APPENDIX III

GN(A) 2 (Revised 1976)

Guarantees & Counter-Guarantees Given by Companies

1. INTRODUCTION

1.1 Companies are often required to furnish guarantees, warranties or indemnities (hereinafter collectively called guarantees) to parties. While normally these guarantees are furnished directly by the company, often they are furnished by other parties like banks, directors etc. on behalf of the company. In such cases, the company issues counter-guarantees to the persons who furnish the guarantee. As there appears to be considerable divergence of practice in the treatment given to guarantees in published accounts of companies, this Note is issued to offer guidance in this matter.

1.2 In a strictly legal sense, it is possible to distinguish between guarantees, warranties and indemnities. However, for the purposes of this Note this distinction is not important.

2. PRACTICES RELATING TO DISCLOSURE PRESENTLY FOLLOWED

The treatment of guarantees and counter-guarantees in published accounts generally follows one of the under mentioned methods:

(a) The guarantees and counter-guarantees are disclosed as a separate item on the balance sheet under the general heading of “Contingent Liabilities”.

(b) The guarantees and counter-guarantees are disclosed by way of a footnote, on the balance sheet but not under the general heading of “Contingent Liabilities”.

(c) The guarantees and counter-guarantees are not disclosed at all.

3. SUGGESTED METHOD OF DISCLOSURE

3.1 The method of disclosure would depend upon the nature of the guarantee. It is possible to group guarantees into the following classes:

(a) A guarantee furnished as security or cover for an existing liability which is already recorded in the books of account.

(b) A guarantee furnished as security or cover for a contingent liability.

(c) A guarantee furnished by way of security for the performance of certain obligations or by way of security to ensure the non-commission of certain statutory or other defaults.

(d) A guarantee furnished in respect of a matter for which no liability, actual or contingent existed prior to the issue of the guarantee.

(e) Other forms of guarantee.

3.2 Where a guarantee falls in category (a) of paragraph 3.1 above, it is not necessary to refer to the guarantee by way of a note, since the principal liability is already recorded and the guarantee does not create any further liability either actual or contingent. Where the guarantee is given by a party other than the company, to secure the liability of the company, a note may, if so desired, be made merely by way of information.

3.3 Where a guarantee falls in category (b) of paragraph 3.1 above, it would be more appropriate to disclose the contingent liability itself rather than the guarantee, not only because it is the former which requires disclosure under the provisions of the Companies Act but also because the guarantee may have been furnished for a possible aggregate sum not equal to or related to the estimated amount at the balance sheet date of the contingent liability required to be disclosed.

3.4 Guarantees which fall in category (c) of paragraph 3.1 above are often issued to public authorities who require guarantees to be furnished to them either by the Company itself or by its bankers in order to protect such authorities from any financial loss which they may suffer as a result of the non-performance of obligations or the commission of defaults by the Companies concerned. For example, an importer may be required to furnish a bond or guarantee to the Customs Authorities which would protect the latter in case the importer either fails to perform certain statutory obligations under the Customs Act and Regulations or commits any statutory defaults. Similarly, the Railway Authorities may require

a guarantee from Companies which wish to transport goods without prepayment of freight or which wish to avail of any other facilities offered by the Railways. In all such cases, there is no liability - either actual or contingent which requires to be disclosed, nor does the mere submission of a guarantee constitute a contingent liability. Where the guarantee is furnished as security against statutory defaults, there is no reason to believe that a Company will commit a statutory default or that it will fail to comply with its statutory obligations. In any case, this is a matter which is in the control of the Company itself and the commission of a statutory default by the Company in the future of its statutory obligations cannot be said to involve the existence of a contingent liability, even though in any such eventuality, the Company would be financially liable for penalty or damages. It should also be recognised that all Companies face a situation of this type and if disclosure is to be made at all, it should be made by all Companies and not merely by those which have furnished a guarantee against the financial liability which they may incur in the future by the commission of statutory defaults or by the non-observance of statutory requirements. If it is accepted that a situation of this type does not involve any actual or contingent liability, it must equally be accepted that there is no obligation to disclose the guarantees given by the Company in respect of its possible future obligations. The question which should be asked is whether any event had taken place at the balance sheet date – or even at the date the balance sheet is signed which has resulted in a liability. The mere possibility or chance of such an event taking place in the future would not involve any question of contingent liability on the balance sheet date. It is therefore suggested that no disclosure need be made – either of the possible future liability or of the guarantee which has been given in order to cover such possible future liability. It would not be appropriate in such cases to suggest that disclosure of the guarantee may be made by way of abundant caution or in order to provide additional information to the shareholders and others, because such disclosure, in fact, can be positively misleading, by conveying a false impression to the casual reader of the balance sheet as to existence of actual or contingent liabilities related to such guarantee.

3.5 Guarantees which fall in category (d) of paragraph 3.1 above are usually in respect of the obligations of parties other than the company. For example, a company may issue a guarantee to a bank in respect of a loan granted by the bank to the company's subsidiary. In this case the issue of the guarantee creates the contingent liability and disclosure becomes necessary. However, the amount of the contingent liability is not the full value of the guarantee but the amount of the loan outstanding at the balance sheet date. It is therefore suggested that the note regarding the contingent liability should disclose both the amount of the guarantee and the amount outstanding at the balance sheet date.

3.6 Where a guarantee does not fall within any of the categories (a) to (d) mentioned in paragraph 3.1 above, disclosure would be necessary only if the issuance of the guarantee has created a contingent liability which did not exist prior to the issue of the guarantee.

4. COUNTER-GUARANTEE

4.1 The principles governing the method of disclosure regarding counter-guarantees should be the same as applicable to guarantees. Counter-guarantees are furnished by a company to the banker or other third party who furnished the principal guarantee on behalf of the company. Obviously, if the principal guarantor is called upon to meet his guarantee obligation, he will proceed against the company in order to recover the amount which he has paid under his guarantee obligation. The only difference between a guarantee and a counter-guarantee in so far as the company is concerned, is that in the former case, the company is obligated on the guarantee to the person to whom it is furnished whereas in the latter case, it is obligated to the banker or other third party who has furnished the original guarantee.

4.2 Where tangible security has been provided to the principal guarantor, this fact should also be disclosed. This situation is frequently encountered in the cases of borrowings from financial institutions, where one institution, after obtaining tangible security, guarantees, on behalf of the borrower, the loans given by another institution. In such cases the classification of the loan has led to much divergence in practice, some companies classifying it as an unsecured loan (as the security is not provided to the lender), and other companies classifying it as a secured loan (as the assets of the company are encumbered). On a strict legal view of the matter, in such cases, the loan is unsecured, but considering the overriding requirement that the accounts should provide a true and fair view of the financial position, the recommended procedure is to classify it as a secured loan, (making it clear that the security is given to the guarantor and not the lender).

4.3 An exception to the rule stated in paragraph 4.1 above would arise in a case where persons connected with the company- e.g. managers, directors, etc. furnished guarantees in respect of the company's obligations and disclosure thereof is required under the provisions of the Companies Act. If any commission is paid to such persons for the issue of the guarantee, the requirements of the Companies Act will have to be observed both with regard to the method of disclosure as also regarding the validity of the payment.

5. GUARANTEES GIVEN BY A COMPANY ON BEHALF OF OTHERS

The foregoing remarks apply either where a company has given a guarantee on its own behalf or where third parties have given a guarantee on behalf of the company and the company has given a counter-guarantee or counter-indemnity to such third parties. Where, however, a company has itself given a guarantee on behalf of third parties, it would certainly be necessary to disclose the same as a contingent liability. Moreover, if such guarantee has been given on behalf of persons concerned with the management of the company – for example directors or managing agents – a further disclosure of this fact would also be required.

6. DISCLOSURE OF GUARANTEES IN THE ACCOUNTS OF A COMPANY RECEIVING A GUARANTEE

A question of disclosure would also arise in the case of a company which receives a guarantee from a debtor or from person to whom a loan has been advanced or from whom money or other obligation is owing to the company, or who is obligated to the company for the performance of services or otherwise. In all such cases, no disclosure of the guarantee is required unless the guarantee is supported by tangible security in which case the classification of the debt, loan, or advance, as the case may be would be "secured" to the extent of the value of the security.

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 in written up in the books of account of a company on revaluation, a corresponding credit is given to the Revaluation Reserve. Such reserve represents the difference between the estimated present market values and the book values of the fixed assets. When such reserve is created, a question arises about its nature and the manner in which it can be utilised. This guidance note deals with accounting treatment of the reserve created on revaluation of fixed assets (herein referred to as "Revaluation Reserve").

2. Part I of Schedule VI to the Companies Act, 1956 provide that every company shall classify its fixed assets under convenient heads and show under each head the original cost, additions/deductions and the total depreciation provided upto the end of each accounting period. When a company revalues its fixed assets, it is necessary for the company to show

separately the date of revaluation and, for a period of five years thereafter, the amount of increase made.

3. When a company revalues its fixed assets, depreciation should be provided on the basis of the revalued figures.

4. A view has been expressed in some quarters that, for measurement of profits, revenue is deemed to have arisen when it is actually collected or when a justifiable claim to collect it arises (e.g. credit sale) or when there is knowledge and evidence that it is capable of being collected if a sale were to be made (i.e. prevailing market price). According to this view, this principle will apply equally to current and fixed assets and, therefore, when fixed assets are written up to their present value, the corresponding Revaluation Reserve cannot be considered as an unrealised reserve. It is, therefore, argued that past accumulated losses as well as depreciation for the year or arrears of depreciation for earlier years which are required to be provided under Section 205 of the Companies Act can be written off or adjusted against such Revaluation Reserve.

5. There is a contrary view that such Revaluation Reserve is created as a result of a book adjustment only and, therefore, such a reserve is an unrealized reserve which is not available for distribution as dividends. When accounts are prepared on the basis of historical cost, measurement of profits can be made by comparing the cost of the assets at the beginning and at the end of the *Treatment of Reserve Created on Revaluation of Fixed Assets 11*accounting period. As such there is no justification for taking credit for unrealised gains because the increase in market value may be due to various extraneous factors such as fall in the purchasing power of currency or other factors not related to the operations of the company. So far as fixed assets are concerned, these are held for the use in the business and not for sale in the normal course of business. In the circumstance, the difference between the market value and the book value does not represent realised gain and cannot be treated as such in the books of account.

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

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

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

This proviso makes it clear that it is necessary to provide for arrears of depreciation of earlier years, if any dividend is to be declared out of profits of any subsequent year. For this purpose depreciation (or arrears of depreciation) is to be provided out of the profits of the company. Indeed, a reference to Part II of Schedule VI to the Companies Act indicates that the Profit and

Loss Account is to be so made as clearly to disclose the result of working of the company during the period covered by the account.

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

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

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

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

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

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

Treatment of Reserve Created on Revaluation of Fixed Assets

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

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Guidance Note on Accounting for Changing Prices

INTRODUCTION

The following is the text of the Guidance Note "Accounting for Changing Prices" issued by the Research Committee of the Institute of Chartered Accountants of India for the information and guidance of members.

1. The subject of treatment of changing prices in financial statements, popularly known as inflation accounting has assumed considerable importance in the last few decades. The persistent inflation during this period has lent urgency to the need for preparing accounting statements which reflect the effects of inflation upon an enterprise. Recognising the importance of this subject the Research Committee of the Institute of Chartered Accountants of India is bringing out this Guidance Note for the benefit of members.

2. The Research Committee wishes to acknowledge that in the preparation of this paper it has drawn heavily on the various publications on the subject by various international professional bodies and more particularly those by the Accounting Standards Committee in the U.K. The Committee recognises that a great deal of research and experimentation on the subject has already been conducted by various professional institutes, accountants and academicians and the Committee has taken these into account in framing this Guidance Note. The main objective of this Guidance Note is to encourage the adoption of accounting for changing prices, and to suggest a methodology relevant in the prevailing economic environment in India.

NEED FOR ACCOUNTING FOR CHANGING PRICES

3. The primary purpose of the financial statements of an enterprise is to present information showing from where the funds have been raised, how they have been utilised and the extent to which such utilisation has resulted in profits or losses during a period. A balance sheet shows in monetary terms the capital, the reserves, loans and other liabilities of a business as on the date at which it is prepared and how the total funds so raised have been distributed over the several types of assets. The profit and loss account on the other hand is a statement showing the way in which profits (losses) have been earned (incurred) during a period. It must

be recognised that the transactions appearing in both the balance sheet and the profit and loss account are recorded in the books of account in monetary amounts which reflect their historical costs. The historical costs basis of accounting reduces to a minimum the extent to which the accounts may be affected by the personal judgement of those responsible for their preparation.

Another advantage of historical cost-based accounts is that the transactions relating thereto are capable of being easily verified by reference to the relevant documentary and other evidence.

4. In an economic environment where prices are constantly rising, as has been the case in our country at least in the last four decades of this century, certain inherent limitations of historical cost-based accounting become apparent.

Firstly, the monetary unit (rupee in our country) which is used as a standard of measurement itself shrinks in value as the prices rise. The historical cost-based accounting ignores this shrinkage in the value of a rupee as a measuring rod and keeps adding transactions which are represented by rupees of differing value over a period of time.

5. Another major problem with historical cost-based accounting is that in periods of inflation it results in substantial diminution in the operating capital and therefore in the operating capability by showing what many have termed as ‘exaggerated and illusory figures’ of profits*. This loss of operating capital arises due to the fact that historical cost-based accounting does not match current revenues with the current costs of operations. For example, the depreciation charge under conventional accounting is based on historical cost of fixed assets. During an inflationary period, the historical cost-based depreciation charge is not adequate to maintain the operating capability of the enterprise.

6. Another factor which contributes to the loss of operating capability is that in historical cost-based accounting, the cost of good sold charged to the profit and loss account is understated. This is because the inventories consumed are valued at their historical costs and not at their current prices. This results in over-statement of profits.

7. It is clear from the above that historical cost-based accounts do not take cognizance of the fact that in an inflationary situation the charging of the historical costs of operations to the profit and loss account may endanger the maintenance of the operating capital of an enterprise besides giving a misleading indication of its profit or loss.

8. Another drawback of the historical cost-based accounting is that by showing assets at their historical costs, the balance sheet does not reflect the current worth of the enterprise.

* In this Guidance Note, the entire discussion is with reference to inflation, which at present is almost a world-wide phenomenon. In deflation, the situation is just the reverse and the accounting may be carried on accordingly.

METHODS OF ACCOUNTING FOR CHANGING PRICES

9. Many proposals have been offered to reduce the limitations of the conventional system of accounting and to recognise the effects of changing prices on the financial statements. Though no consensus has yet been reached on a specific solution, the professional bodies in

various countries have issued a number of statements suggesting the use of different methods of accounting for changing prices. Noteworthy among them are FAS 33 (FASB, USA), SSAP 16 (ASC, U.K.) and IAS 15 (International Accounting Standards Committee). It would indeed be a major development in the building up of a coherent and logical structure of accounting if an objective and useful method of accounting for changing prices gains universal acceptance.

10. Out of the many proposals that have been put forward for accounting for changing prices the following three need specific consideration:

(i) Periodical revaluation of fixed assets along with the adoption of LIFO formula for inventory valuation.

(ii) The current purchasing power accounting method (CPPA)

(iii) The current cost accounting method (CCA)

Each of these methods is discussed in the subsequent paragraphs.

Periodical Revaluation of Fixed Assets along with the Adoption of

LIFO

11. Many enterprises have in periods of inflation been able to keep their operating capability more or less intact by revaluing their fixed assets periodically and by simultaneously adopting the LIFO formula for stock valuation. The main objective of periodic revaluation of fixed assets is to charge by way of depreciation to the Profit and Loss Account an amount which reflects the current cost of replacement. Under this method, the enterprises estimate the replacement cost of the fixed assets at regular intervals of say 3 to 5 years and charge depreciation on the revalued amounts. The revaluation of assets is normally based on expert opinion or on certain specific price indices indicative of the replacement cost of the relevant fixed assets.

12. Many enterprises adopt LIFO (last in-first out) formula for assigning costs between the cost of goods sold and the closing stocks. In many countries like the USA, LIFO has been accepted as a valid basis for assigning costs for *Accounting for Changing Prices 19* the purposes of taxation. Under this method the latest purchase costs are assigned to the cost of goods sold and are therefore written off. The closing stocks on other hand are valued at the earlier costs.

13. Adoption of periodical revaluation along with LIFO is one of the practical approaches to the problem of maintenance of operating capability in a period of inflation. It seeks to maintain the operating capability of an enterprise at least with regard to the fixed assets and the inventories –undoubtedly the two most significant components of the operating capital of an undertaking. However, it must be mentioned that this approach is not a complete solution to the problem. Periodic revaluations tend to be somewhat adhoc in nature and lack the advantages incidental to a systematic and consistent basis. Moreover with the high inflation rates in the present day economies even regular revaluations, say every five years, may not serve the purpose of maintaining the operating capability of an enterprise. Similarly LIFO may in some situations result in the cost of goods sold being reflected at current costs but in many other situations the cost assigned on the basis of LIFO may still fall substantially short of the amount which should

be charged as the current cost of goods sold to maintain the operating capability of the enterprise as far as the inventories are concerned. In view of this, the approach has significance only till such time that a comprehensive and widely acceptable method of accounting for price changes is adopted.

Current Purchasing Power Accounting (CPPA)

14. This method seeks to restate the financial statements in terms of units of equal purchasing power and thus eliminates the effects of changes in the value of money itself. It has been stated earlier that money as a measuring rod is somewhat defective since its value (its command over goods and services in general) keeps on changing due to inflation or deflation. The current purchasing power accounting method overcomes this limitation of the conventional financial statement by restating them in terms of uniform rupees of current purchasing power. Thus the method is not strictly a proposal for a change from the historical cost-based accounting; it merely attempts to remove the distortions in the financial statements which arise due to changing value of rupee.

15. To convert the historical rupees into uniform rupees as at the date of the balance sheet an index portraying the changes in the general purchasing power of the rupee is required. Generally therefore the most broad based index of consumer goods prices or of prices in general is used. The historical cost figures are multiplied by a conversion factor which is the ratio of the index at the date of conversion and the index at the transaction date. Assume that an item of furniture was purchased on January 1, 1978 for Rs. 20,000/-. Its value in terms of rupees of current purchasing power as on December 31, 1980 can be ascertained by multiplying its historical cost by the index number as on December 31, 1980 and dividing the product by the index number as on January 1, 1978. If the general price index on the two dates was 243 and 189 respectively, the cost of the furniture in terms of rupees of December 31, 1980 would be Rs. 25,714 (i.e. Rs. 20,000 x 243/ 189).

Since it is practically very difficult to convert each figure in terms of the index number of the date of the transaction, it is assumed that all transactions take place evenly throughout the year.

16. In converting the historical rupees into rupees of uniform value as at the date of the balance sheet the current purchasing power accounting method makes a distinction between the monetary items and the non-monetary items.

Monetary items are those the amounts of which are fixed by contract or otherwise remain fixed irrespective of any change in the general level of prices.

Examples of monetary assets are cash, debtors, bills receivable, etc. Similarly, debentures, creditors, etc. are monetary liabilities. It is obvious that in a period of inflation, the holders of monetary liabilities gain since they repay the amounts due in rupees of lower purchasing power as compared to that at the time when the liabilities arose. Conversely, the holders of net monetary assets lose in a period of inflation. The current purchasing power accounting method therefore suggests the computation of the purchasing power gain or loss made by an enterprise on holding net monetary items.

17. A number of adjustments are required to be made to restate the conventional financial statements on the basis of current purchasing power.

The illustration at Appendix I shows the basic methodology adopted for the purpose of such restatement.

18. The main advantage of the current purchasing power accounting method, as already stated, is that it removes the shortcomings of money as a measuring rod during the period of price changes. As it uses uniform purchasing power as the measuring unit, it possesses the qualities of objectivity and comparability. Besides, it retains the historical cost accounts as the basic accounts and the price-level adjusted accounts are shown only on a supplementary basis. It is simple to apply and is not very expensive. However, the current purchasing power accounting method has lost considerable support in the recent years mainly because of the fact that the unit of measurement proposed by the method (general purchasing power) is not easily perceived by the users of financial statements. Everyone understands and perceives the monetary unit, but only very few understand a purchasing power unit. Besides, unlike a monetary unit, the purchasing power unit is not a physical object capable of being exchanged between parties to a transaction. Moreover, the method does not solve, except indirectly and incidentally, the problem of gradual depletion of operating capital of an enterprise in periods of inflation.

The balance sheet too, prepared on the CPPA basis, does not reflect the current worth of an enterprise.

Current Cost Accounting (CCA)

19. Current cost accounting or CCA, as it is popularly known, seeks to:

(a) state the assets and liabilities in the balance sheets at their current value, i.e., value as at the date of the balance sheet;

(b) measure the profit or loss after matching current costs with current revenues; and incidentally

(c) remove the distortions of summing up of rupees of different values.

20. CCA is based on the concept of "operating capability" which may be viewed as the amount of goods and services which an entity is capable of providing with its existing resources during a given period. It is argued that in order to maintain its operating capability, an entity should continuously remain in command of resources which form the basis of its activities. To this end, it is necessary to take into account the rising costs of assets consumed in generating the revenues. Current cost accounting by substituting the current cost of assets consumed in place of the corresponding historical costs, takes into account the changes in specific prices of assets as they affect the entity.

21. This method was originally proposed by the Sandilands Committee as Current Cost Accounting (CCA). After considerable debate, in 1980 the Accounting Standards Committee in the U.K. issued the Standard on the subject, i.e., SSAP 16.

The main features of the method are:

(i) Money is the unit of measurement.

(ii) Assets and liabilities are shown in the balance sheet at a valuation (discussed later in detail).

(iii) Operating profit is struck after charging the "value to the business" of assets consumed during the period. Three adjustments – depreciation, cost of sales and monetary working capital – are made to the historical cost profit to arrive at the current cost profit. A fourth adjustment known as gearing adjustment is made to arrive at the current cost profit attributable to the shareholders (discussed later in detail).

Methodology of CCA

22. *Fixed Assets* : The fixed assets should be shown in the balance sheet at their "value to the business". The value to the business of an asset is the amount which the business would lose if it were deprived of that asset. The concepts of gross and net current replacement cost are important in this context.

The gross current replacement cost of an existing asset is the cost that would have to be incurred at the date of the valuation to obtain and install a substantially identical asset in new condition. For example, if an equipment purchased on 1.1.1978 for Rs. 80,000 can be purchased on 31.12.1980 for Rs.1,00,000 its gross current replacement cost on 31.12.1980 is Rs. 1,00,000.

The net current replacement cost of an existing asset refers to that part of the gross current replacement cost which represents its unexpired service potential.

For example, suppose that the equipment in the above example is estimated to have an economic life of five years. Since it has already been used for three years, its net current replacement cost would be Rs. 40,000 (assuming that the equipment will have a zero scrap value at the end of its economic life).

23. *Plant and Machinery*: The gross current replacement costs of items of plant and machinery and other fixed assets (except land and buildings) may be determined by applying the relevant indices to their gross book values. In U.K., the government statistical department regularly publishes indices for various categories of fixed assets and for different industries. In India, however, there is no such agency which publishes specific indices for fixed assets employed in various industries. However, the Bulletin of Wholesale Prices published every month by the Government of India contains details about the price changes of a number of capital assets. In case the use of specific indices is considered inappropriate or impracticable the gross current replacement cost may be determined on the basis of the expert opinion or by comparison with other assets or groups of assets having a similar service potential for which information may be available.

24. *Land and Buildings*: The land & buildings occupied by the owner himself should be shown in the balance sheet at their "value to the business" which will normally be the open market value for their existing use, plus estimated acquisition costs. However, in cases where an open market valuation of the land and buildings as whole cannot be made, the net replacement cost of the buildings and the open market value of land for its existing use plus

the estimated acquisition costs should be taken as their value to the business. The valuation should be made by professionally qualified valuers at periodic intervals.

25. *Inventories*: In the balance sheet the inventories should normally be shown at the lower of the current replacement cost as on the date of the balance sheet and the net realisable value.

26. *Current Cost Operating Profit*: The current cost operating profit should be ascertained by making the following three adjustments to the historical cost profit (before interest on net borrowings). Those adjustments represent the allowance for the impact of price changes on the funds required for maintaining the net operating assets.

(a) depreciation adjustment

(b) cost of sales adjustment

(c) monetary working capital adjustment

27. *Depreciation Adjustment*: The charge to the profit and loss account for depreciation should be equal to the value to the business of the fixed assets consumed during the period. When the fixed assets are valued on the basis of their net current replacement cost, which may increase during the year, the charge may be based on the average net current replacement cost for the period. The current depreciation charge is obtained by apportioning the average net current replacement cost over the expected remaining useful life of the fixed assets as at the beginning of the period. When the fixed assets are revalued every year, there will also be a shortfall of depreciation representing the effect of price rise during the current year on the accumulated depreciation till date. This shortfall is called backlog depreciation which is the amount needed to uplift the accumulated depreciation to a figure needed to cover the total depreciation provision based on replacement cost at the year-end. This backlog depreciation arising out of increase in current costs could be charged either to the general reserves or against the related revaluation surplus on the fixed assets. The former will ensure that the enterprise maintains its operating capital at the time of the replacement of fixed assets. The latter is the recommended procedure in the U.K. standard on the subject.

28. *Cost of Sales Adjustment*: The second adjustment is known as ‘cost of sales adjustments’ (COSA). This represents difference between the value to the business of the stock consumed during the period and its historical cost.

The value to the business of stock will generally be its replacement cost at the date of consumption. Theoretically, the current cost of sales should be determined on an item-by-item basis. In a real world situation, however, it would be impragmatic to do so, and therefore, groups of similar items may be used instead. If a company has a fairly regular sales pattern and if prices have increased steadily during the period, the use of the average method of calculation of current cost of sales may be appropriate.

29. *Monetary Working Capital Adjustment*: The third adjustment called the ‘monetary working capital adjustment’ (MWCA) reflects the amount of additional (or reduced) finance needed for monetary working capital as a result of changes in the input prices of goods and services used and financed by the business. Monetary working capital (usually represented by the difference between the trade debtors and trade creditors) is an integral part of the net operating assets of

the business. In times of rising prices, a business needs more funds to finance monetary working capital. The adjustment reflects this additional need for funds.

30. *Gearing Adjustment*: It is argued that the profit as calculated above reflects the true amount of profit from operation (current cost operating profit) after maintaining the net operating capability of the entity. However, to the extent that the net operating assets are funded through borrowings, the impact of price changes made in arriving at current cost operation profit is not on the shareholders. This is because the repayment obligations in respect of borrowings are not affected by changing prices. It is therefore suggested that the current cost profit attributable to shareholders should be determined by taking into account the method of financing the net operating assets. The current cost profit attributable to shareholders reflects the surplus for the period after making allowance for the impact of price changes on the funds needed to maintain the shareholders' proportion of the net operating assets. To take note of the existence of borrowings in the capital structure, an adjustment known as 'gearing adjustment' is made.

31. A new reserve, the 'current cost reserve', is created to take the credits or charges relating to the revaluation of fixed assets and stock, as also those relating to the depreciation adjustment, the cost of sales adjustment, the monetary working capital adjustment, and the gearing adjustment.

32. *Price Indices in CCA*: Accounting for changing prices involves the use of certain price indices for the restatement of assets and for making adjustments to the historical cost profit and loss account. In the United Kingdom, the Government Statistical Service regularly publishes the relevant price indices. In India, database at such a large scale has not yet been developed. However, the Bulletin of wholesale prices published every month by the Government of India contains details about the price changes of a number of items.

33. The CCA method possesses the merit of closely approximating the impact of specific price changes on the business enterprise because it makes use of specific indices. As such, the method seeks to maintain the operating capability of the enterprise during inflation. The method is however, not free from weaknesses, the most important of which seems to be the element of subjectivity inherent in periodic valuations, specially in our country where specific indices are not generated by an authoritative external agency.

