Edition)]
- (b) Statement on Provision for Depreciation in Respect of Extra or

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

Compendium of Guidance Notes - Accounting

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

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

Methods of Charging Depreciation

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

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

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

Provided that where depreciation is provided for in the manner laid down in clause (b) or clause (c), then, in the event of the depreciable

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asset being sold, discarded, demolished or destroyed the written down value thereof at the end of the financial year in which the asset is sold, discarded, demolished or destroyed, shall be written off in accordance with the proviso to section 350.

.....

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

.....

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

Adoption of different methods for different types of assets

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

Change in the method of providing depreciation

6. The depreciation method selected should be applied consistently from period to period. A change from one method of providing depreciation to another should be made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. When a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use.

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

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

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

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

9. The Committee is of the view that in arriving at the rates at which depreciation should be provided the company must consider the true commercial depreciation, i.e., the rate which is adequate to write off the asset over its normal working life. If the rate so arrived at is higher than the rates prescribed under Schedule XIV, then the company should provide depreciation at such higher rate but if the rate so arrived at is lower than the rate prescribed in Schedule XIV, then the company should provide

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depreciation at the rates prescribed in Schedule XIV, since these represent the minimum rates of depreciation to be provided. Since the determination of commercial life of an asset is a technical matter, the decision of the Board of Directors based on technological evaluation should be accepted by the auditor unless he has reason to believe that such decision results in a charge which does not represent true commercial depreciation. In case a company adopts the higher rates of depreciation as recommended above, the higher depreciation rates/lower lives of the assets must be disclosed as required in Note No. 5 of Schedule XIV to the Companies Act, 1956.

10. This view is supported by the Department of Company Affairs and it has clarified that “the rates as contained in Schedule XIV should be viewed as the minimum rates, and, therefore, a company will not be permitted to charge depreciation at rates lower than those specified in the Schedule in relation to assets purchased after the date of applicability of the Schedule. If, however, on the basis of bona fide technological evaluation, higher rates of depreciation are justified, they may be provided with proper disclosure by way of a note forming part of annual accounts”².

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

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

“Depreciation in respect of extra or multiple shift allowance amounting to rupees has not been provided which is contrary to the

² Circular No. 2/89, dated March 7, 1989 (Annexure I)

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provisions of Schedule XIV to the Companies Act. This has resulted in the profit being overstated by Rs and plant and machinery overstated by Rs.....”.

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

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

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

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

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

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

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

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

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

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

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

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

22. The Committee is accordingly of the view that where a company has been following straight line method of depreciation in respect of its assets

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existing on the date of Schedule XIV coming into force, the following alternative bases may be adopted for computing the depreciation charge:

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

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

Pro-rata Depreciation

24. Note no.4 in Schedule XIV to the Companies Act, 1956, prescribes that “where, during any financial year, any addition has been made to any asset, or where any asset has been sold, discarded, demolished or destroyed, the depreciation on such assets shall be calculated on a *pro rata* basis from the date of such addition or, as the case may be, up to the date on which such asset has been sold, discarded, demolished or destroyed”. The Committee is of the view that a company may group additions and disposals in appropriate time period(s), e.g., 15 days, a month, a quarter etc., for the purpose of charging *pro rata* depreciation in respect of additions and disposals of its assets keeping in view the materiality of the amounts involved.

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

Depreciation on Low Value Items³

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

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

27. The Department of Company Affairs, as per its circular no. 3\19\88-CL. V, dated April 13, 1989, has stated that “For the purpose of determining net profits of any financial year the amount of depreciation required to be

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

deducted in pursuance of clause (k) of sub-section (4) of Section 349 read with Section 350 shall be the amount calculated as per the written down value method at the rate specified in Schedule XIV, on the assets as shown by the books of the Company at the end of the relevant financial year". The Committee is of the opinion that the language of Section 350 as it stands at present, does not permit the use of the Straight Line Method. The aforesaid section makes reference to 'written-down value of the assets' indicating thereby that for the purposes of computation of managerial remuneration, only the WDV method can be used as the SLM rates, by definition, are applicable only to the original cost of the assets and not to the WDV of the assets.

Charging of Depreciation in Case of Revaluation of Assets

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

29. If a company has transferred the difference between the revalued figure and the book value of fixed assets to the "Revaluation Reserve" and

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has charged the additional depreciation related thereto to its Profit and Loss Account, it is possible to transfer an amount equivalent to accumulated additional depreciation from the Revaluation Reserve to the Profit and Loss Account or to the General Reserve provided suitable disclosure is made in the accounts as recommended in this guidance note.

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

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

Annexure I

**Circular No. 2/89
No. 1/17/87-CL.V**

**Government of India
Ministry of Industry
Department of Company Affairs
Shastri Bhavan, 5th Floor, 'A' Wing
Dr. R. P. Road
New Delhi-1, the 7.3.1989**

To

All Chambers of Commerce & Industry.

Subject: Clarification on the provisions relating to depreciation under the Companies Act, 1956, as amended by the Companies (Amendment) Act, 1988.

Dear Sirs,

This Department has been receiving queries from different quarters on the subject mentioned above, from time to time, and, accordingly, the following clarifications are issued:

(1) *Date on which the new provisions relating to depreciation become effective:*

The Companies (Amendment) Act, 1988 specifically provides that Schedule XIV shall be deemed to have come into force on 2-4-1987. The amended provisions of Section 205 and 350 of the Act have come into force on 15-6-1988 by virtue of the notification issued by this Department. A question, therefore, arises whether depreciation can be charged on assets on the basis of the rates provided in Schedule XIV for accounting year ending between 2nd April, 1987 and 14th June, 1988.

In view of the intention of the legislature behind the amendments in Sections 205 and 350 of the Act, the amended provisions have come into force w.e.f. 2-4-1987.

(2) *Recomputation of specified period:*

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It is stated that in 1986, the Department had issued a circular stating that specified period once determined may not be recomputed. Accordingly, the Department had advised the companies that it was open for them not to recompute the specified period even when there is change in the rates of depreciation later on (as against the position of the Department's earlier circular of 1985 on the subject). It is argued that as far as the existing assets are concerned, the companies can follow either of the two circulars. An option under the 1986 circular would thus be available to the companies as at present not recomputing the specified period where the Straight Line Method is used. In other words, where a company decides to follow the 1986 circular, assets on which SLM depreciation was being charged can continue to be depreciated at old SLM rates.

In view of this Department's Circular No. 1 of 1986 (No. 1/1/86-CL.V), dated 21.5.1986, specified period once determined may not be recomputed. The companies which follow this circular may, therefore, continue to charge depreciation at the old SLM rates in respect of the already acquired assets against which depreciation has been provided in earlier years on SLM basis.

(3) Can higher rates of depreciation be charged?

It is stated that Schedule XIV clearly states that a company should disclose depreciation rates if they are different from the principal rates specified in Schedule. On this basis, it is suggested that a company can charge depreciation at rates which are lower or higher than those specified in Schedule XIV.

It may be clarified that the rates as contained in Schedule XIV should be viewed as the minimum rates, and, therefore, a company shall not be permitted to charge depreciation at rates lower than those specified in the Schedule in relation to assets purchased after the date of applicability of the Schedule. However, if on the basis of a bonafide technological evaluation, higher rates of depreciation are justified, they may be provided with proper disclosure by way of a note forming part of annual accounts.

(4) Can SLM rates be different than those specified under Schedule XIV?

It is stated that SLM rates (corresponding to the WDV rates as per Schedule XIV) can be different than those prescribed under Schedule XIV provided a company continues to determine the rates as provided under Section 205. Thus, against the SLM rates prescribed under Schedule XIV of 11.31% (triple shift rate for general plant and machinery), a company can

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charge depreciation at the rate of 10.56%. It may be mentioned that the rate of 11.31% has been determined on the basis of 8 years and 6 months or so of specified period whereas if 95% is divided by 9 years, the corresponding SLM rate comes to 10.56%. The argument is that for calculating the SLM rates complete years have to be taken into account whereas the rates under Schedule XIV also take into account fractions of years.

It is clarified that a company must necessarily provide SLM depreciation on the rates prescribed under Schedule XIV and the interpretation that fractions of years cannot be taken into account is not correct.

Yours faithfully,

U. P. Mathur
Director

Annexure II

**Circular No. 1/85
No. 1/1/85 CL.V No. 15/50/84-CL.VI**

**Government of India,
Ministry of Industry and Company Affairs,
Department of Company Affairs, New Delhi-1,
dated 10.1.1985**

To

All the Chambers of Commerce

Subject: Determination of Depreciation under Section 205(2)(b) of the Companies Act, 1956 consequent upon changes in the Income-tax Rates introduced by Finance Act, 1983.

Dear Sirs,

I am directed to say that during the year 1983, the rates of depreciation under Income-tax Act have been changed on some of the assets. As the depreciation provision in the annual accounts of the Companies Act, 1956 is related to the rates of depreciation as provided in the Income-tax Act, any change in the rates under Income-tax Act affects the provision of depreciation in the annual accounts of the companies. As a result, this Department has received several queries/representations from companies enquiring as to what procedure they should adopt for charging depreciation on straight line method on the assets purchased earlier to the change in the rates of depreciation as provided in the Income-tax Act.

2. This issue has been examined in this Department and it has been decided that under sub-section (5) of Section 205, "specified period" for providing depreciation on straight line method under clause (b) of sub-section (2) of Section 205 has to be recalculated on the basis of the revised rates under Income-tax Act. The companies which adopt the straight line method of depreciation should provide for the depreciation in their annual accounts on the following basis:

- (a) No. of years for which asset has already been depreciated, before the change in depreciation rate.

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Say, 'A' years

- (b) Specified period calculated at revised rates by which 95% of the original cost of asset would have depreciated on written down value method at revised rates.

Say, 'B' years

- (c) Written down value of the asset in the books at the beginning of the year in which rates have been changed under I.T. Act.

Say, Rs. 'X'

- (d) 5% of the original cost.

Say, Rs. 'Y'

- (e) Fixed installments of depreciation to be provided each year after the rate has been changed shall be calculated as per the formula.

$$\frac{X-Y}{B-A}$$

If 'A' is greater than 'B', then the amount (X-Y) may be provided for as depreciation in the year in which rates are changed.

3. You are requested to bring the above views of the Department to the notice of your member companies for their information and guidance.

Sooraj Kapoor
(Joint Director)

Annexure III

**(Circular No. 1/86)
No. 1/1/86-CL.V No. 15(50) 84-CL.VI**

**Government of India,
Ministry of Industry,
Department of Company Affairs,
Shastri Bhavan, 5th Floor, 'A' Wing
New Delhi, the 21-5-1986**

To

All Chambers of Commerce etc.

Subject: Determination of depreciation under Section 205 (2)(b) of the Companies Act, 1956 consequent upon changes in Income-tax Rates introduced by Finance Act, 1983.

Dear Sirs,

I am directed to refer to this Department's Circular of even number dated 10.1.1985 on the above subject and to say that the question of providing depreciation under straight line method and the calculation of specified period, as suggested in the Circular referred to above, has been re-examined. On reconsideration, the Department is of the view that once "Specified period" is determined at the time of purchase of an asset in accordance with the procedure laid down under section 205(5) read with section 350 of the Companies Act with reference to rates of depreciation under Income-tax Act at that time and amount of depreciation fixed under section 205(2)(b) of the Companies Act, the same need not be changed subsequently consequent on changes in the rates of depreciation under Income-tax Act. It is, therefore, open to the Companies to provide for depreciation under clause (b) of Section 205(2) of the Companies Act on the basis of rates of depreciation prescribed under the Income-tax Act and in force at the time of acquisition/purchase of the asset.

B. Bhavani Sankar
Joint Director (Accounts)

GN(A) 8 (Issued 1994)

Guidance Note on Some Important Issues Arising from the Amendments to Schedule XIV to the Companies Act, 1956.¹

1. The Research Committee of the Institute of Chartered Accountants of India has issued a Guidance Note on Accounting for Depreciation in Companies, which was published in 1989. Recently, the Department of Company Affairs, Ministry of Law, Justice and Company Affairs, Government of India, issued a Notification², making certain alterations in Schedule XIV to the Companies Act, 1956. This Guidance Note is being issued to provide guidance on certain significant issues arising from these amendments. This Guidance Note, therefore, supplements the earlier Guidance Note and also supersedes para 26 thereof.

Continuous Process Plant

2. The amended Schedule XIV prescribes, inter alia, general rates of depreciation for a new category of plant known as 'continuous process plant', other than those for which special rates have been prescribed.

3. The expression 'continuous process plant' has been defined in the aforesaid Notification as follows:

“ 'Continuous process plant' means a plant which is required and designed to operate 24 hours a day.”

4. The words “required and designed to operate 24 hours a day” are very significant and should be interpreted with reference to the inherent technical nature of the plant, i.e., the technical design of a continuous process plant is such that there is a requirement to run it continuously for 24 hours a day.

¹ Published in the August 1994 issue of *The Chartered Accountant*.

² See the Appendix for the texts of the Notification dated 16.12.1993 and the subsequent Circular dated 20.12.1993 issued by the Department of Company Affairs.

Issues Arising from the Amendments to Schedule XIV

If it is not so run, there are significant shut-down and/or start-up costs. If such a plant is shut-down, there may be significant spoilage of materials-in-process/some damage to the plant itself/significant energy loss. It is, however, possible that due to various reasons, e.g., lack of demand, maintenance etc., such a plant may be shut down for some time. The shut-down does not change the inherent technical nature of the plant. For instance, a blast furnace which is required and designed to operate 24 hours a day, may be shut down due to various reasons; it would still be considered as a continuous process plant and the relevant rate as per Schedule XIV would be applicable.

5. There can be certain plants which, though may work 24 hours a day, yet their technical design is not such that they have to be operated 24 hours a day, e.g., a textile weaving mill. In such cases, extra shift rates as prescribed in Schedule XIV would be applicable.

6. A continuous process plant is distinct from the repetitive process plant or assembly-line type plants. These plants are not continuous process plants since such plants do not involve significant shut-down and/or start-up costs and are not technically required and designed to operate 24 hours a day, e.g., an automobile manufacturing plant.

7. Another question which may arise is whether an equipment/plant which is ancillary to the continuous process plant should also be considered as a continuous process plant. Where an ancillary equipment/plant is an integral part of the continuous process it should be depreciated along with the main continuous process plant.

8. It is noted that Schedule XIV uses the term 'concern' in the context of extra shift depreciation, whereas in the case of the 'continuous process' the term 'plant' is used. This signifies that it is not necessary for the whole concern to be defined as a continuous process plant for the purposes of the applicability of the depreciation rates relevant thereto.

Depreciation on Low Value Items³

9. The aforesaid Notification has inserted the following, as Note No. 8, in Schedule XIV to the Companies Act:

³ This section supersedes para 26 of the 'Guidance Note on Accounting for Depreciation in Companies', issued by the Research Committee of the Institute of Chartered Accountants of India.

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“Notwithstanding anything mentioned in this Schedule, depreciation on assets, whose actual cost does not exceed five thousand rupees, shall be provided at the rate of hundred percent.”

10. According to the above note, all individual items of fixed assets whose actual cost does not exceed Rs. 5,000 shall be charged depreciation at the rate of 100%. However, in respect of the fixed assets acquired prior to December 16, 1993, alternative bases of computing the depreciation charge are permitted⁴. The amount of write off in respect of low value assets would also therefore depend upon the alternative chosen.

11. It is noted that Note 4 to Schedule XIV requires, inter alia, that where during any financial year any addition has been made to any asset, the depreciation on such assets should be calculated on a pro-rata basis from the date of such addition. Since Note 8 to Schedule XIV (reproduced above) prescribes *the rate of depreciation* of 100 per cent, pro-rata depreciation should be charged on addition of the said low value items of fixed assets also. However, a company can write off fully, low value items on the consideration of materiality. Where such an accounting policy is followed by a company, the same should be disclosed appropriately in the accounts.

⁴ Refer the ‘Guidance Note on Accounting for Depreciation in Companies’ for the permitted alternatives. These alternatives are also given in the para 2 of the Circular issued by the Ministry of Law, Justice & Company Affairs, Department of Company Affairs, (No. 1/12/92-CL. V. Circular No. 14/93, dated 20.12.1993), given in the Appendix.

Appendix

Revision of Rates of Depreciation in Schedule XIV of the Companies Act, 1956

[No. 1/12/92-CL.V; Circular No. 14/93, dated 20.12.1993 issued by the Ministry of Law, Justice & Company Affairs, Department of Company Affairs]

I am directed to enclose herewith a copy of Notification GSR No. 756E dated 16.12.93 in respect of revision of the rates of depreciation in Schedule XIV to the Companies Act, 1956, with a request that these changes may please be circulated widely and brought to the notice of all your constituent member - companies.

2. The changes made in Schedule XIV as per enclosed amending Notification shall apply in respect of the accounts of the companies closed on or after the date of issue of the notification. The revised rates of depreciation shall apply to assets acquired by the companies on or after that date. As regards applicability of these changes to existing assets, the companies are advised to follow the recommendations of the Institute of Chartered Accountants of India contained in its Guidance Notes on the 'Accounting for Depreciation in Companies', reproduced below:

- (a) A company following the written down value (W.D.V.) method of depreciation in respect of its assets should apply the relevant W.D.V. rates prescribed in Schedule XIV to the written down value as at the end of the previous financial year as per the books of the company.
- (b) A company following the straight line method of depreciation in respect of its assets existing on the date of Schedule XIV coming into force may adopt any of the following alternative bases for computing the depreciation charge:
 - (i) The specified period may be recomputed by applying to the original cost, the revised rate as prescribed in Schedule XIV and depreciation charge calculated by allocating the unamortized value as per the books of account over the remaining part of the recomputed specified period.

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- (ii) The company can continue to charge depreciation on straight line basis at old rates in respect of assets existing on the date on which the new provisions relating to depreciation came into force.
- (iii) SLM rates prescribed in Schedule XIV can be straightway applied to the original cost of all the assets including the existing assets from the year of change of the rate.

A.S. Dhillon
Under Secretary

Alterations in Schedule XIV to the Companies Act, 1956

[File No. 1/12/92 CL.V. dated 16.12.1993 issued by the Ministry of Law, Justice and Company Affairs, Department of Company Affairs]

NOTIFICATION

G.S.R. 756(E) In exercise of the powers conferred by sub-section (i) of Section 641 of the Companies Act, 1956 (1 of 1956), the Central Government hereby makes the following alterations in Schedule XIV (hereinafter referred to as the said Schedule) to the said Act namely:

- (1) Under the heading II. PLANT AND MACHINERY:
 - (a) for item (i) relating to general rate and the entries relating thereto, the following shall be substituted, namely:

Issues Arising from the Amendments to Schedule XIV

Rates of Depreciation

Nature of assets 1	Single shift		Double shift		Triple shift	
	WDV 2	SLM 3	WDV 4	SLM 5	WDV 6	SLM 7
(1) General rate applicable to (a) Plant and machinery (not being a ship) other than continuous process plant for which no special rate has been prescribed under (ii) below:	13.91 percent	4.75 percent	20.87 percent	7.42 percent	27.82 percent	10.34 percent
(b) continuous process plant, other than those for which no special rate has been prescribed under (ii) below. ¹ (NESD)	15.33 percent	5.28 percent				

- (b) under item (ii) relating to special rates, for sub-items A.3, A.4, A.5, A.6, A.7, A.8 and A.9 and the entries relating thereto, the following shall be substituted; namely:

Rates of Depreciation

Nature of assets 1	Single shift		Double shift		Triple shift	
	WDV 2	SLM 3	WDV 4	SLM 5	WDV 6	SLM 7
"3. Electrical machinery, X-ray and electrotherapeutic apparatus and accessories thereto, medical, diagnostic equipments, namely, Catscan, Ultrasound machines, ECG monitors, etc. (NESD)	20 percent	7.07 percent	-	-	-	-
4. Juice boiling pans (karhais) (NESD)	20 percent	7.07 percent	-	-	-	-
5. Motor cars, motor cycles, scooters and other mopeds (NESD)	25.89 percent	9.5 percent	-	-	-	-

¹ Editor's Note: There is an apparent drafting error. It should appear as "Continuous process plant, other than those for which a special rate has been prescribed under (ii) below (N.E.S.D.)"

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Nature of assets 1	Single shift		Double shift		Triple shift	
	WDV 2	SLM 3	WDV 4	SLM 5	WDV 6	SLM 7
6. Electrically operated vehicles including battery powered or fuel cell powered vehicles (NESD)	20 percent	7.07 percent				
7. Sugarcane crushers (indigenous kolus and belans) (NESD)	20 percent	7.07 percent				
8. Glass manufacturing concerns except direct fire glass melting furnaces-Recuperative and regenerative glass melting furnaces.	20 percent	7.07 percent	30 percent	11.31 percent	40 percent	16.21 percent
9. Machinery used in the manufacture of electronic goods and components.	15.62 percent	5.38 percent	23.42 percent	8.46 percent	31.23 percent	11.87 percent

- (2) under the heading, III. FURNITURE AND FITTINGS, for items 1 and 2 and the entries relating thereto, the following shall be substituted; namely:

Rates of Depreciation

Nature of assets 1	Single shift		Double shift		Triple shift	
	WDV 2	SLM 3	WDV 4	SLM 5	WDV 6	SLM 7
"1. General rates (NESD)	18.1 percent	6.33 percent	-	-	-	-
2. Rate for furniture and fittings used in hotels, restaurants and boarding houses; schools, colleges and other educational institutions, libraries; welfare centres; meeting halls, cinema houses; theatres and circuses; and for furniture and fittings let out on hire for use on the occasion of marriages and similar functions. (NESD)	25.88 percent	9.5 percent	-	-	-	-".

Issues Arising from the Amendments to Schedule XIV

- (3) in the Notes below the said Schedule:
- (a) in note 6;
- (i) for the figures and words "15 per cent", occurring after clause (b), the figure and words "13.91 per cent" shall be substituted,
- (ii) in item 8, the following shall be omitted, namely:
" (a) Boilers
(c) Process plants",
- (iii) in item 10 the following shall be omitted, namely:
" (a) Boilers
(c) Process plants",
- (iv) in item 11, the following shall be omitted, namely:
" (d) Boilers",
- (v) item 24 relating to "chemical beneficiation process for magnesite ore" shall be omitted;
- (b) after note 6, the following notes shall be inserted, namely:
- "7. 'Continuous process plant' means a plant which is required and designed to operate 24 hours a day.
8. Notwithstanding anything mentioned in this Schedule depreciation on assets, whose actual cost does not exceed five thousand rupees, shall be provided at the rate of hundred per cent."

R.D. Joshi
Joint Secretary

Amending Notification, GSR 416 (E)
dated 14th May, 1993.

GN(A) 9 (Issued 1994)

Guidance Note on Availability of Revaluation Reserve for Issue of Bonus Shares¹

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

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

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

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

3. AS 10 lays down as below:

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

30. An increase in net book value arising on revaluation of fixed assets should be credited directly to owners' interests under the head of revaluation reserve, except that, to the extent that such

¹ Published in the November 1994, issue of *The Chartered Accountant*.

Availability of Revaluation Reserve for Issue of Bonus Shares

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

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

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

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

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

Subject to the above _____".

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

Compendium of Guidance Notes - Accounting

8. In this context, it may also be noted that the Securities and Exchange Board of India (SEBI) has prohibited listed companies from issuing bonus shares out of revaluation reserves².

² Section M of Guidelines for Disclosure and Investor Protection [as amended by RMB (DIP Series) Circular No. (94-95), Dated April 15, 1994]

GN(A) 11 (Issued 1997)

Guidance Note on Accounting for Corporate Dividend Tax

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

2. The salient features of CDT are as below:

- (i) CDT is in addition to the income-tax chargeable in respect of the total income of a domestic company.
- (ii) CDT is chargeable on any amount declared, distributed or paid by such company by way of dividends (whether interim or otherwise) on or after the 1st day of June 1997.
- (iii) The dividends chargeable to CDT may be out of the current profits or accumulated profits.
- (iv) The rate of CDT is ten per cent.
- (v) CDT shall be payable even if no income-tax is payable by the domestic company on its total income.
- (vi) CDT is payable to the credit of the Central Government within 14 days of -
 - (a) declaration of any dividend,
 - (b) distribution of any dividend, or
 - (c) payment of any dividend,whichever is the earliest.

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- (vii) CDT paid shall be treated as the final payment of tax on the dividends and no further credit therefor shall be claimed by the company or by any person in respect of the tax so paid.
- (viii) The expression 'dividend' shall have the same meaning as is given to 'dividend' in clause (22) of Section 2 but shall not include sub-clause (e) thereof. (The relevant extracts of Section 2(22) of the Income-tax Act, 1961, have been reproduced in Annexure II).

Accounting for CDT

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

Disclosure and Presentation of CDT in Financial Statements

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

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

Accounting for Corporate Dividend Tax

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

Recommendations

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

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

Dividend	xxxxx	
Corporate Dividend Tax thereon	<u>xxxxx</u>	xxxxx

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

Annexure I

Relevant Extracts of the Provisions under Chapter XIID of the Income Tax Act, 1961, Regarding Special Provisions Relating to Tax on Distributed Profits of Domestic Companies.

115 O. Tax on Distributed Profits of Domestic Companies

- (1) Notwithstanding anything contained in any other provision of this Act and subject to the provisions of this section, in addition to the income-tax chargeable in respect of the total income of a domestic company for any assessment year, any amount declared, distributed or paid by such company by way of dividends (whether interim or otherwise) on or after the 1st day of June, 1997, whether out of current or accumulated profits shall be charged to additional income-tax (hereafter referred to as tax on distributed profits) at the rate of ten per cent.
- (1A) Notwithstanding that no income-tax is payable by a domestic company on its total income computed in accordance with the provisions of this Act, the tax on distributed profits under sub-section (1) shall be payable by such company.
- (2) The principal officer of the domestic company and the company shall be liable to pay the tax on distributed profits to the credit of the Central Government within fourteen days from the date of -
 - (a) declaration of any dividend; or
 - (b) distribution of any dividend; or
 - (c) payment of any dividend,whichever is earliest.
- (3) The tax on distributed profits so paid by the company shall be treated as the final payment of tax in respect of the amount declared, distributed or paid as dividends and no further credit therefore shall be claimed by the company or by any other person in respect of the amount of tax so paid.

Accounting for Corporate Dividend Tax

- (4) No deduction under any other provision of this Act shall be allowed to the company or a shareholder in respect of the amount which has been charged to tax under sub-section (1) or the tax thereon.

115 Q

.....

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

Annexure II

Relevant Extracts of the Definition of the Term Dividend as per Section 2(22) of the Income Tax Act, 1961.

2(22) ¹“Dividend” includes -

- (a) any distribution by a company of accumulated profits, whether capitalised or not, if such distribution entails the release by the company to its shareholders of all or any part of the assets of the company;
- (b) any distribution to its shareholders by a company of debentures, debenture-stock, or deposit certificates in any form, whether with or without interest, and any distribution to its preference shareholders of shares by way of bonus, to the extent to which the company possesses accumulated profits, whether capitalised or not;
- (c) any distribution made to the shareholders of a company on its liquidation, to the extent to which the distribution is attributable to the accumulated profits of the company immediately before its liquidation, whether capitalised or not;
- (d) any distribution to its shareholders by a company on the reduction of its capital, to the extent to which the company possesses accumulated profits which arose after the end of the previous year ending next before the 1st day of April, 1933, whether such accumulated profits have been capitalised or not;
- (e)

but “dividend” does not include -

- (i) a distribution made in accordance with sub-clause (c) or sub-clause (d) in respect of any share issued for full cash consideration, where the holder of the share is not entitled in the event of liquidation to participate in the surplus assets;

¹ See Circular Nos. 20 (XXI-6), dated 10-5-1955 and 46 (XXI-7), dated 10-11-1955.

Accounting for Corporate Dividend Tax

- ²[(ia) a distribution made in accordance with sub-clause (c) or sub-clause (d) in so far as such distribution is attributable to the capitalised profits of the company representing bonus shares allotted to its equity shareholders after the 31st day of March, 1964, ³[and before the 1st day of April, 1965];]
- (ii) any advance or loan made to a shareholder ⁴[or the said concern] by a company in the ordinary course of its business, where the lending of money is a substantial part of the business of the company;
- (iii) any dividend paid by a company which is set off by the company against the whole or any part of any sum previously paid by it and treated as a dividend within the meaning of sub-clause (e), to the extent to which it is so set off.

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

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

² Inserted by the Finance Act, 1965, w.e.f. 1.4.1965

³ Inserted by the Finance Act, 1965, w.e.f. 1.4.1966

⁴ Inserted by the Finance Act, 1987, w.e.f. 1.4.1988

⁵ Inserted by the Direct Taxation (Amendment) Act, 1964, w.e.f. 1.4.1962

GN(A) 12 (Revised 2000)

Guidance Note on Accounting Treatment for Excise Duty

Foreword to the Third Edition

With the issuance of the (Revised) Accounting Standard 2, 'Valuation of Inventories', which came into effect in respect of accounting periods commencing on or after 1.4.1999, and became mandatory from that date, it became imperative to revise the erstwhile Guidance Note on Accounting Treatment for Excise Duty to bring it in line with the requirements of the Standard.

I am pleased that the Research Committee of the Institute has revised the Guidance Note, which will go a long way in adoption of sound accounting practices in respect of accounting for excise duty.

I am sure that this Edition of the Guidance Note will also be useful to the members in practice as well as in industry.

New Delhi
July 18, 2000

G. Sitharaman
President

Preface to the Third Edition

Subsequent to the issuance of the last Edition of the Guidance Note on Accounting for Excise Duty, the Institute has revised its Accounting Standard 2, 'Valuation of Inventories', which became mandatory for the accounting periods commencing on or after 1.4.1999. It, therefore, became necessary to withdraw the option of disclosing the excise duty liability, in respect of inventories of finished goods lying in bonded warehouse or in the factory in the notes to accounts, which was given in the last Edition of the Guidance Note. Accordingly, the Guidance Note has been revised recommending that the excise duty liability on the said inventories should be provided for in the financial statements. The Guidance Note also provides guidance with regard to estimation of the amount to be provided for the excise duty liability. Certain other modifications have also been made in the Guidance Note incorporating some of the recently decided cases laying down the nature of the excise duty as a manufacturing cost.

I am sure that the Guidance Note will be useful to the members in discharging their day-to-day duties.

New Delhi
July 20, 2000

Bhavna G. Doshi
Chairperson
Research Committee

Foreword to the Second Edition

I am pleased to note that the Research Committee of the Institute has revised its erstwhile Guidance Note on Accounting for Excise Duties and has brought out this Guidance Note on Accounting of Excise Duty with the objective of making the accounting practices with regard to accounting for excise duty more uniform and in harmony with the principles of inventory valuation. Though, the subject of accounting of excise duty has, so far, beset with certain controversies, yet, I hope, with the issuance of this Guidance Note, recommended practices which are broadly in accordance with the generally accepted accounting principles would be well established.

I am confident this Guidance Note will be immensely useful to members and others concerned.

New Delhi
October 10, 1988

K. G. Somani
President

Preface to the Second Edition

The Research Committee of the Institute had issued a Guidance Note on Accounting Treatment for Excise Duties in 1979. Subsequent to the issuance of that Guidance Note, the nature of excise duty has been further clarified by some Supreme Court decisions. Further, the principles to be followed for the valuation of inventories have been explained in the Accounting Standard (AS) 2 on 'Valuation of Inventories', issued by the Institute of Chartered Accountants of India. Pursuant to the aforesaid developments the Research Committee published an Exposure Draft on the subject in the November, 1985, issue of 'The Chartered Accountant'. It was, however, decided by the Council in June 1986 that no revision of the existing Guidance Note was called for at that time.

The Research Committee recently decided that the Guidance Note should now be revised with the view of bringing about more uniformity in the accounting treatment of excise duty. The Guidance Note was accordingly revised in the light of, inter alia, various comments received in response to the aforesaid Exposure Draft and approved by the Council. The revised Guidance Note discusses, at the outset, the normally accepted accounting principles of inventory valuation, followed by the nature of excise duty in the light of various Court decisions and the recommendations on the accounting of excise duty.

I am grateful to Shri P.N. Shah, former President of the Institute and a member of last Research Committee, for preparing the basic draft of the revised Guidance Note. I am also thankful to other members of the Research Committee, in extending their full co-operation in finalising the draft.

I hope this Guidance Note will go a long way in bringing about greater uniformity in the accounting practices in industry with regard to accounting treatment of excise duty.

New Delhi
September 16, 1988

A.H. Dalal
Chairman
Research Committee

Foreword to the First Edition

In certain industries Excise Duty levied by the Government constitutes a major out-flow of funds. Differing views were expressed about the accounting treatment for this expenditure. Some organisations took the view that this was a period cost and could therefore, be treated as an expenditure of the period in which the liability for excise duty was incurred. On the other hand a large number of organisations treated this as an element of cost for the purpose of inventory valuation or carried forward the amount paid in respect of goods cleared from bonded godown but not sold before the close of the accounting period as prepaid expense or deferred charge. In order to determine the correct procedure and to achieve uniformity in the accounting treatment for excise duty, some members sought guidance of the Research Committee on this subject.

Considering the practical importance of the subject the Research Committee made a study of the various issues in depth and issued an exposure draft of the proposed guidance note in March, 1978. This draft was discussed with various members in industry as well as in the profession. Before giving a final shape to the guidance note a discussion paper containing detailed submissions and arguments was prepared and published by the Research Committee in December 1978. The Committee received representations from various members as well as from Chambers of Commerce and Industry, Government bodies and other professional organisations. The various issues relating to the subject were discussed with representatives of various organisations from time to time. After consideration of the above views the guidance note on the subject has now been finalised by the Research Committee and approved by the Council.

This guidance note is being published for the benefit of members. It is also proposed to publish this note in the October, 1979 issue of the Institute's Journal. I hope this Guidance Note will be useful to members of the profession in industry as well as in practice. The conclusions arrived at after detailed consideration of all aspects should go a long way in achieving uniformity in the matter of accounting treatment for excise duty and in disclosure of the policy followed by the concerned organisation.

On behalf of the Research Committee I would like to place on record the untiring efforts put in by Shri Y.H. Malegam F.C.A., in his capacity as Chairman of the Research Committee and later as Vice-President of the

Accounting Treatment for Excise Duty

Institute in drafting the exposure draft, discussion paper and the final guidance note, in discussion the various issues with our members and representatives of various organisations and in synthesising different view points on various issues relating to this complex subject. I would also like to acknowledge my debt of gratitude to the members of the Research Committee, representatives of various organisations and members of the Council and in particular Shri P. K. Mallik F.C.A., the President of the Institute, for extending their fullest co-operation in our efforts to finalise this guidance note.

New Delhi
16th September, 1979

P. N. Shah
Chairman
Research Committee

GN(A) 12 (Revised 2000)

Guidance Note on Accounting Treatment for Excise Duty

Introduction

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

Normally Accepted Accounting Principles for Inventory Valuation

4. Normally accepted accounting principles with regard to the valuation of inventories (i.e., materials or supplies to be consumed in the production process or in the rendering of services, work-in-process and finished goods), as

prescribed in revised Accounting Standard (AS) 2, "Valuation of Inventories", are reproduced below:

"5. Inventories should be valued at the lower of cost and net realisable value.

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

7. The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

8. The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour.

9. The allocation of fixed production overheads for the purpose of their inclusion in the costs of conversion is based on the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. The amount of fixed production overheads allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed production overheads allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads

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are assigned to each unit of production on the basis of the actual use of the production facilities.”

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

Nature of Excise Duty

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

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

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

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

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

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

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

Excise Duty as an Element of Cost

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

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

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

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

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

Provision for Unpaid Excise Duty

14. Since the point of time at which duty is collected is not necessarily the point of time at which the liability to pay the duty arises, situations will often arise when duty remains to be collected on goods which have been manufactured. The most common of these situations arises when the goods are stored under bond, i.e., in a Bonded Store Room, and the duty is paid when the goods are removed from such Bonded Store Room.

Accounting Treatment for Excise Duty

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

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

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

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

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

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

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

Auditor's Responsibility

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

21. As explained in this Guidance Note, the liability for excise duty arises at the point of time at which the manufacture is completed. The excise duty paid or provided on finished goods should, therefore, be included in inventory valuation. Similarly, excise duty paid on purchases (other than those subsequently recoverable by the enterprise from the taxing authorities) as well as intermediary products used for manufacture should also be included in the valuation of work-in-progress or finished goods.

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

23. Summary of Recommendations

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

GN(A) 14 (Issued 2001)

Guidance Note on Accounting by Dot-Com Companies

Foreword

Growth of e-commerce has revolutionised the way of conducting business. The buyers and the sellers are a mere click-of-the-mouse away. In this endeavour, dot-com companies have played a dominant role. The upsurge and recent slump of such companies raised numerous questions about the viability of their business models, particularly, with regard to the accounting practices followed by them. In this scenario, it is but natural that the Institute, being the accounting standards-setting body in the country, should step in to provide authoritative guidance about the accounting treatment of various revenue and expense items peculiar to the dot-com business. Accordingly, the Research Committee of the Institute was entrusted the task of bringing out a pronouncement on the subject.

I congratulate the Research Committee of the Institute for bringing out first a Monograph on the subject and now this Guidance note on Accounting by Dot-Com Companies. I wish to place on record my deep appreciation for Ms. Bhavna Doshi, former Chairperson of Research Committee, for playing the leading role in the preparation of the Monograph and Mr. N. V. Iyer, Chairman, Research Committee, for steering the Guidance Note to its completion in a short span of time. I also acknowledge the contribution made by Dr. Avinash Chander, Technical Director, and Ms. Anuradha Jain, Secretary, Research Committee, for their untiring efforts in this regard.

The Securities and Exchange Board of India is making it mandatory for all listed dot-com companies to follow this Guidance Note. This would lead to adoption of sound accounting practices in a consistent and harmonious manner in the industry. I am sure the issuance of this Guidance Note would also prove to be of immense use to our members in discharging their professional duties.

July 20, 2001
New Delhi.

N. D. Gupta
President

Preface

In recent years, a number of companies, popularly known as dot-com companies, carrying on electronic commerce business, have raised capital in the stock markets of the country. The markets normally value companies based on various types of information including accounting information. As the way of conducting electronic commerce transactions is considerably different from those conducted by the traditional manufacturing, trading and service enterprises, a need was being felt for an authoritative pronouncement which should address significant revenue and expense recognition issues peculiar to electronic commerce business. The Research Committee of the Institute of Chartered Accountants of India decided to issue such a pronouncement and as a result of this endeavour, some time back, brought out a Monograph on Accounting by dot-com companies, basically for the purpose of generating discussion in different quarters. On the basis of the experience gained by the Research Committee on this account, the Committee decided to issue this Guidance Note.

The Guidance Note deals with specific issues relating to electronic commerce and includes accounting issues arising from various revenue and cost items such as membership and subscription fees, revenue from auctions, multiple element arrangements and advertising, and treatment of website development costs, costs of point and loyalty programmes, etc.

I would like to place on record my sincere appreciation of the valuable inputs provided by the SEBI Sub-Committee of the Accounting Standards Committee on Accounting and Disclosure Norms and various experts including Shri Mohandas Pai and Shri Sumanth Cidambi, Chartered Accountants, associated with the preparation of the Guidance Note. I am also grateful to all others for their contributions in giving this Guidance Note its final shape and form through their incisive comments.

I am confident that the Guidance Note will be of immense use to the members in industry as well as those in practice.

July 19, 2001
New Delhi

N. V. Iyer
Chairman
Research Committee

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Guidance Note on Accounting by Dot-Com Companies

(The following is the text of the Guidance Note on Accounting by Dot-Com Companies, issued by the Institute of Chartered Accountants of India. With the issuance of this Guidance Note, the Monograph on Accounting by Dot-Com Companies, issued by the Research Committee of the Institute of Chartered Accountants of India in February 2001, stands withdrawn.)

Introduction

1. This Guidance Note deals with accounting by dot-com companies and other entities engaged in electronic commerce (e-commerce) in respect of certain issues relating to revenue and expense recognition.
2. Some of the accounting issues in dot-com companies have arisen due to the new business models being used in such companies. Some accounting issues, such as those relating to advertising partnerships, rebates, point and loyalty programmes, which are more common in business carried on by dot-com companies, also exist in other businesses.
3. For the purpose of this Guidance Note, dot-com companies include on-line content and Internet commerce companies.

On-line content companies

4. On-line content companies focus on the content sites, i.e., the Internet sites that provide news, information and knowledge as their main business. These include companies that provide Internet navigation services and reference guide information for World Wide Web and that publish, provide or present proprietary, advertising, and/or third party content. Examples of content sites include askjeeves.com, infoseek.co.za, indiainfonline.com, yahoo.com, thestreet.com, etc.

Internet commerce companies

5. Internet commerce companies sell products and services over the websites on the Internet and include on-line dealers. On the basis of the

types of transactions carried on by such companies, the sites are typically classified into Business-to-Business (B2B), Business-to-Consumer (B2C), Consumer-to-Consumer (C2C) and Consumer-to-Business (C2B), sites.

6. B2B sites link different businesses or different parts of a business. Transactions on these sites take place between industrial manufacturers, wholesalers or retailers. Special features of these transactions are high volumes per customer, lesser number of customers, secured payment systems, privacy of information, etc. Examples of sites in this category are indiaconstruction.com, clickforsteel.com and seekandsource.com.

7. B2C sites sell products or services directly to consumers. A large number of dot-com companies fall in this category. Transactions on these websites are characterised by low volumes per consumer and a large number of consumers. Examples of sites in this category are rediff.com, jaldi.com, indiatimes.com, zipahead.com, and fabmart.com.

8. C2C sites enable consumers to buy and sell from each other through auction or other similar sites. Examples of sites in this category are bazee.com and bidorbuy.com.

9. C2B sites enable consumers to set prices and business enterprises bid to offer products and services. Examples of sites in this category are razorfinish.com and priceline.com.

Elements of e-commerce transaction

10. In an e-commerce transaction, all the traditional elements of commerce exist though with some differences. The following elements are ordinarily present in an e-commerce transaction:

- A product or service;
- a place, namely, a website, that displays the products/services and where a business transaction takes place;
- a way for the people to visit the place (website);
- a way to accept orders, e.g., an on-line form;
- a way to accept money – normally through credit cards. Alternatively, the companies may use more traditional billing techniques either on-line or through the mail;

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- a facility to ship products to customers (often, outsourced). In the case of software and information, the product can be transferred over the Web through a file download mechanism;
- a way to accept rejected/returned goods and services;
- a way to handle warrantee claims, if necessary; and
- a way to provide customer service [often through e-mail, on-line forms, on-line knowledge bases and frequently asked questions (FAQs)].

11. Apart from the above elements of e-commerce transactions, certain facilities are also provided on the website, for example, information of the exact status of an order may be provided to the customer.

Scope

12. Dot-com companies engaged in transactions that are similar to transactions entered into by other businesses should follow generally accepted accounting principles for recording those transactions. Similarly, in case of companies normally carrying on other businesses, the recommendations contained in this Guidance Note should be applied for recording e-commerce transactions undertaken by them. The expression 'dot-com companies' includes other entities engaged in e-commerce.

Revenue Recognition

13. The main sources of revenue of dot-com companies presently include:

- Membership and subscription;
- Merchandising activities;
- Advertising services; and
- Other services like web-hosting, content selling, etc.

14. The basic principles of revenue recognition as set out in Accounting Standard (AS) 9, 'Revenue Recognition', apply to recognition of revenue from the above sources. The extracts from AS 9 that are relevant in this context are reproduced below:

“4.1 Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.”

“10. Revenue from sales or service transactions should be recognised when the requirements as to performance set out in paragraphs 11 and 12 are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.”

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

- (i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and***
- (ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.”***

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

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15. On the basis of the above, accounting principles applicable to specific sources of revenue of dot-com companies are discussed in the following paragraphs.

Membership and subscription

16. In order to avail of the services provided by websites, consumers are usually required to pay an amount as membership fees or subscription. Such membership fee or subscription may also be collected in the form of registration fee. While some services are available to members free of cost after registration, other services may be made available only on payment of an additional fee.

17. The membership/registration fees received by a dot-com company may fall in the following categories:

- Non-refundable fees that entitle a member to use the services of the website by making payment for all services separately;
- Non-refundable fees that entitle a member to use the services of the website indefinitely without making any further payment for use of services;
- Non-refundable fees that entitle a member to use the services of the website for a specified period of time;
- Fees that are refundable subject to the fulfillment of certain conditions stipulated in the subscription agreement. Usually contractual stipulations require such conditions to be fulfilled within a specified time period; and
- Periodic membership/subscription fees on monthly, quarterly, annual or such other basis.

18. Recognition of non-refundable fees as revenue on receipt of fees would not be appropriate in instances where the products delivered or services performed do not represent the culmination of the revenue earnings process. Typically, registering members, signing the contract, enrolling the customer or activating services are not discrete revenue earning events. Revenue earning process is completed by performance of specified actions as per the terms of the arrangements, not simply by originating a revenue-generating arrangement.

19. Supply of products or rendering of services by dot-com companies may involve charge of a non-refundable upfront fee/initial (membership/registration) fee with or without subsequent payments for products or services to be provided in future. In those cases where all products or services are to be separately paid for apart from the initial membership fee, the initial membership fee is of the nature of an entrance fee which should be capitalised and revenue from rendering of services or supply of products should be recognised on the basis specified in this regard in AS 9.

20. With regard to non-refundable fees that entitle a member to use the services of the website indefinitely without making any further payment for use of services, the initial fee, in substance, represents wholly or partly an advance payment for products or services to be provided in future. This implies that it is expected that the services would be provided on a continuous basis after payment of up-front fee. The non-refundable up-front fee and the continuing performance obligation related to the services to be provided or products to be delivered form an integrated package. Accordingly, up-front membership fees, even if non-refundable, are actually earned as the products and/or services are delivered and/or rendered over the term of the arrangement or the expected period of performance. Consequently, recognition of such non-refundable fees should be generally deferred and the same should be recognised systematically over the period(s) during which fees are earned. However, keeping in view the uncertain nature of business of a dot-com company, non-refundable fees that entitle a member to use the services of the website indefinitely should be recognised as revenue over a period of not less than five years, on a systematic and rational basis, i.e., on time proportion basis or any other basis, e.g., usage basis, whichever is more representative of the services rendered. In case the company also provides services for periodic subscription, the revenue in respect of non-refundable fees to be recognised on the aforesaid basis should not exceed the corresponding periodic subscription.

21. Non-refundable fees that entitle a member to use the services of the website for a specified period of time in excess of five years should be recognised as revenue as recommended in paragraph 20 above. However, in case the specified period is less than five years, the fees should be recognised as revenue on a systematic and rational basis usually on a time proportion basis over the specified period unless another systematic and rational basis is more representative of the services rendered, e.g., the usage basis.

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22. In respect of membership fees that are refundable to members subject to fulfillment of certain conditions (for example, a stipulated volume of usage within a specified period, etc.), it is not appropriate to recognise such fees as revenue on receipt thereof since it is expected that a member would ordinarily fulfil the conditions. Accordingly, the revenue from such transactions should be recognised when it becomes reasonably certain that conditions would not be fulfilled. Pending the recognition of revenue as aforesaid, the amounts received from customers should be credited and retained in a liability account such as 'Customers Refundable Fees Account'. The company should periodically review the status of this account to ascertain the extent of fulfillment or otherwise of the conditions.

23. Periodic membership subscriptions paid by members to avail of the services offered by the website should be recognised as revenue over the period of the subscription, in accordance with the established principles of accrual accounting.

Merchandising activities

24. One of the significant issues in accounting by dot-com companies is whether to recognise gross amount of revenues and the related cost of sales or to recognise the revenue on net basis, similar to commission. The significance of this issue is enhanced due to the importance often placed on the revenue being used as the basis for valuation of dot-com companies. The question of gross *versus* net revenue and cost recognition ordinarily arises in connection with dot-com companies that distribute or resell third party products or services. This issue typically arises in the B2C sites.

25. In assessing whether revenue should be reported on gross basis with separate recognition of cost of sales or on net basis, it should be considered whether the dot-com company:

- acts as a principal in the transaction, i.e., it assumes significant risks and rewards of ownership, such as the risk of loss in collection, delivery, or returns; or
- acts as an agent or broker for sale of goods or rendering of services, i.e., does not assume significant risks and rewards of ownership; compensation being commission or fee. In this case, the dot-com company is merely engaged in providing the service of bringing the purchaser and the seller together.

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26. Where a dot-com company acts as a principal in the transaction, i.e., significant risks and rewards of ownership are first acquired by it and then transferred on sale, it is appropriate to recognise revenues and the related costs on a gross basis. If the dot-com company does not do so, i.e., it merely acts as an agent, it would be appropriate to recognise only the service charges as revenue, similar to commission.

Auctions

27. Some dot-com companies host auction sites as part of their on-line activities where users can purchase or sell goods or services. The dot-com company ordinarily earns auction revenues through two sources – up-front (listing) fees and transaction-based fees.

28. Listing fees are the up-front fees that the dot-com company receives at the time a seller registers for a listing to be maintained over a specified period of time. The purchaser is paying for a service that is delivered over time. It is appropriate that listing fees are recognised over the period of the contract or arrangement, provided there are no significant outstanding vendor obligations to be fulfilled and collection of the related receivable is reasonably certain.

29. Transaction fees are for facilitating the transaction and are usually based on a percentage of the revenue earned by the seller from the on-line sale. Such fees should be recognised as revenue by the dot-com company upon completion of the transaction or at the time when no further vendor obligations remain to be performed as per the terms with the vendor.

Shipping and handling

30. Dot-com companies selling products on-line often charge customers for shipping and handling activities. Such charges may or may not be a direct reimbursement of the costs incurred by dot-com companies. Some companies display the charges separately whereas some do not.

31. In determining accounting treatment, it should be examined whether the products sold on-line are invoiced to the customers at a composite rate including shipping and handling charges or whether shipping and handling charges are recovered separately as an absolute amount or as a percentage of the sale value. In the former case, it may be appropriate to include such charges as a component of sales revenue provided a clear distinction cannot be made between the product value and the shipping and handling charge

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component. Where such charges are recovered as an absolute amount or as a percentage of sale value separately, these should not be included in sales revenue but should be recorded separately. Thus, such charges should not be included in computing the value of turnover to be disclosed in the statement of profit and loss. Shipping and handling charges should be recognised separately as an income and the actual cost incurred in respect thereof should be recognised as an expense. However, where these charges are clearly a reimbursement by the buyer of the actual cost incurred by the seller, these should be shown as a deduction from the shipping and handling cost in the statement of profit and loss, if the amount involved is material.

Multiple element arrangements

32. A multiple element arrangement generally exists where a dot-com company agrees to deliver more than one product/ service concurrently and deliver certain additional products/services in future. These additional products/services may include upgrades, enhancements or maintenance services. It is sometimes customary to bundle such products and services for a consolidated price.

33. For accounting purposes, it is appropriate to 'unbundle' the separate elements of the arrangement or contract. For this purpose, company-specific fair values in respect of which objective evidence is available should be used, i.e., what the company would have received had it sold each item/ service separately. Company-specific objective evidence of fair value is determined in respect of transactions with unrelated parties. For example, a dot-com company may agree to host another company's website and also provide web maintenance service for a fixed fee of Rs.15 lakh for a term of one year and six months, respectively. If the dot-com company has evidence that in its recent transactions, it has charged separate fees for web hosting and web maintenance of Rs.12 lakh for one year and Rs.6 lakh for six months, respectively, then revenue in respect of the composite service now being provided should be recognised in the ratio of 2:1, i.e., Rs.10 lakh from web hosting over one year and Rs.5 lakh as revenue from web maintenance services over a period of six months.

34. Unbundling of revenues from multiple element arrangements is not performed where the revenue recognition criteria as well as the periods over which revenues would be recognised are the same for individual elements of the multiple element arrangement.

35. In the absence of availability of sufficient company-specific objective evidence of fair values for the allocation of revenue between various

elements, it would be appropriate to defer recognition of the entire revenue from the contract until (a) sufficient company-specific objective evidence comes into existence, or (b) all elements of the arrangement are delivered, whichever is earlier. In the latter case, the composite amount is recognised as revenue on delivery of all elements of arrangement. Associated costs related to such deferred revenues should also be carried forward until they are capable of being matched against revenues recognised in the financial statements.

Advertising services

36. One of the principal sources of revenue of dot-com companies is from the sale of banner and sponsorship advertisements. Banner advertisements are usually hosted for a short duration. Sponsorship advertising contracts have longer terms than banner advertising contracts and also involve more service integration. High profile promotional sponsorships are typically focused on a particular event, such as sweepstakes and lotteries. Visitors to the website are ordinarily encouraged to complete the transaction by clicking on a hypertext link, also known as 'click-through'.

37. A dot-com company's obligations typically include guarantees of minimum number of impressions or click-throughs. Impressions are the number of times that an advertisement appears in pages viewed by users of the dot-com company's on-line sites. It is appropriate to recognise revenue on the basis of the number of impressions or 'click-throughs' unless another systematic and rational basis of revenue recognition is more representative of the services rendered. This is in line with Appendix to AS 9 which states that for "advertising agencies, media commissions will normally be recognised when the related advertisement or commercial appears before the public and the necessary intimation is received by the agency". To the extent the minimum guaranteed impressions are not met, recognition of the corresponding revenue should be postponed until the guaranteed impression levels are achieved. The advertising revenue should only be recognised when no significant obligations remain at the end of the period and collection of the resulting receivable is reasonably certain.

38. Dot-com companies may enter into agreements whereby they agree to host advertisements for customers, without any minimum guaranteed impressions. For example, a dot-com company may enter into an agreement with another company to host a banner advertisement containing details of products/services offered by that company. In this case, it is appropriate to

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recognise advertising revenue on straight-line basis over the period for which the banner is to be hosted unless another systematic and rational basis of revenue recognition is more representative of the services rendered.

Measurement of consideration in advertising barter transactions

39. Dot-com companies sometimes enter into advertising barter transactions with each other, in which they exchange rights to place advertisements on each others' on-line properties, i.e., websites or web pages. A barter transaction may involve exchange of advertising time for products or services.

40. Revenue from advertising barter transactions should be recognised only when the fair values of similar transactions are readily determinable from the entity's history. It would be appropriate to consider fair values of transactions that have occurred not later than six months preceding the sale of similar advertising to unrelated buyers. This will ensure that the comparable values are current and reflect the best estimate of a price at which a willing buyer and a willing seller would be willing to exchange an item or service in a situation other than a distress sale. If economic circumstances have changed such that prior (but not more than six months old) transactions are not representative of current fair value for the advertising surrendered, then a shorter, more representative period should be used. It is inappropriate to consider cash transactions subsequent to the barter transaction to determine fair value.

41. For determining the fair value of advertising space surrendered for cash to be considered 'similar' to the advertising space being surrendered in the barter transaction, the advertising space surrendered must have been in the same media and within the same advertising vehicle (for example, same publication, same website, or same broadcast channel) as the advertising in the barter transaction. In addition, the characteristics of the advertising space surrendered for cash must be reasonably similar to that being surrendered in the barter transaction with respect to:

- (a) Circulation, exposure, or saturation within an intended market;
- (b) Timing (time of day, day of week, daily/weekly, 24 hours a day/ 7 days a week, and season of the year);
- (c) Prominence (page on website, section of periodical, location on page, and size of advertisement);

- (d) Demographics of readers, viewers, or customers;
- (e) Duration (length of time for which the advertisement will be displayed).

42. Where, however, reliable estimates of fair value are not available, it may not be appropriate to recognise revenue and the associated costs involved in barter transactions.

Other services

Revenue from maintenance of websites including web hosting

43. Dot-com companies may also earn revenue from hosting websites for their customers, maintenance of the customers' websites or providing such other services. Revenue from these services should be recognised over the period for which the website is to be hosted or maintained provided such services are rendered over the period of the contract on continuous basis unless another systematic and rational basis of revenue recognition is more representative of the services rendered.

Content Selling

44. Some dot-com companies maintain websites which contain text or other material which can be sold as a content for a price. Generally, a downloading facility of such content is available to the purchaser. In such a case, a question arises as to the timing of the recognition of revenue from the sale of the content downloaded by the customer. Applying the general principle of revenue recognition, the content should generally be considered to be sold when it is delivered to the purchaser. Therefore, keeping in view the terms of individual arrangements and the other relevant facts involved, the dot-com company should determine the time at which the delivery of the content is considered to be complete and recognise the corresponding revenue.

Recognition and Measurement of Costs

Accounting for website development costs¹

45. The website development costs of a new company, should be accumu-

¹ Accounting Standard (AS) 26, 'Intangible Assets', would supersede this section from the date, the Standard becomes mandatory.

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lated, along with other costs incurred upto the time the website is thrown open to the users thereof. Such costs include cost incurred in performing the activities relating to planning the website, obtaining and registering an Internet domain name, testing the website applications, creating initial graphics about website, etc. Keeping in view the nature of the dot-com business, particularly the susceptibility to the rapid technological obsolescence, it is recommended that such costs that are accumulated should be amortised on a systematic and rational basis, over a period not exceeding 2 years after the website is thrown open to the users thereof. The costs so accumulated should be shown as deferred revenue expenditure under the head 'Miscellaneous Expenditure'. All costs incurred, including those for development of new websites, after the first website of the company becomes open to the users should be expensed in the period in which they are incurred.

46. A dot-com company would also incur expenditure on certain items that are similar to entities in other businesses, e.g., expenditure incurred in the acquisition or construction of tangible and intangible assets such as land, buildings, computer hardware, software and knowledge-based content. Since the items of the aforesaid nature are not peculiar only to dot-com companies, the treatment thereof should be the same as in the case of other businesses.

47. An illustrative list of activities performed in website development is given in the Appendix to this Guidance Note.

Rebates, discounts and other sales incentives

48. The accounting treatment of rebates, discounts and other sales incentives depends upon their nature. Where a dot-com company offers rebates or introductory offers at heavily reduced prices in order to stimulate sales and generate new customers, the value of such rebates should be reduced from turnover. This treatment is similar to that accorded to trade discounts. Where the rebates, discounts and other sales incentives are specific in relation to a particular customer, these should be shown by way of deduction from the value of the turnover in the statement of profit and loss of the dot-com company. Other forms of rebate or discount, which are general in nature, should be treated as a selling and marketing expense and charged separately in the profit and loss account. Where rebates, discounts and other sales incentives are in kind, an appropriate estimate of the costs thereof should be made and treated in the manner specified above.

Point and loyalty programmes

49. Point and loyalty programmes have varied features and may be structured in different ways. In some cases, a dot-com company may sell points to its business partners, who then issue the same to their customers based on purchases or other actions. For example, a dot-com company may arrange with a book store to issue reward points to the customers of the book store based on the minimum volume of purchases made by the customers. The customers can exchange these points with the dot-com company for use of the dot-com company's website for a specified period of time. In some cases, the dot-com company may itself award the points in order to encourage its members to take actions that will generate payments from business partners to the company.

50. With regard to the costs related to incentives under point and loyalty programmes incurred by a dot-com company, the following accounting treatment should be adopted:

- (i) Where the incentives under a point and loyalty programme are specific in relation to a particular customer, the cost of providing the incentives should be shown by way of deduction from the value of the turnover in the statement of profit and loss of the dot-com company. In respect of incentives in kind, an appropriate estimate of the costs thereof should be made.
- (ii) In respect of incentives under a point and loyalty programme which are general in nature, i.e., they are not related to specific customers, a general provision therefor should be made in the statement of profit and loss of the dot-com company based on an appropriate estimate of the costs itself.

Equity Based Consideration

51. Some dot-com companies use equity-based consideration to fund expenditures as cash is not an available alternative to attract new business relationships, alliances, or supplier agreements.

52. When a product, service or an asset is acquired in exchange of equity shares by a dot-com company, it should be recorded as below:

- (i) Where a value is placed by the parties to the transaction in respect of a product, service or asset acquired in exchange of equity shares and the transaction is between unrelated parties, the said product, service or asset should be recorded at the value so

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placed, since presumably the said value will represent the fair value thereof.