34. From the discussion above, it is clear that during a period of rising price, historical cost-based financial statements show inflated profits and that the taxation of such profits amounts to a levy on capital. Thus, there is a need for reform in our tax laws and practices which should take into account the impact of rising prices on the funds required for maintenance of the operating capability.

35. Appendix II shows an illustrative set of current cost accounts as adapted from the guidance notes issued by the Accounting Standards Committee in the U.K.

RECOMMENDATIONS

36. The rationale for an accounting technique to make necessary adjustments for changing prices, as also the main solutions, have been discussed above. The Committee's recommendations in this regard are contained in paragraphs 37 - 43.

37. The adoption of a system of accounting for changing prices would require a considerable amount of time, money and specialised skills. Also the various techniques are still in the process of development. However, in view of the importance of the subject, it is recommended that enterprises, particularly the large enterprises, may develop the necessary systems to prepare and present this information.

38. Out of the various methods of accounting for changing prices discussed above, the Current Cost Accounting method seems to be most appropriate in the context of the economic environment in India. The periodic revaluations of fixed assets and the adoption of LIFO formula for inventory valuation are partial responses to the problem of accounting for changing prices. Current Purchasing Power Accounting, though simple to apply, does not ensure the maintenance of the operating capability of an enterprise. Current Cost Accounting, on the other hand, is a rational and comprehensive system of accounting for changing prices as it considers the specific effect of changing prices on individual enterprises and thus ensures that profits are reported only after maintaining the operating capability. However, the introduction of a fullfledged system of Current Cost Accounting on a wide scale in India will inevitably take some time. During this transitional phase, periodic revaluations of fixed assets along with the adoption of LIFO formula for inventory valuation would reflect the impact of changing prices substantially in the case of manufacturing and trading enterprises.

39. Adequate data base has presently not been developed in India for accounting for changing prices. Therefore, every enterprise may have to select the price indices depending on its own circumstances. The detailed price indices published in its monthly bulletin by the Government of India can be adopted in a number of cases. There is no doubt that further steps will have to be taken for the timely publication of statistical information required by various industries for the implementation of accounting for changing prices.

40. Considering the importance of the information regarding the impact of changing prices it is recommended that while the primary financial statements should continue to be prepared and presented on the historical cost basis, supplementary information reflecting the effect of changing prices may also be provided in the financial statements on a voluntary basis, at least by large enterprises.

41. Since the presentation of statements adjusted for the impact of changing prices is voluntary, the enterprise may or may not get this information audited. However, the audit of such statements would enhance their credibility.

42. Apart from its utility in external reporting, accounting for changing prices may also provide useful information for internal management purposes. Accounting information system is designed primarily to provide relevant information to various levels of management with a view to assist in managerial decision- making, control and evaluation. However, in periods of rapid and violent fluctuations in prices, the information provided by historical cost-based accounting

system may need to be supplemented by information regarding the impact of changing prices. The areas in which such information may be of prime importance to management include investment decisions and allocation of resources, divisional and overall corporate performance evaluation, pricing policy, dividend policy etc.

43. In countries like the United Kingdom, there have been some reforms in the tax structure in the wake of introduction of accounting for changing prices. Though, the tax legislation in India at present does not give recognition to such an accounting system, even then accounting for changing prices would be useful for generating relevant information for internal and external decision making.

Note: *For the text of the appendices given in the Guidance Note, students are advised to refer the compendium of Guidance Notes- Accounting (as on July, 1 2006)*

GN(A) 6 (Issued 1988)

GUIDANCE NOTE ON ACCRUAL BASIS OF ACCOUNTING

1. INTRODUCTION

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

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

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

2. ACCRUAL BASIS OF ACCOUNTING

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

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

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

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

Accrual Basis of Accounting

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

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

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

(i) Revenue is recognised as it is earned.

(ii) Costs are matched either against revenues so recognised or against the relevant time period to determine periodic income, and

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

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

3. REVENUE RECOGNITION

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

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

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

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

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

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

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

(i) The seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of goods. Thus, when such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

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

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

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

(ii) royalties - charges for the use of such assets as know-how, patents, trade marks and copyrights;

(iii) dividends - rewards from the holding of investments in shares.

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

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

(ii) Royalties accrue in accordance with the terms of the relevant agreement and are usually recognised on that basis unless, having regard to the substance of the transactions, it is more appropriate to recognise revenue on some other systematic and rational basis.

(iii) Dividends from investments in shares accrue when the owner's right to receive payment is established.

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

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

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

4. RULES FOR EXPENSE RECOGNITION

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

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

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

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

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

(i) Identification with revenue transactions

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

(ii) Identification with a period of time

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

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

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

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

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

(a) it is probable that at the date of the financial statements events subsequent thereto will confirm that (after taking into account any related probable recovery) an asset has been impaired or a liability has been incurred as at that date, and

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

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

5. RECOGNITION OF ASSETS AND LIABILITIES

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

6. CONCEPT OF MATERIALITY

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

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

6.3 The accrual basis of accounting does not necessarily imply that detailed calculations are required to be made in respect of even the smallest and immaterial amounts of revenue and expenditure and 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:

  (i) in the case of the balance sheet, of the state of the company's affairs as at the end of its financial year; and

  (ii) in the case of the profit and loss account, of the profit or loss for its financial year.

APPENDIX

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

REVENUE RECOGNITION

1. Sale of Goods

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

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

(ii) Delivered subject to conditions

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

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

(b) on approval

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

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

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

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

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

(e) Cash on delivery sales

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

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

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

(iv) Special order and shipments i.e. where payment (or partialpayment) is received for goods not presently held in stock e.g. the stock is still to be manufactured or is to be

delivered directly to the customer from a third party

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

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

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

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

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

(vii) Subscriptions for publications

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

(viii) Installments sales

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

2. RENDERING OF SERVICES

(i) Installation fees

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

(ii) Advertising and Insurance Agency Commissions

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

(iii) Financial service commissions

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

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

(a) Whether the service has been provided "once and for all"or is on a "continuing" basis;

(b) the incidence of the costs relating to the service;

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

(iv) Admission fees

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

(v) Entrance and membership fees

Revenue recognition from these sources will depend on the nature of the services being provided. Entrance fee received is generally capitalized. If the membership fee permits only membership and all other services or products are paid for separately, or is 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 or being determined.

4. CONSTRUCTION CONTRACTS[*]

In accounting for construction contracts in financial statements either the percentage of completion method or the completed contract method[1] may be used. When a contractor uses a particular method of accounting for a contract, then the same method should be adopted for all other contracts which meet similar criteria.

LIABILITY FOR EXPENDITURE

Gratuity

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

Guidance Note on Treatment of Expenditure during Construction Period (under revision)

1. INTRODUCTION AND GENERAL NATURE OF THE PROBLEM

1.1 A recent feature of the developing economy in India is the emergence of large capital projects which involve heavy capital investment. A characteristic of such projects is that they usually involve a fairly prolonged period of construction and, owing to the incidence of heavy initial costs and charges in respect of depreciation and other similar matters, the project involves a gestation period of several years before it is able to recoup its initial losses and initial depreciation charges and is able to earn profits commensurate with the investment in the project.

1.2 During the prolonged period of construction, the project has necessarily to incur various expenses which *prima facie,* are of a revenue nature. During the construction period, the project also incurs various expenses of the nature of preliminary expenses, as well as expenses which are associated with the corporate form assumed by the project, such as

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

expenses in connection with the issue of shares and debentures, and expenses in connection with maintaining the secretarial department and the share transfer department. These expenses are in addition to the preliminary project expenditure which would be incurred at a very early stage in the existence of the project and sometimes even before the project has been incorporated in the form of a company.

1.3 Since large capital projects are rarely financed out of shareholder's funds alone, it is usual to find that they incur financial expenses in the way of interest charges and commitment fees during the period of construction, in respect of funds borrowed for the purpose of construction.

1.4 At the same time, the project may also earn some interest and other income during its construction phase from the temporary investment of surplus funds or from other sources.

1.5 An accounting problem is posed by the various matters referred to above. The problem is not merely one of accounting for the income and expenditure which may arise during the construction period. There is also the problem involved in regard to the tax treatment of such income and expenditure during this period and in regard to the method of disclosing such income and expenditure in the financial statements of a company, prepared in accordance with the provisions of the Companies Act. Since there is a certain amount of confused thinking in regard to these matters, it is felt that members would appreciate some advice from the Council and it is possible that the issuance of a recommendation by the Council on this matter will help to achieve a certain degree of uniformity of accounting treatment. It is also hoped that the Government of India and authorities responsible for the Administration of the Companies Act and the Income-tax Act will be influenced by the Council's pronouncement in regard to the correct accounting treatment of income and expenditure during the period of construction.

1.6 Although large capital projects may assume any particular form of organisation, other than the corporate form, it is considered that, in large majority of cases, such projects would be formed as companies under the Companies Act. Consequently, this Note has been framed with special reference to the problems of large capital projects which are organised in the corporate form.

1.7 The expenditure other than direct capital expenditure which may be incurred by a new project during its construction or pre-production period, may be classified under the following different heads, each of which will be considered in later paragraphs of this Note.

(a) Preliminary expenses, formation expenses, expenses in connection with the issue of shares and debentures, expenses in connection with public document such as the prospectus etc.

(b) Preliminary project expenditure incurred in connection with the work of preparing the project report, conducting feasibility studies, preliminary financial studies, land surveys, location studies, etc., handling preliminary negotiations with foreign collaborators and with the Government for the purpose of arranging for industrial licences, etc.

(c) Financial expenses such as interest charges and commitment fees on loans, as well as expenditure incurred for preparing and issuing loan agreements and other documents including debentures, trust deeds in favour of lenders, mortgage and hypothecation deeds, etc.

(d) Indirect expenditure relating to the construction of the project comprising items of expenditure which would normally be regarded as of revenue nature, if incurred after the project commences commercial production.

(e) Other items of expenditure which would also normally be regarded as revenue expenditure if incurred after the project has commenced commercial production which are incurred during the construction stage, although they do not relate either directly or indirectly to the construction work itself.

(f) Corporate expenses, that is, expenses incurred by a company owing to its corporate status.

1.8 Two other problems are also considered in this Note. The first problem relates to the determination of the point of time at which a new project can be said to have concluded the construction stage of its activities and entered into the production stage. Usually, all expenses up to this point of time are capitalised whereas all expenses thereafter are treated as revenue expenses, unless they are directly of a capital nature. Consequently, the exact determination of this point of time is very important both from an accounting point of view as well as from a tax point of view. Another problem which is connected with this arises in a case where there is delay in the start-up or commissioning of the plant for active production after its construction has been physically completed. Such delay may occur due to several reasons many of which are usually beyond the control of the management. For example, electric or water supply may not be ready or there may be delay in the receipt of the first consignment of the raw materials required for the plant. Quite often, such a period of delay may extend to several weeks or even several months. During this period, various indirect expenses continue to be incurred since it would not be practical to discharge employees who have already been engaged, nor it would be possible to reduce the various fixed overhead expenses. The accounting and tax treatment of the expenses incurred during this period, is therefore, also a matter for serious consideration.

1.9 The other problem which is considered in this Note is the one which relates directly to the accounting treatment of indirect expenses incurred by an existing project during the period when it is engaged in a programme of substantial capital expansion. It is considered appropriate to deal with this problem in this Note because it is analogous, in many respects, to the problem relating to the indirect expenditure incurred by a new project during its construction period.

2. PRELIMINARY EXPENSES

These expenses would include formation expenses, expenses in connection with issue of shares and debentures, expenses in connection with public documents such as the prospectus, etc. The present practice is that such expenses are carried forward on the balance sheet and shown under the general group heading of "Miscellaneous Expenditure" except to the extent that they are written off to profit and loss account. There is no legal requirement to write-off these expenses to profit and loss account within any specified period of time nor is there any rigid accounting convention in regard to this matter. However, good corporate practice recognises the need to write-off these expenses to profit and loss account within a period of 3 to 5 years after commencement of commercial production, and this practice is usually followed by most well-managed companies even though, for Income tax purposes, preliminary expenses within prescribed limits can be amortized over ten years. It is recommended that no change is necessary in the existing practice in regard to these expenses, and the present practice may therefore continue both from an accounting point of view as well as from a tax point of view. However, members would be well advised to impress upon their clients that it is good corporate and financial practice to write-off these expenses within as short period as possible after commencement of commercial production and, in any case, it is advisable that this period should not exceed 3 to 5 years.

3. PRELIMINARY PROJECT EXPENDITURE

3.1 Under this classification would be included the expenditure incurred in connection with the work of preparing the project report, conducting feasibility studies, preliminary financial studies, land surveys, location studies, etc. as well as the expenditure involved in connection with preliminary negotiations with foreign collaborators and with the Government for the purpose of arranging for various industrial and other licences, etc.

3.2 The suggested accounting treatment of the foregoing types of expenditure is discussed below:

(a) The cost of preparing the project report as well as the cost of conducting feasibility studies, land surveys, location studies, etc. is definitely related to the overall cost of the project and can be regarded as an addition to the total construction cost of the project. It is therefore recommended that expenditure of this type may be capitalised as part of the total construction cost of the project. The position would be the same whether the expenditure is directly incurred by the company itself or is paid by the company either to its promoters or collaborators or to outside professional or other agencies. The apportionment of this cost as an addition to the cost of various capital assets etc., is considered in a later paragraph which deals generally with the problem of apportionment of indirect construction costs and indirect capital expenditures against the cost of individual assets.

(b) From a purely theoretical standpoint, it may be disputed whether it would be appropriate to accord the same treatment to the costs and expenditures incurred in connection with preliminary financial studies as well as in connection with preliminary negotiations with foreign collaborators and with the Government for the purpose of obtaining the various industrial and other licences. In practice, however, it should be recognised that these costs and expenses are also incurred directly in connection with the project and are definitely related to the project. Without incurring these expenses, it would not be possible for the project to be commissioned, far less completed. Also, in actual practice, it may be very difficult to segregate these expenses from the sum, total of the various indirect expenses incurred during the construction stage of the project and, even if segregated, it is unlikely that these expenses would represent a significant proportion of the total construction cost. It is therefore recommended that these expenses should also be capitalised as part of the total construction cost.

3.3 In a fast growing company, preparations for several projects will usually, be in hand at the same time. Some of the projects may not reach a successful stage. The cost of project reports, feasibility studies, preliminary financial studies, etc., relating to projects which prove infructuous, should not be added to the cost of successful projects but should be aggregated under a separate head and written off against revenue over a period of three to five years. The recommendation contained in paragraph 3.2 above, applies only to costs incurred in respect of projects which ultimately succeed.

4. FINANCIAL EXPENSES

4.1 These expenses would include interest charges and commitment fees on loans, as well as expenditure incurred for preparing and issuing loan agreements and other documents including debentures, trust deeds in favour of lenders, mortgage and hypothecation deeds, etc.

4.2 For the sake of a better understanding of the problem, it may be clarified that the expression "commitment fees" refers to the charges which are sometimes stipulated to be payable to the lenders between the date loan agreement is finalised and the date the loan or any part thereof is actually taken by the company. The full interest charges begin to accrue in favour of the lender only from the date the loan is actually taken, but, in the meantime, the lender is committed to keeping in readiness the funds which he has agreed to lend. For this service, the lender sometimes charges a commitment fee, which is at a rate much lower than the full interest charges and which is, quite often, based on the difference between the full interest charges on the loan and the interest which the lender can earn during the period before the loan is availed of by a temporary or short-term investment of funds.

4.3 There is no doubt that interest charges and commitment fees incurred after the date of commencement of commercial production should be treated as revenue expenditure in the normal way. However, during the period of construction, both these charges would represent indirect construction expenditure and should be added to the total capital cost of the project.

(This view has already been accepted by the Institute vide paragraph No.3.25 of the Statement on Auditing Practices). These remarks would apply with particular force in the case of loans which have been taken for the purpose of capital assets or for incurring capital expenditure. It is possible that the accounting treatment suggested in this paragraph may appear to be slightly controversial and unorthodox from a purely theoretical standpoint but, on practical considerations, the suggested treatment is probably fair and is also probably the most appropriate choice out of various alternatives, each of which is bound to be subject to some practical or theoretical objection. This view has not been accepted by the Supreme Court of India in the case of *Challapalli Sugars Ltd. V C.I. T. (1975) 98 ITR- 167 (S. C.).* With regard to interest charges and commitment fees on loans taken specially and exclusively for the purpose of providing working capital, the treatment suggested above may not be proper and, in this case, it will be more appropriate to transfer the interest charges and commitment fees during the period of construction to a separate account which is carried forward in the balance sheet under the group heading of "Miscellaneous Expenditure" until it is subsequently written-off to profit and loss account after the commencement of commercial production, over a period not exceeding 3 to 5 years.

4.4 It may be emphasised that the accounting treatment suggested in the foregoing paragraph would apply only to actual interest charges and commitment fees. It would not apply to any notional or imputed interest charges which are not actually incurred. For example, it would not be appropriate to compute the notional interest on the share capital during the period of construction and charge the same as an addition to the construction cost. The only exception to this would be in a case where interest is actually paid on share capital during the period of construction under section 208 of the Companies Act, 1956, in which case, as mentioned in that section, such interest charges can be capitalised as part of the construction cost or as part of the cost of the relevant plant and equipment.

4.5 Although it is stated in paragraph 4.3 that the interest charges on loans taken for the purpose of providing working capital cannot logically be treated as capital expenditure and added to the cost of fixed assets as an indirected charge relating thereto, these remarks would not apply to the case of a loan which is taken partly for the purpose of providing working capital and partly for the purpose of financing capital expenditure. In that case, the total amount of the loan should be reasonably apportioned between working capital and fixed capital expenditure, the interest during the construction period on the latter portion can be treated as indirect capital expenditure and added to the cost of the relevant fixed assets, in the same manner as is suggested in the early part of paragraph 4.3.

4.6 The costs and charges incurred for preparing and issuing loan agreements and other documents including debentures, trust deeds in favour of lenders, mortgage and hypothecation deeds, etc., are sometimes written off to profit and loss account, whereas in other cases, especially if the amount involved is heavy, the total amount is carried forward on the balance sheet as an item of "Miscellaneous Expenditure" and is written-off to revenue over a period of years. These alternative methods of accounting apply where such costs and charges are incurred after the commencement of commercial production. In the latter case, that is, where the total amount of such costs and charges are treated as deferred revenue expenditure, it is recommended that they should be written off to revenue as soon as possible and, in any case, over a period not exceeding 3 to 5 years. Where however such charges are incurred during the period of construction, it is suggested that they should be capitalised in the same manner as interest charges.

5. INDIRECT EXPENDITURE INCIDENTAL AND RELATED TO CONSTRUCTION

5.1 This paragraph deals with the bulk of the indirect expenditure which should be incurred by a project during its construction period, with the exception of the various other expenditures which are considered in separate paragraphs of this Note. A characteristic of this type of - expenditure is that, for a running concern it would be of a revenue nature. However, because the expenditure is incurred during the construction period and because, during that period, the expenditure is indirectly related to construction and is incidental thereto, it should be capitalised as part of the construction cost.

5.2 The following list of some of the possible items of expenditure which would qualify for inclusion under this heading is by no means exhaustive but is merely illustrative of the type of expenditures which are discussed in this paragraph:-

(a) Expenditure on employees who are either assigned to construction work or to supervision over construction work including salaries, provident fund and other benefits, staff welfare expenses etc.

(b) Expenditure on technical and other consultants.

(c) General administrative and office expenditure which is indirectly related or incidental to construction, including, as may be appropriate, stationery and printing, rent, rates and taxes, postage and telegrams, travel and conveyance etc.

(d) Appropriate insurance charges.

(e) Appropriate expenditures on maintenance and operation of vehicles.

(f) Appropriate expenditures in connection with temporary structures and service facilities built or acquired specially for the purpose of construction (see paragraphs 9.4 and 9.5 of this Note).

(g) Preliminary project expenditure to the extent to which it is capitalised as part of the construction cost (see paragraph 3 of this Note).

(h) Financial expenses including interest and other similar charges (see paragraph 4 of the Note).

(i) Depreciation on fixed assets as well as on temporary structure and other facilities; used during the period of construction (see paragraphs 9.4 and 9.5 of this Note).

(j) Expenses on test runs (see paragraph 11 of this Note).

(k) Expenses on land grading and levelling (see paragraph 9.6 of this Note).

5.3 In actual practice, it will be a matter for careful consideration whether a certain revenue type expenditure is to be included under the heading of indirect expenditure related and incidental to construction, or whether it would be more appropriate to treat it as an item of other indirect expenditure not related to construction and therefore not qualifying for ultimate inclusion in the total construction cost. Some indication of the principles to be applied is given in the discussion contained in this paragraph which relates to the indirect expenditure which can be capitalised as part of the indirect construction cost, as compared to the discussion in the immediately succeeding paragraph (paragraph 6) which deals with indirect expenditure which is not related to construction and which should not therefore be capitalised as part of the indirect construction cost. In actual practice, however, the dividing line will always be very thin.

6. OTHER INDIRECT EXPENDITURE NOT RELATED TO CONSTRUCTION

6.1 This heading refers to various items of indirect expenditure incurred by a project during its construction period, which are not related either directly or indirectly to the work of construction, but which are incurred mainly in preparation for the work which will be undertaken after the project commences commercial production.

6.2 Expenditure under this head would include expenses in connection with staff training programmes, as well as expenditure relating to the work of preparing for the production activities which are soon to commence. For example, the concern would naturally have to recruit and train its sales staff and its general office staff well in advance of the date of commercial production. It may also have to send a few selected trainees overseas, especially if there is a foreign collaborator involved in the project who has undertaken to provide such training abroad. Expenses will also be incurred in connection with the salaries of employees who are appointed ahead of the date of production but whose work involves no connection, direct or indirect, with the work of construction, for example, employees of the sales department, publicity and public relations departments, etc. The concern may also engage in advance publicity campaigns in the press and otherwise in order to popularise itself and its products, well in advance of the date it goes into production.

6.3 Indirect expenses of the type discussed in this paragraph cannot be regarded as part of the incidental cost of construction because as explained above, they are not related either directly or indirectly to the work of construction. At the same time, since these expenses are incurred during the pre production period, they cannot be written off to revenue. The only alternative, therefore, is to treat such expenses as deferred revenue expenditure to be carried forward on the balance sheet under the general heading of “Miscellaneous Expenditure”.

They should, however, be written off to revenue as soon as possible after the commencement of commercial production and, in no case, should the period of such write-off extend beyond a reasonable period of time say three to five years, depending upon circumstances.

7. CORPORATE EXPENSES

7.1 If a new project is constituted in the corporate form, it will incur certain expenses during its pre-production or construction period simply because it is constituted as a company.

7.2 Expenses of this type would include Directors' fees - especially their sitting fees or meeting fees and travelling expenses - expenditure of the secretarial department and the share registration department, charges paid to outside professional or other agencies entrusted with the work of handling share issues or share transfers, etc. Fees or other remuneration paid to whole-time, managing or technical directors would not be included under this head but would have to be considered as part of the indirect expenditure during construction which have already been discussed in paragraph 5 above.

7.3 Expenditure of this type has no connection with construction and cannot therefore be capitalised as an indirect cost of the construction. Since this expenditure cannot also be written off to revenue during the pre-production period it may be treated in the same manner as the other indirect expenditure discussed in paragraph 6 - namely, it may be treated initially as deferred revenue expenditure to be shown in the Balance Sheet under the group heading of "Miscellaneous Expenditure" and written off as soon as possible in the manner as is suggested above in paragraph 6.3 relating to other indirect expenditure.

8. INCOME DURING THE CONSTRUCTION OR PRE-CONSTRUCTION PERIOD

8.1 It is possible that a new project may earn some income from miscellaneous sources during its construction or pre-production period. Such income may be earned by way of interest from the temporary investment of surplus funds prior to their utilisation for capital or other expenditure or from sale of products manufactured during the period of test runs and experimental production. Such items of income should be disclosed separately either in the profit and loss account, where this account is prepared during construction period, or in the account/statement prepared in lieu of the profit and loss account, i.e., Development Account/Incidental Expenditure During Construction Period Account/Statement on Incidental Expenditure During Construction (Refer to para 14.7). The treatment of such incomes for arriving at the amount of expenditure to be capitalised / deferred, has been dealt with in para 15.2.

8.2 The question relating to tax liability on the income during the construction or pre-production period needs to be considered. Necessary provision for such liability should be made in the accounts.

9. CAPITAL EXPENDITURE DURING THE CONSTRUCTION OR PRE-PRODUCTION PERIOD

9.1 The expenditure during the construction or pre-production period which is directly of a capital nature can be further classified as follows:

(a) Advance payments to contractors for construction work.

(b) Construction work-in-progress

(c) Purchase or acquisition of fixed assets during the construction period.

(d) Cost of structure, facilities, etc. constructed or acquired during the construction period for use in the construction.

(e) Land, and expenditure on land.

In addition, there may be expenditure that goes waste e.g., when a machine gets heavily damaged and becomes useless.

Each of the foregoing classifications is considered in greater detail in the subsequent paragraphs.

9.2 (a) Sometimes, payments are made to contractors as advances from time to time or in accordance with the specific terms of the contract. This is particularly true in the case of construction contracts which are executed on the basis of a so-called "turn-key" agreement. However, in addition to 'turn-key" contracts, advance payments made to contractors may be a feature of other types of contracts as well. In all such cases, until the contract is completed and the constructed project handed over by the contractor, several payments are made to the contractor by way of advances to enable the contractor to meet his various financial commitments. In the books of account of the company making such payments, they should be treated as advance payments until the contract is completed, at which time the total of the advance payments made can be adjusted against the final contract price. Having regard to the nature and purpose of the advance, it would be preferable for a fair presentation to disclose it in the balance sheet as a separate item under the heading "Fixed Capital Expenditure" rather than under "Loans and Advances". Alternatively, if the Company prefers to classify the advances to contractors under the heading "Loans and Advances" this should be described clearly in such a manner so as to indicate that the advances are of a capital nature and represent advance payments to contractors for construction work. However, irrespective of the method which is adopted in classifying the advances on the balance sheet, they should not be segregated or classified against any specific "Fixed Assets" until the construction work is completed and the title to the property constructed or delivered by the contractor has passed to the purchaser. The same considerations would also apply where the construction work is sub-divided among a number of contractors the principal consideration being, to treat such payments as advances until the project under construction is completed and the property therein passes from the contractor to the company as the owner. In certain construction contracts, the total amount payable to the contractor or contractors is fixed, whereas in other types of arrangements, the total amount is determined by reference to calculations of the contractor's cost plus an agreed margin of profit, or other similar calculations. Where the total contract consideration is fixed lump sum, and the contract embraces the acquisition or construction of several units of plant and machinery, this should be apportioned on a reasonable basis amongst the various components. Such apportionment, however, is important and essential not only because it is necessary to record separately the value of the different units of fixed assets, but also because the rate of depreciation for each of those units would be different both from the tax point of view as well as from the point of view of corporate accounting. Wherever possible; this apportionment should be made on the basis of the data furnished by the contractor himself, failing which the apportionment would have to be made by the Board of Directors on any other reasonable basis which may be proper and appropriate in the circumstances. It is suggested that in cases where the apportionment is not made on the basis of the data furnished by the contractor himself, or on the basis of any other objective evidence, the financial statements should contain a note indicating briefly the manner in which the total consideration has been apportioned over the various units of fixed assets.