- (ii) Where the value is not placed by the parties to the transaction in respect of the product, or service or asset acquired in exchange of equity shares or the transaction is between the related parties, the product, service or asset should be recorded on the following basis, since in case of transactions between related parties, the value placed may not necessarily represent the relevant fair value:
 - (a) Where fair value of the product, service or asset acquired is available, the product, service or asset should be recorded at the said fair value.
 - (b) Where fair value of the product, or service or asset is not available but the fair value of the equity transferred is available, the product, service or asset should be recorded at the fair value of the equity consideration.

In the above cases, where the value of the products, services or assets acquired is in excess of the face value of the equity shares transferred, the difference should be credited to share premium account.

For the purpose of the above, 'fair value' is the price that would be agreed to in an open and unrestricted market between knowledgeable and willing parties dealing at arm's length who are fully informed and are not under any compulsion to transact.

The related parties are those parties that are considered to be related as per Accounting Standard (AS) 18, 'Related Party Disclosures', issued by the Institute of Chartered Accountants of India.

Disclosure

53. Besides the disclosure of the significant accounting policies as per the requirement of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies', issued by the Institute of Chartered Accountant of India, the bases for arriving at the fair values in respect of the following should be disclosed in the financial statements of a dot-com company:

- (i) Different elements comprising a multiple arrangement.
- (ii) Advertising barter transactions.
- (iii) Equity based consideration.

Appendix

Illustrative List of Activities Performed at Planning Stage

1. Develop a business, project plan, or both. This may include identification of specific goals for the website (for example, to provide information, supplant manual processes, conduct e-commerce, and so forth), a competitive analysis, identification of the target audience, creation of time and cost budgets, and estimates of the risks and benefits.
2. Determine the functionalities (for example, order placement, order and shipment tracking, search engine, e-mail, chat rooms, and so forth) of the website.
3. Identify necessary hardware (for example, the server) and web applications. Web applications are the software needed for the website's functionalities. Examples of web applications are search engines, interfaces with inventory or other back-end systems, as well as systems for registration and authentication of users, content management, usage analysis, and so forth.
4. Determine the technology necessary to achieve the desired functionalities. Factors might include, for example, target audience numbers, user traffic patterns, response time expectations, and security requirements.
5. Explore alternatives for achieving functionalities (for example, internal *versus* external resources, custom-developed *versus* licensed software, company owned *versus* third-party hosted applications and servers).
6. Conceptually formulate and/or identify graphics and content.
7. Invite vendors to demonstrate how their web applications, hardware, or service will help achieve the website's functionalities.
8. Selection of external vendors for consultants.
9. Identify internal resources for work on the website design and development.

10. Identify software tools and packages required for development purposes.
11. Address legal considerations such as privacy, copyright, trademark and compliance.

Illustrative List of Activities Performed at Website Development Stage

1. Acquire or develop the software tools required for the development work (for example, HTML editor, software to convert existing data to HTML form, graphics software, multimedia software, and so forth).
2. Obtain and register an Internet domain name.
3. Acquire or develop software necessary for general website operations, including server operating system software, Internet server software, web browser software, and Internet protocol software.
4. Develop or acquire and customise code for web applications (for example, catalogue software, search engines, order processing systems, sales tax calculation software, payment systems, shipment tracking applications or interfaces, e-mail software and related security features).
5. Develop or acquire and customise database software to integrate distributed applications (for example, corporate databases, accounting systems) into web applications.
6. Develop HTML web pages or develop templates and write code to automatically create HTML pages.
7. Purchase the web and application server(s), Internet connection (bandwidth), routers, staging servers (where preliminary changes to the website are made in a test environment), and production servers (accessible to customers using the website). Alternatively, these services may be provided by a third party via a hosting arrangement.
8. Install developed applications on the web server(s).
9. Initial creation of hypertext links to other websites or to destinations within the website. Depending on the site, links may be extensive or minimal.
10. Test the website applications (for example, stress testing).

Illustrative List of Activities Performed at Graphics and Content Development Stages

1. Create initial graphics for the website. Graphics include the design or layout of each page (that is, the graphical user interface), colour, images and the overall 'look and feel' and 'usability' of the website. Creation of graphics may involve coding of software, either directly or through the use of graphic software tools. The amount of coding depends on the complexity of the graphics.
2. Create content or populate databases. Content may be created or acquired to populate databases or web pages. Content may be acquired from unrelated parties or may be internally developed.
3. Enter initial content into the website. Content is text or graphical information (exclusive of graphics described in (1) above) on the website which may include information on the entity, products offered, information sources that the user subscribes to, and so forth. Content may originate from databases that must be converted to HTML pages or databases that are linked to HTML pages through integration software. Content also may be coded directly into web pages.

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Guidance Note on Accounting for Oil and Gas Producing Activities

Foreword

The petroleum sector plays a pivotal role in the overall economic development of the country. India is a country where the demand for petroleum products is higher than their production and the shortfall in supply is met through imports. In order to reduce high dependence on imports, the government has opened this sector for private players also, which traditionally was a domain of public sector undertakings. As a result, the number of players operating in the sector is increasing. In the changing scenario, a need was being felt for bringing out a pronouncement to address the industry-specific accounting issues relating to exploration, development and production of oil and gas with a view to bring about establishment of sound accounting principles. It is heartening to note that the Research Committee has formulated this 'Guidance Note on Accounting for Oil and Gas Producing Activities'.

I would like to congratulate Shri Rajkumar S. Adukia, Chairman, Research Committee, other members of the Research Committee, authors of the draft, Officers of the Technical Directorate of the Institute and other interest groups who have made invaluable contributions in the formulation of this Guidance Note.

I hope that this endeavour of the Research Committee will go a long way in establishing sound accounting principles and provide guidance to the members as well as to the others concerned.

New Delhi
February 4, 2003

Ashok Chandak
President

Preface

Oil and gas producing industry (Upstream Petroleum Industry) is a highly capital intensive industry as a huge amount of expenditure is required to be incurred on acquisition, exploration and development activities before the commencement of actual production. At the time of incurrence of expenditure, particularly on exploration activities, the result of the same is not known and a large portion of the expenditure does not normally result in discovery of any oil and gas. In such circumstances, the issue of treatment of the expenditure incurred on various activities assumes greater significance.

The Research Committee has formulated this 'Guidance Note on Accounting for Oil and Gas Producing Activities' to lay down accounting treatment for costs incurred on acquisition of mineral interests in properties, exploration, development and production activities. The Guidance Note, *inter alia*, also lays down accounting treatment for abandonment costs which can be a major amount particularly in case of offshore operations. The Guidance Note recognises that there are two methods of accounting, viz., the Successful Efforts Method and the Full Cost Method. While the Guidance Note recommends the adoption of the Successful Efforts Method as a preferred method of accounting, it also permits the use of the Full Cost Method. The Guidance Note, while recommending that change in the method of accounting from Full Cost Method to Successful Efforts Method should be with retrospective effect, does not permit the change in the method of accounting from Successful Efforts Method to Full Cost Method.

I am glad to place on record our deep appreciation of Shri K.S. Sundara Raman for preparing the basic draft of the Guidance Note. I would also like to acknowledge the invaluable contributions made by the members of the Study Group, viz., Ms. Satyavati Berera (convenor), Shri A.K. Banerjee, Shri Ram Parkash, Shri P.S. Gopal, Shri J.D. Basrur and Shri Mukesh Bhutani, in this endeavour of the Research Committee. I am also thankful to various representatives of industry for giving their invaluable comments and suggestions on the draft Guidance Note.

I would also like to thank all the members of the Research Committee, namely, Shri N. Nityananda (Vice-Chairman), Shri Ashok Chandak (President), Shri R. Bupathy (Vice-President), Shri N.V. Iyer, Shri Shantilal Daga, Shri Niranjana Saha, Shri Sunil Goyal, Dr. Sunil Gulati, Shri Vinod Jain, Shri G.C. Srivastava, Shri Jose Pottokaran, Shri Thomas Mathew, Shri Chandrakant B. Thakar, Shri Subhash Chandra Chawla and Shri Vishnu Anant Mahajan.

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I also compliment the invaluable contribution made by Dr. Avinash Chander, Technical Director, Ms. Anuradha Jain, Secretary, Research Committee and Mr. Vishal Bansal, Technical Officer, of the Institute of Chartered Accountants of India, at the various stages of the finalisation of the Guidance Note.

I sincerely believe that this Guidance Note will go a long way in establishing sound accounting and reporting principles in the oil and gas producing industry.

New Delhi
February 4, 2003

Rajkumar S. Adukia
Chairman
Research Committee

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Guidance Note on Accounting for Oil and Gas Producing Activities

(The following is the text of the Guidance Note on Accounting for Oil and Gas Producing Activities, issued by the Council of the Institute of Chartered Accountants of India.)

Introduction

1. Oil and gas producing industry, which is extractive in nature, involves activities relating to acquisition of mineral interests in properties, exploration (including prospecting), development, and production of oil and gas. The aforesaid activities are collectively referred to as upstream operations and form the 'Upstream Petroleum Industry'. The industry is commonly referred to as the 'E&P' industry. The peculiar nature of the industry requires establishment of industry-specific accounting principles in relation to expense recognition, measurement and disclosure.

Objective

2. The objective of this Guidance Note is to provide guidance on accounting for costs incurred on activities relating to acquisition of mineral interests in properties, exploration, development and production of oil and gas.

Scope

3. This Guidance Note applies to costs incurred on acquisition of mineral interests in properties, exploration, development and production of oil and gas activities, i.e., upstream operations. This Guidance Note also deals with other accounting aspects such as accounting for abandonment costs and impairment of assets that are peculiar to the enterprises carrying on oil and gas producing activities. It does not address accounting and reporting issues

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relating to the transporting, refining and marketing of oil and gas. This Guidance Note also does not apply to accounting for:

- (a) activities relating to the production of natural resources other than oil and gas, and
- (b) the production of geothermal steam or the extraction of hydrocarbons as a by-product of the production of geothermal steam or associated geothermal resources.

Definitions

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

Cost Centre: Cost centre is a unit identified to capture costs based on suitable criteria such as geographical or geological factors. Cost centre is not larger than a field in case of Successful Efforts Method and under Full Cost Method, the cost centre is not normally smaller than a country except where warranted by major difference in economic, fiscal or other factors in the country.

Depreciation: Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined. Depreciation also includes 'depletion' of natural resources through the process of extraction or use.

Development Well: A well drilled, deepened, completed or recompleted within the proved area of an oil or gas reservoir to the depth of a stratigraphic horizon known to be productive.

Exploratory Well: A well drilled for the purpose of searching for undiscovered oil and gas accumulations on any geological prospect. An exploratory well is a well that is not a development well, a service well, or a stratigraphic test well, as those terms are defined separately.

Field: An area consisting of a single reservoir or multiple reservoirs all grouped on or related to the same individual geological structural feature and/or stratigraphic condition. There may be two or more

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reservoirs in a field which are separated vertically by intervening impervious strata, or laterally by local geologic barriers, or by both. Reservoirs that are associated by being in overlapping or adjacent fields may be treated as a single or common operational field. The geological terms 'structural feature' and 'stratigraphic condition' are intended to identify localised geological features as opposed to the broader terms of basins, trends, provinces, plays, areas-of-interest, etc.

Oil and Gas Reserves: Oil and gas reserves are those quantities of oil and gas, which are anticipated to be commercially recoverable from known accumulations from a given date forward. All oil and gas reserve estimates involve some degree of uncertainty. Uncertainty depends chiefly on availability of reliable geological and engineering data at the time of the estimate and interpretation of data.

Based on relative degree of uncertainty, oil and gas reserves can be classified as 'Proved Oil and Gas Reserves' and 'Unproved Oil and Gas Reserves'.

Proved Oil and Gas Reserves: Proved oil and gas reserves are those quantities of mineral oil, natural gas and natural gas liquids which, upon analysis of geological and engineering data, demonstrate with reasonable certainty to be commercially recoverable in future from known oil and gas reservoirs under existing economic and operating conditions.

Establishment of current economic conditions includes relevant historical oil and gas prices and associated costs under existing government regulations, if any. Oil and gas reserves, which can be produced economically through application of advanced recovery techniques, are included in proved classification after successful pilot testing.

Proved oil and gas reserves can be classified as 'Proved developed oil and gas reserves' and 'Proved undeveloped oil and gas reserves'.

Proved Developed Oil and Gas Reserves: Proved developed oil and gas reserves are reserves that can be expected to be recovered through existing wells with existing equipment and operating methods. Additional oil and gas expected to be obtained through the application of advanced recovery techniques

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for supplementing the natural forces and mechanisms of primary recovery should be included as *proved developed reserves* only after testing by a pilot project or after the operation of an installed programme has confirmed through production response that increased recovery will be achieved.

Proved Undeveloped Oil and Gas Reserves: Proved undeveloped oil and gas reserves are reserves that are expected to be recovered from new wells on undrilled acreage, or from existing well for which a relatively major expenditure is required for recompletion. Reserves on undrilled acreage should be limited to those drilling units offsetting productive units that are reasonably certain of production when drilled. Proved reserves for other undrilled units can be claimed only if it can be demonstrated with certainty that there is continuity of production from the existing productive formation. Under no circumstances should estimates for proved undeveloped reserves be attributable to any acreage for which an application of advanced recovery technique is contemplated, unless such techniques have been proved effective by actual tests in the area and in the same reservoir.

Reservoir: A porous and permeable underground formation containing a natural accumulation of producible oil or gas that is confined by impermeable rock or water barriers and is individual and separate from other reservoirs.

Service Well: A service well is a well drilled or completed for the purpose of supporting production in an existing field. Wells in this class are drilled for the following specific purposes: gas injection (natural gas, propane, butane, or flue gas), water injection, steam injection, air injection, polymer injection, salt-water disposal, water supply for injection, observation, or injection for combustion.

Stratigraphic Test Well: A stratigraphic test is a drilling effort, geologically directed, to obtain information pertaining to a specific geologic condition. Such wells customarily are drilled without the intention of being completed for hydrocarbon production. This classification also includes tests identified as core tests and all types of expendable holes related to hydrocarbon exploration. Stratigraphic test wells (sometimes called expendable wells) are classified as follows:

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- (a) *Exploratory-type stratigraphic test well:*
stratigraphic test well not drilled in a proved area.
- (b) *Development-type stratigraphic test well:*
stratigraphic test well drilled in a proved area.

Unit of Production (UOP) method: The method of depreciation (depletion) under which depreciation (depletion) is calculated on the basis of the number of production or similar units expected to be obtained from the asset by the enterprise.

5. The definitions of certain other terms relevant for the Guidance Note are given in Appendix.

Classification of E&P Activities and Related Costs

Acquisition Activities

6. Activities carried out by an E&P enterprise towards the acquisition of right(s) to explore, develop and produce oil and gas constitute acquisition activities. Once the areas of oil and gas finds are identified, the E&P enterprise approaches the owner who owns the rights for the exploration, development and production of the underground minerals in respect of the property or area. In order to undertake surveys and exploration activities in India, an E&P enterprise has to first obtain a Petroleum Exploration License (PEL) or Letter of Authority (LOA). For engaging in development and production activities, an enterprise has to obtain a Mining Lease (ML). At present, the PEL/LOA and the ML for onshore E&P activities are granted by the State Governments upon recommendation of the Central Government and for offshore E&P activities by the Central Government.

Acquisition Costs

7. Acquisition costs cover all costs incurred to purchase, lease or otherwise acquire a property or mineral right. These include lease bonus, brokers' fees, legal costs, cost of temporary occupation of the land including crop compensation paid to farmers and all other costs incurred in acquiring these rights. These are costs incurred in acquiring the right to explore, drill and produce oil and gas including the initial costs incurred for obtaining the PEL/LOA and ML. Annual licence fees are excluded.

Exploration Activities

8. Exploration activities cover the prospecting activities conducted in the search for oil and gas. In the course of an appraisal programme these activities include but are not limited to aerial, geological, geophysical, geochemical, palaeontological, palynological, topographical and seismic surveys, analysis, studies and their interpretation, investigations relating to the subsurface geology including structural test drilling, exploratory type stratigraphic test drilling, drilling of exploration and appraisal wells and other related activities such as surveying, drill site preparation and all work necessarily connected therewith for the purpose of oil and gas exploration.

Exploration Costs

9. Principal types of exploration costs cover all direct and allocated indirect expenditure which include depreciation and applicable operating costs of related support equipment and facilities and other costs of exploration activities that are:

- (i) costs of surveys and studies mentioned in paragraph 8 above, rights of access to properties to conduct those studies (e.g., costs incurred for environment clearance, defence clearance, etc.), and salaries and other expenses of geologists, geophysical crews and other personnel conducting those studies. Collectively, these are referred to as geological and geophysical or 'G&G' costs;
- (ii) costs of carrying and retaining undeveloped properties, such as delay rental, *ad valorem* taxes on properties, legal costs for title defence, maintenance of land and lease records and annual licence fees in respect of Petroleum Exploration License;
- (iii) dry hole contributions and bottom hole contributions;
- (iv) costs of drilling and equipping exploratory and appraisal wells; and
- (v) costs of drilling exploratory-type stratigraphic test wells.

Development Activities

10. Development activities for extraction of oil and gas include, but are not limited to the purchase, shipment or storage of equipment and materials used

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in developing oil and gas accumulations, completion of successful exploration wells, the drilling, completion, re-completion and testing of development wells, the drilling, completion and re-completion of service wells, the laying of gathering lines, the construction of offshore platforms and installations, the installation of separators, tankages, pumps, artificial lift and other producing and injection facilities required to produce, process and transport oil or gas into main oil storage or gas processing facilities, either onshore or offshore, including laying of infield pipelines, the installation of the said storage or gas processing facilities.

Development Costs

11. Development costs cover all the direct and allocated indirect expenditure incurred in respect of the development activities including costs incurred to:

- (i) gain access to and prepare well locations for drilling, including surveying well locations for the purpose of determining specific development drilling sites, clearing ground, draining, road building and relocating public roads, gas lines and power lines to the extent necessary in developing the proved oil and gas reserves;
- (ii) drill and equip development wells, development-type stratigraphic test wells and service wells including the cost of platforms and of well equipment such as casing, tubing, pumping equipment and the wellhead assembly;
- (iii) acquire, construct and install production facilities such as lease flow lines, separators, treaters, heaters, manifolds, measuring devices and production storage tanks, natural gas cycling and processing plants and utility and waste disposal systems; and
- (iv) provide advanced recovery system.

Development costs also include depreciation and applicable operating cost of related support equipment and facilities in connection with development activities, and annual license fees in respect of Mining Lease.

Production Activities

12. Production activities consist of pre-wellhead (e.g., lifting the oil and gas to the surface, operation and maintenance of wells, extraction rights,

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etc.,) and post-wellhead (e.g., gathering, treating, field transportation, field processing, etc., upto the outlet valve on the lease or field production storage tank, etc.,) activities for producing oil and/or gas.

Production Costs

13. Production costs consist of direct and indirect costs incurred to operate and maintain an enterprise's wells and related equipment and facilities, including depreciation and applicable operating costs of support equipment and facilities. Examples of production costs are:

(a) Pre-wellhead costs:

Costs of labour, repairs and maintenance, materials, supplies, fuel and power, property taxes, insurance, severance taxes, royalty, etc., in respect of lifting the oil and gas to the surface, operation and maintenance including servicing and work-over of wells.

(b) Post-wellhead costs:

Costs of labour, repairs and maintenance, materials, supplies, fuel and power, property taxes, insurance, etc., in respect of gathering, treating, field transportation, field processing, including cess upto the outlet valve on the lease or field production storage tank, etc.

Accounting for Acquisition, Exploration and Development Costs

14. There are two alternative methods for accounting for acquisition, exploration and development costs, viz.,

(i) Successful Efforts Method (SEM)

(ii) Full Cost Method (FCM)

Successful Efforts Method

Description

15. Under the successful efforts method, generally only those costs that lead directly to the discovery, acquisition, or development of specific, discrete oil and gas reserves are capitalised and become part of the capitalised costs of the cost centre. Costs that are known at the time of incurrence to fail to

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meet this criterion are generally charged to expense in the period they are incurred. When the outcome of such costs is unknown at the time they are incurred, they are recorded as capital work-in-progress and written off when the costs are determined to be non-productive.

Arguments in favour of the Successful Efforts Method

16. *Successful efforts costing reflects the normal concept of an asset.* An asset is an economic resource expected to provide future benefits. The 'Framework for the Preparation and Presentation of Financial Statements', in paragraph 49, defines an 'asset' as follows:

"An *asset* is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise."

17. Paragraphs 88 and 89 of the Framework reproduced below describe, respectively, when an asset is and is not to be recognised in the balance sheet:

"88. An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably.

89. An asset is not recognised in the balance sheet when expenditure has been incurred for which it is considered improbable that economic benefits will flow to the enterprise beyond the current accounting period. Instead, such a transaction results in the recognition of an expense in the statement of profit and loss. This treatment does not imply either that the intention of management in incurring expenditure was other than to generate future economic benefits for the enterprise or that management was misguided. The only implication is that the degree of certainty that economic benefits will flow to the enterprise beyond the current accounting period is insufficient to warrant the recognition of an asset."

18. The Framework defines income (revenue) and expenses in terms of increases or decreases in assets and liabilities. The Framework does not provide for deferrals or accruals of costs or income based on an independently defined notion of profit or loss. Stated another way, the Framework does not provide for smoothing or normalising of earnings by deferring costs that do not meet the definition of an asset. Under the

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successful efforts method, those costs that clearly do not relate to future benefits are not capitalised.

19. *The successful efforts method reflects the volatility that is inherent in exploring for oil and gas reserves.* Those favouring successful efforts accounting argue that this method reflects the inherent risks and volatility that exist in the extractive industries because costs of unsuccessful efforts are charged to expense as they occur. They maintain that the capitalisation of unsuccessful exploratory efforts and their subsequent depreciation as unrelated reserves are produced would result in income smoothing that hides that volatility. Such capitalisation not only distorts the balance sheet by including as assets costs that have no future benefits, it also distorts the statement of profit and loss by deferring to future periods expenses that are incurred in the current period. Income smoothing results in the reporting of an artificial income both when the costs are deferred and throughout the periods of depreciation.

20. *The successful efforts method is consistent with the concept of matching* according to which expenses are recognised in the statement of profit and loss on the basis of a direct association between the costs incurred and the earning of specific items of income. However, the application of the matching concept does not allow the recognition of items in the balance sheet, which do not meet the definition of assets and liabilities.

21. Under the successful efforts method, the propriety of carrying forward costs incurred and subsequently matching them against future revenues depends on whether a specific cost can be identified with specific reserves. If this direct relationship does not exist, the cost should be charged to expense. If a direct association does not exist between a non-productive cost and reserves found and developed, the cost should not be classified as an asset because it is deemed to not provide future benefits in the form of cash flows. Charging non-productive costs to expense is consistent with the Framework – costs that do not result directly in future benefits are properly charged to expense. If costs related to unsuccessful ventures are not charged to expense, both current and future financial statements are distorted because those costs must eventually be removed from the balance sheet and reported in the statement of profit and loss even though they contribute nothing to future revenues.

22. *Successful efforts accounting comes closer than other cost-based accounting methods to reflecting management's successes or failures in its efforts to find new oil and gas reserves.* If costs of unsuccessful exploration

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and development activities are capitalised rather than expensed, and carried forward and combined with costs incurred in prior years and with costs of the current year's successful activities, the efficiency and effectiveness of management is not evaluated in the statement of profit and loss because of the income smoothing that results. Under successful efforts accounting, this income smoothing is greatly reduced or eliminated.

Arguments against the Successful Efforts Method

23. *Under the successful efforts method, the statement of profit and loss can give a false impression of performance in terms of success in finding new oil and gas reserves because of the effect of decisions to expand or curtail exploration expenditure.* A reduction in exploration expense resulting from the curtailment of likely exploration would increase reported net profit in the years in which the exploration is cut back, even though because of the cutback in exploration few or no new reserves are added. The cutback in reserve additions and the continuation of production results in a depletion of the enterprise's reserves, the source of its future profits and its long-run success. On the other hand, an enterprise with an outstanding exploration programme may increase its expenditures for exploration. This would almost certainly increase the current charges to expense for unsuccessful exploration efforts, reducing reported profit, even though the increased exploration may result in the addition of many new reserves that will produce future profits. Those who favour successful efforts accounting reply to this argument by observing that the goal of accounting is to reflect faithfully economic events. If management curtails exploration, this will be reflected in the financial statements under successful efforts accounting. Proponents of successful efforts accounting argue that perhaps, supplemental information about reserve quantities and value is needed to indicate success or failure of exploration activity.

24. *Because of the charge-off of unsuccessful pre-production costs, successful efforts accounting often results in an understatement of assets and net income of a growing enterprise that has a successful and increasing exploration programme.* In future years, when the exploration programme has stabilised or is actually decreasing, the deductions for unsuccessful projects will decrease or will become stable, resulting in higher reported net income. The understatement of income during the early years of the enterprise's activities may make it difficult to secure funds from either equity issues or borrowings.

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25. *The successful efforts method assesses success or failure too early in a project.* Success or failure of exploration projects usually cannot be measured until the exploration activities are completed, which may involve many years. In the intervening years, decisions must be made about costs to be charged to expense and costs to be capitalised. These decisions are often subjective until the ultimate outcome is known, and different individuals will assess the same circumstances differently. This subjectivity from incomplete knowledge will result in different reported net income depending on the judgement of those making the assessment.

26. *The successful efforts method fails to recognise that in an E&P enterprise, management makes its plans and allocates resources to its search for new reserves on an enterprise-wide basis.* The successful efforts method forces the costs of unsuccessful projects to be expensed even though they are an expected part of an exploration programme. The goal of exploration is to add new reserves and management knows that there will be failures in the process of attaining this goal. Management realises that costs of the failures must be offset by the results from successful ventures. Thus, they argue, costs of unsuccessful pre-production projects should be viewed as part of the cost of reserves obtained through successful exploration projects. Some argue that successful efforts accounting fails to recognise that all pre-production costs are incurred to find and develop whatever reserves result from pre-production activities.

Full Cost Method

Description

27. Under the full cost method, all costs incurred in prospecting, acquiring mineral interests, exploration, and development, are accumulated in large cost centres that may not be related to geological factors. The cost centre, under this method, is not normally smaller than a country except where warranted by major difference in economic, fiscal or other factors in the country. The capitalised costs of each cost centre are depreciated as the reserves in each cost centre are produced.

Arguments in favour of the Full Cost Method

28. *The full cost method reflects the way in which enterprises search for, acquire, and develop mineral resources.* These activities are carried out in diverse locations, using various techniques and it is accepted that some projects will not result directly in the addition of reserves. However, it is

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planned that the value added by the successful ventures in a cost centre will be greater than the losses resulting from unsuccessful ventures in that cost centre and will result in an overall profit in the long term. Under the full cost method, all costs incurred at any time and at any place in a cost centre in an attempt to add commercial reserves are an essential part of the cost of any reserves added in that cost centre. As a result they are directly associated with the enterprise's reserves in that centre and all the costs should be treated as part of the cost of the mineral assets in the cost centre.

29. *The full cost method provides better matching of income and expenses.* It is argued that there is a better matching of income and expenses if total costs are depreciated on a pro-rata basis as the total reserves in a large cost centre are produced than there would be if reserves and costs are matched in many small cost centres. In periods when an enterprise using successful efforts accounting incurs large pre-production expenditures in seeking new reserves, those costs that do not result in new reserves will be charged to expense, reducing profit and possibly resulting in a loss. The variability in profit resulting from changes in the expensing of pre-production costs are eliminated under the full cost method.

30. *The full cost method is like absorption costing for manufactured inventories.* Oil and gas reserves are similar to a long-term inventory item. Generally, inventories are accounted for on an absorption cost basis. The costs related to unsuccessful efforts are very similar to normal recurring spoilage occurring in manufacturing operations. It is customary to treat normal spoilage costs as part of the cost of the good units manufactured.

31. *The full cost method avoids distortions of reported earnings.* Users of financial statements in the E&P industry are interested primarily in earnings and changes in earnings from year to year. It is argued that, if successful efforts accounting is used, distortions are caused by expensing unsuccessful efforts to find and develop new reserves, which may vary widely from year to year. Under the full cost method, these annual 'distortions' of income resulting from expensing the charges for unsuccessful pre-production activities are eliminated.

Arguments against the Full Cost Method

32. *Under the full cost method, many costs that are capitalised fail to meet the definition of 'asset' under the 'Framework for the Preparation and Presentation of Financial Statements'.* Unsuccessful prospecting costs, unsuccessful exploration costs, the costs of properties that contain no oil and

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gas reserves, and many other costs that will be capitalised are known to provide no future economic benefits. They will not contribute to the production of goods or services to be sold by the enterprise, they cannot be exchanged for other assets, they cannot be used to settle a liability, and they cannot be distributed to the owners of the enterprise. Further, Accounting Standard (AS) 2, 'Valuation of Inventories', requires that "abnormal amounts of wasted materials, labour, or other production costs" should be excluded from the cost of inventories and recognised as expenses in the period in which they are incurred (paragraph 13).

33. *The full cost method delays loss recognition.* Expenses should be reported on a timely basis. Costs that do not result directly in future benefits are costs that are properly charged to expense. Capitalising such costs results in deferring the effects of expenses.

34. *The full cost method impedes measurement of the efficiency and effectiveness of the enterprise's exploration and development activities.* Costs of unsuccessful activities are treated in the same way as successful activities and are matched against future revenues from all of the enterprise's successful exploration and development activities. In any given year, management may conduct exploration and development activities that are completely unsuccessful, yet the statement of profit and loss would not reveal this fact.

Recommendation

35. On an overall consideration, the advantages of the successful efforts method far outweigh its disadvantages particularly keeping in view its conceptual superiority over the full cost method. Accordingly, the successful efforts method is recommended to be the preferred method, though an enterprise is permitted to follow the full cost method. The application of these methods is discussed hereinafter.

Application of Successful Efforts Method

36. Under the successful efforts method, in respect of a cost centre, the following costs should be treated as capital work-in-progress when incurred:

- (i) All acquisition costs;
- (ii) Exploration costs referred to in paragraph 9 (iv) and (v); and
- (iii) All development costs.

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37. All costs other than the above should be charged as expense when incurred.

38. When a well is ready to commence commercial production, the costs referred to in paragraph 36 (ii) and (iii) corresponding to proved developed oil and gas reserves should be capitalised as 'completed wells' from capital work-in-progress to the gross block of assets. With respect to costs referred to in paragraph 36 (i), the entire cost should be capitalised from capital work-in-progress to the gross block of assets. There is a rebuttable presumption that a well is ready to commence commercial production within two years from the establishment of proved developed oil and gas reserves. If the well is not ready for commercial production within the aforesaid period, the relevant costs included in capital work-in-progress should be capitalised on the expiry of the aforesaid period of two years.

39. If the cost of drilling exploratory well relates to a well that is determined to have no proved reserves, then such costs net of any salvage value are transferred from capital work-in-progress and charged as expense as and when its status is decided as dry or of no further use. Costs of exploratory wells-in-progress should not be carried over for more than a period of two years from the date of completion of drilling unless it could be reasonably demonstrated that the well has proved reserves and development of the field in which the well is located has been planned with required capital investment such as development wells, pipelines, etc., in which case the costs of the exploratory well can be carried forward without any time limit.

Depreciation (Depletion)

40. Depreciation (Depletion) is calculated, using the unit of production method. The application of this method results in oil and gas assets being written off at the same rate as the quantitative depletion of the related reserve. For the properties or groups of properties containing both oil reserves and gas reserves, the units of oil and gas used to compute depletion are converted to a common unit of measure on the basis of their approximate relative energy content, without considering their relative sales values (general approximation is 1000 cubic meters of gas is equivalent to 1 metric tonne of oil). Unit-of-production depletion rates are revised whenever there is an indication of the need for revision but at least once a year. These revisions are accounted for prospectively as changes in accounting estimates, i.e., a change in the estimate affects the current and future periods, but no adjustment is made in the accumulated depletion applicable to prior periods.

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41. The depreciation charge or the UOP charge for the acquisition cost within a cost centre is calculated as under:

$$\text{UOP charge for the period} = \text{UOP rate} \times \text{Production for the period}$$

$$\text{UOP rate} = \frac{\text{Acquisition cost of the cost centre}}{\text{Proved Oil and Gas Reserves}}$$

42. The depreciation charge or the Unit of Production (UOP) charge for all capitalised costs excluding acquisition cost within a cost centre is calculated as under:

$$\text{UOP charge for the period} = \text{UOP rate} \times \text{Production for the period}$$

$$\text{UOP rate} = \frac{\text{Depreciation base of the cost centre}}{\text{Proved Developed Oil and Gas Reserves}}$$

43. Depreciation base of the cost centre should include

- (a) Gross block of the cost centre (excluding acquisition costs)
- (b) Estimated dismantlement and abandonment costs net of estimated salvage values pertaining to proved developed oil and gas reserves

and should be reduced by the accumulated depreciation and any accumulated impairment charge of the cost centre.

44. 'Proved Oil and Gas Reserves' for the purpose of paragraph 41 comprise proved oil and gas reserves estimated at the end of the period as increased by the production during the period. 'Proved Developed Oil and Gas Reserves' for the purpose of paragraph 42 comprise proved developed oil and gas reserves estimated at the end of the period as increased by the production during the period. Additional reserves from advanced recovery techniques are to be considered as proved developed oil and gas reserves only after the required investments have been capitalised.

Application of Full Cost Method

45. Under the full cost method, in respect of a cost centre, the following costs should be treated as capital work-in-progress when incurred:

- (i) All acquisition costs;

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- (ii) All exploration costs; and
- (iii) All development costs.

46. All costs other than the above should be charged as expense when incurred.

47. When any well in a cost centre is ready to commence commercial production, the costs referred to in paragraph 45 above corresponding to all the proved oil and gas reserves in that cost centre should be capitalised from capital work-in-progress to the gross block of assets. In respect of oil and gas reserves proved subsequently, the capital work-in-progress corresponding to such reserves should be capitalised at the time when the said reserves are proved. The expenditure which does not result in discovery of proved oil and gas reserves should be transferred from capital work-in-progress to the gross block of assets as and when so determined.

Depreciation (Depletion)

48. The depreciation should be calculated on the capitalised cost according to the unit of production method as explained in paragraph 40 above. In case of full cost method, the depreciation charge or the unit of production (UOP) charge for all costs within a cost centre is calculated as under:

$$\text{UOP charge for the period} = \text{UOP rate} \times \text{Production for the period}$$

$$\text{UOP rate} = \frac{\text{Depreciation base of the cost centre}}{\text{Proved Oil and Gas Reserves}}$$

49. The depreciation base of the cost centre should include

- (a) Gross block of the cost centre;
- (b) The estimated future expenditure (based on current costs) to be incurred in developing the proved oil and gas reserves referred to in paragraph 50;
- (c) Estimated dismantlement and abandonment costs net of estimated salvage values for facilities set up for developing the proved oil and gas reserves referred to in paragraph 50;

and should be reduced by the accumulated depreciation and any accumulated impairment charge of the cost centre.

50. 'Proved Oil and Gas Reserves' for this purpose comprise developed and undeveloped oil and gas reserves estimated at the end of the period as increased by the production during the period.

Accounting for Production Costs

51. Production costs, mentioned in paragraph 13 above, become part of the cost of oil and gas produced, along with depreciation (depletion) of capitalised acquisition, exploration and development costs.

Accounting for Cost of Support Equipment and Facilities

52. The cost of acquiring or constructing support equipment and facilities used in E&P activities should be capitalised in accordance with Accounting Standard (AS) 10, 'Accounting for Fixed Assets'. Depreciation on such equipment and facilities should be arrived at in accordance with Accounting Standard (AS) 6, 'Depreciation Accounting', and accounted for as exploration cost, development cost or production cost, as may be appropriate.

Accounting for Abandonment Costs

53. Abandonment costs are the costs incurred on discontinuation of all operations and surrendering the property back to the owner. These costs relate to plugging and abandoning of wells, dismantling of wellheads, production and transport facilities and to restoration of producing areas in accordance with license requirements and the relevant legislation.

54. The full eventual liability for abandonment cost net of salvage values should be recognised at the outset on the ground that a liability to remove an installation exists the moment it is installed. Thus, an enterprise should capitalise as part of the cost centre the amount of provision required to be created for subsequent abandonment. Charge for abandonment costs should not be discounted to its present value. The provision for estimated abandonment costs should be made at current prices considering the environment and social obligations, terms of mining lease agreement, industry practice, etc.

55. No gain or loss should be recognised if only an individual well or individual item of equipment is abandoned as long as the remainder of the wells in the cost centre continue to produce oil or gas. Instead, the asset

being abandoned be deemed to be fully depreciated. When the last well on the cost centre ceases to produce and the entire cost centre is abandoned, gain or loss should be recognised.

Capitalisation of Borrowing Costs

56. Capitalisation of borrowing costs under the full cost method as well as the successful efforts method should be carried out in accordance with the Accounting Standard (AS) 16, 'Borrowing Costs'. For the purpose of AS 16, all the costs that are classified under capital work-in-progress should be considered as the qualifying asset.

Impairment of Assets

57. Accounting Standard (AS) 28, 'Impairment of Assets', is applicable to E&P enterprises irrespective of the method of accounting used. For the purpose of AS 28, each cost centre used for depreciation (depletion) purposes should be treated as a Cash Generating Unit.

Accounting for Interests in Joint Ventures

58. Many E&P enterprises enter into joint venture agreements for oil and gas exploration, development and production. In case of such arrangements, the accounting principles prescribed in Accounting Standard (AS) 27, 'Financial Reporting of Interests in Joint Ventures', should be applied.

Changes in Accounting Policies

59. An enterprise may change the method of accounting from full cost method to successful efforts method. The change in the method of accounting should be carried out with retrospective effect. Such a change is treated as a change in accounting policy and should be accounted for in accordance with Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

60. When a change in the method of accounting is made, the effect thereof is calculated in accordance with the new method as if the enterprise was always following the new method. The resulting deficiency/surplus should be charged/credited to the statement of profit and loss in the year in which the method of accounting is changed.

Disclosure

61. An E&P enterprise should disclose the following in its financial statements:

- (i) The method of accounting followed.
- (ii) Net quantities of an enterprise's interests in proved reserves and proved developed reserves of (a) oil (including condensate and natural gas liquids) and (b) gas as at the beginning and additions, deductions, production and closing balance for the year.
- (iii) Net quantities of an enterprise's interest in proved reserves and proved developed reserves of (a) oil and (b) gas should also be disclosed on the geographical basis.
- (iv) The reporting of reserve quantities should be stated in metric tonnes for oil reserves and cubic meters for gas reserves.

Appendix

Glossary

1. Abandon

To discontinue attempts to produce oil and gas from a mining lease area or a well and to plug the reservoir in accordance with regulatory requirements and salvage all recoverable equipments.

2. Appraisal Well

A well drilled as part of an appraisal drilling programme, which is carried out to determine the physical extent of oil and gas reserves and likely production rate of a field.

3. Block

A defined area for purposes of licensing or leasing to an enterprise or enterprises for exploration, development and production rights.

4. Bottom-Hole Contributions

Money or property paid to an operator for use in drilling a well on property in which the payer has no property interest. The contributions are payable when the well reaches a pre-determined depth, regardless of whether the well is productive or non-productive. The payer may receive proprietary information on the well's potential productivity.

5. Condensate

Low vapour pressure hydrocarbons obtained from Natural Gas through condensation or extraction and refer solely to those hydrocarbons that are liquid at normal surface temperature and pressure conditions.

6. Dry Hole

A well, which has proved to be non-productive.

7. Dry Hole Contribution

A contribution made by one enterprise to costs incurred by another enterprise that is drilling a nearby well to obtain information from the

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enterprise drilling the well; the contribution is made when the well is complete and is found to be unsuccessful.

8. Geological and Geophysical Studies

Processes which seek surface or subterranean indications of earth structure or formation where experience has shown the possibility of existence of mineral deposits.

9. Geological Survey

An exploratory programme directed to examination of rock and sediments obtained by boring or drilling, or by inspection of surface outcroppings.

10. Geophysical Survey

A study of the configuration of the earth's crust in a given area, as determined by the use of seismic, gravity, magnetic and geo-chemical procedures.

11. Mining Lease

The license issued for offshore and onshore properties for conducting development and production activity.

12. Natural Gas Liquids (NGL)

Hydrocarbons (primarily ethane, propane, butane and natural gasoline) which can be extracted from wet natural gas and become liquid under various combinations of increasing pressure and lower temperature.

13. Petroleum Exploration License

The license issued for offshore and onshore properties for conducting exploration activity.

14. Support Equipment and Facilities

Equipment and facilities of the nature of service units, camp facilities, godowns (for stores and spares), workshops (for equipment repairs), transport services (trucks and helicopters), catering facilities and drilling and seismic equipment.

15. Work-Over

Remedial work to the equipment within a well, the well pipework or relating to attempts to increase the rate of flow.

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Guidance Note on Accounting for Employee Share-based Payments

Foreword


In today's modern business world, human capital has become one of the most important resources. The enterprises are, therefore, more than ever interested not only in retaining their employees but also for attracting the best talent from outside. This has led to the enterprises adopting non-traditional methods of making payments to their employees. Employee share-based payment is one of such methods, the use of which has increased significantly during recent times. Now-a-days, not only more and more enterprises are adopting this method of compensating their employees but also such payments, once thought of as a perquisite only for top executives, is percolating down the line in the organisation. Emergence of share-based payment as an important means of employee compensation has also generated heated debate on the manner of accounting for such payments. In this scenario, a need was being felt, all over the world, for laying down sound accounting principles for all types of employee share-based payments.

I am happy to note that the Research Committee, realising the need for accounting for employee share-based compensation in India, has formulated this Guidance Note on Accounting for Employee Share-based Payments. The Guidance Note provides extensive guidance on accounting for various aspects of such payments.

I wish to place on record my deep appreciation of Shri Anuj Goyal, Chairman, Research Committee, Officers of the Technical Directorate and various interest groups who have made invaluable contribution in the finalisation of this Guidance Note.

I am confident that this Guidance Note will be immensely useful not only to the members but also to others concerned.

New Delhi
January 3, 2005


Sunil Goyal
President

Preface

Employee share-based payments generally involve grant of shares or stock options to the employees at a concessional price or a future cash payment based on the increase in the price of the shares from a specified level. Such payments are known with a variety of names. In any case, these payments now-a-days constitute an important part of the overall remuneration package of the employees, in various industries. The basic objective of such payments is to compensate employees for their services and/or to provide an incentive to the employees for remaining in the employment of the enterprise and for improving their performance. In this scenario, the issue of recognition and measurement of services received under an employee share-based payment plan assumes great significance. To provide guidance on this issue as well as on other related issues, the Research Committee has formulated this Guidance Note on Accounting for Employee Share-based Payments.

The Guidance Note recognises that there are two methods of accounting for employee share-based payments, viz., the fair value method and the intrinsic value method and permits the enterprises to use either of the two methods for accounting for such payments. However, an enterprise using the intrinsic value method is required to make extensive fair value disclosures. The Guidance Note is a comprehensive document that deals with various significant aspects of such plans including those related to performance conditions, modifications to the terms and conditions of the grant of shares or stock options, reload feature, cash-settled employee share-based payment plans, employee share-based payment plans with cash alternatives, graded vesting, earnings-per-share implications, accounting for employee share-based payments administered through a trust, etc. The Guidance Note also recommends detailed disclosure requirements. The appendices to the Guidance Note provide detailed guidance on measurement of fair value of shares and stock options, including determination of various inputs to the option-pricing models and examples to illustrate application of various principles recommended in the Guidance Note.

I would like to take this opportunity to place on record my deep appreciation of the efforts put in by Shri Abizer Diwanji and Shri Harshu Ghate, two experts in the area, who contributed in the preparation of the basic draft of the Guidance Note. I am also thankful to various interest groups for giving their invaluable comments and suggestions during the preparation of the

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Guidance Note. My thanks are also due to Shri S.C. Vasudeva, my esteemed colleague on the Research Committee and the Central Council, for his invaluable support and contribution in the finalisation of the Guidance Note. I would also like to thank all other members of the Research Committee, namely, Shri V. Murali (Vice-Chairman), Shri Sunil Goyal (President), Shri K.S. Vikamsey (Vice-President), Shri Abhijit Bandyopadhyay, Shri Charanjot Singh Nanda, Shri Harinderjit Singh, Shri Pawan Kumar Sharma, Shri Rajkumar S. Adukia, Shri Akhilesh Ranjan, Shri Sidharth Kumar Birla and members co-opted on the Committee for their suggestions and inputs.

I sincerely compliment Dr. Avinash Chander, Technical Director, Ms. Anuradha Jain, Secretary to the Research Committee, and Shri Vishal Bansal, Sr. Technical Officer, for their invaluable contribution and efforts at various stages of the finalisation of the Guidance Note.

I am confident that this Guidance Note will go a long way in establishing best accounting practices in respect of accounting for employee share-based payment plans and will be useful to the members and others concerned.



New Delhi
January 3, 2005

Anuj Goyal
Chairman
Research Committee

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Guidance Note on Accounting for Employee Share-based Payments*

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

Introduction

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

2. Recognising the need for establishing uniform sound accounting principles and practices for all types of share-based payments, the Accounting Standards Board of the Institute of Chartered Accountants of India is developing an Accounting Standard covering various types of share-

* Guidance Note on Accounting for Employee Share-based Payments incorporates limited revision made pursuant to the decision taken at the 267th meeting of the Council held on March 12-14, 2007 at New Delhi. An announcement in this regard was placed on March 29, 2007 on the website of the Institute and published in the May, 2007 issue of 'The Chartered Accountant'. Accordingly, paras 42A & 42B have been added and Appendix VI has been revised subsequent to the above announcement of the Institute.

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based payments including employee share-based payments. However, as the formulation of the Standard is likely to take some time, the Institute has decided to bring out this Guidance Note. The Guidance Note recognises that there are two methods of accounting for employee share-based payments, viz., the fair value method and the intrinsic value method and permits as an alternative the intrinsic value method with fair value disclosures. Once the Accounting Standard dealing with Share-based Payments comes into force, this Guidance Note will automatically stand withdrawn.

Scope

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

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

5. For the purposes of this Guidance Note, a transaction with an employee in his/her capacity as a holder of shares of the enterprise is not an employee share-based payment. For example, if an enterprise grants all holders of a particular class of its shares the right to acquire additional shares or stock options of the enterprise at a price that is less than the fair value of those shares or stock options, and an employee receives such a right because he/she is a holder of shares or stock options of that particular class, the granting or exercise of that right is not subject to the requirements of this Guidance Note.

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

¹ A 'Group' is a parent and all its subsidiaries.

Accounting for Employee Share-based Payments

grants shares to its employees as a preferential allotment while the price and other terms remain the same as those to other investors.

Definitions

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

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

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

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

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

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

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

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

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

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

Grant Date is the date at which the enterprise and its employees agree to the terms of an employee share-based payment plan. At grant date, the enterprise confers on the employees the right to cash or shares of the enterprise, provided the specified vesting conditions, if any, are met. If that

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agreement is subject to an approval process, (for example, by shareholders), grant date is the date when that approval is obtained.

Intrinsic Value is the amount by which the quoted market price of the underlying share in case of a listed enterprise or the value of the underlying share determined by an independent valuer in case of an unlisted enterprise, exceeds the exercise price of an option.

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

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

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

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

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

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

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

Vesting Conditions are the conditions that must be satisfied for the employee to become entitled to receive cash, or shares of the enterprise, pursuant to an employee share-based payment plan. Vesting conditions

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include service conditions, which require the employee to complete a specified period of service, and performance conditions, which require specified performance targets to be met (such as a specified increase in the enterprise's share price over a specified period of time).

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

Accounting

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

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

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

Equity-settled Employee Share-based Payment Plans

Recognition

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

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

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

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

Determination of vesting period

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

14. There might be performance conditions that must be satisfied, such as the enterprise achieving a specified growth in profit or a specified increase in the share price of the enterprise. Thus, if an employee is granted stock options conditional upon the achievement of a performance condition and remaining in the employment of the enterprise until that performance condition is satisfied, and the length of the vesting period varies depending on when that performance condition is satisfied, the enterprise should presume that the services to be rendered by the employee as consideration for the stock options will be received in the future, over the expected vesting period. The enterprise should estimate the length of the expected vesting period at grant date, based on the most likely outcome of the performance

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condition. If the performance condition is a market condition, the estimate of the length of the expected vesting period should be consistent with the assumptions used in estimating the fair value of the options granted, and should not be subsequently revised. If the performance condition is not a market condition, the enterprise should revise its estimate of the length of the vesting period, if necessary, if subsequent information indicates that the length of the vesting period differs from previous estimates.

Measurement

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

Determining the fair value of shares or stock options granted

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

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model for valuing stock options) and should incorporate all factors and assumptions that knowledgeable, willing market participants would consider in setting the price (subject to the requirements of paragraphs 18 to 21).

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

Treatment of vesting conditions

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

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

20. Market conditions, such as a target share price upon which vesting (or exercisability) is conditioned, should be taken into account when estimating the fair value of the shares or stock options granted. Therefore, for grants of shares or stock options with market conditions, the enterprise should recognise the services received from an employee who satisfies all

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

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other vesting conditions (e.g., services received from an employee who remains in service for the specified period of service), irrespective of the fact whether that market condition is satisfied.

Treatment of a reload feature

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

After vesting date

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

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

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

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

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

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In addition, the enterprise should recognise the effects of modifications that increase the total fair value of the employee share-based payment plan or are otherwise beneficial to the employee.

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

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

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of the shares or stock options originally granted, which is recognised over the remainder of the original vesting period.

- (c) If the enterprise modifies the vesting conditions in a manner that is beneficial to the employee, for example, by reducing the vesting period or by modifying or eliminating a performance condition (other than a market condition, changes to which are accounted for in accordance with (a) above), the enterprise should take the modified vesting conditions into account when applying the requirements of paragraphs 18 to 20.

26. Furthermore, to apply the requirements of paragraph 24, if the enterprise modifies the terms or conditions of the shares or stock options granted in a manner that reduces the total fair value of the employee share-based payment plan, or is not otherwise beneficial to the employee, the enterprise should nevertheless continue to account for the services received as consideration for the shares or stock options granted as if that modification had not occurred (other than a cancellation of some or all the shares or stock options granted, which should be accounted for in accordance with paragraph 27). For example:

- (a) if the modification reduces the fair value of the shares or stock options granted, measured immediately before and after the modification, the enterprise should not take into account that decrease in fair value and should continue to measure the amount recognised for services received as consideration for the shares or stock options based on the grant date fair value of the shares or stock options granted.
- (b) if the modification reduces the number of shares or stock options granted to an employee, that reduction should be accounted for as a cancellation of that portion of the grant, in accordance with the requirements of paragraph 27.
- (c) if the enterprise modifies the vesting conditions in a manner that is not beneficial to the employee, for example, by increasing the vesting period or by modifying or adding a performance condition (other than a market condition, changes to which are accounted for in accordance with (a) above), the enterprise should not take the modified vesting conditions into account when applying the requirements of paragraphs 18 to 20.

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27. If the enterprise cancels or settles a grant of shares or stock options during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied):

- (a) the enterprise should account for the cancellation or settlement as an acceleration of vesting, and should therefore recognise immediately the amount that otherwise would have been recognised for services received over the remaining vesting period.
- (b) any payment made to the employee on the cancellation or settlement of the grant should be deducted from the relevant equity account (e.g., Stock Options Outstanding Account) except to the extent that the payment exceeds the fair value of the shares or stock options granted, measured at the cancellation/settlement date. Any such excess should be recognised as an expense.
- (c) if new shares or stock options are granted to the employee as replacement for the cancelled shares or stock options, the enterprise should account for the granting of replacement shares or stock options in the same way as a modification of the original grant of shares or stock options, in accordance with paragraphs 24 to 26. For the purposes of the aforesaid paragraphs, the incremental fair value granted is the difference between the fair value of the replacement shares or stock options and the net fair value of the cancelled shares or stock options, at the date the replacement shares or stock options are granted. The net fair value of the cancelled shares or stock options is their fair value, immediately before the cancellation, less the amount of any payment made to the employee on cancellation of the shares or stock options that is deducted from the relevant equity account in accordance with (b) above.

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

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

Cash-settled Employee Share-based Payment Plans

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

Recognition

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

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

Measurement

32. For cash-settled employee share-based payment plan, the enterprise should measure the services received and the liability incurred at the fair value of the liability. Until the liability is settled, the enterprise should

remeasure the fair value of the liability at each reporting date and at the date of the settlement, with any changes in fair value recognised in profit or loss for the period.

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

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

Employee Share-based Payment Plans with Cash Alternatives

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

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

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

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

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

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

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

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

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

- (a) If the enterprise elects to settle in cash, the cash payment should be accounted for as a deduction from the relevant equity account (e.g., Stock Options Outstanding Account) except as noted in (c) below.

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- (b) If the enterprise elects to settle by issuing shares, the balance in the relevant equity account should be treated as consideration for the shares issued except as noted in (c) below.
- (c) If the enterprise elects the settlement alternative with the higher fair value (e.g., the enterprise elects to settle in cash the amount of which is more than the fair value of the shares had the enterprise elected to settle in shares), as at the date of settlement, the enterprise should recognise an additional expense for the excess value given, i.e., the difference between the cash paid and the fair value of the shares that would otherwise have been issued, or the difference between the fair value of the shares issued and the amount of cash that would otherwise have been paid, whichever is applicable.

Intrinsic Value Method

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

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

Recommendation

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

Graded Vesting

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

42A. As an alternative to the accounting treatment specified in paragraph 42, in case the options/shares are granted under graded vesting plan with only service conditions, an enterprise has an option to recognise the share-based compensation cost on a straight-line basis over the requisite service period for the entire award (i.e., over the requisite service period of the last separately vesting portion of the award). However, the amount of compensation cost recognised at any date must at least equal the portion of the grant-date value of the award that is vested at that date.

42B. An enterprise should make a policy decision as to whether to follow the accounting treatment specified in paragraph 42 or paragraphs 42A.

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

Employee Share-based Payment Plan Administered through a Trust

43. An enterprise may administer an employee share-based payment

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plan through a trust constituted for this purpose. The trust may have different kinds of arrangements, for example, the following:

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

44. Since the trust administers the plan on behalf of the enterprise, it is recommended that irrespective of the arrangement for issuance of the shares under the employee share-based payment plan, the enterprise should recognise in its separate financial statements the expense on account of services received from the employees in accordance with the recommendations contained in this Guidance Note. Various aspects of accounting for employee share-based payment plan administered through a trust under the arrangements mentioned above, are illustrated in Appendix VII, for the purpose of preparation of separate financial statements.

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

Earnings Per Share Implications

46. For the purpose of calculating Basic Earnings Per Share as per Accounting Standard (AS) 20, 'Earnings Per Share', shares or stock options granted pursuant to an employee share-based payment plan, including shares or options issued to an ESOP trust, should not be included in the shares outstanding till the employees have exercised their right to obtain

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shares or stock options, after fulfilling the requisite vesting conditions. Till such time, shares or stock options so granted should be considered as dilutive potential equity shares for the purpose of calculating Diluted Earnings Per Share. Diluted Earnings Per Share should be based on the actual number of shares or stock options granted and not yet forfeited, unless doing so would be anti-dilutive.

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

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

Disclosures

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

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

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

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

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- (b) the number and weighted average exercise prices of stock options for each of the following groups of options:
 - (i) outstanding at the beginning of the period;
 - (ii) granted during the period;
 - (iii) forfeited during the period;
 - (iv) exercised during the period;
 - (v) expired during the period;
 - (vi) outstanding at the end of the period; and
 - (vii) exercisable at the end of the period.
- (c) for stock options exercised during the period, the weighted average share price at the date of exercise. If options were exercised on a regular basis throughout the period, the enterprise may instead disclose the weighted average share price during the period.
- (d) for stock options outstanding at the end of the period, the range of exercise prices and weighted average remaining contractual life (comprising the vesting period and the exercise period). If the range of exercise prices is wide, the outstanding options should be divided into ranges that are meaningful for assessing the number and timing of additional shares that may be issued and the cash that may be received upon exercise of those options.

51. An enterprise should disclose the following information to enable users of the financial statements to understand how the fair value of shares or stock options granted, during the period, was determined:

- (a) for stock options granted during the period, the weighted average fair value of those options at the grant date and information on how that fair value was measured, including:
 - (i) the option pricing model used and the inputs to that model, including the weighted average share price, exercise price, expected volatility, option life (comprising the vesting period and the exercise period), expected dividends, the risk-free interest rate and any other inputs to the model, including the method used and the assumptions made to incorporate the effects of expected early exercise;

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- (ii) how expected volatility was determined, including an explanation of the extent to which expected volatility was based on historical volatility; and
 - (iii) whether and how any other features of the option grant were incorporated into the measurement of fair value, such as a market condition.
- (b) for other instruments granted during the period (i.e., other than stock options), the number and weighted average fair value of those instruments at the grant date, and information on how that fair value was measured, including:
 - (i) if fair value was not measured on the basis of an observable market price, how it was determined;
 - (ii) whether and how expected dividends were incorporated into the measurement of fair value; and
 - (iii) whether and how any other features of the instruments granted were incorporated into the measurement of fair value.
- (c) for employee share-based payment plans that were modified during the period:
 - (i) an explanation of those modifications;
 - (ii) the incremental fair value granted (as a result of those modifications); and
 - (iii) information on how the incremental fair value granted was measured, consistently with the requirements set out in (a) and (b) above, where applicable.

52. An enterprise should disclose the following information to enable users of the financial statements to understand the effect of employee share-based payment plans on the profit or loss of the enterprise for the period and on its financial position:

- (a) the total expense recognised for the period arising from employee share-based payment plans in which the services received did not qualify for recognition as a part of the cost of

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an asset and hence were recognised immediately as an expense, including separate disclosure of that portion of the total expense that arises from transactions accounted for as equity-settled employee share-based payment plans;

- (b) for liabilities arising from employee share-based payment plans:
 - (i) the total carrying amount at the end of the period; and
 - (ii) the total intrinsic value at the end of the period of liabilities for which the right of the employee to cash or other assets had vested by the end of the period (e.g., vested stock appreciation rights).

Appendix IX contains illustrative disclosures.

Effective Date

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

Appendix I

Estimating the Fair Value of Shares or Stock Options Granted

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

Shares

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

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

Stock Options

4. For stock options granted to employees, in many cases market prices are not available, because the options granted are subject to terms and

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conditions that do not apply to traded options. If traded options with similar terms and conditions do not exist, the fair value of the options granted should be estimated by applying an option pricing model.

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

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

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

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

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

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

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

Inputs to option pricing models

11. In estimating the expected volatility of and dividends on the underlying shares, the objective is to approximate the expectations that would be reflected in a current market or negotiated exchange price for the option. Similarly, when estimating the effects of early exercise of employee stock options, the objective is to approximate the expectations that an outside party with access to detailed information about employees' exercise behaviour would develop based on information available at the grant date.

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

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

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

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

Expected early exercise

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

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

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

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

20. Separating an option grant into groups for employees with relatively homogeneous exercise behaviour is likely to be important. Option value is not a linear function of option term; value increases at a decreasing rate as the term lengthens. For example, if all other assumptions are equal, although a two-year option is worth more than a one-year option, it is not worth twice as much. That means that calculating estimated option value on the basis of a single weighted average life that includes widely differing

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individual lives would overstate the total fair value of the stock options granted. Separating options granted into several groups, each of which has a relatively narrow range of lives included in its weighted average life, reduces that overstatement.

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

Expected volatility

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

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

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

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

- (a) Implied volatility from traded stock options on the shares of the enterprise, or other traded instruments of the enterprise that include option features (such as convertible debt), if any.
- (b) The historical volatility of the share price over the most recent period that is generally commensurate with the expected term of the option (taking into account the remaining contractual life of the option and the effects of expected early exercise).
- (c) The length of time shares of an enterprise have been publicly traded. A newly listed enterprise might have a high historical volatility, compared with similar enterprises that have been listed longer. Further guidance for newly listed enterprises is given in paragraph 26 of this Appendix.
- (d) The tendency of volatility to revert to its mean, i.e., its long-term average level, and other factors indicating that expected future volatility might differ from past volatility. For example, if share price of an enterprise was extraordinarily volatile for some identifiable period of time because of a failed takeover bid or a major restructuring, that period could be disregarded in computing historical average annual volatility.
- (e) Appropriate and regular intervals for price observations. The price observations should be consistent from period to period. For example, an enterprise might use the closing price for each week or the highest price for the week, but it should not use the closing price for some weeks and the highest price for other weeks.

Newly listed enterprises

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

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pattern and level of historical volatility of enterprises in the same industry for the first six years in which the shares of those enterprises were publicly traded.

Unlisted enterprises

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

Expected dividends

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

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

30. Option pricing models generally call for expected dividend yield. However, the models may be modified to use an expected dividend amount rather than a yield. An enterprise may use either its expected yield or its expected payments. If the enterprise uses the latter, it should consider its historical pattern of increases in dividends. For example, if policy of an

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enterprise has generally been to increase dividends by approximately 3 per cent per year, its estimated option value should not assume a fixed dividend amount throughout the option's life unless there is evidence that supports that assumption.

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

Risk-free interest rate

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

Capital structure effects

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

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

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as on exercising an otherwise similar traded option that does not dilute the share price.

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

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

Appendix II

Equity-settled Employee Share-based Payment Plans

Illustration 1 : Stock Options with Service Condition only

(A) Accounting during the vesting period

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

Vesting Period	3 years
Exercise Period	3 years
Expected Life	5 years
Exercise Price	Rs. 50
Market Price	Rs. 50
Expected forfeitures per year	3%

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

Suggested Accounting Treatment

Year 1

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

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

$$\begin{aligned} \text{Fair value of options expected to vest} \\ = 2,73,802 \text{ options} \times \text{Rs. } 15 = \text{Rs. } 41,07,030 \end{aligned}$$

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

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

(Being compensation expense recognised in respect of the ESOP)

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

Year 2

1. At the end of the financial year, management has changed its estimate of expected forfeiture rate from 3 per cent to 6 per cent per year. The revised number of options expected to vest is 2,49,175 (3,00,000 x .94 x .94). Accordingly, the fair value of revised options expected to vest is Rs. 37,37,625 (2,49,175 x Rs. 15). Consequent to the change in the expected forfeitures, the expense to be recognised during the year are determined as below:

$$\text{Revised total fair value} \qquad \qquad \qquad \text{Rs. } 37,37,625$$

$$\begin{aligned} \text{Revised cumulative expense at the end} \\ \text{of year 2} = (\text{Rs. } 37,37,625 \times 2/3) \qquad \qquad \qquad = \text{Rs. } 24,91,750 \end{aligned}$$

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Expense already recognised in year 1 = Rs. 13,69,010

Expense to be recognised in year 2 = Rs. 11,22,740

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

Employee compensation expense A/c Dr. Rs. 11,22,740
 To Stock Options Outstanding A/c Rs. 11,22,740
(Being compensation expense recognised in respect of the ESOP)

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

Year 3

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

No. of options actually vested = $840 \times 300 = 2,52,000$

Fair value of options actually vested
(Rs. 2,52,000 x Rs. 15) = Rs. 37,80,000

Expense already recognised Rs. 24,91,750

Expense to be recognised in year 3 Rs. 12,88,250

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

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

(Being compensation expense recognised in respect of ESOP)

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

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

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

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

Suggested Accounting Treatment

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

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

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Particulars	Exercise Date	
	Year-end 5	Year-end 6
No. of employees exercising option	200	600
No. of shares issued on exercise @ 300 per employee	60,000	1,80,000
Exercise Price received @ Rs. 50 per share	30,00,000	90,00,000
Corresponding amount recognised in the 'Stock Options Outstanding A/c' @ Rs. 15 per option	9,00,000	27,00,000
<i>Total Consideration</i>	39,00,000	1,17,00,000
Amount to be recorded in 'Share Capital A/c' @ Rs. 10 per share	6,00,000	18,00,000
Amount to be recorded in 'Securities Premium A/c' @ Rs. 55 per share	33,00,000	99,00,000
<i>Total</i>	39,00,000	1,17,00,000

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

Year 5 Bank A/c Dr. Rs. 30,00,000
 Stock Options Outstanding A/c Dr. Rs. 9,00,000
 To Share Capital A/c Rs. 6,00,000
 To Securities Premium A/c Rs. 33,00,000
 (Being shares issued to the employees against the options vested in them in pursuance of the Employee Stock Option Plan)

Year 6 Bank A/c Dr. Rs. 90,00,000
 Stock Options Outstanding A/c Dr. Rs. 27,00,000
 To Share Capital A/c Rs. 18,00,000
 To Securities Premium A/c Rs. 99,00,000
 (Being shares issued to the employees against the options vested in them in pursuance of the Employee Stock Option Plan)

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

Stock Options Outstanding A/c Dr.	Rs. 1,80,000	
To General Reserve		Rs. 1,80,000

(Being the balance standing to the credit of the Stock Options Outstanding Account, in respect of vested options expired unexercised, transferred to the general reserve)

(C) Intrinsic value method

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

Illustration 2: Grant with a Performance Condition, in which the Length of the Vesting Period varies

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

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

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

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

Suggested Accounting Treatment

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

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Particulars	Year 1	Year 2	Year 3
Length of the expected vesting period (at the end of the year)	2 years	3 years	3 years
No. of employees expected to meet vesting conditions	440 employees	417 employees	419 employees
No. of options expected to vest	44,000	41,700	41,900
Fair value of options expected to vest @ Rs. 30 per option (Rs.)	13,20,000	12,51,000	12,57,000
Compensation expense accrued till the end of year (Rs.)	6,60,000 [13,20,000 /2]	8,34,000 (12,51,000 * 2/3)	12,57,000
Compensation expense recognised till the end of previous year (Rs.)	Nil	6,60,000	8,34,000
Compensation expense to be recognised for the year (Rs.)	6,60,000	1,74,000	4,23,000

Illustration 3 : Grant with a Performance Condition, in which the number of Stock Options varies

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

On the grant date, the enterprise estimates that the stock options have a fair value of Rs. 20 per option. The enterprise also estimates that the

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

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

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

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

Suggested Accounting Treatment

Since the number of options varies depending on the outcome of a performance condition that is not a market condition, the effect of that condition (i.e., the possibility that the number of stock options might be 100, 200 or 300) is not taken into account when estimating the fair value of the stock options at grant date. Instead, the enterprise revises the transaction amount to reflect the outcome of that performance condition, as illustrated below.

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

Illustration 4: Grant with a Performance Condition, in which the Exercise Price varies

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

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

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

Suggested Accounting Treatment

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

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

Illustration 5: Grant with a Market Condition

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

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

Suggested Accounting Treatment

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

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

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

Illustration 6: Grant with a Market Condition, in which the Length of the Vesting Period varies

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

The enterprise applies a binomial option pricing model, which takes into account the possibility that the share price target will be achieved during the ten-year life of the options, and the possibility that the target will not be achieved. The enterprise estimates that the fair value of the stock options at grant date is Rs. 25 per option. From the option pricing model, the enterprise determines that the mode of the distribution of possible vesting dates is five years. In other words, of all the possible outcomes, the most likely outcome of the market condition is that the share price target will be achieved at the end of year 5. Therefore, the enterprise estimates that the expected vesting period is five years. The enterprise also estimates that two executives will have left by the end of year 5, and therefore expects that 80,000 stock options (10,000 stock options x 8 executives) will vest at the end of year 5.

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

Suggested Accounting Treatment

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

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

Illustration 7: Employee Share Purchase Plan

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

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

Suggested Accounting Treatment

Paragraph 15 of the text of the Guidance Note provides that the enterprise should measure the fair value of the employee services received by reference to the fair value of the shares or stock options granted. To apply this requirement, it is necessary first to determine the type of instrument granted to the employees. Although the plan is described as an employee stock purchase plan (ESPP), some ESPPs include option features and are therefore, in effect, stock option plans. For example, an ESPP might include a 'lookback feature', whereby the employee is able to purchase shares at a discount, and choose whether the discount is applied to the share price of the enterprise at the date of grant or its share price at the date of purchase. Or an ESPP might specify the purchase price, and then allow the employees a significant period of time to decide whether to participate in the plan. Another example of an option feature is an ESPP that permits the participating employees to cancel their participation before or at the end of a specified period and obtain a refund of amounts previously paid into the plan.

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

Another factor to consider is the effect of post-vesting transfer restrictions, if any. Paragraph 3 of the Appendix I to the Guidance Note states that, if shares are subject to restrictions on transfer after vesting date, that factor should be taken into account when estimating the fair value of those shares, but only to the extent that the post-vesting restrictions affect the price that a knowledgeable, willing market participant would pay for that share. For example, if the shares are actively traded in a deep and liquid market, post-vesting transfer restrictions may have little, if any, effect on the price that a knowledgeable, willing market participant would pay for those shares.

In this example, the shares are vested when purchased, but cannot be sold for five years after the date of purchase. Therefore, the enterprise should consider the valuation effect of the five-year post-vesting transfer restriction. This entails using a valuation technique to estimate what the price of the restricted share would have been on the purchase date in an arm's length transaction between knowledgeable, willing parties. Suppose that, in this example, the enterprise estimates that the fair value of each restricted share is Rs. 28. In this case, the fair value of the instruments granted is Rs. 4 per

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share (being the fair value of the restricted share of Rs. 28 less the purchase price of Rs. 24). Because 64,000 shares were purchased, the total fair value of the instruments granted is Rs. 2,56,000.

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

Appendix III

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

Illustration 1: Grant of Stock Options that are Subsequently Repriced

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

Suppose that 40 employees leave during year 1. Also suppose that by the end of year 1, the share price of the enterprise has dropped, and the enterprise reprices its stock options, and that the repriced stock options vest at the end of year 3. The enterprise estimates that a further 70 employees will leave during years 2 and 3, and hence the total expected employee departures over the three-year vesting period is 110 employees. During year 2, a further 35 employees leave, and the enterprise estimates that a further 30 employees will leave during year 3, to bring the total expected employee departures over the three-year vesting period to 105 employees. During year 3, a total of 28 employees leave, and hence a total of 103 employees ceased employment during the vesting period. For the remaining 397 employees, the stock options vested at the end of year 3.

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

Suggested Accounting Treatment

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

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

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

Year	Calculation	Compensation expense for period (Rs.)	Cumulative compensation expense (Rs.)
1	(500 – 110) employees × 100 options × Rs. 15 × 1/3	1,95,000	1,95,000
2	(500 – 105) employees × 100 options × (Rs. 15 × 2/3 + Rs. 3 × 1/2) – Rs. 1,95,000	2,59,250	4,54,250
3	(500 – 103) employees × 100 options × (Rs. 15 + Rs. 3) – Rs. 4,54,250	2,60,350	7,14,600

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

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

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

Suggested Accounting Treatment

Paragraph 19 of the text of the Guidance Note requires, for a performance condition that is not a market condition, the enterprise to recognise the services received during the vesting period based on the best available estimate of the number of shares or stock options expected to vest and to revise that estimate, if necessary, if subsequent information indicates that the number of shares or stock options expected to vest differs from previous estimates. On vesting date, the enterprise revises the estimate to equal the number of instruments that ultimately vested. However, paragraph 24 of the text of the Guidance Note requires, irrespective of any modifications to the terms and conditions on which the instruments were granted, or a cancellation or settlement of that grant of instruments, the enterprise to recognise, as a minimum, the services received, measured at the grant date fair value of the instruments granted, unless those instruments do not vest because of failure to satisfy a vesting condition (other than a market condition) that was specified at grant date. Furthermore, paragraph 26(c) of the text of this Guidance Note specifies that, if the enterprise modifies the vesting conditions in a manner that is not beneficial to the employee, the enterprise does not take the modified vesting conditions into account when applying the requirements of paragraphs 18 to 20 of the text of the Guidance Note.

Therefore, because the modification to the performance condition made it less likely that the stock options will vest, which was not beneficial to the employee, the enterprise takes no account of the modified performance condition when recognising the services received. Instead, it continues to

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recognise the services received over the three-year period based on the original vesting conditions. Hence, the enterprise ultimately recognises cumulative remuneration expense of Rs. 1,80,000 over the three-year period (12 employees × 1,000 options × Rs. 15).

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

Appendix IV

Cash-settled Employee Share-based Payment Plans

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

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

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

Year	Fair Value	Intrinsic Value
1	Rs. 15.30	
2	Rs. 16.50	
3	Rs. 19.20	Rs. 16.00
4	Rs. 21.30	Rs. 21.00
5		Rs. 26.00

Suggested Accounting Treatment

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

Year 1

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

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

Provision required at the year-end

$$2,73,802 \text{ SARs} \times \text{Rs. } 15.30 \times 1/3 = \text{Rs. } 13,96,390$$

Less: provision at the beginning of the year Nil

Expense for the year Rs. 13,96,390

Year 2

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

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

Provision required at the year-end

$$2,49,175 \text{ SARs} \times \text{Rs. } 16.50 \times 2/3 = \text{Rs. } 27,40,925$$

Less: provision at the beginning of the year Rs. (13,96,390)

Expense for the year Rs. 13,44,535

Year 3

No. of SARs actually vested

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

No. of SARs exercised at the year-end

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

No. of SARs outstanding at the year-end 1,32,000 SARs

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

$$1,32,000 \text{ SARs} \times \text{Rs. } 19.20 = \text{Rs. } 25,34,400$$

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Plus: Cash paid on exercise of SARs by employees

1,20,000 SARs x Rs. 16.00 = Rs. 19,20,000

Total Rs. 44,54,400

Less: provision at the beginning of the year Rs. (27,40,925)

Expense for the year Rs. 17,13,475

Year 4

No. of SARs outstanding at the beginning

of the year 1,32,000 SARs

No. of SARs exercised at the year-end

300 employees x 300 SARs 90,000 SARs

No. of SARs outstanding at the year-end 42,000 SARs

Provision required in respect of SARs outstanding

at the year-end

42,000 SARs x Rs. 21.30 = Rs. 8,94,600

Plus: Cash paid on exercise of SARs

90,000 SARs x Rs. 21.00 = Rs. 18,90,000

Total Rs. 27,84,600

Less: provision at the beginning of the year Rs. (25,34,400)

Expense for the year Rs. 2,50,200

Year 5

No. of SARs outstanding at the beginning of the

year 42,000 SARs

No. of SARs exercised at the year-end

140 employees x 300 SARs 42,000 SARs

No. of SARs outstanding at the year-end Nil

Provision required in respect of SARs outstanding at

the year-end Nil

Plus: Cash paid on exercise of SARs

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42,000 SARs x Rs. 26.00 =	<u>Rs. 10,92,000</u>
<i>Total</i>	Rs. 10,92,000
Less: provision at the beginning of the year	<u>Rs. (8,94,600)</u>
Expense for the year	<u>Rs. 1,97,400</u>

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

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

(Being compensation expense recognised in respect of SARs)

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

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

(Being cash paid on exercise of SARs)

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

Intrinsic Value Method

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

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Year	Intrinsic Value
1	Rs. 9.00
2	Rs. 12.00
3	Rs. 16.00
4	Rs. 21.00
5	Rs. 26.00

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

Year 1

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

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

Provision required at the year-end

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

Less: provision at the beginning of the year Nil

Expense for the year Rs. 8,21,406

Year 2

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

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

Provision required at the year-end

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

Less: provision at the beginning of the year Rs. (8,21,406)

Expense for the year Rs. 11,71,994

Year 3

No. of SARs actually vested

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

No. of SARs exercised at the year-end

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400 employees x 300 SARs	<u>1,20,000 SARs</u>
No. of SARs outstanding at the year-end	<u>1,32,000 SARs</u>
Provision required in respect of SARs outstanding at the year-end	
1,32,000 SARs x Rs. 16.00 =	Rs. 21,12,000
Plus: Cash paid on exercise of SARs by employees	
1,20,000 SARs x Rs. 16.00 =	<u>Rs. 19,20,000</u>
<i>Total</i>	Rs. 40,32,000
Less: provision at the beginning of the year	<u>Rs. (19,93,400)</u>
Expense for the year	<u>Rs. 20,38,600</u>

Year 4

No. of SARs outstanding at the beginning of the year	1,32,000 SARs
No. of SARs exercised at the year-end	
300 employees x 300 SARs	<u>90,000 SARs</u>
No. of SARs outstanding at the year-end	<u>42,000 SARs</u>
Provision required in respect of SARs outstanding at the year-end	
42,000 SARs x Rs. 21.00 =	Rs. 8,82,000
Plus: Cash paid on exercise of SARs	
90,000 SARs x Rs. 21.00 =	<u>Rs. 18,90,000</u>
<i>Total</i>	Rs. 27,72,000
Less: provision at the beginning of the year	<u>Rs. (21,12,000)</u>
Expense for the year	<u>Rs. 6,60,000</u>

Year 5

No. of SARs outstanding at the beginning of the year	42,000 SARs
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No. of SARs exercised at the year-end	
140 employees x 300 SARs	<u>42,000 SARs</u>
No. of SARs outstanding at the year-end	<u>Nil</u>
Provision required in respect of SARs outstanding at the year-end	Nil
<i>Plus:</i> Cash paid on exercise of SARs	
42,000 SARs x Rs. 26.00 =	<u>Rs. 10,92,000</u>
<i>Total</i>	Rs. 10,92,000
<i>Less:</i> provision at the beginning of the year	<u>Rs. (8,82,000)</u>
Expense for the year	<u>Rs. 2,10,000</u>

Appendix V

Employee Share-based Payment Plan with Cash Alternatives

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

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

Scenario 1: The cash alternative

Scenario 2: The equity alternative

Suggested Accounting Treatment

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

Fair value under equity settlement	
1,200 shares x Rs. 48 =	Rs. 57,600
Fair value under cash settlement	
1,000 shares x Rs. 50 =	<u>Rs. 50,000</u>
Fair value of the equity component	
(Rs. 57,600 – Rs. 50,000) =	<u>Rs. 7,600</u>

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Fair value of the liability component Rs. 50,000

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

Year 1

Provision required at the year-end

1,000 x Rs. 52.00 x 1/3 = Rs. 17,333

Less: provision at the beginning of the year _____ Nil

Expense for the year Rs. 17,333

Year 2

Provision required at the year-end

1,000 x Rs. 55.00 x 2/3 = Rs. 36,667

Less: provision at the beginning of the year Rs. 17,333

Expense for the year Rs. 19,334

Year 3

Provision required at the year-end

1,000 x Rs. 60.00 = Rs. 60,000

Less: provision at the beginning of the year Rs. 36,667

Expense for the year Rs. 23,333

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

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

Employee compensation expense A/c Dr. _____

To Provision for liability component
of employee share-based payment
plan _____

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

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

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

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

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

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

Scenario 1: The cash alternative

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

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

Stock Options Outstanding A/c	Dr. Rs. 7,600
To General Reserve	Rs. 7,600

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

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Scenario 2: *The equity alternative*

Stock Options Outstanding A/c	Dr.	Rs. 7,600	
Provision for liability component of employee share-based payment plan	Dr.	Rs. 60,000	
To Share Capital A/c (1,000 shares x Rs. 10)			Rs. 10,000
To Securities Premium A/c			Rs. 57,600
(Being shares issued on exercise of equity alternative under the employee share-based payment plan)			

Appendix VI

Graded Vesting

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

Suggested Accounting Treatment

A. If accounting treatment specified in paragraph 42 is followed.

1. Since the options granted have a graded vesting schedule, the enterprise segregates the total plan into different groups, depending upon the vesting dates and treats each of these groups as a separate plan.
2. The enterprise determines the number of options expected to vest under each group as below:

<u>Vesting Date (Year-end)</u>	<u>Options expected to vest</u>
1 300 options x 1,000 employees x 25% x 0.97	= 72,750 options
2 300 options x 1,000 employees x 25% x 0.97 x 0.97	= 70,568 options
3 300 options x 1,000 employees x 50% x 0.97 x 0.97 x 0.97	= <u>1,36,901 options</u>
<i>Total options expected to vest</i>	<u>2,80,219 options</u>

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

Accounting for Employee Share-based Payments

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

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

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

Intrinsic Value Method

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

Compendium of Guidance Notes - Accounting

option. In such a case, total compensation expense for the options expected to vest would be determined as follows:

Vesting Date (End of year)	Expected Vesting (No. of Options)	Value per Option (Rs.)	Compensation Expense (Rs.)
1	72,750	6	4,36,500
2	70,568	6	4,23,408
3	1,36,901	6	8,21,406
<i>Total</i>			16,81,314

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

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

B. If accounting treatment specified in paragraph 42A is followed:

The enterprise can elect to recognise compensation expense on a straight-line basis. In that case, the total compensation expense to be attributed on a straight-line basis over each year in the 3-year vesting period is approximately Rs. 12,32,780 (36,98,399/3) under the 'Fair Value Method' and Rs.5,60,438 (16,81,314/3) under the 'Intrinsic Value Method'. However, as per paragraph 42A, the compensation expense recognised at any date must be at least equal to the amount attributable to options that are vested at that date. For example, if 50 per cent of the options vested in the first year of the 3-year vesting period, approximately Rs. 18,49,200 (36,98,399/2) would be recognised in that year under the 'Fair Value Method' and Rs.8,40,657 (16,81,314/2) would be recognised in that year under the 'Intrinsic Value Method'.

Accounting for Employee Share-based Payments

In the above illustration, under this alternative accounting treatment, the enterprise could use a single weighted-average expected life to value the entire award and arrive at a different amount of total compensation expense under the 'Fair Value Method', which could, then, be attributed on a straight-line basis over the three-year vesting period.

The choice of attribution method for awards under graded vesting plan (i.e. to follow paragraph 42 or paragraph 42A) is a policy decision that is not dependent on an enterprise's choice of valuation technique.

Appendix VII

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

Illustration 1: Enterprise Allots Shares to the ESOP Trust as and when the Employees Exercise Stock Options

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

- (a) The grant is administered by an ESOP trust appointed by the enterprise. According to the terms of appointment, the enterprise agrees to allot shares to the ESOP trust as and when the stock options are exercised by the employees.
- (b) The number of employees expected to complete one year vesting period, at the beginning of the plan, is 900, i.e., 100 employees are expected to leave during the vesting period and, consequently, the options granted to them are expected to be forfeited.
- (c) Actual forfeitures, during the vesting period, are equal to the expected forfeitures and 900 employees have actually completed one year vesting period.
- (d) All 900 employees exercised their right to obtain shares vested in them in pursuance of the ESOP at the end of year 2.

Accounting for Employee Share-based Payments

- (e) Apart from the shares allotted to the trust, the enterprise has 10,00,000 shares of Rs. 10 each outstanding at the end of year 1. The said shares were issued at a premium of Rs. 15 per share. The full amount of premium received on issue of shares is still standing to the credit of the Securities Premium Account. The enterprise has not made any change in the share capital upto the end of year 2, except that arising from transactions with the employees pursuant to the Employee Stock Option Plan.

Suggested Accounting Treatment

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

Year 1

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

No. of options expected to vest
(1,000 – 100) employees x 300 options = 2,70,000 options

Fair value of options expected to vest
2,70,000 options x Rs. 15 = Rs. 40,50,000

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

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

To Stock Options Outstanding A/c Rs. 40,50,000

(Being compensation expense recognised in respect of the ESOP)

Compendium of Guidance Notes - Accounting

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

Extracts from the Balance Sheet

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

Year 2

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

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

Accounting for Employee Share-based Payments

Particulars	Computations
No. of employees exercising option	900
No. of shares issued on exercise @ 300 per employee	2,70,000
Exercise Price @ Rs. 50 per share	1,35,00,000
Fair value of options @ Rs. 15 per option	40,50,000
<i>Total Consideration</i>	1,75,50,000
Amount to be recorded in 'Share Capital A/c' @ Rs. 10 per share	27,00,000
Amount to be recorded in 'Securities Premium A/c' @ Rs. 55 per share	1,48,50,000
<i>Total</i>	1,75,50,000

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

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

(Being shares allotted to the ESOP Trust for issuance to the employees against the options vested in them in pursuance of the Employee Stock Option Plan)

4. The Share Capital Account and the Securities Premium Account are disclosed in the balance sheet as below:

Extracts from the Balance Sheet

Liabilities	Amount (Rs.)
Share Capital	
<i>Paid-up Capital:</i>	
12,70,000 equity shares of Rs. 10 each fully paid	1,27,00,000
(Of the above, 2,70,000 shares of Rs. 10 each have been issued to the employees pursuant to an Employee Share-based Payment Plan. The issue price of the share was Rs. 65 per share out of which Rs. 15 per share were received in the form of employee services over a period of one year).	
Reserves and Surplus	
Securities Premium A/c	2,98,50,000

Computation of Earnings Per Share

For the purpose of calculating Basic EPS, stock options granted pursuant to the employee share-based payment plan would not be included in the shares outstanding till the employees have exercised their right to obtain shares, after fulfilling the requisite vesting conditions. Till such time, stock options so granted would be considered as dilutive potential equity shares for the purpose of calculating Diluted EPS.

Illustration 2: Enterprise Provides Finance to the ESOP Trust for Subscription to Shares Issued by the Enterprise at the Beginning of the Plan

Continuing Illustration 1 above, suppose the enterprise provides finance, at the grant date, to the ESOP trust for subscription to the shares of the enterprise equivalent to the number of shares expected to vest. With the help of finance provided by the enterprise, the trust subscribes to the shares offered by the enterprise at a cash price of Rs. 50 per share, at the beginning of the plan. The Trust would issue shares to the employees as and when they exercise the right vested in them in pursuance of the

Accounting for Employee Share-based Payments

Employee Stock Option Plan (ESOP). The other facts of the case are the same as in Illustration 1.

Suggested Accounting Treatment

The computations of employee compensation expense, amount to be recognised in the Share Capital Account and the Securities Premium Account, etc., would be the same as that in Illustration 1 above.

Year 1

1. The enterprise passes the following entry to record provision of finance [Rs. 1,35,00,000 (i.e., 2,70,000 shares x Rs. 50)] to the ESOP trust:

Amount recoverable from ESOP	
Trust A/c	Dr. Rs. 1,35,00,000
To Bank A/c	Rs. 1,35,00,000
(Being finance provided to the ESOP trust for subscription of shares)	

2. The enterprise passes the following entry to record the allotment of 2,70,000 shares to the ESOP Trust at Rs. 65 per share [comprising the exercise price (Rs. 50) and the fair value of options (Rs. 15)]:

Bank A/c	Dr. Rs. 1,35,00,000	
Amount recoverable from ESOP		
Trust A/c	Dr. Rs. 40,50,000	
To Share Capital A/c		Rs. 27,00,000
To Securities Premium A/c		Rs. 1,48,50,000
(Being shares allotted to the ESOP Trust in respect of the Employee Stock Option Plan)		

3. The enterprise passes the following entry to recognise the employee services received during the year:

Employee compensation expense A/c	Dr. Rs. 40,50,000	
To Stock Options Outstanding A/c		Rs. 40,50,000
(Being compensation expense recognised in respect of the ESOP)		

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4. The Share Capital Account, the Securities Premium Account, credit balance in the 'Stock Options Outstanding Account' and debit balance in the 'Amount recoverable from ESOP Trust Account' are disclosed in the balance sheet as below:

Extracts from the Balance Sheet

Liabilities	Amount (Rs.)	
Share Capital		
<i>Paid-up Capital:</i>		
12,70,000 equity shares of Rs. 10 each	1,27,00,000	
Less: Amount recoverable from ESOP Trust (face value of 2,70,000 share allotted to the Trust)	<u>27,00,000</u>	1,00,00,000
Stock Options Outstanding Account		40,50,000
Reserves and Surplus		
Securities Premium Account	2,98,50,000	
Less: Amount recoverable from ESOP Trust (Premium on 2,70,000 share allotted to the Trust)	<u>1,48,50,000</u>	1,50,00,000

5. Apart from other required disclosures, the enterprise gives a suitable note in the Notes to Accounts to explain the transaction and the nature of deduction of the 'Amount recoverable from ESOP Trust' made from the 'Share Capital' and the 'Securities Premium Account'.

Year 2

1. On exercise of the right to obtain shares, the ESOP trust issues shares to the respective employees after receiving the exercise price of Rs. 50 per share. The ESOP Trust passes on the exercise price received on issue of shares to the enterprise. The enterprise passes the following entry to record the receipt of the exercise price:

Accounting for Employee Share-based Payments

Bank A/c	Dr. Rs. 1,35,00,000
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To Amount recoverable from ESOP Trust A/c	Rs. 1,35,00,000
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(Being amount received from the ESOP Trust against finance provided to it at the beginning of the Employee Stock Option Plan)

2. The enterprise transfers the balance standing to the credit of the 'Stock Options Outstanding Account' to the 'Amount recoverable from ESOP Trust Account' by passing the following entry:

Stock Options Outstanding A/c Dr. Rs. 40,50,000

To Amount recoverable from ESOP Trust A/c	Rs. 40,50,000
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(Being consideration for shares issued to the employees received in the form of employee services adjusted against the relevant account)

3. The Share Capital Account and the Securities Premium Account are disclosed in the balance sheet as below:

Extracts from the Balance Sheet

Liabilities	Amount (Rs.)
Share Capital	
<i>Paid-up Capital:</i>	
12,70,000 equity shares of Rs. 10 each fully paid	1,27,00,000
(Of the above, 2,70,000 shares of Rs. 10 each have been issued to the employees (through ESOP Trust) pursuant to an Employee Share-based Payment Plan. The issue price of the share was Rs. 65 per share out of which Rs. 15 per share were received in the form of employee services over a period of one year).	
Reserves and Surplus	
Securities Premium Account	2,98,50,000

Computation of Earnings Per Share

For the purpose of calculating Basic EPS, shares allotted to the ESOP Trust pursuant to the employee share-based payment plan would not be included in the shares outstanding till the employees have exercised their right to obtain shares, after fulfilling the requisite vesting conditions. Till such time, the shares so allotted would be considered as dilutive potential equity shares for the purpose of calculating Diluted EPS.

Illustration 3: Enterprise Provides Finance to the ESOP Trust to Purchase Shares from the Market at the Beginning of the Plan

Continuing Illustration 2 above, suppose the enterprise does not issue fresh shares to the ESOP Trust. Instead, it provides finance, at the grant date, to the trust to purchase shares of the enterprise from the market, equivalent to the number of shares expected to vest. With the help of finance provided by the enterprise, the ESOP Trust purchases 2,70,000 shares from the market @ Rs. 52 per share at the beginning of the plan. The other facts remain the same as in Illustration 2 above.

Suggested Accounting Treatment

Year 1

1. The enterprise passes the following entry to record provision of finance [Rs. 1,40,40,000 (i.e., 2,70,000 shares x Rs. 52)] to the ESOP trust:

Amount recoverable from

ESOP Trust A/c	Dr. Rs. 1,40,40,000	
To Bank A/c		Rs. 1,40,40,000

(Being finance provided to the ESOP trust for purchase of shares in respect of the ESOP)

2. The enterprise passes the following entry at the end of the year to recognise the employee services received during the year:

Accounting for Employee Share-based Payments

Employee compensation expense A/c	Dr. Rs. 40,50,000	
To Stock Options Outstanding A/c		Rs. 40,50,000
(Being compensation expense recognised in respect of the ESOP)		

3. Credit balance in the 'Stock Options Outstanding Account' is disclosed on the liability side of the balance sheet under a separate heading, between 'Share Capital' and 'Reserves and Surplus'. Debit balance in the 'Amount recoverable from ESOP Trust Account' is disclosed on the asset side under a separate heading, between the 'Investments' and the 'Current Assets, Loans and Advances'. On this basis, the relevant extracts of the balance sheet appear as below:

Extracts from the Balance Sheet

Liabilities	Amount (Rs.)
Share Capital	
<i>Paid-up Capital:</i>	
10,00,000 equity shares of Rs. 10 each	1,00,00,000
Stock Options Outstanding Account	40,50,000
Reserves and Surplus	
Securities Premium Account	1,50,00,000
Assets	Amount (Rs.)
Investments	—
Amount recoverable from ESOP Trust	1,40,40,000
Current Assets, Loans and Advances	—

4. Apart from the other required disclosures, the enterprise gives a suitable note in the 'Notes to Accounts' to explain the transaction and the nature of the 'Amount recoverable from ESOP Trust'.

Compendium of Guidance Notes - Accounting

Year 2

1. On exercise of the right to obtain shares by the employees, the ESOP trust issues shares to the respective employees after receiving the exercise price. The exercise price so received is passed on to the enterprise. The amount received, in this manner, is Rs. 1,35,00,000 (i.e., 900 employees x 300 options x Rs. 50). The enterprise passes the following entry to record the receipt of the exercise price:

Bank A/c	Dr. Rs. 1,35,00,000	
To Amount recoverable from ESOP Trust A/c		Rs. 1,35,00,000

(Being amount received from the ESOP trust against the finance provided to it in respect of the Employee Stock Option Plan)

2. The enterprise transfers an amount equivalent to the difference between the cost of shares to the ESOP Trust and the exercise price from the 'Stock Options Outstanding Account' to the 'Amount recoverable from ESOP Trust Account'. In the present case, there is a difference of Rs. 2 per share (i.e., Rs. 52 – Rs. 50) between the cost of shares and the exercise price. The number of shares issued to the employees is 2,70,000. The enterprise, accordingly, transfers an amount of Rs. 5,40,000 from the 'Stock Options Outstanding Account' to the 'Amount recoverable from ESOP Trust Account' by passing the following entry:

Stock Options Outstanding A/c	Dr. Rs. 5,40,000	
To Amount recoverable from ESOP Trust A/c		Rs. 5,40,000

(Being the difference between the cost of shares to the ESOP Trust and the exercise price adjusted)

3. The balance of Rs. 35,10,000 (i.e., Rs. 40,50,000 – Rs. 5,40,000) standing to the credit of the 'Stock Options Outstanding Account' is transferred to the 'General Reserve' by passing the following entry:

Stock Options Outstanding A/c	Dr. Rs. 35,10,000	
To General Reserve		Rs. 35,10,000

(Being balance in the 'Stock Options Outstanding Account' transferred to the 'General Reserve', at the end of the Employee Stock Option Plan)

Accounting for Employee Share-based Payments

4. The Share Capital Account, the Securities Premium Account and the General Reserve are disclosed in the balance sheet as below:

Extracts from the Balance Sheet

Liabilities	Amount (Rs.)
Share Capital	
<i>Paid-up Capital:</i>	
10,00,000 equity shares of Rs. 10 each fully paid	1,00,00,000
Reserves and Surplus	
Securities Premium Account	1,50,00,000
General Reserve	xx,xx,xxx
<i>Add: Amount transferred from the Stock</i>	
Options Outstanding Account	<u>35,10,000</u> yy,yy,yyy

5. The enterprise gives a suitable note in the 'Notes to Accounts' to explain the nature of the addition of Rs. 35,10,000 made in the 'General Reserve'.

Computation of Earnings Per Share

In this case, the enterprise does not issue any new shares either at the beginning of the Employee Stock Option Plan or on exercise of stock options by the employees. Instead, the ESOP Trust purchases the shares from the market at the beginning of the plan and the employees exercising options vested in them are granted shares out of the shares so purchased. The shares purchased by the Trust represent the shares that have already been issued by the enterprise and the same should continue to be included in the shares outstanding for the purpose of calculating Basic EPS as would have been done prior to the purchase of the shares by the Trust. Since the exercise of stock options granted under the plan does not result into any fresh issue of shares, the stock options granted would not be considered as dilutive potential equity shares for the purpose of calculating Diluted EPS.

Appendix VIII

Computation of Earnings Per Share

Illustration : At the beginning of year 1, an enterprise grants 300 stock options to each of its 1,000 employees, conditional upon the employees remaining in the employment of the enterprise for two years. The fair value of the stock options, at the date of grant, is Rs. 10 per option and the exercise price is Rs. 50 per share. The other relevant terms of the grant and assumptions are as below:

- (a) The number of employees expected to complete two years vesting period, at the beginning of the plan, is 900. 50 employees are expected to leave during the each of the year 1 and year 2 and, consequently, the options granted to them are expected to be forfeited.
- (b) Actual forfeitures, during the vesting period, are equal to the expected forfeitures and 900 employees have actually completed two-years vesting period.
- (c) The profit of the enterprise for the year 1 and year 2, before amortisation of compensation cost on account of ESOPs, is Rs. 25,00,000 and Rs. 28,00,000 respectively.
- (d) The fair value of shares for these years was Rs. 57 and Rs. 60 respectively.
- (e) The enterprise has 5,00,000 shares of Rs. 10 each outstanding at the end of year 1 and year 2.

Compute the Basic and Diluted EPS, ignoring tax impacts, for the year 1 and year 2.

Suggested Computations

- (a) The stock options granted to employees are not included in the shares outstanding till the employees have exercised their right to obtain shares or stock options, after fulfilling the requisite vesting conditions. Till such time, the stock options so granted are considered as dilutive potential equity shares for the purpose of calculating Diluted EPS. At the end of each year,

Accounting for Employee Share-based Payments

computations of diluted EPS are based on the actual number of options granted and not yet forfeited.

- (b) For calculating diluted EPS, no adjustment is made to the net profit attributable to equity shareholders as there are no expense or income that would result from conversion of ESOPs to the equity shares.
- (c) For calculating diluted EPS, the enterprise assumes the exercise of dilutive options. The assumed proceeds from these issues are considered to have been received from the issue of shares at fair value. The difference between the number of shares issuable and the number of shares that would have been issued at fair value are treated as an issue of equity shares for no consideration.
- (d) As per paragraph 47 of this Guidance Note, the assumed proceeds to be included for computation, mentioned at (c) above, include (i) the exercise price; and (ii) the unamortised compensation cost related to these ESOPs, attributable to future services.

Compendium of Guidance Notes - Accounting

(e) The enterprise calculates the basic and diluted EPS as below:

Particulars	Year 1	Year 2
Net profit before amortisation of ESOP cost	Rs. 25,00,000	Rs. 28,00,000
Less: Amortisation of ESOP cost [(900 employees x 300 options x Rs. 10)/2]	(Rs. 13,50,000)	(Rs. 13,50,000)
Net profit attributable to equity shareholders	Rs. 11,50,000	Rs. 14,50,000
Number of shares outstanding	5,00,000	5,00,000
Basic EPS	Rs. 2.30	Rs. 2.90
Number of options outstanding (Options granted less actual forfeitures)	2,85,000 [1,000 employees x 300 options – (50 employees x 300 options)]	2,70,000 [2,85,000 options – (50 employees x 300 options)]
Unamortised compensation cost per option	Rs. 5 [Rs. 10 – Rs. 10/2]	Rs. 0
Number of dilutive potential equity shares	10,000 [2,85,000 – ((2,85,000 * 50) + (2,85,000 * 5))/57]	45,000 [2,70,000 – (2,70,000 * 50)/60]
No. of equity shares used to compute diluted earnings per share	5,10,000	5,45,000
Diluted EPS	Rs. 2.255	Rs. 2.66

Appendix IX

Illustrative Disclosures

The following example illustrates the disclosure requirements in paragraphs 49 to 52 of the text of the Guidance Note.³

**Extract from the Notes to the Financial Statements of Company Z
(for the year ended 31 December, 2005)**

Employee Share-based Payment Plans

1. During the period ended 31 December, 2005, the Company had four share-based payment arrangements, which are described below:

<i>Type of arrangement</i>	<i>Senior management stock option plan</i>	<i>General employee stock option plan</i>	<i>Executive stock plan</i>	<i>Senior management stock appreciation cash plan</i>
Date of grant	January 1, 2004	January 1, 2005	January 1, 2005	July 1, 2005
Number granted	50,000	75,000	50,000	25,000
Contractual life	10 years	10 years	N/A	10 years
Vesting conditions	1.5 years service and achievement of a share price target, which was achieved.	Three years service.	Three years service and achievement of a target growth in earnings per share.	Three years service and achievement of a target increase in market share.

³ **Note:** The illustrative example is not intended to be a template or model and is therefore not exhaustive. For example, it does not illustrate the disclosure requirements in paragraph 51(c) of the text of the Guidance Note.

Compendium of Guidance Notes - Accounting

2. The estimated fair value of each stock option granted in the general employee stock option plan is Rs. 23.60. This was calculated by applying binomial option pricing model. The model inputs were the share price at grant date of Rs. 50, exercise price of Rs. 50, expected volatility of 30 per cent, no expected dividends, contractual life of ten years, and a risk-free interest rate of 5 per cent. To allow for the effects of early exercise, it was assumed that the employees would exercise the options after vesting date when the share price was twice the exercise price. Historical volatility was 40 per cent, which includes the early years of the Company's life; the Company expects the volatility of its share price to reduce as it matures.

3. The estimated fair value of each share granted in the executive stock plan is Rs. 50.00, which is equal to the share price at the date of grant.

4. Further details of the two stock option plans are as follows :

	2004		2005	
	<i>Number of options</i>	<i>Weighted average exercise price</i>	<i>Number of options</i>	<i>Weighted average exercise price</i>
Outstanding at start of year	0	-	45,000	Rs. 40
Granted	50,000	Rs. 40	75,000	Rs. 50
Forfeited	(5,000)	Rs. 40	(8,000)	Rs. 46
Exercised	0	-	(4,000)	Rs. 40
Outstanding at end of year	45,000	Rs. 40	1,08,000	Rs. 46
Exercisable at end of year	0	Rs. 40	38,000	Rs. 40

5. The weighted average share price at the date of exercise for stock options exercised during the period was Rs. 52. The options outstanding at December 31, 2005 had an exercise price of Rs. 40 or Rs. 50, and a weighted average remaining contractual life of 8.64 years.

Accounting for Employee Share-based Payments

6. Other information regarding employee share-based payment plans is as below:

	2004 (Rs.)	2005 (Rs.)
Expense arising from employee share-based payment plans	4,95,000	11,05,867
Expense arising from share and stock option plans	4,95,000	10,07,000
Closing balance of liability for cash stock appreciation plan	—	98,867
Expense arising from increase in fair value of liability for cash stock appreciation plan	—	9,200

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Guidance Note on Accounting for State-level Value Added Tax

Foreword

In India, taxation, more so the commodity taxation, influences the free flow of goods and services between States. Therefore, it is of vital importance to eliminate the fiscal barriers between the States and harmonise taxes being levied by different States. This would pave way for much needed development of nation-wide market in India. The negative features of the present sales tax system have made it unworkable, particularly in the context of on-going economic liberalisation.

The solution to the problems faced by the assesseees and administration in the area of indirect taxation lies in introducing a destination based, invoice based and consumption based Value Added Tax. Value Added Tax (VAT) by its very name implies tax on value addition. Tax is paid at every level where there is value addition to a product, but there is a set off for tax paid at earlier levels of production. Thus, the cascading effect of taxation is avoided. The VAT will benefit common people, traders, industrialists and also the Government. It is indeed a move towards more efficiency, equitable competition and fairness in the taxation system. For these beneficial effects, VAT was introduced first in Brazil in mid 1960's, then in European countries in 1970's and subsequently introduced in about 130 countries. Even in India, the VAT system was introduced by the Government of India about ten years back in respect of Central excise duties. At the State-level, the VAT system as decided by the State Governments, would now be introduced in terms of Entry 54 of the State List of the Constitution.

Undoubtedly, the reform process involves significant transformation from the present procedures and practices in the tax system. And for this, the perceptions and attitudes of all the stakeholders, i.e., the consumers, the business and industry, the tax professionals, peoples' representatives, the tax officers and the Government, have to be taken into account by initiating a wide ranging discussion on the relevant issues, concerns and options and transform the system quickly.

Accounting for State-level Value Added Tax

The effectiveness of the Value Added Tax lies in its successful implementation after making the trade and industry aware of all the finer elements of the new system and allaying any misapprehensions. Towards meeting this goal, the publication entitled 'Guidance Note on Accounting for State-level Value Added Tax', seeks to provide guidance on the accounting issues arising in the implementation of VAT. I congratulate the Research Committee of the Institute in formulating the Guidance Note on a timely basis so that all concerned are clear about the accounting implications of VAT as soon as the VAT is implemented in various States.

I am confident that this publication would be extremely helpful not only to the members but also to the others concerned.



New Delhi
March 28, 2005

Kamlesh S. Vikamsey
President

Preface

Indirect tax reforms have always been an integral part of the liberalisation process since 1991. In the first phase, India has been steadily attempting to move towards a tax structure that is simple, moderate, rational and easy to administer and comply with. At the central level, the move has been to bring down the tariffs – both excise and customs, reduce the number of rates, correct anomalies, get rid of the complexities in the system and on the whole reduce the interface with the government. Reforms at central level were smooth and brought in mainly through the annual budget presentation in the Parliament and are applicable through-out the country.

In addition to indirect taxes levied by the centre, states are empowered to levy certain indirect taxes. Sales tax forms major part of revenue for almost all states. In many states, both inputs as well as outputs are taxed creating a cascading effect. The viable solution found was to shift to destination based VAT, i.e., value added tax which is the practice followed in many of the developed countries.

State-level Value Added Tax (VAT) is a multi-point sales tax with set-off for tax paid on purchases. Unlike the present sales tax scheme, which is essentially a single point tax, VAT is charged and collected at each stage of production/processing/trading, on the portion of the value added to the goods sold. It contemplates rebating tax paid on inputs/capital goods and on account of this, it does not have any cascading effect. It comes into effect from April 1, 2005 in place of the sales tax in various States. Introduction of VAT is aimed at increasing the competitiveness of Indian industry by removal of the existing system of multiple taxes prevailing in the Indian tax system. In this direction, an empowered Committee of State Finance Ministers, constituted by the Ministry of Finance, Government of India, prepared the basic design of VAT. The States are expected to follow this basic design although they have freedom for making appropriate variations in their respective State VAT laws.

For successful implementation of the VAT, appropriate accounting thereof is of utmost importance. Recognising this, the Research Committee of the ICAI decided to take upon itself the preparation of the 'Guidance Note on Accounting for State-level Value Added Tax' so that it could be issued under the authority of the Council of the Institute.

The Guidance Note lays down the principles and provides guidance in respect of accounting for various aspects of State-level Value Added Tax, including accounting for credit/set-off available for input-tax paid on purchases and

accounting for VAT payable on sales. Being 'principle-based', this Guidance Note would be applicable across all States in the country even though there are some variations in the State VAT Acts. For better understanding, it also contains illustrative examples clarifying accounting issues involved in VAT.

I would like to take this opportunity to place on record my deep appreciation for the contribution made by Shri Ved Jain, Chairman, Fiscal Laws Committee, and other members of the Fiscal Laws Committee for their invaluable inputs. I am also thankful to Shri Ashok Chandak and Shri R. Bupathy, past Presidents, Shri Govind Goyal, Shri Rajiv Dave, Shri Rajat Talati, Shri Ajay Mehra, Shri Barun Kumar Ghosh, Shri S. K. Chowdhury, and other experts for giving their invaluable comments and suggestions on the draft Guidance Note.

I would also like to thank all the members of the Research Committee, namely, Shri K. P. Khandelwal (Vice-Chairman), Shri Kamlesh S. Vikamsey (President), Shri T.N. Manoharan (Vice-President), Shri Anuj Goyal, Shri H. N. Motiwalla, Shri Shanti Lal Daga, Shri T.G. Srinivasan, Ms. Bulbul Sen, Shri Gobind Prasad Agrawal, Shri K. Nagarajan, Shri O.P. Maheshwari, Shri R.M. Kothari, Shri Rajiv Dave, Shri Sujal A. Shah, and Shri S.C. Vasudeva (Special Invitee).

I sincerely appreciate the efforts put in by Dr. Avinash Chander, Technical Director, Ms. Anuradha Jain, Secretary, Research Committee and Shri Vishal Bansal, Senior Technical Officer, of the Institute of Chartered Accountants of India, in preparing the draft of the Guidance note.

I firmly believe that this publication would be very useful to the members of the Institute and others interested in the subject.



Pankaj I. Jain
Chairman
Research Committee

New Delhi
March 28, 2005

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Guidance Note on Accounting for State-level Value Added Tax

(The following is the text of the Guidance Note on Accounting for State-level Value Added Tax, issued by the Council of the Institute of Chartered Accountants of India.)

Introduction

1. The State-level Value Added Tax (hereinafter referred to as 'Value Added Tax' or 'VAT') comes into effect from April 1, 2005, in place of the sales tax structure prevalent in various States. The VAT intends to bring harmonisation in the tax structure of various States and rationalise the overall tax burden. The essence of VAT is that it provides credit/set-off for input tax, i.e., tax paid on purchases, against the output tax, i.e., tax payable on sales.

2. VAT is a State subject, for which the States are independent in taking decisions. The States, through discussion in the Empowered Committee of State Finance Ministers, constituted by the Ministry of Finance, Government of India, have found it in their interest to have certain features of VAT to be common for all the States with a view to avoid unhealthy competition. These features are contained in the 'White Paper on State-Level Value Added Tax' released by the Empowered Committee on January 17, 2005 and constitute the basic design of VAT. At the same time, the States have freedom for making appropriate variations in their respective State laws consistent with this basic design.

Objective

3. The objective of this Guidance Note is to provide guidance in respect of accounting for various aspects of State-level Value Added Tax, including accounting for credit/set-off available for input-tax paid on purchases and accounting for VAT payable on sales.

Salient Features of Value Added Tax (VAT)

4. Salient features of VAT are briefly set out hereinafter. Reference may, however, be made to the respective State Acts, Rules, Notifications and Circulars issued from time to time for details of the provisions of VAT laws prevalent in various States.

5. The nature of VAT, as discussed in this Guidance Note, is based on the White Paper released by the Empowered Committee referred to in paragraph 2 above. Since the VAT laws of the States are to be based on the White Paper, the nature of VAT in all the States would be the same.

6. A trader/manufacturer (hereinafter referred to as a 'dealer') who is registered or is required to be registered under the respective State laws on VAT is entitled to an input tax credit (hereinafter referred to as 'VAT credit') in respect of tax paid on purchases made during the tax period where the purchases arise in the course of his activities as a dealer. The VAT credit is allowed for purchase of inputs/supplies meant for sale or for utilisation in the process of production for such sale, irrespective of when these are utilised/sold, and reduces the immediate tax liability. The VAT is based on the value addition to the goods, and the related VAT liability of the dealer is calculated by deducting VAT credit from tax payable on sales during the tax/payment period (say, a month). If, for example, input worth Rs. 1,00,000/- is purchased and sales are worth Rs. 2,00,000/- in a month, and input tax rate and output tax rate are 4% and 12.5% respectively, VAT credit and calculation of VAT is as shown below:

(a)	Input purchased during the month	Rs. 1,00,000
(b)	Output sold during the month	Rs. 2,00,000
(c)	Input tax paid and available as 'VAT credit' (Rs. 1,00,000 x 4%)	Rs. 4,000
(d)	Gross output tax payable (Rs. 2,00,000 x 12.5%)	Rs. 25,000
(e)	VAT payable during the month after adjustment of VAT credit [(d) – (c)]	Rs. 21,000

7. VAT credit is given to a dealer for purchase of inputs/supplies in a State meant for sales within the State as well as in other States. Even for stock transfer/consignment sale of goods out of the State, input tax paid in excess of a certain percentage is eligible for VAT credit. VAT credit is available in respect of all purchases made and taxes paid thereon within the State. However, no credit under the VAT laws is allowable in respect of taxes paid on purchases made from other States.

8. If the VAT credit exceeds the tax payable on sales in a month, the excess credit may be carried over to the future month(s). If there is any excess unadjusted VAT credit at the end of the specified period, the same is eligible for refund. The period for which the excess VAT credit can be carried over before becoming eligible for refund is prescribed in the respective State VAT laws.

9. All goods, except liquor, lottery tickets, petrol, diesel, aviation turbine fuel and other motor spirits whose prices are not fully market determined, are covered under VAT and get the benefit of VAT credit. The goods not covered by VAT are taxed under the Sales Tax Act or any other State Act or by making special provisions in the VAT Act itself.

10. Besides prescribing various rates of tax for goods, the State-level VAT laws may also specify (a) certain goods which are exempt, and (b) the sales which are 'zero' rated. The essential difference between the exempt sales and 'zero' rated sales is that while in both the cases, the dealer does not charge VAT, in case of 'zero' rated sales, he is eligible to claim VAT credit for tax paid on purchase of inputs whereas for the exempted sales, he is not eligible to claim VAT credit for the tax paid on the purchase of inputs.

11. Exports sales are 'zero' rated under the VAT laws. This means that the dealer is not required to charge any tax or pay any VAT on the export sales. The dealer, however, is entitled to VAT credit in respect of tax paid within a State on purchase of inputs. The VAT credit is not restricted to only those goods which are meant or used in the manufacture for exports. If, in any tax period, the VAT credit declared in the VAT return exceeds the output tax and the dealer has declared international exports in the same tax period, he can claim refund of the excess VAT credit. The refund will be made within the period prescribed under the State VAT laws. The units located in Special Economic Zones (SEZ) and Export Oriented Units (EOUs) are granted either exemption from payment of input tax or refund of the input tax paid within the prescribed period.

12. In some State VAT laws, industrial units may be granted the facility of deferring output tax net of VAT credit. Such units continue to collect tax on sales from the customers at the time of making sales, but the tax is payable after a certain specified period. The period of eligibility, the method of computing the eligible amount, the re-payment etc., in such cases, shall be in a manner prescribed under the respective State VAT laws.

13. All tax-paid goods purchased on or after April 1, 2004 and still in stock as on April 1, 2005 are eligible to avail VAT credit, subject to submission of requisite documents. Resellers holding tax-paid goods on April 1, 2005 are also eligible. VAT is levied on the goods when sold on and after April 1, 2005 and VAT credit is given for the sales tax already paid in the previous year. This VAT credit is available over a period of 6 months after an interval of 3 months needed for verification. In certain States, however, immediate credit for tax-paid goods lying in stock on April 1, 2005 may be available.

14. VAT credit on all capital goods, except a few capital goods included in the negative list of respective State laws, is also available to dealers. VAT credit on capital goods may be adjusted over a maximum of 36 equal monthly instalments. The States may at their option reduce the number of instalments or may grant full credit in the month of purchase of such capital goods. Some of the State laws on VAT, e.g., the West Bengal Value Added Tax Act, 2003, have defined the term 'Capital Asset' to include components, spare parts, accessories, tools, etc., which are basically of the nature of inventories.

15. Small dealers with gross annual turnover not exceeding the limit specified in White Paper are not liable to pay VAT. However, States have flexibility to fix threshold limit within the specified limit and, therefore, certain States have fixed lower limits in this regard. Small dealers with annual gross turnover not exceeding the specified limit in this respect, who are otherwise liable to pay VAT, however, have the option to pay tax under an alternative scheme known as the 'composition scheme'. The dealers opting for this scheme are required to pay tax at a small percentage, as prescribed, of gross turnover and are not entitled to any VAT credit. Certain States have fixed lower limits of turnover under the composition scheme.

16. In some of the States, the dealers executing works contracts, have been given an option either to pay tax on the value of the goods at the time of incorporation of such goods in the works executed, at the rates applicable to the goods, or they may opt to pay tax by way of composition at applicable rates on a certain percentage of the total consideration received as may be

prescribed, and in such a case, they may not be entitled to any VAT credit or may be entitled to a partial VAT credit.

17. The entire design of VAT with input tax credit is mainly based on documentation of tax invoice, cash memo or bill. Every registered dealer, having turnover in excess of the amount specified, issues to the purchaser, serially numbered tax invoice with the prescribed particulars. This tax invoice is required to be signed and dated by the dealer or his regular employee, showing the required particulars. The dealer is required to keep a counterfoil or duplicate of the tax invoice duly signed and dated. Failure to comply with the above attracts penalty. The dealer is also required to keep and maintain a true and correct account of his business transactions, and maintain appropriate records to ascertain his tax liability. Various States have prescribed the records required to be maintained by dealers engaged in various businesses.

18. The State VAT laws also provide for issuance of credit notes/debit notes by the dealer in cases of wrong calculation of tax or return of goods after sales/ purchases are made or in respect of annual discounts and other price adjustments on settlement between the seller and the buyer.

Accounting Treatment for VAT Credit in case of Inputs/Supplies

19. The accounting treatment for VAT credit recommended in the following paragraphs is required only in situations where the VAT credit is available. Accordingly, accounting treatment recommended hereinafter would not be applicable in cases where no VAT credit is available such as for:

- (i) dealers not registered under VAT; or
- (ii) dealers having turnover below the threshold limit as fixed under the State laws on VAT, and opting for composition scheme; or
- (iii) dealers engaged in the works contract and opting to pay tax by way of composition; or
- (iv) purchase of goods from unregistered dealers.

20. In the light of the salient features of VAT discussed above, the VAT is a procedure whereby a dealer can utilise credit for tax paid on inputs/supplies against tax payable on sales. Under the VAT, credit in respect of purchases

made during a period can be set-off against the tax payable on sales during that period, irrespective of when the supplies/inputs purchased are utilised/sold. This implies that VAT credit is a credit on purchase of inputs/supplies and a dealer becomes entitled to it immediately upon making a purchase. This implies that the dealer does not have to wait for the sales to be made or the purchased goods to be used for production to claim VAT credit. Further, there is no relationship between the inputs and the outputs, if all sales are taxable.

21. With a view to recommend appropriate accounting treatment for VAT credit, it would be useful to note the requirements of paragraphs 6 and 7 of Accounting Standard (AS) 2, 'Valuation of Inventories', issued by the Institute of Chartered Accountants of India, dealing with 'cost of inventories' and 'costs of purchase', which are as below:

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

"7. The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase."

Attention is invited to the paragraph related to 'costs of purchase', according to which, only those taxes have to be included as costs of purchase which are not subsequently recoverable by the enterprise from the taxing authorities. Since the tax paid on inputs is available for set-off against the tax payable on sales or is refundable, it is of the nature of taxes recoverable from taxing authorities and accordingly, input tax paid should not be included in the costs of purchase.

22. In view of the above, the amount of tax paid on purchase of inputs/supplies and available for VAT credit should be debited to a separate account, say, VAT Credit Receivable (Inputs) Account. As and when VAT credit is actually utilised against VAT payable on sales, appropriate accounting entries will be required to record the adjustment, i.e., VAT Credit Receivable (Inputs) Account should be credited with a corresponding debit to the account maintained for tax payable on sales. The debit balance in VAT Credit Receivable (Inputs)

Account, at the year-end, should be shown on the 'Assets' side of the balance sheet under the head 'Loans and Advances'.

23. A dealer may purchase certain common inputs which are to be used for making taxable sales as well as for making exempt sales. In such a case, the dealer, on the date of purchase, should estimate inputs expected to be used for making taxable sales and for making exempt sales. The dealer should recognise VAT credit only in respect of those inputs which are expected to be used for making taxable sales and no VAT credit should be recognised in respect of inputs expected to be used for making exempt sales. Subsequently, in case the actual use is different from the estimated use, the dealer should pass an appropriate adjustment entry for the same. Similarly, in the case of stock transfer/consignment sale of goods out of the State where VAT credit is available only to the extent of a certain portion of input tax paid, the dealer should make an estimate of the expected stock transfers/consignment sales and account for accordingly.

Accounting Treatment for VAT Credit in case of Capital Goods

24. The accounting treatment recommended in the following paragraphs applies only to those capital goods which are eligible for the credit.

25. Paragraph 9.1 of Accounting Standard (AS) 10, Accounting for Fixed Assets, issued by the Institute of Chartered Accountants of India, *inter-alia*, provides as below:

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

VAT credit is considered to be of the nature of a refundable tax. Therefore, the tax paid on purchase of capital goods should not be included in the cost of such capital goods.

26. As discussed in paragraph 14, VAT credit on capital goods may or may not be available immediately. To the extent VAT credit is available immediately, the amount in respect thereof should be debited to an appropriate account, say, 'VAT Credit Receivable (Capital Goods) Account' and the balance which

is not available immediately, should be debited to another appropriate account, say, 'VAT Credit Deferred (Capital Goods) Account'. Subsequently, when the balance credit or a part thereof becomes available, the appropriate adjustment for the same should be made, i.e., the amount of credit becoming available should be credited to 'VAT Credit Deferred (Capital Goods) Account' with a corresponding debit to 'VAT Credit Receivable (Capital Goods) Account'. Depreciation should be charged on the original cost of fixed asset excluding VAT credit.

Accounting Treatment for Liabilities Adjusted from VAT Credit Receivable Balance – Inputs and/or Capital Goods

27. A dealer may, normally, utilise the VAT credit receivable balance pertaining either to inputs or to capital goods for adjusting/setting-off the following liabilities:

- (a) Liability in respect of VAT payable on sales.
- (b) Liability in respect of disallowance/withdrawal of VAT credit.