9.2 (b) Advance payments to contractors should be made with due regard to the normal considerations of internal control. When the terms of the contract are specific and explicit, the advance payments should naturally be made on the basis of the contract terms. Where the contract indicates that advance payments are to be made, but does not specify the amount and frequency of such payments, it is for the Company's directors to establish a suitable procedure in order to ensure that advance payments are not made recklessly, in excess of the progress of the work, thereby making it difficult for the company to retain ultimate control over the contractor. In most cases, a fair arrangement requires that advance payments may be made on the basis of work completed as determined under the joint certificate of the engineers from both sides after keeping a reasonable margin. However, this cannot be taken as a hard and fast rule and, within the normal limitations of internal control and contractual terms, each case should be considered on its own merits.

9.3 In complicated projects, the principal construction work relating to the plant and machinery is usually of a highly technical nature and, as such, it is usually assigned to a specialised contractor to whom advances are paid from time to time which are adjusted at the end of the construction in the manner suggested in the immediately preceding paragraph. In addition, in such cases, it is frequently found that the company itself undertakes directly the construction of the non-technical aspects of the project with such local outside help as may be necessary. For example, in a project involving the construction of a complicated chemical plant, the work of constructing the plant itself may be entrusted to specialised contractors with expert technical know-how in the subject. However, in addition to the construction of the chemical plant which needs specialised know-how, the project would also require the construction of employee housing, railway sidings, roads in the factory area, various utility and service facilities, etc., which the company may either construct on its own or whose construction may be entrusted by the company to various local contractors acting under the supervision of the company's own engineers. In such a case, the expenditure on the latter items of construction work should be shown in the accounts suitably classified under the general caption "Construction work-in-progress" or some other similar caption while the advances paid to the principal contractor for the construction of the chemical plant would continue to be treated in the manner as suggested in the preceding paragraph. Where local construction work of a subsidiary nature is carried out by the company in the manner indicated in this paragraph, it is necessary to recognise that the company may incur certain common expenses which would have to be suitably apportioned over the various units of the local construction work. For example, the company may engage the services of a firm of consulting engineers to supervise the local construction work in which case the fees and expenses paid to them may have to be apportioned suitably over the various items involved, such as employee housing, railway sidings, roads within the factory area, utility and service facilities, etc.

9.4 In addition to any local construction work of the nature mentioned in the preceding paragraph, it is almost inevitable that the company will purchase various items of fixed assets during its construction or pre-production period. The commonest example of such a purchase would be the purchase of automobiles, transport equipment, furniture and fixtures, and office equipment, etc. Such assets would be required from the very inception of the company even before the company enters its productive stage. It is extremely likely that all or some of the fixed assets purchased during the construction period may be actually or indirectly utilised in the work of construction, in which case the appropriate depreciation charges during the period in which they are utilised in the work of construction should be treated as part of the indirect construction expenditure and dealt with in the manner suggested in paragraph 5 of this Note which deals with the treatment of indirect expenditure during the construction. For example, earth moving equipment, tractors and heavy motorised equipment purchased during the period of construction may be utilised directly for the purpose of construction. To a lesser extent, motor cars and office equipment may also be utilised for the purpose of the construction work, though indirectly. If some equipment purchased during the period of construction has been utilised only partly for purposes of construction, a part of the depreciation thereon, on the basis of a suitable proportion, should be capitalised as an indirect expenditure incurred during the construction period. Therefore the total cost of the equipment purchased during the construction period less the depreciation charged during that period should be carried forward to the production period so that the accounts of the production period would begin with the depreciation value of such equipment, which would then be further depreciated in the normal way.

9.5 Where the work of construction is likely to be prolonged, it is inevitable that certain facilities would have to be acquired or constructed especially for the purpose of the construction. In some cases, these facilities can be used with suitable adjustments after the commencement of production, whereas in other cases, they would have to be scrapped or dismantled after completion of construction. For example, if the construction work has to be undertaken at a fairly remote place, it may be necessary to construct temporary housing for the workers who will be engaged on the construction work. In most cases, the housing which is constructed for this purpose will be of a temporary nature and would, in all probability, be much in excess of the company's requirements after it commences production. Similarly, it may be necessary to provide temporary water connections and electricity supply during the period of construction which are intended to be dismantled and disconnected after permanent arrangements are made for the company's water and electric power requirements. It may also be necessary to purchase or acquire equipment especially for the purpose of construction for example, earth-moving equipment, cranes, cement batching and mixing equipment, etc. It is suggested, that in such cases, the proper procedure would be initially to capitalise the cost of all such temporary facilities and equipment. Logically, depreciation should be charged on such facilities and equipment during the period of construction, but in actual practice this may not always be possible because of the difficulty involved in ascertaining the fair amount of such depreciation. Therefore, a more convenient method in practice would be initially to capitalise the full cost of such temporary facilities, services and equipment and thereafter to credit against this cost the residual or scrap value thereof at the end of the construction period. In those cases where the temporary facilities and equipment are sold or scrapped or are intended to be sold or scrapped at the end of the construction period, the value to be credited would be the actual or estimated sale value or scrap value. Where, however, the assets are intended to be taken over by the company for use in production at the end of the construction period, the value to be credited would have to be estimated on some reasonable basis. Thereafter, the initial cost of the temporary facilities and equipment less the value credited at the end of the construction period, should be treated as an element of the indirect cost of construction and dealt with accordingly in the manner suggested in paragraph 5 of this Note, dealing with the subject of indirect expenditure during construction. In effect, what this means is that the depreciation in the value of the temporary facilities and equipment used during the construction period would be charged to the cost of construction.

9.6 The expenditure on land would represent an element of cost common to all new capital projects large or small. The matter, however, is not entirely simple and therefore some elaboration is necessary. Obviously, any consideration paid directly for the purchase of land would have to be capitalised and accounted for separately as the cost of land. In a large number of cases, the land is not purchased outright but is acquired with the help of various Government agencies under the relevant laws relating to land acquisition, which aim at enabling essential industries to obtain land at a reasonable cost without the risk of being, in effect "black mailed" by a few landlords who refuse to sell their property, thereby defeating the purpose of acquiring other tracts of land adjacent to, or surrounding, that property. Where the land is acquired in this manner, the cost of acquisition would usually represent deposits paid to, or through, the relevant Collector or other Government agency. The amounts so paid may be shown in the balance sheet as cost of land, provided that, in appropriate circumstances, a suitable note is given indicating that the cost of land represents the value of deposits paid up to date for land acquisition purposes, which would be adjusted when the final value of land is determined and the title to land is transferred to the company. In addition to the actual cost of land, various expenses may be incurred in connection with the land which should also be capitalised. These expenses would include the following :

(a) Legal costs, stamp duties and fees, etc.

(b) Cost of measuring the land, investigating its title, etc.

(c) Cost of acquiring trees and other structures which stand on the land, even though they may not be of any ultimate use to the new project and may in fact have to be demolished in order to clear the land for construction.

(d) Expenditure on grading and levelling the land in order to make it fit for construction.

(e) Expenditure on land surveys.

As regards items (a) and (b), they would invariably have to be capitalised as part of the cost of land. As regards item (c), if any of the structures standing on the land have been, or can be, utilised for the purpose of the project, the estimated apportioned value of that structure should be capitalised separately from the value of the land, otherwise the total value paid for the land including that structure may be regarded as part of the cost of land. For example, if the total amount paid for a piece of land is, say, Rs. 10 lakhs, and the land so purchased has a warehouse standing on it, it would be necessary to determine whether or not the project intends to utilise that warehouse or whether it intends to demolish it before constructing on the land. In the latter case the total consideration of Rs. 10 lakhs would have to be treated as the cost of land. On the other hand, in the former case, a suitable estimate would have to be made of the value of the warehouse. Assuming such value to be Rs. 1 lakh, it would be appropriate to capitalise Rs. 9 lakhs as the cost of the land and separately capitalise Rs 1 lakhs as the value of the warehouse to be included under the caption of "Factory Buildings". As regards (d), i.e., the expenditure on levelling and grading the land it is submitted that this can be treated as an indirect cost of construction rather than as an additional cost relating to the land itself, having regard to the primary purpose for which this expenditure is incurred. Wherever possible, the expenditure on levelling, clearing and grading the land should be related with, and added to, the cost of the particular buildings or other structures which stand on each particular piece of land. Where this is not practicable, the total expenditure on levelling, clearing and grading the land may be apportioned among the different buildings and structures standing on the land in the ratio of the respective areas occupied by each such building or structure, or in any other suitable ratio. What is stated above in this context is not intended to imply that only that portion of the expenditure on levelling, clearing and grading the land can be capitalised, as an indirect cost of construction, which relates to the area of the land actually occupied by a building or other structure. It is recognised that, in practice, it may not be possible to occupy the entire land area by constructing a building or other structures thereon. If the entire land is reasonably occupied by buildings or other structures and if the expenditure on levelling, clearing and grading the land is reasonably incurred for the purpose of the construction, such expenditure can be treated entirely as an indirect cost of construction and capitalised as part of the cost of the buildings or other structures. However, any part of the expenditure on levelling, clearing and grading the land which is incurred for purposes of landscaping or for any other purposes, not connected with the construction of the project, should be treated as part of the cost of land. As regards (e) it is suggested that the expenditure on land surveys should be treated as part of the preliminary project expenditure and capitalised as an element of indirect construction cost in the manner discussed in paragraph 3 of this Note.

9.7 Reference has been made in the earlier paragraphs of this section to expenditure incurred on construction under agreements with contractors. There are a few specific matters and problems which may arise in connection with construction contracts and the expenditure incurred thereon which are considered below:

(a) It is possible that, in addition to constructing the plant or other structures, the contractors may also agree to render other services. For example: the contractors may agree to supply technical know-how, train the technicians of the purchasing company, and provide credit facilities to the purchasing company by way of deferred payment terms in connection with the purchase cost under the contract. In such cases, the value of the additional services rendered by the contractors should be separated from the cost of the construction and accounted for accordingly. This would present no problem if the contract itself stipulates a separate consideration for the construction as well as for each such specific service. However, if the contract consideration is not so specified, the lump sum consideration would then have to be apportioned between the construction cost and the value of each such specific service in some suitable manner which is appropriate in the circumstances of the case. The basis of such apportionment should preferably be indicated in a footnote to the financial statements. In the example given above, the consideration, if any, which is paid separately for the value of the technical know-how supplied by the contractors, would have to be accounted for, depending on the nature of the technical know-how which is supplied. If the technical know-how which is supplied by the contractors relates to the construction of the plant, it may be added to the value of the plant. The only question in that case would be the apportionment of the total consideration for such technical know-how among the different units of the plant which are constructed by utilising the know-how. Such apportionments can be made in any suitable manner. Wherever possible, in making the apportionment, regard should be had to any data which may be supplied by the contractors and which may indicate a suitable basis for apportionment. Failing any such data, the apportionment may be made on the basis of the value or cost of the different units which are constructed or on the basis of the approximate time spent by the contractors in designing the construction of each unit, or on any other suitable basis. Care should be taken, however, to ensure that no part of the value of the technical know-how relating to construction is apportioned to any unit of construction which has not involved the utilisation of such know-how. If, on the other hand, the technical know-how which is supplied relates to productive facilities and processes, the value would have to be treated initially as an item of deferred revenue expenditure to be amortised in suitable instalments after the commencement of production, preferably over a period not exceeding 3 to 5 years after the commencement of production. Any consideration paid separately to the contractors for training the technicians of the purchasing company would have to be treated also as deferred revenue expenditure in the manner suggested in paragraphs 6.2 and 6.3 of this Note. Any expenditure by way of interest charges on the credit facilities provided by the contractor would have to be treated in the manner suggested in paragraph 4 of this Note, which deals in some detail with the various items of financial expenses.

(b) In several contracts for construction, there is a stipulation which requires the purchasing company to pay separately the various reimbursable expenses of the contractor such as customs duty, clearing and forwarding charges, ocean freight, railway freight, etc. The payment of many of these charges would be made in composite amounts and it would be necessary to apportion such payments among the different units of construction - either on the basis of contract allocation wherever possible or, in the alternative, on some other suitable basis.

(c) The purchasing company would also often need to maintain an establishment at the port of entry in order to deal with clearing and forwarding matters and the cost of such establishment would similarly have to be apportioned over the various units of construction in some suitable manner.

(d) Another common charge requiring similar apportionment would be the fees payable to the overall consulting or supervising engineers, if any.

(e) Several construction contracts contain a price escalation clause which operates under different circumstances. If any circumstances have arisen under which this clause would operate, the additional amount under the price escalation clause which is paid or payable on the basis thereof, would have to be apportioned over the different units of construction - either on the basis of direct allocation or in any other suitable manner.

(f) Also, construction contracts - especially with foreign contractors - sometimes provide for payments to be made free of income tax or payments to be made in an amount which after deducting income tax, would leave a net residue with the (foreign) contractor of a stated amount. In such cases, care should be taken to ensure that the gross amount payable under the contract is apportioned over the various units which are constructed.

9.8 During the course of construction of a big project, some losses are bound to occur. To an extent the losses may be treated as normal and added to the cost of the project. For instance, a wall may have to be pulled down and rebuilt. The total cost then can be capitalised. However, to the extent the loss is avoidable and results from inefficiency, mischief or an accident it should not be treated as part of the cost of the project. The amount of such a loss should be segregated and written off when production commences, over a period of three to five years.

10. CAPITAL EXPENDITURE NOT REPRESENTED BY ASSETS

Sometimes, circumstances force a project to incur capital expenditure which is not represented by any specific or tangible assets. For example, a project may have to pay the cost of laying pipelines in order to facilitate the supply of its products or raw materials to or from a seaport, but the Port Trust or other similar authorities may insist that the pipelines belong to them even though the cost thereof is paid by the company. In other cases, a project may have to agree with a local authority to pay the cost or part of the cost of roads to be built by that authority in the vicinity of the project for the purpose of facilitating the business of the project. In this case also, the capital expenditure incurred by the project for this purpose would not be represented by any actual assets, since the roads would remain the property of the relevant State authorities even though the whole or a part of their cost may have been defrayed by the company in order to facilitate its business. In all such cases the expenditure so incurred would have to be treated in the books of account as a capital expenditure. There seems to be no valid objection to disclosing the same in the balance sheet under the general heading of "Capital Expenditure" subject to two conditions. In the first place, the description of the specific item on the balance sheet should be such as to indicate quite clearly that the capital expenditure is not represented by any assets owned by the company. In the second place, the capital expenditure should be written off over the approximate period of its utility or over a relatively brief period not exceeding five years, whichever is less. In fact, having regard to the nature of the expenditure and the purpose for which it is incurred, it is suggested that it would be more appropriate and realistic to classify such expenditure in the balance sheet under the heading of "Capital Expenditure" rather than either, write-off the expenditure to revenue or classify the expenditure under the heading of "Miscellaneous Expenditure" or "Deferred Revenue Expenditure".

11. EXPENDITURE ON START-UP AND COMMISSIONING OF THE PROJECT

11.1 After the plant has been constructed and the project has been completed in all respects it is usually tested and adjusted for commercial production before it is finally commissioned. Several items of expenditure are necessarily incurred in the process of starting the plant, adjusting it, and experimenting with and adjusting the plant for commercial production. The expenditure incurred during this period and in this process would include the salaries or fees of consulting engineers, travelling expenses in connection with visits by engineers and technicians to the plant, as well as the cost of raw materials and stores consumed in the process of test runs.

11.2 As a general rule, it would be correct to capitalise all expenses incurred during this period and in connection with the process of start-up and commissioning of the plant, for two reasons. In the first place, such expenses would be incurred in order to bring the plant up to the stage at which it can commence commercial production. In the second place, this expenditure would normally be incurred before the plant is taken over. On both these considerations, it would be fair and correct to capitalise the expenditure incurred on start-up and commissioning the plant. The expenditure so incurred may be capitalised in the same way as other indirect construction expenditure.

11.3 Sometimes, the agreement with the contractors responsible for constructing the plant stipulates that the plant will not be finally taken over until after the guarantee period has been satisfactorily completed. In most cases, the guarantee period would be completed several months after the commencement of commercial production. Obviously, in such cases, it would not be fair to continue to capitalise the expenses incurred after the commencement of commercial production merely because the guarantee period has not been completed and therefore the property in the plant has not been finally transferred to the purchasing company. In such cases, the general rule should be followed which is, that all expenditure of a revenue nature incurred after the date when the plant is ready to commence commercial production should be written off as revenue expenditure.

11.4 During the period of test runs and experimental production it is quite possible that some income will be earned through the sale of the merchandise produced or manufactured during this period. The sale revenue should be set off against the indirect expenditure incurred during the period of test runs and treated as suggested in para 15.2.

12. DATE OF COMMENCEMENT OF COMMERCIAL PRODUCTION

12.1 In any project which involves lengthy construction period, it is extremely important to be very specific about the selection of a "cut-off date", based on the date when the project is officially recognised as being ready for commercial production. In theory, it may appear to be a relatively simple matter to select this date, but in actual practice many complications may arise owing to the fact that there is often an intervening period between the date when the plant is finally completed and commissioned and the date when commercial production actually begins. This intervening period is due to the time taken up in completing the various tests and experiments which are usually necessary before commercial production can begin as well as the time which is sometimes lost because all requisite permission from Government Departments and all necessary service facilities such as water and electric power are not ready and available on the date when the plant is completed and commissioned.

12.2 In several cases, guidance may be available in selecting the official date of commencement of production by reference to the date of the inauguration ceremony as well as by reference to the date which is publicly and officially announced by the company as the date on which it has commenced commercial production. It should be borne in mind, in this connection, that "commercial production" is a term of somewhat wider import than the mere term "production". Even during a period of test runs and experimentation, a plant may be engaged in actual production, but until the test runs are completed and the plant is properly adjusted on the basis thereof, it may not be said to be ready for "commercial production". The term "commercial production" refers to production in commercially feasible quantities and in a commercially practicable manner.

12.3 As discussed in other paragraphs of this Note, various expenditures of a revenue nature which are incurred during the construction period are either capitalised as part of the indirect cost of construction, or are carried forward as deferred revenue expenditure, as may be appropriate. However, from the moment the plant is completed and commissioned and is ready for commercial production, all expenditures of revenue nature must be charged to the profit and loss account. It is for this reason that it is so important to determine the "cut-off date" based on the date when the plant is ready for commercial production, with a great degree of precision.

12.4 It is important to note in this connection that what is significant for this purpose is the date when the plant is ready for commercial production and not the date when the plant actually commences commercial production. Therefore, if a plant had been completed and commissioned and is ready for commercial production, but the company for some reason or other, does not start commercial production immediately thereafter, the expenditure incurred during this intermediate period must be treated as revenue expenditure and cannot be capitalised. This follows from an important rule, both in accounting principle as well as in economic theory. The rule is that only those expenses should be capitalised as part of the cost of an asset which relate to the acquisition or construction of that asset or which add anything to the value or utility of that asset. When a plant has once been completed and is ready for commercial production, the expenditure incurred during the intervening period of delay in actually commencing commercial production is neither related to the acquisition or construction of the fixed assets nor does it add to the value or utility thereof - consequently, it must be written off as revenue expenditure and cannot be capitalised.

12.5 As regards the general principles which would assist in the determination of the appropriate date when a company can be said to be ready to commence business, guidance can be obtained from several decided tax cases which are relevant because the consideration under which a new project can be said to have been set up or established so that it is ready to commence business are almost identical for tax purposes as well as for accounting purposes. The following general principles emerge from a consideration of some of the decided tax cases on this subject.

(a) The expression "set-up" as applied to a new project for tax purposes is identical with the expression "ready to commence business."

(b) The setting up of a new business or a new project represents a stage which is anterior to the actual commencement of business.

(c) There is a clear distinction between commencement of business and setting up a business; what is important is the date on which the business is set up rather than the date on which the business is actually commenced.

(d) When an undertaking is established and is ready to commence business, it may be said that it has been set up.

(e) There may be an interval of time between the setting up of a business and actual commencement of business, in which case all expenses incurred during this interval of time would be permissible deductions for tax purposes - and would also have to be treated as revenue expenses for accounting purposes.

(f) The expression "set up" as used in the Income and Wealth Tax Acts with reference to a new undertaking means that the undertaking is complete and ready to be commissioned and ready to commence business. It is implied in this that the factory must have been erected and the plant and machinery installed, before the business can be said to have been set up, but it is not essential that the business should have been actually commenced. It is also not essential that the factory should have actually functioned or gone into production.

The aforesaid principles are based on the following tax decisions:

(1) Western India Vegetable Products Limited v. C.I.T. 26 ITR-151 (Bombay).

(2) C.I.F. v. Sarabhai Sons Ltd. 90 ITR-318 (Gujarat).

(3) Sarabhai Management Corporation Ltd. v. C.I.T. 102 ITR-25 (Gujarat).

(4) C.W.T. v. Ramaraju Surgical Cotton Mills Ltd. 63 ITR-478 (S.C.)

(5) Travancore Cochin Chemicals Pvt. Ltd. v. C.W.T. 65 ITR-651 (S.C.)

13. INTERVAL BETWEEN ESTABLISHING OF A BUSINESS AND THE COMMENCEMENT OF ACTUAL PRODUCTION

13.1 As indicated in paragraph 12, a new project can be treated as having arrived at the revenue earning stage as soon as it is ready to commence commercial production, that is as soon as it is established and is ready for commercial production. However, there is often an interval of time between the date a project is completed and commissioned and is ready for production and the date when commercial production actually begins. The question which is discussed in this paragraph relates to the treatment of the expenditure incurred during this period.

13.2 In the normal course, the interval of time between the date a project is commissioned and is ready for production and the date that commercial production actually begins should be very brief. However, several factors sometimes operate to make this interval of time very prolonged and this is especially so in India because of the multifarious list of regulations to be complied with before commencing production as well as the acute shortage of basic materials and services. For example, the fact that certain licences may have not been obtained in time from a Government or local authorities may hold up commercial production. In other cases, the plant may be commissioned and completed and may be ready in all respects to commence production, but there may be delay in obtaining the power line or the water supply. Sometimes, one project is linked to another in such a way that it relies on the latter for its supply of raw materials. This is particularly the case with the chemical and process industries. For example, a fertiliser plant may be established as part of a large petrochemical complex. One of the essential raw materials for making fertilisers may be derived from the petro chemical complex. In such a case, even if the fertiliser plant is complete in all respects and is commissioned for commercial production, it cannot actually commence production until the petro chemical complex has been completed, it will thus be appreciated that circumstances can arise in which the interval of time between the completion of the plant and its readiness for commercial production and the time when commercial production actually commences will be very prolonged indeed. During such an interval of time, it is inevitable that the normal running expenses will continue to be incurred.

13.3 Having regard to the consideration outlined in paragraph 12 which deals in some detail with the date of commencement of commercial production, it would follow that all expenses of a revenue nature incurred after the date when the plant is completed and commissioned and is ready for commercial production or, to put it differently, all expenses of a revenue nature incurred after the date when the business has been set up or established would have to be charged to the profit and loss account and can no longer be capitalised, even though commercial production has not actually commenced. There is no reason to depart from this principle even in a case where there is a prolonged interval of time between the date of setting up or establishing a business and the date on which it actually commences commercial production.

13.4 If commercial production is considerably delayed, the problem which would arise is that there would be no income during the period of such delay while, on the other hand, the expenditure of a revenue nature incurred during this period would have to be charged to the profit and loss account as mentioned above. If the period of delay in commencing commercial production is extremely prolonged, the only possible concession which may be made is that the expenditure incurred during this period can be treated as deferred revenue expenditure, to be amortised over a period not exceeding 3 to 5 years after the commencement of commercial production. This procedure is not, however, recommended as a matter of general policy or practice, but may be resorted to only in those exceptional cases where fairly heavy revenue expenditure is incurred during a prolonged period of delay in commencing commercial production. In any case, it would be completely wrong to treat such expenditure as capital expenditure since it does not add in any way to the value or cost or utility of the plant and other manufacturing facilities which have already been constructed but which have remained idle due to delay in commencing commercial production.

13.5 After commercial production has been commenced, it is customary to provide depreciation on fixed assets for the full annual period disregarding any short periods during the year when particular assets have remained idle due to various reasons. This is only a rule of practical convenience but the application of the rule also takes into consideration the fact that an asset does depreciate to some extent even during idle periods and also, when fixing the depreciation rate, some regard is usually given to the fact that there will inevitably be a few idle periods when the particular plant or machinery will not remain in use. However, if there is delay in commencing commercial production, it is suggested that it would not be necessary to provide depreciation on fixed assets during this period. In other words, it would be necessary to provide depreciation on fixed assets only as from the date when commercial production is actually commenced.

14. DISCLOSURE IN FINANCIAL STATEMENTS

14.1 The method of disclosure of the expenditure incurred during the construction period, in the financial statements prepared during that period would obviously depend on the nature of those expenses. In certain cases, no difficulty would arise and the disclosure would be made in accordance with generally accepted accounting principles.

14.2 As regards advances to contractors pending completion of the construction work, reference may be made to the detailed discussion in paragraph 9.2(a) of this Note which indicates the manner in which such advances, should be disclosed in the financial statements.

14.3 It is suggested that, in a large number of cases, it would be appropriate to indicate the following items in the balance sheet under the general heading of “Fixed Assets”.

(a) Fixed assets actually purchased during the construction period less depreciation thereon, which may be described in a separate Schedule annexed to the balance sheet (see paragraph 9.4 of this Note) - this would also include land and expenses on land (see paragraph 9.6 of this Note).

(b) Construction work-in-progress- to be described either on the balance sheet itself by reference to relevant headings or in a separate Schedule annexed to the balance sheet (see paragraph 9.3 of this Note).

(c) Cost of temporary structures and other facilities erected or acquired specially for the purpose of construction (see paragraph 9.5 of this Note) - these items would continue to appear on the balance sheet until end of the construction period when they would either be transferred to the general fixed assets of the company if absorbed by the company for use in its operations, or the temporary structures and other facilities would be sold or scrapped if no longer required.

(d) Incidental and indirect expenditure relating to construction (see paragraph 5)- this would also include preliminary project expenditure to the extent to which it is capitalised as part of the total construction cost as well as financial expenses in the way of interest charges etc. which are similarly capitalised (see paragraphs 3 and 4 of this note).

14.4 It would be appropriate to indicate the following items in the balance sheet under the general heading of "Miscellaneous Expenditure" or "Deferred Revenue Expenditure" as may be appropriate:

(a) Corporate expenses - including preliminary expenses, formation expenses in connection with issue of shares and debentures, expenses of the share registrar's department, expenses in connection with the issue of public documents such as prospectus, director's sitting fees and travelling expenses, etc. (see paragraphs 2 and 7 of this Note).

(b) Preliminary project expenditure to the extent, it is not considered to be a part of the indirect construction expenditure (see paragraph 3 of this Note)

(c) Financial expenses including interest and other similar charges, to the extent that they are not capitalised as part of the indirect cost of construction (see paragraph 4 of this Note)

(d) Indirect expenditure not related to construction (see paragraph 6 of this Note)

14.5 Income during the construction or pre production period should be shown separately in the financial statements (see paragraph 8.1 of this Note). However, contributions made by Government or other parties toward expenses shown under each of the headings and sub-headings as suggested in the above paragraphs can be deducted therefrom. It is suggested that such deductions should be shown separately in the financial statements.

14.6 As indicated elsewhere in this Note, almost all the expenditure during the period of construction would be either capitalised or would be treated as deferred revenue expenditure, to be amortised in suitable annual instalments extending over a period of 3 to 5 years after the commencement of production. On the other hand, there would be little or no revenue, or income during the construction period and such income, of a minor nature, which may be earned during this period, can be adequately accounted for in the manner suggested in paragraph 15.2 of this Note.