28. All liabilities adjusted out of the VAT credit receivable balance should be credited to the VAT Credit Receivable (Inputs) Account or VAT Credit Receivable (Capital Goods) Account. The corresponding debit for the same should be given to the account maintained for recording VAT liability on sales, say, 'VAT Payable Account', if the liability for VAT payable on sales has been met by using the balance in the said account.

29. If, on the other hand, the amount utilised pertains to disallowance/withdrawal of VAT credit taken on purchase of inputs made during the year, the same should be added to the cost of inputs. Appropriate adjustment in that case would have to be made while valuing inventory of inputs. If the amount adjusted pertains to disallowance/withdrawal of credit in respect of purchases effected in earlier years, the accounting treatment would depend on whether the said inputs/supplies are available in stock or not. If they are not available, i.e., these have already been sold, the disallowance/withdrawal should be debited to profit and loss account and treated as expense of the current year. If these are still lying in stock, the amount should be added to the cost of inputs.

30. If the amount utilised out of VAT credit receivable balance pertains to any disallowance/withdrawal of VAT credit on capital goods, the same should be added to the cost of the relevant fixed asset. For accounting purposes, depreciation on the revised unamortised depreciable amount should be provided prospectively over the residual useful life of the asset. In case the fixed asset no longer exists, the relevant amount should be written-off in the profit and loss account with an appropriate disclosure. If the amount of VAT credit disallowed on capital goods is standing to the debit of VAT Credit Deferred (Capital Goods) Account and has not been transferred to VAT Credit Receivable (Capital Goods) Account, the account to be credited would be the VAT Credit Deferred (Capital Goods) Account.

Accounting Treatment for Refund of Input Tax

31. Input tax which cannot be adjusted against the VAT payable over the specified period of time and input tax paid on purchases made for exports out of the country are eligible for refund. Any refund of input tax received in this manner should be credited to the VAT Credit Receivable (Inputs) Account or VAT Credit Receivable (Capital Goods) Account, as appropriate.

Valuation of Inventories of Inputs and Final Products

32. The inventory of inputs should be valued net of input tax. In other words, the tax on inputs will not form part of the cost of inventories. Balance in VAT Credit Receivable (Inputs) Account should be shown in the Balance Sheet under the head 'Loans and Advances' on the 'Assets' side.

33. Where inputs/supplies have been obtained from small dealers or other dealers who are exempt from VAT, the actual cost of purchase should be considered as a part of cost of inventory.

34. Where purchases are made from the dealers who are not eligible under the relevant State VAT Laws, e.g., unregistered dealers, to pass VAT credit and, therefore, cannot issue tax invoice in accordance with the applicable law, the inventories of such inputs should be valued at the actual cost inclusive of the input tax.

35. While valuing inventories of final products, the value of inputs should be net of the input tax where VAT credit is available.

Valuation of Inventories of Capital Goods

36. Inventories of capital goods, such as, components, spare parts, accessories, tools, etc., should be valued net of VAT credit. In other words, input tax paid on such capital goods should not form part of their cost.

Accounting Treatment for VAT Credit on Goods lying in Stock at the Inception of the VAT Scheme

37. As mentioned in paragraph 13 above, VAT credit is also available in respect of tax-paid goods lying in stock at the inception of the VAT scheme. The amount of VAT credit available in respect of opening stock should be credited to 'VAT Credit Available on Opening Stock Account' at the inception of the VAT scheme, if required documents for availing this credit are available with the dealer. The corresponding debit for this amount should be given to 'VAT Credit Receivable (Inputs) Account' if the VAT credit is available immediately. If the VAT credit is not available immediately but is available in future, the corresponding debit for this amount should be given to 'VAT Credit Deferred (Opening Stock) Account'. Subsequently, when this credit becomes actually available, the appropriate adjustment for the same should be made, i.e., the amount of credit becoming available should be credited to 'VAT Credit Deferred (Opening Stock) Account' with a corresponding debit to 'VAT Credit Receivable (Inputs) Account'. In the profit and loss account, the amount of 'VAT Credit Available on Opening Stock Account' should be shown as a deduction from the value of opening stock.

Accounting Treatment for Output Tax, i.e., VAT on Sales

38. Output tax or VAT payable on sales is an indirect tax which is ultimately borne by the final consumer but is collected at each stage of distribution chain. A question may arise as to whether VAT recovered from the customers should be recognised as income in the profit and loss account and, correspondingly, whether VAT payable on sales should be treated as an expense.

39. The *Framework for the Preparation and Presentation of Financial Statements*, issued by the Institute of Chartered Accountants of India, has defined the term 'income' as below:

"Income is increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants."

The Value Added Tax (VAT) is collected from the customers on behalf of the VAT authorities and, therefore, its collection from the customers is not an economic benefit for the enterprise and it does not result in any increase in the equity of the enterprise. Accordingly, it should not be recognised as an income of the enterprise. Similarly, the payment of VAT should not be treated as an expense in the financial statements of the enterprise.

40. In view of the above, it is recommended that the amount of tax collected from customers on sale of goods should be credited to an appropriate account, say, 'VAT Payable Account'. Where the enterprise has not charged VAT separately but has made a composite charge, it should segregate the portion of sales which is attributable to tax and should credit the same to 'VAT Payable Account' at periodic intervals. The amounts of VAT payable adjusted against the VAT Credit Receivable (Inputs) Account or VAT Credit Receivable (Capital Goods) Account and amounts paid in cash will be debited to this account. The credit balance in VAT Payable Account, at the year-end, should be shown on the 'Liabilities' side of the balance sheet under the head 'Current Liabilities'.

41. Where a dealer is enjoying tax holiday and, therefore, his liability to pay output tax is deferred for a period more than one year under the State laws on VAT, the amount in the 'VAT Payable Account' should not be reflected as a current liability. The same should be reflected as a long-term liability.

Illustrations

42. Examples illustrating the accounting treatment of important aspects of VAT are given in the Appendix to this Guidance Note.

Appendix

(This appendix, which is illustrative only and does not form part of the Guidance Note, provides examples to illustrate application of the principles explained in this Guidance Note.)

VAT Credit in Case of Inputs/Supplies

Illustration 1

1. A dealer purchases the following goods in a State during the month of March 20x6:

Particulars	Total Amount (Rs.)	Input Tax Paid (Rs.)	Net Amount (Rs.)
4% VAT Goods	10,40,000	40,000	10,00,000
12.5% VAT Goods	9,00,000	1,00,000	8,00,000
VAT Exempt Goods	2,00,000	-	2,00,000
Total	21,40,000	1,40,000	20,00,000

2. The input tax paid on purchase of goods is eligible for VAT credit.
3. Sales made by the dealer during the month are as below:

Particulars	Gross Amount (Rs.)	Output Tax Collected (Rs.)	Net Sales Consideration (Rs.)
4% VAT Goods	11,44,000	44,000	11,00,000
12.5% VAT Goods	10,12,500	1,12,500	9,00,000
VAT Exempt Goods	2,50,000	-	2,50,000
Total	24,06,500	1,56,500	22,50,000

Suggested Accounting Treatment

1. The dealer passes the following entry to record the goods purchased and input tax paid thereon:

4% VAT Goods Purchase A/c	Dr.	Rs. 10,00,000	
12.5 % VAT Goods Purchase A/c	Dr.	Rs. 8,00,000	
VAT Exempt Goods Purchase A/c	Dr.	Rs. 2,00,000	
VAT Credit Receivable (Inputs) A/c	Dr.	Rs. 1,40,000	
To Bank A/c			Rs. 21,40,000
(Being goods purchased and input tax paid)			

2. The dealer passes the following entry to record the goods sold and VAT collected thereon:

Bank A/c	Dr.	Rs. 24,06,500	
To 4% VAT Goods Sales A/c			Rs. 11,00,000
To 12.5 % VAT Goods Sales A/c			Rs. 9,00,000
To VAT Exempt Goods Sales A/c			Rs. 2,50,000
To VAT Payable A/c			Rs. 1,56,500
(Being goods sold and VAT collected)			

3. The dealer passes the following entry to record the liability for VAT payable met by using the balance in the VAT Credit Receivable (Inputs) Account:

VAT Payable A/c	Dr.	Rs. 1,40,000	
To VAT Credit Receivable (Inputs) A/c			Rs. 1,40,000
(Being liability for VAT payable met by using the balance in the VAT Credit Receivable (Inputs) Account)			

4. Net credit balance of Rs. 16,500 (i.e., Rs. 1,56,500 – Rs. 1,40,000) in VAT Payable A/c is disclosed in the balance sheet as below:

Extracts from the Balance Sheet

Current Liabilities:

	Rs.
VAT Payable Account	16,500

5. Accounting Standard (AS) 2, 'Valuation of Inventories', does not require disclosure of components of the cost of inventories as a part of significant accounting policies. However, the dealer may, if he so desires, include the following sentence in the accounting policy regarding valuation of inventories to specify the treatment regarding VAT credit available on purchases:

'The cost of inventories is net of VAT credit.'

6. The dealer may include the following sentence in the accounting policy regarding revenue recognition to specify the treatment of output tax:

'Sales are exclusive of VAT.'

7. Suppose the dealer makes payment of outstanding VAT liability at the beginning of the next month. To record the payment, the dealer passes the following entry:

VAT Payable A/c	Dr. Rs. 16,500	
To Bank A/c		Rs. 16,500
(Being payment made for VAT liability)		

Illustration 2

1. A dealer purchases the following goods in a State during the month of March 20x6:

Particulars	Total Amount (Rs.)	Input Tax Paid (Rs.)	Net Amount (Rs.)
4% VAT Goods	10,40,000	40,000	10,00,000
12.5% VAT Goods	9,00,000	1,00,000	8,00,000
VAT Exempt Goods	2,00,000	-	2,00,000
Total	21,40,000	1,40,000	20,00,000

2. The other facts of the illustration are as below:

- (a) On March 1, 20x6, there was an opening balance of Rs. 1,00,000 in the VAT Credit Receivable (Inputs) Account.
- (b) During the month, the dealer made a stock transfer of 12.5% VAT goods costing Rs. 2,50,000 out of the State. The stock transfer was an exceptional case for the dealer and, therefore, he had not made an estimate in this regard at the time of purchase. VAT credit to the extent of 4% is not allowed on stock transfer as per the State VAT laws.
- (c) The dealer utilised 4% VAT goods costing Rs. 2,00,000 as input for manufacture of exempted goods. The decision to manufacture the exempted goods was made by the dealer after the purchase of goods and, therefore, he had not made an estimate in this regard at the time of purchase. No VAT credit is available on the inputs used for the manufacture of exempted goods as per the State VAT laws.

- (d) The dealer has received a refund of Rs. 20,000 out of VAT Credit Receivable (Inputs) Account outstanding at the beginning of the month.
- (e) VAT payable on sales made during the month is Rs. 1,15,500.

Suggested Accounting Treatment

1. The entry to record the goods purchased and input tax paid thereon will be the same as in Illustration 1.

2. Since the dealer has recognised full VAT credit at the time of purchase, he is required to reverse the VAT credit to the extent of 4% at the time when the stock transfer takes place. The dealer passes the following entry to record the reversal amounting to Rs. 10,000 (Rs. 2,50,000 x 4%):

12.5 % VAT Goods Purchase A/c Dr. Rs. 10,000

To VAT Credit Receivable (Inputs) A/c Rs. 10,000

(Being VAT Credit reversed to the extent of 4% on stock transfer)

3. The dealer passes entry to record the VAT reversal amounting to Rs. 8,000 (Rs. 2,00,000 x 4%) arising because of goods used as input for manufacture of exempted goods:

4% VAT Goods Purchase A/c Dr. Rs. 8,000

To VAT Credit Receivable (Inputs) A/c Rs. 8,000

(Being VAT credit reversed on the goods used as input for manufacture of exempted goods)

4. The dealer passes the following entry to record the refund of VAT credit received:

Bank A/c Dr. Rs. 20,000

To VAT Credit Receivable (Inputs) A/c Rs. 20,000

(Being refund of VAT Credit Receivable)

5. VAT Credit Receivable (Inputs) A/c will appear in the books of the dealer as below:

VAT Credit Receivable (Inputs) A/c

Date	Particulars	Debit (Rs.)	Credit (Rs.)	Balance	
				Dr./Cr.	Amount (Rs.)
March 20x6	To Balance b/d	1,00,000		Dr.	1,00,000
	To Bank	1,40,000		Dr.	2,40,000
	By 12.5 % VAT Goods Purchase A/c		10,000	Dr.	2,30,000
	By 4% VAT Goods Purchase A/c		8,000	Dr.	2,22,000
	By Bank		20,000	Dr.	2,02,000
	By VAT Payable A/c		1,15,500	Dr.	86,500
	By Balance c/d		86,500		
	<i>Total</i>	2,40,000	2,40,000		

6. Net debit balance of Rs. 86,500 in the VAT Credit Receivable (Inputs) A/c is disclosed in the balance sheet as below:

Extracts from the Balance Sheet

Assets **Amount (Rs.)**

Loans and Advances

VAT Credit Receivable (Inputs) A/c 86,500

VAT Credit in Case of Capital Goods

Illustration 1

On June 1, 20x6, a dealer purchases one machine in a State for the total cost of Rs. 93,60,000 which includes input tax of Rs. 3,60,000. As per the State VAT laws, input tax paid on purchase of machinery is adjustable as VAT credit over 36 equal monthly instalments beginning July 1, 20x6. Till the end of the year, the dealer has not utilised the VAT credit available on the machine.

Suggested Accounting Treatment

1. The dealer passes the following entry to record the machinery purchased and input tax paid thereon:

Machinery A/c	Dr.	Rs. 90,00,000	
VAT Credit Deferred (Capital Goods) A/c	Dr.	Rs. 3,60,000	
To Bank A/c			Rs. 93,60,000
(Being machinery purchased and input tax paid)			

2. When the VAT credit becomes actually available, the dealer passes the following entry to recognise the same every month:

VAT Credit Receivable (Capital Goods) A/c	Dr.	Rs. 10,000	
To VAT Credit Deferred (Capital Goods) A/c			Rs. 10,000
(Being a portion of VAT credit on purchase of machinery becoming available)			

3. The dealer charges depreciation on the cost of machinery excluding VAT credit (i.e., Rs. 93,60,000 – Rs. 3,60,000 = Rs. 90,00,000).
4. Balances in VAT Credit Deferred (Capital Goods) A/c and VAT Credit Receivable (Capital Goods) A/c are disclosed in the balance sheet as on March 31, 20x7 as below:

Extracts from the Balance Sheet

Assets	Amount (Rs.)
<i>Loans and Advances</i>	
VAT Credit Deferred (Capital Goods) A/c	2,70,000
VAT Credit Receivable (Capital Goods) A/c	90,000

Illustration 2

VAT laws of a State come into effect from April 1, 20x5. The laws provide VAT credit for tax paid on capital assets which have been purchased between April 1, 20x3 and March 31, 20x5 and sold on after April 1, 20x5 but before December 31, 20x5.

On April 1, 20x5, a dealer has a machinery which was purchased on December 31, 20x3 for Rs. 12,00,000. The dealer has created provision for depreciation of Rs. 1,50,000 on the machinery till March 31, 20x5. On July 1, 20x5, the dealer sells the said machinery for Rs. 15,00,000. Depreciation on the machinery for the period of April 1, 20x5 to June 30, 20x5 is Rs. 30,000. As per the State VAT laws, the dealer is entitled to VAT credit of Rs. 1,35,000 on sale of the machinery.

Suggested Accounting Treatment

1. As per the Guidance Note, a dealer should recognise VAT credit as soon as he becomes entitled to it. In the present case, as per the State VAT laws, the dealer becomes entitled to VAT credit only when the machinery is sold. Accordingly, he should recognise the VAT credit only on sale of the machinery. To recognise the credit, the dealer passes the following entry:

July 1, 20x5 VAT Credit Receivable
 (Capital Goods) A/c Dr. Rs. 1,35,000

To Machinery A/c Rs. 1,35,000

(Being VAT credit becoming available on sale of
machinery)

2. Machinery A/c will appear in the books of the dealer as below:

Machinery A/c

Date	Particulars	Debit (Rs.)	Credit (Rs.)	Balance	
				Dr./ Cr.	Amount (Rs.)
20x5 April 1	To Balance b/d (Original Cost)	12,00,000		Dr.	12,00,000
July 1	By Bank (Sale Consideration)		15,00,000	Cr.	3,00,000
July 1	By Provision for Depreciation (Upto March 31, 20x5)		1,50,000	Cr.	4,50,000
July 1	By Depreciation for current year		30,000	Cr.	4,80,000
July 1	By VAT Credit Receivable (Capital Goods) A/c		1,35,000	Cr.	6,15,000
July 1	To Profit on sale	6,15,000			Nil
	<i>Total</i>	18,15,000	18,15,000		

VAT Credit in Case of Opening Stock at the Inception of VAT Scheme

Illustration 1

On April 1, 20x5 (the date on which VAT scheme comes into effect), a dealer has an opening stock of Rs. 9,36,000 and the dealer has paid sales tax of Rs. 36,000 on purchase. As per the State VAT laws, these goods are eligible for availing VAT credit in respect of the tax paid. This VAT credit will be available over a period of 6 months after an interval of 3 months needed for verification.

Suggested Accounting Treatment

1. On April 1, 20x5, the dealer passes the following entry to record the VAT credit that will be available in respect of the opening stock:

VAT Credit Deferred (Opening Stock) A/c	Dr.	Rs. 36,000	
To VAT Credit Available on Opening Stock A/c			Rs. 36,000
(Being VAT credit in respect of opening stock at the inception of the VAT scheme)			

2. On July 1, 20x5, when first instalment of VAT credit becomes actually available, the dealer passes the following entry to recognise the amount becoming available:

VAT Credit Receivable (Inputs) A/c	Dr.	Rs. 6,000	
To VAT Credit Deferred (Opening Stock) A/c			Rs. 6,000
(Being a portion of VAT credit on opening stock becoming available)			

3. The dealer will repeat the entry mentioned at 2 above for the next 5 months to record the amount of VAT credit becoming available.

4. The dealer discloses opening stock and VAT credit availed in respect thereof in the profit and loss account in the following manner:

Extracts from the Profit and Loss Account

Particulars	Amount (Rs.)	
Opening Stock	Rs. 9,36,000	
Less: VAT Credit Available on Opening Stock	<u>Rs. 36,000</u>	Rs. 9,00,000

Illustration 2

Continuing Illustration 1, suppose as per the State VAT laws, immediate VAT credit in respect of the tax paid on opening stock is available. In case any part of the opening stock remains unsold upto December 31, 20x5, the dealer is required to reverse VAT credit in respect of unsold stock. The dealer has unsold goods worth Rs. 2,50,000 (net of VAT credit) from the opening stock on December 31, 20x5 and, therefore, he is required to reverse VAT credit to the extent of Rs. 10,000.

Suggested Accounting Treatment

1. On April 1, 20x5, the dealer passes the following entry to record the VAT credit available in respect of the opening stock:

VAT Credit Receivable (Inputs) A/c	Dr.	Rs. 36,000	
To VAT Credit Available on Opening Stock A/c			Rs. 36,000
(Being VAT credit in respect of opening stock at the inception of the VAT scheme)			

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2. On December 31, 20x5, the dealer passes the following entry to reverse the VAT credit in respect of unsold goods:

VAT Credit Available on Opening Stock A/c	Dr.	Rs. 10,000	
To VAT Credit Receivable (Inputs) A/c			Rs. 10,000
(Being VAT credit reversed in respect of unsold opening stock)			

GN(A) 20 (Issued 2005)

Guidance Note on Accounting for Fringe Benefits Tax

Foreword

Of all the sources of government receipts, the most important is tax-revenue. It is also the most important instrument for ensuring social justice, both in equitably distributing the burden of development, as also in reducing inequalities of incomes. Compared to other sources such as borrowing and deficit financing, it is preferable because, unlike borrowing, it involves no interest burden, and unlike deficit financing, it does not result in rise in prices.

In the recent years the Government has undertaken major reforms of the tax-system of the country. The several changes in the taxes, direct and indirect, subserve important goals of the Government as envisaged in its new economic policy. As another step in this direction, the Finance Act, 2005, has introduced Chapter XII-H on 'Income-tax on Fringe Benefits' in the Income-tax Act, 1961. With the introduction of Fringe Benefits Tax, the profession of Chartered Accountants is placed with the responsibility of ensuring proper financial reporting of the tax. Since the Fringe Benefits Tax has raised issues of accounting, I am happy that the Research Committee of the Institute has formulated this Guidance Note on Accounting for Fringe Benefits Tax which has been issued under the authority of the Council of the Institute.

I am confident that this Guidance Note would be useful not only to the members but also to others concerned.



New Delhi
July 15, 2005

Kamlesh S. Vikamsey
President

Preface

India has a well developed tax structure with a three-tier federal structure, comprising the Union Government, the State Governments, and the Urban/Rural Local Bodies. The power to levy taxes and duties is distributed among the three tiers of Governments, in accordance with the provisions of the Indian Constitution. One of the main taxes/duties that the Union Government is empowered to levy is Income-tax. Recently, the Finance Act, 2005, has introduced Fringe Benefits Tax which is a new tax in the tax regime of India.

The Fringe Benefits Tax is an additional tax to be paid by an employer in addition to the income-tax payable for every assessment year starting from the assessment year 2006-07. The tax is to be paid in respect of the fringe benefits provided or deemed to have been provided by an employer to his employees. Fringe Benefits Tax is a new law and as is the case with any new law, many issues arise not only in respect of its interpretation and application but also with regard to accounting for the tax for the purpose of preparation of financial statements. The Institute of Chartered Accountants of India, being the premier accounting body in the country, decided to pro-actively provide guidance on its accounting and for this purpose to issue a Guidance Note on the subject through its Research Committee. Accordingly, the Research Committee prepared the Guidance Note on Accounting for Fringe Benefits Tax, which has been subsequently approved by the Council of the Institute.

The Guidance Note deals with accounting for Fringe Benefits Tax, particularly with regard to the recognition and presentation of the Fringe Benefits Tax in the financial statements. The Guidance Note does not deal with accounting for 'fringe benefits' as such.

I am thankful to Shri S.C.Vasudeva, my esteemed senior colleague, on the Research Committee and the Central Council and the Chairman, Accounting Standards Board, for his invaluable support and contribution in the finalisation of the Guidance Note. I also place on record my sincere appreciation for the contribution made by Shri Ved Jain, my colleague on the Central Council and the Chairman of Fiscal Laws Committee. I would also like to thank all other members of the Research Committee, namely, Shri K.P.Khandelwal (Vice-Chairman), Shri Kamlesh S. Vikamsey (President), Shri T.N.Manoharan (Vice-President), Shri Shanti Lal Daga, Shri Anuj Goyal, Shri H.N.Motiwalla, Ms. Bulbul Sen, Shri T.G.Srinivasan, Shri Gobind Prasad Agrawal, Shri K.

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Nagarajan, Shri O.P. Maheshwari, Shri R.M. Kothari, Shri Rajiv Dave and Shri Sujal A. Shah for their invaluable suggestions and inputs.



Pankaj Jain
Chairman
Research Committee

New Delhi
July 15, 2005

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Guidance Note on Accounting for Fringe Benefits Tax

(The following is the text of the Guidance Note on Accounting for Fringe Benefits Tax, issued by the Council of the Institute of Chartered Accountants of India¹.)

1. The Finance Act, 2005, has introduced Chapter XII-H on 'Income-tax on Fringe Benefits' [hereinafter referred to as 'Fringe Benefits Tax']. The relevant extracts from Chapter XII-H of the Income-tax Act, 1961 (hereinafter referred to as 'the Act'), governing the Fringe Benefits Tax, have been reproduced in the Annexure to this Guidance Note. This Guidance Note is being issued to provide guidance on accounting for Fringe Benefits Tax, particularly with regard to the recognition and presentation of Fringe Benefits Tax in the financial statements. The Guidance Note does not deal with accounting for 'fringe benefits' as such.

2. The salient features of Fringe Benefits Tax are as below:

- (a) Fringe Benefits Tax is tax payable by an employer in respect of fringe benefits provided or deemed to have been provided by the employer to his employees during the previous year.
- (b) Fringe Benefits Tax is in addition to the income-tax charged under the Act.
- (c) Fringe Benefits Tax is payable at the specified rate on the value of fringe benefits. The value of fringe benefits is calculated in accordance with the provisions of section 115WC of the Income-tax Act, 1961, reproduced in the Annexure to this Guidance Note.
- (d) An employer is required to pay Fringe Benefits Tax even if no income-tax on the total income is payable.

¹ Recommendations contained in this Guidance Note are intended to apply only to items which are material.

- (e) The term 'employer' means:
 - (i) a company;
 - (ii) a firm;
 - (iii) an association of persons or a body of individuals, whether incorporated or not, but excluding any fund or trust or institution eligible for exemption under clause (23C) of section 10 or registered under section 12AA of the Act;
 - (iv) a local authority; and
 - (v) every artificial juridical person, not falling within any of the preceding sub-clauses.
- (f) The term 'fringe benefits' means any consideration for employment provided by way of –
 - (i) any privilege, service, facility or amenity, directly or indirectly, provided by an employer, whether by way of reimbursement or otherwise, to his employees (including former employee or employees);
 - (ii) any free or concessional ticket provided by the employer for private journeys of his employees or their family members; and
 - (iii) any contribution by the employer to an approved superannuation fund for employees.

The privilege, service, facility or amenity does not include perquisites in respect of which tax is paid or payable by the employee.
- (g) The fringe benefits shall be deemed to have been provided by the employer to his employees, if the employer has, in the course of his business or profession (including any activity whether or not such activity is carried on with the object of deriving income, profits or gains), incurred any expense on or

made any payment for the purposes stated in section 115WB(2) of the Act. Examples of the purposes stated under the said section are entertainment, festival celebrations, gifts, maintenance of guest house, employees' welfare, hotel, boarding and lodging, conveyance, tour and travel (including foreign travel), etc.

- (h) Every employer who during a previous year has paid or made provision for payment of fringe benefits to his employees, is required to furnish a return of fringe benefits to the Assessing Officer in the prescribed form, on or before the due date, in respect of the previous year.
- (i) Fringe Benefits Tax, like any other direct tax, is not an allowable expenditure for the purpose of computation of taxable income.

Nature of Fringe Benefits Tax

3. With a view to recommend a proper and uniform accounting treatment for the Fringe Benefits Tax, it is necessary to understand the nature of Fringe Benefits Tax which is discussed in paragraph 4.

4. The Fringe Benefits Tax has been introduced under the Income-tax Act, 1961, as 'additional income-tax', vide section 115WA(1) which provides as below:

"In addition to the income-tax charged under this Act, there shall be charged for every assessment year commencing on or after the 1st day of April, 2006, additional income-tax (in this Act referred to as fringe benefit tax) in respect of the fringe benefits provided or deemed to have been provided by an employer to his employees during the previous year at the rate of thirty per cent on the value of such fringe benefits."

Thus, the above stated tax is an additional income-tax payable by the employer on the value of fringe benefits provided or deemed to have been provided to its employees.

Recognition and Measurement of Fringe Benefits Tax

5. An employer becomes liable to pay Fringe Benefits Tax as soon as it incurs an expense which is considered to be a fringe benefit as per the requirements of Chapter XII-H of the Income-tax Act, 1961, even though the actual payment of the tax and/or assessment of the tax takes place on a later date. Accordingly, the employer should recognise, in the financial statements for the period, expense for the Fringe Benefits Tax paid/payable in respect of all expenses giving rise to such tax incurred during that period.

6. As discussed in paragraph 2(c) above, the Fringe Benefits Tax is payable at the specified rate on the value of fringe benefits. The value of fringe benefits is calculated in accordance with the provisions of section 115WC of the Act. The employer should, therefore, measure the amount of the Fringe Benefits Tax keeping in view the aforesaid provisions of the Act.

Presentation of Fringe Benefits Tax in Financial Statements

7. Paragraph 5 of Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', issued by the Institute of Chartered Accountants of India, provides as below:

“5. All items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise.”

Since the Fringe Benefits Tax is an additional tax for the employer, it should be included in the determination of net profit or loss for the period, *i.e.*, the Fringe Benefits Tax, should be charged to the profit and loss account.

8. In the context of presentation of the Fringe Benefits Tax in the profit and loss account of companies, it has been considered whether the tax is covered by the requirement of clause 3(vi) of Part II of Schedule VI to the Companies Act, 1956, which provides as below:

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“The amount of charge for Indian income-tax and other Indian taxation on profits, including, where practicable, with Indian income-tax any taxation imposed elsewhere to the extent of the relief, if any, from Indian income-tax and distinguishing, where practicable, between income-tax and other taxation.”

As discussed in paragraph 4 above, the Fringe Benefits Tax is an additional income-tax. Accordingly, the Fringe Benefits Tax is covered by the above clause and should be shown separately, if material.

9. Keeping in view the above, the Fringe Benefits Tax should be disclosed as a separate item after determining profit before tax on the face of the profit and loss account for the period in which the related fringe benefits are recognised. An illustration of the disclosure of Fringe Benefits Tax may be as below:

Profit before tax			xxx
Less: Income-tax expense:			
Current tax	xxx		
Deferred tax	<u>xxx</u>	xxx	
Fringe Benefits Tax		<u>xxx</u>	<u>xxx</u>
Profit after tax			<u>xxx</u>

10. The amount of the Fringe Benefits Tax (net of the advance tax thereon), outstanding if any, at the year-end, should be disclosed as a provision in the balance sheet.

Annexure

The Relevant Extracts from Chapter XII-H of the Income-tax Act, 1961, Governing the Fringe Benefits Tax (For assessment year 2006-07)

A.—Meaning of certain expressions

Definitions

115W. In this Chapter, unless the context otherwise requires,—

- (a) “employer” means,—
 - (i) a company;
 - (ii) a firm;
 - (iii) an association of persons or a body of individuals, whether incorporated or not, but excluding any fund or trust or institution eligible for exemption under clause (23C) of section 10 or registered under section 12AA;
 - (iv) a local authority; and
 - (v) every artificial juridical person, not falling within any of the preceding sub-clauses;
- (b) “fringe benefit tax” or “tax” means the tax chargeable under section 115WA.

B.—Basis of charge

Charge of Fringe Benefit Tax

115WA. (1) In addition to the income-tax charged under this Act, there shall be charged for every assessment year commencing on or after the 1st day of April, 2006, additional income-tax (in this Act referred to as fringe benefit tax) in respect of the fringe benefits provided or deemed to have been provided

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by an employer to his employees during the previous year at the rate of thirty per cent on the value of such fringe benefits.

(2) Notwithstanding that no income-tax is payable by an employer on his total income computed in accordance with the provisions of this Act, the tax on fringe benefits shall be payable by such employer.

Fringe Benefits

115WB. (1) For the purposes of this Chapter, “fringe benefits” means any consideration for employment provided by way of—

- (a) any privilege, service, facility or amenity, directly or indirectly, provided by an employer, whether by way of reimbursement or otherwise, to his employees (including former employee or employees);
- (b) any free or concessional ticket provided by the employer for private journeys of his employees or their family members; and
- (c) any contribution by the employer to an approved superannuation fund for employees.

(2) The fringe benefits shall be deemed to have been provided by the employer to his employees, if the employer has, in the course of his business or profession (including any activity whether or not such activity is carried on with the object of deriving income, profits or gains) incurred any expense on, or made any payment for, the following purposes, namely:—

- (A) entertainment;
- (B) provision of hospitality of every kind by the employer to any person, whether by way of provision of food or beverages or in any other manner whatsoever and whether or not such provision is made by reason of any express or implied contract or custom or usage of trade but does not include—

Accounting for Fringe Benefits Tax

- (i) any expenditure on, or payment for, food or beverages provided by the employer to his employees in office or factory;
 - (ii) any expenditure on or payment through paid vouchers which are not transferable and usable only at eating joints or outlets;
- (C) conference (other than fee for participation by the employees in any conference).

Explanation.—For the purposes of this clause, any expenditure on conveyance, tour and travel (including foreign travel), on hotel, or boarding and lodging in connection with any conference shall be deemed to be expenditure incurred for the purposes of conference;

- (D) sales promotion including publicity:

Provided that any expenditure on advertisement,—

- (i) being the expenditure (including rental) on advertisement of any form in any print (including journals, catalogues or price lists) or electronic media or transport system;
- (ii) being the expenditure on the holding of, or the participation in, any press conference or business convention, fair or exhibition;
- (iii) being the expenditure on sponsorship of any sports event or any other event organised by any Government agency or trade association or body;
- (iv) being the expenditure on the publication in any print or electronic media of any notice required to be published by or under any law or by an order of a court or tribunal;

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(v) being the expenditure on advertisement by way of signs, art work, painting, banners, awnings, direct mail, electric spectacles, kiosks, hoardings, bill boards or by way of such other medium of advertisement; and

(vi) being the expenditure by way of payment to any advertising agency for the purposes of clauses (i) to (v) above,

shall not be considered as expenditure on sales promotion including publicity;

(E) employees' welfare.

Explanation.—For the purposes of this clause, any expenditure incurred or payment made to fulfil any statutory obligation or mitigate occupational hazards or provide first aid facilities in the hospital or dispensary run by the employer shall not be considered as expenditure for employees' welfare;

(F) conveyance, tour and travel (including foreign travel);

(G) use of hotel, boarding and lodging facilities;

(H) repair, running (including fuel), maintenance of motor cars and the amount of depreciation thereon;

(I) repair, running (including fuel) and maintenance of aircrafts and the amount of depreciation thereon;

(J) use of telephone (including mobile phone) other than expenditure on leased telephone lines;

(K) maintenance of any accommodation in the nature of guest house other than accommodation used for training purposes;

(L) festival celebrations;

(M) use of health club and similar facilities;

(N) use of any other club facilities;

(O) gifts; and

(P) scholarships.

(3) For the purposes of sub-section (1), the privilege, service, facility or amenity does not include perquisites in respect of which tax is paid or payable by the employee.

Value of Fringe Benefits

115WC. (1) For the purpose of this Chapter, the value of fringe benefits shall be the aggregate of the following, namely:—

(a) cost at which the benefits referred to in clause (b) of sub-section (1) of section 115WB, is provided by the employer to the general public as reduced by the amount, if any, paid by, or recovered from, his employee or employees:

Provided that in a case where the expenses of the nature referred to in clause (b) of sub-section (1) of section 115WB are included in any other clause of sub-section (2) of the said section, the total expenses included under such other clause shall be reduced by the amount of expenditure referred to in the said clause (b) for computing the value of fringe benefits;

(b) actual amount of contribution referred to in clause (c) of sub-section (1) of section 115WB;

(c) twenty per cent of the expenses referred to in clauses (A) to (K) of sub-section (2) of section 115WB;

(d) fifty per cent of the expenses referred to in clauses (L) to (P) of sub-section (2) of section 115WB.

(2) Notwithstanding anything contained in sub-section (1),—

(a) in the case of an employer engaged in the business of hotel, the value of fringe benefits for the purposes referred to in clause (B) of sub-section (2) of section 115WB shall be “five per cent”

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instead of “twenty per cent” referred to in clause (c) of sub-section (1);

- (b) in the case of an employer engaged in the business of construction, the value of fringe benefits for the purposes referred to in clause (F) of sub-section (2) of section 115WB shall be “five per cent” instead of “twenty per cent” referred to in clause (c) of sub-section (1);
- (c) in the case of an employer engaged in the business of manufacture or production of pharmaceuticals, the value of fringe benefits for the purposes referred to in clauses (F) and (G) of sub-section (2) of section 115WB shall be “five per cent” instead of “twenty per cent” referred to in clause (c) of sub-section (1);
- (d) in the case of an employer engaged in the business of manufacture or production of computer software, the value of fringe benefits for the purposes referred to in clauses (F) and (G) of sub-section (2) of section 115WB shall be “five per cent” instead of “twenty per cent” referred to in clause (c) of sub-section (1);
- (e) in the case of an employer engaged in the business of carriage of passengers or goods by motor car, the value of fringe benefits for the purposes referred to in clause (H) of sub-section (2) of section 115WB shall be “five per cent” instead of “twenty per cent” referred to in clause (c) of sub-section (1);
- (f) in the case of an employer engaged in the business of carriage of passengers or goods by aircraft, the value of fringe benefits for the purposes referred to in clause (I) of sub-section (2) of section 115WB shall be taken as *Nil*.

*C.— Procedure for filing of return in respect of fringe benefits,
assessment and payment of tax in respect thereof*

Return of Fringe Benefits

115WD. (1) Without prejudice to the provisions contained in section 139, every employer who during a previous year has paid or made provision for payment of fringe benefits to his employees, shall, on or before the due date, furnish or cause to be furnished a return of fringe benefits to the Assessing Officer in the prescribed form and verified in the prescribed manner and setting forth such other particulars as may be prescribed, in respect of the previous year.

Explanation.—In this sub-section, “due date” means,—

- (a) where the employer is—
 - (i) a company; or
 - (ii) a person (other than a company) whose accounts are required to be audited under this Act or under any other law for the time being in force,the 31st day of October of the assessment year;
- (b) in the case of any other employer, the 31st day of July of the assessment year.

Payment of Fringe Benefits Tax

115WI. Notwithstanding that the regular assessment in respect of any fringe benefits is to be made in a later assessment year, the tax on such fringe benefits shall be payable in advance during any financial year, in accordance with the provisions of section 115WJ, in respect of the fringe benefits which would be chargeable to tax for the assessment year immediately following that financial year, such fringe benefits being hereafter in this Chapter referred to as the “current fringe benefits”.

Advance Tax in Respect of Fringe Benefits

115WJ. (1) Every assessee who is liable to pay advance tax under section 115WI, shall on his own accord, pay advance tax on his current fringe benefits calculated in the manner laid down in sub-section (2).

(2) The amount of advance tax payable by an assessee in the financial year shall be thirty per cent of the value of the fringe benefits referred to in section 115WC, paid or payable in each quarter and shall be payable on or before the 15th day of the month following such quarter:

Provided that the advance tax payable for the quarter ending on the 31st day of March of the financial year shall be payable on or before the 15th day of March of the said financial year.

(3) Where an assessee, has failed to pay the advance tax for any quarter or where the advance tax paid by him is less than thirty per cent of the value of fringe benefits paid or payable in that quarter, he shall be liable to pay simple interest at the rate of one per cent on the amount by which the advance tax paid falls short of, thirty per cent of the value of fringe benefits for any quarter, for every month or part of the month for which the shortfall continues.

GN(A) 21 (Issued 2005)

Guidance Note on Accounting by Schools

Foreword

Education is one of the most important aspects of our national life. Needless to mention, education holds the key to the development and progress in every sphere of our existence. From an integrated and synergic viewpoint, educational system constitutes the foundation of the legal, administrative, civic and other domains of India of tomorrow. Schools, undoubtedly, form the foundation of the entire education system.

For carrying out their activities, schools receive large amount of funds from Government and other sources. In various segments of the society, a concern was being expressed for greater accountability of the financial resources used by the schools. Financial reporting provides information to present and potential resource providers in making rational decisions about the allocation of resources to various organisations. Keeping this in view, a need was being felt for developing an accounting and financial reporting framework for schools based on sound accounting principles. To fulfill that need I am happy that the Research Committee of the Institute has formulated this Guidance Note on Accounting by Schools which has been approved by the Council of the Institute.

I am confident that this Guidance Note would be extremely helpful not only to the members of the Institute but also to others concerned.



New Delhi
July 21, 2005

Kamlesh S. Vikamsey
President

Preface

Education is an investment in the human capital of a country as it fosters growth, social equality and technological progress. Globalisation and the emergence of a new society more dependent on knowledge and information technology, have further underlined the importance of education in pursuing developmental goals. At present, innumerable schools are running in the country to impart education at primary and secondary level. The issues involved in accounting and financial reporting of schools are more or less common. This 'Guidance Note on Accounting by Schools' primarily focuses to address the various issues by establishing sound accounting practices and recommending uniform formats of income and expenditure account and balance sheet.

The Guidance Note deals with specific issues relating to accounting by schools and is applicable to all non-governmental schools whether Government aided or not and whether established by a trust or a society or by any other form of organisation. The Guidance Note specifically deals with accounting issues related to fees and other charges received from students; salaries, allowances and retirement benefits; grants and donations; depreciation of assets; related party disclosures and transition to the accrual basis of accounting which is a scientific method of accounting. It is expected that the implementation of this Guidance Note will impart greater transparency and uniformity in the financial statements of schools thereby increasing accountability of the financial resources used by the schools.

The representatives of Ministry of Human Resource Development, Council of Indian School Certificate Examinations and Central Board of Secondary Education were involved in the formulation of the Guidance Note. The draft of the Guidance Note had also been circulated among various associations of schools and also hosted on the web site of the Institute for comments.

I would like to take this opportunity to place on record my sincere appreciation for the contribution made by Shri Vivek Bharadwaj (Ministry of Human Resource Development), Ms. Rita Wilson (Council of Indian School Certificate Examinations), Shri Sanjay Garg (Central Board of Secondary Education), Shri Virender Kalra, a practising Chartered accountant and other experts for giving their invaluable comments and suggestions on the draft Guidance Note.

Accounting by Schools

I sincerely appreciate the efforts put in by Dr. Avinash Chander, Technical Director, Ms. Anuradha Jain, Secretary, Research Committee, and Ms. Jyoti Singh, Technical Officer, of the Institute of Chartered Accountants of India, in preparing the draft of the Guidance Note.

I firmly believe that this publication would prove useful in establishing sound accounting and reporting system in schools and would be immensely helpful to the members of the Institute and others concerned.



New Delhi
July 21, 2005

Pankaj I. Jain
Chairman
Research Committee

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Guidance Note on Accounting by Schools

(The following is the text of the Guidance Note on Accounting by Schools, issued by the Council of the Institute of Chartered Accountants of India.)

Introduction

1. Schools form the foundation of the entire education system of a country. The quality of education imparted in schools, therefore, is of prime importance in determining the quality of manpower which a country has. Keeping in view the significant role played by schools in development of qualitative manpower in a country, the Government provides resources, particularly in the form of concessions and incentives, to schools. Apart from the Government, education being considered as a noble activity since ages, various philanthropists, including various industrial houses, have contributed to the cause of education, particularly at school level. Thus, school as an institution has developed primarily as a not-for-profit activity.

2. Given the historical background of development of schools primarily as a not-for-profit activity, accounting and financial reporting practices followed by non-governmental schools have been oriented towards meeting the needs of the governing bodies running the schools. However, in recent years, with increase in government aid to schools particularly in the form of concessions and incentives, increased fees charged from the students and increased donations by certain donor-agencies, greater need is being felt for accountability of the financial resources used by the schools. A sound accounting and financial reporting framework acts as an important ingredient for promoting accountability of an organisation. It has, however, been found that the present system of accounting and financial reporting followed in schools does not adequately meet the accountability concerns of the donor-agencies, including Government, and other stakeholders such as the parents of the students who provide funds to the schools in the form of fees and donations¹. The basis of accounting being followed in schools is generally

¹ Such concerns have been expressed, for example, by the Supreme Court in *Modern School Vs. Union of India and Ors.* (2001) and the Report of the Committee on Fee Hike and Other Charges in Recognised Unaided Private Schools in Delhi (1999)

not based on scientific accrual basis of accounting and also the accounting practices which are being followed are diverse.

Objectives

3. The objectives of this Guidance Note are to recommend -
 - (i) application of sound accounting principles pertaining to recognition, measurement and disclosure of various items of income and expenses, assets and liabilities in the financial statements of schools keeping in view the peculiarities of the activities of the schools, and
 - (ii) formats of financial statements keeping in view not-for-profit being the objective of the school,with a view to harmonise the diverse accounting practices being followed in the schools.

Scope

4. This Guidance Note is applicable to all non-governmental schools whether Government aided or not, whether established by a trust or a society or by any other form of organisation².
5. For the purpose of this Guidance Note, a school is considered as the reporting entity and, therefore, it has to keep separate books of account and has to prepare separate financial statements. Thus, if a society or a trust runs two schools, each school should maintain its separate books of account and prepare separate financial statements as recommended in this Guidance Note. This, however, does not preclude the society or the trust from preparation of the financial statements of the society or the trust as a whole, including therein income, expenses, assets and liabilities pertaining to the school(s) established by it, as per the requirements of any statute or a regulator or otherwise.

constituted by the Government of National Capital Territory of Delhi pursuant to the judgement of the Hon'ble High Court of Delhi, dated 30/10/1998 in C.W. No. 3723 of 1997.

² Other types of educational institutions like colleges may also apply the principles laid down in this Guidance Note to the extent applicable.

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6. This Guidance Note is applicable not only to educational activities of the schools but also to other activities which are incidental to the educational activities such as provision of hostel facilities, canteen facilities, transportation, books and stationery, etc.

Definitions

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

Accounting period means the period of 12 months commencing on the first day of April every year.

Accounting policies are the specific principles, bases, conventions, rules and practices adopted by a school in preparing and presenting financial statements.

Accrual basis means a basis of accounting under which transactions and other events are recognised when they occur (and not only when cash or its equivalent is received or paid). Therefore, the transactions and events are recorded in the accounting records and recognised in the financial statements of the periods to which they relate. The elements recognised under accrual accounting are assets, liabilities, revenue and expenses.

Assets are resources controlled by a school as a result of past events and from which future economic benefits or service potential are expected to flow to the school.

Designated funds are unrestricted funds which have been set aside by the school management for specific purposes or to meet specific future commitments.

Endowment funds are restricted funds received with the stipulation of keeping the principal intact and to use for a specified purpose the income derived from investing the principal.

Expenses are decreases in economic benefits or service potential during the accounting period in the form of outflows or depletion of assets or incurrences of liabilities that result in decreases in general fund/corpus of school, other than those relating to distributions/transfers to the trust or society or any other body managing the school.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Financial statements include income and expenditure account and balance sheet and other statements and explanatory notes which form part thereof.

Income is the increase in economic benefits or service potential during the accounting period when that increase results in an increase in general fund/corpus of school, other than increases relating to contributions/transfers from the trust or society or any other body managing the school.

Liabilities are present obligations of the school arising from past events, the settlement of which is expected to result in an outflow from the school of resources embodying economic benefits or service potential.

Restricted funds are contributions received by the school, the use of which is restricted by the contributors.

School includes a pre-primary, primary, middle and higher secondary school, and also includes any other institution which imparts education or training below the degree level, but does not include an institution which imparts technical education.

Unrestricted funds are contributions received or funds generated by the school, the use of which is not restricted by the contributors.

Accounting Framework for Schools

8. The Framework is concerned with general purpose financial statements (hereafter referred to as 'financial statements'). Such financial statements are prepared and presented at least annually and are directed toward the common information needs of a wide range of users. These users have to rely on the financial statements as their major source of financial information and cannot prescribe the information they want from an organisation. The general purpose financial statements should, therefore, be prepared and presented with their needs in view. Special purpose financial reports, for example, computations prepared for taxation purposes or specialised needs of regulatory bodies, donor agencies, or others having the authority to obtain the type of information they need are outside the scope of this Framework. For instance, a statute/regulation in a state applicable to schools may prescribe certain specific requirements, e.g., utilisation of funds in a particular manner or statement of

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fees to be charged in each academic year, etc. Where the general purpose financial statements prepared in accordance with the recommendations contained in this Guidance Note do not provide such requisite information, it would be appropriate to prepare a separate statement for the specific purpose envisaged in the relevant statute/regulation. The recommendations contained in this Guidance Note may be applied to such specific purpose statements to the extent appropriate.

9. It is often argued that since profit is not the objective of schools, the accounting framework, which is relevant for business entities is not appropriate for schools. With a view to recommend suitable accounting system for schools, it would be imperative to understand the major ingredients of an accounting framework. An accounting framework primarily comprises the following:

(a) Elements of financial statements basically comprising income, expenses, assets and liabilities

The framework aims to identify which items should be considered as income, expenses, assets and liabilities, for the purpose of including the same in the financial statements by defining the aforesaid terms.

(b) Principles for recognition of items of income, expenses, assets and liabilities

These principles lay down the *timing* of recognition of the aforesaid items in the financial statements. In other words, these principles lay down *when* an item of income, expense, asset or liability should be recognised in the financial statements.

(c) Principles of measurement of items of income, expense, assets and liabilities

These principles lay down at *what* amount the aforesaid items should be recognised in the financial statements.

(d) Presentation and disclosures principles

These principles lay down the manner in which the financial statements are to be presented and the disclosures which should be made therein.

10. It may be noted that what is considered as an asset, e.g., land and furniture, by a business entity is an asset for a not-for-profit organisation

also. Same is the case for items of income, expenses and liabilities. Similarly, insofar as the recognition principles are concerned, it is felt that there is no difference in preparing the financial statements of business entities and not-for-profit organisations such as schools. For example, the timing of the recognition of a grant as an income in the financial statements of an organisation does not depend upon the purpose for which the organisation is run. A grant is recognised as income in the financial statements, under accrual basis of accounting, when it becomes reasonably certain that the grant will be received and that the organisation will fulfill the conditions attached to it, and under cash basis of accounting at the time when the grant is actually received. Thus, a business entity and a not-for-profit organisation would follow the aforesaid criteria for recognition of grant as income depending upon the basis of accounting (i.e., cash or accrual basis, discussed hereinafter) followed by the respective organisation rather than the purpose for which the organisation is run. Similarly, principles for recognition of expenses, assets and liabilities would be the same for a business entity and a not-for-profit organisation.

11. Insofar as the measurement principles are concerned, the same principles are relevant to a not-for-profit organisation as well as to a business entity. For example, depreciation of an asset represents primarily the extent to which the asset is used during an accounting period by an organisation. Thus, whether an asset, such as a photocopying machine, is used by a school or a business entity, the measure of charge by way of depreciation depends primarily upon the use of the asset rather than the purpose for which the organisation is run, i.e., profit or not-for-profit motive. Accordingly, the measurement principles for income, assets and liabilities should be the same for business entities and not-for-profit organisations such as schools.

12. Insofar as presentation of financial statements is concerned, not-for-profit organisations generally follow what is known as 'fund based accounting' whereas the business entities do not follow this system. This is because the not-for-profit organisations are generally funded by way of grants, donations or similar contributions which may or may not impose conditions on their usage. In other words, the use of funds may be restricted by an outside agency such as a donor or self-imposed by the organisation. The restrictions can be temporary or permanent (e.g., in case of endowments). Certain contributions may not carry restrictions of usage, i.e., these are unrestricted. It is, therefore, felt that the financial statements of not-for-profit organisations should reflect income, expenses, assets and liabilities in respect of such

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funds separately so as to enable the users of the financial statements, such as the contributors, to assess the usage of funds contributed by them. It may, thus, be seen that the fund-based accounting is relevant primarily for the purpose of presentation of financial statements and not for the purpose of identification, recognition and measurement of various items of income and expenses, assets and liabilities.

13. It may, therefore, be concluded from the above that while the identification, recognition and measurement of elements of financial statements are sector-neutral, the presentation of financial statements may differ among different sectors, viz., for-profit sector and not-for-profit sector. Similarly, disclosure principles may differ among various sectors.

14. In the sections following hereinafter, first, the bases of accounting, viz., cash and accrual, are discussed, since recognition and measurement of elements of financial statements depends on it. Thereafter, the recognition and measurement principles with regard to items of income, expenses, assets and liabilities are discussed followed by the formats of financial statements under which the fund based accounting is discussed in detail.

Basis of Accounting

15. The commonly prevailing bases of accounting are:

- (a) cash basis of accounting; and
- (b) accrual basis of accounting.

16. Under cash basis of accounting, transactions are recorded when the related cash receipts or cash payments take place. Thus, revenue (e.g., from fees, etc.) is recognised when cash is received. Similarly, expenditure on acquisition and maintenance of assets used in rendering of services by an organisation as well as on employee remuneration and other items is recorded when the related payments are made. No subsequent account is taken of whether the asset is still in use, has reached the end of its useful life, or has been sold. Thus, cash-based information fails to show a proper picture of financial position and performance. A cash-based system does not provide information about total costs of an organisation's activities.

17. Accrual basis of accounting is the method of recording transactions by which revenues, expenses, assets and liabilities are reflected in the accounts

in the period in which they accrue. Accrual basis of accounting attempts to record the financial effects of the transactions and other events of an enterprise in the period in which they occur rather than recording them in the period(s) in which cash is received or paid by the organisation. Accrual basis recognises that the economic events that affect an organisation's performance often do not coincide with the cash receipts and payments. The goal of accrual basis of accounting is to relate the accomplishments (measured in the form of revenues) and the efforts (measured in terms of costs) so that the reported net income measures an organisation's performance during a period rather than merely listing its cash receipts and payments. Apart from income measurement, accrual basis of accounting recognises assets, liabilities or components of revenues and expenses for amounts received or paid in cash in past, and amounts expected to be received or paid in cash in future. One of the resultant advantages is that it offers the opportunity to the organisation to improve management of assets. Similarly, accrual-based accounting provides useful information about the real level of an organisation's liabilities, relating to both debts and other obligations such as employee entitlements. Accrual is, thus, a scientific basis of accounting and has conceptual superiority over the cash basis of accounting. It is, therefore, recommended that all schools should maintain their books of account on accrual basis for all elements of financial statements.

Recognition and Measurement Principles

18. As noted above, the recognition and measurement principles for elements of financial statements are sector-neutral. Thus, schools should follow recognition and measurement principles, within the framework of accrual basis of accounting, for the purpose of preparation of their financial statements. Sound accounting principles under accrual basis of accounting, albeit in the context of business, industrial and commercial enterprises, have been laid down in the Accounting Standards, issued by the Institute of Chartered Accountants of India (ICAI). Since the focus of this Guidance Note is, inter alia, to recommend accounting for various items of income and expenses, assets and liabilities for the purpose of preparation and presentation of financial statements with a view to reflect a true and fair view of the operating results and state of affairs of the schools under accrual basis of accounting, Accounting Standards issued by ICAI have been followed in this Guidance Note for suggesting the accounting treatment in respect of various items of income, expenses, assets and liabilities. With regard to detailed treatment and for items not specifically dealt with in the Guidance Note, the relevant Accounting

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Standards should be referred to and followed with appropriate modifications, where necessary. Thus, while applying the accounting standards certain terms used in the Accounting Standards may need to be modified in the context of the corresponding appropriate terms for schools, e.g., where an accounting standard refers to the 'Statement of Profit and Loss', it should be considered that the standard refers to the 'Income and Expenditure Account' in the context of schools.

19. So far, the Institute of Chartered Accountants of India has issued 29 Accounting Standards out of which one standard (viz., AS 8) is no longer in force. For the purpose of applicability of Accounting Standards, enterprises have been classified into three categories, viz., Level I, Level II and Level III depending upon their nature and size. [(Reference for this purpose may be made to Compendium of Accounting Standards (including Interpretations as on July 1, 2004) (page (Ixvi))]³. Keeping in view the nature of activities carried on by the schools, some accounting standards may not be relevant to the schools unless events or transactions of the nature covered by the standard take place⁴. For example, Accounting Standard (AS) 22, Accounting for Taxes on Income, would be relevant only where the school is required to pay any tax under the provisions of the Income-tax Act.

20. The Accounting Standards are intended to apply only to items which are material. Information is material if its misstatement (i.e., omission or erroneous statement) could influence the decisions of users taken on the basis of financial information. Materiality depends on the size and nature of the item or error, judged in the particular circumstances of its misstatement. Materiality provides a threshold or cut-off point rather than being a primary

³ Reference for this purpose may be made to Appendix I to the Compendium of Accounting Standards (As on July 1, 2012) at page no. 639.

⁴ Accounting Standards normally not relevant to schools are as follows:

- (i) AS 7, Construction Contracts
- (ii) AS 14, Accounting for Amalgamations
- (iii) AS 17, Segment Reporting
- (iv) AS 20, Earnings Per Share
- (v) AS 21, Consolidated Financial Statements
- (vi) AS 22, Accounting for Taxes on Income
- (vii) AS 23, Accounting for Investments in Associates in Consolidated Financial Statements
- (viii) AS 24, Discontinuing Operations
- (ix) AS 25, Interim Financial Reporting
- (x) AS 27, Financial Reporting of Interests in Joint Ventures

qualitative characteristic which the information must have if it is to be useful. For example, a calculator purchased by a school for its use, costing Rs. 100, can be recognised as an expense in the year of purchase, although it fulfils the definition of a 'fixed asset', in case, considering the value of its other assets, revenue and its surplus, the size of the amount of Rs. 100 is not considered material.

21. Accounting Standards generally relevant to schools have been discussed hereinafter while dealing with peculiar items of income, expenses, assets and liabilities.

Income

22. Income is increase in economic benefits or service potential during the accounting period when the increase results either in the form of inflows or enhancements of assets or in the form of decreases in liabilities. The definition of income encompasses both revenue and gains. Revenue arises in the course of the ordinary activities of a school such as from receipt of tuition and other fees from the students, donations, sale of publications, prospectus, application forms, products in a canteen owned by the school, etc.

23. Gains represent other items that meet the definition of 'income' and may, or may not, arise in the course of the ordinary activities of a school. Gains represent increases in economic benefits and as such are no different in nature from revenue. Gains include, for example, those arising on disposal of fixed assets and sale of investments. When gains are recognised in the income and expenditure account, they are usually disclosed separately.

Recognition Criteria for Items of Income

24. An item that meets the definition of income becomes eligible to be recognised in the financial statements if -

- (a) it is probable that the inflow or other enhancement of future economic benefits has occurred; and
- (b) the inflow or other enhancements of future economic benefits can be measured reliably.

Revenue Recognition

25. The criteria for recognition of income specified in the above paragraph have been applied for developing principles of recognition of revenue in Accounting Standard (AS) 9, Revenue Recognition, in respect of revenue arising from sale of goods, rendering of services and use of resources of the organisation by others. In the context of a school, the principles related to recognition of revenue from sale of goods may be relevant for the purpose of recognising revenue from sale of publications, prospectus, products sold in the canteen owned by the school, etc. Revenue recognition principles related to rendering of services would be relevant for the purpose of recognition of tuition and other fees received from the students, since a school renders the service of education. Revenue recognition principles related to revenue from use of organisation's resources by others are relevant for the purpose of recognition of income from interest, rent, etc. The principles related to the aforesaid aspects are as below:

- (i) Revenue from sales or service transactions should be recognised when the requirements as to performance set out in paragraphs (ii) and (iii) below are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.
- (ii) In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:
 - (a) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and
 - (b) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.
- (iii) In a transaction involving the rendering of services, performance should be measured either under the completed service contract method or under the proportionate completion method, whichever relates the revenue to the work accomplished. Such performance

Accounting by Schools

should be regarded as being achieved when no significant uncertainty exists regarding the amount of the consideration that will be derived from rendering the service.

- (iv) Revenue arising from the use by others of organisation's resources yielding interest, royalties and dividends should only be recognised when no significant uncertainty as to measurability or collectability exists. These revenues are recognised on the following basis:

- | | |
|--|---|
| (a) Interest | on a time proportion basis taking into account the amount outstanding and the rate applicable |
| (b) Royalties | on an accrual basis in accordance with the terms of the relevant agreement. |
| (c) Dividends from Investments in shares | when the owner's right to receive payment is established. |

26. The application of the above principles laid down in AS 9 to certain significant peculiar items of financial statements of schools are dealt with hereinafter.

Tuition fees and fees received for pursuit of other curriculum activities

27. A major portion of revenue for a school is tuition fees from students and fee for pursuit of other curriculum activities such as library fees, computer fees, science fees, etc. According to the Appendix to AS 9, revenue arising from tuition fees should be recognised over the period of instruction. Thus, if the academic year of the school and the accounting year are different then it is possible that some fees may be received in advance or is outstanding at the end of the accounting year. Any fees received in advance for next accounting year should not be recognised as income for the year in which it is received, but should be shown as a liability in the balance sheet of the school. Such fees should be recognised as income in the income and expenditure account of the next accounting year to which it relates. Similarly, fees relating to the current year, if any, due from the students at the end of the accounting year should be recognised as income of the year. In rare circumstances, it may be unreasonable to expect ultimate collection of the

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outstanding dues from the students at the balance sheet date. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made.

28. The fee received for pursuit of other curriculum activities is also of the same nature as that of tuition fees and, therefore, the same principles are applicable for its recognition.

One time charges

29. Schools normally receive one time charges, i.e., the charges which are paid only once during the tenure of the studentship in the school. These charges are usually in the form of fees for admission to school, registration fees, etc. and are generally non-refundable. Such charges should be recognised as income when received.

Periodic charges

30. In addition to tuition fees and fees for pursuit of other curriculum activities and one-time charges, schools also receive some other non-refundable charges from the students on periodic basis, for example, magazine/newspapers charges and other annual charges received from the students at the beginning of each academic year. Such charges should be recognised as income on a time proportion basis over the relevant period. In case, any student is admitted to the school during the session, then the relevant period for this purpose will be the remaining academic year from the date of admission of the student.

Caution money

31. At the time of admission of a student to a school, caution money is also received which is refundable to the student at the time the student leaves the school. Caution money is of the nature of a deposit and, therefore, should not be considered as income. It should be shown as a liability in the balance sheet of the school. The caution money should be recognised as income only when a student waives his right to receive the caution money or it is forfeited by the school as per the rules or a student does not claim the caution money after becoming entitled to receive the same within the period during which refund can be claimed as per the policy of the school. The amount of caution money refundable to students within 12 months of the balance sheet date should be reflected as a 'current liability' in the balance

sheet and the caution money refundable beyond 12 months of the balance sheet date should be shown separately as a liability of long-term nature in the balance sheet.

Sale of prospectus, etc.

32. Revenue arising from the sale of prospectus and admission forms should be recognised at the time when the sale takes place.

Canteen Income

33. Canteen income may fall in either one or more of the following categories:

- Sale of products where the canteen is owned and run by the school itself;
- Contract charges where contract of running the canteen has been given to an outside party;
- Mess charges received from the students living in the hostel who pay a fixed amount per month for supply of food, etc.

34. Revenue from sale of products from the canteen owned by the school should be recognised when the sale takes place. Revenue from contract charges of the canteen given on contract should be recognised on a time proportion basis over the relevant contract period. Revenue from mess charges received from the students living in the hostel should also be recognised on a time proportion basis over the period for which charges have been received.

School premises given on rent to outside parties

35. Schools may give their premises on rent to outside parties for various purposes, such as, holding examinations, marriages, etc., and/or for running management or coaching institutes on part-time basis after the school hours. If the premises given on rent are owned by the school, rental income arising therefrom is the income of the school and should be treated as such even if it is received directly by the trust or society running the school. Such rental income should be recognised on a time proportion basis over the period for which the rent is received.

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Hostel fees

36. Hostel fees is the fees charged for boarding and lodging from the students who avail the hostel facility. Such fees may be charged on monthly, quarterly, half-yearly or even annual basis. Revenue from such fees should be recognised on time proportion basis over the period for which the fee is received. Thus, any fees received in advance or fees outstanding at the end of the accounting period should be accounted for in the same manner as discussed in paragraph 27 above for tuition fees and fees received for pursuit of other curriculum activities.

Revenue from provision of transportation facility

37. Revenue from provision of transportation facility to the students may fall in either of the following categories:

- Transportation fees where the school itself owns the transportation facilities, e.g., buses and vans;
- Contract charges where contract of providing transportation facility has been given to an outside party.

38. Revenue from transportation fees where the school itself owns transportation facilities should be recognised over the period during which the concerned facilities are provided by the school. Thus, any fee received in advance or fee outstanding at the end of the accounting period should be accounted for in the same manner as discussed in paragraph 27 above. Revenue from contract charges where the contract of providing facility has been given to an outside party should be recognised on a time proportion basis over the relevant contract period.

Supply of books, uniforms, etc., to the students

39. Schools generally enter into contracts, with outside parties, for supplying books, stationery, uniforms, etc., to the students. Such a party may pay to the school either a lump sum amount or a commission based on the value of the goods sold to the students. Where the party pays a lump sum amount to the school, revenue in this regard should be recognised on a time proportion basis over the period for which the amount is received, because, revenue is based on the period of contract and not on the value of goods sold by the contractor. However, where the school receives commission based on the

value of goods sold, revenue from the commission should be recognised at the time when sales are made by the contractor and an intimation to that effect is received.

Sponsorship fees

40. Some entities may place their banner(s) in the programmes or functions or may sponsor programmes or functions organised by the school. Any fees received from such entities is the revenue for the school and should be recognised in the income and expenditure account for the period in which the concerned programme or function is held.

Advertisements for School Magazine

41. The school magazine is, ordinarily, an annual feature and schools receive charges from various outside parties to publish their advertisements in it. As per the Appendix to AS 9, revenue in this regard should be recognised when the advertisement appears before the readers of the magazine, i.e., on publication and release of the school magazine to the students.

Amount received from Board for payment to Exam Invigilators

42. Schools receive amounts from the Education Boards for payment to the invigilators for conducting Board examinations. The amount received from the Board should be recognised as income and the amount paid/payable to the invigilators should be shown as an expense in the income and expenditure account. In case any amount received is lying with the school at the balance sheet date and has not been disbursed to the invigilators, it should be disclosed as a current liability of the school.

Board Fee

43. The Boards of Secondary Education like, CBSE, ICSE, etc., conduct examinations for Class X and XII in order to grant qualifying certificates to successful candidates of the affiliated schools. Schools collect the Board fee from the students and submit the same to the Boards. Board fee collected from the students should be recognised as income and the same paid/payable to the Board should be recognised as an expense in the income and expenditure account. In case a school receives Board fee from a student which is not remitted to the Board at the balance sheet date, the same should be shown as current liability in the balance sheet of the school.

Grants-in-Aid and Donations – Recognition and Measurement

44. Grants are assistance by government/non-government agencies in cash or in kind to a school for past or future compliance with certain conditions. Schools receive grants from various sources for various purposes such as those stated below:

- ☐ Building grant;
- ☐ Staff grant;
- ☐ Pension and retirement benefit grant;
- ☐ Grants for the acquisition of essential equipments, furniture, games and sports materials, etc.;
- ☐ Grants for purchase of books for the library and for establishing a book bank;
- ☐ Contingent grant for meeting expenditure on repairs of furniture, stationery, electricity, water charges, postage, periodicals, etc.;
- ☐ Rent grant;
- ☐ Depreciation grant;
- ☐ Hostel maintenance grant and hostel building depreciation grant.

45. The receipt of grants by a school is significant in preparation of the financial statements for two reasons. Firstly, if a grant has been received, an appropriate method of accounting therefor is necessary. Secondly, it is desirable to give an indication of the extent to which the recipient school has benefited from such grant during the reporting period. Further, this will facilitate comparison of the school's financial statements with those of prior periods and with those of other schools, which are receiving similar types of grant.

46. Accounting Standard (AS) 12, 'Accounting for Government Grants', prescribes accounting for government grants. The accounting treatment prescribed in AS 12 is based on the nature of the grant and the purpose for which the grant is received. Accordingly, a school should follow the principles enunciated in the standard in respect of accounting for government grants as

also for the grants received from non-government sources, e.g., individual donors and corporate bodies.

47. Keeping in view the principles enunciated in AS 12, nature of activities carried on by schools and to maintain uniformity of accounting policies followed, a school should account for grants as follows:

- (i) A school should recognise a grant when and only when there is reasonable assurance that the grant will be received and the school will be able to comply with the conditions attached to it. A mere promise of a grant does not warrant its recognition in the books of the school; there has to be a reasonable assurance with regard to the above mentioned factors.
- (ii) Grant received or receivable for construction or acquisition of a specific fixed asset, such as, land, building, furniture, etc., should be accounted for as below:
 - (a) Grants received to acquire a non-depreciable asset, e.g., freehold land, should be recognised separately as a 'restricted fund' in the balance sheet. When the asset is acquired, the concerned restricted fund is transferred to the 'General fund' in the balance sheet. However, if a grant related to a non-depreciable asset requires the fulfilment of certain obligations, the grant should be treated as deferred income which should be recognised as income over the same period over which the cost of meeting such obligations is charged to income. As an example, where a grant is received for acquiring land conditional upon the erection of a building on the land, it would be appropriate to recognise it as income over the life of the building.
 - (b) Grants related to a depreciable fixed asset should be treated as deferred income which should be recognised in the income and expenditure account by allocating it over the useful life of the asset in proportions in which depreciation on the asset concerned is charged.
 - (c) The deferred income balance, if any, should be shown separately in the balance sheet.

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- (iii) Grants in the form of non-monetary assets (such as fixed assets) received at a concessional rate should be accounted for on the basis of their acquisition cost. In case a non-monetary asset is received free of cost, it should be recorded at a nominal value of Re.1.
- (iv) Grants received for the purpose of meeting the revenue expenditure of the school such as, staff grant, pension and retirement benefits grant, contingent grant, rent grant, depreciation grant, hostel maintenance grant, etc., should be recognised on a systematic basis in the income and expenditure account over the periods necessary to match them with the related costs which they are intended to compensate.
- (v) Grants of the nature of promoters' contribution (e.g., the grant received from the trust owning the school) should be recognised separately as a part of the General Fund in the balance sheet.
- (vi) In some cases, a grant may be receivable by a school as compensation for expenses or losses incurred in a previous accounting period, or for providing immediate financial support to the school with no related further costs. Such grants should be recognised and disclosed in the income and expenditure account of the period in which they are receivable.
- (vii) The amount refundable in respect of grants received that relate to revenue as well as those that relate to specific fixed assets, should be applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount should be charged to the income and expenditure account of the school.

48. The principles enunciated in respect of grants as dealt with in the above paragraphs also apply to donations.

49. The detailed application of the principles enunciated above in respect of grants and donations in the financial statements, in the context of fund-based accounting, has been dealt with subsequently.

Expenses

50. The definition of 'expense' encompasses both expenses that arise in the course of the ordinary activities of the school as well as losses. Expenses that arise in the course of the ordinary activities of the school include, for example, salaries paid to teachers and other employees, retirement benefits to teachers and other employees, depreciation on fixed assets, repairs and maintenance of school building and furniture, electricity charges, stationery, etc. The expenses take the form of an outflow or depletion of assets or enhancement of liabilities.

51. Losses represent other items that meet the definition of 'expense' and may or may not arise in the course of the ordinary activities of the school. Losses represent decreases in economic benefits and as such they are no different in nature from other expenses. Losses include, for example, those resulting from disasters such as fire and flood, as well as those arising on the disposal of fixed assets. The definition of expenses also includes unrealised losses. These losses are generally recognised in the income and expenditure account, and are usually disclosed separately.

Recognition Criteria for Items of Expenses

52. An item that meets the definition of 'expense' becomes eligible to be recognised in the income and expenditure account when and only when:

- (a) it is probable that the consumption or loss of future economic benefits resulting in a reduction in assets and/or an increase in liabilities has occurred;
- (b) the consumption or loss of future economic benefits can be measured reliably.

53. Under accrual basis of accounting, expenses are recognised on the following bases:

- (i) *Identification with revenue transactions*

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

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(ii) Identification with a period of time

In many cases, although some costs may have connection with the revenue for the period, the relationship is so indirect that it is impracticable to attempt to establish it. However, there is a clear identification with a period of time. Such costs are regarded as 'period costs' and are expensed in the relevant period, e.g., salaries, telephone, travelling, depreciation on office building, etc. Similarly, the costs the benefits of which do not clearly extend beyond the accounting period are also charged as expenses.

54. Expenses relating to a future period are accounted for as prepaid expenses even though they are paid for in the current accounting period. Similarly, expenses of the current year, for which payment has not yet been made (outstanding expenses) are charged to the income and expenditure account for the current accounting period.

55. The application of the expense recognition criteria stated above, in the context of certain important expenses incurred by a school, are dealt with hereinafter.

Depreciation

56. Most schools use buildings, computers, furniture and fixtures and other assets having long life. Such assets are used by the school over their useful life and, accordingly, depreciate over that period. Such assets are known as 'depreciable assets'.

57. Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Thus, the purpose of charging depreciation is to spread the cost of a depreciable asset over its useful life so as to charge it as an expense in the income and expenditure account. A corresponding depreciation fund may be created by a school, as a management decision or under a legal requirement, if any, to replace the asset on the expiry of its useful life. Thus, non-creation of a depreciation fund, if there is no legal requirement, does not adversely affect true and fair view of the financial statements even though it may be financially prudent to do so.

58. Accounting Standard (AS) 6, 'Depreciation Accounting', prescribes requirements for charging depreciation on various depreciable assets. Keeping in view the requirements of AS 6, nature of activities carried on by schools and to maintain uniformity of accounting policies followed by various schools, a school should provide for depreciation on its various depreciable assets as below:

- (i) A school should charge depreciation according to the written down value method at rates recommended in Appendix I to the Guidance Note.
- (ii) Any addition or extension which becomes an integral part of the existing asset should be depreciated at a rate that has the impact of writing-off 95% of the original cost of addition or extension over the remaining useful life of the existing asset. Alternatively, depreciation on such addition or extension may be provided at the rate applied to the existing asset. However, where an addition or extension retains its separate identity and is capable of being used after the existing asset is disposed of, depreciation on the same should be provided independently at the rate applicable to it.
- (iii) Where a depreciable asset is disposed of, scrapped, retired, etc., the net surplus or deficiency, if material, should be disclosed separately.

Salaries, allowances and retirement benefits

59. A substantial portion of the revenue of a school is applied towards payment of salaries, allowances and retirement benefits to teaching and non-teaching employees. The expenditure should be booked as expense in the period in which the employee renders service.

60. As far as accounting for retirement benefits is concerned, it is recommended that the principles laid down in Accounting Standard (AS) 15, 'Accounting for Retirement Benefits in the Financial Statements of Employers' (Issued 1995)⁵, should be followed, the salient features of which,

⁵ With regard to the applicability of the Standard to schools, the revised AS 15 (revised 2005) titled as 'Employee Benefits' may be referred to. The revised Standard comes into effect in respect of accounting periods commencing on or after April 1, 2006 (published in the March, 2006 issue of 'The Chartered Accountant').

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from the perspective of a school, are given below:

- (i) The cost of providing retirement benefits to employees should be allocated to periods during which the services are rendered by the employees. This is because a school assumes obligation to pay retirement benefits in respect of an accounting period in consideration of services rendered by the employees during that period. Accounting for retirement benefit costs on cash basis, i.e., only when employees receive payments (termed as pay-as-you-go method), is not appropriate.
- (ii) A *defined contribution scheme* is a scheme under which amounts to be paid as retirement benefits are determined by contributions to a fund together with earnings thereon. An example of a defined contribution scheme is contributory provident fund under which the employer's obligation is to contribute a certain specified percentage of salary of an employee as provident fund.

In respect of retirement benefits in the form of provident fund and other defined contribution schemes, the contribution payable by the school for a year should be charged to the income and expenditure account for the year.

- (iii) A *defined benefit scheme* is a scheme under which amounts to be paid as retirement benefits are determined usually by reference to employee's earnings and/or years of service. Examples of defined benefit schemes are pension and gratuity. Defined benefit schemes should be accounted for as follows:
 - (a) An appropriate charge to the income and expenditure account for a year should be made through a provision for the accruing liability. The accruing liability should be calculated according to actuarial valuation. However, if a school employs only a few persons, say less than twenty, it may calculate the accrued liability by reference to any other rational method, e.g., a method based on the assumption that such benefits are payable to all employees at the end of the accounting year.
 - (b) Actuarial valuations should normally be conducted at least once in every three years. Where the actuarial valuations are

not conducted annually, the actuary's report should specify the amounts to be charged to the income and expenditure account of each year during the inter-valuation period.

- (c) In case the liability for retirement benefits is funded through a scheme administered by an insurer (e.g., Life Insurance Corporation), an actuarial certificate or a confirmation from the insurer should be obtained that the contribution payable to the insurer is the appropriate accrual of the liability for the year. The contribution payable should be charged to the income and expenditure account for the year.

Other expenses

61. Other expenses such as, telephone, electricity, conveyance, etc., should be recognised in the income and expenditure account on the basis of the criteria for recognition of expenses as stated in paragraphs 52 to 54 above.

Assets

62. As per the definition, an asset is a resource controlled by a school as a result of past events and from which future economic benefits or service potential are expected to flow to the school. A resource should be considered to be controlled by a school if it is in a position to control the use of the asset, i.e., it is in a position to obtain all the rewards from the asset which means all the future economic benefits associated with it will flow to the school.

63. Many assets, for example, computers and buildings have a physical form. However, physical form is not essential to the existence of an asset. Hence, intangible assets such as copyrights and computer software are also assets, if they are controlled by the school and future economic benefits from their use are expected to flow to the school.

Recognition and Measurement of Assets

64. An asset should be recognised in the balance sheet when and only when:

- (a) it is probable that the future economic benefits embodied in the asset will be received; and
- (b) the asset possesses a cost or value that can be measured reliably.

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65. Assets can be classified into various categories depending on their nature and life such as, fixed assets – tangible and intangible; current assets such as stores, receivables; loans and advances; cash and bank balances; investments – both current and long-term, etc.

66. The recognition and measurement principles with regard to the aforesaid categories of assets are dealt with hereinafter in the context of the accounting standards where relevant from the perspective of schools.

Fixed assets

67. Accounting Standard (AS) 10, 'Accounting for Fixed Assets', lays down, inter alia, recognition and measurement principles with regard to tangible fixed assets, the salient features of which from the perspective of a school are given below:

- (i) A *fixed asset* is defined as “an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business”.
- (ii) The financial statements should disclose, *inter alia*, the historical cost of fixed assets.
- (iii) The cost of a fixed asset should be determined as below:
 - (a) The cost of a purchased fixed asset should comprise its purchase price and any attributable cost of bringing the asset to its working condition for its intended use.
 - (b) The cost of a self-constructed fixed asset should comprise those costs that relate directly to the specific asset and those that are attributable to the construction activity in general and can be allocated to the specific asset.
- (iv) Subsequent expenditure related to an item of fixed asset should be added to its book value only if it increases the future benefits from the existing asset beyond its previously assessed standard of performance.

- (v) Material items retired from active use and held for disposal should be stated at the lower of their net book value and net realisable value and shown separately in the financial statements.
- (vi) A fixed asset should be eliminated from the financial statements on disposal or when no further benefit is expected from its use and disposal.
- (vii) Losses arising from the retirement or gains or losses arising from disposal of a fixed asset should be recognised in the income and expenditure account.

68. All costs which are incurred in bringing an asset to its working condition for its intended use should be added to the cost of the fixed asset. Examples of directly attributable costs are, initial delivery and handling costs, site preparation, professional fees, for example fees of architects and engineers. In case of land, cost of any improvement to land such as filling cost, fencing cost, etc. should be capitalised as a part of the cost of land. In case any super-structure has been built on land, the cost of such super-structure should be capitalised separately under the head 'buildings'.

69. Where a fixed asset is obtained free of cost, e.g., land is provided by individuals or institutions for construction of schools etc., the cost of such an asset to the schools is nil. In substance, receipt of such an asset is a non-monetary grant and, accordingly, should be accounted for as per AS 12, which requires that non-monetary grants should be accounted for at a nominal value (e.g., rupee one). Any incidental costs of acquisition such as registration charges, transportation charges, etc., should be added to the cost of the fixed asset.

70. Where more than one asset, e.g., land and building, are purchased for a consolidated price, the consideration is apportioned to the various assets on a fair basis, e.g., as determined by a competent valuer.

Intangible Assets

71. Insofar as computer software acquired by a school for its internal use is concerned, it should be recognised at cost, i.e, purchase price, including any import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities) and any directly attributable expenditure on making the software ready for its use. AS 26 lays down that

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only in those cases where the software is not an integral part of the related hardware, computer software should be treated as an intangible asset. Thus, software of the nature of operating system of a computer should not be separately recognised as an intangible asset. Cost of software capitalised should be amortised on straight-line basis over a period of about 3 to 5 years as per Appendix A1 to Accounting Standard (AS) 26, Intangible Assets. Other intangible assets, if any, should also be accounted for as per AS 26.

Investments

72. As per Accounting Standard (AS) 13, investments are “assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise”. Schools may invest their funds in securities such as, government bonds and units. They may also invest monies received in respect of specific funds created by them with a view to liquidate them at the time of incurrence of the expenditure for the specified purpose.

73. Schools should account for investments in accordance with AS 13, the salient features of which, from the perspective of schools, are given below:

- (i) A school should disclose current investments and long term investments distinctly in its financial statements. A *current investment* is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made. A *long term investment* is an investment other than a current investment.
- (ii) The cost of an investment should include acquisition charges such as brokerage, fees and duties. Where an investment has been purchased on cum-dividend or cum-interest basis, the interest or dividend received subsequently should be allocated between pre-acquisition and post-acquisition periods. The interest or dividend relating to the pre-acquisition period represents a recovery of cost and should, accordingly, be deducted in arriving at cost.
- (iii) Investments classified as current investments should be carried in the financial statements at the lower of cost and fair value.
- (iv) The comparison of cost and fair value for determining the carrying amount of current investments should be made either on an

individual investment basis (i.e., cost and fair value should be compared separately for each investment) or by category of investment (i.e., cost of an entire category of investments such as government securities should be compared with its fair value).

- (v) Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution should be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually.
- (vi) Any reduction in the carrying amount and any reversals of such reductions should be charged to income.
- (vii) On disposal of an investment, the difference between the carrying amount and net disposal proceeds should be charged or credited to income. When disposing of a part of the holding of an individual investment, the carrying amount to be allocated to that part is to be determined on the basis of the average carrying amount of the total holding of the investment.

Current assets, loans and advances

74. Current assets, loans and advances should be carried at the lower of cost and their net realisable value. In view of this, if there is a significant uncertainty about collectability of a loan or advance, e.g., loan given to employees, a provision to the extent of the amount considered uncollectable should be made by a charge to the income and expenditure account.

Liabilities

75. An essential characteristic of a liability is that the enterprise has a present obligation. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or a statutory requirement. This is normally the case, for example, with amounts payable for goods and services received and taxes to be paid. Obligations also arise, however, from normal practices followed by the enterprise, custom and a desire to maintain good relations or act in an equitable manner.

Recognition and Measurement of Liabilities

76. A liability should be recognised in the balance sheet when and only when:

- (a) it is probable that any future sacrifice of economic benefits will be required; and
- (b) the amount of the liability can be measured reliably.

77. The settlement of a liability usually involves the enterprise giving up resources embodying economic benefits in order to satisfy the claim of the other party. Settlement of a liability may occur in a number of ways, for example, by:

- (a) payment of cash;
- (b) transfer of other assets;
- (c) provision of services;
- (d) replacement of that obligation with another obligation.

An obligation may also be extinguished by other means, such as a creditor waiving or forfeiting its rights.

78. In the case of schools, normally, the liabilities are in the form of payments due towards the suppliers of material and services or any income received in advance. These liabilities should be measured at the amount at which they are due for payment and recognised on the basis of the criteria specified above.

Provisions

79. Some liabilities can be measured only by using a substantial degree of estimation. Such liabilities are commonly described as 'provisions'. Examples of provisions include provision for refund of fees paid by students.

Recognition and Measurement of a Provision

80. A school should recognise and measure provisions in accordance with Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent

Assets'. The standard requires that a provision should be recognised when:

- (a) there is a present obligation as a result of a past event;
- (b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- (c) a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised.

As per AS 29, present obligation is an obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not. According to AS 29, 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.

Contingent liabilities

81. AS 29 defines the terms 'contingent liability' and 'possible obligation' as below:

"A contingent liability is:

- (a) a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or***
- (b) a present obligation that arises from past events but is not recognised because:***
 - (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or***
 - (ii) a reliable estimate of the amount of the obligation cannot be made.***

Possible obligation – an obligation is a possible obligation if, based on the evidence available, its existence at the balance sheet date is considered not probable."

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82. Examples of contingent liabilities in the context of schools are suits filed by teachers in courts for increase in salary, suits filed by parents against increase in fees being charged by the school. There can be other such contingencies, the outcome of which will be known only on the occurrence or non-occurrence of uncertain future events.

83. As per AS 29, a school should not recognise a contingent liability on the face of financial statements, but it should make the following disclosures, for each class of contingent liability, in the notes to financial statements, unless the possibility of any outflow in settlement is remote:

- (a) a brief description of the nature of the contingent liability;
- (b) an estimate of its financial effect;
- (c) an indication of the uncertainties relating to any outflow; and
- (d) the possibility of any reimbursement.

84. Where any of the information required in paragraph 83 is not disclosed because it is not practicable to do so, that fact should be stated.

Books of Account to be kept by a School

85. Every school should maintain proper books of account with respect to -

- (a) all sums of money received by the school and the matters in respect of which receipts take place, showing distinctly the amounts received from students and through grants and donations;
- (b) all sums of money expended by the schools and the matters in respect of which expenditure takes place;
- (c) all assets and liabilities of the school.

86. Proper books of account would not be deemed to be kept with respect to the matters specified therein, -

- (a) if such books are not kept as are necessary to give a true and fair view of the state of affairs of the school, and to explain its transactions;

- (b) if such books are not kept on accrual basis and according to the double entry system of accounting; and
- (c) if such books are not kept so as to reflect a true and fair view of various funds maintained by the school.

87. An illustrative list of books of account and records which may be generally maintained by a school is given in Appendix II.

Formats of Financial Statements

88. The accounting process in an organisation culminates in the preparation of its financial statements. The financial statements are intended to reflect the operating results during a given period and the state of affairs at a particular date in a clear and comprehensive manner. The basic financial statements relevant to a school are income and expenditure account and balance sheet and the notes and other statements and explanatory material that are an integral part of the financial statements. They may also include supplementary schedules and information based on or derived from, and expected to be read with such statements. Such schedules and supplementary information may deal with, for example, movement in various funds. In addition, schools are encouraged to prepare a cash flow statement, in accordance with Accounting Standard (AS) 3, 'Cash Flow Statements', issued by the Institute of Chartered Accountants of India. Financial statements do not, however, include reports by the governing body, for example, the trustees, statement by the chairman, discussion and analysis by management and similar reports that may be included in a financial or annual report.

89. Income and expenditure account is prepared by a school in lieu of a profit and loss account. An income and expenditure account should contain all revenues earned and expenses incurred by a school during an accounting period. Since the purpose of fund-based accounting in a school, discussed in detail hereinafter, is to present income and expenses in respect of restricted funds as distinguished from unrestricted funds, it is recommended that the income and expenditure account should have three columns, namely,

- (i) 'Unrestricted Funds', further sub-classified into 'Designated Funds' and 'General Fund';
- (ii) 'Restricted Funds'; and

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- (iii) 'Total' column reflecting the total income and expenses of 'Unrestricted Funds' and 'Restricted Funds'.

90. For the preparation of income and expenditure account only revenue items are taken into consideration and capital items are totally excluded. Revenues received in advance and prepaid expenses at the end of the accounting period are also excluded while preparing this account and are disclosed as a liability and an asset, respectively, in the balance sheet. These are included as incomes and expenses in the accounting periods to which they relate.

91. Any transfer to a designated fund is an 'appropriation' of the 'surplus' (i.e., excess of income over expenditure) arising during the period and is not an expense for the period. Appropriations should, therefore, be made after determination of 'surplus' for the period.

92. A school should not present the balance sheet in multi-columnar form. An integrated balance sheet for the school as a whole should be presented. In the balance sheet, assets and liabilities should not be set-off against each other. Balance of various funds should be disclosed in the balance sheet under, 'Funds Employed'.

93. In the preparation and presentation of the financial statements, the overall consideration should be that they give a true and fair view of the state of affairs of the school and of the surplus or deficiency as reflected by the balance sheet and the income and expenditure account, respectively. The financial statements should disclose every material transaction, transactions of an exceptional and extraordinary nature.

94. The recommended formats of income and expenditure account and balance sheet are given in Appendix III.

Fund Based Accounting

95. Schools may receive grants/donations and other forms of revenue the use of which is unrestricted, (i.e., these funds can be used for the general purposes of the school) or the use of which is subject to the restrictions imposed by the contributors (i.e., such funds can only be used for specific purposes and, therefore, are not available for the school's general purposes). Also, the schools may, on their own, earmark certain funds for specific purposes, e.g., library fund for purchase of books for the library. For the

purpose of appropriate presentation of these funds in the financial statements, it is necessary to understand their nature and characteristics, which are described below:

- (a) *Unrestricted funds*: Unrestricted funds refer to funds contributed to a school with no specific restrictions. These funds are used for the general purposes of the school. All revenues (donations, grants, investment income, fees, etc.) not subject to external restrictions are a part of 'unrestricted funds'. For the purpose of presentation in the income and expenditure account and the balance sheet the unrestricted funds are classified into two categories, viz., designated funds and general fund.
 - (i) *Designated funds*: Designated funds are unrestricted funds which have been set aside by the school for specific purposes or to meet future commitments, e.g., library fund and science fund. Unlike restricted funds, any designations are self-imposed and are not normally legally binding. The school can lift the designation whenever it wishes to and reallocate the funds to some other designated purpose(s).
 - (ii) *General fund*: 'Unrestricted funds' other than the 'designated funds' are a part of the 'General fund'.
- (b) *Restricted funds*: Restricted funds are subject to certain conditions set out by the contributors and agreed to by the school when accepting the contributions. The restriction may apply to the use of the moneys received or income earned from the investment of such moneys or both.

Endowment funds are a form of restricted funds. Endowment funds are those funds which have been received with a stipulation from the donor that the amount received should not be used for any purpose and only the income earned from investments of these funds can be used either for general purposes of the school or for specific purposes, depending on the terms of the contribution made. Usually, the amount received is invested outside the school as per the terms of the contribution, if any.

The manner of creation, utilisation of various types of funds, including income from investments of the funds, has been dealt with in the following paragraphs.

Designated Funds

96. Designated funds are created by appropriation of the surplus for the year for meeting revenue expenditure or capital expenditure in future. When a revenue expenditure is incurred in respect of which a designated fund has been created, the same is debited to the income and expenditure account ('Designated Funds' column). A corresponding amount is transferred from the concerned designated fund account to the credit of the income and expenditure account after determining the surplus/deficit for the year since the purpose of the designated fund is over to that extent. Where the designated fund has been created for meeting a capital expenditure, the relevant asset account is debited by the amount of such capital expenditure and a corresponding amount is transferred from the concerned designated fund account to the credit of the income and expenditure account after determining surplus/deficit for the year. In respect of the assets, e.g., a building, being constructed by the school, on completion of the same, the entire balance, if any, of the relevant designated fund is transferred to the credit of the income and expenditure account after determining the surplus/deficit for the year.

97. In case the school is holding specific investments against the designated funds, income earned, if any, on such investments, is credited to the income and expenditure account for the year in which the income is so earned and is shown in 'Designated Funds' column. An equivalent amount may be transferred to the concerned designated fund account after determining the surplus/deficit for the year as per the policy of the school.

General Fund

98. All items of revenue and expenses that do not relate to any designated fund or restricted fund are reflected in the 'General Fund' column of the income and expenditure account. The surplus/deficit for the year after appropriations is transferred and presented as surplus/deficit separately as a part of 'General Fund' in the balance sheet. Apart from such surplus/deficit, the 'General Fund' also includes the following which are separately presented in the balance sheet:

- (i) Grants related to a non-depreciable asset (see paragraph 47 (ii)(a)).
- (ii) Grants of the nature of promoters' contribution (see paragraph 47 (v)).

Restricted Funds

99. Restricted funds that represent the contributions received whose use is restricted by the contributors, are credited to a separate fund account when the amount is received and reflected separately in the balance sheet. Such funds may be received for meeting revenue expenditure or capital expenditure. Where the fund is meant for meeting revenue expenditure, upon incurrence of such expenditure, the same is charged to the income and expenditure account ('Restricted Funds' column); a corresponding amount is transferred from the concerned restricted fund account to the credit of the income and expenditure account ('Restricted Funds' column). Where the fund is meant for meeting capital expenditure, upon incurrence of the expenditure, the relevant asset account is debited which is depreciated as per the recommendations contained in this Guidance Note. Thereafter, the concerned restricted fund account is treated as deferred income, to the extent of the cost of the asset, and is transferred to the credit of the income and expenditure account in proportion to the depreciation charged every year (both the income so transferred and the depreciation should be shown in the 'Restricted Funds' column). The unamortised balance of deferred income would continue to form part of the restricted fund. Any excess of the balance of the concerned restricted fund account over and above the cost of the asset may have to be refunded to the donor. In case the donor does not require the same to be refunded, it is treated as income and credited to the income and expenditure account pertaining to the relevant year ('General Fund' column). Where the restricted fund is in respect of a non-depreciable asset, the concerned restricted fund account is transferred to the 'General Fund' in the balance sheet when the asset is acquired.

100. The restricted funds will normally carry a stipulation as to the use of income earned on investments made out of the contributions received. If the terms stipulate that the income earned should be used for the same purpose for which the contribution was made, the income earned should be credited to the concerned restricted fund account. Where the terms stipulate a general use of the income earned, the same should be credited to the income and expenditure account ('General Fund' column) of the year in which the income is so earned.

101. Income earned from investments of endowment funds is recognised in the income and expenditure account only to the extent of the expenditure incurred for the relevant purpose. Both the income and the expense should

be shown in the 'Restricted Funds' column. Any excess of the income not recognised as aforesaid would continue to remain part of the concerned fund.

Disclosures

102. In respect of funds, schools should disclose the following in the schedules/notes to accounts:

- (a) In respect of each major fund, opening balance, additions during the period, deductions/utilisation during the period and balance at the end;
- (b) Assets, such as investments, and liabilities belonging to each fund separately;
- (c) Restrictions, if any, on the utilisation of each fund balance;
- (d) Restrictions, if any, on the utilisation of specific assets.

Related Party Disclosures

103. Accounting Standard (AS) 18, 'Related Party Disclosures', issued by the Institute of Chartered Accountants of India, requires disclosures to be made in respect of related party transactions. Keeping in view the involvement of public funds, in the context of a school, the following disclosures should be made by way of a note to the financial statements of the school:

- (i) Transactions between the school and the trust or society managing the school.
- (ii) Transactions between the school and the trustees or the members of the governing body of the school.
- (iii) Transactions between the school and the author of the trust or the founder of the institution.
- (iv) Transactions between the school with another school or any other educational entity managed by the same trust or society, if permitted by the relevant legislation/bye-laws etc.
- (v) Transactions between the school and the relatives of the trustees, or members of the governing body managing the school or the

author of the trust or the founder of the institution. For this purpose, a relative, in the context of an individual, means “the spouse, son, daughter, brother, sister, father and mother who may be expected to influence, or influenced by, that individual in his/her dealing with the school”.

- (vi) Transactions between the school and its ‘key management personnel’ or the relatives of the key management personnel. Key management personnel would represent those persons in the school who have the authority and responsibility for planning, directing and controlling the activities of the school. In case of a school, an example of a key management personnel is the principal.

104. If there have been transactions between related parties, during the existence of a related party relationship, the school should disclose the following:

- (i) the name of the transacting related party;
- (ii) a description of the relationship between the parties;
- (iii) a description of the nature of transactions;
- (iv) volume of the transactions; either as an amount or as an appropriate proportion;
- (v) the amounts or appropriate proportions or outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date; and
- (vi) amounts written off or written back in the period in respect of debts due from or to related parties.

105. The following are examples of the related party transactions in respect of which disclosures may be made by a school:

- purchases or sales of fixed assets;
- rendering or receiving of services;

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- leasing or hire purchase arrangements;

106. Items of a similar nature may be disclosed in aggregate by type of related party except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the school.

107. Disclosure of details of particular transactions with individual related parties would frequently be too voluminous to be easily understood. Accordingly, items of a similar nature may be disclosed in aggregate by type of related party. However, this is not done in such a way as to obscure the importance of significant transactions, e.g., purchases or sales of books are not aggregated with purchases or sales of fixed assets. Nor a material related party transaction with an individual party is clubbed in an aggregated disclosure.

Transition to Accrual Basis of Accounting

108. A major problem in transition from cash basis of accounting to accrual basis of accounting is determination of opening balances of assets and liabilities.

109. Many assets, e.g., those received by way of donations or gifts, may not have been recorded at the time they were acquired. It is necessary to identify such assets and account for them appropriately. In every case where the original cost cannot be ascertained, without unreasonable expense or delay, the valuation shown by the books should be considered. For the purpose of this paragraph, such valuation should be the net amount at which an asset stood in the school's books at the commencement of the application of this Guidance Note after deduction of the amounts previously provided or written off for depreciation. Similarly, the opening balances of current assets like, receivables and loans and advances, should also be determined.

110. In the case of liabilities, the school should make an assessment on the basis of records available of the amounts payable to creditors, suppliers and others in respect of expenditure incurred for acquisition of assets or to meet revenue expenses.

111. The difference, if any, between the total debit balances and the credit balances as determined on the basis of the paragraphs 109 and 110 above, should be taken as the balance of the 'General Fund'.

Appendix I

Rates of depreciation

Fixed Asset	Rate of depreciation (on written down value basis)
Buildings	5%
Furniture and fixtures	25%
Scientific equipments	40%
Computers	40%
Library books	50%
Buses, vans, etc.	30%
Cars, scooters, etc.	25%
Plant and machinery including Air-conditioners, generators, fire extinguishers, telephone, television sets, etc.	20%
Musical Instruments	50%
Sports equipments	50%

Notes

1. Where, during any financial year, any addition has been made to any asset, depreciation for the full year should be charged on such addition for that particular year. Similarly, where any asset has been sold, discarded, demolished or destroyed, no depreciation should be charged on such assets for that particular year.

2. In the case of small value assets, whose actual cost does not exceed five thousand rupees, depreciation should be provided at the rate of hundred per cent. However, where the aggregate actual cost of individual items of

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assets costing Rs. 5,000 or less constitutes more than 10 per cent of the total actual cost of the concerned category of assets, rates of depreciation applicable to such items should be the rates as specified in this Appendix.

3. The rates contained in this Appendix should be viewed as the minimum rates and, therefore, a school should not charge depreciation at rates lower than those specified in this Appendix in relation to assets purchased after the date of the applicability of the Guidance Note. However, if on the basis of a bona fide technological evaluation, higher rates of depreciation are justified, the same may be provided with proper disclosures by way of a note forming part of accounts.

4. As regards other tangible depreciable assets for which no rate of depreciation has been laid down in this Appendix, depreciation should be provided on a basis which has the effect of writing off by way of depreciation at least 95% of the original cost to the school of each such depreciable asset on the expiry of its useful life in accordance with the written down value method.

5. This Appendix also applies to the assets financed under a lease agreement.

Appendix II

Books of Account and Records

(This Appendix is not a part of the Guidance Note and is illustrative in nature.)

Books of account

1. Cash Book.
2. Bank Book.
3. Journal.
4. General ledger.
5. Subsidiary ledgers.

Registers and other records so as to give information in relation to:

1. Fees received from students (in respect of admission fee, tuition fee, library fee, examination fee, etc.).
2. Grants-in-aid received from various sources.
3. Scholarship and special stipends.
4. Funds such as building, library, laboratory, games, furniture, equipments, endowment, provident fund, poor students fund, deposits, etc.
5. Immovable properties and other fixed assets.
6. Investments.
7. Minutes of the meetings of the Managing Committee of the school.
8. Stock (for books, stationery, uniform, etc.).
9. Caution money received from students.

Appendix III

Formats of Financial Statements of Schools

PART I – GENERAL INSTRUCTIONS AND ACCOUNTING PRINCIPLES

1. The financial statements of Schools (viz., Balance Sheet and Income and Expenditure Account) should be prepared on accrual basis.
2. A statement of all significant accounting policies adopted in the preparation and presentation of the Balance Sheet and the Income and Expenditure Account should be included in the School's Balance Sheet. Where any of the accounting policies is not in conformity with the recommendations contained in this Guidance Note, and the effect of departures therefrom is material, the particulars of the departure should be disclosed, together with the reasons therefor and also the financial effect thereof except where such effect is not ascertainable.
3. Accounting policies should be applied consistently from one financial year to the next. Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed. In case of a change in accounting policies which has a material effect in the current period, the amount by which any item in the financial statements is affected by such change, should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.
4. The accounting treatment and presentation in the Balance Sheet and the Income and Expenditure Account of transactions and events should be governed by their substance and not merely by the legal form.
5. In determining the accounting treatment and manner of disclosure of an item in the Balance Sheet and/or the Income and Expenditure Account, due consideration should be given to the materiality of the item.
6. Notes to the Balance Sheet and the Income and Expenditure Account should contain only the explanatory material pertaining to the items in the Balance Sheet and the Income and Expenditure Account.
7. If the information required to be given under any of the items or sub-items in these formats cannot be conveniently included in the Balance Sheet

or the Income and Expenditure Account itself, as the case may be, it can be furnished in a separate Schedule or Schedules to be annexed to and forming part of the Balance Sheet or the Income and Expenditure Account. This is recommended where items are numerous.

8. The Schedules referred to above, accounting policies and explanatory notes should form an integral part of the financial statements.

9. The corresponding amounts for the immediately preceding financial year for all items shown in the Balance Sheet and the Income and Expenditure Account should also be given in the Balance Sheet or the Income and Expenditure Account, as the case may be.

10. The disclosures suggested in the formats are minimum requirements. A school is encouraged to make additional disclosures.

PART II – BALANCE SHEET

FUNDS EMPLOYED

UNRESTRICTED FUNDS

General Fund

- | | |
|--|--|
| (i) Funds contributed by promoters | General Fund includes all financial resources except those required to be accounted for in another fund, i.e., it includes funds which neither have any restriction on their use nor have been designated for any specific purpose. The balance, if any, in the income and expenditure account after appropriation, i.e., surplus/(deficit) is transferred to this fund. |
| (ii) Funds related to non-depreciable assets not requiring fulfilment of any obligation | Grants and donations relating to non-depreciable assets, e.g., freehold land, which do not require fulfilment of any obligation, are included under this head. |
| (iii) Surplus/(Deficit) | 'Surplus/(Deficit)' represents the balance of Income |

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and Expenditure Account, after appropriations, if any.

Designated Funds

Designated/Earmarked funds are unrestricted funds set aside by the School for specific purposes or to meet specific future commitments.

RESTRICTED FUNDS

Restricted funds are funds subject to certain conditions set out by the contributors and agreed to by the School when accepting the contribution. This head includes:

- (i) Endowment funds.
- (ii) Funds related to depreciable/non-depreciable assets in respect of which assets are still to be acquired.
- (iii) Balances of deferred income, e.g., grants and donations in respect of which specific depreciable assets have been acquired.
- (iv) Funds related to specific items of revenue expenditure not yet incurred.

Each restricted fund should be reflected separately either on the face of the balance sheet or in the schedule(s) to the balance sheet.

Notes:

1. The following particulars should be shown in respect of Surplus/(Deficit):

Balance at the beginning of the year

Add: Excess of income over expenditure for the year after appropriations, if any.

Less: Excess of expenditure over income for the year after appropriations, if any.

Balance at the end of the year

Accounting by Schools

2. The following particulars should be shown in respect of each Designated and Restricted Fund:

- (a) Balance at the beginning of the year
- (b) Additions during the year
- (c) Deductions during the year
- (d) Balance at the end of the year

3. Designated/Restricted Funds represented by specifically earmarked bank balances/investments should be disclosed separately in respect of each fund.

LOANS, if any

Notes:

1. Loans, if any, should be classified as 'secured' and 'unsecured' on the basis of the fact whether these are secured or not, wholly or partly, against an asset of the School.

2. Interest free loans should be disclosed separately from interest bearing loans. Interest accrued and due on loans should be included under the appropriate sub-heads.

**Caution Money
received from
students**

The amount of caution money refundable to students beyond 12 months from the balance sheet date.

REPRESENTED BY

FIXED ASSETS

Land

Includes freehold land and leasehold land.

Buildings

Include school buildings, hostel and staff residential buildings, office buildings, temporary structures and sheds.

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Plant and machinery	Include air conditioners, generator sets, television sets, fire extinguishers, etc.
Vehicles	Include buses, lorries, vans, cars, scooters, etc.
Office equipments	Include such items as fax machines, photocopiers, EPABX, typewriters, duplicating machines, etc.
Computers	
Furniture and fixtures	Include such items as desks/benches, cabinets, almirahs, tables, chairs and partitions.
Science Equipments	Include such items as microscopes, telescopes, dissection equipment, glass apparatus, measurement instruments and other types of laboratory equipment, etc.
Sports Equipments	Include items such as table tennis table, gym equipment.
Library books	
Livestock	
Intangible assets	Include Computer Software.
Other fixed assets	

Notes:

1. Under each head, the original cost, the additions thereto and deductions therefrom during the year, depreciation written off or provided during the year, and the total depreciation written off or provided up to the end of the year should be stated.
2. Advance payments to contractors and suppliers should not be classified under the specific fixed assets but disclosed as a separate item.

3. Separate disclosure under each of the above heads should be made in respect of donated assets, i.e., assets that have been received free of cost as non-monetary grant/donation by the School as well as assets financed under a lease agreement.

4. Restrictions, if any, on the utilisation of each asset should also be disclosed in the notes to accounts.

**CAPITAL WORK-
IN-PROGRESS**

Capital expenditure on incomplete construction work should be shown under this head

INVESTMENTS

**Long-term
Investments**

'Long-term investment' means an investment other than a current investment.

Central Government
securities

State Government
securities

Other securities

Notes:

Aggregate amount of the School's long-term quoted investments and also the market value thereof should be shown. Aggregate amount of the School's unquoted investments should also be shown.

'Quoted investment' for this purpose, means an investment in respect of which a quotation or permission to deal on a recognised stock exchange has been granted, and the expression 'unquoted investment' should be construed accordingly.

Current Investments

'Current investment' means an investment that is by its nature readily realisable and is intended to

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be held for not more than one year from the date on which such investment is made.

Central Government securities

State Government securities

Other securities

CURRENT ASSETS

Closing Stock

Includes materials held by school canteen (where run by the school itself), publications held by the school for sale.

Receivables

Donations and grants receivable

Include donations and grants in respect of which there is reasonable assurance that (i) the School will comply with the conditions attached, and (ii) the donations and grants will be received.

Others (please specify)

Balances with Banks and Post Office

Particulars should be given of balances lying on current accounts, call accounts and deposit accounts.

with Scheduled Banks

with Non-scheduled Banks

with Post Office

Cash Balances

Include cheques, drafts and pay orders on hand.

Other Current Assets

Items such as interest accrued on investments should be included under this head.

Where any item constitutes ten percent or more of total current assets, the nature and amount of such item should be shown separately.

**LOANS, ADVANCES
AND DEPOSITS**

Advances to staff

Interest bearing

Non-interest bearing

**Advances to suppliers/
contractors**

Advances in cash to
contractors for capital
works

Advances in cash to other
contractors/suppliers

Material issued to
contractors

Advances in cash for
services

Advances to Others

Other amounts
recoverable in cash or
kind or for value to
be received

Prepaid expenses

**Deposits (other than
with banks)**

Telephone

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Electricity

Others

Where any item constitutes ten per cent or more of total loans, advances and deposits, the nature and amount of such item should be shown separately and the same should not be included under this head.

**LESS: CURRENT
LIABILITIES AND
PROVISIONS**

Current Liabilities

Creditors

For Goods

For Services

For Statutory Liabilities

Expenses Payable

*Caution Money
received from
students*

The amount of caution money refundable to students during 12 months from the balance sheet date.

From current students

From ex-students

*Other Current
Liabilities*

Where any item constitutes ten per cent or more of total current liabilities and provisions, the nature and amount of such item should be shown separately and the same should not be included under this head.

Provisions

For retirement benefits

Others (specify)

PART III – INCOME AND EXPENDITURE ACCOUNT

INCOME	March 31, 20X5			March 31, 20X4
	Unrestricted Funds		Restricted Funds	Total
	General Funds	Designated Funds		

Fees from students

Tuition & other fees

Admission fees

Registration charges

Examination fees

Board examination fees

Transportation charges

Annual charges

Hostel fee

Fine

Others

**Fees from students for
activities**

Sports fee

Library fee

Science fee

Computer fee

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Others

Donations and Grants

**Income from sale of items
such as admission forms,
prospectuses, magazines
and other publications**

**Income from canteen
contracts, cycle stand
contracts, etc.**

**Rent (from letting out
school premises)**

**Invigilation fees received
from Board**

**Income from holding
events, etc.**

- Gross Receipts from Annual
Function/ Sports Carnival

Less: Direct expenditure
incurred on the function/
carnival

- Gross Receipts from fetes

Less: Direct expenditure
incurred on the fetes

- Gross Receipts for
educational tours

Less: Direct expenditure
incurred on the tours

Others (net of the direct expenditure, separately disclosed)

Interest and dividends

Profit on sale of fixed assets and investments

Income from estate (rent, sale of orchid produce, etc.)

Miscellaneous income

Excess of Expenditure over Income for the year

EXPENDITURE

**Staff Payments & Benefits
(Separately for teaching and non-teaching staff)**

Salaries and wages including allowances

Employee welfare including retirement benefits

Invigilation charges paid

Other employee costs

Transportation expenses

- In respect of vehicles owned by the School

- In respect of vehicles not owned by the School including

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rentals paid and other
expense, if any.

Affiliation charges

**Board Examination fees
paid/payable to the Board**

Hostel running expenses

**Administrative & General
Expenses**

Rents, rates and taxes

Communication expenses

Printing & stationery

Electricity and Water charges

Travelling & conveyance
expenses of teaching and
non-teaching staff

Insurance charges

Promotional expenses

Remuneration to auditors
(including expenses
reimbursed)

Others

Repairs & Maintenance

Buildings

Furniture & Fixtures

Others

Depreciation

**Financial Expenses such
as interest on loans**

**Loss on sale of fixed
assets and investments**

Other Expenses

Write offs and provisions

Miscellaneous expenses

**Excess of Income over
Expenditure for the year**

Appropriations:

Transfers to funds, e.g.,
building fund, library fund,
science fund, etc.

Transfers from funds

**PART IV – INSTRUCTIONS FOR PREPARING
INCOME AND EXPENDITURE ACCOUNT**

1. The Income and Expenditure Account should disclose every material feature and should be so made out as to clearly disclose the result of the working of the School during the period covered by the account.
2. Any item under which income exceeds 1 per cent of the total fee receipts of the School or Rs. 5,000/-, whichever is higher, should be shown as a separate and distinct item against an appropriate account head in the Income and Expenditure Account. These items, therefore, should not be shown under the head 'miscellaneous income'.
3. Any item under which expenses exceed 1 per cent of the total fee receipts of the School or Rs. 5,000/-, whichever is higher, should be shown as a separate and distinct item against an appropriate account head in the Income and Expenditure Account. These items, therefore, should not be shown under the head 'miscellaneous expenses'.
4. The details of hostel running expenses should be disclosed separately in the notes to the Income and Expenditure Account.

GN(A) 22 (Issued 2006)

Guidance Note on Accounting for Credit Available in respect of Minimum Alternative Tax under the Income-tax Act, 1961

Foreword

Tax-revenue is the most important source of income for the government. It is also the most important instrument in the hands of the government for bringing equity by reducing disparities of income. It is always desired by the government to increase its revenue without putting burden of fresh taxes on the existing classes of taxpayers but to broaden the base of taxpayers. The concept, behind the introduction of Minimum Alternative Tax (MAT) in the direct tax system of India, is to make sure that the companies having large profits and declaring heavy dividends to shareholders but which are not contributing to the exchequer by taking advantage of various incentives and exemptions provided in the Income-tax Act, should be brought under the tax net. Such companies have to pay a fixed percentage of book profit as minimum alternative tax.

The amendment to section 115JAA of the Income-tax Act, 1961 by the Finance Act, 2005 has raised many technical issues regarding the accounting treatment of credit available on MAT paid. I am happy to note that the Research Committee, realising the need for providing guidance on this issue, has formulated this Guidance Note on Accounting for Credit Available in respect of Minimum Alternative Tax under the Income-tax Act, 1961, on a very timely basis before the closing of financial year 2005-06.

I wish to place on record my deep appreciation of Shri Pawan Kumar Sharma, Chairman, Research Committee, other esteemed members of the Research Committee and officers of the Technical Directorate who have made invaluable contribution in the finalisation of this Guidance Note.

I am confident that this Guidance Note will be immensely useful not only to the members but also to others concerned.

New Delhi
March 24, 2006

T.N. Manoharan
President

Preface

The concept of Minimum Alternative Tax (MAT) was introduced by the Finance Act, 1987. The motive was to widen the tax net by bringing more and more taxpayers under the umbrella of direct tax system of the country. Since its introduction, the provisions related to MAT have been revised more than once. The insertion of sub-section (1A) to section 115JAA, of the Income-tax Act, 1961 by the Finance Act, 2005 (granting credit in respect of MAT paid), raised certain issues regarding the treatment of such credit, like, in view of Accounting Standard 22, Accounting for Taxes on Income, whether the credit available is deferred tax or not. There were also many interpretations of when and how the credit should be recognised and represented in the financial statements. The Research Committee, recognising the need of a Guidance Note on these issues, formulated this Guidance Note to deal with the aspects of accounting and presentation of MAT paid and the credit available in this regard.

It may be noted that the Institute had in the year 1997 issued a Guidance Note on Accounting in Respect of Minimum Alternative Tax which dealt with the recognition of MAT credit in the context of the Guidance Note on Accounting for Taxes on Income. The said Guidance Note on Accounting in respect of MAT credit was withdrawn pursuant to AS 22, Accounting for Taxes on Income, becoming mandatory.

I would like to take this opportunity to place on record my appreciation of Dr. Avinash Chander, Technical Director, Ms. Anuradha Jain, Secretary, Research Committee and Shri Piyush Tewari, Executive Officer in the Technical Directorate for preparing the basic draft of the Guidance Note. I also wish to place on record my gratitude to Shri H.N. Motiwalla, Vice Chairman of the Research Committee and Shri S. C. Vasudeva, my esteemed colleague on the Research Committee and the Central Council, for their support and contribution in finalisation of the Guidance Note. I also express my sincere gratitude to Shri T.N. Manoharan, President, ICAI, and Shri Sunil Talati, Vice President, ICAI, for their guidance, support and encouragement in striving towards various activities of the Committee for the year 2006-07.

New Delhi
March 24, 2006

Pawan Kumar Sharma
Chairman
Research Committee

GN(A) 22 (Issued 2006)

**Guidance Note on
Accounting for Credit
Available in respect of Minimum
Alternative Tax under
the Income-tax Act, 1961**

(The following is the text of the Guidance Note on Accounting for Credit Available in Respect of Minimum Alternative Tax Under the Income-tax Act, 1961, issued by the Council of the Institute of Chartered Accountants of India.)

Introduction

1. The Finance Act, 1997, introduced section 115JAA in the Income-tax Act, 1961 (hereinafter referred to as the 'Act') providing for tax credit in respect of MAT paid under section 115JA (hereinafter referred to as 'MAT credit') which could be carried forward for set-off for five succeeding years in accordance with the provisions of the Act. Section 115JA was inserted by the Finance Act, 1996, w.e.f. 1.4.1997. The said section provided for payment of Minimum Alternative Tax (hereinafter referred to as 'MAT') by certain companies, where the total income, as computed under the Income-tax Act, 1961, in respect of any previous year relevant to the assessment year commencing on or after 1st day of April, 1997, but before the 1st day of April, 2001, was less than 30% of its book profit. In such a case, the total income of the company chargeable to tax for the relevant previous year was deemed to be an amount equal to thirty per cent of its book profit.

2. The Finance Act, 2000, w.e.f. 1.4.2001, introduced section 115JB according to which a company is liable to pay MAT under the provisions of the said section in respect of any previous year relevant to the assessment year commencing on or after the 1st day of April, 2001. The MAT under this section is payable where the normal income-tax payable by such company in the previous year is less than 7.5 per cent (10 per cent proposed by the Finance Bill, 2006) of its book profit which is deemed to be the total income of the company. Such

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company is liable to pay income-tax at the rate of 7.5 per cent (10 per cent proposed by the Finance Bill, 2006) of its book profit. The Finance Act, 2005, inserted sub-section (1A) to section 115JAA, to grant tax credit in respect of MAT paid under section 115JB of the Act with effect from assessment year 2006-07.

3. The salient features of MAT credit under section 115JAA as applicable, in respect of tax paid under sections 115JA and 115JB, are as below:

- (a) A company, which has paid MAT, would be allowed credit in respect thereof.
- (b) The amount of MAT credit would be equal to the excess of MAT over normal income-tax for the assessment year for which MAT is paid.
- (c) No interest is allowable on such credit.
- (d) The MAT credit so determined can be carried forward for set-off for five succeeding assessment years from the year in which MAT credit becomes allowable. The Finance Bill, 2006, has proposed that credit in respect of MAT paid under section 115JB can be carried forward upto seven succeeding assessment years (hereinafter referred to as the 'specified period').
- (e) The amount of MAT credit can be set-off only in the year in which the company is liable to pay tax as per the normal provisions of the Act and such tax is in excess of MAT for that year.
- (f) The amount of set-off would be to the extent of excess of normal income-tax over the amount of MAT calculated as if section 115JB had been applied for that assessment year for which the set-off is being allowed.

Accounting Treatment

Whether MAT credit is a deferred tax asset

4. An issue has been raised whether the MAT credit can be considered as a deferred tax asset within the meaning of Accounting Standard (AS) 22, Accounting for Taxes on Income, issued by the Institute of Chartered Accountants of India. In this context, the following definitions given in AS 22 are noted:

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“Timing differences are the differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods.”

“Accounting income (loss) is the net profit or loss for a period, as reported in the statement of profit and loss, before deducting income tax expense or adding income tax saving.”

“Taxable income (tax loss) is the amount of the income (loss) for a period, determined in accordance with the tax laws, based upon which income tax payable (recoverable) is determined.”

5. From the above, it is noted that payment of MAT, does not by itself, result in any timing difference since it does not give rise to any difference between the accounting income and the taxable income which are arrived at before adjusting the tax expense, namely, MAT. In other words, under AS 22, deferred tax asset and deferred tax liability arise on account of differences in the items of income and expenses credited or charged in the profit and loss account as compared to the items of income that are taxed or items of expense that are allowed as deduction, for the purposes of the Act. Thus, deferred tax assets and deferred tax liabilities do not arise on account of the amount of the tax expense itself. In view of this, it is not appropriate to consider MAT credit as a deferred tax asset for the purposes of AS 22.

Whether MAT credit can be considered as an ‘asset’

6. Although MAT credit is not a deferred tax asset under AS 22 as discussed above, yet it gives rise to expected future economic benefit in the form of adjustment of future income tax liability arising within the specified period. A question, therefore, arises whether the MAT credit can be considered as an ‘asset’ and in case it can be considered as an asset whether it should be so recognised in the financial statements.

7. The Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India, defines the term ‘asset’ as follows:

“An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.”

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8. MAT paid in a year in respect of which the credit is allowed during the specified period under the Act is a resource controlled by the company as a result of past event, namely, the payment of MAT. MAT credit has expected future economic benefits in the form of its adjustment against the discharge of the normal tax liability if the same arises during the specified period. Accordingly, MAT credit is an 'asset'.

9. According to the Framework, once an item meets the definition of the term 'asset', it has to meet the criteria for recognition of an asset so that it may be recognised as such in the financial statements. Paragraph 88 of the Framework provides the following criteria for recognition of an asset:

“88. An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably.”

10. In order to decide when it is 'probable' that the future economic benefits associated with the asset will flow to the enterprise, paragraph 84 of the Framework, *inter alia*, provides as below:

“84. The concept of probability is used in the recognition criteria to refer to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the enterprise. The concept is in keeping with the uncertainty that characterises the environment in which an enterprise operates. Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence available when the financial statements are prepared.”

11. The concept of probability as contemplated in paragraph 84 of the Framework relates to both items of assets and liabilities and, therefore, the degree of uncertainty for recognition of assets and liabilities may vary keeping in view the consideration of 'prudence'. Accordingly, while for recognition of a liability the degree of uncertainty to be considered 'probable' can be 'more likely than not' (as in paragraph 22 of Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets') for recognition of an asset, in appropriate conditions, the degree may have to be higher than that. Thus, for the purpose of consideration of the probability of expected future economic benefits in respect of MAT credit, the fact that a company is paying MAT and not the normal income tax, provides a *prima facie* evidence that normal income tax liability may not arise within the specified period to avail MAT credit. In view

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of this, MAT credit should be recognised as an asset only when and to the extent there is convincing evidence that the company will pay normal income tax during the specified period. Such evidence may exist, for example, where a company has, in the current year, a deferred tax liability because its depreciation for the income-tax purposes is higher than the depreciation for accounting purposes, but from the next year onwards, the depreciation for accounting purposes would be higher than the depreciation for income-tax purposes, thereby resulting in the reversal of the deferred tax liability to an extent that the company becomes liable to pay normal income tax.