14.7 There is some doubt on the question whether or not a company is obliged to prepare a profit and loss account during the period of construction when it is not in fact engaged in any revenue operations. In view of the requirement of Section 210(3) of the Companies Act, every company has to prepare its profit and loss account from the date of incorporation. However, to prepare a profit and loss account during the period of construction might be somewhat misleading as it may give an impression to the lay shareholder that the company was engaged in revenue operations during this period and has incurred a substantial loss in those operations. It is true that the requirements of Part II of Schedule VI to the Companies Act relating to disclosure of specific items of expenditure have to be complied with. However, these requirements can be adequately complied with if the relevant items of expenditure requiring specific disclosure are suitably disclosed under the heading "Development Account", "Expenditure During Construction Account", "Statement of Incidental Expenditure During Construction" or by any other suitable name. This practice has also been recommended by the Department of Company Affairs, Government of India, as per their circular No.2/17/64, dated 29th January, 1964 which is given in Appendix B.

Where the aforesaid practice is followed, it is desirable that a note be inserted in the financial statements explaining the reason for not preparing a profit and loss account. It appears that this would represent reasonable compliance with the legal requirements, since, the specific disclosure requirements of Schedule VI, Part II are complied with. Whether the disclosure should be made in the conventional profit and loss account form or through an account/statement as per the recommendation made in the above paragraph, is a matter for each company to decide. In this connection, it may be noted that Schedule VI, Part II of the Act only contains disclosure requirements and does not prescribe specific form of profit and loss account unlike Schedule VI, Part I which does so for the balance sheet.

14.8 Reference has been made in this Note to a number of cases where it may be appropriate to treat certain expenditures incurred during the construction period as "deferred revenue expenses". It is necessary that the financial statements should disclose the amount and brief details of the expenses which have been deferred indicating the extent to which they have been written off to profit and loss account. In appropriate cases, it may also be necessary to give a note indicating the reasons and basis for the deferral of expenses.

14.9 Normally, it should not be necessary to disclose in the Schedule of fixed assets the extent to which the cost of the various assets is comprised of direct capital expenses and allocated indirect expenses respectively, since the latter are also ultimately treated as capital expenses forming part of the cost of the relevant assets. In appropriate cases, however, a note may be given indicating the basis of allocation of indirect expenses incurred during the period of construction - especially if the indirect expenses form a sizeable proportion of the total capital expenditure.

14.10 Illustrative Specimen Statements are given in Appendices at the end of this book

15. ALLOCATION OF INDIRECT CAPITAL EXPENDITURE TO SPECIFIC ASSET HEADS

15.1 Mention has been made in earlier paragraphs of this Note to the various items of indirect expenditure which may be capitalised. In particular, attention is drawn to the undernoted paragraphs which deal with different items of indirect expenditure which may be capitalised as part of the cost of construction.

Paragraph 3	-	relating to Preliminary Project Expenditure.
Paragraph 4	-	relating to Interest Charges and other Financial Expenses.
Paragraph 5	-	relating to Indirect Expenditure Incidental to Construction.
Paragraph 9.5	-	relating to expenditure on Temporary Structures and Service Facilities Built or Acquired Specially for the purpose of Construction.
Paragraph 9.4/5	-	relating to Depreciation on Fixed Assets as well as on Temporary Structures and other Facilities used during the period of construction.
Paragraph 9.6	-	relating to the Expenditure on Land Grading and Levelling.
Paragraph 11.	-	relating to Expenditure on Test Runs.

15.2 From the total of the aforesaid items of indirect expenditure would be deducted the income, if any, earned during the period of construction provided it can be identified with the project.

15.3 While the construction work is in progress, the various items of indirect capital expenditure may be carried forward to be ultimately included as part of the indirect cost of construction. It is not necessary to make any attempt to apportion the various items of indirect capital expenditure to any specific asset or assets while the construction work is still in progress. However, after the construction work is completed, it will be necessary to tackle the problem of the specific allocation of the total indirect capital expenditure to the various individual asset or assets.

15.4 The first principle to be borne in mind is to exclude from such allocation those assets which have not benefited from the indirect capital expenditure, as well as those capital assets to which the indirect expenditure is not at all related. For example, in most cases, capital expenditure on land would not be affected by any of the items of indirect capital expenditure and it would therefore be inappropriate to add to the value of the land any element representing the indirect capital expenditure incurred during construction. Similarly, in several cases, many of the items of indirect capital expenditure would not be related to the cost of the buildings constructed for the project. For example, it is unlikely that the technical consultants engaged to assist on the construction of a complex project would have devoted any portion of their time to the construction of buildings which may therefore have been left entirely to local contractors - in which case it would not be appropriate to add to the cost of buildings any element of indirect capital expenditure which represents the expenditure on technical consultants.

15.5 It follows from what is stated above that the first step in allocating the indirect expenditure during construction would be to prepare, in as much detail as may be possible, a statement indicating the various items of fixed assets which have not benefited from certain specific items of indirect capital expenditure. Another statement should be prepared analysing the indirect capital expenditure in as much detail as possible, after which an attempt should be made to indicate against each item of indirect capital expenditure the specific assets or group of assets to which that expenditure was related. For example, if an oil refinery is being constructed, it is possible that one of the items of indirect expenditure would represent, say, the expenditure on welding consultants engaged specially for the construction of storage tanks. In that case, when analysing the total indirect capital expenditure, care should be taken to state against the item relating to the expenditure on welding consultants the fact that this expenditure was incurred exclusively for the construction of storage tanks. If this is done, it would follow logically that certain items of indirect capital expenditure can be allocated straightway to those specific assets or groups of assets to which they are related. It would also follow from the method suggested above that inappropriate allocations of indirect capital expenditure would be avoided. For example, in the illustration given above, the indirect expenditure incurred on welding consultants would not be apportioned indiscriminately to all items of fixed assets, if the method suggested above is adopted.

15.6 On the actual allocation of indirect capital expenditure, it is impossible to be dogmatic or to make any specific pronouncements. Much would depend upon the circumstances of each case as well as the total amount of the expenditure to be allocated. If the total of the indirect expenditure is a relatively small amount, elaborate methods of allocation need not be adopted. On the other hand, if the total indirect capital expenditure is relatively significant, greater care should be taken to select a suitable basis of allocation, otherwise, the total asset values would not be realistic. Basically, the problem should be solved in the manner suggested above - which is to allocate, as far as possible, items of indirect capital expenditure to those specific asset or assets to which they are related.

15.7 In a large number of cases of indirect capital expenditure, it would obviously be impossible to link the expenditure to any specific asset or assets. In that case, it is suggested that the indirect expenditure may be allocated having regard to various applicable considerations, some of which are suggested below:

(a) Some items of indirect capital expenditure may be susceptible to allocation on the basis of analysis of time spent on different items of construction by designated groups of personnel, for example, the indirect expenditure representing the element of cost incurred on technical consultants for different items of construction.

(b) In other cases, a more suitable method of allocation would be obtained by reference to the cubic or tonnage measurement of different items of construction. For example, the indirect expenditure which is incurred in connection with civil engineering work can be allocated quite appropriately on the basis of the cubic measurement of the buildings or other structures. On the other hand the indirect expenditure involving freight and clearing charges can be appropriately allocated to different assets on the basis of tonnage measurements.

(c) As already suggested earlier in paragraph 9.6 relating to the indirect expenditure on land grading and clearing, the indirect expenditure incurred on grading and clearing the land may be allocated to the different structures which stand on the land, in proportion to the respective area occupied by the various structures.

15.8 The considerations suggested in the preceding paragraph are obviously illustrative rather than exhaustive and, in each particular case, the allocation of indirect capital expenditure would have to be made on the basis of the consideration which is most suitable bearing in mind, however, the fact that too meticulous an attention to this problem is not called for. Any method of allocation is bound to be somewhat arbitrary and the time and expenditure incurred in the process of allocation should not be disproportionate.

16. EXPANSION OF EXISTING PROJECTS

16.1 The major part of this Note is devoted to a consideration of the accounting problems relating to new capital projects while they are in the stage of construction. Somewhat similar accounting problems are also encountered by an existing enterprise when it embarks on a programme of capital expansion concurrently with current production.

16.2 It is suggested that the following guidelines may be regarded as the basis of determining the correct accounting treatment in the case of a project which carries out a programme of capital expansion concurrently with normal production:

(a) All direct expenditure must be capitalised in the normal way.

(b) The indirect expenditure which is capitalised should be restricted to the additional expenditure, if any, incurred as a result of capital expansion and construction. In other words, the indirect expenditure which is capitalised should be limited to the marginal increase in such expenditure involved as a result of capital expansion. It would not be correct or appropriate to capitalise indirect expenditure on *a pro rata* basis as that would have the effect of reducing the charge to current revenue for the indirect expenditure which would have been incurred in connection with the normal revenue operations in any case, even in the absence of any capital expansion plans. To put it differently, indirect expenditure should be marginally capitalised so as to ensure that current revenue does not suffer as a result of any additional indirect expenditure incurred because of construction. On the other hand, it is not intended that current revenue should actually benefit by reason of the capital expansion project which is what would happen if indirect expenditure is capitalised on *a pro rata* basis.

17. SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

17.1 A characteristic of large capital projects is that they usually involve a prolonged period of construction during which the projects incur various items of direct as well as indirect expenditure while, at the same time, it may also earn some income from miscellaneous sources during its construction phase. An accounting problem is posed with regard to the treatment of expenditure incurred and income earned during the construction period (paragraph 1).

17.2 As regards the preliminary corporate expenses incurred by a new project - such as company formation expenses, expenses in connection with the issue of shares and debentures, etc. it is suggested that the present practice may continue. Consequently, such expenses should be carried forward on the balance sheet and shown under the group heading of "Miscellaneous Expenditure", but they should be written off within a period of three to five years after commencement of commercial production (paragraph 2).

17.3 It is recommended that the preliminary project expenditure incurred in connection with the preparation of the project report, conducting feasibility studies, surveys, etc. should be capitalised as part of the indirect construction cost. From a practical point of view it is also suggested that the same treatment should be accorded to the expenditure incurred in connection with preliminary studies and preliminary negotiations with foreign collaborators and government authorities (paragraph 3).

17.4 It is recommended that the interest charges and commitment fees incurred during the construction period on loans and other forms of borrowing, should be treated as part of the indirect construction cost, if the loan or other borrowing was taken or incurred for the purpose of financing the construction of the project (paragraph 4.3).

17.5 If the loan or other form of borrowing was taken or incurred for the purpose of providing working capital, the interest and other charges thereon during the period of construction may be treated as deferred revenue expenditure, to be written off to revenue over a period of three to five years after commencement of production. In case a loan has been taken jointly for the purpose of financing the construction and for working capital, the interest and the commitment charge should be apportioned on a reasonable basis. The portion relating to financing of construction should be capitalised and the other should be treated as deferred revenue expenditure to be written off over a period of three to five years after production commences (paragraphs 4.3 and 4.5).

17.6 The same treatment should be accorded to the various costs and charges incurred for preparing the loan agreements and other documents as is given to the interest and commitment fees incurred on the loan during the construction period (paragraph 4.6).

17.7 Notional or imputed interest charges, which are not actually incurred, should not be capitalised (paragraph 4.4).

17.8 As regards the indirect expenditure incurred during the construction period, it is recommended that it should be capitalised as part of the indirect construction cost to the extent to which the expenditure is indirectly related to construction or is incidental thereto (paragraph 5.1). The different kinds of expenditure which may qualify for inclusion as indirect capital expenditure are given in paragraph 5.2 by way of examples of such expenditure.

17.9 As regards other indirect expenditure incurred during the construction period which is not at all related to the construction activity nor is incidental ‘ thereto, it is recommended that such expenditure should be treated as deferred revenue expenditure and written off to revenue within a period of three to five years after commencement of production. Examples of such expenditure are given in paragraph 6.2.

17.10 It is recommended that a similar treatment should also be accorded to various “Corporate expenses” incurred during the construction period (paragraph 7)

17.11 During the construction period, a project may earn income from miscellaneous sources - for example, interest income, income from hire of equipment or assets and income from sale of products manufactured during the period of test runs and experimental production. It is recommended that where such income can be identified with the project, it should be deducted from the total of the indirect expenditure so that only the net amount of the expenditure is capitalised or treated as deferred revenue expenditure, as the case may be (paragraph 15.2). In either case, consideration may have to be given to the question of providing for the income tax liability on such income (paragraph 8.2).

17.12 Advance payments and other similar payments to contractors during the period of construction should not be segregated or classified against any specific “Fixed Assets” until the contract has been completed and the property handed over by the contractor to the purchaser so that legal title to the fixed assets has passed to the purchaser. In the meantime, advance payments to contractors should be shown separately in the balance sheet as such, either under the general heading of “Fixed Capital Expenditure” or as a separate item under the general heading of “Loans and Advances” with a clear indication that the advance is of a capital nature for pending construction work [paragraph 9.2(a)].

Reasonable control should be exercised over advance payments to contractors in order to ensure that such payments are covered by the terms of the contract. Where the terms of the contract are not explicit, advance payment should not ordinarily exceed the value of completed work after retaining a reasonable margin [paragraph 9.2(b)].

17.13 In the case of a composite construction contract - especially a “turnkey’ contract - for a fixed total amount of consideration, it will be necessary, at the end of the construction, to apportion the total contractual value between the various units of plant and assets represented thereby. Such apportionment should be made on the basis of data furnished by the contractor himself, if possible; otherwise, on the basis of any other available evidence [paragraph 9.2(a)].

17.14 Capital expenditure incurred directly by the project itself on incomplete construction work should be shown in the balance sheet as “construction work in progress” or under a similar caption (paragraph 9.3).

17.15 Where the total construction work is spread over more than one contractor or where part of the construction work is handled through contractors while a part thereof is undertaken directly by the project itself, it will be necessary to apportion on a suitable basis certain common expenses incurred in connection with the construction - for example, fees and expenses of consulting engineers, custom duties, freight and clearance charges, expenses of the establishment maintained at the port of entry, etc. [paragraphs 9.3 and 9.7(b),(c) and (d)]

17.16 Any complete units of fixed assets purchased or acquired during the construction period should be shown in the accounts as “fixed assets” or “capital expenditure” - for example, transport equipment, furniture and fixtures and office equipment (paragraph 9.4).

17.17 Similarly, it would be appropriate to capitalise the value of any facilities or equipment which have been acquired or built specially for the purpose of construction, for example, temporary housing for construction labour, temporary warehouses for construction stores, temporary water and power connections, and purchase of construction equipment such as cranes, earth moving equipment, etc. (paragraph 9.5).

17.18 It is recommended that depreciation should be charged during the construction period on any items of fixed assets or temporary construction facilities used during the period of construction. Such depreciation may be charged either by applying the normal depreciation rates to the original cost of such assets, or, in the alternative, the depreciation may be charged indirectly by capitalising the difference between the original cost of the equipment or facilities and the sale or scrap value thereof at the end of the construction. The latter method is particularly appropriate in the case of special construction equipment and temporary construction facilities. In either case, the depreciation provided during the construction period should ordinarily be treated as part of the indirect construction cost and capitalised accordingly. If any item of fixed assets used during the construction period is retained by the project for use after production, the residual book value of such assets should be depreciated in the normal way after commencement of production (paragraphs 9.4 and 9.5).

17.19 In several cases, the land required for a new capital project is acquired with the help of government authorities under the relevant land acquisition laws. In such cases, the total amount of deposits paid for acquisition of land pending completion of the land acquisition proceedings may be shown in the balance sheet as “cost of land” rather than “deposits” - subject to suitable disclosure as to the absence of title as well as of the fact that the land cost represents deposit payments which are subject to suitable adjustment after determination of the final land value (paragraph 9.6).

17.20 Legal costs, stamp duties and fees, cost of measuring the land and investigating its title, etc., should invariably be capitalized as part of the cost of the land (paragraph 9.6).

17.21 The value of any structures purchased together with the land may be segregated and capitalised separately from the cost of the land, if it is intended to retain the structure for use in the operations of the project after it commences production. If this is not intended and if the structures purchased with the land are to be demolished for the purpose of construction, the entire value paid for the land, including the structures purchased along with the land, should be capitalized as the cost of the land itself [paragraph 9.6(c)].

17.22 If the operation of levelling, clearing and grading the land is undertaken principally for the purpose of construction, the cost of such levelling, clearing and grading may be capitalised as an indirect element of the construction cost, in which case it may be apportioned between the different buildings and structures standing on the land in the ratio of the respective areas occupied by such buildings and structures (paragraph 9.6).

17.23 Abnormal losses, resulting from inefficiency, mischief or accidents should not be capitalised but should be written off over a period of 3 to 5 years against revenue when production commences (paragraph 9.8).

17.24 Sometimes, capital expenditure is incurred which is not represented by any specific assets. Examples of such expenditure are given in paragraph 10. It is recommended that such expenditure may be shown in the balance sheet under the heading of “capital expenditure” with suitable disclosure (paragraph 10).

17.25 It is recommended that the expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, may be capitalised as an indirect element of the construction cost. However, the expenditure incurred over a prolonged guarantee period during which the plant is commercially operated cannot be capitalised and must be treated as revenue expenditure even though the contract may stipulate that the plant will not be finally taken over until after the satisfactory completion of the guarantee period (paragraph 11).

17.26 It is extremely important to fix a specific date representing the date when the plant-has been completed, set up and is recognised as being ready for commercial production. For this purpose, the term “commercial production” refers to production in commercially feasible quantities and in a commercially practicable manner. Consequently it is not sufficient if the plant is ready for experimental production on a limited scale. With reference to the determination of the specific date when the plant can be said to be ready for “commercial production”, some guidance may be obtained from the several decided tax cases on this subject (paragraphs 12.1,12.2 and 12.5).

17.27 All expenses incurred after the date when the plant is ready for commercial production should be charged to the profit and loss account as revenue expenses - with the exception only of those expenses which are directly of a capital nature. This accounting treatment is also applicable during the period when the plant is ready for commercial production even though actual commercial production has been delayed for some reason. Sometimes, there may be considerable delay between the date when the plant is ready for commercial production and the date of actual commencement of production. Such prolonged delay may occur due to several possible factors. If the period of delay in commencing production is extremely prolonged, with the result that there is no matching of income to set-off the revenue expenditure incurred during this period, it may be permissible to treat such expenditure initially as “deferred revenue expenditure” to be written off within a period of three to five years after commencement of production. In all cases of normal delay in commencing commercial production, however, expenses of a revenue nature incurred during the period of delay should be debited to profit and loss account. It would not be necessary, however, to provide any depreciation on fixed assets until after the date when they are first utilised in the company’s operations. Consequently, it would not be necessary to provide any depreciation on fixed assets during the period of delay in commencing production, if the fixed assets have not actually been utilised during this period (paragraphs 12.3, 12.4 and 13).

17.28 If a company’s financial statements are prepared during the period when the company is still engaged in the construction of its project, some consideration would have to be given to the question of appropriate disclosure in those financial statements (paragraph 14.1).

17.29 The cost of all incomplete construction work executed by the company itself should be shown under the general heading of “Construction Work-in-progress” with suitable sub-headings to describe the various items. Any completed units of fixed assets actually purchased or acquired during the construction period should be shown in the normal way as “Fixed Assets” after providing for appropriate depreciation thereon. In the case of temporary structures and other facilities erected or acquired specially for the purpose of construction, as well as in the case of special construction equipment, the cost thereof should be shown in the balance sheet as part of the company’s “Fixed Assets”. It would be necessary to indicate whether such assets as stated in the balance sheet as “at cost” or “at cost less depreciation”. In some cases, it may be appropriate to state the value of such assets in the balance sheet as “at cost” where the ultimate intention is to determine the depreciation of such assets at the end of the construction period by measuring the difference between the original cost of such assets and their saleable or scrap value at the end of the construction. In that case, the description of such assets in the balance sheet as “at cost” should be clarified by a suitable disclosure of this fact (paragraph 14.3).

17.30 During the period of construction, a company may incur several expenses of a revenue nature. In some cases, such expenses would be treated as indirect or incidental expenses relating to construction whereas in other cases, if the indirect expenses do not relate and are incidental to construction, they may be treated as “Deferred Revenue Expenditure”. There may also be cases of various corporate expenses, formation expenses, etc., which are treated as “Preliminary Expenses”. The Statement of Incidental Expenditure During Construction for the periods covered should give details of expenses as per Part II of Schedule VI of the Companies Act (paragraphs 14.4, 14.5, 14.6 and 14.7).

17.31 It is also recommended that, in appropriate cases, the financial statements should disclose the amount and brief details of “Deferred Revenue Expenses” indicating the reasons and basis for the deferral of such expenses. The financial statements should also disclose, in appropriate cases, the basis of allocation of indirect capital expenses to the various units of plant and machinery, buildings, etc.-especially if the direct construction expenses form a sizeable proportion of the total capital expenditure (paragraphs 14.8 and 14.9).

17.32 The allocation of indirect capital expenditure to specific asset heads would have to be made bearing in mind a few general principles. Such allocation should be made only after the construction work has been completed and no attempt should be made to allocate indirect capital expenditure to specific asset heads while the construction work is still in progress. Wherever possible, specific items of indirect expenditure should be allocated directly to related asset heads. In those cases where such direct allocation is not possible, it will be necessary to have recourse to indirect allocation. Even in such cases, however, care should be taken 'to exclude from such allocation those assets or groups of assets which have not benefited from any particular item of indirect capital expenditure, as well as those fixed assets to which a particular item of indirect expenditure is not at all related. Having ascertained and identified the various items of indirect expenditure against the various asset heads or groups of assets to which they may be related, the actual process of such indirect allocation may be accomplished by one of several methods, taking care to select the method which is most appropriate to a particular case. For example, in some cases the indirect allocation may be made on the basis of time analysis whereas in other cases, a more suitable method of allocation would be obtained by reference to the cubic, tonnage, or area measurements of the different items of construction. Failing any such appropriate basis of allocation, the indirect expenses may be apportioned by reference to the total direct capital costs of the different items of fixed assets (paragraph 15).

17.33 When an existing enterprise carries out a programme of capital expansion concurrently with normal production, all direct capital expenditure must be capitalised in the normal way. As regards indirect expenditure, only that portion of such expenditure should be capitalised which represents the marginal increase in such expenditure involved as a result of capital expansion. It would not be appropriate in such a case to capitalise indirect expenditure on a *pro rata* basis (paragraph 16).

GN(A) 7 (Issued 1989)

Guidance Note on

Accounting for Depreciation in Companies[1]

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

[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.

accounting for depreciation applicable to all entities. As such, the Standard is applicable to companies also in all matters where there are no specific requirements under the Companies Act.

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

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

(a) Guidance Note on Provision for Depreciation [published in Compendium of Guidance Notes, Vol. 1 (2nd Edition)]

(b) Statement on Provision for Depreciation in Respect of Extra or Multiple Shift Allowance [Published in Compendium of Statements and Standards on Accounting, 1st Edition]

(c) Statements on Changes in the Mode of Charging Depreciation in Accounts [Published as an Appendix in the Guide to Company Audit]

(d) Guidance Note on Accounting for Depreciation Consequent to Changes in Rates of Depreciation [Published in Compendium of Guidance Notes, Vol. II, 1st Edition]

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

METHODS OF CHARGING DEPRECIATION

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

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

(a) to the extent specified in section 350; or

(b) in respect of each item of depreciable asset, for such an amount as is arrived at by dividing ninety-five percent of the original cost thereof to the company by the specified period in respect of such asset; or

(c) on any other basis approved by the Central Government which has the effect of writing off by way of depreciation ninety-five percent of the original cost to the company of each such depreciable asset on the expiry of the specified period; or

(d) as regards any other depreciable asset for which no rate of depreciation has been laid down by this Act or rules made thereunder, on such basis as may be approved by the Central Government by the general order published in the Official Gazette or by any special order in any particular case:

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

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

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

Adoption of different methods for different types of assets

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

Change in the method of providing depreciation

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

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

RELEVANT RATES OF DEPRECIATION FOR THE PURPOSE OF PREPARATION OF ACCOUNTS OF A COMPANY

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

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

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

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

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

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

An example of the qualification is given below:

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

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

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

(i) As far as recomputation of specified period is concerned, the specified period be recomputed by applying to the original cost, the revised rate of depreciation as prescribed under Income-tax Rules.

(ii) As far as charge of depreciation is concerned, depreciation be charged by allocating the written down value as per books over the remaining part of the recomputed specified period.

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

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

been provided in earlier years on SLM basis."

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

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

(a) Where a company follows the manner of charging depreciation recommended by the Department of Company Affairs in its Circular No. 1/85, it has to change its depreciation rates as follows:

    (i) The specified period should be recomputed by applying to the original cost, the revised rate as prescribed in Schedule XIV;

    (ii) depreciation charge should be calculated by allocating the unamortized value as per the books of account over the remaining part of the recomputed specified period.

(b) A company which follows the Circular No. 1/86, can continue to charge depreciation on straight line basis at old rates in respect of assets existing on the date on which the new provisions relating to depreciation came into force.

(c) SLM rates prescribed in Schedule XIV can be straightaway applied to the original cost of all the assets including the existing assets from the year of change of the rates.

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

PRO-RATA DEPRECIATION

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

25. Where the financial year of a company is more/less than 12 months, a question may arise as to whether the rates of depreciation prescribed in Schedule XIV are to be applied proportionately to the duration of the financial year of the company or the said rates are to be

applied as flat rates irrespective of the duration of the financial year. It may be argued that since section 205 and 350 of the Companies Act, 1956, are in relation to the financial year, the rates prescribed in Schedule XIV are applicable in respect of the financial year of the company, irrespective of its duration. The Committee is, however, of the opinion that in view of the true and fair consideration of preparation of accounts, the rates of depreciation as per Schedule XIV should be applied proportionately taking into consideration the duration of the financial year.

DEPRECIATION ON LOW VALUE ITEMS[3]

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 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"

[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.

which is created by a company by transferring the difference between the revalued figure and the book value of the fixed assets.

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

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

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

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

GN(A) 9 (Issued 1994)

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

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

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

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

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

3. AS 10 lays down as below:

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

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

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

5. Share capital represents the amount of money or money's worth received from the owners and the capitalisation of earned profits or other gains arising out of an arm's length transaction. It has, therefore, been a cardinal principle that only such profits as are earned or

the relevant capital receipts (e.g. share premium), as are realised, can be capitalised.

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

"The company has issued bonus shares for 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.

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

GN(A) 11 (Issued 1997)

Guidance Note on

Accounting for Corporate Dividend Tax

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

2. The salient features of CDT are as below:

(i) CDT is in addition to the income-tax chargeable in respect of the total income of a domestic company.

(ii) CDT is chargeable on any amount declared, distributed or paid by such company by way of dividends (whether interim or otherwise) on or after the 1st day of June 1997.

(iii) The dividends chargeable to CDT may be out of the current profits or accumulated profits.

(iv) The rate of CDT is ten per cent.

(v) CDT shall be payable even if no income-tax is payable by the domestic company on its total income.

(vi) CDT is payable to the credit of the Central Government within 14 days of -

(a) declaration of any dividend,

(b) distribution of any dividend, or

(c) payment of any dividend,

whichever is the earliest.

(vii) CDT paid shall be treated as the final payment of tax on the dividends and no further credit therefor shall be claimed by the company or by any person in respect of the tax so paid.

(viii) The expression 'dividend' shall have the same meaning as is given to 'dividend' in clause (22) of Section 2 but shall not include sub-clause (e) thereof. (The relevant extracts of Section 2(22) of the Income-tax Act, 1961, have been reproduced in Annexure II).

ACCOUNTING FOR CDT

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

DISCLOSURE AND PRESENTATION OF CDT IN FINANCIAL STATEMENTS

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

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

6. The liability in respect of CDT arises only if the profits are distributed as dividends

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

RECOMMENDATIONS

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

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

Dividend	xxxxx	
Corporate Dividend Tax thereon	xxxxx	xxxxx

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

Annexure I

RELEVANT EXTRACTS OF THE PROVISIONS UNDER CHAPTER XII D OF THE INCOME TAX ACT, 1961, REGARDING SPECIAL PROVISIONS RELATING TO TAX ON DISTRIBUTED PROFITS OF DOMESTIC COMPANIES.