12. Where MAT credit is recognised as an asset in accordance with paragraph 11 above, the same should be reviewed at each balance sheet date. A company should write down the carrying amount of the MAT credit asset to the extent there is no longer a convincing evidence to the effect that the company will pay normal income tax during the specified period.

Presentation of MAT credit in the financial statements

Balance Sheet

13. Where a company recognises MAT credit as an asset on the basis of the considerations specified in paragraph 11 above, the same should be presented under the head 'Loans and Advances' since, there being a convincing evidence of realisation of the asset, it is of the nature of a pre-paid tax which would be adjusted against the normal income tax during the specified period. The asset may be reflected as 'MAT credit entitlement'.

14. In the year of set-off of credit, the amount of credit availed should be shown as a deduction from the 'Provision for Taxation' on the liabilities side of the balance sheet. The unavailed amount of MAT credit entitlement, if any, should continue to be presented under the head 'Loans and Advances' if it continues to meet the considerations stated in paragraph 11 above.

Profit and Loss Account

15. According to paragraph 6 of Accounting Standards Interpretation (ASI) 6, 'Accounting for Taxes on Income in the context of Section 115JB of the Income-tax Act, 1961', issued by the Institute of Chartered Accountants of India, MAT is the current tax. Accordingly, the tax expense arising on account of payment of MAT should be charged at the gross amount, in the normal way, to the profit

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and loss account in the year of payment of MAT. In the year in which the MAT credit becomes eligible to be recognised as an asset in accordance with the recommendations contained in this Guidance Note, the said asset should be created by way of a credit to the profit and loss account and presented as a separate line item therein.

GN(A) 23 (Revised 2012)

Guidance Note on Accounting for Real Estate Transactions

Foreword

Growth of the real estate sector in the recent past in India, indicates the importance of this sector in Indian economy. Along with fulfilling one of the basic necessities for human existence, i.e., housing, this sector has also been used as a key tool by the Indian Government in achieving an overall socio-economic growth during the last few decades. The development in the real estate market encompasses growth in both commercial and residential spheres. As there are large numbers of entities in this segment, there is intense pressure amongst the entities to stay on top in the investors' choice list.

The Institute of Chartered Accountants of India (ICAI), while realising the role of this sector in fuelling growth of Indian economy and recognising need for guidance on accounting for real estate sales, in 2006, issued *Guidance Note on Recognition of Revenue by Real Estate Developers*.

With the fast growth of this sector, the volume and the number of transactions in this sector have also grown significantly. In the recent past, different practices followed by the various real estate developers in recognising their revenue has also been amongst the favourite headlines in the news across the country. Considering this, ICAI felt that the revision of the Guidance Note is necessary. I appreciate the initiative taken by the Accounting Standards Board in this regard.

I wish to place on record my deep appreciation of CA. Manoj Fadnis, Chairman, Accounting Standards Board, and members of the Accounting Standards Board who have made invaluable contribution in the finalisation of this Guidance Note.

I hope that this revised Guidance Note will be useful – both to our members as well as the others concerned.

New Delhi
February, 2012

CA. G. Ramaswamy
President

Preface

In recent years, with the increase in the demand for real estate, due to factors such as the fast growing population, introduction of various home loan schemes, the growth in the real estate sector has increased manifold. This sector has also emerged as one of the best investing opportunities not only for Indian investors but also for foreign investors. Huge foreign direct investment in the last five years in this sector is witness to this fact. As the premier accounting standards-setting body, the ICAI, due to the distinguished revenue model of this sector, felt that the accounting guidance earlier given by the ICAI in the Guidance Note on *Recognition of Revenue by Real Estate Developers* required revision, so that the diverse practices followed by different players in the market can be harmonised into a single uniform practice, particularly, in the application of Percentage of Completion Method of recognising the revenue. The Guidance Note primarily provides guidance on application of percentage of completion method, where it is appropriate to apply this method, i.e., where such transactions and activities of real estate have the same economic substance as construction contracts. For this purpose, the Guidance Note draws upon the principles enunciated in Accounting Standard (AS) 7, *Construction Contracts*. In respect of transactions of real estate which are in substance similar to delivery of goods, principles enunciated in Accounting Standard (AS) 9, *Revenue Recognition*, are applied.

I would like to convey my sincere thanks to our Honourable President CA. G. Ramaswamy and Vice-President CA. Jaydeep N. Shah and CA.S. Santhanakrisnan, Vice- Chairman, ASB for their constant support and co-operation.

I would like to take this opportunity to place on record my deep appreciation of the efforts put in by CA. J. Venkateshwarlu, CA. Vinod Jain, CA. P. R. Ramesh and Shri Chandrasekhar Gokhale, who made immense contribution in the preparation of the basic draft of the revised Guidance Note. I would also like to thank various representatives of the industry, market participants, our members and other individuals for giving their invaluable suggestions on the draft Guidance Note from time to time.

I sincerely compliment Dr. Avinash Chander, Technical Director and CA. Geetanshu Bansal, Senior Executive Officer, for their invaluable contribution and efforts at various stages of finalising of the Guidance Note.

Accounting for Real Estate Transactions

I am confident that this Guidance Note will be extremely useful to the members of the Institute and others interested in the subject.

New Delhi
February 11, 2012

CA. Manoj Fadnis
Chairman
Accounting Standards Board

GN(A) 23 (Revised 2012)

Guidance Note on Accounting for Real Estate Transactions

(The following is the text of the Guidance Note on Accounting for Real Estate Transactions, issued by the Council of the Institute of Chartered Accountants of India.)

1. Objective and Scope

Objective

1.1 The objective of this Guidance Note is to recommend the accounting treatment by enterprises dealing in 'Real Estate' as sellers or developers. The term 'real estate' refers to land as well as buildings and rights in relation thereto. Enterprises who undertake such activity are generally referred to by different terms such as 'real estate developers', 'builders' or 'property developers'.

Scope

1.2 This Guidance Note covers all forms of transactions in real estate. An illustrative list of transactions which are covered by this Guidance Note is as under:

- (a) Sale of plots of land (including long term sale type leases) without any development.
- (b) Sale of plots of land (including long term sale type leases) with development in the form of common facilities like laying of roads, drainage lines and water pipelines, electrical lines, sewage tanks, water storage tanks, sports facilities, gymnasium, club house, landscaping etc.
- (c) Development and sale of residential and commercial units, row houses, independent houses, with or without an undivided share in land.

- (d) Acquisition, utilisation and transfer of development rights.
- (e) Redevelopment of existing buildings and structures.
- (f) Joint development agreements for any of the above activities.

1.3 The Guidance Note primarily provides guidance on application of percentage of completion method where it is appropriate to apply this method as explained in subsequent paragraphs as such transactions and activities of real estate have the same economic substance as construction contracts. For this purpose, the Guidance Note draws upon the principles enunciated in Accounting Standard (AS) 7, *Construction Contracts*. In respect of transactions of real estate which are in substance similar to delivery of goods principles enunciated in Accounting Standard (AS) 9, *Revenue Recognition*, are applied.

1.4 Real estate transactions of the nature covered by Accounting Standard (AS) 10, *Accounting for Fixed Assets*, Accounting Standard (AS) 12, *Accounting for Government Grants*, Accounting Standard (AS) 19, *Leases*, and Accounting Standard (AS) 26, *Intangible Assets*, are outside the scope of this Guidance Note.

1.5 This Guidance Note should be applied to all projects in real estate which are commenced on or after April 1, 2012 and also to projects which have already commenced but where revenue is being recognised for the first time on or after April 1, 2012. An enterprise may choose to apply this Guidance Note from an earlier date provided it applies this Guidance Note to all transactions which commenced or were entered into on or after such earlier date. This Guidance Note supersedes the Guidance Note on Recognition of Revenue by Real Estate Developers, issued by the Institute of Chartered Accountants of India in 2006, when this Guidance Note is applied as above.

2. Definitions

2.1 Project – Project is the smallest group of units/plots/saleable spaces which are linked with a common set of amenities in such a manner that unless the common amenities are made available and functional, these units /plots / saleable spaces cannot be put to their intended effective use.

A larger venture can be split into smaller projects if the basic conditions as set out above are fulfilled. For example, a project may comprise a cluster of towers

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or each tower can also be designated as a project. Similarly, a complete township can be a project or it can be broken down into smaller projects.

2.2 Project Costs – Project costs in relation to a project ordinarily comprise:

- (a) *Cost of land and cost of development rights* -All costs related to the acquisition of land, development rights in the land or property including cost of land, cost of development rights, rehabilitation costs, registration charges, stamp duty, brokerage costs and incidental expenses.
- (b) *Borrowing Costs* – In accordance with Accounting Standard (AS) 16, *Borrowing Costs* which are incurred directly in relation to a project or which are apportioned to a project .
- (c) *Construction and development costs* – These would include costs that relate directly to the specific project and costs that may be attributable to project activity in general and can be allocated to the project.

2.3 Construction costs and development costs that relate directly to a specific project include:

- (a) land conversion costs, betterment charges, municipal sanction fee and other charges for obtaining building permissions;
- (b) site labour costs, including site supervision;
- (c) costs of materials used in construction or development of property;
- (d) depreciation of plant and equipment used for the project ;
- (e) costs of moving plant, equipment and materials to and from the project site;
- (f) costs of hiring plant and equipment;
- (g) costs of design and technical assistance that is directly related to the project;

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- (h) estimated costs of rectification and guarantee work, including expected warranty costs; and
- (i) claims from third parties.

2.4 The following costs should not be considered part of construction costs and development costs if they are material:

- (a) General administration costs;
- (b) selling costs;
- (c) research and development costs;
- (d) depreciation of idle plant and equipment;
- (e) cost of unconsumed or uninstalled material delivered at site; and
- (f) payments made to sub-contractors in advance of work performed.

2.5 Costs that may be attributable to project activity in general and can be allocated to specific projects include:

- (a) insurance;
- (b) costs of design and technical assistance that is not directly related to a specific project; and
- (c) construction or development overheads; and
- (d) borrowing costs.

Such costs are allocated using methods that are systematic and rational and are applied consistently to all costs having similar characteristics. The allocation is based on the normal level of project activity. Construction overheads include costs such as the preparation and processing of construction personnel payroll.

2.6 **Project revenues** – Project revenues include revenue on sale of plots, undivided share in land, sale of finished and semi-finished structures, consideration for construction, consideration for amenities and interiors, consideration for parking spaces and sale of development rights.

Project revenues are measured as the consideration received or receivable. The measurement of project revenues is affected by a variety of uncertainties that depend on the outcome of future events. The estimates often need revision as events occur and uncertainties are resolved. Therefore, the amount of project revenue may increase or decrease from one reporting period to the next.

3. Accounting for Real Estate Transactions

3.1 Real estate activities and transactions take diverse forms. While some are for sale of land (developed or undeveloped), others are for construction, development or sale of units that are not complete at the time of entering into agreements for construction, development or sale.

3.2 The typical features of most construction/development of commercial and residential units have all features of a construction contract – land development, structural engineering, architectural design and construction are all present. The natures of these activities are such that often the date when the activity is commenced and the date when the activity is completed usually fall into different accounting periods. It is not unusual for such activities to spread over two or more accounting periods.

3.3 For recognition of revenue in case of real estate sales, it is necessary that all the conditions specified in paragraphs 10 and 11 of Accounting Standard (AS) 9, Revenue Recognition, are satisfied. As stated above, real estate sales take place in a variety of ways and may be subject to different terms and conditions as specified in the agreement for sale. Accordingly, the point of time at which all significant risks and rewards of ownership can be considered as transferred, is required to be determined on the basis of the terms and conditions of the agreement for sale. In case of real estate sales, the seller usually enters into an agreement for sale with the buyer at initial stages of construction. This agreement for sale is also considered to have the effect of transferring all significant risks and rewards of ownership to the buyer provided the agreement is legally enforceable and subject to the satisfaction of conditions which signify transferring of significant risks and rewards even though the legal title is not transferred or the possession of the real estate is not given to the buyer. Once the seller has transferred all the significant risks and rewards to the buyer, any acts on the real estate performed by the seller are, in substance, performed on behalf of the buyer in the manner similar to a contractor. Accordingly, revenue in such cases is recognised by applying the percentage of completion method on the basis of the methodology explained in AS 7, *Construction Contracts*.

Further, where individual contracts are part of a single project, although risks and rewards may have been transferred on signing of a legally enforceable individual contract but significant performance in respect of remaining components of the project is pending, revenue in respect of such an individual contract should not be recognised until the performance on the remaining components is considered to be completed on the basis of the aforesaid principles. This Guidance Note, thus, provides guidance in the application of:

- Principles of AS 9 in respect of sale of goods for recognising revenue, costs and profits from transactions of real estate which are in substance similar to delivery of goods where the revenues, costs and profits are recognised when the revenue recognition process is completed; and
- Percentage completion method for recognising revenue, costs and profits from transactions and activities of real estate which have the same economic substance as construction contracts.

3.4 The application of the methods described in paragraph 3.3 above requires a careful analysis of the elements of the transaction, agreement, understanding and conduct of the parties to the transaction to determine the economic substance of the transaction. The economic substance of the transaction is not influenced or affected by the structure and/or legal form of the transaction or agreement.

4. Application of Principles of AS 9 in Respect of Sale of Goods to a Real Estate Project

4.1 The application of principles of AS 9 in respect of sale of goods requires recognition of revenues on completion of the transaction/activity when the revenue recognition process in respect of a real estate project is completed as explained in paragraph 4.2 below.

4.2 The completion of the revenue recognition process is usually identified when the following conditions are satisfied:

- (a) The seller has transferred to the buyer all significant risks and rewards of ownership and the seller retains no effective control of the real estate to a degree usually associated with ownership;

- (b) The seller has effectively handed over possession of the real estate unit to the buyer forming part of the transaction;
- (c) No significant uncertainty exists regarding the amount of consideration that will be derived from the real estate sales; and
- (d) It is not unreasonable to expect ultimate collection of revenue from buyers.

4.3 Where transfer of legal title is a condition precedent to the buyer taking on the significant risks and rewards of ownership and accepting significant completion of the seller's obligation, revenue should not be recognised till such time legal title is validly transferred to the buyer.

5. Application of Percentage Completion Method

5.1 The percentage completion method should be applied in the accounting of all real estate transactions/activities in the situations described in paragraph 3.3 above, i.e., where the economic substance is similar to construction contracts. Some further indicators of such transactions/activities are:

- (a) The duration of such projects is beyond 12 months and the project commencement date and project completion date fall into different accounting periods.
- (b) Most features of the project are common to construction contracts, viz., land development, structural engineering, architectural design, construction, etc.
- (c) While individual units of the project are contracted to be delivered to different buyers these are interdependent upon or interrelated to completion of a number of common activities and/or provision of common amenities.
- (d) The construction or development activities form a significant proportion of the project activity.

5.2 This method is applied when the outcome of a real estate project can be estimated reliably and when all the following conditions are satisfied:

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- (a) total project revenues can be estimated reliably;
- (b) it is probable that the economic benefits associated with the project will flow to the enterprise;
- (c) the project costs to complete the project and the stage of project completion at the reporting date can be measured reliably; and
- (d) the project costs attributable to the project can be clearly identified and measured reliably so that actual project costs incurred can be compared with prior estimates.

When the outcome of a project can be estimated reliably, project revenues and project costs associated with the project should be recognised as revenue and expenses respectively applying the percentage of completion method in the manner detailed in paragraphs 5.3 to 5.8 below.

5.3 Further to the conditions in paragraph 5.2 there is a rebuttable presumption that the outcome of a real estate project can be estimated reliably and that revenue should be recognised under the percentage completion method only when the events in (a) to (d) below are completed.

- (a) All critical approvals necessary for commencement of the project have been obtained. These include, wherever applicable:
 - (i) Environmental and other clearances.
 - (ii) Approval of plans, designs, etc.
 - (iii) Title to land or other rights to development/ construction.
 - (iv) Change in land use.
- (b) When the stage of completion of the project reaches a reasonable level of development. A reasonable level of development is not achieved if the expenditure incurred on construction and development costs is less than 25 % of the construction and development costs as defined in paragraph 2.2 (c) read with paragraphs 2.3 to 2.5.

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- (c) Atleast 25% of the saleable project area is secured by contracts or agreements with buyers.
- (d) Atleast 10 % of the total revenue as per the agreements of sale or any other legally enforceable documents are realised at the reporting date in respect of each of the contracts and it is reasonable to expect that the parties to such contracts will comply with the payment terms as defined in the contracts. To illustrate - If there are 10 Agreements of sale and 10 % of gross amount is realised in case of 8 agreements, revenue can be recognised with respect to these 8 agreements.

5.4 When the outcome of a real estate project can be estimated reliably and the conditions stipulated in paragraphs 5.2 and 5.3 are satisfied, project revenue and project costs associated with the real estate project should be recognised as revenue and expenses by reference to the stage of completion of the project activity at the reporting date. For computation of revenue the stage of completion is arrived at with reference to the entire project costs incurred including land costs, borrowing costs and construction and development costs as defined in paragraph 2.2. Whilst the method of determination of stage of completion with reference to project costs incurred is the preferred method, this Guidance Note does not prohibit other methods of determination of stage of completion, e.g., surveys of work done, technical estimation, etc. However, computation of revenue with reference to other methods of determination of stage of completion should not, in any case, exceed the revenue computed with reference to the 'project costs incurred' method. Illustration appended to this Guidance Note clarifies the method of computation of revenue.

5.5 The project costs which are recognised in the statement of profit and loss by reference to the stage of completion of the project activity are matched with the revenues recognised resulting in the reporting of revenue, expenses and profit which can be attributed to the proportion of work completed. Costs incurred that relate to future activity on the project and payments made to sub-contractors in advance of work performed under the sub-contract are excluded and matched with revenues when the activity or work is performed. This method provides useful information to the extent of contract activity and performance during a period.

5.6 The recognition of project revenue by reference to the stage of completion of the project activity should not at any point exceed the estimated total revenues

from 'eligible contracts'/other legally enforceable agreements for sale. 'Eligible contracts' means contracts/ agreements specified in paragraph 5.3 where at least 10% of the contracted amounts have been realised and there are no outstanding defaults of the payment terms in such contracts.

5.7 When it is probable that total project costs will exceed total eligible project revenues, the expected loss should be recognised as an expense immediately. The amount of such a loss is determined irrespective of:

- (a) commencement of project work; or
- (b) the stage of completion of project activity.

5.8 The percentage of completion method is applied on a cumulative basis in each reporting period to the current estimates of project revenues and project costs. Therefore, the effect of a change in the estimate of project costs, or the effect of a change in the estimate of the outcome of a project, is accounted for as a change in accounting estimate. The changed estimates are used in determination of the amount of revenue and expenses recognised in the statement of profit and loss in the period in which the change is made and in subsequent periods.

5.9 The changes to estimates referred to in paragraph 5.8 above also include changes arising out of cancellation of contracts and cases where the property or part thereof is subsequently earmarked for own use or for rental purposes. In such cases any revenues attributable to such contracts previously recognised should be reversed and the costs in relation thereto shall be carried forward and accounted in accordance with AS 10, *Accounting for Fixed Assets*.

6. Accounting for Sale of Land or Plots

A. Sale of plots of land without any development

Revenue from sale of land or plots should be recognised when all the conditions in paragraph 4.2 above are met.

B. Sale of developed plots

Where the development activity is significant and if the projects meet the criteria specified in paragraphs 3.3 and 5.1 above, the percentage completion method is used to account for such sales.

7. Transferable Development Rights

7.1 Transferable Development Rights (TDRs) are generally acquired in different ways as mentioned hereunder:

- (a) Direct purchase.
- (b) Development and construction of built-up area.
- (c) Giving up of rights over existing structures or open land.

7.2 When development rights are acquired by way of direct purchase or on development or construction of built-up area, cost of acquisition would be the cost of purchases or amount spent on development or construction of built-up area, respectively. Where development rights are acquired by way of giving up of rights over existing structures or open land, the development rights should be recorded either at fair market value or at the net book value of the portion of the asset given up whichever is less. For this purpose, fair market value may be determined by reference either to the asset or portion thereof given up or to the fair market value of the rights acquired whichever is more clearly evident.

7.3 When development rights are utilised in a real estate project by an enterprise, the cost of acquisition should be added to the project costs.

7.4 When development rights are sold or transferred, revenue should be recognised when both the following conditions are fulfilled:

- (a) title to the development rights is transferred to the buyer; and
- (b) it is not unreasonable to expect ultimate realisation of revenue.

8. Transactions with Multiple Elements

8.1 An enterprise may contract with a buyer to deliver goods or services in addition to the construction/development of real estate [e.g. property management services, sale of decorative fittings (excluding fittings which are an integral part of the unit to be delivered), rental in lieu of unoccupied premises, etc.]. In such cases, the contract consideration should be split into separately identifiable components including one for the construction and delivery of real estate units.

8.2 The consideration received or receivable for the contract should be allocated to each component on the basis of the fair market value of each component.

8.3 The accounting of each of the components should be in accordance with paragraph 3.3 above.

9. Disclosure

9.1 An enterprise should disclose:

- (a) the amount of project revenue recognised as revenue in the reporting period;
- (b) the methods used to determine the project revenue recognised in the reporting period; and
- (c) the method used to determine the stage of completion of the project.

9.2 An enterprise should also disclose each of the following for projects in progress at the end of the reporting period:

- (a) the aggregate amount of costs incurred and profits recognised (less recognised losses) to date; and
- (b) the amount of advances received;
- (c) the amount of work in progress and the value of inventories;
- (d) Excess of revenue recognised over actual bills raised (unbilled revenue).

Illustration on application of percentage completion method

Total saleable area	20,000 Sq. ft.
Estimated Project Costs(This comprises land cost of Rs. 300 Lakhs and construction costs of Rs. 300 Lakhs)	Rs. 600 lakhs

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Cost incurred till end of reporting period (This includes land cost of Rs. 300 lakhs and construction cost of Rs. 60 Lakhs)	Rs. 360 Lakhs
Total Area Sold till the date of reporting period	5,000 Sq. ft.
Total Sale Consideration as per Agreements of Sale executed	Rs. 200 Lakhs
Amount realised till the end of the reporting period	Rs.50 Lakhs
Percentage of completion of work	60% of total project cost including land cost or 20% of total construction cost

At the end of the reporting period the enterprise will not be able to recognise any revenue as reasonable level of construction, which is 25% of the total construction cost, has not been achieved, though 10% of the agreement amount has been realised.

Continuing the illustration

If the work completed till end of reporting period is (This includes land cost of Rs 300 Lakhs and construction cost of Rs 90 lakhs)	Rs. 390 Lakhs
Percentage of completion of work would be	65% of total project cost including land cost or 30% of construction cost

The enterprise would be able to recognise revenues at the end of the accounting period. The revenue recognition and profits would be as under:

Revenue recognised (65 % of Rs 200 lakhs as per Agreement of Sale)	Rs. 130 Lakhs
Proportionate cost (5000 sft./20,000 sft.) X 390	Rs. 97.50 Lakhs
Income from the project	Rs. 32.50 Lakhs
Work in progress to be carried forward	Rs. 292.50 Lakhs

GN(A) 24 (Issued 2006)

Guidance Note on Measurement of Income Tax Expense for Interim Financial Reporting in the Context of AS 25

Foreword

In the present fast changing era of business, timely and reliable interim financial reporting plays a crucial role in providing useful financial information about an enterprise to various stakeholders to base their economic and financial decisions. The Council of the Institute of Chartered Accountants of India has issued Accounting Standard (AS) 25, 'Interim Financial Reporting', which lays down the principles of recognition and measurement of items in the interim financial reporting besides laying down various requirements in respect of presentation and disclosures. The measurement of income tax has a significant impact on financial statements – both interim and annual. In recent past, certain issues were being raised regarding measurement of income tax expense for interim financial reporting by applying principles of AS 25. I am very pleased that the Research Committee of the Institute took upon the task of preparing the Guidance Note on 'Measurement of Income-tax Expense for Interim Financial Reporting in the Context of AS 25' which has, subsequently, been approved by the Council.

I wish to place on record my deep appreciation of CA. Pawan Kumar Sharma, Chairman, Research Committee, other esteemed members of the Research Committee and officers of the Technical Directorate who have made invaluable contribution in the finalisation of this Guidance Note.

I am confident that this Guidance Note will be immensely useful not only to the members of the Institute but also to others concerned.

New Delhi
November 6, 2006

CA. T.N. Manoharan
President

Preface

The general principles of measurement and recognition of items contained in the interim financial reports are prescribed by Accounting Standard (AS) 25, 'Interim Financial Reporting'. AS 25 requires an enterprise to apply the same accounting policies in its interim financial reports as in its annual financial statements. Among other expenses, income tax expense is an important item of interim and annual financial reports. Hence, correct measurement of income tax expense is very important for reporting purposes. Certain issues were being raised on as to how and at which rate the income tax expense should be measured for the purpose of interim financial reporting although the limited revision of AS 25 had attempted to settle the issues. However, keeping in view that a need was still being felt for guidance, the Research Committee decided to formulate this Guidance Note on 'Measurement of Income-tax Expense for Interim Financial Reporting in the Context of AS 25' to deal with various aspects in the measurement of income tax expense for the purpose of interim financial reporting.

I would like to take this opportunity to express my gratitude and thanks to my esteemed Council colleague CA. S.C. Vasudeva for his guidance throughout the preparation of this Guidance Note. I would also like to place on record my appreciation of CA. Himanshu Kishnadwala for preparing the basic draft of the Guidance Note. My thanks are also due to all other members of Research Committee, namely, CA. H. N. Motiwalla, Vice-Chairman, CA. T. N. Manoharan, President (Ex-officio), CA. Sunil H. Talati, Vice-President (Ex-officio), CA. Jayant Gokhale, CA. Pankaj I. Jain, CA. Rajkumar S. Adukia, CA. Kashi P. Khandelwal, CA. Anuj Goyal, CA. Charanjot Singh Nanda and members co-opted on the Committee for their suggestions and inputs. I also wish to place on record my gratitude to Dr. Avinash Chander, Technical Director, and CA. Anuradha Jain, Secretary, Research Committee, for their contribution in finalisation of the Guidance Note. I believe and trust that this publication would prove useful to the members of the Institute and others concerned.

New Delhi
November 08, 2006

CA. Pawan Kumar Sharma
Chairman
Research Committee

GN(A) 24 (Issued 2006)

Guidance Note on Measurement of Income Tax Expense for Interim Financial Reporting in the Context of AS 25

(The following is the text of the Guidance Note on Measurement of Income-tax Expense for Interim Financial Reporting in the context of AS 25, issued by the Council of the Institute of Chartered Accountants of India.)

1. Accounting Standard (AS) 25, 'Interim Financial Reporting', issued by the Council of the Institute of Chartered Accountants of India (ICAI), prescribes the minimum content of an interim financial report and the principles for recognition and measurement in complete or condensed financial statements for an interim period. AS 25 became mandatory in respect of accounting periods commencing on or after 1st April, 2002. In accordance with the Accounting Standards Interpretation (ASI) 27, 'Applicability of AS 25 to Interim Financial Results', the recognition and measurement principles laid down in AS 25 should be applied for recognition and measurement of items contained in the interim financial results presented under Clause 41 of the Listing Agreement entered into between stock exchanges and the listed enterprises. This Guidance Note deals with the measurement of income tax expense for the purpose of inclusion in the interim financial reports.

2. The general principles for recognition and measurement have been laid down in AS 25 as below:

***“27. An enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. However, the frequency of an enterprise’s reporting (annual, half-yearly, or quarterly) should not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes should be made on a year-to-date basis.*”**

28. Requiring that an enterprise apply the same accounting policies in its interim financial statements as in its annual financial statements may seem to suggest that interim period measurements are made as if each interim period stands alone as an independent reporting period. However, by providing that the frequency of an enterprise's reporting should not affect the measurement of its annual results, paragraph 27 acknowledges that an interim period is a part of a financial year. Year-to-date measurements may involve changes in estimates of amounts reported in prior interim periods of the current financial year. But the principles for recognising assets, liabilities, income, and expenses for interim periods are the same as in annual financial statements."

3. Paragraph 29(c) of AS 25 illustrates the application of the general principles for recognition and measurement of tax expense in interim periods, as below:

"29...

- (c) income tax expense is recognised in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year. Amounts accrued for income tax expense in one interim period may have to be adjusted in a subsequent interim period of that financial year if the estimate of the annual income tax rate changes."

4. Appendix 3 to AS 25 illustrates the general recognition and measurement principles for the preparation of interim financial reports. Paragraphs 8 to 16 of the Appendix provide guidance on the computation of income-tax expense for the interim period, which are reproduced in Appendix A to this Guidance Note for ready reference. Paragraph 8 of the Appendix states as below:

- "8. Interim period income tax expense is accrued using the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate applied to the pre-tax income of the interim period."

5. The various steps involved in the measurement of income tax expense for the purpose of interim financial reports are as below:

- (i) An enterprise will first have to estimate its annual accounting income. For this purpose, an enterprise would have to take into account all probable events and transactions that are expected to occur during the financial year. Such an estimate would involve, e.g., estimating on prudent basis, the depreciation on expected expenditure on acquisition of fixed assets, profits from sale of fixed assets/investments, etc. Such future events and transactions should be taken into account only if there is a reasonable certainty that the same would take place during the financial year.
- (ii) The enterprise should next estimate its tax liability for the financial year. For this purpose, the enterprise will have to estimate taxable income for the year. By applying the enacted or the substantively enacted tax rate on the taxable income, an estimate of the current tax for the year is arrived at. The estimates of tax liability would have to be based on the estimated deductions, allowances, etc., that would be available to the enterprise, provided there is a reasonable certainty for the same. The enterprise would also have to estimate the deferred tax assets/liabilities by applying the principles of Accounting Standard (AS) 22, 'Accounting for Taxes on Income', issued by the Institute of Chartered Accountants of India. Special considerations may have to be applied in certain cases as below:
 - (a) Where brought forward losses exist from the previous financial year (when deferred tax asset was not recognised on considerations of prudence as per AS 22): In such a situation, for estimating the current tax liability, the brought forward losses would have to be deducted from the estimated annual accounting income as explained in paragraph 16 of Appendix 3 to AS 25 (reproduced in Appendix A to this Guidance Note). Since such carried forward losses will get set-off during the year, these would not have any tax consequence in future periods.

- (b) Where brought forward losses exist (when deferred tax asset was recognised on the considerations of prudence as per AS 22): In such a situation, current tax would be computed in the same manner as explained in (a) above. However, in the determination of deferred tax, the tax expense arising from the reversal of the deferred tax asset recognised previously, to the extent of reversal of deferred tax asset in the current year, would also be considered.
- (iii) The enterprise would now have to calculate the weighted average annual effective tax rate. This tax rate would be determined by dividing the estimated tax expense as arrived at step (ii) above by the estimated annual accounting income as arrived at step (i) above. Where different tax rates are applicable to different portions of the estimated annual accounting income, e.g., normal tax rate and a different tax rate for capital gains, the weighted average annual effective tax rate would have to be calculated separately for such portions of estimated annual accounting income.
- (iv) The weighted average annual effective tax rate arrived at step (iii) would be applied to the accounting income for the interim period for determining the income tax expense to be recognised in the interim financial reports.

6. Accounting for interim period income-tax expense as suggested above is based on the approach prescribed in AS 25 that the interim period is part of the whole accounting year (often referred to as the 'integral approach') and, therefore, the said expense should be worked out on the basis of the estimated weighted average annual effective income-tax rate. According to this approach, the said rate is determined on the basis of the taxable income for the whole year, and applied to the accounting income for the interim period in order to determine the amount of tax expense for that interim period. This is in contrast to accounting for certain other expenses such as depreciation which is based on the approach prescribed in AS 25 that the interim period should be considered on stand-alone basis (often referred to as the 'discrete approach') because expenses such as depreciation are worked out on the basis of the period for which a fixed asset was available for use. The aforesaid treatments are, however, consistent with the

Measurement of Income Tax Expense for Interim Financial Reporting...

requirement contained in paragraph 27 of AS 25 that an enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements.

7. Appendix B contains examples of computing weighted average annual effective tax rate.

Appendix A

Extracts from Appendix 3 to Accounting Standard (AS) 25, Interim Financial Reporting

Measuring Income Tax Expense for Interim Period

8. Interim period income tax expense is accrued using the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate applied to the pre-tax income of the interim period.

9. This is consistent with the basic concept set out in paragraph 27 that the same accounting recognition and measurement principles should be applied in an interim financial report as are applied in annual financial statements. Income taxes are assessed on an annual basis. Therefore, interim period income tax expense is calculated by applying, to an interim period's pre-tax income, the tax rate that would be applicable to expected total annual earnings, that is, the estimated average effective annual income tax rate. That estimated average annual income tax rate would reflect the tax rate structure expected to be applicable to the full year's earnings including enacted or substantively enacted changes in the income tax rates scheduled to take effect later in the financial year. The estimated average annual income tax rate would be re-estimated on a year-to-date basis, consistent with paragraph 27 of this Statement. Paragraph 16(d) requires disclosure of a significant change in estimate.

10. To the extent practicable, a separate estimated average annual effective income tax rate is determined for each governing taxation law and applied individually to the interim period pre-tax income under such laws. Similarly, if different income tax rates apply to different categories of income (such as capital gains or income earned in particular industries), to the extent practicable a separate rate is applied to each individual category of interim period pre-tax income. While that degree of precision is desirable, it may not be achievable in all cases, and a weighted average of rates across

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such governing taxation laws or across categories of income is used if it is a reasonable approximation of the effect of using more specific rates.

11. As illustration, an enterprise reports quarterly, earns Rs. 150 lakhs pre-tax profit in the first quarter but expects to incur losses of Rs 50 lakhs in each of the three remaining quarters (thus having zero income for the year), and is governed by taxation laws according to which its estimated average annual income tax rate is expected to be 35 per cent. The following table shows the amount of income tax expense that is reported in each quarter:

(Amount in Rs. lakhs)

	1 st Quarter	2 nd Quarter	3 rd Quarter	4 th Quarter	Annual
Tax Expense	52.5	(17.5)	(17.5)	(17.5)	0

Difference in Financial Reporting Year and Tax Year

12. If the financial reporting year and the income tax year differ, income tax expense for the interim periods of that financial reporting year is measured using separate weighted average estimated effective tax rates for each of the income tax years applied to the portion of pre-tax income earned in each of those income tax years.

13. To illustrate, an enterprise's financial reporting year ends 30 September and it reports quarterly. Its year as per taxation laws ends 31 March. For the financial year that begins 1 October, Year 1 ends 30 September of Year 2, the enterprise earns Rs 100 lakhs pre-tax each quarter. The estimated weighted average annual income tax rate is 30 per cent in Year 1 and 40 per cent in Year 2.

(Amount in Rs. lakhs)

	Quarter Ending 31 Dec. Year 1	Quarter Ending 31 Mar. Year 1	Quarter Ending 30 June Year 2	Quarter Ending 30 Sep. Year 2	Year Ending 30 Sep. Year 2
Tax Expense	30	30	40	40	140

Tax Deductions/Exemptions

14. Tax statutes may provide deductions/exemptions in computation of income for determining tax payable. Anticipated tax benefits of this type for the full year are generally reflected in computing the estimated annual effective income tax rate, because these deductions/exemptions are calculated on an annual basis under the usual provisions of tax statutes. On the other hand, tax benefits that relate to a one-time event are recognised in computing income tax expense in that interim period, in the same way that special tax rates applicable to particular categories of income are not blended into a single effective annual tax rate.

Tax Loss Carryforwards

15. A deferred tax asset should be recognised in respect of carryforward tax losses to the extent that it is virtually certain, supported by convincing evidence, that future taxable income will be available against which the deferred tax assets can be realised. The criteria are to be applied at the end of each interim period and, if they are met, the effect of the tax loss carryforward is reflected in the computation of the estimated average annual effective income tax rate.

16. To illustrate, an enterprise that reports quarterly has an operating loss carryforward of Rs 100 lakhs for income tax purposes at the start of the current financial year for which a deferred tax asset has not been recognised. The enterprise earns Rs 100 lakhs in the first quarter of the current year and expects to earn Rs 100 lakhs in each of the three remaining quarters. Excluding the loss carryforward, the estimated average annual income tax rate is expected to be 40 per cent. The estimated payment of the annual tax on Rs. 400 lakhs of earnings for the current year would be Rs. 120 lakhs $\{(Rs. 400 \text{ lakhs} - Rs. 100 \text{ lakhs}) \times 40\%\}$. Considering the loss carryforward, the estimated average annual effective income tax rate would be 30% $\{(Rs. 120 \text{ lakhs}/Rs. 400 \text{ lakhs}) \times 100\}$. This average annual effective income tax rate would be applied to earnings of each quarter. Accordingly, tax expense would be as follows:

(Amount in Rs. lakhs)					
	1 st Quarter	2 nd Quarter	3 rd Quarter	4 th Quarter	Annual
Tax Expense	30.00	30.00	30.00	30.00	120.00

Appendix B

Examples of Computation of Weighted Average Annual Effective Tax Rate

Example 1: When deferred tax asset was not recognised for carried forward losses from earlier accounting periods.

	Quarter I	Quarter II	Quarter III	Quarter IV	Total
	Rs.	Rs.	Rs.	Rs.	Rs.
Estimated Pre-tax Income (after considering estimated depreciation on the probable acquisition of fixed assets during the year)	(25)	175	(25)	50	175
Carried forward losses from earlier accounting periods, the deferred tax asset in respect of which was not recognised as it did not meet the requirements of prudence laid down in AS 22. During this year, in view of the expected taxable income, this loss is expected to be set off thereagainst. Therefore, it will not have any tax effect on future periods.					(25)
Additional estimated depreciation as per tax laws as compared to the accounting depreciation after considering depreciation on probable					(50)

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capital expenditure on acquisition of fixed assets during the year.					
Estimated taxable income on which tax payable.					100
Applicable tax rate (say)					30%
Estimated current tax expense for the year.					30
Estimated deferred tax expense for the year (50×30/100)					15
Weighted Average Annual Effective Tax Rate (current tax)					$\frac{30}{175} \times 100 = 17.14\%$
Weighted Average Annual Effective Tax Rate (deferred tax)					$\frac{15}{175} \times 100 = 8.57\%$
Tax expense for the interim period					
Current tax	(4.29)	30	(4.29)	8.57	29.99
Deferred tax	(2.14)	15	(2.14)	4.29	15.01
Total	(6.43)	45	(6.43)	12.86	45.00

- (a) The above calculation needs to be done for every interim period for which recognition and measurement of tax expense is required.
- (b) It is presumed that there are no other differences between accounting income and taxable income.

Example 2: When deferred tax asset was recognised for carried forward losses from earlier accounting periods.

	Quarter I	Quarter II	Quarter III	Quarter IV	Total
	Rs.	Rs.	Rs.	Rs.	Rs.
Estimated Pre-tax Income (after considering estimated depreciation on the probable acquisition of fixed assets during the year)	(25)	175	(25)	50	175
Carried forward losses from earlier accounting periods, the deferred tax asset in respect of which was recognised on the basis of considerations of AS 22. During this year, in view of the expected taxable income, this loss is expected to be set off thereagainst. This will result in reversal of the deferred tax asset in the current year.					(25)
Additional estimated depreciation as per tax laws as compared to the accounting depreciation after considering depreciation on probable capital expenditure on acquisition of fixed assets during the year.					(50)
Estimated taxable income on which tax payable.					100
Applicable tax rate (say)					30%

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Estimated current tax expense for the year.					30
Estimated deferred tax expense for the year:					22.5
(i) Deferred tax liability on account of timing difference in depreciation (50×30/100)	15				
(ii) Reversal of deferred tax asset (25×30/100)	7.5				
Weighted Average Annual Effective Tax Rate (Current tax)					30/175 × 100 =17.14%
Weighted Average Annual Effective Tax Rate (Deferred tax)					22.5/175 ×100 = 12.86%
Tax expense for the interim period					
Current tax	(4.29)	30.0	(4.29)	8.57	29.99
Deferred tax	(3.21)	22.5	(3.21)	6.43	22.51
Total	(7.50)	52.5	(7.50)	15.00	52.50

- (a) The above calculation needs to be done for every interim period for which recognition and measurement of tax expense is required.
- (b) It is presumed that there are no other differences between accounting income and taxable income.

Example 3: *When progressive rates of tax are applicable*

Under the Indian tax system, the tax rates for corporates and firms are not progressive (i.e., based on levels of income), but are flat rates. Therefore, the tax rate to be applied in the interim period would be the normal rate applicable to the entity. However, the calculation of weighted average annual effective tax rate can be illustrated as below where the tax rates are progressive:

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Estimated annual income Rs.1 lakh

Assumed Tax Rates:

On first Rs. 40,000 30%

On the balance income 40%

Tax expense: 30% of Rs. 40,000 + 40% of Rs. 60,000 = Rs. 36,000

Weighted average annual effective tax rate = $\frac{36,000}{1,00,000} \times 100 = 36\%$

Supposing the estimated income of each quarter is Rs. 25,000, the tax expense of Rs. 9,000 (36% of Rs. 25,000) would be recognised in each of the quarterly financial reports.

Example 4: *When different rates of tax are applicable to different portions of the estimated annual accounting income (refer para5(iii))*

Estimated annual income Rs. 1 lakh

(inclusive of Estimated Capital Gains

(earned in Quarter II)

Rs. 20,000)

Assumed Tax Rates:

On Capital Gains 10%

On other income:

First Rs. 40,000 30%

Balance income 40%

Assuming there is no difference between the estimated taxable income and the estimated accounting income,

Tax Expense:

On Capital Gains portion of annual income:

10% of Rs. 20,000

Rs. 2,000

On other income: 30% of Rs. 40,000 + 40% of Rs.40,000

Rs.28,000

Total: Rs.30,000

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Weighted Average Annual Effective Tax Rate:

On Capital Gains portion of annual income: $\frac{2,000}{20,000} \times 100 = 10\%$

On other income: $\frac{28,000}{80,000} \times 100 = 35\%$

Supposing the estimated income of each quarter is Rs.25,000, when income of Rs.25,000 for 2nd Quarter includes capital gains of Rs.20,000, the tax expense for each quarter will be calculated as below:

	<u>Income</u>	<u>Tax Expense</u>
Quarter I:	Rs. 25,000	35% of Rs. 25,000 = Rs. 8,750
Quarter II:		
	Capital Gains: Rs. 20,000	10% of Rs. 20,000 = Rs. 2,000
	Other: Rs. 5,000	35% of Rs. 5,000 = Rs. 1,750
		<hr/> Rs. 3,750
Quarter III:	Rs. 25,000	35% of Rs. 25,000 = Rs. 8,750
Quarter IV:	Rs. 25,000	35% of Rs. 25,000 = Rs. 8,750
		<hr/>
Total tax expense for the year		= Rs. 30,000
		<hr/>

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Guidance Note on Accounting Treatment for MODVAT/CENVAT

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

Introduction

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

Objective

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

MODVAT Credit Scheme (Upto 31.3.2000) – Salient Features

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

Input Duty Credit Scheme

7. Provisions in relation to this Scheme are contained in Rules 57A to 57J of the Central Excise Rules, 1944. The Scheme covers inputs and final products classifiable under any of the headings of the Chapters of the Central Excise Tariff Act, 1985. The salient features of the Input Duty Credit Scheme are as follows:

Accounting Treatment for MODVAT/CENVAT

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

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

"It is clear from these Rules, as we read them, that a manufacturer obtains credit for the excise duty paid on raw material to be used by him in the production of an excisable product immediately it makes the requisite declaration and obtains an acknowledgement thereof. It is entitled to use the credit at any time thereafter when making payment of excise duty on the excisable product. There is no provision in the Rules which provides for a reversal of the credit by the excise authorities except where it has been illegally or irregularly taken, in which event it stands cancelled or, if utilised, has to be paid for. We are here really concerned

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with credit that has been validly taken, and its benefit is available to the manufacturer without any limitation in time or otherwise unless the manufacturer itself chooses not to use the raw material in its excisable product. The credit is, therefore, indefeasible. It should also be noted there is no co-relation of the raw material and the final product; that is to say, it is not as if credit can be taken only on a final product that is manufactured out of the particular raw material to which the credit is related. The credit may be taken against the excise duty on a final product manufactured on the very day that it becomes available.”

Capital Goods Duty Credit Scheme

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

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

General

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

- (i) A manufacturer is required to comply with various procedural requirements, in particular, filing of declaration, and maintenance of register of receipts, issues and balance of inputs and capital goods in Form RG-23A Part I and RG-23C Part I, respectively. It is also required to maintain registers related to MODVAT credit in respect of inputs and capital goods in Form RG-23A Part II and RG-23C Part II, respectively.
- (ii) There is no time limit for utilisation of MODVAT credit. Government is, however, empowered to provide for lapsing of unutilised credit balances for specific products.
- (iii) Cash refund of duty credit is not allowable except in case of export of goods if the manufacturer is unable to utilise duty credit towards payment of excise duty on clearance of final goods from his factory.

CENVAT Scheme (Effective from 1.4.2000) – Salient Features

11. Modified Value Added Tax (MODVAT) scheme has been replaced by Central Value Added Tax (CENVAT) Scheme with effect from 1.4.2000. The same is contained in newly inserted Rules 57AA to 57AK. CENVAT Scheme, in essence, is the same as MODVAT Scheme except that it is simpler in that, the erstwhile separate schemes for inputs and capital goods are merged into one under CENVAT Scheme. The scope of the Scheme is also expanded in that all inputs (except High Speed Diesel Oil and Petrol) and specified capital goods (except equipments or appliances used in office) are covered in the Scheme.

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

13. The major difference between MODVAT and CENVAT Schemes is in relation to capital goods. The CENVAT credit in respect of capital goods received in a factory at any point of time in a given financial year is allowed to be taken only for an amount not exceeding fifty percent of the duty paid on such capital

goods in the same financial year. The balance of CENVAT credit can be taken in any financial year(s) subsequent to the financial year in which the capital goods were received in the factory of the manufacturer provided capital goods are still in the possession and use of the manufacturer of final products in such subsequent year(s). The condition of possession and use is not applicable to components, spares and accessories, refractories and refractory materials and goods falling under Tariff Heading 68.02 and sub-heading 6801.10 of first Schedule of the Central Excise Tariff Act, 1985, if they are not removed without use.

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

Accounting Treatment in Case of Inputs Used in or in Relation to Manufacture of Final Products

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

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

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

17. It may be appropriate to quote the following paragraphs nos. 6 and 7, dealing with 'cost of inventories' and 'costs of purchase', of Accounting

Standard (AS) 2 (Revised) on 'Valuation of Inventories', issued by the Institute of Chartered Accountants of India.

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

7. The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.”

Particular attention is invited to the paragraph related to 'costs of purchase', according to which, only those duties have to be included as costs of purchase which are not subsequently recoverable by the enterprise from the taxing authorities. Since the specified duty on inputs is available for set-off against the excise duty on final products, it is considered of the nature of duty recoverable from taxing authorities.

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

Change in Accounting Policy

19. In cases, where enterprises were accounting for MODVAT credit on inputs in accordance with the erstwhile inclusive method, i.e., the second alternative¹

¹ Para 6.1(b) of erstwhile Guidance Note has been withdrawn. This para recommended as below:
“(b) in the second alternative, the cost of inputs may be recorded at the total amount paid to the supplier inclusive of the specified duty on inputs. To the extent the MODVAT credit is utilised for payment of excise duty on final products, the amount could be credited to a separate account, e.g., MODVAT Credit Availed Account. Out of the MODVAT Credit Availed Account, the amount of MODVAT credit availed in respect of consumption of inputs would be reduced from the total cost of inputs consumed. The balance amount standing to the credit of MODVAT Credit Availed Account representing MODVAT credit in respect of input not consumed but lying in stock could be shown in the balance sheet as deduction from the value of inventory. It will have to be ensured that the set-off for MODVAT credit on input not yet consumed is carried forward and there is no accounting of double income, firstly, as set-off adjusted as reduction in the cost of input and secondly, as credit taken in the profit and loss account by inclusion of the specified duty on input as part of value of inventory of the input.”

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recommended in the earlier edition (1995) of the Guidance Note on Accounting Treatment for MODVAT, they will have to change the method of accounting in accordance with paragraph 16 of this Guidance Note. Accordingly, such an enterprise will have to adjust the amount of opening stock in respect of the accounting periods commencing on or after April 1, 1999, in such a way so that the opening stock should appear at the amount which would have been arrived at had the method suggested in paragraph 16 of this Guidance Note been followed. This could be done by adjusting the amount of opening stock in respect of the accounting periods commencing on or after April 1, 1999, by the amount of the balance lying in the MODVAT credit availed account. Further, an amount equal to the balance of RG23A register, representing the MODVAT credit receivable in respect of the inputs purchased in the earlier years should be transferred to MODVAT Credit Receivable Account² with a corresponding adjustment in the amount of opening stock. After the aforesaid adjustments, the MODVAT Credit Receivable Account should also appear at the amount which would have been arrived at had the method suggested in paragraph 16 of this Guidance Note been followed. An example illustrating the change in accounting policy has been given as Annexure B.

Appropriate disclosures as per Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, are also required to be made in the financial statements for change in accounting policy.

Accounting Treatment – Job-work

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

² At the time of transfer to the MODVAT Credit Receivable Account, the MODVAT credit receivable should be reviewed and if it is found that the MODVAT credit is not likely to be used in the normal course of business within a reasonable time or it is revealed that the terms and conditions subject to which the benefit of MODVAT credit is available, have not been complied with or are not being capable of compliance, then such credit should not be transferred to MODVAT Credit Receivable Account.

Accounting Treatment for MODVAT/CENVAT

20. In a case where an enterprise removes inputs as such or in a partially processed form to a place outside the factory for the purpose of testing, repairing, refining, reconditioning or carrying out any other operations necessary for manufacture of final products, the enterprise is required to debit MODVAT Credit Register (RG 23A) or account current with an amount equal to 10% of the value of inputs or partially processed inputs, as the case may be. The said debit is in the nature of deposit and is available for credit at the time of return of duly processed goods to the factory within the prescribed time. The said deposit is also available for adjustment against duty payment if the goods are not received back in the factory within the prescribed time limit. If this amount is debited to MODVAT Credit Register (RG 23A), the same should be accounted for as a deposit and should be debited to a separate account with appropriate nomenclature say, 'MODVAT Credit Deposit (Jobwork) Account' and credited to 'MODVAT Credit Receivable Account'. This deposit amount should be credited and 'MODVAT Credit Receivable Account' should be debited at the time of receipt of duly processed goods in the factory within the prescribed time limit or for adjustment of duty if the goods are not received back in the factory within the prescribed time limit. *This requirement of debit has been dispensed with under CENVAT Scheme.*

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

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

Accounting Treatment for MODVAT Credit in Case of Capital Goods Used for Manufacture of Specified Goods

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

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

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

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

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

25. MODVAT credit in respect of capital goods should be recognised in the books of account when the following conditions are satisfied: (i) The enterprise is entitled to the MODVAT credit as per the Rules, and (ii) there is a reasonable certainty that the MODVAT credit would be utilised.

Accounting Treatment for CENVAT Credit in Case of Capital Goods

26. The nature of the CENVAT Credit in respect of capital goods is the same as that of MODVAT Credit. However, the CENVAT Credit in respect of capital goods is allowed for an amount not exceeding fifty percent of the duty paid on such capital goods in the financial year in which the goods are received in factory and the balance will be allowed in the subsequent year(s). In case the conditions specified in para 25 above are met and the enterprise decides to take CENVAT credit, the entire amount of CENVAT Credit should be deducted from the cost of capital goods. The amount of CENVAT credit taken in the financial year, in which goods are received, should be debited to an appropriate account, say, 'CENVAT Credit Receivable (Capital Goods) Account' and balance may be debited to another appropriate account, say, 'CENVAT Credit Deferred Account'. In the subsequent financial year(s), when balance CENVAT credit is availed of, the appropriate adjustment for the same should be made, i.e., amount of CENVAT credit availed of should be credited to 'CENVAT Credit Deferred Account' with a corresponding debit to 'CENVAT Credit Receivable (Capital Goods) Account'.

Accounting Treatment where Capital Goods are Acquired on Lease or Hire Purchase

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

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

"Minimum Lease Payments: The payments over the lease term that the lessee is or can be required to make (excluding costs for services and

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taxes to be paid by and be reimbursable to the lessor) together with the residual value.”

Where the specified duty on capital goods does not form part of the financing arrangement and the lessee pays the duty directly to the supplier, obviously the same need not be recorded in the books of the lessor.

In the books of the lessee, MODVAT/CENVAT credit receivable on the capital assets acquired on lease should be treated in the same manner as recommended in paras 24 and 26 above, except that the cost of the relevant leased capital asset and depreciation is not accounted in the books of the lessee.

29. Capital asset acquired on hire purchase should be recorded and disclosed³ at net cash value, i.e., cash value net of MODVAT/CENVAT credit receivable in the books of the hirer. The other accounting treatment in relation to MODVAT/CENVAT in the books of the hirer should be the same as if the asset has been acquired on outright purchase basis. The aforesaid accounting treatment, in the books of the hirer, should be made whether or not the specified duty on the capital goods forms part of the financing arrangement. In the books of the vendor, in case the specified duty on capital goods forms part of the hire purchase arrangement and the benefit of MODVAT/CENVAT credit is available to the hirer, the vendor should book the sale in the normal course inclusive of the specified duty on the capital goods. However, where the specified duty on the capital goods does not form part of the financing arrangement and the hirer directly assumes the liability in respect thereof, the same need not be recorded in the books of the vendor.

Review of Balances in MODVAT/CENVAT Credit Receivable Accounts

30. Balances in MODVAT/CENVAT Credit Receivable Accounts, pertaining to both inputs and capital goods, should be reviewed at the end of the year and if it is found that the balances of the MODVAT/CENVAT credit are not likely to be used in the normal course of business within a reasonable time, then, notwithstanding the right to carry forward such excess credit in the Excise Rules, the non-useable excess credit should be adjusted in the accounts. The

³ Disclosure should be “with an appropriate narration to indicate that the enterprise does not have full ownership thereof” [Accounting Standard (AS) 10, ‘Accounting for Fixed Assets’].

Accounting Treatment for MODVAT/CENVAT

consequence would be that the balances of the MODVAT/CENVAT Credit Receivable Accounts in the financial accounts may be lower than the credit available as per the MODVAT/CENVAT Credit registers. In such a case, a reconciliation statement would have to be prepared indicating the amounts adjusted so that a track is kept for the difference between the balances and the difference between the financial accounts and the credit available as per the excise registers can be explained in subsequent years also.

31. (a) The above adjustment related to input credit should be made to the raw material or input purchase account. The effect of this would be to increase the cost of purchase and thereby to increase the cost of inputs for the purpose of accounting for consumption and valuation of closing stocks. Where it is not possible to debit or identify this excess credit to a particular lot or lots of materials purchased, such excess credit may be apportioned over the entire purchases of raw materials, components etc., entitled to MODVAT/CENVAT credit during the year on pro-rata basis.

(b) The adjustment of excess credit related to capital goods should be made to the concerned Capital Goods Account. The excess MODVAT/CENVAT credit, either availed or deferred, which relates to fixed assets acquired, should be added to the cost of the relevant fixed asset. For accounting purposes, depreciation on the revised unamortised depreciable amount should be provided prospectively over the residual useful life of the asset. In case the fixed asset no longer exists, the relevant amount should be written-off in the profit and loss account. To facilitate aforesaid treatment, MODVAT/CENVAT credit record should be maintained fixed asset-wise in the relevant RG Register. In relation to capital goods other than fixed assets, the accounting treatment for the excess MODVAT/CENVAT credit would be the same as stated in para 31(a) above. It is, therefore, advisable that MODVAT/CENVAT Credit Receivable (Capital Goods) Account is maintained separately for fixed assets and other capital goods.

(c) For capital goods acquired on lease, the amount of excess MODVAT/CENVAT credit should be written-off on a pro-rata basis along with the lease rentals.

32. Where, at any time during the year, it is revealed that the terms and conditions subject to which the benefit of MODVAT/CENVAT credit is available, have not been complied with or are not being capable of compliance, e.g., where the inputs are destroyed prior to the manufacture of final product or the relevant

plant and machinery cannot be put to use for the manufacture of final product, appropriate adjustments should be made in the accounts to reverse such credit which cannot be availed of, as recommended in para 31 (a) for inputs and 31 (b) and (c) for capital goods.

Accounting Treatment for Duty Demands paid by Debit to MODVAT/CENVAT Credit Balance – Inputs and/or Capital Goods

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

Valuation of Inventories of Inputs

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

35. In some cases 'inputs' may be exempted from excise duty in the hands of the supplier, e.g., job charges are exempt from excise duty provided the prescribed procedures are observed. Small-scale suppliers who are in the

Accounting Treatment for MODVAT/CENVAT

exempted category may also supply the inputs free from the levy of excise duty. In such circumstances normal valuation rules in determining the cost of inventories are to be applied as these are not subject to the specified duty on inputs relief. Where purchases are made from the dealers who are not eligible under the Central Excise Rules to pass MODVAT/CENVAT credit and, therefore, cannot issue an invoice in accordance with the aforesaid Rules, the valuation should be made at the actual cost inclusive of excise duty.

36. In some cases, the same item of input can be obtained from different sources, some of them may be able to provide the required documents evidencing payment of duty while others may not be able to provide the required documents. In such cases where it is not possible for the buyer to take advantage of the MODVAT/CENVAT credit, the closing stock of inputs of such items should be valued inclusive of the specified duty on inputs.

37. If any input is used for the production of more than one final product, some of which are excisable while others are either not chargeable to excise duty or chargeable at nil rate of duty, and separate inventory of the input is not maintained, the entire inventory of inputs should be valued at net of input duty. However, if separate inventory is being maintained, the inventory of inputs useable for final products chargeable to excise duty should be valued at net of input duty and the inventory of inputs useable for final products not chargeable to duty should be valued at the actual cost inclusive of excise duty.

38. While valuing inventories of final products⁴, the value of inputs should be net of the duty on inputs, that is, the purchase cost as reduced by the MODVAT/CENVAT credit.

Valuation of Inventory of Capital Goods

39. Inventories of capital goods should be valued net of MODVAT/CENVAT credit taken on capital goods. In other words, specified duties paid on such capital goods will not form part of their cost.

⁴ For accounting treatment of excise duty with regard to valuation of inventories, reference may be made to the Guidance Note on Accounting Treatment for Excise Duty, issued by the Institute of Chartered Accountants of India (Published in 'The Chartered Accountant', July 2000).

ANNEXURE A

Illustration of Accounting for MODVAT/CENVAT Credit on Inputs

The illustration is based on the following assumptions:

- (i) There is an opening stock of 10 units purchased at Rs. 10/- per unit (Excise duty paid on these units was @ Rs. 2/- per unit).
- (ii) 100 units of raw materials are purchased at Rs. 10/- per unit, plus Rs. 2/- for excise duty, aggregating to Rs. 12/-.
- (iii) 70 units of raw material are consumed in a process involving manufacture of a component. All the 70 units are sold in the year. The balance 40 units are manufactured and sold in the subsequent year.
- (iv) The manufactured components are sold at a price of Rs. 15/- per unit (including excise duty Rs.3/- per unit).
- (v) MODVAT/CENVAT credit is available on the raw material purchased and can be set-off against the excise duty payable on the final product.
- (vi) Conversion costs are ignored.