115 O. Tax on Distributed Profits of Domestic Companies

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

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

(1) shall be payable by such company.

(2) The principal officer of the domestic company and the company shall be liable to pay the tax on distributed profits to the credit of the Central Government within fourteen days from the date of -

  (a) declaration of any dividend; or

  (b) distribution of any dividend; or

(c) payment of any dividend,

whichever is earliest.

(3) The tax on distributed profits so paid by the company shall be treated as the final payment of tax in respect of the amount declared, distributed or paid as dividends and no further credit therefore shall be claimed by the company or by any other person in respect of the amount of tax so paid.

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

115 Q

....

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

Annexure II

RELEVANT EXTRACTS OF THE DEFINITION OF THE TERM DIVIDEND AS PER SECTION 2(22) OF THE INCOME TAX ACT, 1961.

2(22) [1]"Dividend includes -

(a) any distribution by a company of accumulated profits, whether capitalised or not, if such distribution entails the release by the company to its shareholders of all or any part of the assets of the company;

(b) any distribution to its shareholders by a company of debentures, debenture-stock, or deposit certificates in any form, whether with or without interest, and any distribution to its preference shareholders of shares by way of bonus, to the extent to which the company possesses accumulated profits, whether capitalized or not;

(c) any distribution made to the shareholders of a company on its liquidation, to the extent to which the distribution is attributable to the accumulated profits of the company immediately before its liquidation, whether capitalised or not;

(d) any distribution to its shareholders by a company on the reduction of its capital, to the extent to which the company possesses accumulated profits which arose after the end of the previous year ending next before the 1st day of April, 1933, whether such accumulated profits have been capitalised or not;

(e) ....but 'dividend' does not include -

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

(ii) any advance or loan made to a shareholder [4][or the said concern] by a company in the ordinary course of its business, where the lending of money is a substantial part of the business of the company;

(iii) any dividend paid by a company which is set off by the company against the whole or any part of any sum previously paid by it and treated as a dividend within the meaning of sub-clause (e), to the extent to which it is so set off.

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

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

GN(A) 12 (Revised 2000)

Guidance Note on

Accounting Treatment for Excise Duty

INTRODUCTION

1. The Institute of Chartered Accountants of India had issued a Guidance Note on Accounting Treatment for Excise Duties in 1979. In order to bring uniformity in the accounting treatment of excise duty and inventory valuation, the Guidance Note was revised in 1988. Keeping in view further developments, viz., issuance of the revised Accounting Standard (AS) 2, "Valuation of Inventories" (which has come into effect in respect of accounting periods commencing on or after 1.4.1999 and is mandatory in nature), it has been decided to revise this Guidance Note again. This revised Guidance Note is being issued in supersession of the earlier Guidance Note issued in 1988 and is effective in respect of accounting periods beginning on or after April 1,1999.

2. This Guidance Note recommends accounting treatment for Excise Duty in respect of excisable goods produced or manufactured by an enterprise. A separate Guidance Note on Accounting Treatment for MODVAT sets out principles for accounting for MODVAT (now

renamed as 'CENVAT').

3. At the outset, this Guidance Note briefly deals with normally accepted accounting principles for inventory valuation as prescribed in revised Accounting Standard (AS) 2, "Valuation of Inventories" issued by the Institute of Chartered Accountants of India, and nature of excise duty. For details, reference should be made to revised Accounting Standard (AS) 2 and Central Excise Act, Rules, Notifications and Circulars.

NORMALLY ACCEPTED ACCOUNTING PRINCIPLES FOR INVENTORY VALUATION

4. Normally accepted accounting principles with regard to the valuation of inventories (i.e., materials or supplies to be consumed in the production process or in the rendering of services, work-in-process and finished goods), as prescribed in revised Accounting Standard (AS) 2, "Valuation of Inventories", are reproduced below:

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

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

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

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

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

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

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

NATURE OF EXCISE DUTY

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

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

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

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

6. The levy of excise duty is not restricted only to excisable goods manufactured and intended for sale. It is also leviable on excisable goods manufactured or produced in a factory for internal consumption. Such intermediate products may be used in manufacture of final products or for repairs within the factory or for use as capital goods within the factory. Excisable goods so used for captive consumption may be eligible for exemption under specific notifications issued from time to time. Finished excisable goods cleared from the place of removal may also be eligible for whole or partial duty exemption in terms of notifications

issued from time to time. Such exemption, subject to specified limits, if any, may relate to a manufacturer, e.g., a small-scale industrial unit. Exemption may be goods specific, e.g., handicrafts are currently wholly exempt from duty. The exemption may also be end-use specific, e.g., goods for use by defence services. Excisable goods can be removed for export out of India either wholly without payment of duty or under bond or on payment of duty under claim for rebate of duty paid.

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

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

EXCISE DUTY AS AN ELEMENT OF COST

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

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

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

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

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

PROVISION FOR UNPAID EXCISE DUTY

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

The most common of these situations arises when the goods are stored under bond, i.e., in a Bonded Store Room, and the duty is paid when the goods are removed from such Bonded Store Room.

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

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

(a) The liability for excise duty arises at the point of time at which the manufacture is completed and it is only its collection which is deferred; and

(b) failure to provide for the liability will result in the balance sheet not showing a true and fair view of the state of affairs of the enterprise.

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

(a) Though the liability for excise duty arises at the point of time at which the manufacture is completed, it gets quantified only when goods are cleared from the factory or the bonded warehouse;

(b) the actual liability for excise duty may get modified by the time the goods are cleared from the factory or bonded warehouse;

(c) where goods are damaged or destroyed before clearance, excise duty may be waived by the competent authority and therefore the duty may never be paid; and

(d) failure to provide for the liability does not affect the profits or losses.

18. Since the liability for excise duty arises when the manufacture of the goods is completed,

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

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

AUDITOR'S RESPONSIBILITY

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

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

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

23. SUMMARY OF RECOMMENDATIONS

(i) Excise duty should be considered as a manufacturing expense and like other manufacturing expenses be considered as an element of cost for inventory valuation.

(ii) Where excise duty is paid on excisable goods and such goods are subsequently utilised in the manufacturing process, the duty paid on such goods, if the same is not recoverable from taxing authorities, becomes a manufacturing cost and must be included in the valuation of work-in-progress or finished goods arising from the subsequent processing of such goods.

(iii) Where the liability for excise duty has been incurred but its collection is deferred, provision for the unpaid liability should be made.

(iv) Excise duty cannot be treated as a period cost.

(v) If the method of accounting for excise duty is not in accordance with the principles explained in this Guidance Note, the auditor should qualify his report.

Guidance Note on Accounting Treatment for MODVAT/CENVAT

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

INTRODUCTION

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

OBJECTIVE

2. The objective of this Guidance Note is to provide guidance in respect of accounting for MODVAT/CENVAT credit. Salient features of MODVAT and CENVAT credit schemes are briefly set out hereinafter. Reference may be made to Central Excise Act, 1944, Central Excise Rules, 1944, Notifications and Circulars issued from time to time for details of the

provisions of MODVAT/CENVAT Schemes. Guidance for accounting for excise duty is provided in the Guidance Note on Accounting Treatment for Excise Duty, which has been revised and issued separately.

MODVAT CREDIT SCHEME (UPTO 31.3.2000) – SALIENT

FEATURES

3. Modified Value Added Tax (MODVAT) Scheme allows instant credit of specified duties paid on specified inputs used in or in relation to manufacture of specified final excisable goods to be utilised for payment of *552 Compendium of Guidance Notes – Accounting* excise duties in respect of such goods. The Scheme covers imported goods as also those acquired indigenously. Specified duty in relation to imported goods is countervailing duty and in case of indigenous goods is excise duty, additional excise duty under Additional Duties of Excise (Textile and Textile Articles) Act, 1978 as also additional excise duty under Additional Duties of Excise (Goods of Special Importance) Act, 1957.

4. MODVAT Scheme was introduced in 1986, effective from 1.3.86, with a view to reduce the cascading effect of duties. Initially, the Schemewas restrictive in its application in that

(i) it applied only to limited categories of inputs and final goods;and

(ii) use of inputs in or in relation to manufacture of final goods was essential for utilisation of duty credit for payment of excise duties on clearance of such final goods. In other words, correlation of inputs and final goods was essential though one to one correlation of inputs was not essential.

5 Significant amendments have since been made to the MODVAT Scheme and the scope of the Scheme has been expanded considerably. Salient features of the Scheme are summarised hereinafter.

6. The Scheme applies to inputs ('Input Duty Credit Scheme') and capital goods ('Capital Goods Duty Credit Scheme').

Input Duty Credit Scheme

7. Provisions in relation to this Scheme are contained in Rules 57A to 57J of the Central Excise Rules, 1944. The Scheme covers inputs and final products classifiable under any of the headings of the Chapters of the Central Excise Tariff Act, 1985. The salient features of the Input Duty Credit Scheme are as follows:

(i) The Scheme is operative only when excise duty is payable on final goods. Thus, MODVAT credit cannot be availed of if the final goods are exempted from duty or are chargeable to nil rate of duty. However, the Scheme is operative in case the final goods enjoy partial exemption from duty.

(ii) Correlation between inputs and final goods is not required, i.e., *Accounting Treatment for*

MODVAT/CENVAT 553 duty credit in respect of any input brought into the factory can be utilised for payment of duty on any final product manufactured in that factory even if that input is not used in or in relation to manufacture of that final product.

(iii) A manufacturer is required to debit RG 23A or account current with an amount equal to 10% of the value of inputs or partially processed inputs removed from his factory for jobwork. The said amount is available as credit on return of processed/final goods to his factory from jobworkers' premises or on clearance of such processed/final goods from jobworkers' premises, if so permitted by the Commissioner, within specified time period.

The debited amount is also available for adjustment against duty payable on such inputs or partially processed inputs not received back within specified time.

(iv) If common inputs are used in manufacture of final products which do not attract duty liability as also those which are chargeable to duty, manufacturer (except in specified cases) is required to pay an amount equal to 8% of the price of products not chargeable to duty at the time of clearance of such products.

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

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

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

Capital Goods Duty Credit Scheme

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

(i) The Scheme covers specified capital goods used in the factory of the manufacturer in relation to the production of specified final products;

(ii) A manufacturer would not be entitled to the MODVAT credit on capital goods until the capital goods are installed or, as the case may be, used for manufacture of excisable goods, in the factory of the manufacturer;

(iii) A manufacturer has option to:

(a) avail MODVAT credit in respect of duty paid on capital goods as per the Rules;

or

(b) claim depreciation on duty element under Section 32 of the Income-tax Act, 1961 or claim deduction of duty element by way of revenue expenditure under any section of the Income-tax Act, 1961, as the case may be;

(iv) A manufacturer can claim MODVAT credit of the duty element of capital goods even if capital goods are acquired on lease, hire-purchase or loan agreement if specified duty is paid by manufacturer either directly to capital goods supplier or to the finance company before payment of first lease/hire-purchase or loan installment, as the case may be.

General

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

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

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

(ii) There is no time limit for utilisation of MODVAT credit. Government is, however, empowered to provide for lapsing of unutilised credit balances for specific products.

(iii) Cash refund of duty credit is not allowable except in case of export of goods if the manufacturer is unable to utilise duty credit towards payment of excise duty on clearance of final goods from his factory.

CENVAT SCHEME (EFFECTIVE FROM 1.4.2000) – SALIENT

FEATURES

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

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

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

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

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

ACCOUNTING TREATMENT IN CASE OF INPUTS USED IN OR IN RELATION TO MANUFACTURE OF FINAL PRODUCTS

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

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

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

17. It may be appropriate to quote the following paragraphs nos. 6 and 7, dealing with 'cost

of inventories' and 'costs of purchase', of Accounting Standard (AS) 2 (Revised) on 'Valuation of Inventories', issued by the Institute of Chartered Accountants of India.

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

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

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

Change in Accounting Policy

19. In cases, where enterprises were accounting for MODVAT credit on inputs in accordance with the erstwhile inclusive method, i.e., the second alternative[1] 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 Account[2] with a corresponding adjustment in the amount of opening stock. After the aforesaid adjustments, the MODVAT Credit Receivable Account should also appear at the amount which would have been arrived at had the method suggested in paragraph 16 of this Guidance Note been followed. An example illustrating the change in accounting policy has been given as Annexure B. Appropriate disclosures as per Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, are also required to be made in the financial statements for change in accounting policy.

Accounting Treatment – Job-work

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

20. In a case where an enterprise removes inputs as such or in a partially processed form to a place outside the factory for the purpose of testing, repairing, refining, reconditioning or carrying out any other operations necessary for manufacture of final products, the enterprise is required to debit MODVAT Credit Register (RG 23A) or account current with an amount equal to 10% of the value of inputs or partially processed inputs, as the case may be. The said debit is in the nature of deposit and is available for credit at the time of return of duly processed goods to the factory within the prescribed time. The said deposit is also available for adjustment against duty payment if the goods are not received back in the factory within the prescribed time limit. If this amount is debited to MODVAT Credit Register (RG 23A), the same should be accounted for as a deposit and should be debited to a separate account with appropriate nomenclature say, 'MODVAT Credit Deposit (Jobwork) Account' and credited to 'MODVAT Credit Receivable Account'. This deposit amount should be credited and 'MODVAT Credit Receivable Account' should be debited at the time of receipt of duly processed goods in the factory within the prescribed time limit or for adjustment of duty if the goods are not received back in the factory within the prescribed time limit. *This requirement of debit has been dispensed with under CENVAT Scheme.*

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

21. An enterprise may receive inputs from a principal for processing and/ or converting to final products on job work basis and may be required to avail MODVAT/CENVAT credit on such inputs and discharge duty liability on clearance of final products on behalf of the principal; the ownership of the inputs and final products continuing to be of the principal. In such cases, the enterprise should, at the time of taking MOVDAT/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 TREATEMNT FOR CENVAT CREDIT IN CASE OF CAPITAL GOODS

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

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

Accounting Treatment for MODVAT/CENVAT

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

ACCOUNTING TREATMENT WHERE CAPITAL GOODS ARE ACQUIRED ON LEASE OR HIRE PURCHASE

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

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

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

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

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

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

REVIEW OF BALANCES IN MODVAT/CENVAT CREDIT RECEIVABLE ACCOUNTS

30. Balances in MODVAT/CENVAT Credit Receivable Accounts, pertaining to both inputs

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

31. (a) The above adjustment related to input credit should be made to the raw material or input purchase account. The effect of this would be to increase the cost of purchase and thereby to increase the cost of inputs for the purpose of accounting for consumption and valuation of closing stocks. Where it is not possible to debit or identify this excess credit to a particular lot or lots of materials purchased, such excess credit may be apportioned over the entire purchases of raw materials, components etc., entitled to MODVAT/CENVAT credit during the year on pro-rata basis.

(b) The adjustment of excess credit related to capital goods should be made to the concerned Capital Goods Account. The excess MODVAT/ CENVAT credit, either availed or deferred, which relates to fixed assets acquired, should be added to the cost of the relevant fixed asset. For accounting purposes, depreciation on the revised unamortised depreciable amount should be provided prospectively over the residual useful life of the asset. In case the fixed asset no longer exists, the relevant amount should be written-off in the profit and loss account. To facilitate aforesaid treatment, MODVAT/CENVAT credit record should be maintained fixed asset-wise in the relevant RG Register. In relation to capital goods other than fixed assets, the accounting treatment for the excess MODVAT/CENVAT credit would be the same as stated in para 31(a) above. It is, therefore, advisable that MODVAT/CENVAT Credit Receivable (Capital Goods) Account is maintained separately for fixed assets and other capital goods.

(c) For capital goods acquired on lease, the amount of excess MODVAT/ CENVAT credit should be written-off on a pro-rata basis along with the lease rentals.

32. Where, at any time during the year, it is revealed that the terms and conditions subject to which the benefit of MODVAT/CENVAT credit is available, have not been complied with or are not being capable of compliance, e.g., where the inputs are destroyed prior to the manufacture of final product or the relevant plant and machinery cannot be put to use for the manufacture

of final product, appropriate adjustments should be made in the accounts to reverse such credit which cannot be availed of, as recommended in para 31 (a) for inputs and 31 (b) and (c) for capital goods.

ACCOUNTING TREATMENT FOR DUTY DEMANDS PAID BY DEBIT TO MODVAT/CENVAT CREDIT BALANCE – INPUTS AND/ OR CAPITAL GOODS

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

VALUATION OF INVENTORIES OF INPUTS

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

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

36. In some cases, the same item of input can be obtained from different sources, some of them may be able to provide the required documents evidencing payment of duty while others may not be able to provide the required documents. In such cases where it is not possible for the buyer to take advantage of the MODVAT/CENVAT credit, the closing stock of inputs of

such items should be valued inclusive of the specified duty on inputs. *Accounting Treatment for MODVAT/CENVAT 565* 37. If any input is used for the production of more than one final product, some of which are excisable while others are either not chargeable to excise duty or chargeable at nil rate of duty, and separate inventory of the input is not maintained, the entire inventory of inputs should be valued at net of input duty. However, if separate inventory is being maintained, the inventory of inputs useable for final products chargeable to excise duty should be valued at net of input duty and the inventory of inputs useable for final products not chargeable to duty should be valued at the actual cost inclusive of excise duty.

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

VALUATION OF INVENTORY OF CAPITAL GOODS

39. Inventories of capital goods should be valued net of MODVAT/ CENVAT credit taken on capital goods. In other words, specified duties paid on such capital goods will not form part of their cost.

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

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

GN(A) 13 (Issued 2000)

Guidance Note on

Accounting for Investments in the

Financial Statements of Mutual Funds

INTRODUCTION

1. The Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, (hereinafter referred to as 'the Regulations') have prescribed accounting policies to be followed by mutual funds for the preparation of their financial statements which, inter alia, require that "for the purpose of all financial statements, all investments shall be marked to market and investments shall be carried out in the balance sheet at market value. However, till necessary guidance notes are issued by the Institute of Chartered Accountants of India to their members, in the above matter, investments may be continued to be valued at cost, with the market value shown separately and the reconciliation statement for the changes in investments valued in the two different ways, shall be provided" [Clause 2(i) of Eleventh Schedule to the Regulations].

2. Clause (a) of the Ninth Schedule to the Regulations, prescribing Accounting Policies and

Standards, also provides as below:

"For the purposes of the financial statements, mutual fund shall mark all investments to market and carry investments in the balance sheet at market value. However, since the unrealised gain arising out of appreciation on investments cannot be distributed, provision has to be made for exclusion of this item when arriving at distributable income."

3. Accounting Standard (AS) 13 on 'Accounting for Investments', issued by the Institute of Chartered Accountants of India, does not apply to accounting for investments in the financial statements of mutual funds. This Guidance Note is being issued primarily with the objective of providing guidance on accounting for investments in the financial statements of mutual funds, where they are marked to market, as stipulated in the above requirements of the Regulations.

4. This Guidance Note does not apply to Unit Trust of India (UTI) in view of the fact that UTI is governed by the provisions of Unit Trust of India Act, 1963, and Rules framed thereunder.

FORMS OF INVESTMENTS

5. Regulation 43 of the Regulations, prescribes that the moneys collected under any scheme of a mutual fund should be invested only in money market instruments or in the capital market or in privately placed debentures or securitised debts. If mutual fund collects money under any money market scheme of a mutual fund, the money collected is to be invested only in money market instruments in accordance with the directions issued by the Reserve Bank of India in this regard. A mutual fund can also, in the case of securitised debts, invest in asset backed securities but the fund is precluded from investing in mortgage backed securities. The investments that a mutual fund can make are subject to the investment restrictions specified in the Seventh Schedule to the Regulations.

CLASSIFICATION OF INVESTMENTS

6. The Regulations do not require classification of investments into any categories, such as current and long term. Annexure 1A of the Eleventh Schedule to the Regulations, which prescribes the contents of scheme-wise Balance Sheet, requires separate disclosure of investments into the following types:

(i) Equity shares;

(ii) Preference shares;

(iii) Privately placed debentures/bonds;

(iv) Debentures and Bonds listed/awaiting listing on the recognized stock exchange;

(v) Calls paid in advance;

(vi) Term Loans;

(vii) Central and State Government Securities (including treasury bills);

(viii) Commercial Paper;

(ix) Others.

It may be noted that item (vi), i.e., term loans was meant to cover such transactions permitted before the Regulations came into force.

COST OF INVESTMENTS

7. As per clause (k) of the Ninth Schedule to the Regulations, the “cost of investments acquired or purchased should include brokerage, stamp charges and any charge customarily included in the broker’s bought note. In respect of debt instruments any front-end discount offered should be reduced from the cost of the investment.” Clause (c) of the said Schedule requires that when interest-bearing investments are purchased, “interest paid for the period from the last interest due date upto the date of purchase must not be treated as a cost of purchase.” In case of investments which carry right to dividend, the cost of investment is reduced by dividends only if they clearly represent a recovery of a part of the cost, e.g., where dividends are passed on by the broker at the time of giving delivery either by giving separate cheque along with the scrips or through credit in his bill. This could arise where (a) the fund has bought shares on cum-dividend basis but delivery is after time limit of book closure of dividend, or (b) Non-Pari Passu (NPP) shares are delivered, i.e., contract was for purchase of old shares, but NPP shares are delivered. National Securities Depository Limited (NSDL) transaction charges and custodian transaction charges identifiable with respect to a particular transaction, are considered as cost of investments. However, such charges which are not identifiable with respect to a particular transaction are not considered as cost of investments.

CARRYING AMOUNT AND THE TREATMENT OF DEPRECIATION AND APPRECIATION WHEN INVESTMENTS ARE MARKED TO MARKET

8. The market value of investments should be determined on the basis of investment valuation norms prescribed in the Eighth Schedule to the Regulations.

9. The basic objective of marking the investments to market, in a mutual fund, is to arrive at the current net asset value of the units. It is felt that this basic objective would be met if the investments are marked to market for balance sheet purposes. Further, as per the existing generally accepted accounting principles in India, unrealised profit is not considered for arriving at the profit (loss) for the period concerned. The recommendations on accounting for investments in the financial statements of mutual funds contained in the following paragraphs are based on the aforesaid principles.

10. The investments should be marked to market on the balance sheet date. The provision for depreciation in the value of investments should be made in the books by debiting the Revenue Account. The provision so created should be shown as a deduction from the value of investments in the balance sheet. However, unrealised appreciation should be directly transferred to the Unrealised Appreciation Reserve, i.e., without routing it through the Revenue Account with the corresponding debit to the Investments Account. It is recommended

that the Unrealised Appreciation Reserve should be reversed at the beginning of the next accounting year.

11. Clause 2(i) of the Eleventh Schedule also provides that "where the financial statements are prepared on a mark to market basis, there *need not be* a separate provision for depreciation". However, keeping in view 'prudence' as a factor for preparation of financial statements and correct disclosure of the amount of depreciation on investments, it is recommended that the gross value of depreciation on investments should be reflected in the Revenue Account rather than the same being netted off with the appreciation in the value of other investments. In other words, depreciation/appreciation on investments should be worked out on an individual investment basis or by category of investment basis, but not on an overall (or global) basis for the entire investment portfolio.

DISPOSAL OF INVESTMENTS

12. The profit/loss arising on the disposal of investment would be the difference between the selling price and the cost. The profit arising on disposal of investment should be recognised fully in the Revenue Account. The amount of loss on the disposal of investment should also be recognised fully in the Revenue Account, if it has been sold in the same year in which it was purchased or if no provision was created for depreciation in the value of investment. However, if the investment is sold in the subsequent year(s) and provision was created as on the last balance sheet date for depreciation in the value of investment, the loss should be charged against the said provision to the extent of balance available in the said account and the balance of loss, if any, should be charged directly to the Revenue Account.

DISCLOSURE

13. Accounting policy for valuation of investments should be disclosed as required by Annexure 1A of the Eleventh Schedule to the Regulations.

GN(A) 16 (Issued 2003)
Guidance Note on
Accounting for Securitisation

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

INTRODUCTION

1. Securitisation is the process by which financial assets such as loan receivables, mortgage backed receivables, credit card balances, hire-purchase debtors, lease receivables, trade debtors, etc., are transformed into securities. Securitisation is different from 'factoring' in that 'factoring' involves transfer of debts without transformation thereof into securities. A securitisation transaction, normally, has the following features:

- Financial assets such as loan assets, mortgages, credit card balances, hire-purchase debtors, trade debtors, etc., or defined rights therein, are transferred, fully or partly, by the owner (the Originator) to a Special Purpose Entity (SPE) in return for an immediate cash payment and/or other consideration. The assets so transferred are the ‘securitised assets’ and the assets or rights, if any, retained by the Originator are the ‘retained assets’.

- The SPE finances the assets transferred to it by issue of securities such as Pass Through Certificates (PTCs) and/or debt securities to investors.
- A usual feature of securitisation is ‘credit enhancement’, i.e., an arrangement which is designed to protect the holders of the securities issued by an SPE from losses and/or cash flow mismatches arising from shortfall or delays in collections from the securitised assets. The arrangement often involves one or more of the following:
- *Provision of cash collateral,* i.e., a deposit of cash which in specified circumstances can be used by the SPE for discharging its financial obligation in respect of the securities held by the investors.
- Over collaterisation, i.e., making available to the SPE assets in excess of the securitised assets, the realization of which can be used in specified circumstances to fund the shortfalls and/or mismatches in fulfilment of its financial obligations by the SPE.
- Recourse obligation accepted by the Originator.
- Third party guarantee, i.e., a guarantee given by a third party by accepting the obligation to fund any shortfall on the part of the SPE in meeting its financial obligations in respect of the securitisation transaction.
- *Structuring of the instruments issued by an SPE into senior and subordinated securities* such that the senior securities (issued to investors) are cushioned by the subordinated securities (issued normally to the Originator) against the risk of shortfalls in realisation of securitised assets. Payments on subordinated securities are due only after the amounts due on the senior securities are discharged.
- The Originator may continue to service the securitised assets (i.e., to collect amounts due from borrowers, etc.) with or without servicing fee for the same.
- The Originator may securitise or agree to securitise future receivables, i.e., receivables that are not existing at the time of agreement but which would be arising in future. In case of such securitisation, the future receivables are estimated at the time of entering into the transaction and the purchase consideration for the same is received by the Originator in advance. Securitisation can also be in the form of ‘Revolving Period Securitisation’ where future receivables are transferred as and when they arise or at specified intervals; the transfers being on prearranged terms.

A diagrammatic presentation of a typical securitisation transaction is given in Appendix I.

2. This Guidance Note deals with accounting for securitisation transactions in the books of

Originator, specially addressing issues such as when to derecognise, fully or partly, the securitised assets; treatment of securitisation of future receivables; measurement of consideration received in the form of securities; etc. The Guidance Note also deals with accounting for securitisation transactions in the books of SPEs. Another issue dealt with relates to accounting for investments in the securities such as PTCs and/or debt securities issued by the SPE, in the books of Investors.

DEFINITIONS

3. The following terms are used in this Guidance Note with the meanings specified:

Call Option is an option that entitles the Originator to repurchase the financial assets transferred under a securitisation transaction from the SPE. The Option may be at a predetermined price or at a value to be determined, for example, fair value on the date of exercise of Call Option.

Clean-up Call Option is an option held by the servicer (who may be the Originator) to purchase the remaining transferred securitised assets or the remaining beneficial interests in the SPE if the amount of securitised assets or beneficial interests falls to a level at which the cost of servicing those assets or beneficial interests becomes burden some in relation to the benefits of servicing.

Interest Strip is a contractual arrangement to separate the right to all or part of the interest due on a debenture, bond, mortgage loan or other interest bearing financial asset from the financial asset itself.

Investor is the person who finances the acquisition of the securitised assets or of beneficial interest therein by subscribing to PTCs and/or debt securities issued by an SPE.

Originator is an entity that owns the financial assets proposed to be securitised and initiates the process of securitisation in respect of such assets.