The accounting treatment as per paragraph 16 is illustrated on the next page

Accounting Treatment for MODVAT/CENVAT

Profit & Loss Account

<i>Particulars</i>	<i>Units</i>	<i>Rate</i>	<i>Amount</i>	<i>Particulars</i>	<i>Units</i>	<i>Rate</i>	<i>Amount</i>
To Opening Stock of Raw Materials	10	10	100	By Sales	70	15	1,050
To Purchases of Raw Materials	<u>100</u>	<u>10</u>	<u>1,000</u>				
	110	10	1,100				
Less: Stock of Raw Materials	<u>40</u>	<u>10</u>	<u>400</u>				
			700				
To Excise Duty	70	3	210				
To Gross Profit			140				
			1,050				1,050

Note

1. Opening balance of the MODVAT/CENVAT Credit Receivable Account is Rs. 20/-.

2. Besides showing stock of raw materials at Rs. 400/-, the Balance Sheet would also reflect, 'MODVAT/CENVAT Credit Receivable Account' at Rs. 10/-, arising out of the following entries:

(a) Purchase A/c	Dr.	1,000	
MODVAT/CENVAT Credit Receivable A/c	Dr.	200	
To Sundry Creditors			1,200

(Being the purchase of 100 units at Rs. 10/- plus Rs. 2/- for excise duty in respect of which the company is eligible to claim MODVAT/CENVAT credit)

(b) Excise Duty A/c	Dr.	210	
To MODVAT/CENVAT Credit Receivable A/c			210

(Being the payment of excise duty out of MODVAT/CENVAT credit available to the company)

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Balance Sheet			
Liabilities	Amount	Assets	Amount
		Current Assets, Loans and Advances	
		(A) <i>Current Assets</i>	
		Inventory of raw materials	400
		(B) <i>Loans and Advances</i>	
		MODVAT/CENVAT Credit	
		Receivable A/c	10

The opening balances of inventories of raw materials and MODVAT/CENVAT Receivable Account, for the next year, would be Rs. 400/- and Rs. 10/-, respectively.

ANNEXURE 'B'**Illustration of Change in Accounting Policy**

(See paragraph 19 of the Guidance Note)

Continuing the illustration given in Annexure 'A' and supposing that an enterprise followed the erstwhile inclusive method for accounting for MODVAT credit, the accounting treatment as per this method would be as follows:

Profit & Loss Account							
<i>Particulars</i>	<i>Units</i>	<i>Rate</i>	<i>Amount</i>	<i>Particulars</i>	<i>Units</i>	<i>Rate</i>	<i>Amount</i>
To Opening Stock of Raw Materials	10	12	120	By Sales	70	15	1,050
To Purchases of Raw Materials	<u>100</u>	<u>12</u>	<u>1,200</u>				
	110	12	1,320				
Less: Stock of Raw Materials	<u>40</u>	<u>12</u>	<u>480</u>				
Raw Material consumed	70	12	840				
Less: MODVAT Credit	<u>70</u>	<u>2</u>	<u>140</u>				
	70	10	700				
To Excise Duty	70	3	210				
To Gross Profit			140				
			1,050				1,050

Note:

- (1) Opening Balance of MODVAT Credit Availed A/C was Nil.
- (2) Besides showing stock of raw material at Rs.480, the balance of 'MODVAT Credit Availed Account' would be Rs.70, arising out of the following entries:

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(a) At the time when credit is availed of and adjusted against the excise duty which becomes payable:

Excise Duty A/c	Dr.	Rs. 210	
To MODVAT Credit Availed A/c			Rs. 210

(Being the payment of excise duty from the MODVAT Credit available to the company)

(b) At the year end, to the extent raw material items have been consumed in the production:

MODVAT Credit Availed A/c	Dr.	Rs. 140	
To Material Consumed			Rs. 140

(Being the set off the MODVAT credit availed against materials consumed)

Balance Sheet			
Liabilities	Amount	Assets	Amount
		Current Assets, Loans and Advances	
		<i>(A) Current Assets</i>	
		Inventory of Raw Material	480
		Less: MODVAT Credit Availed A/c	<u>70</u> 410

In the above example, the RG 23A register would show a balance of Rs.10 representing the MODVAT credit receivable in respect of inputs purchased.

Now the enterprise changes the accounting policy to that recommended in paragraph 16 the Guidance Note. In that case, the following journal entries will be passed (See paragraph 19):

I. MODVAT Credit Availed A/c	Dr.	Rs. 70	
To Opening Stock			Rs. 70

(Being the opening stock adjusted by the balance of MODVAT Credit Availed Account).

Accounting Treatment for MODVAT/CENVAT

II. MODVAT Credit Receivable A/c	Dr.	Rs. 10	
To Opening Stock			Rs. 10

(Being an amount equal to the balance of RG 23A register, representing the MODVAT credit receivable in respect of inputs purchased transferred to MODVAT Credit Receivable Account)

As a result of above entries, the figures of opening stock and MODVAT Credit Receivable A/c would appear at Rs. 400 (i.e. Rs.480-70-10) and Rs.10 respectively. It may be noted that these figures are the same had the method suggested in paragraph 16 of the Guidance Note been followed.

(See note to the balance sheet in the illustration given in Annexure A of the Guidance Note).

GN(A) 26 (Issued 2008)

Guidance Note on Applicability of Accounting Standard (AS) 20, Earnings Per Share¹

(The following is the text of the 'Guidance Note on the Applicability of Accounting Standard (AS) 20, Earnings Per Share', issued by the Council of the Institute of Chartered Accountants of India. Pursuant to the issuance of this Guidance Note, Accounting Standards Interpretation (ASI) 12 – 'Applicability of AS 20 (Re. AS 20)', stands withdrawn.)

Introduction

1. This Guidance Note deals with the issue whether companies which are required to give information under Part IV of Schedule VI to the Companies Act, 1956, should calculate and disclose earnings per share in accordance with Accounting Standard (AS) 20, *Earnings Per Share*.
2. AS 20 came into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory in nature, from that date, in respect of enterprises whose equity shares or potential equity shares are listed on a recognised stock exchange in India. AS 20 does not mandate an enterprise, which has neither equity shares nor potential equity shares which are so listed, to calculate and disclose earnings per share, but, if that enterprise discloses earnings per share for complying with the requirements of any

¹ This Guidance Note was earlier issued as Accounting Standards Interpretation (ASI) 12, 'Applicability of AS 20 (Re. AS 20)' by the Institute of Chartered Accountants of India (ICAI). While the Accounting Standards notified by the Central Government under the Companies (Accounting Standards) Rules, 2006, have incorporated the 'Consensus' part of various ASIs issued by the ICAI, ASI 12 has not been so incorporated as it was felt that it is primarily clarificatory in nature. The Council of the ICAI, has accordingly, decided to withdraw ASI 12, and issue the same as a Guidance Note as it provides appropriate guidance on the subject.

Applicability of Accounting Standard (AS) 20, Earnings Per Share

statute or otherwise, it should calculate and disclose earnings per share in accordance with AS 20.

Recommendation

3. Since Part IV of Schedule VI to the Companies Act, 1956, requires, among other things, disclosure of earnings per share, every company which provides information under Part IV of Schedule VI to the Companies Act, 1956, should calculate and disclose earnings per share in accordance with AS 20, whether or not its equity shares or potential equity shares are listed on a recognised stock exchange in India.

GN(A) 27 (Issued 2008)

Guidance Note on Remuneration Paid to Key Management Personnel – Whether a Related Party Transaction¹

(The following is the text of the 'Guidance Note on Remuneration paid to key management personnel – whether a related party transaction' issued by the Council of the Institute of Chartered Accountants of India. Pursuant to the issuance of this Guidance Note, Accounting Standards Interpretation (ASI) 23, 'Remuneration paid to key management personnel – whether a related party transaction (Re. AS 18)', stands withdrawn.)

Introduction

1. This Guidance Note deals with the issue whether remuneration paid to key management personnel is a related party transaction. Another related issue dealt by this Guidance Note is whether remuneration paid to non-executive directors on the Board of Directors is a related party transaction.

2. Accounting Standard (AS) 18, *Related Party Disclosures*, defines "related party transaction" as **"a transfer of resources or obligations between related parties, regardless of whether or not a price is charged."** Further, paragraph 24 of AS 18 provides as under:

"The following are examples of the related party transactions in respect of which disclosures may be made by a reporting enterprise:

¹ This Guidance Note was earlier issued as Accounting Standards Interpretation (ASI) 23, 'Remuneration paid to key management personnel - whether a related party transaction (Re. AS 18)' by the Institute of Chartered Accountants of India (ICAI). While the Accounting Standards notified by the Central Government under the Companies (Accounting Standards) Rules, 2006, have incorporated the 'Consensus' part of various ASIs issued by the ICAI, ASI 23 has not been so incorporated as it was felt that it is primarily clarificatory in nature. The Council of the ICAI, has accordingly, decided to withdraw ASI 23, and issue the same as a Guidance Note as it provides appropriate guidance on the subject.

Remuneration paid to Key Management Personnel-Whether A Related...

- purchases or sales of goods (finished or unfinished);
- purchases or sales of fixed assets;
- rendering or receiving of services;
- agency arrangements;
- leasing or hire purchase arrangements;
- transfer of research and development;
- licence agreements;
- finance (including loans and equity contributions in cash or in kind); guarantees and collaterals; and
- management contracts including for deputation of employees.”

3. As per the definition of the expression ‘related party transaction’, the transaction should be between related parties to qualify as a related party transaction. Since key management personnel are related parties under AS 18, remuneration paid to key management personnel is a related party transaction requiring disclosures under AS 18. Further, in case non-executive directors on the Board of Directors are not related parties, remuneration paid to them is not considered a related party transaction.

Recommendation

4. Remuneration paid to key management personnel should be considered as a related party transaction requiring disclosures under AS 18. In case non-executive directors on the Board of Directors are not related parties, remuneration paid to them should not be considered a related party transaction.

GN(A) 28 (Issued 2008)

Guidance Note on Applicability of AS 25 to Interim Financial Results¹

(The following is the text of the 'Guidance Note on Applicability of AS 25 to Interim Financial Results', issued by the Council of the Institute of Chartered Accountants of India. Pursuant to the issuance of this Guidance Note, Accounting Standards Interpretation (ASI) 27 - 'Applicability of AS 25 to Interim Financial Results (Re. AS 25)', stands withdrawn.)

Introduction

1. This Guidance Note deals with the issue whether Accounting Standard (AS) 25, *Interim Financial Reporting*, is applicable to interim financial results presented by an enterprise pursuant to the requirements of a statute/regulator, for example, quarterly financial results presented under Clause 41 of the Listing Agreement entered into between Stock Exchanges and the listed enterprises.
2. Accounting Standard (AS) 25, *Interim Financial Reporting*, issued by the Council of the Institute of Chartered Accountants of India, came into effect in respect of accounting periods commencing on or after 1-4-2002. If any enterprise is required or elects to prepare and present an interim financial report, it should comply with this Standard (applicability paragraph).
3. AS 25 further provides as follows:

¹ This Guidance Note was earlier issued as Accounting Standards Interpretation (ASI) 27, 'Applicability of AS 25 to Interim Financial Results (Re. AS 25)' by the Institute of Chartered Accountants of India (ICAI). While the Accounting Standards notified by the Central Government under the Companies (Accounting Standards) Rules, 2006, have incorporated the 'Consensus' part of various ASIs issued by ICAI, ASI 27 has not been so incorporated as it was felt that it was not relevant to the requirements of the Companies Act, 1956. The Council of the ICAI, accordingly, has decided to withdraw ASI 27 and issue the same as a Guidance Note as it provides appropriate guidance on the subject.

Applicability of AS 25 to Interim Financial Results

“1. This Statement does not mandate which enterprises should be required to present interim financial reports, how frequently, or how soon after the end of an interim period. If an enterprise is required or elects to prepare and present an interim financial report, it should comply with this Statement.

2. A statute governing an enterprise or a regulator may require an enterprise to prepare and present certain information at an interim date which may be different in form and/or content as required by this Statement. In such a case, the recognition and measurement principles as laid down in this Statement are applied in respect of such information, unless otherwise specified in the statute or by the regulator.”

“4. The following terms are used in this Statement with the meanings specified:

.....

Interim financial report means a financial report containing either a complete set of financial statements or a set of condensed financial statements (as described in this Statement) for an interim period.”

Recommendation

4. The presentation and disclosure requirements contained in AS 25 should be applied only if an enterprise prepares and presents an ‘interim financial report’ as defined in AS 25. Accordingly, presentation and disclosure requirements contained in AS 25 are not required to be applied in respect of interim financial results (which do not meet the definition of ‘interim financial report’ as per AS 25) presented by an enterprise. For example, quarterly financial results presented under Clause 41 of the Listing Agreement entered into between Stock Exchanges and the listed enterprises do not meet the definition of ‘interim financial report’ as per AS 25. However, the recognition and measurement principles laid down in AS 25 should be applied for recognition and measurement of items contained in such interim financial results.

GN(A) 29 (Issued 2008)

Guidance Note on Turnover in case of Contractors¹

(The following is the text of the 'Guidance Note on Turnover in case of Contractors', issued by the Council of the Institute of Chartered Accountants of India. Pursuant to the issuance of this Guidance Note, Accounting Standards Interpretation (ASI) 29 – 'Turnover in case of Contractors (Re. AS 7)', stands withdrawn.)

Introduction

1. This Guidance Note deals with the issue whether the revenue recognised in the financial statements of contractors as per the requirements of Accounting Standard (AS) 7, *Construction Contracts* (revised 2002), can be considered as 'turnover'.
2. AS 7 (revised 2002) deals, *inter alia*, with revenue recognition in respect of construction contracts in the financial statements of contractors. It requires recognition of revenue by reference to the stage of completion of a contract (referred to as 'percentage of completion method'). This method results in reporting of revenue which can be attributed to the proportion of work completed. Under this method, contract revenue is recognised as revenue in the statement of profit and loss in the accounting period in which the work is performed.

¹ This Guidance Note was earlier issued as Accounting Standards Interpretation (ASI) 29, 'Turnover in case of Contractors (Re. AS 7)' by the Institute of Chartered Accountants of India (ICAI). While the Accounting Standards notified by the Central Government under the Companies (Accounting Standards) Rules, 2006, have incorporated the 'Consensus' part of various ASIs issued by the ICAI, ASI 29 has not been so incorporated as it was felt that it is primarily clarificatory in nature. The Council of the ICAI, has accordingly, decided to withdraw ASI 29, and issue the same as a Guidance Note as it provides appropriate guidance on the subject.

3. The paragraph dealing with the 'Objective' of AS 7 (revised 2002) provides as follows:

"Objective

The objective of this Statement is to prescribe the accounting treatment of revenue and costs associated with construction contracts. Because of the nature of the activity undertaken in construction contracts, the date at which the contract activity is entered into and the date when the activity is completed usually fall into different accounting periods. Therefore, the primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which construction work is performed. This Statement uses the recognition criteria established in the Framework for the Preparation and Presentation of Financial Statements to determine when contract revenue and contract costs should be recognised as revenue and expenses in the statement of profit and loss. It also provides practical guidance on the application of these criteria."

From the above, it may be noted that AS 7 (revised 2002) deals, *inter alia*, with the allocation of contract revenue to the accounting periods in which construction work is performed.

4. Further, paragraphs 21 and 31 of AS 7 (revised 2002) provide as follows:

"21. When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date. An expected loss on the construction contract should be recognised as an expense immediately in accordance with paragraph 35."

"31. When the outcome of a construction contract cannot be estimated reliably:

- (a) revenue should be recognised only to the extent of contract costs incurred of which recovery is probable; and***

(b) contract costs should be recognised as an expense in the period in which they are incurred.

An expected loss on the construction contract should be recognised as an expense immediately in accordance with paragraph 35.”

From the above, it may be noted that the recognition of revenue as per AS 7 (revised 2002) may be inclusive of profit (as per paragraph 21 reproduced above) or exclusive of profit (as per paragraph 31 reproduced above) depending on whether the outcome of the construction contract can be estimated reliably or not. When the outcome of the construction contract can be estimated reliably, the revenue is recognised inclusive of profit and when the same cannot be estimated reliably, it is recognised exclusive of profit. However, in either case it is considered as revenue as per AS 7 (revised 2002).

5. ‘Revenue’ is a wider term. For example, within the meaning of Accounting Standard (AS) 9, *Revenue Recognition*, the term ‘revenue’ includes revenue from sales transactions, rendering of services and from the use by others of enterprise resources yielding interest, royalties and dividends. The term ‘turnover’ is used in relation to the source of revenue that arises from the principal revenue generating activity of an enterprise. In case of a contractor, the construction activity is its principal revenue generating activity. Hence, the revenue recognised in the statement of profit and loss of a contractor in accordance with the principles laid down in AS 7 (revised 2002), by whatever nomenclature described in the financial statements, is considered as ‘turnover’.

Recommendation

6. The amount of contract revenue recognised as revenue in the statement of profit and loss as per the requirements of AS 7 (revised 2002), should be considered as ‘turnover’.

GN(A) 30 (Issued 2012)

Guidance Note on Accounting for Rate Regulated Activities

Foreword

In India, some of the large public sector and private sector entities are involved in businesses which are regulated in one form or the other by a statute in India. The object of regulation is typically to promote the orderly growth and development of the regulated industry, protect the interest of consumers, regulate competition and monitor social and environmental issues within the industry. Generally, price or rate regulation is provided in the industries in which the general public is interested like electricity, telecommunication etc.

The rate regulation, as presently prevailing in India in respect of industries such as electricity, does result in creation of a right (asset) or an obligation (liability), as the case may be, as envisaged by the accounting framework, while it may not be so in respect of other industries. So, not accounting for the right to receive cash flows or the obligation to refund cash flows under such a regulatory requirement would not reflect a true and fair view of assets/liabilities and income/expenses as reflected in the financial statements. To provide guidance in this regard and to address the industry- specific accounting issues relating to rate regulated activities, a need was being felt for bringing out a pronouncement with a view to bring about establishment of sound accounting principles. It is heartening to note that the Accounting Standards Board of the Institute has formulated this 'Guidance Note on Accounting for Rate Regulated Activities'.

I would like to congratulate CA. Manoj Fadnis, Chairman, Accounting Standards Board and members of the Accounting Standards Board and others who have made invaluable contribution in the formulation of this Guidance Note.

I hope that this endeavour of the Accounting Standards Board will go a long way in establishing sound accounting principles and provide guidance to the members as well as to others concerned.

New Delhi
February 12, 2012

CA. G. Ramaswamy
President

Preface

In India, regulators in certain sectors such as electricity allow the entities falling in their domain to charge rates from their customers that are based on allowable costs like interest cost, depreciation, operating and maintenance including a reasonable mark-up.

From rate regulation, an issue arises as to whether an entity should recognise in its financial statements the right to recover incurred costs or the obligation to refund amounts received for which costs have not been incurred through future tariff adjustments. Recognition of the right to recover incurred costs in the future or the obligation to refund amounts received in the financial statements of the entity would arise if they meet the definition of assets and liabilities as provided in the *Framework for the Preparation and Presentation of Financial Statements* issued by the Institute of Chartered Accountants of India.

Keeping in view this, the Accounting Standards Board has formulated this '*Guidance Note on Rate Regulated Activities*' which deals with the effects on an entity's financial statements of its operating activities that provide goods or services whose prices are subject to cost-of-service regulation. This Guidance Note provides guidance on the measurement basis of a regulatory asset or a regulatory liability and the disclosures that identify and explain the amounts recognised in the financial statements arising from a regulatory asset or a regulatory liability. The Guidance Note will assist users of those financial statements to understand the nature and financial effects of its rate- regulated activities.

I would like to convey my sincere thanks to our Honourable President CA. G. Ramaswamy and Vice-President CA. Jaydeep N. Shah in providing unflinching support on various activities of the Board. I would like to convey my sincere thanks to CA.S. Santhanakrisnan, Vice- Chairman, ASB for his constant support and co-operation.

I would also like to acknowledge the invaluable contribution made by Shri Naveen N. D Gupta, Convener of the Study Group , Shri. Ravindra Vadali, Shri K. Sreekant, Shri Amal Sinha, Shri Udit Sinha and other experts in this endeavour of the Accounting Standards Board. I am also thankful to various representatives of industry for giving their invaluable comments and suggestions on the draft Guidance Note.

Accounting for Rate Regulated Activities

I sincerely compliment Dr. Avinash Chander, Technical Director and CA. Geetanshu Bansal, Senior Executive Officer, of the Institute of Chartered Accountants of India in finalising the draft of the Guidance Note.

I sincerely believe that this Guidance Note will go a long way in establishing sound accounting and reporting principles in the rate regulated entities.

New Delhi
February 11, 2012

CA. Manoj Fadnis
Chairman
Accounting Standards Board

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Guidance Note on Accounting for Rate Regulated Activities

(The National Advisory Committee on Accounting Standards (NACAS) constituted under the Companies Act, 1956, by the Ministry of Corporate Affairs, while considering Indian Accounting Standards converged with IFRS, suggested that the Institute of Chartered Accountants of India (ICAI) may issue a Guidance Note to address accounting issues for rate regulated entities. Since, accounting for rate regulated activities would be relevant in the context of the existing notified Accounting Standards also, the following text of the Guidance Note has been formulated by the Council of ICAI in that context. The Guidance Note will be considered by the NACAS as it may require modification in the relevant Accounting Standards where and to extent the accounting treatment of such activities is affected by this Guidance Note. Accordingly, the Guidance note will be effective from a date to be announced later.)

Introduction

Background

1. Regulation of different economic activities through bodies established under statute or otherwise can be found in many countries. The object of regulation is typically to promote the orderly growth and development of the regulated industry, protect the interests of consumers, regulate competition, monitor social and environmental issues within the industry etc. Regulation of utilities like telecommunication, electricity and water often aims to control prices, ensure service quality, protect the environment and establish an investment environment capable of attracting capital at reasonable cost. In India we have different bodies such as the Reserve Bank of India, Securities and Exchange Board of India, Insurance Regulatory and Development Authority, Central Electricity Regulatory Commission, State Electricity Regulatory Commissions, Directorate General of Hydrocarbons (DGH), Telecom Regulatory Authority of India etc. for regulating different sectors.

2. Regulation can take many forms depending upon the industry and objectives to be achieved. Rate regulation is one of the main forms of regulation often found in the utility sector or in sectors dealing with 'public goods' or other important goods and services. For example, in India, electricity prices are regulated by the CERC/SERCs, fertilizer prices and highway tolls are regulated by the Government.

Framework for rate regulation

3. A key aspect of rate regulation is that the regulator is empowered to determine prices that bind the entity's customers under a statute or otherwise. Regulatory authorities are usually set up under a legislation which stipulates their constitution, functions, powers etc. While such legislation may provide the general guidelines and considerations for determination of tariffs, the regulatory authority decides the particular methodology to be adopted for tariff setting which is notified through regulations or rules. The regulator from time to time issues orders for tariff setting in individual cases which provide further guidance on the implementation of the notified regulations and rules. The legislation, regulations, rules and tariff orders provide the entity with the framework for charging the customers for the regulated goods and services.

4. Entities subject to price regulation are not allowed to charge prices for regulated goods or services other than those approved by the regulatory authority. In those circumstances, the regulator acts on behalf of the customers who individually would have no bargaining power with the entity. The regulator also acts on behalf of the entity. Agreements between a rate-regulated entity and its customers cannot be understood without reference to the regulation in place. Therefore, it can be said that such agreements are different from the agreements between an entity and its customers in a non-regulated environment.

Methods and process of rate regulation

5. There are several basic methods for rate regulation and in each case, the application of a particular methodology may vary with the regulator, the entity being regulated and the circumstances faced. Some of the forms of rate regulation are cost of service regulation, price-cap mechanisms or a hybrid methodology featuring combinations of price cap and cost-of-service approaches.

6. Under the cost-of-service regulation (also referred to as return-on-rate-

base regulation) rates are set to give the entity the opportunity to recover its costs of providing the good or service plus a fair return. Under price cap regulation, the regulator caps the rates at which the entity can charge for the goods or services. In such cases, while the initial rates may reflect the cost of service, subsequent increases or decreases may be made in accordance with a formula.

7. The regulators may adopt several approaches for cost-of-service regulation. The regulator may stipulate the various costs which can be covered under the tariff, the admissible rate of return and the mechanism for recovery of the tariffs. Alternatively, the regulator establishes the revenues required to cover the expected cost of providing the regulated service, including a fair return on the investment in the regulated operations. This amount is called the “revenue requirement.” The regulator then sets rates that will provide the entity with a reasonable opportunity to recover its revenue requirement.

8. Not all costs that an entity incurs are automatically recoverable from its customers. Regulators typically review entities’ costs to ensure that they were appropriately incurred to provide the regulated service and were ‘prudent’. When a regulator decides that a cost was not prudently incurred, it may disallow all or part of the cost, thereby reducing (or eliminating) any future recovery of that cost. Consequently, a cost must be permitted by the regulator to be included in the determination of rates. In cost-of-service regulation, such costs are the actual or estimated costs for which revenue is intended to provide recovery and include costs of debt and a reasonable return on shareholders’ investments.

9. Cost-of-service rate-making does not necessarily equals a one-for-one pass-through of all costs. Regulations enable for rate fixation which provides that the entity will recover its costs using reasonable assumptions regarding demand as well as normal expenditures. The regulator to promote efficiencies may stipulate performance norms for recovery of some costs or may provide recovery of some elements of cost as per norms while other elements are recovered at actuals. For example, tariff regulations issued by many of the SERCs in the electricity sector in India classify costs into ‘controllable’ and ‘uncontrollable’ costs and provide for adjustment of tariffs for the ‘uncontrollable costs’ during ‘truing up’ process while variations in the ‘controllable costs’ are to be borne by the entity. In some cases, the regulators also prescribe a formula for sharing efficiency gains between the entity and the customers, such as the gains on account of reduction in distribution losses etc.

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10. The regulatory mechanism provides for a rate review or 'truing up' exercise at periodic intervals to adjust the rates, downward or upward, to ensure recovery of costs and a reasonable return on investment. For 'truing up' of the initially determined rates, the entity provides the regulator with details of actual costs, capital expenditure etc., based on audited accounts and other supporting evidence. The regulator reviews the details of actual costs provided by the entity and may also provide opportunity to other stakeholders to submit their comments on the entity's application for rate review. Upon such review, the regulator determines the additional costs which can be recovered by the entity or amounts which need to be refunded to the customers.

11. Following the truing up exercise, the regulator usually adjusts the rates to be charged from customers so as to ensure recovery of additional costs or refund of amounts, as the case may be. The regulators may also decide not to immediately adjust the rates due to various considerations, for example, to avoid rate fluctuations or to smooth out an increase in rates, and require the regulated entity to defer the recovery or refund of the difference between the expected and actual amount of those costs. This results in a portion of the costs (or cost savings) of one period being included or adjusted in the revenue of another period.

Objectives

12. This Guidance Note deals with the effects on an entity's financial statements of its operating activities that provide goods or services whose prices are subject to cost-of-service regulation.

13. The objectives of this Guidance Note are to recommend:

- (i) the recognition of a regulatory asset or regulatory liability if the regulator permits the entity to recover specific previously incurred costs or requires it to refund previously collected amounts and to earn a specified return on its regulated activities by adjusting the prices it charges to its customers;
- (ii) the measurement basis of a regulatory asset or regulatory liability both on initial recognition and at the end of each subsequent reporting period; and
- (iii) the disclosures that identify and explain the amounts recognised in the entity's financial statements arising from a regulatory asset or regulatory liability

and assist users of those financial statements to understand the nature and financial effects of its rate-regulated activities.

Scope

14. An entity should apply this 'Guidance Note' to its operating activities that meet the following criteria:

- i. the regulator establishes the price the entity must charge its customers for the goods or services the entity provides, and that price binds the customers; and
- ii. the price established by regulation (the 'rate') is designed to recover the specific costs the entity incurs in providing the regulated goods or services and to earn a specified return. The specified return could be a minimum or range and need not be a fixed or guaranteed return.

15. If regulation establishes different rates for different categories, such as different classes of customers or volumes purchased, the related operating activities of an entity are within the scope of this 'Guidance Note' provided that the regulator approves the definition and the rate for each of those categories and that all customers of the same category are bound by the same rate.

16. Activities of an entity which are subject to other forms of regulation are not covered by this Guidance Note. For example, the telecom sector in India, though regulated by the Telecom Regulatory Authority of India (TRAI), is not subject to price regulation which provides for recovery of entity specific costs plus a specified return. Similarly, some regulations determine rates based on targeted or assumed costs, for example industry averages, rather than the actual costs incurred or expected to be incurred by the entity. Activities regulated in this way are not within the scope of this Guidance Note.

17. Where the prices an entity charges its customers for the goods or services it provides are regulated according to a 'price cap', the entity cannot charge more than the set prices. Under such regulation the buyer is assured of the result while the supplier takes the risk and receives the rewards from additional effort or from the implementation of cost-reducing innovations. Though the prices are regulated and bind customers, this Guidance Note does not cover such

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activities because prices are not designed to recover the entity's specific costs to provide the goods or services.

18. Regulators may require a regulated entity to maintain its accounts in a form that permits the regulator to obtain the information needed for regulatory purposes. This Guidance Note does not address an entity's accounting for reporting to regulators (regulatory accounting).

19. Rate regulation may be applied to all or only a portion of an entity's activities. In some cases, an entity may have both regulated and non-regulated activities. In others, the entity may be permitted to negotiate rates individually with some customers. This Guidance Note applies only to the activities of an entity that meet the criteria set out in paragraph 14.

20. The entity should determine at the end of each reporting period whether its operating activities during the reporting period meet the criteria in paragraph 14 for application of this Guidance Note.

Definitions

21. The following terms are used in this Guidance Note with the meanings specified:

- i. A **regulator** is an authorised body empowered by statute or by any government or any authorised agency of a government to set rates that binds an entity's customers.
- ii. **Cost of Service** regulation is a form of regulation for setting an entity's prices (rates) in which there is a cause-and-effect relationship between the entity's specific costs and its revenues.
- iii. A **regulatory asset** is an entity's right to recover fixed or determinable amounts of money towards incurred costs as a result of the actual or expected actions of its regulator under the applicable regulatory framework.
- iv. A **regulatory liability** is an entity's obligation to refund or adjust fixed or determinable amounts of money as a result of actual or

expected action of its regulator under the applicable regulatory framework.

Accounting Issues arising from Rate Regulation

22. Rate regulation of an entity's business activities creates operational and accounting situations that would not have arisen in the absence of such regulation. With cost-of-service regulation, there is a direct link between the costs that an entity is expected to incur and its expected revenue as the rates are set to allow the entity to recover its expected costs. However, there could be a significant time lag between incurrence of costs by the entity and their recovery through tariffs. Recovery of certain costs may be provided for by regulation either before or after the costs are incurred. Rate regulations are enforceable and can create legal rights and obligations for the entity.

23. An issue therefore arises as to whether an entity should recognise in its financial statements the right to recover incurred costs or the obligation to refund amounts received for which costs have not been incurred through future tariff adjustments. Recognition of the right to recover incurred costs in the future or the obligation to refund amounts received in the financial statements of the entity would arise if they meet the definition of assets and liabilities as provided in the *Framework for the Preparation and Presentation of Financial Statements* issued by the Institute of Chartered Accountants of India.

Regulatory assets

24. The Framework, defines an 'asset' as follows:

"An *asset* is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise."

In a cost-of-service regulation, the resource is the right conferred by the regulator whereby the costs incurred by the entity result in future cash flows. In such cases, incurrence of costs creates an enforceable right to set rates at a level that permits the entity to recover those costs, plus a specified return, from an aggregate customer base. For example, if the regulator has approved certain additions to be made by the entity in its assets base during the tariff period, which would be added to the asset base for tariff setting, the entity upon making such additions obtains the

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right to recover the costs and return as provided in the regulatory framework though the actual recovery through rates may take place in the future. While adjustment of future rates is the mechanism the regulator uses to implement its regulation, the right in itself is a resource arising as a result of past events and from which future cash inflows are expected.

25. The cause-and-effect relationship between an entity's costs and its rate-based revenue demonstrates that an asset exists. In this case, the entity's right that arises as a result of regulation relates to identifiable future cash flows linked to costs it previously incurred, rather than a general expectation of future cash flows based on the existence of predictable demand. The binding regulations/orders of the regulator for recovery of incurred costs together with the actual incurrence of costs by the entity would satisfy the definition of asset as per the Framework since the entity's right (to recover amounts through future rate adjustments) constitutes a resource arising as a result of past events (incurrence of costs permitted by the regulator for recovery from customers) from which future economic benefits are expected to flow (increased cash flows through rate adjustments).

26. As regards the 'control' criterion in the definition of an asset as per the Framework, it may be argued that though the entity has a right to recover the costs incurred, it does not control the same since it cannot force individual customers to purchase goods or services in future. In this regard, it may be mentioned that the rate regulation governs the entity's relationship with its customer base as a whole and therefore creates a present right to recover the costs incurred from an aggregate customer base. Although the individual members of that group may change over time, the relationship the regulator oversees is between the entity and the group. The regulator has the authority to permit the entity to set rates at a level that will ensure that the entity receives the expected cash flows from the customers' base as a whole. Further, the Framework states that control over the future economic benefits is sufficient for an asset to exist, even in the absence of legal rights. The key notion is that the entity has access to a resource and can limit others' access to that resource which is satisfied in case of the right provided by the regulator to recover incurred costs through future rate adjustments. Any issues regarding recoverability of the amounts should not affect the recognition of the right in the financial statements though they certainly merit consideration in its measurement.

Regulatory liabilities

27. The Framework defines a liability as ‘a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.’ In cost-of-service regulation, an obligation arises because of a requirement to refund to customers excess amounts collected in previous periods. In such cases, collecting amounts in excess of costs and the allowed return creates an obligation to return the excess collection to the aggregate customer base. For example, if the tariffs initially set assume a certain level of costs towards energy purchased but the actual costs incurred by the entity are less than such assumed levels, the entity would be obliged to make a refund following the ‘truing up’ exercise by the regulator. Such obligation is a present obligation relating to amounts the entity has already collected from customers owed to the entity’s customer base as a whole, not to individual customers. It is not a possible future obligation because the regulator has the authority to ensure that future cash flows from the customer base as a whole would be reduced to refund amounts previously collected. The obligation exists even though its amount may be uncertain. An economic obligation is something that results in reduced cash inflows, directly or indirectly, as well as something that results in increased cash outflows. Obligations link the entity with what it has to do because obligations are enforceable against the entity by legal or equivalent means.

Nature of regulatory assets and regulatory liabilities

28. Regulatory assets and regulatory liabilities that would be recognised as a result of application of this Guidance Note are not financial instruments since the entity does not have the right to request reimbursement from, or the obligation to make payments to, individual customers for fixed or determinable amounts under a contract.

29. The regulatory assets are also not intangible assets as per AS 26, *Intangible Assets* since they are not identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes. Accordingly, it would be appropriate to classify the assets and liabilities arising out of rate regulation separately from other assets and liabilities.

Recognition

30. A regulatory asset should be recognised when it is probable that the future economic benefits associated with it will flow to the entity as a result of the actual or expected actions of the regulator under the applicable regulatory framework and the amount can be measured reliably.

31. Probability refers to the degree of uncertainty that future economic benefits associated with the regulatory asset will flow to the entity. Therefore, the probability criterion is said to be met when there is a reasonable assurance that future economic benefits will flow from the regulatory asset to the entity. A regulatory asset can be recognised when the regulatory framework provides for the recovery of the incurred costs and the entity has incurred such costs. If the recovery of the incurred costs is at the discretion of the regulator, the right can at best be said to be a contingent asset as per Accounting Standard (AS) 29, *Provisions, Contingent Liabilities and Contingent Assets*. In such case it would not be appropriate to recognise an asset till the approval of the regulator is received. For example, if any additions to the rate base are subject to the approval of the regulator, the entity should not recognise a regulatory asset on account of costs incurred on capital additions before approval of the regulator since the recovery of additional amounts through tariffs is contingent upon approval by the regulator.

32. In some cases, a regulator permits an entity to include in the rate base, as part of the cost of self-constructed (tangible) fixed assets or internally generated intangible assets, amounts that would otherwise be recognised as expense in the statement of profit and loss in accordance with Accounting Standards. After the construction or generation is completed, the resulting cost is the basis for depreciation or amortisation and unrecovered investment for rate determination. A regulatory asset should be recognised by the entity in respect of such costs since the same is recoverable from the customers in future through tariffs.

33. As regards the criterion for reliable measurement, since the recoverable amount is linked to the specific costs incurred which are permitted to be recovered by the regulatory framework, meeting the same may not present much difficulty for regulatory assets.

34. A regulatory liability should be recognised:

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- (i) when an entity has a present obligation as a result of a past event;
- (ii) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- (iii) a reliable estimate can be made of the amount of the obligation.

35. Since in a cost-of-service regulation, the tariffs are subjected to 'truing up' based on actual costs incurred and prudence checks by the regulator, if the costs incurred by the entity are lower than those initially considered for rate determination, the entity has no realistic alternative to making a refund to the customers. Similarly, if the tariffs are set assuming certain level of additions to the asset base and the actual additions by the entity are lower, the entity would be required to refund a portion of the tariffs collected due to the lower additions to the asset base. The regulatory framework may also provide for other circumstances which would warrant a refund of the amounts collected to the customers directly or indirectly through a downward adjustment of rates. For example a electricity distribution entity may have an obligation to share gains from reduction of distribution losses with the consumers in a specified ratio which would be passed on to consumers through an adjustment in future tariffs. Such amounts should be recognised as a liability if on the balance sheet date it is probable that the entity would be required to make refund upon review by the regulator and a reliable estimate can be made of the amount of refund.

36. Regulated entities should comply with the requirements of the Accounting Standards in the same way as other entities.¹ Therefore, if the criteria in paragraph 14 are satisfied, the entity should recognise regulatory assets and regulatory liabilities in accordance with this Guidance Note in addition to the assets and liabilities recognised in accordance with the Accounting Standards in the normal course.

Measurement

37. On initial recognition and at the end of each subsequent reporting period, an entity should measure a regulatory asset or regulatory liability at the best estimate of the amount expected to be recovered or refunded or adjusted as future cash flows under the regulatory framework. A regulatory asset or regulatory

¹ For rate regulated activities, the relevant Accounting Standards will be modified where and to extent the accounting treatment of such activities would be affected by this Guidance Note.

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liability should not be discounted to its present value.

38. Estimates of the amount expected to be recovered, refunded or adjusted are determined by the judgment of the management of the entity considering various factors such as:

- i. statutes or regulations that specifically provide for the recovery of the cost in rates;
- ii. formal approvals from the regulator specifically authorising recovery of the cost in rates;
- iii. previous formal approvals from the regulator allowing recovery for substantially similar costs (precedents) for a specific entity or other entities in the same jurisdiction;
- iv. written approval from the regulator (although not a formal approval) approving future recovery in rates;
- v. uniform regulatory guidance providing for the treatment of various costs that the regulator typically follows in setting rates;
- vi. opinions of independent experts regarding recoverability of the cost on the basis of regulations and past practice;
- vii. any additional evidence provided by events after the balance sheet date, where appropriate as per the applicable Accounting Standard.

Impairment

39. An entity should review the estimates of the amount expected to be recovered, refunded or adjusted at least at the end of each reporting period to reflect the current best estimate. If expectation differs from previous estimates, the changes should be accounted for as a change in an accounting estimate in accordance with relevant requirements of the applicable Accounting Standard. If an entity concludes that it is not reasonable to assume that it will be able to collect sufficient revenues from its customers to recover its costs, this is an indication that the cash-generating unit in which the regulatory assets and regulatory liabilities are included may be impaired. Accordingly, the entity shall test that cash-generating unit for impairment in accordance with AS 28 *Impairment of Assets*.

De-recognition

40. An entity should derecognise the entire carrying amount of regulatory assets and regulatory liabilities when the underlying activities fail to meet the criteria in paragraph 14 and any resulting loss/gain should be recognised in the statement of profit and loss.

41. If it is no longer probable that the future economic benefits associated with a regulatory asset will flow to the entity or an outflow of resources embodying economic benefits will be required to settle a regulatory liability, the regulatory asset or liability, as the case may be, should be de-recognised and any resulting loss/gain should be recognised in the statement of profit and loss.

Presentation

42. An entity should present regulatory assets and regulatory liabilities as current/non-current, as the case may be, in the balance sheet, separately from other assets and liabilities.

43. An entity should offset rate regulated assets and liabilities pertaining to the same regulator.

Disclosures

44. An entity should disclose information that:

- i. enables users of the financial statements to understand the nature and the financial effects of rate regulation on its activities; and
- ii. identifies and explains the amounts of regulatory assets and regulatory liabilities, and related income and expenses, recognised in its financial statements.

45. An entity should disclose the fact that some or all of its operating activities are subject to rate regulation, including a description of their nature and extent.

46. An entity should disclose the break-up of regulated assets and regulated liabilities into major components of the respective balances in the notes to accounts.

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47. For each set of operating activities subject to a different regulator, an entity should disclose the following information:

- i. an explanation of the approval process for the rate subject to regulation (including the rate of return), including information about how that process affects both the underlying operating activities and the specified rate of return;
- ii. the indicators that management considered in concluding that such operating activities are within the scope of this 'Guidance Note', if that conclusion requires significant judgement;
- iii. significant assumptions used in measurement of regulatory assets and regulatory liabilities including:
 - (a) the supporting regulatory action, for example, the issue of a formal approval for costs to be recovered pending a final ruling at a later date and that date, when known, or
 - (b) the entity's assessment of the expected future regulatory actions.

An entity should disclose the above information for each category of regulatory asset and regulatory liability that is subject to a different regulator.

48. A disclosure should be made of reconciliation from the beginning to the end of the period, in tabular format unless another format is more appropriate, of the carrying amount in the balance sheet of the regulatory asset and regulatory liability, including at least the following elements:

- i. the amount recognised in the statement of profit and loss relating to balances from prior periods collected or refunded in the current period.
- ii. the amount of costs incurred in the current period that were recognised in the balance sheet as regulatory assets and regulatory liabilities to be recovered or refunded in future periods.
- iii. other amounts that affected the regulatory asset and regulatory liability, such as items acquired or assumed in amalgamation etc.,

Accounting for Rate Regulated Activities

or the effects of changes in foreign exchange rates or estimated cash flows. If a single cause has a significant effect on the regulatory asset and regulatory liability, the entity should disclose it separately.

49. When an entity derecognises regulatory assets and regulatory liabilities in accordance with paragraphs 41 and 42 because the related operating activities fail to meet the criteria in paragraph 14, it should disclose a statement to that effect, the reasons for the conclusion that the criteria in paragraph 14 are not met, a description of the operating activities affected and the amount of regulatory assets and regulatory liabilities derecognised.

50. If the disclosures required by paragraphs 46–49 of this Guidance Note do not meet the objectives set out in paragraph 45, the entity should disclose whatever additional information is necessary to meet those objectives.

Effective Date

51. An entity should apply this Guidance Note for accounting periods beginning on or after the date (to be announced separately).

Transition

52. On the first occasion this Guidance Note is applied, the entity should recognise in the financial statements regulatory assets and liabilities as on that date with corresponding credit/charge to opening balance of revenue reserves.

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Guidance Note on Accounting for Self-generated Certified Emission Reductions (CERs)

Foreword

At present, rise in global temperatures is a major concern all over the world. The speed of warming has been almost three times the century long average since 1970. The main cause of the rise in global surface temperature is the human-induced emissions of Green House Gases (GHG's) into the environment. To address the issue of global warming caused by various gases, the concept of emission rights was brought out in the well known Kyoto Protocol. As per the Kyoto Protocol, at present, developing and least-developed countries are not bound by the amount of GHG emissions that they can release in the atmosphere, though they too generate GHG emissions. India, being a developing country, has emerged to be a beneficiary as Indian entities can set up Clean Development Projects which reduce GHG emissions and thereby generate Certified Emission Reductions (CERs) which can be sold to developed countries and used by the latter to meet their binding emission reductions.

The recent times have witnessed a rise in the number of transactions involving carbon trading. With India being an important partner in such transactions, the Accounting Standards Board of Institute of Chartered Accountants of India (ICAI) has formulated this Guidance Note on Accounting for Self-generated Certified Emission Reductions (CERs) to provide guidance on the accounting issues involved in such transactions, as the carbon trading market is expected to grow in the years to come.

I would like to congratulate CA. Manoj Fadnis, Chairman, Accounting Standards Board, and other members of the Accounting Standards Board who have made invaluable contribution in the formulation of this Guidance Note.

Accounting for Self-generated Certified Emission Reductions (CERs)

I hope that this endeavour of the Accounting Standards Board will go a long way in establishing sound principles on accounting for CERs and provide guidance to the members as well as to others concerned.

New Delhi
February 11, 2012

CA. G. Ramaswamy
President

Preface

Greenhouse gases are necessary to life as they keep the earth's surface warmer than it otherwise would be. But, as the concentrations of these gases continue to increase in the atmosphere, the Earth's temperature is climbing above past levels. To limit concentration of Green House Gases (GHGs) in the atmosphere for addressing the problem of global warming, United Nation Framework Convention on Climate Change (UNFCCC) was adopted in 1992. Kyoto Protocol came in force in February 2005 which sets limits to the maximum amount of emission of GHGs by countries. Presently, the Kyoto Protocol commits 41 developed countries to reduce their GHG emissions. The developing and least-developed countries are not bound by amount of GHG emissions that they can release in the atmosphere.

Large number of entities in India are generating carbon credits. Carbon credits being a relatively new area, a need was felt to provide accounting guidance in this area. Keeping this in view the Accounting Standards Board has formulated this Guidance Note on Accounting for Self-generated Certified Emission Reductions (CERs).

This Guidance Note provides guidance on accounting for carbon credits. Kyoto Protocol provides three market-based mechanisms – Joint Implementation (JI), Clean Development Mechanism (CDM), and International Emission Trading (IET). The only mechanism relevant in Indian context is Clean Development Mechanism (CDM) under which CERs are granted. The Guidance Note lays down the guidance on matters of applying accounting principles relating to recognition, measurement and disclosures of CERs generated by the entity under the Clean Development Mechanism.

I would like to convey my sincere thanks to our Honourable President CA. G. Ramaswamy and Vice-President CA. Jaydeep N. Shah for providing guidance and able leadership in the affairs connected with the Board.

I would like to take this opportunity to place on record my deep appreciation of the efforts put in by CA. S. Santhanakrishnan, Vice-Chairman, Accounting Standards Board and CA. S. A. Murali Prasad who made immense contribution in the preparation of this Guidance Note. I would also like to thank various representatives of the industry, our members and other individuals for giving their invaluable suggestions on the draft Guidance Note from time to time.

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I am also thankful to Dr. Avinash Chander, Technical Director, CA. Geetanshu Bansal, Senior Executive Officer of the Institute of Chartered Accountants of India, for the untiring efforts made by them in finalising the Guidance Note.

New Delhi
February 11, 2012

CA. Manoj Fadnis
Chairman
Accounting Standards Board

GN(A) 31 (Issued 2012)

Guidance Note on Accounting for Self-generated Certified Emission Reductions (CERs)

(The following is the text of the Guidance Note on Accounting for Self-generated Certified Emission Reductions (CERs), issued by the Council of the Institute of Chartered Accountants of India.)

Introduction

1. One challenge facing the human race is that of global warming. To address the issue of global warming, the United Nations Framework Convention on Climate Change (UNFCCC) was adopted in 1992, with the objective of limiting the concentration of Green House Gases (GHGs¹) in the atmosphere. Subsequently, to supplement the Convention, the Kyoto Protocol came into force in February 2005, which sets limits to the maximum amount of emission of GHGs by countries. The Kyoto Protocol at present commits 41 developed countries (known as Annex I countries) to reduce their GHG emissions by at least 5% below their 1990 baseline emission by the commitment period of 2008-2012. As per the Kyoto Protocol, at present, developing and least-developed countries are not bound by the amount of GHG emissions that they can release in the atmosphere, though they too generate GHG emissions.

2. Under the Kyoto Protocol, countries with binding emission reduction targets (which at present are applicable to developed countries) in order to meet the assigned reduction targets are issued allowances (carbon credits) equal to the amount of emissions allowed. An allowance (carbon credit) represents an allowance to emit one metric tonne of carbon dioxide equivalent. To meet the emission reduction targets, binding countries in turn set limits on the GHG emissions by their local businesses and entities. Further, in order to enable the developed countries to meet their emission reduction targets, Kyoto Protocol provides three market-based mechanisms – Joint Implementation

¹ GHGs refer to polluting gases including carbon dioxide which cause global warming.

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(JI), Clean Development Mechanism (CDM), and International Emission Trading (IET).

3. Under JI, a developed country with a relatively high cost of domestic GHG reduction can set up a project in another developed country that has a relatively low cost and earn carbon credits that may be applied to their emission targets. Under CDM, a developed country can take up a GHG reduction project activity in a developing country where the cost of GHG reduction is usually much lower and the developed country would be given carbon credits for meeting its emission reduction targets. Examples of projects include reforestation schemes and investment in clean technologies. In case of CDM, entities in developing/least developed countries can set up a GHG reduction project, get it approved by UNFCCC and earn carbon credits. Such carbon credits generated can be bought by entities of developed countries with emission reduction targets. The unit associated with CDM is Certified Emission Reduction (CER) where one CER is equal to one metric tonne of carbon dioxide equivalent. Under IET, developed countries with emission reduction targets can simply trade in the international carbon credit market. This implies that entities of developed countries exceeding their emission limits can buy carbon credits from those whose actual emissions are below their set limits. Carbon credits can be exchanged between businesses/entities or bought and sold in international market at the prevailing market price.

4. These mechanisms serve the objective of both the developed countries with emission reduction targets, who are the buyers of carbon credits as well as of the developing and least developed countries with no emission targets (at present), who are the sellers/suppliers of carbon credits. The non-polluting companies from less developed countries can sell the quantity of carbon dioxide emissions they have reduced (carbon credits) and earn extra money in the process. This mechanism of buying and selling carbon credits is known as carbon trading.

Clean Development Mechanism and CERs

5. The Clean Development Mechanism is a flexible mechanism to enable countries with GHG emission reduction commitments, i.e., Annex I countries to meet their commitments by paying for GHG emission reductions in developing countries (non-Annex I countries). Such CDM projects earn saleable Certified Emission Reduction (CER) units, each equal to one metric tonne of carbon dioxide equivalent, which can be counted towards meeting Kyoto targets (given

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in Annexure B of Kyoto Protocol). This mechanism encourages the non-Annex I countries, i.e., developing and least developed countries which at present are not bound by Kyoto Protocol to reduce GHG emissions. India, being a non-Annex I country, has emerged to be a beneficiary as Indian entities can set up CDM projects which reduce GHG emissions and thereby generate CERs which can be sold to Annex I countries and used by the latter to meet their binding emission reductions.

6. To be eligible for CDM benefits, the proposed project must have the feature of additionality, i.e., the CDM project must provide reductions in emissions that are additional to that would occur in the absence of the project. For example, an entity can generate CERs under CDM, if it installs a waste heat boiler that saves energy. This is because reduced fuel use reduces the amount of carbon dioxide emitted. However, if an entity has to undertake the project activity because of law, for example, if the industry is legally mandated to have a waste-heat recovery boiler, such a project is generally not eligible for CDM benefits.

7. An entity desirous of undertaking a CDM project activity, generate carbon credits there from, and earn revenue needs to go through several stages. These are described below:

(i) Registration/Accreditation of the project

As a first step, an entity desirous of setting up a CDM project needs to get the project registered with the CDM Executive Board of the UNFCCC. To do so, it needs to develop a Project Design Document (PDD) which contains the description of the proposed CDM project. The entity also needs an approval from the Designated National Authority (DNA) which is an office, ministry or other official entity appointed by a Party to the Kyoto Protocol to review and give national approval to projects proposed under the CDM. India's DNA is the National CDM Authority (NCDMA). Once approved by the DNA, the proposed project is required to be validated by a Designated Operational Entity (DOE). A DOE is a company/organisation accredited by the CDM Executive Board that checks whether the project meets the CDM criteria. The DOE checks the PDD and hosts the same on UNFCCC's website for public comments for a period of 30 days. Upon the expiry of this period, the DOE makes a determination as to whether on the basis of the information provided and taking into consideration the comments received, the project should be validated. Once satisfied, the DOE

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submits the validation report and all the other necessary documents to the CDM Executive Board along with the request for project registration, and all these documents are hosted on UNFCCC's website. If within 8 weeks no request for review of the proposed CDM project is received by UNFCCC, the project is automatically registered.

(ii) Monitoring, Verification and Issuance of CERs

Once the project is registered and becomes operational, the performance of the CDM project is monitored and verified periodically (usually once a year) to determine whether emission reductions have taken place before the CDM Executive Board can issue CERs. For this, the entity having got itself successfully registered appoints a DOE which is different from the one involved in the first stage. The DOE assesses the quality/quantity of GHG emission reductions and compliance with all CDM criteria. After successful verification, the DOE submits the verification report and other relevant documents to the Executive Board and requests for issuance of CERs. UNFCCC hosts all these documents on its website and if within 15 days from the date of making the request for issuance no request for review is received, CERs are certified and issued to the entity. Certification is a written assurance by UNFCCC that a project activity achieved the emission reductions as verified.

(iii) Sale/Trade

The CERs obtained by the entity may be sold to those who need it.

8. From the above, it follows that there are various parties involved in the carbon trading process. These include (i) Generating entity/generator, i.e., the entity which undertakes CDM project activity to generate CERs; (ii) CDM Executive Board of UNFCCC which approves the CDM projects and issues CERs; (iii) Designated National Authority as defined above and in India it refers to National CDM Authority; (iv) Designated Operational Entities as defined above which validate and verify the CDM project and its operations; and (v) the buying entity/buyer which buys the CERs generated by the generator and for the purpose of this Guidance Note it refers to the entity of a developed country which is bound by the Kyoto Protocol emission reduction targets.

Objective

9. With large number of entities in India generating carbon credits and the carbon credits being a relatively new area, a need was felt to provide guidance on accounting in this area. There is no specific Accounting Standard or interpretation provided by the International Accounting Standard Board (IASB) in relation to the accounting for Certified Emissions Reductions (CERs). The debate is still on for an appropriate treatment for Carbon Emission Reductions (CERs) in the international forum.

There are, however, existing Accounting Standards (AS) that deal with the principles that should govern accounting for Certified Emissions Reductions (CERs). But the lack of specific guidance furthers the scope for judgement and results in varying treatments.

Scope

10. Kyoto Protocol provides three market-based mechanisms – Joint Implementation (JI), Clean Development Mechanism (CDM), and International Emission Trading (IET). The accounting issues and the consequent accounting treatment involved in the three different mechanisms may be different. However, since at present the Clean Development Mechanism is the relevant mechanism in India and with India currently not being under the obligation to reduce its GHG emissions as per the Kyoto Protocol, this Guidance Note provides guidance on accounting for carbon credits, i.e., CERs generated under the Clean Development Mechanism. This Guidance Note provides guidance on matters of applying accounting principles relating to recognition, measurement and disclosures of CERs generated by the entity that has obtained the same under the Clean Development Mechanism (hereinafter referred to as ‘self-generated CERs’).

This Guidance Note does not address the accounting issues involved in carbon credits under Joint Implementation and International Emission Trading the other two mechanisms under the Kyoto Protocol.

This Guidance Note also does not deal with purchased CERs or with the use of CERs in own business.

Accounting Treatment

Whether CER is an ‘asset’

11. An issue that arises in accounting for carbon credits is that whether the carbon credits generated under the Clean Development Mechanism, i.e., CERs, can be considered as assets of the generating entity.

12. The ‘Framework for the Preparation and Presentation of Financial Statements’, issued by the Institute of Chartered Accountants of India, defines an ‘asset’ as follows:

“An *asset* is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.”

CER is an ‘asset’ as per the definition given in the Framework

13. From the above-mentioned definition of ‘asset’ it follows that for a CER to be considered as an asset of the generating entity, it should be a resource controlled by the generating entity arising as a result of past events, and from which future economic benefits are expected to flow to the generating entity.

14. In order to generate CERs, an entity undertakes a CDM project activity and thereby reduces carbon emissions. It is mentioned in paragraph 9 above that various stages are involved in a CDM project activity to generate CERs. After a successful registration, as the CDM project is operated, carbon emission reductions are generated and these continue to be generated over the course of the project. However, at this stage, i.e., when the emission reductions are taking place, CERs do not arise. It may be argued that as soon as emission reductions take place these should be considered as assets since certification thereof subsequently in the form of CERs is a procedural aspect. In this regard, it is noted that issuance of CERs is subject to the verification process, i.e., CERs are applied for and on the expiry of 15 days having received no request for review and after having satisfied all requirements, a communication is received from UNFCCC thereby crediting CERs to the generating entity. It is, thus, possible that emission reductions may not eventually result in to creation of CERs. Accordingly, at this stage when emission reductions are taking place, CERs can, at best, be said to be contingent assets as per Accounting Standard (AS) 29, *Provisions, Contingent Liabilities and Contingent Assets*, which defines

a contingent asset as “**a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise**”. This is because when the generating entity reduces carbon emissions by way of a CDM project, the generating entity becomes eligible to receive CERs from UNFCCC. However, whether CERs will actually arise and be received by the generating entity or not will depend on a future uncertain event, i.e., certification of the same by UNFCCC.

15. It follows from the above that a CER comes into existence and meets the definition of an asset only when the communication of credit of CERs is received by the generating entity. This is because only at this stage the CER becomes a resource controlled by the generating entity and therefore leads to expected future economic benefits in the form of cash and cash equivalents which would arise on the future sale of CERs. As stated above, at other earlier stages of the CDM project activity, there is no resource in existence for the generating entity, and hence the question of ‘resource controlled’ and ‘expected future economic benefits’ therefore do not arise. Accordingly, CER is an ‘asset’, when it comes into existence as stated aforesaid.

Recognition of CERs

16. According to the ‘Framework for the Preparation and Presentation of Financial Statements’, once an item meets the definition of the term ‘asset’, it has to meet the criteria for recognition of an asset as laid down in the Framework so that it may be recognised in the financial statements. In other words, it has to be seen when the CERs should be recognised in the financial statements. As per paragraph 88 of the Framework, the criteria for recognition of an asset are as follows:

“88. An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably.”

17. From paragraph 15 it follows that CERs come into existence when these are credited by UNFCCC in a manner to be unconditionally available to the generating entity. Therefore, CERs should not be recognised before that stage. Further, from the above it follows that for CERs to be recognised in the financial statements of the generating entity as assets, the two criteria with regard to

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probable future economic benefits flowing from the CERs and CERs possessing a cost or value that can be measured with reliability should be met as follows:

- (a) As regards the probability criterion for recognition of CERs, it may be mentioned that the concept of probability refers to the degree of certainty that future economic benefits associated with CERs will flow to the entity. Therefore, the probability criterion is said to be met when there is a reasonable assurance that future economic benefits will flow from the CERs to the entity. As the market for CERs is relatively new, the future economic benefits may not always be assured. Thus, an entity needs to make an assessment for the probability of future economic benefits. Accordingly, if there is a probable market for the self-generated CERs ensuring flow of economic benefits in the future, CERs should be recognised.
- (b) As regards the criterion for measurement of cost or value, there are certain costs which are incurred to generate CERs, and therefore the cost of CERs can be measured reliably. The value at which CERs are to be measured is discussed in later paragraphs.

For reasons stated above, the recognition of CERs as an asset at any earlier or later stage than when they are credited by UNFCCC is not justified in the following cases:

- (a) CERs are recognised upon execution of a firm sale contract for the eligible credits.
- (b) CERs are recognised on an entitlement basis based on reasonable certainty after making adjustments for expected deductions.

What type of asset is a CER

18. Having agreed that a CER is an asset as per the 'Framework for the Preparation and Presentation of Financial Statements' and also having determined when a CER meets the recognition criteria, its nature is to be examined. Keeping in view the non-physical form of CERs, the definition of 'intangible asset', as per Accounting Standard (AS) 26, *Intangible Assets*, is noted as follows:

“An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.”

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19. From the above, it is noted that though CERs are non-monetary assets without a physical form, they do not strictly fall within the meaning of 'intangible asset' as per AS 26. The reason is that CERs are not held for use in the production or supply of goods or services, and neither are CERs used for administrative purposes nor are they used for the purpose of renting to others. Instead, CERs generated by the generating entity are held for the purpose of sale.

However, it may be mentioned that though the definition of 'intangible asset' does not mention assets held for sale, the other requirements of AS 26, such as the following, indicate that intangible assets include assets which are developed by an entity for sale:

“44. An intangible asset arising from development (or from the development phase of an internal project) should be recognised if, and only if, an enterprise can demonstrate all of the following:

- (a) the technical feasibility of completing the intangible asset so that it will be available for use or sale;***
- (b) its intention to complete the intangible asset and use or sell it;***
- (c) its ability to use or sell the intangible assets;***
- (d) ...***
- (e) the availability of adequate technical, financial and other resources to complete the development and use or sell the intangible asset; and***
- (f) ...” [Emphasis supplied]***

20. Further, though CERs are intangible assets as mentioned above, AS 26² scopes out those intangible assets from its purview which are specifically dealt with in another Accounting Standard and requires them to be accounted for in accordance with that Standard. For instance, intangible assets held for the

² Reference may be made to paragraph 2 of AS 26.