Pass Through Certificates (PTCs) are instruments acknowledging a beneficial interest in the securitised assets such that the payment of interest on such instruments and the repayment of the principal are directly or indirectly linked or related to realisations from the securitised assets.

Principal Strip is the right to the remainder of the financial asset net of all rights that have been stripped therefrom by one or more contractual arrangements such as by an Interest Strip.

Recourse Obligation is the obligation of the Originator to reimburse or compensate, fully or partly, the investors for, or otherwise bear the risk of, shortfalls, such as those, arising from:

♦ • failure of debtors to pay or to pay when due; or

♦ • pre-payments; or

- other defects in securitised financial assets.

Servicing Asset is a contract to service financial assets under which the estimated future revenues from contractually specified servicing fees, late charges and other related revenues are expected to more than adequately compensate the servicer (who may be the Originator) for performing the services. A servicing contract can be either:

- undertaken together with selling or securitising the financial assets being serviced; or
- purchased or assumed separately.

Special Purpose Entity (SPE) is an entity which acquires the financial assets under securitisation and normally holds them till maturity. SPE is an independent entity, usually constituted as a trust though it may be constituted in other forms, for example, as a limited company, formed with small capital for the specific purpose of funding the transaction by issue of PTCs or debt securities.

ACCOUNTING IN THE BOOKS OF ORIGINATOR

Derecognition of securitised asset

4. Securitised asset should be derecognised in the books of the Originator, if and only if, either by a single transaction or by a series of transactions taken as a whole, the Originator loses control of the contractual rights that comprise the securitised asset. The Originator loses such control if it surrenders the rights to benefits specified in the contract. Determining whether the Originator has lost control of the securitised asset depends both on the Originator's position and that of the SPE. Consequently, if the position of either the Originator or the SPE indicates that the Originator has retained control, the Originator should not remove the securitised asset from its balance sheet.

5. The Originator has not lost control over the securitised asset, for example, where

(a) the creditors of the Originator are entitled to attach or otherwise deal with the securitised assets;

(b) the SPE does not have the right (to the extent it was available to the Originator) to pledge, sell, transfer or exchange for its own benefit the securitised asset;

(c) the Originator has the right to reassume control of the securitised asset except

(i) where it is entitled to do so by a Call Option, where such Call Option can be justified on its own commercial terms as a separate transaction between the SPE and the Originator, for instance, where the Call Option is exercisable at fair value of the asset on the date of exercise of the Option; or

(ii) where it is entitled to do so by a Clean-up Call Option.

6. Whether the Originator has lost control over the securitised asset should be determined on the basis of the facts and circumstances of the case by considering all the evidence

available. It would be incorrect to hold that the derecognition criterion prescribed in paragraph 4 is not met in the following cases:

(a) The Originator continues to service the securitised asset. Such servicing by itself would not lead to a conclusion that the Originator has not lost control over the securitised asset.

(b) An obligation is cast on the Originator to repurchase the securitised asset at a predetermined price. Such an obligation is not an entitlement to reassume ownership available to the Originator. Notwithstanding such an obligation the securitised asset would be beyond the control of the Originator. The obligation accepted by the Originator should be accounted for in the manner indicated in paragraph 10 of this Guidance Note. However, where the Originator is both entitled and obligated to repurchase the securitised asset at a pre-determined price, the Originator is not considered to have lost control over the securitised asset and, therefore, the same should not be removed from the balance sheet of the Originator.

7. On derecognition, the difference between the book value of the securitised asset and consideration received should be treated as gain or loss arising on securitisation and disclosed separately in the statement of profit and loss. On the other hand, if the derecognition criterion as prescribed in paragraph 4 is not met, the asset should continue to be recognised in the books of the Originator and consideration received for the asset so transferred, should be accounted for as a borrowing secured there against.

8. The consideration received in a form other than cash, e.g., securities issued by the SPE, should be measured at the lowest of the

(a) the fair value of the consideration;

(b) the net book value of the securitised assets; and

(c) the net realisable value of the securitised assets.

In case the consideration has been received partly in cash and partly in a form other than cash, the non-cash component of the consideration should be measured at the lowest of the

(a) the fair value of the non-cash component;

(b) the net book value of the securitised assets as reduced by the cash received; and

(c) the net realisable value of the securitised assets as reduced by the cash received.

The fair value is the price that would be agreed upon between knowledgeable, willing parties in an arm's length transaction. Quoted market price in an active, liquid and freely accessible market, if available, is normally the best evidence of fair value. If quoted market price is not available, estimate of fair value may be based on the market prices of assets similar to those received as consideration. In case the market prices of similar assets are also not available, the estimate of fair value may be based on generally accepted valuation techniques such as the present value of estimated future cash flows. These techniques would require estimates and assumptions about various matters such as estimates of future revenues, future expenses and assumptions about interest rates, defaults and likely prepayments. Some of these estimations, e.g., estimation of future cash flows and discount rates may present significant difficulties. It would be necessary to make the best estimate based on reasonable and supportable assumptions and projections. All available evidence should be considered in developing the requisite estimate and assumptions.

9. In case the securitised assets qualify for derecognition, the entire expenses incurred on the transaction, say, legal fees, etc., should be expensed at the time of the transaction and should not be deferred. Where the securitised assets do not qualify for derecognition and, therefore, the consideration received in respect thereof is treated as a secured borrowing, such expenses should either be amortised over the term of the secured borrowing or recognised immediately in the statement of profit and loss.

10. If a securitised asset qualifies to be derecognised as per paragraph 4 and the Originator has accepted recourse or similar obligation, e.g., the Originator has granted a Put Option at a predetermined price to the SPE, then the contingent loss arising therefrom, should be accounted for as per Accounting Standard (AS) 4, ‘Contingencies and Events Occurring After the Balance Sheet Date’, issued by the Institute of Chartered Accountants of India. This would require that a provision be made for the contingent loss arising from the obligation, where the criteria specified in the Standard in this regard are satisfied.

FUTURE RECEIVABLES / REVOLVING SECURITISATION

11. Any purchase consideration received by the Originator on the securitisation of future receivables should be accounted for as an advance, since the assets proposed to be securitised would not be existing at the time of the agreement, but would arise in future. The cost of bringing these assets into existence would also be incurred in future. In such cases, the criterion for derecognition prescribed in paragraph 4 should be applied as and when the relevant assets come into existence. Till such time the amounts received, if any, on account of the proposed securitisation should be reflected as an advance. The other requirements of the Guidance Note also apply, mutatis mutandis, in case of securitisation of future receivables.

12. In case of revolving period securitisation where financial assets are transferred as and when they come into existence or at specified intervals and the purchase consideration is paid to the Originator at the time of such transfer, all requirements of this Guidance Note, except paragraph 11, apply.

PARTIAL DERECOGNITION

13. An Originator may transfer only a part of the financial asset in a securitisation transaction instead of transferring the complete asset. Such transfer may occur in two ways. One way is where a proportionate share of the asset is transferred. For example, the Originator may transfer a proportionate share of loan (including right to receive both interest and principal), in

such a way that all future cash flows, profit/loss arising on loan will be shared by the Originator and the SPE in fixed proportions. A second way of transferring a part of a financial asset arises where the asset comprises the rights to two or more benefit streams, and the Originator transfers one or more of such benefit streams while retaining the others. For example, the Originator may securitise the Principal Strip of the loan while retaining the Interest Strip and Servicing Asset.

14. If the Originator transfers a part of a financial asset while retaining the other part, the part of the original asset which meets the derecognition criterion as set out in paragraph 4 should be derecognised whereas the remaining part should continue to be recognised in the books. Similarly, if any new interest has been created as a result of securitisation transaction, such as a Call Option, the new interest should be recognised in the books in accordance with the relevant accounting principles.

15. If the Originator transfers a proportionate part of the asset, the previous carrying amount of the asset is apportioned among the part transferred and the part retained on the basis of proportion transferred and proportion retained. For example, if the Originator transfers 75% of an asset to the SPE, 75% of the carrying amount of the asset should be considered as securitised. Where the securitised part of the asset qualifies to be derecognised as per the requirements of paragraph 4, the entity would continue to recognise the remaining part of the asset at 25% of the carrying amount.

16. In case the asset comprises the rights to two or more benefit streams and one or more of such benefit streams is/are transferred while retaining the others, the carrying amount of such financial asset should be apportioned between the part(s) transferred and the part(s) retained on the basis of their relative fair values as on the date of transfer. The fair values of the parts should be determined on the basis described in paragraph 8. If fair value of the part of the asset that is retained cannot be measured reliably, that part should be valued at a nominal value of Re.1. Similarly, if any new financial asset, e.g., a call option, has been created as a result of securitisation transaction and its fair value cannot be measured reliably, initial carrying amount of the asset should be recognised at a nominal value of Re.1.

17. An example illustrating the computations and accounting treatment in case of partial derecognition is given in Appendix II to this Guidance Note.

ACCOUNTING IN THE BOOKS OF SPECIAL PURPOSE ENTITY

18. The SPE should recognise the asset received under a securitisation transaction, if the Originator loses control over the securitised asset on the basis of the criterion prescribed in paragraph 4. The asset so received should be recognised at the amount of consideration, if the consideration has been paid in cash. In case the consideration has been paid in a form other than cash, e.g., securities, the asset so received should be recorded either at its intrinsic value or at the fair value of the consideration, whichever is more clearly evident. If both the values are equally evident the asset should be valued at the lower of the two values.

19. If the beneficial ownership in the securitised asset has not been transferred to the SPE or the Originator has not lost control over the asset as per the requirements of paragraph 4, the SPE should not recognise the asset received. In such a case, the consideration paid should be recorded as a lending secured against the financial asset received under securitisation transaction.

20. The amount received by the SPE on issue of PTCs or other securities should be shown on the liability side of the balance sheet, with appropriate description, keeping in view the nature of securities issued.

ACCOUNTING IN THE BOOKS OF THE INVESTOR

21. The Investor should account for the PTCs and/or debt securities acquired by it as an investment in accordance with Accounting Standard (AS) 13, 'Accounting for Investments'. However, where in case of an Investor, AS 13 is not applicable because of the Investor being specifically exempted from the application of AS 13, the investments in PTCs and/or other securities should be valued and accounted for as per the relevant accounting principles applicable to the Investor.

DISCLOSURES

22. In addition to the disclosures arising from recommendations made in paragraph 10, the following disclosures should be made in the financial statements of the Originator:

(i) The nature and extent of securitisation transaction(s), including the financial assets that have been derecognised.

(ii) The nature and the amounts of the new interests created, if any.

(iii) Basis of determination of fair values, wherever applicable.

23. The following disclosures should be made in the financial statements of the SPE:

(i) The nature of the securitisation transaction(s) including, in particular, a description of the rights of the SPE vis-à-vis the Originator whether arising from the securitisation transaction or a transaction associated therewith.

(ii) Basis of determination of fair values, wherever applicable.

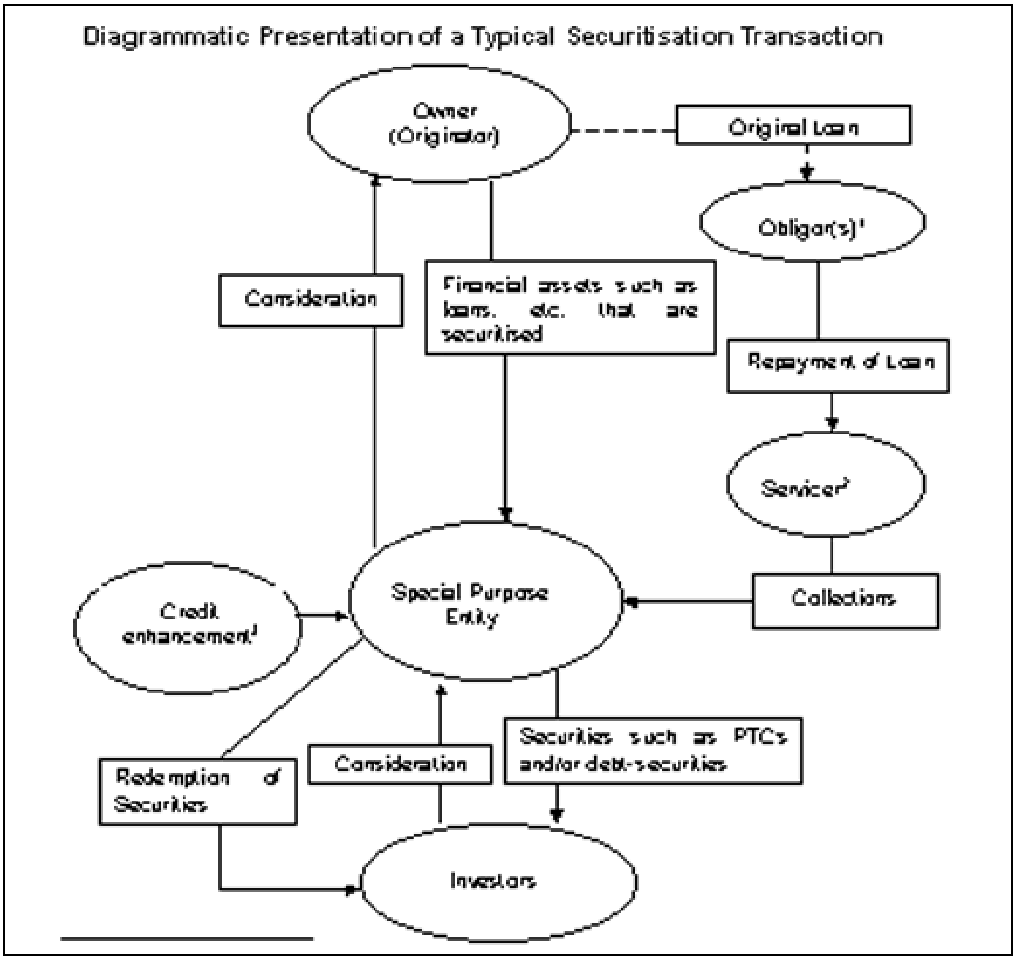
24. The Investor should make disclosure of investments in PTCs and/or debt securities as required by Accounting Standard (AS) 13, 'Accounting for Investments'. However, where in the case of an Investor, AS 13 is not applicable because the Investor is specifically exempted from the application of AS 13, the Investor should make such disclosures as per the relevant requirements.

Note : For Appendices given in the Guidance Note , students are advised to refer the Compendium of Guidance Notes Accounting as on July 1, 2006)

Appendix I

(This Appendix does not form part of the Guidance Note and is merely illustrative.)

Diagrammatic Presentation of a Typical Securitisation Transaction



[1] Obligor is an entity which has received a loan giving rise to the financial asset that is securitised by the Originator.
[2] can be the Originator also.
[3] may be provided either by the Originator or by any third party.

Appendix II

Illustration of Computation and Accounting in Case of Partial Derecognition

(This Appendix does not form part of the Guidance Note and is merely illustrative.)

1. Suppose Company 'C' holds Rs. 1,000/- of loans yielding interest @ 18% p.a. for their estimated lives of nine years. Considering the interest rate the fair value of these loans is estimated at Rs. 1,100/-. The company securitises the principal component of the loan plus the right to receive interest @ 14% to an SPE for Rs. 1,000/-. Out of the balance interest of 4%, it is

stipulated that half of such balance interest, namely 2%, will be due to the company as fees for continuing to service the loans. The fair value of the servicing asset so created is estimated, after taking into account the costs likely to be incurred in servicing the loan, at Rs. 40. The remaining half of the interest is due to the company as an interest strip receivable, the fair value of which is estimated at Rs. 60.

2. Since the company has securitised the principal and a part of the interest, it is necessary to compute the cost attributable to various components assuming that the securitised components meet the derecognition criteria. This computation can be done by apportioning the carrying amount of the asset in the ratio of fair values as follows:

Fair Value of securitised component of the loan

	Rs.	**Rs.**
Fair value of loan		1,100
Less: Fair value of servicing asset	40	
Fair value of interest strip	60	100
Fair value of securitised component of loan		1,000

Apportionment of carrying amount based on relative fair values

Particulars	**Fair Values**	**%age based on Total Fair Value**	**Carrying Amount / Cost**
Securitised component of loan	1000	91	910
Servicing Asset	40	3.6	36
Interest Strip Receivable	60	5.4	54
	1,100	100	1,000

3. The profit arising on securitisation should be computed as follows:

	Rs.
Net proceeds of securitisation	1,000
Less: Cost (apportioned carrying amount) of securitised component of loan	910
Profit on securitisation	90

4. Based on the above, the following journal entries would be passed in the books of the Originator:

		Rs.	Rs.
(a) To record securitisation of principal plus right to 14% interest			
Cash A/c	Dr.	1,000	
To Loans A/c (cost of securitised component)			910
To Profit on Securitisation			90
(b) To record the creation of servicing asset and interest strip receivable			
Servicing asset A/c	Dr.	36	
Interest strip A/c	Dr.	54	
To Loans A/c			90

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GUIDANCE NOTE ON ACCOUNTING FOR EQUITY INDEX AND EQUITY STOCK FUTURES AND OPTIONS

(The following is the text of the Guidance Note on Accounting for Equity Index and Equity Stock Futures and Options, issued by the Council of the Institute of Chartered Accountants of India. With the issuance of this Guidance Note, Guidance Note on Accounting for Equity Index Futures and Guidance Note on Accounting for Equity Index Options and Equity Stock Options, issued by the Council of the Institute of Chartered Accountants of India, stand withdrawn.)

INTRODUCTION

1. During the last few years, a number of new financial instruments have assumed significance in the Indian economy. With rapid globalisation, this trend is likely to accelerate in future. Derivatives are a kind of financial instruments whose values change in response to the change in specified interest rates, security prices, commodity prices, index of prices or rates, or similar variables. Typical examples of derivatives are futures and forward contracts, swaps and option contracts.

2. Equity index futures, equity stock futures, equity index options and equity stock options are traded on some major stock exchanges. For instance, in case of equity index futures and equity index options, The National Stock Exchange of India Limited (NSE) and The Stock Exchange, Mumbai (BSE) have introduced trading in S&P CNX NIFTY index and BSE SENSEX, respectively. In case of equity stock futures and equity stock options, NSE and BSE have introduced trading in certain securities specified by the Securities and Exchange Board of India (SEBI).

3. This Guidance Note deals with accounting treatment of equity index futures, equity stock futures, equity index options and equity stock options (hereinafter collectively referred to as 'Equity Derivative Instruments') from the viewpoint of the parties who enter into such contracts as buyers or sellers.

4. Equity Derivative Instruments are a type of financial instruments, which are bought or sold with specific motives, e.g., speculation, hedging and arbitrage. The accounting treatment recommended in this Guidance Note is applicable to all contracts entered into for Equity Derivative Instruments irrespective of the motive.

Nature of Equity Derivative Instruments

5. In order to understand the nature of various Equity Derivative Instruments, it is essential to first understand the meaning of the terms 'forward contract', 'futures contract' and 'options contract'.

6. A forward contract is an agreement between two parties whereby one party agrees to buy

from, or sell to, the other party an asset at a future time for an agreed price (usually referred to as the ‘contract price’). The parties to forward contracts may be individuals, corporates or financial institutions. At maturity, a forward contract is settled by delivery of the asset by the seller to the buyer in return for payment of the contract price. For example, a person (X) may enter into a forward contract with another person (Y) on June 15, 20x3 to buy 10 kgs. of silver at the end of 90 days at a price of Rs. 8,200 per kg. At the end of the 90 days, Y will deliver 10 kgs. of silver to X against payment of Rs. 82,000. If the price of silver, at the end of the 90 days, is Rs. 8,300 per kg., X would make a profit of Rs. 1,000 and Y would lose Rs. 1,000, as X could sell silver bought at Rs. 82,000 for Rs. 83,000, whereas Y would have to buy silver for Rs. 83,000 and sell for Rs. 82,000. On the other hand, if the price of silver at the end of the 90 days is Rs. 7,800 per kg., X would lose Rs. 4,000, whereas Y would make a profit of Rs. 4,000, as X would have to sell silver bought at Rs. 82,000 for Rs. 78,000, whereas Y would buy silver for Rs. 78,000, which he would sell to X at Rs. 82,000.

7. A futures contract, like a forward contract, is an agreement between two parties to buy or sell an asset at a certain time in future for an agreed price. Futures contracts are normally traded on an exchange. To make trading possible, the exchange specifies certain standardised features of the contract. The exchange may also provide for guarantee mechanism to ensure that each party to the contract meets its obligations and, consequently, risk from default by parties is minimised.

8. An Option is a type of derivative instrument whereby a person gets the right to buy or sell at an agreed amount an underlying asset on or before the specified future date. He is not under any obligation to do so. The person who gets such right is called ‘Option Buyer’ or ‘Option Holder’. The person against whom the buyer/holder can exercise his right is called ‘Option Seller’ or ‘Option Writer’. Unlike a buyer/holder, the seller/writer of an option has no right but has an obligation to sell or buy the underlying asset as and when the buyer/holder exercises his right. In order to acquire the right of Option, the buyer/holder pays to the seller/writer an Option Premium, which is the price, paid for the right. Every option contract is for a specific period of time. On the expiry of the specified period, the contract also expires. On the basis of the rights of the buyer with regard to the time of settlement, the Options can be classified into two broad categories, viz., American style options and European style options. In case of American style options, the buyer/holder can exercise his right at any time before the contract expires or on the Expiry Date, whereas in case of European style options, the buyer/holder can exercise his right only on the Expiry Date.

9. An Option can either be a ‘Call Option’ or a ‘Put Option’. In case of Call Option, buyer/holder of the Option gets the right to purchase the underlying asset whereas in case of Put Option buyer/holder gets the right to sell the underlying asset. In market terminology, a person buying a Call Option is considered to have made a ‘long call’ and a person buying a Put Option is considered to have made a ‘long put’. Similarly, a person selling a Call Option or

a Put Option is considered to have made a 'short call' or a 'short put', respectively. In a Call Option the seller/writer of the Option has an obligation to sell the underlying asset, whereas in a Put Option the seller/writer has an obligation to buy the underlying asset. The rights and the obligations of the parties involved in an option contract can be summarised in a tabular form as under:

Option Type	Buyer/Holder	Seller/Writer
Call	Right but not an obligation to buy the underlying asset.	Obligation but no right to sell the underlying asset.
Put	Right but not an obligation to sell the underlying asset.	Obligation but no right to buy the underlying asset.

10. The price at which the buyer/holder has the right to buy or sell and the seller/writer has an obligation to sell or buy is known as the 'Strike' or 'Exercise' price.

11. It may be noted that the buyer/holder of an option can make a loss of no more than the Option Premium paid to the seller/writer but the possible gain is unlimited. On the other hand, the Option Seller/Writer's maximum gain is limited to the Option Premium charged by him from the buyer/holder but can make unlimited loss.

12. In market terminology, an option contract can be 'at the money', 'in the money' or 'out of the money'. 'At the money' means that the current market value of the underlying asset is the same as the Exercise Price of the Option. A Call Option is said to be 'in the money' if the current market value of the underlying asset is above the Exercise Price of the Option. A Put Option is said to be 'in the money' if the current market value of the underlying asset is below the Exercise Price of the Option. A Call Option is said to be 'out of the money' if the current market value of the underlying asset is below the Exercise Price of the Option. A Put Option is said to be 'out of the money' if the current market value of the underlying asset is above the Exercise Price of the Option.

13. Futures and options are both standardised derivative instruments traded on a stock exchange. The difference between these two types of derivative instruments is in respect of the rights and obligations of the parties involved in such contracts. In case of a futures contract, both the parties are under obligation to complete the contract on the specified date. However, in case of options contract, the buyer/holder has a right, but no obligation to exercise the Option, whereas the seller/writer has an obligation but no right to complete the contract.

14. There can be futures and options on commodities, currencies, securities, stock index, individual stock, etc. In India, SEBI has permitted trading in futures and options in two equity indexes, viz., BSE SENSEX and S&P CNX NIFTY and certain specified securities listed on the stock exchanges. Currently, these futures and options contracts are traded on The Stock

Exchange, Mumbai and The National Stock Exchange of India Limited.

EQUITY INDEX FUTURES AND EQUITY STOCK FUTURES

15. An equity index futures contract is a futures contract in which the underlying asset is an equity index, e.g., S&P CNX NIFTY or BSE SENSEX. In other words, it is a contract to buy or sell equity index at an agreed amount on a specified future date.

16. An equity stock futures contract is a futures contract in which the underlying asset is a security, e.g., equity shares of ABC Limited, equity shares of PQR Limited, etc. In other words, it is a contract to buy or sell a security at an agreed amount on a specified future date.

17. The following are the basic differences between these two types of equity futures:

(a) The underlying asset

In case of equity index futures, the underlying asset is equity index itself (e.g., BSE SENSEX, S&P CNX NIFTY), whereas in case of equity stock futures, the underlying asset is a security (e.g., equity shares of a company).

(b) The mode of settlement

By its very nature, the index cannot be delivered on maturity of the contract. As such, the settlement of an equity index futures contract takes the form of payment of the difference between the price as agreed in the contract (contract price) and the value of the index on the maturity date (Settlement Date), in cash. In contrast, an equity stock futures contract can be settled either through delivery of security for which the contract was entered into or by receipt/payment of the difference between contract price and the value of the security for which the contract was entered into, in cash, just like equity index futures. At present, in India, equity stock futures contracts are settled through cash. However, in near future equity stock futures may be settled through physical delivery of shares.

18. Examples of Equity Index Futures

(i) In July, Mr. A enters into an equity index futures contract to buy 100 units of BSE SENSEX of September 20x3 series at a price of, say, Rs. 3,650 per unit. As a result, Mr. A is under obligation to buy 100 units of BSE SENSEX on the Settlement Date at the rate of Rs. 3,650 per unit. On the Settlement Date, if the price of BSE SENSEX is higher than Rs. 3,650, say, Rs. 3,680 per unit, Mr. A will receive Rs. 30 per unit (the difference between the price on the Settlement Date and the contract price). On the other hand, if, on the Settlement Date, the price of BSE SENSEX is lower than Rs. 3,650, say, Rs. 3,610 per unit, Mr. A will pay Rs. 40 per unit.

(ii) In July, Mr. B enters into an equity index futures contract to sell 200 units of S&P CNX NIFTY of September 20x3 series at a price of, say, Rs. 1,100 per unit. As a result, Mr. B is under obligation to sell 200 units of S&P CNX NIFTY on the Settlement Date at the rate of Rs. 1,100 per unit. On the Settlement Date, if the price of the S&P CNX NIFTY is higher than Rs. 1,100, say, Rs. 1,125 per unit, Mr. B will pay Rs. 25 per unit (the difference between the price on the Settlement Date and the contract price). On the other hand, if, on the Settlement Date, the price of S&P CNX NIFTY is lower than Rs. 1,100, say, Rs. 1,050 per unit, Mr. B will receive Rs. 50 per unit.

19. Examples of Equity Stock Futures

(i) In July, Mr. A enters into an equity stock futures contract to buy 1,000 equity shares of XYZ Limited of September 20x3 series at a price of, say, Rs. 250 per share. As a result, Mr. A is under obligation to buy 1,000 equity shares of XYZ Limited on the Settlement Date at the rate of Rs. 250 per share. On the Settlement Date, Mr. A will have to settle the contract either through purchase of shares or by payment/receipt of the difference between the contract price of Rs. 250 per share and the price of the shares of XYZ Limited on that date, depending upon whether the contract is delivery-settled or cash-settled. If the contract is delivery-settled, on the Settlement Date, Mr. A will buy 1,000 equity shares of XYZ Limited at a price of Rs. 250 per share. On the other hand, if the contract is cash-settled, on the Settlement Date, if the price of the shares of XYZ Limited is higher than Rs. 250, say, Rs. 280 per share, Mr. A will receive Rs. 30 per share (the difference between the price on the Settlement Date and the contract price). However, if, on the Settlement Date, the price of the shares of XYZ Limited is quoted lower than Rs. 250, say, Rs. 210 per share, Mr. A will pay Rs. 40 per share.

(ii) In July, Mr. B enters into an equity stock futures contract to sell 500 equity shares of PQR Limited of September 20x3 series at a price of, say, Rs. 500 per share. As a result, Mr. B is under obligation to sell 500 equity shares of PQR Limited on the Settlement Date at the rate of Rs. 500 per share. On the Settlement Date, Mr. B will have to settle the contract either through sale of shares or by payment/receipt of the difference between the contract price of Rs. 500 per share and the price of the shares of PQR Limited on that date, depending upon whether the contract is delivery-settled or cash-settled. If the contract is delivery-settled, on the Settlement Date, Mr. B will sell 500 equity shares of PQR Limited at a price of Rs. 500 per share. On the other hand, if the contract is cash-settled, on the Settlement Date, if the price of the shares of PQR Limited is higher than Rs. 500, say, Rs. 525 per share, Mr. B will pay Rs. 25 per share (the difference between the price on the Settlement Date and the contract price). However, if, on the Settlement Date, the price of the shares of PQR Limited is lower than Rs. 500, say, Rs. 450 per share, Mr. B will receive Rs. 50 per share.

EQUITY INDEX OPTIONS AND EQUITY STOCK OPTIONS

20. Equity index options are a type of derivative instruments whereby a person gets the right

to buy or sell an agreed number of units of equity index on a specified future date. Equity stock options are a type of derivative instruments whereby a person gets the right to buy or sell an agreed number of units of a security on or before a specified future date. At present, in India, trading in equity index options is allowed in two indexes, viz., BSE SENSEX and S&P CNX NIFTY and equity stock options are allowed in certain specified securities listed on the stock exchanges.

21. The following are the basic differences between these two types of equity options:

(a) The underlying asset

In case of equity index options, the underlying asset is equity index itself (e.g., BSE SENSEX, S&P CNX NIFTY), whereas in case of equity stock options, the underlying asset is a security (e.g., equity shares of a company).

(b) The time of settlement

Equity index options are of European style, i.e., buyer/holder can exercise his option only on the day on which the option expires, whereas equity stock options are of American style, i.e., the buyer/holder can exercise his option at any time before the Expiry Date or on the date of expiry itself.

(c) The mode of settlement

By its very nature, the index cannot be delivered on maturity of the contract. As such, the settlement of an equity index options contract takes the form of payment of the difference between the Strike/Exercise Price and the value of the index on the Expiry Date, in cash. In contrast, equity stock options contract can be settled either through delivery of security for which an options contract was entered into or by payment of the difference between the Strike/Exercise Price and the value of the security for which the options contract was entered into, in cash, just like equity index option. At present, in India, equity stock options are settled through cash. However, in near future equity stock options may be settled through physical delivery of shares.

22. Examples of Equity Index Options

Call Options

In July, Mr. A (buyer/holder) enters into an equity index options contract to buy a Call Option for 200 units of S&P CNX NIFTY of September 20x3 series at a price of Rs. 1,100 per unit. As a result, Mr. A obtains the right to buy 200 units of S&P CNX NIFTY on the Expiry Date at Rs. 1,100 per unit. For this right, Mr. A pays a premium of Rs. 10 per unit of index to the seller/writer of the option. If, on the Expiry Date, the price of S&P CNX NIFTY is higher than Rs. 1,100, Mr. A will exercise his right to call. By exercising the right to call, he will receive the difference between the price on the Expiry Date and the Strike Price. On the other hand, if the price is below Rs. 1,100, he will not exercise his Call Option.

Put Options

In July, Mr. B (buyer/holder) enters into an equity index options contract to buy a Put Option for 100 units of BSE SENSEX of September 20x3 series at a price of Rs. 3,650 per unit. As a result, Mr. B obtains a right to sell 100 units of BSE SENSEX on the Expiry Date at Rs. 3,650 per unit. For this right, Mr. B pays a premium of Rs. 25 per unit of index to the seller/writer of the option. If, on the Expiry Date, the price of BSE SENSEX is lower than Rs. 3,650, Mr. B will exercise his right to put. By exercising the right to put, he will receive the difference between the Strike Price and the price on the Expiry Date. On the other hand, if the price is above Rs. 3,650, he will not exercise his Put Option.

23. Examples of Equity Stock Options

Call Options

In July, Mr. A (buyer/holder) enters into an equity stock options contract to buy a Call Option for 1,000 equity shares of XYZ Limited of September 20x3 series at a price of Rs. 250 per share. As a result, Mr. A obtains a right to buy 1,000 equity shares of XYZ Limited at the rate of Rs. 250 per share on or before the Expiry Date. For this right, Mr. A pays a premium of Rs. 5 per equity share to the seller/writer of the option. If, at any time on or before the Expiry Date, the price of the equity shares is quoted higher than Rs. 250, Mr. A may exercise his right to call. In case the contract is delivery-settled, by exercising the right to call, Mr. A will acquire 1,000 equity shares of XYZ Limited at Rs. 250 per share and since the prevailing market price is higher, he can make a profit by selling these shares in the market. In case the contract is cash-settled, by exercising the right to call, Mr. A will receive the difference between the prevailing market price and the Strike Price. On the other hand, if the market price is below Rs. 250 per share, he will not exercise his Call Option.

Put Options

In July, Mr. B (buyer/holder) enters into an equity stock options contract to buy a Put Option for 500 equity shares of PQR Limited of September 20x3 series at a price of Rs. 500 per share. As a result, Mr. B obtains a right to sell 500 equity shares of PQR Limited on or before the Expiry Date at the rate of Rs. 500 per share. For this right, Mr. B pays a premium of Rs. 15 per equity share to the seller/writer of the Option. If, at any time on or before the Expiry Date, the price of the equity shares is quoted lower than Rs. 500, Mr. B may exercise the right to put. In case the contract is delivery-settled, by exercising his right to put, Mr. B will sell equity shares of PQR Limited at Rs. 500 per share and since the prevailing market price is lower, he can make a profit by buying these shares in the market. In case the contract is cash-settled, by exercising the right to put, Mr. B will receive the difference between the Strike Price, i.e., Rs. 500 per share and the prevailing market price. On the other hand, if the market price is above Rs. 500 per share, Mr. B will not exercise his Put Option.

Definitions

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

Call Option: A Call Option is an Option to buy the specified underlying asset on or before the Expiry Date.

Clearing Corporation/House: Clearing Corporation/House means the Clearing Corporation/House approved by SEBI for clearing and settlement of trades on the Derivatives Exchange/Segment. (The terms ‘Clearing Corporation’ and ‘Clearing House’ have been used interchangeably in this Guidance Note)

Clearing Member: Clearing Member means a member of the Clearing Corporation and includes all categories of Clearing Members as may be admitted as such by the Clearing Corporation to the Derivatives Segment.

Client: A Client means a person, on whose instructions and, on whose account, the Trading Member enters into any contract for the purchase or sale of any contract or does any act in relation thereto.

Contract Month: Contract Month, in relation to a futures contract, means the month in which the exchange/Clearing Corporation rules require a contract to be finally settled, and in relation to an options contract, means the month in which the Expiry Date falls.

Daily Settlement Price: Daily Settlement Price is the closing price of the equity index/stock futures contract for the day or such other price as may be decided by the Clearing House from time to time.

Derivatives: Derivatives include,

(a) a security derived from a debt instrument, share, loan, whether secured or unsecured, risk instrument or contract for differences or any other form of security;

(b) a contract which derives its value from the prices, or index of prices, of underlying securities.

Derivative Exchange/Segment: Derivative Exchange means an Exchange approved by SEBI as a Derivative Exchange. Derivative Segment means Segment of an existing Exchange approved by SEBI as Derivative Segment.

Exercise Date: Exercise Date is the date on which the buying/selling right in the Option is actually exercised by the Option Buyer/Holder.

Exercise of an Option: Exercise of an Option means enforcing the right by the Option Buyer/Holder available under the option contract of buying or selling the underlying asset at the Strike Price.

Expiry Date: Expiry Date is the last date on or upto which the Option can be exercised.

Final Settlement Price: Final Settlement Price is the closing price of the Equity Derivative

Instruments contract on the last trading day of the contract or such other price as may be specified by the Clearing Corporation, from time to time.

Long Position: Long Position means outstanding purchase obligations in respect of equity index/stock futures contracts at any point of time.

Open Interest: Open Interest means the total number of Equity Derivative Instruments contracts that have not yet been offset and closed by an opposite contract nor fulfilled either by delivery of cash or by actual delivery of underlying security.

Option: Option is a contract, which gives the buyer/holder the right, but not the obligation, to buy or sell a specified underlying asset at a predetermined price.

Option Buyer/Holder: Option Buyer/Holder is the person who buys a Call or a Put Option.

Option Premium: Option Premium is the price paid by the Option Buyer/Holder to the Option Seller/Writer to acquire the right in the Option.

Option Seller/Writer: Option Seller/Writer is the person who sells a Call or a Put Option.

Put Option: Put Option is an Option to sell the specified underlying asset on or before the Expiry Date.

Settlement Date: Settlement Date means the date on which the outstanding obligations in an equity index/stock futures contract are required to be settled as provided in the bye-laws of the Derivatives Exchange/Segment.

Short Position: Short Position means outstanding sell obligations in respect of equity index/stock futures contracts at any point of time.

Strike Price/Exercise Price: Strike Price/Exercise Price is the price specified in the option contract at which the underlying asset may be purchased or sold by the buyer/holder.

Trading Member: Trading Member means a member of the Derivatives Exchange/Segment and registered with SEBI.

Trading Mechanism

25. Trading in Equity Derivative Instruments has commenced in India in a separate segment of existing stock exchanges known as ‘Derivatives Segment’. The Clearing Corporation/House of the exchange may act as legal counter-party to all deals or may provide an unconditional guarantee for all the deals in Equity Derivative Instruments on the exchange. Thus, for all practical purposes, both the parties to an Equity Derivative Instruments contract would be assured that the obligations of the other party would be met – either by the party itself or, in the event of default on the part of the party, by the Clearing Corporation.

26. A Client can trade in Equity Derivative Instruments only through a Trading Member of the exchange. A Clearing Member can also act as a Trading Member. The process of trading is similar to screen-based trading in securities like shares on an exchange.

27. The exchanges, allowing trading in Equity Derivative Instruments contracts, introduce standardised contracts where the Settlement Date/Expiry Date, as the case may be, is specified by the stock exchange and the Clients can enter into contracts with different contract/Strike Prices, as the case may be, and different premiums, if relevant. The Settlement Date/Expiry Date adopted by BSE and NSE is the last Thursday of a Contract Month. For example, the Equity Derivative Instruments contracts of August 2003 series will expire on 28th August 2003 (being the last Thursday of August 2003). In both BSE and NSE, the Equity Derivative Instruments contracts will have a maximum of three month trading cycle – the near month (one), the next month (two) and the far month (three). Thus, in August 2003, one would be able to enter into futures contracts for the months of August 2003, September 2003 and October 2003. On 28th August, 2003 (last Thursday of August 2003) the Equity Derivative Instruments contracts for August 2003 series will be finally settled/will expire and thereafter trading in November 2003 series will start.

28. Each exchange permitting Equity Derivative Instruments trading also provides the contract specifications. For example, the NSE has decided to permit contract multiplier of 200 for the S&P CNX NIFTY futures/options contracts, whereas the BSE has decided that the contract multiplier would be 50 for trading in BSE SENSEX. Similarly, for each individual stock, market lot has been decided. A person can trade in Equity Derivative Instruments only in the multiples of the market lot.

29. In order to minimise the risk of failure of parties to a contract in fulfilling their respective obligations under the contract, the Clearing Corporation, from time to time, prescribes margin requirements for Clearing/Trading Members. Margins are required to be paid by Clearing/Trading Members, who, in turn, collect margins from their respective Clients. Margins can be paid in cash or be provided by way of a bank guarantee or by deposit receipts or securities or such other mode and would be subject to such terms and conditions as the Clearing Corporation may specify from time to time. There is a continuing obligation, during the contract period, to maintain margins at the levels specified by the Clearing Corporation, from time to time.

30. Every Client is required to pay an initial margin to the Trading Member/Clearing Member at the time of entering into an Equity Derivative Instruments contract. Such a margin is calculated by using a Software called 'Standard Portfolio Analysis of Risk' (SPAN). SPAN calculates risk arrays for all the open positions on an overall basis and gives the output in the form of a risk parameters file. This risk parameters file is made available to all the participants of Derivatives Segment. Members and Clients use the data from SPAN risk file, together with their position data, to calculate SPAN margin requirements on their respective positions on daily basis. SPAN calculates the margin by determining the worst possible loss using 16 risk scenarios. The Clients pay the deficit margin to, or receive the refund of excess margin from, the Trading Member/Clearing Member on daily basis.

EQUITY INDEX FUTURES AND EQUITY STOCK FUTURES

31. In addition to the payment of the Initial Margin computed as per paragraph 30 above, both the parties to the equity index/stock futures contract are required to pay daily 'Mark-to-Market Margin'. For computation of 'Mark-to-Market Margin', all outstanding contracts, whether Long or Short, of a Clearing Member in an equity index/stock futures contract are deemed to have been settled at the Daily Settlement Price. Such a member would be liable to pay to, or be entitled to collect from, the Clearing House the difference between the price at which such contract was bought or sold and the Daily Settlement Price of that day, or the Settlement Price of the previous trading day and the Settlement Price of the contract at the end of the trading day, as the case may be. The Mark-to-Market Margin would be paid only in cash. After such settlement with the Clearing House, the member would be deemed to be Long or Short, as the case may be, in contracts at the Daily Settlement Price. Supposing 'X' buys one unit of an equity index future of one month maturity (say, April) on March 29 for Rs. 1,420. If at the end of the day (i.e., March 29) the Daily Settlement Price of the equity index futures has fallen to Rs. 1,400, he would pay Rs. 20 to the Clearing House. The position for the subsequent days upto March 31 would be as follows:

	Assumed Daily Settlement Price (Rs.)	
March 30	1,435	Receive Rs. 35
March 31	1,430	Pay Rs. 5

Such differences would be directly debited/credited to the separate bank account required to be maintained by the Clearing Member with the Clearing Corporation. The Clearing Member would, in turn, debit/credit the bank account of the Trading Member, who, in turn, would debit/credit the account of the Client.

32. Each party to an equity index/stock futures contract is under an obligation to meet its commitment at the maturity of the contract. However, either party can, at any time during the currency of the contract, square-up its future obligations under the contract by entering into a reverse contract. For example, a person who is a buyer of 300 units of Stock of LMN Co. Limited September 2003 series can enter into another contract of September 2003 series for sale of 300 units of Stock of LMN Co. Limited. Any gain or loss on the original contract arising after the date of entering into the second contract would be offset by an equivalent loss or gain on the second contract. On entering into a reverse contract, the purchase and sales contracts offset each other automatically.

33. In case of non-payment of daily settlement dues by the Client, before the next trading day, the Clearing Member would be at liberty to close out transactions by selling or buying the futures contracts, as the case may be. The loss incurred in this regard would be met from the margin money of the Client and the gains, if any, would accrue to the Client. In case of shortfall caused by loss being in excess of the margin money, the amount would be recovered from the Client.

EQUITY INDEX OPTIONS AND EQUITY STOCK OPTIONS

34. In case of equity index options and equity stock options contracts, Option Buyer/Holder is required to pay Option Premium to the Option Seller/Writer to acquire the right in the Options. When a person buys or sells Options, the premium amount will be debited or credited to the separate bank account of the Clearing Member with the Clearing Corporation. At the BSE and the NSE, this premium is normally debited or credited on the next trading day (T+1 Basis).

35. After entering into an option contract, a Client can square-up his position by entering into a reverse contract of the same series with the same Strike Price. For example, a buyer/holder having bought S&P CNX NIFTY Call Option of September 20x3 series with Strike Price of Rs. 1,150 can square-up his position by selling/writing S&P CNX NIFTY Call Option of September 20x3 series with Rs. 1,150 as Strike Price. In such a case, the gain or loss of the Client will be the difference between Option Premium received and paid after reducing/adding the brokerage charged by the Clearing Member. Thus, profit can be earned by or loss can be reduced to the difference in the premium amounts by squaring-up the position, before the Expiry Date.

36. On the expiry of a Call Option, if the market price of the underlying asset is lower than the Strike Price, the call would expire unexercised. Likewise, if on the expiry of a Put Option, the market price of the underlying asset is higher than the Strike Price, the Put Option would expire unexercised. When an Option Buyer/Holder decides to exercise his Option, he gives the exercise notice through the trading network during the time specified by the Clearing Corporation. The Clearing Corporation assigns the exercise notice to the Option Seller/Writer through the Trading Member.

37. Practically, all those Options, which are favourable to the buyer/holder on Expiry Date, are deemed to be exercised. No special notice is required to be sent by the buyer/holder. However, the buyer/holder can let a favourable Option expire unexercised, if he so desires, upon intimation to the stock exchange.

ACCOUNTING TREATMENT IN THE BOOKS OF THE CLIENT

38. Accounting for payments/receipts in respect of initial margin is common for all types of Equity Derivative Instruments contracts. Paragraphs 39 to 41 hereinafter deal with the same. Accounting for aspects peculiar to different Equity Derivative Instruments is dealt with thereafter.

ACCOUNTING FOR INITIAL MARGIN

39. Every Client is required to pay to the Trading Member/Clearing Member, initial margin, computed as per SPAN, for entering into an Equity Derivative Instruments contract. Such initial margin paid/payable should be debited to an appropriate account, say, ‘Initial Margin –

Equity Derivative Instruments Account'. Any amount paid/received subsequently on account of initial margin is also debited/credited to the account.

40. At the balance sheet date, the balance in the 'Initial Margin – Equity Derivative Instruments Account' should be shown separately under the head 'Current Assets'. Where any amount has been paid in excess of the initial margin, the excess should be disclosed separately as a deposit under the head 'Current Assets'. Where instead of paying initial margin in cash, the Client provides bank guarantees or lodges securities with the member, a disclosure in respect of outstanding Equity Derivative Instruments contracts at the year-end should be made separately for each type of instrument in the notes to the financial statements of the Client.

41. Sometimes, the Client may deposit a lumpsum amount with the Clearing/Trading Member in respect of margin money instead of paying/receiving margin money on daily basis. The amount so paid is in the nature of a deposit and should be debited to an appropriate account, say, 'Deposit for Margin Money Account'. The amount of initial margin received into/paid from such account should be debited/credited to the 'Deposit for Margin Money Account' with a corresponding credit/debit to the 'Initial Margin – Equity Derivative Instruments Account'. At the year-end, any balance in the 'Deposit for Margin Money Account' should be shown as a deposit under the head 'Current Assets'.

ACCOUNTING FOR EQUITY INDEX FUTURES AND EQUITY STOCK FUTURES

ACCOUNTING FOR PAYMENT/RECEIPT OF MARK-TO-MARKET MARGIN

42. Payments made or received on account of Mark-to-Market Margin by the Client would be credited/debited to the bank account and the corresponding debit or credit for the same should be made to an appropriate account, say, 'Mark-to-Market Margin – Equity Index Futures Account' or 'Mark-to-Market Margin – Equity Stock Futures Account', as the case may be.

43. The amount of Mark-to-Market Margin received into/paid from lumpsum deposit with the Clearing/Trading Member should be debited/credited to the 'Deposit for Margin Money Account' with a corresponding credit/debit to the 'Mark-to-Market Margin – Equity Index Futures Account' or the 'Mark-to-Market Margin – Equity Stock Futures Account', as the case may be.

ACCOUNTING FOR OPEN INTERESTS IN FUTURES CONTRACTS AS ON THE BALANCE SHEET DATE

44. The debit/credit balance in the 'Mark-to-Market Margin – Equity Index Futures Account' or the 'Mark-to-Market Margin – Equity Stock Futures Account', as the case may be, represents the net amount paid to/received from the Clearing/Trading Member on the basis of movement in the prices of equity index futures or equity stock futures till the balance sheet date in respect of open futures contracts. In case the said account(s) has a debit balance on the balance sheet date, the same should be shown as a current asset. On the other hand, in

case the said account(s) has a credit balance on the balance sheet date, the same should be shown as a current liability.

45. Keeping in view 'prudence' as a consideration for the preparation of financial statements, a provision for the anticipated loss in respect of open futures contracts should be made. For this purpose, the net amount paid/received on account of Mark-to-Market Margin on open futures contracts on the balance sheet date should be determined Index-wise/Scrip-wise. Where the Index-wise/Scrip-wise balance is a debit balance representing the net amount paid, provision should be made for the said amount. However, where the Index-wise/Scrip-wise balance is a credit balance representing the net amount received, the same should be ignored keeping in view the consideration of 'prudence'. To facilitate these computations, the Mark-to-Market Margin account(s) may be maintained Index-wise/Scrip-wise.

46. The provision as created above should be credited to an appropriate account, say, 'Provision for Loss on Equity Index Futures Account' or to 'Provision for Loss on Equity Stock Futures Account', as the case may be. In case of any opening balance in the 'Provision for Loss on Equity Index Futures Account' or the 'Provision for Loss on Equity Stock Futures Account', the same should be adjusted against the provision required in the current year and the profit and loss account should be debited/credited with the balance provision required to be made/excess provision written back.

47. The 'Provision for Loss on Equity Index Futures Account' or the 'Provision for Loss on Equity Stock Futures Account' should be shown as a deduction from the balance of the 'Mark-to-Market Margin – Equity Index Futures Account' or the 'Mark-to-Market Margin – Equity Stock Futures Account', if disclosed as a current asset. On the other hand, if the above-stated Margin account(s) is disclosed as a current liability, the aforesaid provision account(s) should be shown as a provision on the liabilities side of the balance sheet.

ACCOUNTING AT THE TIME OF FINAL SETTLEMENT OR SQUARING-UP

Index futures and cash-settled stock futures contracts

48. At the expiry of a series of equity index futures/equity stock futures, the profit/loss, on final settlement of the contracts in the series, should be calculated as the difference between the Final Settlement Price and the contract prices of all the contracts in the series. The profit/loss, so computed, should be recognised in the profit and loss account by corresponding debit/credit to the 'Mark-to-Market Margin – Equity Index Futures Account' or the 'Mark-to-Market Margin – Equity Stock Futures Account', as the case may be.

49. The same accounting treatment as recommended in paragraph 48 should be made when a contract is squared-up by entering into a reverse contract. If more than one contract in respect of the relevant series of equity index futures/equity stock futures contract to which the squared-up contract pertains is outstanding at the time of the squaring-up of the contract, the contract price of the contract so squared-up should be determined using Weighted Average

Method for calculating profit/loss on squaring-up.

Delivery-settled stock futures contracts

50. Under the delivery-settled stock futures contracts, at the time of final settlement, securities will be transferred in consideration for cash at the contract price. In such a case, irrespective of the price of the security on the Settlement Date, the same will be reflected in the books at its original contract price. Thus, the relevant securities account is debited or credited for Long and Short futures contract, respectively, by the contract price, by a corresponding credit/debit to 'Mark-to-Market Margin – Equity Stock Futures Account', and cash/bank account.

ACCOUNTING IN CASE OF DEFAULT

51. When a Client defaults in making payment in respect of Mark-to-Market Margin, the contract is closed out. The amount not paid by the Client is adjusted against the initial margin already paid by him. In the books of the Client, the amount of Mark-to-Market Margin so adjusted should be debited to the 'Mark-to-Market Margin – Equity Index Futures Account' or the 'Mark-to-Market Margin – Equity Stock Futures Account', as the case may be, with a corresponding credit to the 'Initial Margin – Equity Derivative Instruments Account'. In case, the amount to be paid on account of Mark-to-Market Margin exceeds the initial margin, the excess is a liability and should be shown as such under the head 'Current Liabilities and Provisions', if it continues to exist on the balance sheet date. The amount of profit or loss on the contract so closed out should be calculated and recognised in the profit and loss account in the manner described in paragraphs 48 and 49.

ACCOUNTING FOR EQUITY INDEX OPTIONS AND EQUITY STOCK OPTIONS

ACCOUNTING FOR PAYMENT/RECEIPT OF THE PREMIUM

52. At the time of entering into an options contract, the buyer/holder of the Option is required to pay the premium. In the books of the buyer/holder, such premium should be debited to an appropriate account, say, 'Equity Index Option Premium Account' or 'Equity Stock Option Premium Account', as the case may be. In the books of the seller/writer, such premium received should be credited to an appropriate account, say, 'Equity Index Option Premium Account' or 'Equity Stock Option Premium Account', as the case may be.

ACCOUNTING FOR OPEN INTERESTS IN OPTIONS CONTRACTS AS ON THE BALANCE SHEET DATE

53. The 'Equity Index Option Premium Account' and the 'Equity Stock Option Premium Account' should be shown under the head 'Current Assets' or 'Current Liabilities', as the case

may be. In case of multiple Options, entries recommended in paragraph 52 above may be made in one ‘Equity Index Options Premium Account’ or ‘Equity Stock Options Premium Account’, in respect of Options of all indexes/scrips. The balance of this composite account should be shown under the head ‘Current Assets’ or ‘Current Liabilities’, as the case may be.

54. In the books of the buyer/holder, a provision should be made for the amount by which the premium paid for the Option exceeds the premium prevailing on the balance sheet date since the buyer/holder can reduce his loss to the extent of the premium prevailing in the market, by squaring-up the transaction. The provision so created should be credited to an appropriate account, say, ‘Provision for Loss on Equity Index Option Account’ or to ‘Provision for Loss on Equity Stock Option Account’, as the case may be. The provision made as above should be shown as a deduction from the balance of the ‘Equity Index Option Premium Account’ or the ‘Equity Stock Option Premium Account’ which is shown under the head ‘Current Assets’. The excess of premium prevailing in the market on the balance sheet date over the premium paid is not recognised keeping in view the consideration of prudence.

55. In the books of the seller/writer, a provision should be made for the amount by which premium prevailing on the balance sheet date exceeds the premium received for that Option. This provision should be credited to ‘Provision for Loss on Equity Index Option Account’ or to ‘Provision for Loss on Equity Stock Option Account’, as the case may be, with a corresponding debit to profit and loss account. ‘Equity Index Option Premium Account’ or ‘Equity Stock Option Premium Account’ and ‘Provision for Loss on Equity Index Option Account’ or ‘Provision for Loss on Equity Stock Option Account’ should be shown under the head ‘Current Liabilities and Provisions’. The excess of premium received over the premium prevailing on the balance sheet date is not recognised keeping in view the consideration of prudence.

56. In case of multiple open options at the year-end, a Index-wise/Scrip-wise provision should be made considering all the open options of any Strike Price and any Expiry Date under that index/scrip taken together as illustrated below:

For Stock Options of ABC Limited	In Situations			
	A	B	C	D
	Rs.	Rs.	Rs.	Rs.
Bought				
Total premium paid on all open options bought	2,00,000	1,00,000	1,00,000	1,00,000
Less: Total premium prevailing on Balance Sheet date for all open options bought	3,00,000	50,000	80,000	1,50,000
X	-1,00,000	50,000	20,000	-50,000

Sold				
Total premium prevailing on the Balance Sheet date for all open options sold	2,50,000	2,00,000	1,50,000	1,30,000
Less: Total premium received on all open options sold	1,00,000	3,00,000	1,00,000	1,80,000
Y	1,50,000	-1,00,000	50,000	-50,000
Provision required =X+Y (if positive)	50,000	NIL	70,000	NIL

The amount of provision required in respect of each scrip or index as illustrated above should be aggregated and a composite 'Provision for Loss on Equity Stock Options Account' or 'Provision for Loss on Equity Index Options Account' should be credited by debiting the profit and loss account.