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purpose of sale in the ordinary course of business are excluded from the scope of AS 26 (paragraph 2) and, therefore, are to be accounted for as per Accounting Standard (AS) 2, *Valuation of Inventories*. In this context, the definition of the term ‘inventories’ as given in AS 2 is noted below:

“Inventories are assets:

- (a) held for sale in the ordinary course of business;***
- (b) in the process of production for such sale; or***
- (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.”***

21. From the above, it follows that CERs are inventories of the generating entity as they are generated and held for the purpose of sale in the ordinary course of business. Therefore, even though CERs are intangible assets these should be accounted for as per the requirements of AS 2.

Measurement

Measurement of CERs

22. As stated above, CERs are inventories for an entity which generates the CERs. Therefore, the valuation principles as prescribed in AS 2 should be followed for CERs. As per AS 2, inventories should be valued at the lower of cost and net realisable value. Accordingly, CERs should be measured at cost or net realisable value, whichever is lower.

Cost of Inventories

23. AS 2 prescribes the composition of cost of inventories as follows:

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

24. Various costs are incurred by the generating entity to set up a CDM project activity, operate the CDM project and generate CERs. These may include the following:

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- (i) research costs arising from exploring alternative ways to reduce emissions;
- (ii) costs incurred in developing the selected alternative as a process/device to reduce emissions;
- (iii) costs incurred to prepare the Project Design Documents;
- (iv) fees paid to DOEs for validation and verification and to the National Authority for approval;
- (v) fees of registering with UNFCCC;
- (vi) costs incurred for monitoring the reductions of emissions;
- (vii) costs incurred for certification of CERs; and
- (viii) operating costs incurred to run the CDM project.

25. As already mentioned earlier, CERs do not come into existence and, therefore, do not become the assets of the generating entity till the UNFCCC certifies and credits the same to the generating entity. Accordingly, not all costs incurred by the generating entity give rise to CERs and therefore not all costs can be considered as the costs of bringing the CERs to existence (i.e., their present location and condition). For example, the research and development costs as mentioned above are the pre-implementation costs of the CDM projects which do not result in CERs. Accordingly, these should be treated as per Accounting Standard (AS) 26, *Intangible Assets* (refer also to paragraph 30 below) when they bring into existence a separate intangible asset such as a patent of a process to reduce carbon emissions. Similarly, the other costs such as those incurred for preparation of PDD and registration of the CDM project with UNFCCC, etc., do not result in CERs coming into existence, and therefore these costs cannot be inventorised. It is only the costs incurred for the certification of CERs by UNFCCC which bring the CERs into existence by way of credit of the same by UNFCCC to the generating entity. Thus, the costs incurred by the generating entity for certification of CERs, are the costs of inventories of CERs.

26. In order to certify and issue CERs, UNFCCC imposes two types of levies on the generating entity. The first type of levy is in kind whereby a specified percentage of the CERs earned are deducted at the point of issuance by the

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UNFCCC. In other words, the generating entity is issued CERs net of this levy. For example, if this levy is 2% and if 1000 CERs are to be issued, then after deducting 20 CERs, 980 CERs will be credited. This levy is applied to all projects other than those of the Least Developed Countries. The second type of levy imposed is in the form of a cash payment which is charged by the UNFCCC towards meeting administrative costs of UNFCCC. In this levy, a fixed payment per unit of CER is charged for the total CERs credited to the generating entity. Taking the above example further, if USD 0.10 per CER is charged towards the second levy, then the generating entity will need to make a payment at this rate for the 980 CERs credited to it, i.e., USD 98. Apart from these two levies, the generating entity normally pays a fee to the consultant for the services rendered to obtain the certification of CERs by UNFCCC.

27. From the above, it follows that the 'costs incurred for certification of CERs' at which the inventory of CERs should be valued include the consultant's fee and the cash payment made under the second levy to the UNFCCC for obtaining the credit of CERs. The deduction of CERs by UNFCCC under the first levy is in kind which increases the per unit cost of the CERs credited to the generating entity.

Net Realisable Value

28. AS 2 defines net realisable value as follows:

"Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale."

29. In the determination of the net realisable value of CERs, paragraph 22 of AS 2 reproduced below should be used as guidance:

"22. Estimates of net realisable value are based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realise. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the balance sheet date to the extent that such events confirm the conditions existing at the balance sheet date."

Income Recognition

30. Since CERs are recognised as inventories, the entity should apply AS 9 to recognise revenue in respect of sales of CERs .

Measurement of underlying assets related to CERs

31. For the generation of CERs, the generating entity may create certain intangible and tangible assets. For example, for reducing emissions, an entity may carry out some research and development which may result into creation of an intangible asset. Insofar as expenditure on research and development is concerned, the entity should apply AS 26, *Intangible Assets*.

32. In some cases, an entity may use a tangible asset to reduce emissions. For example, an entity may use incinerators for the purpose of reducing carbon emissions. In respect of such equipments/devices, the provisions of the Accounting Standard (AS) 10, (Revised) *Tangible Fixed Assets*³ will apply, as is evident from the following paragraph thereof:

“8.1A. Items of tangible fixed assets may be acquired for safety or environmental reasons. The acquisition of such tangible fixed assets, although not directly increasing the future economic benefits of any particular existing item of tangible fixed asset, may be necessary for an enterprise to obtain the future economic benefits from its other assets. Such items of tangible fixed assets qualify for recognition as assets because they enable an enterprise to derive future economic benefits from related assets in excess of what could be derived had those items not been acquired. For example, a chemical manufacturer may install new chemical handling processes to comply with environmental requirements for the production and storage of dangerous chemicals; related plant enhancements are recognised as an asset because without them the enterprise is unable to manufacture and sell chemicals. However, the resulting carrying amount of such an asset and related assets is reviewed for impairment in accordance with AS 28, *Impairment of Assets*.”

33. From the above, it is clear that any pollution control/emission reduction devices installed by the generating entity for the purpose of generating CERs are fixed assets and therefore they shall be accounted for as per AS 10 (Revised).

³ AS 10(revised), *Tangible Fixed Assets* is being formulated.

Accounting for Self-generated Certified Emission Reductions (CERs)

Presentation

34. An entity should present certified emission rights as part of Inventories, in the balance sheet, separately from other categories of Inventories such as Raw Materials, Work-in-process, Finished goods and others.

Disclosure

35. An entity should disclose the following information relating to certified emission rights in the financial statements:

- a) No. of CERs held as inventory and the basis of valuation.
- b) No. of CERs under certification.
- c) Depreciation and operating and maintenance costs of Emission Reduction equipment expensed during the year.

Effective Date

36. An entity should apply this Guidance Note for accounting periods beginning on or after April 01, 2012.

Transition

37. On the first occasion this Guidance Note is applied, the entity should recognise in the financial statements certified emission rights earned as on that date with corresponding credit to revenue reserves.

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Guidance Note on Accounting and Auditing of Political Parties

Foreword

Political Parties are one of the core organisations for functioning of a democracy. In this dynamic scenario, where the sources of funding of the Political Parties are diversified, the objectives of accountability and transparency seem to be of great importance. Transparent accounting and financial reporting are also central to the fulfilment of new age governance. The introduction of acceptable accounting practices and disclosure norms are not just technical practices but the foundations for the integrity and maturity of the Political Parties. Political Parties would, therefore, need to reflect their 'financial position' and 'financial performance' which should indicate their ability to achieve their developmental goals, meet their programme targets, their efficiency in the use of resources.

It has, however, been felt that the present system of accounting and financial reporting followed by Political Parties in India does not adequately meet the accountability concerns of the stakeholders. The ICAI, therefore, as desired by the Election Commission of India (ECI) made certain recommendations to the ECI for improving the present system of accounting followed by Political Parties in India. Subsequent to the above, it is heartening to note that the ICAI has formulated this Guidance Note on '*Accounting and Auditing of Political Parties*'. I congratulate CA. S.B. Zaware under whose able convenorship a study group was setup by the Council for finalising the draft of the Guidance Note. I also thank the other members of the group in making invaluable contribution in this endeavour.

I hope that this endeavour of the Election Commission of India and ICAI will go a long way in establishing sound accounting principles and provide guidance to the Political Parties, members and others concerned.

New Delhi
February, 2012

CA. G. Ramaswamy
President

Preface

India being a democratic country has a large number of national as well as regional Political Parties. Political Parties are the part and parcel of a democratic system. In a democratic setup, Political Parties are the public organisations which contest elections to occupy the decisive position of authority. They provide as important link between the Government and people as these are generally concerned with provision of social welfare, macro-economic management of the economy, and economic prosperity of its people. Consequently, in a democratic society like ours, the citizens deserve a fair account of how their money is being used by the Political Parties and the Government. As public organisations, it is necessary that Political Parties accountable to general public. It is a widely recognised fact that one of the means of ensuring public accountability and transparency is the dissemination of relevant financial information about the operating activities of the entity and its financial condition to all stakeholders.

Keeping the above in view, the Election Commission of India (ECI) approached ICAI, to recommend changes in order to bring uniformity in Accounting and Auditing practices being followed by Political Parties presently. Taking forward a step in the direction subsequent to the submission of the recommendations on the above to the ECI, the ICAI has formulated this '*Guidance Note on Accounting and Auditing of Political Parties*' which lays down the Uniform Accounting and Auditing Framework for the preparation and presentation of financial statements by Political Parties. The Guidance Note, *inter alia*, also lays down the principles of recognition, measurement and disclosure of items of income, expenses, assets and liabilities in the financial statements of Political Parties. A uniform format of financial statements has also been recommended.

I am thankful to CA. Amarjit Chopra, former President, CA. G. Ramaswamy, President and CA. Jaydeep Shah, Vice President for opportunity given to the Study-group to deliberate and pen down the draft of the Guidance Note. I place on record my deep appreciation of CA. Nilesh Shivji Vikamsey and CA. Atul Chunilal Bheda, members of the Study-group for the invaluable contributions made by them. I also compliment the invaluable contribution made by Dr. Avinash Chander, Technical Director and Ms. Deepti Dhiman, Section Officer from Technical Directorate, involved in the formulation of the Guidance Note.

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I deeply appreciate the valuable suggestions and deliberations of Dr. S.Y. Quraishi, Chief Election Commissioner, Shri V.S. Sampath, Election Commissioner, Shri. H.S. Brahma, Election Commissioner, Mr. P.K. Dash, Director General and other officials of Election Commission of India.

I sincerely believe that this Guidance Note will prove to be useful for political parties as well as for our members and go a long way in establishing sound accounting and auditing principles for the political parties.

February, 2012

CA. S.B. Zaware
Convenor

Study Group of the Council on
'Uniform Accounting and Auditing Framework for Political Parties'

Accounting and Auditing of Political Parties

Dr. S. Y. Quraishi
Chief Election Commissioner of India




भारत निर्वाचन आयोग
Election Commission of India

MESSAGE

Transparency and Accountability are the cardinal principles of democracy. To ensure this, the Election Commission had asked the Institute of Chartered Accountants of India (ICAI) to develop standardized formats for auditing of accounts of political parties. I am happy that ICAI has come up with suitable recommendations and has decided to obtain feedback from its members and the general public on its 'Guidance Note on Accounting and Auditing of Political Parties'.

Political parties are major stakeholders in a democracy. They seek to represent public interest in legislative and executive fora. Therefore, transparency and accountability in their functioning is desirable in the best interests of democracy and their own credibility.

I would like to compliment the ICAI for its positive role and I am sure their efforts will go a long way in development of a stronger and mature democracy in India.



(S.Y. Quraishi)

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Guidance Note on Accounting and Auditing of Political Parties

(Following is the text of the Guidance Note on Accounting and Auditing of Political Parties, issued by the Council of the Institute of Chartered Accountants of India.)

1. Introduction

India is a democratic country with federal features and Political Parties are one of the core institutions for the democracy. Party system is inevitable in a democratic setup. In other words, a democratic Government always works through Political Parties. Political Parties are supposed to enlighten, represent and protect the people's interest in a representative democracy. Following are the features of a Political Party:

1. Organisational structure and stability
2. Definite objectives
3. Activities on the basis of ideas, principles and mandates.
4. Redressal of public issues
5. Ultimate objective of attaining governmental power

When a Political Party or group of Parties in coalition win majority of seats in election, it forms the Government. Other Parties, which do not get the majority, play the role of opposition Parties. Political Parties convey the views and demands of the people to the Government. Hence, all Political Parties that exist in a country along with the ruling Party, are generally concerned with provision of public good and services to citizens, provision of social welfare, macro-economic management of the economy, management of assets and liabilities and economic prosperity of the people of the country. Consequently, in a democratic society like ours, various stakeholders and general public at large

deserve a true and fair account of how their money is being raised and used by the Political Parties and how effectively the financial affairs of the economy are being managed.

In this dynamic scenario, where the sources of funding of the Political Parties have been diversified, the objective of accountability and transparency seems to be of great importance. One of the means of ensuring public accountability and transparency is the dissemination of relevant financial information about the operating activities of the entity and its financial condition. Financial information is generally communicated through financial reports.

It has, however, been felt that the present system of accounting and financial reporting followed by Political Parties in India does not adequately meet the accountability concerns of the contributors, donors, other stakeholders such as members/beneficiaries, volunteers and general public etc.

A large number of Political Parties exist in India. The Political Parties registered with the Election Commission of India file a return containing '*A Statement of Election Expenditure by the Party*' and '*A Statement of Contributions received by the Party during a particular year*' in a prescribed format, which is not sufficient to meet the financial information requirements of the stakeholders. Moreover, various Acts and Legislations governing the Political Parties across India do not lay down any financial accounting and reporting framework. Consequently, preparation of appropriate financial statements and maintaining proper books of account by Political Parties is of utmost importance. It is also necessary to lay down an appropriate 'Auditing Framework' for Political Parties.

A need is, therefore, being felt for improved accountability of the financial resources used by the Political Parties. A sound accounting and auditing framework acts as an important ingredient for promoting accountability of a organisation.

2. Objectives

The objectives of this Guidance Note are to recommend the following:

- (a) An Accounting & Reporting Framework for the preparation and presentation of financial statements in Political Parties. This includes recommendation of appropriate basis of accounting, the application of sound accounting principles pertaining to recognition, measurement and disclosure of various items of income and expenses, assets and liabilities in the financial

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statements of Political Parties keeping in view the peculiarities of the activities of Political Parties.

- (b) Applicability of Accounting Standards issued by the Institute of Chartered Accountants of India to Political Parties.
- (c) Standardised formats of Financial Statements for Political Parties.
- (d) Applicability of 'Auditing and Assurance Standards' issued by the ICAI, to Political Parties.

3. Scope

- (a) The guidance provided under this Guidance Note is applicable to the Political Parties registered with the Election Commission of India under *the Representation of People Act, 1951*.
- (b) This Guidance Note contains a standardised framework for preparation and presentation of financial statements of Political Parties, using sound accounting principles pertaining to recognition, measurement and disclosures.
- (c) For the purpose of this Guidance Note, a Political Party is considered as the reporting entity. Most of the Political Parties have wings/branches at State Level/District/City/Town/Village Level. For the sake of convenience and transparency, A Political Party may maintain separate accounts for each such wing/branch. However, for the purpose of preparation of financial statements of the Political Party, the accounts for all branch offices have to be consolidated into that of the Political Party as the reporting entity.

4. Basis of Accounting

The term 'basis of accounting' refers to the timing of recognition of revenue, expenses, assets and liabilities in accounts.

The commonly prevailing bases of accounting under Double Entry Book Keeping system are:

- (i) Cash basis of accounting; and
- (ii) Accrual basis of accounting.

Under the cash basis of accounting, transactions are recorded when the related cash receipts or cash payments take place. Thus, revenue of Political Parties, such as donations, grants, etc. is recognised when funds are actually received. Similarly, acquisition and maintenance of assets used for rendering services as well as for employee remuneration and other items are recorded when the related payments are made. The end-output of cash basis of accounting is a statement of Receipts and Payments that classifies cash receipts and cash payments under different heads.

Accrual basis of accounting is the method of recording transactions by which revenue, expenses, assets and liabilities are reflected in the accounts in the period in which they accrue. The accrual basis of accounting includes considerations relating to accrual of income, provisioning of expenses, allocations like depreciation and amortisation. This basis is also referred to as 'Mercantile Basis of Accounting' and commonly in use.

Accrual basis of accounting records the financial effects of the transactions and other events in the period in which they occur rather than recording them in the period(s) in which cash is received or paid. Accrual basis recognises that the economic events that affect an entity's performance often do not coincide with the cash receipts and payments. The objective of accrual basis of accounting is to relate the accomplishments (measured in the form of revenue) and the efforts (measured in terms of costs) so that the reported net income/surplus measures an entity's performance during a period rather than merely listing its cash receipts and payments. Apart from income measurement, accrual basis of accounting recognises assets, liabilities or components or revenue and expenses for amounts received or paid in cash in past, and amounts expected to be received or paid in cash in future.

In cash basis of accounting, no account is taken of whether the asset is still in use, has reached the end of its useful life, or has been sold. Thus, cash-based information fails to show a proper picture of the financial position and performance for the accounting period. A cash-based system does not provide information about total costs of an organisation's activities. On the other hand, accrual system of accounting offers the opportunity to the organisation to improve management of assets, and provides useful information about the real level of organisation's liabilities, relating to both debts and other obligations such as employee entitlements.

Accrual is, thus, a scientific basis of accounting and has conceptual superiority over the cash basis of accounting. It is, therefore, recommended that Political Parties should maintain their books of account on accrual basis.

5. Accounting Framework for Political Parties

This Framework is concerned with General Purpose Financial Statements (hereafter referred to as 'Financial Statements') and a Cash Flow Statement, viz., the Balance Sheet, Income and Expenditure Account prepared under accrual basis of accounting. Such financial statements are prepared and presented at least annually and are directed towards the common information needs of a wide range of users such as the general public, regulators (Election Commission of India), and donor agencies. These users have to rely on the financial statements as their major source of financial information and cannot prescribe the information they want from an organisation. The General Purpose Financial Statements should, therefore, be prepared and presented with their needs in view. Special purpose financial reports, for example, computations prepared for taxation purposes or others having the authority to obtain the type of information they need are outside the scope of this Framework. Where the General Purpose Financial Statements prepared in accordance with the recommendations contained in this Guidance Note do not provide such specific requisite information, it would be appropriate to prepare a separate statement for the specific purpose envisaged in the relevant statute/regulation or specified in the donor requirements. The recommendations contained in this Guidance Note may be applied to such specific purpose statements to the extent appropriate.

With a view to recommend suitable accounting system for Political Parties, it would be imperative to understand the major ingredients of an accounting framework as discussed in the following paragraphs:

(a) Elements of financial statements basically comprising Income, Expenses, Assets and Liabilities

The framework aims to identify the items that should be considered as income, expenses, assets and liabilities by Political Parties (hereafter referred to as 'entity') for the purpose of including the same in the financial statements by defining the aforesaid terms.

'Assets' are resources controlled by an entity from which future economic benefits or service potential is expected to flow to the entity. It may thus be noted that the definition of 'asset' would remain the same whether an entity is a business enterprise or a Political Party, insofar as expectation of the future economic benefits is concerned. In other words, what is considered as an asset by a business entity e.g., Land, Building, Furniture and Equipment etc., would be considered as asset by a Political Party also. However, in case of a Political Party, certain items which may not have future economic benefits but have service potential would also be considered as assets. Many assets, for example, computers and buildings have a physical form. However, physical form is not essential to the existence of an asset. Hence, intangible assets such as copyrights and computer software are also assets, if they are controlled by the Political Party and future benefits from their use are expected to flow to the Political Party.

A 'liability' is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

An essential characteristic of a liability is that the entity has a present obligation. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or a statutory requirement. This is normally the case, for example, with amounts payable for goods and services received and taxes, if any, to be paid. Obligations also arise, however, from normal practices followed by the entity, custom and a desire to maintain good relations or act in an equitable manner.

'Income' is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in owners' interest, other than those relating to contributions from owners.

Revenue arises in the course of ordinary activities of an organisation. Revenue in case of Political Parties is in the form of :

- (i) Grants from government/foundations/donor agencies on the basis of duly approved grant letters, specifying the timeframe/guidelines for grant accrual;
- (ii) Donations;

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- (iii) Fee and Subscription from Members;
- (iv) Sale of Publications, if any;
- (v) Interest and dividend from investments; and
- (vi) Collection from sale of coupons.

Gains represent other items that meet the definition of 'Income' and may or may not arise in the course of the ordinary activities of Political Parties. Gains represent increases in economic benefits and as such are no different in nature from revenue. Gains include, for example, profits arising from the disposal of fixed assets and sale of investments. When gains are recognised in the 'Income and Expenditure Account, they are usually disclosed separately.

'Expenses' are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in owners' interest, other than those relating to distributions to owners.

The definition of 'Expense' encompasses both expenses that arise in the course of the ordinary activities of Political Parties as well as losses. Expenses that arise in the course of the ordinary activities of Political Parties include monetary expenses such as election expenditure; office administration/maintenance expenses; salaries and other employee costs; and non-monetary expenses such as depreciation. The expenses take the form of an outflow or depletion of assets or enhancement of liabilities.

Losses represent other items that meet the definition of 'Expense' and may or may not arise in the course of the ordinary activities of Political Parties. Losses represent decreases in economic benefits and as such they are no different in nature from other expenses. Losses include, for example, those resulting from disasters such as fire and flood, as well as those arising from the disposal of fixed assets. The definition of expenses also includes unrealised losses. These losses are generally recognised in the Income and Expenditure account, and are usually disclosed separately.

(b) Principles for recognition of items of Income, Expenses, Assets and Liabilities

Accounting and Auditing of Political Parties

These principles lay down the *timing* of recognition of the aforesaid items in the financial statements of Political Parties. In other words, these principles lay down *when* an item of Income, Expense, Asset or Liability should be recognised in the financial statements.

There is no difference in the application of the recognition principles to business enterprises and Political Parties. For example, the timing of the recognition of a grant/donation/contribution as an income in the financial statements of an organisation does not depend upon the purpose for which the organisation is run. A grant is recognised as income in the financial statements, under accrual basis of accounting, when it becomes reasonably certain that the grant/donation/contribution will be received and that the organisation will fulfill the conditions attached to it. Thus, a business enterprise and a Political Party would both follow the aforesaid criteria for recognition of grant as income. Similarly, principles for recognition of other Incomes, Expenses, Assets and Liabilities would be the same for other entities and Political Parties for which Framework for the Preparation and Presentation of Financial Statements as in case of commercial entities, may be referred.

Recognition Criteria for Items of Income

An item that meets the definition of income becomes eligible to be recognised in the financial statements if:

- (i) it is probable that the inflow or other enhancement of future economic benefits has occurred; and
- (ii) the inflow or other enhancements of future economic benefits can be measured reliably.

Recognition Criteria for Items of Expense

An item that meets the definition of expense becomes eligible to be recognised in the Income and Expenditure account when and only when:

- (i) it is probable that the consumption or loss of future economic benefits resulting in a reduction in assets and/or an increase in liabilities has occurred;
- (ii) the consumption or loss of future economic benefits can be measured reliably.

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Under accrual basis of accounting, expenses are recognised on the following basis:

- (i) *Identification with revenue transactions:* Costs directly associated with the revenue recognised during the relevant period (in respect of which whether money has been paid or not) are considered as expenses and are charged to income for the period.
- (ii) *Identification with a period of time:* In many cases, although some costs may have connection with the revenue for the period, the relationship is so indirect that it is impracticable to attempt to establish it. However, there is a clear identification with a period of time. Such costs are regarded as 'period costs' and are expensed in the relevant period, e.g., salaries, telephone, travelling, depreciation on office building, etc. Similarly, the costs the benefits of which do not clearly extend beyond the accounting period are also charged as expenses.

Expenses relating to a future period are accounted for as 'prepaid expenses' even though they are paid for in the current accounting period. Similarly, expenses of the current year, for which payment has not yet been made as 'outstanding expenses', are charged to the Income and Expenditure account for the current accounting period.

Recognition of Assets

An asset should be recognised in the Balance Sheet when and only when:

- (i) it is probable that the future economic benefits embodied in the asset will be received; and
- (ii) the asset possesses a cost or value that can be measured reliably.

Assets can be classified into various categories depending on their nature and life such as fixed assets; intangible assets; investments – both current and long-term; and current assets – inventories, loans and advances, cash and bank balances.

Recognition of Liabilities

A liability should be recognised in the balance sheet when and only when:

- (i) it is probable that any future sacrifice of economic benefits will be required; and
- (ii) the amount of the liability can be measured reliably.

Contingent liabilities:

Terms 'contingent liability' is defined as below:

"A contingent liability is:

- (a) a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or***
- (b) a present obligation that arises from past events but is not recognised because:***
 - (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or***
 - (ii) a reliable estimate of the amount of the obligation cannot be made."***

"Possible obligation – an obligation is a possible obligation if, based on the evidence available, its existence at the balance sheet date is considered not probable."

A Political Party should not recognise a contingent liability on the face of financial statements, but it should make the following disclosures, for each class of contingent liability, in the notes to financial statements, unless the possibility of any outflow in settlement is remote:

- (i) a brief description of the nature of the contingent liability;
- (ii) an estimate of its financial effect;
- (iii) an indication of the uncertainties relating to any outflow; and
- (iv) the possibility of any reimbursement.

Where any of the information required in the paragraph above is not disclosed because it is not practicable to do so, that fact should be stated.

(c) Principles of *measurement* of items of Income, Expenses, Assets and Liabilities

These principles lay down at what amount the aforesaid items should be recognised in the financial statements. Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the balance sheet and statement of Income and Expenditure. This involves the selection of the particular basis of measurement. Ordinarily, the same principles of measurement would be applicable in case of Political Parties as those for business enterprises. A number of different measurement bases are employed to different degrees and in varying combinations in financial statements such as historical cost, current cost, realisable (settlement) value and present value depending on the nature of the asset.

(d) Presentation and disclosure principles

These principles lay down the manner in which the financial statements are to be presented by Political Parties and the disclosures to be made therein. Insofar as presentation of financial statements is concerned, the principles in case of Political Parties may differ from those applicable to other entities. Similarly, there may be some specific disclosures which the Political Parties may be required to disclose.

6. Accounting Standards and their Applicability to Political Parties

Accounting is often said to be a social science. It operates in an open and ever-changing economic environment. The nature of transactions entered into by various entities and the circumstances surrounding such transactions differ widely. This characteristic of accounting measurements historically led to the adoption of different accounting practices by different entities for dealing with similar transactions or situations.

Recognising the need for bringing about a greater degree of uniformity in accounting measurements, the trend all over the world now is towards

formulation of Accounting Standards to be adopted in preparation of accounting information and its presentation in financial statements. Accounting Standards lay down the rules for recognition, measurement, disclosures and presentation of accounting information by different entities.

In India, the task of formulating Accounting Standards has been taken up by the Institute of Chartered Accountants of India (ICAI). The Accounting Standards issued by the Institute of Chartered Accountants of India are applicable to Commercial, Industrial and Business enterprises.

Political Parties fall under non-commercial, non-industrial or non-business entities, hence Accounting Standards are usually not applicable to these entities.

‘*Preface to the Statements of Accounting Standards*’ issued by the ICAI has, however, clarified that even if a small portion of a charitable organisation is considered to be commercial, industrial or business in nature, then it cannot claim exemption from application of Accounting Standards. In that case Accounting Standards should apply to the entity as a whole and not only to commercial, industrial or business transactions.

The Preface states the following:

“3.3 Accounting Standards are designed to apply to the general purpose financial statements and other financial reporting, which are subject to the attest function of the members of the ICAI. Accounting Standards apply in respect of any entity (whether organised in corporate, co-operative or other forms) engaged in commercial, industrial or business activities, irrespective of whether it is profit oriented or it is established for charitable or religious purposes. Accounting Standards will not, however, apply to entities only carrying on the activities which are not of commercial, industrial or business nature, (e.g., an activity of collecting donations and giving them to flood affected people). Exclusion of an entity from the applicability of the Accounting Standards would be permissible only if no part of the activity of such entity is commercial, industrial or business in nature. Even if a very small proportion of the activities of an entity is considered to be commercial, industrial or business in nature, the Accounting Standards would apply to all its activities including those which are not commercial, industrial or business in nature.”

Since the wholesome principles contained in the Accounting Standards provide

most appropriate guidance even in case of those organisations to which Accounting Standards do not apply, it is recommended that Political Parties, irrespective of the fact that no part of the activities is commercial, industrial or business in nature that all Political Parties should follow Accounting Standards(See Appendix I). These Accounting Standards would help Political Parties to maintain uniformity in presentation of financial statements, proper disclosure and transparency. However, while applying the Accounting Standards, certain terms used and content/context in the Accounting Standards may need to be modified for Political Parties. For instance, where an Accounting Standard refers to the term 'Statement of Profit and Loss', in the context of Political Parties, the term 'Income and Expenditure account' should be used.

7. Books of Account to be Maintained by Political Parties

The Political Parties should maintain the following books of account –

1. Cash Book/Bank Book
2. Journal Book
3. Ledger

Books of account should be maintained like any other commercial organisation following the rules of Double Entry Book Keeping System and generally accepted accounting practices prevailing in India.

Political Parties with reference to specific requirements may also other books of account e.g. Receipt Book, Purchase Book, Inventory Register and Voucher files etc. as deemed necessary.

Every Political Party should maintain proper books of account with respect to:

- (i) all sums of monies received by the Political Party and the matters in respect of which receipts take place, showing distinctly the amounts received from income generating activities and through grants/donations/contribution;
- (ii) all sums of money expended by the Political Party and the matters in respect of which expenditure takes place;

- (iii) all assets and liabilities of the Political Party .

Proper books of account would not be deemed to be kept with respect to the matters specified therein:

- (i) if such books are not kept as are necessary to give a true and fair view of the state of affairs, income and expenditure and cash flows of the Political Party, and to explain its transactions;
- (ii) if such books are not kept on accrual basis and according to the double entry system of accounting.

8. Formats of Financial Statements under Accrual Basis of Accounting

It is suggested that the following statements should form part of General Purpose Financial Statements of a Political Party:

1. Balance Sheet
2. Income and Expenditure Account
3. Cash Flow Statement
4. Notes forming part of financial statements.

An integrated Balance Sheet for the Political Party as a whole should be presented. In the Balance Sheet, assets and liabilities should not be set-off against each other, even though these may be related to the same programme/project. Rather these should be disclosed separately. Balances of various funds should be distinctly disclosed in the Balance Sheet.

In the preparation and presentation of financial statements, the overall consideration should be that they give a true and fair view of the state of affairs of the Political Party and of the surplus or deficit as reflected in the Balance Sheet and the Income and Expenditure Account, respectively. The financial statements should disclose every material transaction, including transactions of an exceptional and extraordinary nature. The financial statements should be prepared in conformity with relevant statutory requirements, accounting standards and other recognised accounting principles and practices.

For use by Political Parties, for which the governing statute does not prescribe any formats, the formats of financial statements are given in the *Appendix II*. The formats should be viewed as the minimum rather than the maximum information that Political Parties should present in their financial statements. Those Political Parties who wish to present more detailed information are encouraged to do so.

9. Auditing Framework for Political Parties

The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework. An audit conducted in accordance with the Standards on Auditing (SAs) and relevant ethical requirements enables the auditor to form that opinion. The auditor's opinion on the financial statements deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Such an opinion is common to all audits of financial statements.

In some cases, however, the applicable laws and regulations may require auditors to provide opinions on other specific matters, such as the effectiveness of internal control, or the consistency of a separate management report with the financial statements. While the SAs include requirements and guidance in relation to such matters to the extent that they are relevant to forming an opinion on the financial statements, the auditor would be required to undertake further work if the auditor had additional responsibilities to provide such opinions.

In conducting an audit of financial statements, the overall objectives of the auditor are:

- (i) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and

- (ii) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.

Ordinarily, the basic flow of an audit of financial statements, conducted in accordance with the Standards on Audit, issued by the Institute of Chartered Accountants of India, would be as follows:

Stage 1: Client acceptance/retention procedures

Stage 2: Agreeing the Terms of engagement

Stage 3: Audit Planning

Stage 4: Performing risk assessment procedures

Stage 5: Assessing risk of material misstatements

Stage 6: Responding to assessed risks

Stage 7: Performing further audit procedures

Stage 8: Evaluating audit evidence obtained

Stage 9: Communication and Reporting

It must, however, be noted that aspects like audit documentation, audit planning and risk assessment are iterative and pervasive to any audit. Further, the Institute has issued 35 Standards covering the above mentioned stages of an audit. Since the subject matter of an audit are the financial statements themselves, it is, therefore, necessary to first crystallise the formats of the financial statements of a political party which would then be the starting point for an audit.

An illustrative format of Auditor's Report on the Financial Statements of a Political Party is given in *Appendix III*.

Appendix I

Applicability of Accounting Standards issued by the ICAI to Political Parties

Accounting Standards issued by the ICAI

AS No.	Title
1	Disclosure of Accounting Policies
2	Valuation of Inventories
3	Cash Flow Statement
4	Contingencies and Events occurring after the Balance Sheet Date
5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
6	Depreciation Accounting
7	Accounting for Construction Contracts
9	Revenue Recognition
10	Accounting for Fixed Assets
11	Accounting for the Effect of Changes in Foreign Exchange Rates
12	Accounting for Government Grants
13	Accounting for Investments
14	Accounting for Amalgamations
15	Accounting for Retirement Benefits in the Financial Statements of Employers
16	Borrowing Costs
17	Segment Reporting
18	Related Party Disclosures
19	Leases
20	Earnings Per Share
21	Consolidated Financial Statements

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AS No.	Title
22	Accounting for Taxes on Income
23	Accounting for Investment in Associates in Consolidated Financial Statements
24	Discontinuing Operations
25	Interim Financial Reporting
26	Intangible Assets
27	Financial Reporting of Interests in Joint Venture
28	Impairment of Assets
29	Provisions, Contingent Assets and Contingent liabilities
30	Financial Instruments: Recognition and Measurement
31	Financial Instruments: Presentation
32	Financial Instruments: Disclosure

It may be noted that, so far, the Institute of Chartered Accountants of India has formulated 32 Accounting Standards out of which one Standard [viz., Accounting Standard (AS) 8, *Accounting for Research and Development*] is no longer in force and three Standards [viz., Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*; Accounting Standard (AS) 31, *Financial Instruments: Presentation*; and Accounting Standard (AS) 32, *Financial Instruments: Disclosure*] are not yet mandatory even in case of commercial entities.

It may also be noted that the following Accounting Standards may not be relevant to Political Parties. However, it is suggested that Political Parties should follow such Accounting Standards to the extent relevant, keeping in view the activities carried out by them:

- (AS 7) Accounting for Construction Contracts
- (AS 14) Accounting for Amalgamations
- (AS 16) Borrowing Costs
- (AS 17) Segment Reporting
- (AS 20) Earnings Per Share

Compendium of Guidance Notes - Accounting

- (AS 21) Consolidated Financial Statements
- (AS 22) Accounting for Taxes on Income etc.
- (AS 23) Accounting for Investment in Associates in Consolidated Financial Statements
- (AS 24) Discontinuing Operations
- (AS 25) Interim Financial Reporting
- (AS 27) Financial Reporting of Interests in Joint Venture
- (AS 28) Impairment of Assets

It may also be noted that where an Accounting Standard on the subject matter relevant to Political Parties does not exist, the Political Parties may draw guidance from Accounting Standards for Local Bodies (ASLBs) issued by ICAI and in case of non existence of guidance even from ASLBs, the Political Parties may draw guidance from the corresponding International Public Sector Accounting Standards (IPSASs).

Appendix II**Formats of Financial Statements (Political Parties)**

NAME OF POLITICAL PARTY _____

BALANCE SHEET AS AT _____

(`)

SOURCES OF FUNDS	Schedule	Current Year	Previous Year
CORPUS FUND	1		
GENERAL FUND	2		
EARMARKED FUNDS	3		
RESERVES	4		
LOANS/BORROWINGS	5		
Secured			
Unsecured			
CURRENT LIABILITIES & PROVISIONS	6		
TOTAL			
APPLICATION OF FUNDS			
FIXED ASSETS	7		
Tangible Assets			
Intangible Assets			
Capital Work-in-progress			
INVESTMENTS	8		
Long Term			
Current Investments			
CURRENT ASSETS	9		
LOANS, ADVANCES & DEPOSITS	10		
TOTAL			
Significant Accounting Policies	20		
Notes on Accounts	21		

NAME OF POLITICAL PARTY _____

INCOME AND EXPENDITURE ACCOUNT FOR THE PERIOD/ YEAR ENDED _____

(`)

INCOME	Schedule	Current Year	Previous Year
FEE & SUBSCRIPTIONS	11		
GRANTS / DONATIONS/ CONTRIBUTIONS	12		
COLLECTION BY ISSUING COUPONS/SALE OF PUBLICATIONS	13		
OTHER INCOME	14		
TOTAL (A)			
EXPENDITURE			
ELECTION EXPENDITURE	15		
EMPLOYEE COSTS	16		
ADMINISTRATIVE AND GENERAL EXPENSES	17		
FINANCE COSTS	18		
DEPRECIATION & AMORTISATION EXPENSES			
OTHER EXPENSES	19		
TOTAL (B)			
Balance being excess of Income over Expenditure (A-B)			
Transfers to/from reserves			
Balance Being Surplus (Deficit) Carried to General Fund			
Significant Accounting Policies	20		
Notes on Accounts	21		

General Instructions

1. The financial statements of Political Parties (viz., Balance Sheet and Income and Expenditure Account) should be prepared on accrual basis.
2. A statement of all significant accounting policies adopted in the preparation and presentation of the Balance Sheet and the Income and Expenditure Account should be included in the Political Party's Financial Statements. Where any of the accounting policies is not in conformity with Accounting Standards, and the effect of departures from Accounting Standards is material, the particulars of the departure should be disclosed, together with the reasons therefore and also the financial effect thereof except where such effect is not ascertainable.
3. Accounting policies should be applied consistently from one financial year to the next. Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed. In case of a change in accounting policies which has a material effect in the current period, the amount by which any item in the financial statements is affected by such change, should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.
4. The accounting treatment and presentation in the financial statements should be governed by their substance and not merely by the legal form.
5. In determining the accounting treatment and manner of disclosure of an item in the financial statements, due consideration should be given to the materiality of the item.
6. Notes to the financial statements should contain the explanatory material pertaining to the items included therein.
7. If the information required to be given under any of the items or sub-items in these formats cannot be conveniently included in the Balance Sheet or the Income and Expenditure Account itself, as the case may be, it can be furnished in a separate schedule or schedules to be annexed to and forming part of the Balance Sheet or the Income and Expenditure account. This is recommended where items are numerous.

Compendium of Guidance Notes - Accounting

8. The schedules referred to above, accounting policies and explanatory notes should form an integral part of the financial statements.
9. The corresponding amounts for the immediately preceding financial year for all items shown in the Balance Sheet and the Income and Expenditure Account and Cash Flow Statement should also be given in the Balance Sheet or Income and Expenditure Account and Cash Flow Statement, as the case may be.
10. A cash flow statement may be annexed to the Balance Sheet, wherever applicable, showing cash flows during the period covered by the Income and Expenditure Account and during the corresponding previous period.
11. Disclosures as suggested in the formats are minimum requirements. A Political Party is encouraged to make additional disclosures.
12. The figures in the financial statements, if rounded off, should be rounded off as below:

Amount of Gross Revenue (in `)	Rounding off to (`)
Up to one crore	Actual in rupees
One Crore or more but less than one hundred crore	Lakh / Million
One hundred Crore or more	Crore / Billion

Schedules Forming Part of Accounts

NAME OF ENTITY _____

SCHEDULES FORMING PART OF BALANCE SHEET AS AT

SCHEDULE 1 – CORPUS FUND

- (a) Corpus Fund refers to funds contributed by founders/promoters/members of the Political Party.
- (b) The Opening Balances, Additions and the Closing Balance of the Corpus/Capital Fund should be shown under this head.

SCHEDULE 2 – GENERAL FUND

- (a) Donations/contributions from Companies, individuals/general public should be included under this fund.
- (b) This head should also include the funds contributed by the members of the party other than the members referred to in above schedule.
- (c) The balance, if any, in the income and expenditure account after appropriation, i.e., surplus/(deficit) is transferred to this fund.

SCHEDULE 3 – EARMARKED FUNDS

- (a) Designated/Earmarked funds are funds set aside by the Political Parties for specific purposes or to meet specific future commitments.
- (b) The following should be shown in respect of each of the designated fund:
 - (i) Balance at the beginning of the year
 - (ii) Additions during the year
 - (iii) Deductions during the year
 - (iv) Balance at the end of the year

Compendium of Guidance Notes - Accounting

- (c) Disclosures should be made under relevant heads based on self-imposed conditions/restrictions on the grants.
- (d) Assets, such as investments, and liabilities related to each designated fund should be disclosed separately.

SCHEDULE 4 – RESERVES

Following reserves may be created by a Political Party

- (a) Revaluation reserve is created to reflect effects of changing prices, fixed assets otherwise stated at historical costs, are revalued and the historical cost substituted by a revaluation, normally done by competent valuers. Such substitution resulting in an upward revaluation is required to be shown as a “Revaluation Reserve”.
- (b) Special reserves comprise the reserves required to be created pursuant to any statutory or regulatory requirement applicable to the entity.
- (c) General reserve is a reserve other than capital reserve and revaluation reserve.
- (d) Following particulars should be shown in respect of each reserve:
 - (i) Balance at the beginning of the year.
 - (ii) Additions during the year.
 - (iii) Deductions during the year.
 - (iv) Balance at the end of the year.

SCHEDULE 5 – LOANS/BORROWINGS

- (a) The head should be classified into funds borrowed from, Financial Institutions, banks or other institutions or agencies etc. and separately disclosed.
- (b) Borrowings should further be sub-classified as secured and unsecured and specified separately in each case. Secured loans

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and borrowings should be such as are against hypothecation/pledge/charge on asset on the entity. Unsecured loans and borrowings comprise amount in respect of which no asset of entity is charged as security or encumbered.

- (c) Terms of repayment of term loans and other loans should be stated.
- (d) Loans, if any, should also be classified on the basis of due date into the following categories:
 - (i) Loans repayable within 12 months
 - (ii) Loans repayable within 1 to 5 years
 - (iii) Loans repayable after 5 years
- (e) Interest free loans should be disclosed separately from interest bearing loans, interest accrued and due on loans should be included under appropriate sub-head.
- (f) Nature of security should be specified separately in each case.

SCHEDULE 6 – CURRENT LIABILITIES & PROVISIONS

- (a) Current Liabilities should be classified and disclosed separately as:
 - (i) Creditors
 - (ii) Statutory Liabilities
 - (iii) Interest accrued but not due on borrowings
 - (iv) Expenses Payable
 - (v) Other Current Liabilities (specify)
- (b) Provisions should be classified and disclosed as follows:
 - (i) For retirement benefits
 - (ii) Others (specify)

Compendium of Guidance Notes - Accounting

- (c) Where any item constitutes ten percent or more of the total current liabilities and provisions, the nature and amount of such items may be shown separately and may not be included under the head 'Others'

SCHEDULE 7 – FIXED ASSETS

Under this head, classification and disclosures should be as follows:

TANGIBLE ASSETS	
Land	Includes freehold land and leasehold land.
Buildings	Include office and other buildings, residential buildings, school and college buildings, hospital buildings, public buildings, temporary structures and sheds.
Plant and machinery	Includes air conditioners, generator sets, television sets, fire extinguishers, etc.
Vehicles	Include buses, lorries, vans, cars, scooters, etc.
Office equipments	Include such items as fax machines, photocopiers, EPABX, typewriters, duplicating machines, etc.
Computers/Peripherals	Include computers, printers and other peripherals like CDs, U.P.S & Software etc.
Furniture, fixtures and fittings, and electrical appliances	Furniture includes items such as cabinets, almirahs, tables, chairs and partitions include electrical fixtures and fittings such as fans, bulbs and tube lights and electrical appliances such as air-conditioners, water and air coolers, etc.
Library Books	In some cases the number of Library Books could be very large or there may be an established Library. In such cases these books may be disclosed as a separate category of assets. Library books will include books/journals/information stored in CD ROMs
CAPITAL WORK-IN-PROGRESS	Fixed assets in the course of construction should be shown against this head till they are ready

	for their intended use. Plant, machinery and equipment acquired and pending installation should be included here. Advances to suppliers/contractors on capital account should also be included.
INTANGIBLE ASSETS	Should be classified as computer software purchased, patents, trade marks etc. and should be specified separately.

- (a) Fixed assets are those assets which are held with the intention of being used for the purpose of producing or providing services and not held for sale in the normal course.
- (b) Under each head, the original cost, the additions thereto and deductions there from during the year, depreciation written off or provided during the year, and the total depreciation written off or provided up to the end of the year should be stated.
- (c) The cost of a fixed asset should be determined by adding to the purchase price any attributable costs of bringing it to its working condition for its intended use.
- (d) The cost of construction of a fixed asset should be determined by adding to the purchase price of the materials and consumables used, the costs incurred by the Political Party which are attributable to the construction of that asset.
- (e) Advance payments to contractors and suppliers should be classified as capital work-in-progress.
- (f) Separate disclosure under each of the above heads should be made in respect of donated assets (i.e., assets that have been received free of cost as non-monetary grant/at concessional value donation by the Political Party and assets financed under a lease agreement.
- (g) Fair values of all the donated fixed assets, existing on the Balance Sheet date, should be disclosed in the notes to accounts. If it is not practicable to determine the fair values of the assets on each

Compendium of Guidance Notes - Accounting

balance sheet date, then such values may be determined after a suitable interval, say, every three years. In such a case, date of determination of fair values should also be disclosed along with the fair values of assets.

- (h) Restrictions, if any, on the utilisation of each asset should also be disclosed in the notes to accounts.

SCHEDULE 8 – INVESTMENTS

- (a) The investments should be classified and disclosed under long term investments and current investments.
- (b) 'Current Investment' means an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made.
- (c) 'Long-term Investment' means an investment other than a current investment.
- (d) Both 'Long-term Investment' & 'Current Investment' should be classified and disclosed as follows:
 - (i) Investment made in Government Securities
 - (ii) Other approved Securities
 - (iii) Others (to specified)
- (e) Long-term investments should be measured at cost. The book value of long-term investments should be reduced to recognise a decline, other than temporary, in their value. Such reduction should be determined and made for each investment individually.
- (f) Aggregate amount of the Political Party's long-term quoted investments and also the market value thereof should be shown. Aggregate amount of the Political Party's unquoted investments should also be shown.

- (g) 'Quoted investment' for this purpose, means an investment in respect of which a quotation or permission to deal on a recognised stock exchange has been granted, and the expression 'unquoted investment' should be construed accordingly.
- (h) Current investments should be shown at the lower of cost and fair value, which should be determined either on an individual investment basis or by category of investment.
- (i) The significant restrictions on the right of ownership, realisability of investment should be disclosed by way of notes.

SCHEDULE 9 – CURRENT ASSETS

- (a) If the net realisable value of any current asset, except items held for distributing either free of cost or at a nominal amount, is lower than its book value, the amount to be included in respect of that asset should be the net realisable value.
- (b) The current assets should be classified and disclosed as follows:
 - (i) Inventories: Include items that are held in the normal course, or in the form of materials or supplies to be consumed.
 - Mode of valuation of the Inventories should be disclosed.
 - (ii) Receivables should be classified and disclosed as:
 - Grants/Donations/Contributions in respect of which, there is a reasonable assurance that (i) the entity will comply with the conditions attached, and (ii) the donation/grants will be received.
 - Others (specify)
 - Any debts due by the employees of the entity should be separately stated.

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- (iii) Balances with Banks & Post office should be shown as follows:
 - With Scheduled Banks
 - With Non-scheduled Banks
 - With Post Office
 - Particulars should be given of balances lying on current account, call accounts and deposit accounts should be given.
 - Bank deposits with more than 12 months maturity should be disclosed separately.
 - Where any deposit accounts are pledged or charged as security or are encumbered, the fact should be disclosed.
 - Overdue/matured deposits should be separately disclosed.
- (iv) Cash and Cash equivalents should be classified as cash on hand, cheques and drafts on hand, balance with banks and others (specify) and disclosed accordingly.
- (v) Other current assets should be classified and disclosed as follows:
 - 'Other current assets' is an all-inclusive heading, which incorporates current assets that do not fit into any other asset categories.
 - Interest accrued on investments should be included under this head.
 - Where any item constitutes ten percent or more of the total or more of the total current assets, the nature and amount of such items may be shown separately.

SCHEDULE 10 – LOANS, ADVANCES & DEPOSITS

- (a) These should be classified and disclosed as follows:
 - (i) Loans & advances to-
 - Staff (interest bearing and non-interest bearing should be shown separately)
 - Others (includes (i) other amounts recoverable in cash or kind for value to be received, and (ii) prepaid expenses)
 - (ii) Deposits (other than with bank) such as for telephone and electricity etc.
 - (iii) Others (specify)
- (b) Where any item constitutes ten percent or more of total loans, advances and deposits, the nature and amount of such item may be shown separately and the same may not be included under the head 'Others'.

Income and Expenditure Account

1. The Income and Expenditure Account should disclose every material feature and should be so made out as to clearly disclose the result of the working of the Political Party during the period covered by the account.
2. Donations and grants should be recognised only at a stage when there is a reasonable assurance that the Political Party will comply with the conditions attached, and the donations and grants will be received.
3. Any item under which income/expense exceed one percent of annual gross revenue of the Political Party or Rs. 50,000/- whichever is higher should be shown as a separate and distinct item against an appropriate account head in the Income and Expenditure Account. These items, therefore, should not be shown under the head miscellaneous and other income/expense.
4. Depreciation should be provided so as to charge the depreciable amount of a depreciable asset over its useful life. As the matter of guidance, Schedule XIV to the Companies Act, 1956, may be followed for rate(s) of depreciation.
5. A Political Party should disclose the following additional information by way of notes:
 - (a) Fair value and quantitative details of the services rendered by volunteers/members for which no payment has been made (wherever practicable).
 - (b) Net gain/loss on foreign currency transaction.
 - (c) Details of items of exceptional and extraordinary nature.
 - (d) Prior period items.

SCHEDULE 11 – FEES & SUBSCRIPTIONS

- (a) This should be classified and disclosed as follows:
 - (i) Entrance Fees

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- (ii) Annual Fees/Subscriptions from members
 - (iii) Subscriptions for Publications (if any)
 - (iv) Others (Specify)
- (b) In case the fees like entrance fee, subscriptions etc. are in the nature of capital receipts, such amount should be recognised to the Corpus Fund. Otherwise such fees will be incorporated in this schedule.

SCHEDULE 12 – GRANTS/DONATIONS/CONTRIBUTIONS

The grants/donations/contributions received should be classified and disclosed as follows:

- (a) Individual donors
- (b) Companies/Organisations
- (c) Institutions/Welfare Bodies
- (d) Others (Specify)

SCHEDULE 13 – COLLECTION FROM ISSUANCE OF COUPONS/ SALE OF PUBLICATIONS

Income under this head should be classified and disclosed as follows:

- (a) Revenue from issuance of Coupons of different denominations should be disclosed separately.
- (b) Revenue from sale of publications of the party (if any) should be disclosed.

SCHEDULE 14 – OTHER INCOME

Other incomes should be classified and disclosed as follows:

- (a) Interest earned on government securities, bonds & debentures, deposits with scheduled & non-scheduled banks, saving accounts and loans & advances given to employees or others etc.

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- (b) Income from investments in mutual funds etc.
- (c) Profit on sale of investments
- (d) Profit on sale of fixed assets
- (e) Rent received
- (f) Other miscellaneous income
- (g) Items of material amounts included in miscellaneous income should be separately disclosed.

SCHEDULE 15 – ELECTION EXPENDITURE

These should be classified and disclosed as follows:

- (a) Publicity expenses:
 - (i) Printed Material, like manifestos, pamphlets, posters, handbills, etc.
 - (ii) Electronic Media(including hiring time slots, etc., in TV channels)
 - (iii) Making & distribution of video films
 - (iv) Making & distribution of audio CDs
 - (v) Advertising in newspapers, magazines, souvenirs, etc.
 - (vi) Cut-out, hoarding banners, flags, arches, gates etc.
 - (vii) Others (specify)
- (b) Travel expenses of leaders & workers:
 - (i) Aircrafts/Helicopters
 - (ii) Others
- (c) Other expenses:

- (i) Boarding & lodging expenses
- (ii) Public Meetings
- (iii) Other Misc. (specify)

SCHEDULE 16 – EMPLOYEE COSTS

These should be classified and disclosed as follows:

- (a) Salaries and Wages
- (b) Allowances and Bonus
- (c) Contribution to Provident and other Funds
- (d) Employees Retirement and Terminal Benefits
- (e) Others (specify)

SCHEDULE 17 – ADMINISTRATIVE AND GENERAL EXPENSES

These should be classified and disclosed as follows:

- (a) Rents
- (b) Rates and taxes
- (c) Communication expenses
- (d) Printing & stationery
- (e) Electricity
- (f) Travelling & conveyance expenses
- (g) Insurance charges
- (h) Remuneration to auditors
- (i) Professional Charges

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- (j) Repair & Maintenance of Building, Furniture & Fixture, Plant & Machinery etc.
- (k) Others (specify)

SCHEDULE 18 – FINANCE COSTS

Finance cost should be classified and disclosed as follows:

- (a) Interest on fixed loans
- (b) Interest on other loans
- (c) Bank charges
- (d) Others (specify)

SCHEDULE 19 – OTHER EXPENSES

Other expenses should be classified as write-offs, provisions, miscellaneous expenses, loss on sale of investments and fixed assets etc. and disclosed as accordingly.

SCHEDULE 20 – SIGNIFICANT ACCOUNTING POLICIES

Political Parties should disclose their significant accounting policies and this disclosure should be made at one place.

Where a Political Party has followed a basis of accounting other than accrual, a disclosure in this regard should be made. An illustrative list of accounting policies that a Political Party could disclose is as follows:

- (a) The bases of recognition of major types of expenses and revenue
- (b) Accounting for income from and expenditure on specialised activities such as welfare programmes
- (c) Conversion or translation of foreign currency (in case of organisations receiving foreign funds)
- (d) Method(s) of depreciation

- (e) Valuation of inventories
- (f) Valuation of investments
- (g) Treatment of employee benefits
- (h) Valuation of fixed assets
- (i) Treatment of contingent liabilities

SCHEDULE 21 – NOTES ON ACCOUNTS

- (a) Significant contributions/donations/collection from issuance of coupons exceeding Rs. 5,00,000/- to any individual or any other party should be disclosed with names.
- (b) Donation received from outside India should be disclosed with names.
- (c) Penalties on electoral officers alongwith the material electoral officers should be disclosed.

Appendix III

Illustrative Format of Auditor's Report on the Financial Statements of a Political Party

Auditor's Report

To

The President/Chief (or equivalent),
Name of the Political Party

We have audited the attached Balance Sheet of (name of the Political Party), as at 31st March 2XXX, and also the Income and Expenditure Account and the Cash Flow Statement for the year ended on that date annexed thereto. These financial statements are the responsibility of the Political Party's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the auditing standards generally accepted in India. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statements presentation. We believe that our audit provides a reasonable basis for our opinion.

Further, we report that:

- (i) We have obtained all the information and explanations, which to the best of our knowledge and belief were necessary for the purposes of our audit;
- (ii) In our opinion, proper books of account have been kept by the Political Party so far as appears from our examination of those books (and proper returns adequate for the purposes of our audit have been received from the branches not visited by us);

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- (iii) The Balance Sheet, Income and Expenditure Account and Cash Flow Statement dealt with by this report are in agreement with the books of account.
- (iv) In our opinion and to the best of our information and according to the explanations given to us, the said accounts give a true and fair view in conformity with the accounting principles generally accepted in India:
 - a) in the case of the Balance Sheet, of the state of affairs of the Political Party as at 31st March 2XXX;
 - b) in the case of the Income and Expenditure Account, of the Surplus/Deficit year ended on that date; and
 - c) in the case of the Cash Flow Statement, of the cash flows for the year ended on that date.

For ABC & Co.
Chartered Accountants

Signatures
(Name of the Member Signing the Audit Report)
Membership Number

Place of Signature

Date

Appendix

Appendix I

LIST OF GUIDANCE NOTES ON ACCOUNTING IN FORCE AS ON JULY 1, 2012

Description	No.	Year of Issue
Guidance Note on Treatment of Reserve Created on Revaluation of Fixed Assets	GN(A)3	1982
Guidance Note on Terms Used in Financial Statements (<i>under revision</i>)	GN(A)5	1983
Guidance Note on Accrual Basis of Accounting (<i>under revision</i>)	GN(A)6	1988
Guidance Note on Accounting for Depreciation in Companies	GN(A)7	1989
Guidance Note on Some Important Issues Arising from the Amendments to Schedule XIV to the Companies Act, 1956	GN(A)8	1994
Guidance Note on Availability of Revaluation Reserve for Issue of Bonus Shares	GN(A)9	1994
Guidance Note on Accounting for Corporate Dividend Tax	GN(A)11	1997
Guidance Note on Accounting Treatment for Excise Duty	GN(A)12	Revised 2000
Guidance Note on Accounting by Dot-Com Companies (<i>under revision</i>)	GN(A)14	2001
Guidance Note on Accounting for Oil and Gas Producing Activities (<i>under revision</i>)	GN(A)15	2003
Guidance Note on Accounting for Employee Share-based Payments	GN(A)18	2005
Guidance Note on Accounting for State-level Value Added Tax	GN(A)19	2005
Guidance Note on Accounting for Fringe Benefits Tax	GN(A)20	2005

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Guidance Note on Accounting by Schools	GN(A)21	2005
Guidance Note on Accounting for Credit Available in Respect of Minimum Alternative Tax under the Income-tax Act, 1961	GN(A)22	2006
Guidance Note on Accounting for Real Estate	GN(A)23	Revised 2012
Guidance Note on Measurement of Income Tax Expense for Interim Financial Reporting in the Context of AS 25	GN(A)24	2006
Guidance Note on Accounting Treatment for MODVAT/CENVAT	GN(A)25	Revised 2000
Guidance Note on Applicability of Accounting Standard (AS) 20, Earnings Per Share (<i>corresponding to ASI 12</i>)	GN(A)26	2008
Guidance Note on Remuneration Paid to Key Management Personnel – Whether a Related Party Transaction (<i>corresponding to ASI 23</i>)	GN(A)27	2008
Guidance Note on Applicability of AS 25 to Interim Financial Results (<i>corresponding to ASI 27</i>)	GN(A)28	2008
Guidance Note on Turnover in case of Contractors (<i>corresponding to ASI 29</i>)	GN(A)29	2008
Guidance Note on Accounting for Rate Regulated Activities	GN(A)30	2012
Guidance Note on Accounting for Self-generated Certified Emissions Reductions(CERs)	GN(A)31	2012
Guidance Note on Accounting and Auditing of Political Parties	GN(A)32	2012

Appendix II

LIST OF GUIDANCE NOTES ON ACCOUNTING WITHDRAWN/ SUPERSEDED BY ACCOUNTING STANDARDS

*(With reference to the Compendium of Guidance Notes on Accounting
as on July 1, 2006)*

Description	No.	Year of Issue/ revision
Guidance Note on Mode of Valuation of Fixed Assets	GN(A)1	1976
Guidance Note on Guarantees & Counter-Guarantees Given by Companies	GN(A)2	1976
Guidance Note on Accounting for Changing Prices.	GN(A)4	1982
Guidance Note on Accounting for Leases	GN(A)10	1995
Guidance Note on Accounting for Investments in the Financial Statements of Mutual Funds	GN(A)13	2000
Guidance Note on Accounting for Securitisation	GN(A)16	2003
Guidance Note on Accounting for Equity Index and Equity Stock Futures and Options	GN(A)17	2003
Guidance Note on Treatment of Expenditure during Construction Period	***	1993