57. In case of any opening balance in the 'Provision for Loss on Equity Stock Options Account' or the 'Provision for Loss on Equity Index Options Account', the same should be adjusted against the provision required in the current year and the profit and loss account be debited/credited with the balance provision required to be made/excess provision written back.

58. In case of multiple open options at the year-end, the 'Provision for Loss on Equity Stock Options Account' or the 'Provision for Loss on Equity Index Options Account', as the case may be, should be shown as a deduction from the 'Equity Stock Options Premium Account' and the 'Equity Index Options Premium Account' respectively, if these have a debit balance and are disclosed under the head 'Current Assets'. In case the 'Equity Stock Options Premium Account' and the 'Equity Index Options Premium Account' have a credit balance and are disclosed under the head 'Current Liabilities', the respective provision account should be shown under 'Provisions' under the head 'Current Liabilities and Provisions'.

ACCOUNTING AT THE TIME OF FINAL SETTLEMENT

Index options and cash-settled stock options contracts

59. *In the books of the buyer/holder:* On exercise of the Option, the buyer/holder will recognise premium as an expense and debit the profit and loss account by crediting the 'Equity Index Option Premium Account' or the 'Equity Stock Option Premium Account'. Apart from the above, the buyer/holder will receive favourable difference, if any, between the Final Settlement Price as on the Exercise/Expiry Date and the Strike Price, which will be recognised as income.

60. *In the books of the seller/writer:* On exercise of the Option, the seller/writer will recognise premium as an income and credit the profit and loss account by debiting the 'Equity Index Option Premium Account' or the 'Equity Stock Option Premium Account'. Apart from the

above, the seller/writer will pay the adverse difference, if any, between the Final Settlement Price as on the Exercise/Expiry Date and the Strike Price. Such payment will be recognised as a loss.

Delivery-settled stock options contracts

61. If an Option expires unexercised, the accounting entries will be the same as those in case of cash-settled options. If the Option is exercised, securities will be transferred in consideration for cash at the Strike Price. In such a case, the accounting treatment should be as recommended in the following paragraphs.

62. *In case of buyer/holder:* For a Call Option, the buyer/holder will receive the security for which the Call Option was entered into. The buyer/holder should debit the relevant security account and credit cash/bank. For a Put Option, the buyer/holder will deliver the security for which the Put Option was entered into. The buyer/holder should credit the relevant security account and debit cash/bank. In addition to this entry, the premium paid should be transferred to the profit and loss account, the accounting entries for which should be the same as those in case of cash settled options.

63. *In case of seller/writer:* For a Call Option, the seller/writer will deliver the security for which the Call Option was entered into. The seller/writer should credit the relevant security account and debit cash/bank. For a Put Option, the seller/writer will receive the security for which the Put Option was entered into. The seller/writer should debit the relevant security account and credit cash/bank. In addition to this entry, the premium received should be transferred to the profit and loss account, the accounting entries for which should be the same as those in case of cash settled options.

ACCOUNTING AT THE TIME OF SQUARING-UP OF AN OPTION CONTRACT

64. When an Options contract is squared-up by entering into a reverse contract, the difference between the premium paid and received, after adjusting the brokerage charged, on the squared-up transactions should be transferred to the profit and loss account.

METHOD FOR DETERMINATION OF PROFIT/LOSS IN MULTIPLE OPTIONS SITUATION

65. For working out profit or loss in case of outstanding multiple options of the same scrip/index with the same Strike Price and the same Expiry Date, weighted average method should be followed on squaring-up of transactions. Similarly, for working out profit or loss in case of outstanding multiple equity stock options of the same scrip with the same Strike Price and the same Expiry Date, weighted average method should be followed where such Option(s) is/are exercised before the Expiry Date.

Disclosure

66. The enterprise should disclose the accounting policies and the methods adopted, including criteria for recognition and the basis of measurement applied for various Equity

Derivative Instruments.

67. Where initial margin is paid by way of a bank guarantee and/or lodging of securities, the amount of such bank guarantee/book value and market value of the securities in respect of outstanding Equity Derivative Instruments contracts at the year-end, should be disclosed separately for each type of instrument.

68. The enterprise should give the details as illustrated below in respect of futures contracts outstanding at the year-end (Open Interests) for each Equity Index/Stock Futures:

Name of Equity Index/Stock Futures	No. of contracts	No. of Units	
		Long	Short
XYZ Limited			
PQR Limited			

Note: All open index/stock futures interests should be added together, irrespective of the contract price and series for each equity index/stock for the purpose of disclosure.

69. The buyer/holder and the seller/writer of the option should give the details as illustrated below in respect of option contracts outstanding as at the year-end for each Equity Index/Stock Option:

Name of the Equity Option index/stock	Total premium carried forward as at the year end net of provisions made
	(Rs.)
XYZ Limited	2,00,000
PQR Limited	1,50,000

Note: All open options should be added together, irrespective of the Strike Price and the Expiry Date for each equity index/stock for the purpose of disclosure.

Illustration

70. Examples illustrating the accounting treatment of important aspects of Equity Derivative Instruments 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.)

ILLUSTRATION 1: Accounting for INITIAL margin

Suppose Mr. X enters into certain Equity Derivative Instruments contracts on March 28, 20x3. The Initial Margin on these contracts, calculated as per the SPAN, is Rs. 30,000. The Margin for the subsequent days, calculated as per the SPAN, is as follows:

On 29th March, 20x3	Rs. 35,000
On 30th March, 20x3	Rs. 25,000
On 31st March, 20x3	Rs. 27,000

SUGGESTED ACCOUNTING TREATMENT

1. The following entries may be passed for the payment/receipt of the Initial Margin:

28/3/x3	Initial Margin – Equity Derivative Instruments A/c	Dr.	Rs.30,000	
	To Bank A/c			Rs.30,000
	(Being initial margin paid on Equity Derivative Instruments contracts)			
29/3/x3	Initial Margin – Equity Derivative Instruments A/c	Dr.	Rs. 5,000	
	To Bank A/c			Rs. 5,000
	(Being further margin paid to the exchange)			
30/3/x3	Bank A/c	Dr.	Rs.10,000	
	To Initial Margin – Equity Derivative Instruments A/c			Rs.10,000
	(Being refund of margin from the exchange)			
31/3/x3	Initial Margin – Equity Derivative Instruments A/c	Dr.	Rs. 2,000	
	To Bank A/c			Rs. 2,000
	(Being further margin paid to the exchange)			

2. The Initial Margin paid on Equity Derivative Instruments will be disclosed in the balance sheet as follows:

Extracts from the Balance Sheet

CURRENT ASSETS

Initial Margin – Equity Derivative Instruments A/c Rs. 27,000

3. In respect of initial margin, the following disclosure may be made in the notes to accounts:

'Initial Margin on Equity Derivative Instruments contracts has been paid in cash only.'

ILLustration 2: Accounting for Equity index futures

(A) ACCOUNTING FOR PAYMENT/RECEIPT OF MARK-TO-MARKET MARGIN

1. Suppose Mr. A purchases the following units of Equity Index Futures:

Date of Purchase	Name of the Futures contract	Expiry Date/ Series	Contract Price per unit (Rs.)	Contract Multiplier (No. of Units)
28th March, 20x3	EF1	May 20x3	1,420	200
29th March, 20x3	EF2	June 20x3	4,280	50
29th March, 20x3	EF1	May 20x3	1,416	200

2. Daily Settlement Prices of the above units of Equity Index Futures are as follows:

Date	EF1 May Series (Rs.)	EF2 June Series (Rs.)
28/03/20x3	1,410	-
29/03/20x3	1,428	4,300
30/03/20x3	1,435	4,270
31/03/20x3	1,407	4,290

SUGGESTED ACCOUNTING TREATMENT

1. The amount of Mark-to-Market Margin Money received/paid due to increase/decrease in Daily Settlement Prices is as below:

Date	EF1 May Series (Rs.)		EF2 June Series (Rs.)		Net Amount (Rs.)	
	Receive	Pay	Receive	Pay	Receive	Pay
28/03/20x3	-	2,000	-	-	-	2,000
29/03/20x3	6,000	-	1,000	-	7,000	-
30/03/20x3	2,800	-	-	1,500	1,300	-
31/03/20x3	-	11,200	1,000	-	-	10,200

2. The amount of Mark-to-Market Margin Money received/paid will be credited/debited to 'Mark-to-Market Margin – EIF A/c' by passing the following entries:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)

March 20x3				
28	Mark-to-Market Margin – EIF A/c	Dr.	2,000	
	To Bank A/c			2,000
	(Being net MTM Margin Money paid for day)			
29	Bank A/c	Dr.	7,000	
	To Mark-to-Market Margin – EIF A/c			7,000
	(Being net MTM Margin Money received)			
30	Bank A/c	Dr.	1,300	
	To Mark-to-Market Margin – EIF A/c			1,300
	(Being net MTM Margin Money received)			
31	Mark-to-Market Margin – EIF A/c	Dr.	10,200	
	To Bank A/c			10,200
	(Being net MTM Margin Money paid for day)			
	Total		20,500	20,500

3. On the above basis, 'Mark-to Market Margin – EIF A/c' for the year will appear as follows in the books of Mr. A:

Mark-to-Market Margin – EIF A/c

Date	Particulars	Debit (Rs.)	Credit (Rs.)	Balance Dr./Cr.	Balance Amount (Rs.)
March					
28	To Bank	2,000		Dr.	2,000
29	By Bank		7,000	Cr.	5,000
30	By Bank		1,300	Cr.	6,300
31	To Bank	10,200		Dr.	3,900
31	By Balance c/d		3,900		
	Total	12,200	12,200		

(B) ACCOUNTING FOR OPEN INTERESTS ON THE BALANCE SHEET DATE

SUGGESTED ACCOUNTING TREATMENT

1. Continuing Illustration 2(A) above, on 31st March, 20x3, Mark-to-Market (MTM) Margin Money received/paid on all the contracts in each of the indexes is as follows:

Amount paid on the contracts in respect of EF1	Rs. 4,400
Amount received on the contracts in respect of EF2	Rs. 500

2. Keeping in view the consideration of prudence, a provision should be created for

anticipated loss on open contracts in respect of EF1, equivalent to the amount paid, by passing the following entry, whereas the amount received in open contracts in respect of EF2 would be ignored:

Profit & Loss A/c	Dr.	Rs. 4,400	
To Provision for Loss – EIF A/c			Rs. 4,400

(Being provision created for the amount paid to Clearing Member/Trading Member on account of movement in the prices of the contracts in respect of EF1)

3. In the balance sheet, the debit balance of 'Mark-to-Market Margin – EIF A/c' and 'Provision for Loss – EIF Account' would be shown as follows:

Extracts from the Balance Sheet

Liabilities	Amount (Rs.)	Assets		Amount (Rs.)
Current Liabilities and Provisions		Current Assets, Loans and Advances		
(A) Current Liabilities		*(A) Current Assets*		
(B) Provisions		*(B) Loans and Advances*		
Excess of Provision for		Mark-to-Market Margin – EIF A/c	3,900	
Loss – EIF A/c over		*Less*: Provision for Loss – EIF A/c	4,400	
MTM – EIF A/c	500	Excess amount to be shown as Provision	500	

4. In respect of open equity index futures contracts, the following disclosures should be made in the notes to accounts:

Detail of Open Interests in Equity Index Futures contracts

Name of Equity Index Future	No. of contracts	Units	
		Long	Short
EF1	2	400	
EF2	1	50	

(C) ACCOUNTING AT THE TIME OF SQUARING-UP/FINAL SETTLEMENT OF THE CONTRACTS

Continuing Illustration 2(A) above, the following further facts are provided:

1. Equity Index Futures contracts are squared-up at the Daily Settlement Price of the day on the following dates:

- EF2 June Series on 1st April, 20x3
- 200 Units of EF1 May Series on 2nd April, 20x3
- 200 Units of EF1 May Series on 3rd April, 20x3

2. Daily Settlement Prices of the units of Equity Index Futures, till squaring-up of the contracts, are as follows:

Date	EF1 May Series (Rs.)	EF2 June Series (Rs.)
01/04/20x3	1,415	4,250
02/04/20x3	1,430	-
03/04/20x3	1,442	-

SUGGESTED ACCOUNTING TREATMENT

1. The amount of Mark-to-Market Margin Money received/paid due to increase/decrease in Daily Settlement Prices is as below:

Date	EF1 May Series (Rs.)		EF2 June Series (Rs.)		Net Amount (Rs.)	
	Receive	Pay	Receive	Pay	Receive	Pay
01/04/20x3	3,200	-	-	2,000	1,200	-
02/04/20x3	6,000	-	-	-	6,000	-
03/04/20x3	2,400	-	-	-	2,400	-

2. The amount of profit/loss arising on squaring-up is calculated, using Weighted Average method, as follows:

Name of the Futures contract	*EF2*	*EF1*	*EF1*
Series	*June 20x3*	*May 20x3*	*May 20x3*
Date of Squaring-up	*1st April, 20x3*	*2nd April, 20x3*	*3rd April, 20x3*
Contract Price per unit (in Rs.)	4,280	1,418[1]	1,418[1]
Settlement Price per unit (in Rs.)	4,250	1,430	1,442
Profit (+) / Loss (-) per unit (in Rs.)	(-) 30	(+) 12	(+) 24
Number of Units	50	200	200
Total Profit (+) / Loss (-) (in Rs.)	(-) 1,500	(+) 2,400	(+) 4,800

3. On the above basis, the following entries will be passed for the amount of Mark-to-Market Margin Money received/paid and profit/loss arising on the squaring-up:

[1] Weighted Average Price = (1,420 * 200 + 1,416 * 200)/400

Date	Particulars		L.F.	Debit (Rs.)	Credit (Rs.)
April 20x3					
01	Bank A/c	Dr.		1,200	
	To Mark-to-Market Margin – EIF A/c				1,200
	(Being net MTM Margin Money received)				
01	Profit & Loss A/c	Dr.		1,500	
	To Mark-to-Market Margin – EIF A/c				1,500
	(Being loss on squaring-up)				
02	Bank A/c	Dr.		6,000	
	To Mark-to-Market Margin – EIF A/c				6,000
	(Being net MTM Margin Money received)				
02	Mark-to-Market Margin – EIF A/c	Dr.		2,400	
	To Profit & Loss A/c				2,400
	(Being profit on squaring-up of the contract)				
03	Bank A/c	Dr.		2,400	
	To Mark-to-Market Margin – EIF A/c				2,400
	(Being net MTM Margin Money received)				
03	Mark-to-Market Margin – EIF A/c	Dr.		4,800	
	To Profit & Loss A/c				4,800
	(Being profit on squaring-up of the contract)				
	Total			18,300	18,300

4. In this case, 'Mark-to-Market Margin – EIF A/c' for the year will appear as follows in the books of Mr. A:

Mark-to-Market Margin – EIF A/c

Date	Particulars	Debit (Rs.)	Credit (Rs.)	Balance	
				Dr./Cr.	Amount (Rs.)
April 20x3					
01	To Balance b/d	3,900		Dr.	3,900
01	By Bank		1,200	Dr.	2,700
01	By Profit & Loss A/c		1,500	Dr.	1,200
02	By Bank		6,000	Cr.	4,800
02	To Profit & Loss A/c	2,400		Cr.	2,400
03	By Bank		2,400	Cr.	4,800

03	To Profit & Loss A/c	4,800		Nil
	Total	11,100	11,100	

5. In case the contracts as above are not squared-up, but are settled on the final settlement date, the same entries as have been passed on squaring-up of the contracts, will be passed at the time of final settlement.

Illustration 3: Accounting FOr Equity Stock futures

ACCOUNTING FOR EQUITY STOCK FUTURES WHICH ARE SETTLED IN CASH

The accounting treatment for Equity Stock Futures settled in cash would be the same as that in the case of Equity Index Futures. This is because in both the cases the settlement is done otherwise than by delivery of the underlying assets.

ACCOUNTING FOR EQUITY STOCK FUTURES WHICH ARE SETTLED BY DELIVERY

Accounting for payment/receipt of Mark-to-Market Margin and for Open Interests on the balance sheet date will be the same as that in case of cash-settled futures. The accounting at the time of final settlement of delivery-settled Equity Stock Futures contracts might be explained with the help of example given hereunder.

1. Suppose Mr. A purchases the following units of Equity Stock Futures (ESF):

Date of Purchase	ESF (Name of the company)	Settlement Date/Series	Contract Price Per Unit (Rs.)	Contract Multiplier (No. of Units)
28th March, 20x3	XYZ Limited	May, 20x3	1,420	200
29th March, 20x3	PQR Limited	June, 20x3	4,280	50
29th March, 20x3	XYZ Limited	May, 20x3	1,416	200

2. The contracts are settled through physical delivery of shares on the Settlement Date, i.e., both the contracts for shares of XYZ Limited (May 20x3 Series) are settled by purchasing the shares on the Settlement Date, viz., May 29, 20x3. Similarly, the contract for shares of PQR Limited (June 20x3 Series) is settled by purchasing the shares on the Settlement Date, viz., June 26, 20x3.

3. Net Mark-to-Market Margin received in respect of the contracts for shares of XYZ Limited (May 20x3 Series) till the Settlement Date is Rs. 4,000. Net Mark-to-Market Margin paid in respect of the contract for shares of PQR Limited (June 20x3 Series) till the Settlement Date is Rs. 3,500.

SUGGESTED ACCOUNTING TREATMENT

At the time of final settlement, the shares are required to be purchased/sold against the payment/receipt of the contract price. The amount paid/received earlier in the form of Mark-to-Market Margin will be adjusted against the amount payable/receivable. Accordingly, the following entries will be passed for purchase of shares on the final settlement of the contract:

Date	Particulars		L. F.	Debit (Rs.)	Credit (Rs.)
May 20x3					
29	Shares of XYZ Limited A/c	Dr.		5,67,200	
	Mark-to-Market Margin – ESF A/c	Dr.		4,000	5,71,200
	To Cash/Bank A/c				
	(Being shares purchased on Settlement Date by payment of the net amount due in respect of the contracts)				
June 20x3					
26	Shares of PQR Limited A/c	Dr.		2,14,000	
	To Cash/Bank A/c				2,10,500
	To Mark-to-Market Margin – ESF A/c				3,500
	(Being shares received on settlement of contract by payment of the net amount due)				

Illustration 4: Accounting for equity index options

(A) ACCOUNTING FOR PAYMENT/RECEIPT OF PREMIUM AND FOR FINAL SETTLEMENT OF THE CONTRACTS

1. Suppose Mr. A buys the following equity index options and the seller/writer of these options is Mr. B:

Date of Purchase	Type of Options contract	Expiry date	Premium per unit (Rs.)	Contract Multiplier (No. of units)	Strike price (Rs.)
28th March, 20x3	S&P CNX NIFTY – Call	May 29, 20x3	15	200	880
28th March, 20x3	S&P CNX NIFTY – Put	May 29, 20x3	20	200	885

2. Mr. A. and Mr. B follow the calendar year as the accounting year.

SUGGESTED ACCOUNTING TREATMENT

In the books of the buyer/holder, i.e., Mr. A

1. The following entry may be passed to record the amount of premium paid:

28/3/x3	Equity Index Option Premium A/c	Dr.	Rs. 7,000	
	To Bank A/c			Rs. 7,000
	(Being premium paid on equity Index options)			

2. The following entries may be passed at the time of final settlement of the contracts:

Situation 1 Call Option May 20x3 Strike Price Rs. 880; price on expiry Rs. 875

29/5/x3	Profit and Loss A/c	Dr.	Rs. 3,000	
	To Equity Index Option Premium A/c			Rs. 3,000
	(Being the premium on the options contract written off on expiry of the option)			

Option will not be exercised in this situation.

Situation 2 Call Option May 20x3 Strike Price Rs. 880; price on expiry Rs. 890

29/5/x3	Bank A/c	Dr.	Rs. 2,000	
	To Profit and Loss A/c			Rs. 2,000
	(Being the profit on exercise of the option received.)			
29/5/x3	Profit and Loss A/c	Dr.	Rs. 3,000	
	To Equity Index Option Premium A/c			Rs. 3,000
	(Being the premium on the options contract written off on exercise of the option)			

Situation 3 Put Option May 20x3 Strike Price Rs. 885; price on expiry Rs. 875

29/5/x3	Bank A/c	Dr.	Rs. 2,000	
	To Profit and Loss A/c			Rs. 2,000
	(Being the profit on exercise of the option received.)			
29/5/x3	Profit and loss A/c	Dr.	Rs. 4,000	
	To Equity Index Option Premium A/c			Rs. 4,000
	(Being the premium on the options contract written off on exercise of the option)			

Situation 4 Put Option May 20x3 Strike Price Rs. 885; price on expiry Rs. 890

29/5/x3	Profit and Loss A/c	Dr.	Rs. 4,000	
	To Equity Index Option Premium A/c			Rs. 4,000

(Being the premium on the options contract written off on expiry of the option)

Option will not be exercised in this situation.

In the books of the seller/writer, i.e., Mr. B

1. The following entry may be passed to record the amount of premium received:

28/3/x3	Bank A/c	Dr.	Rs. 7,000	
	To Equity Index Option Premium A/c			Rs. 7,000

(Being the premium on the option collected)

2. The following entries may be passed at the time of final settlement of the contracts:

Situation 1 Call Option May 20x3 Strike Price Rs. 880; price on expiry Rs. 875

29/5/x3	Equity Index Option Premium A/c	Dr.	Rs. 3,000	
	To Profit and Loss A/c			Rs. 3,000

(Being the premium on the options contract recognised as income on expiry of the option)

Option will not be exercised in this situation.

Situation 2 Call Option May 20x3 Strike Price Rs. 880; price on expiry Rs. 890

29/5/x3	Profit and Loss A/c	Dr.	Rs. 2,000	
	To Bank A/c			Rs. 2,000

(Being loss on exercise of the option paid)

29/5/x3	Equity Index Option Premium A/c	Dr.	Rs. 3,000	
	To Profit and Loss A/c			Rs. 3,000

(Being the premium on the options contract recognised as income on exercise of the option)

Situation 3 Put Option May 20x3 Strike Price Rs. 885; price on expiry Rs. 875

29/5/x3	Profit and Loss A/c	Dr.	Rs. 2,000	
	To Bank A/c			Rs. 2,000

(Being loss on exercise of the option paid)

29/5/x3	Equity Index Option Premium A/c	Dr.	Rs. 4,000	
	To Profit and Loss A/c			Rs. 4,000

(Being the premium on the options contract recognised as income on exercise of the option)

Situation 4 Put Option May 20x3 Strike Price Rs. 885; price on expiry Rs. 890

29/5/x3	Equity Index Option Premium A/c	Dr.	Rs. 4,000	
	To Profit and Loss A/c			Rs. 4,000
	(Being the premium on the options contract recognised as income on expiry of the option)			

Option will not be exercised in this situation.

(B) ACCOUNTING FOR OPEN OPTIONS AT THE END OF AN ACCOUNTING PERIOD

Continuing with Illustration 4(A) above, except the following facts:

(a) Mr. A and Mr. B follow the financial year as the accounting year. Consequently, options entered into in one accounting period are settled in another accounting period.

(b) On 31st March, 20x3: For Call Option May 20x3 Strike Price Rs. 880, closing rate of premium Rs. 6 per unit. For Put Option May 20x3 Strike Price Rs. 885, closing rate of premium Rs. 28 per unit.

SUGGESTED ACCOUNTING TREATMENT

In the books of the buyer/holder, i.e., Mr. A

1. Net provision required to be made in the books of account would be computed as follows:

Call Option May 20x3 Strike Price Rs. 880	
Premium paid	Rs. 3,000
Less: Premium on the balance sheet date	Rs. 1,200
Provision required	Rs. 1,800
Put Option May 20x3 Strike Price Rs. 885	
Premium paid	Rs. 4,000
Less: Premium as on the balance sheet date	Rs. 5,600
Provision required	Rs. –1,600
Net provision to be made in the books of account:	Rs. 200

2. The following entry may be passed to create provision for the above amount:

31/3/x3	Profit and Loss A/c	Dr.	Rs. 200	
	To Provision for Loss on Equity Index Options A/c			Rs. 200
	(Being provision for loss on options as on 31-3-20x3)			

3. In the balance sheet, the balance of 'Equity Index Options Premium Account' and 'Provision for Loss on Equity Index Options Account' would be shown as below:

Extracts from the Balance Sheet

Current Assets:

	Rs.
Equity Index Options Premium Account	7,000
Less: Provision for Loss on Equity Index Options	(200)
	6,800

4. In respect of the premium carried forward (net of provisions), the following disclosure may be made in notes to accounts:

Name of Options (Equity index/stock)	Premium carried forward as at the year-end net of provisions
S&P CNX NIFTY	Rs. 6,800

5. At the time of final settlement of these contracts, the same entries would be passed as in the case of Illustration 4(A) above.

In the books of seller/writer, i.e., Mr. B

1. Net provision required to be made in the books of account may be computed as follows:

Call Option May 20x3 Strike Price Rs. 880	
Premium as on the balance sheet date	Rs. 1,200
Less: Premium received	Rs. 3,000
Provision required	Rs. -1,800
Put Option May 20x3 Strike Price Rs. 885	
Premium as on the balance sheet date	Rs. 5,600
Less: Premium received	Rs. 4,000
Provision required	Rs. 1,600
Net provision to be made in the books of account:	Rs. NIL
	(Since the net difference is negative.)

2. In the balance sheet, the balance of 'Equity Index Options Premium Account' would be shown as below:

Extracts from the Balance Sheet

Current Liabilities and Provisions:

	Rs.
Equity Index Options Premium Account	7,000
Provision for Loss on Equity Index Options	NIL

3. In respect of the premium carried forward (including provisions), the following disclosure may be made in notes to accounts:

Name of Options (Equity index/stock)	Total Premium carried forward as at the year-end including provisions made
S&P CNX NIFTY	Rs. 7,000

4. At the time of final settlement of these contracts, the same entries would be passed as in the case of Illustration 4(A) above.

ILLUSTRATION 5: Accounting for equity stock options

ACCOUNTING FOR EQUITY STOCK OPTIONS WHICH ARE SETTLED IN CASH

Accounting entries for Equity Stock Options settled in cash will be the same as that in the case of Equity Index Options. This is because in both the cases the settlement is done otherwise than by delivery of the underlying assets.

ACCOUNTING FOR EQUITY STOCK OPTIONS WHICH ARE SETTLED BY DELIVERY

Accounting entries for the payment/receipt of premium and for open options at the balance sheet date will be the same as that in the case of cash settled options. The accounting entries at the time of final settlement, presuming that options are exercised, will be as follows:

Suppose Mr. A buys the following Equity Stock Options and the seller/writer of the options is Mr. B

Date of Purchase	Type of the Options contract	Expiry date	Market Lot	Premium per unit	Strike Price (Rs.)
27^{th} June, 20x3	XYZ Co. Limited – Call	August 28, 20x3	100	15	230
30^{th} June, 20x3	ABC Co. Limited – Put	August 28, 20x3	200	20	275

SUGGESTED ACCOUNTING TREATMENT

In the books of the buyer/ holder, i.e., Mr. A

1. The following entries may be passed at the time of exercise of the Call Option:

Equity Shares of XYZ Limited A/c	Dr.	Rs. 23,000	
To Bank A/c			Rs.23,000
(Being Call Option exercised and shares acquired)			
Profit and Loss A/c	Dr.	Rs. 1,500	
To Equity Stock Option Premium A/c			Rs. 1,500
(Being the premium on the options contract written off on exercise of the option)			

2. The following entries may be passed at the time of exercise of the Put Option:

Bank A/c	Dr.	Rs. 55,000	
To Equity Shares of ABC Limited A/c			Rs. 55,000
(Being Put Option exercised and shares delivered)			
Profit and Loss A/c	Dr.	Rs. 4,000	
To Equity Stock Option Premium A/c			Rs. 4,000
(Being the premium on the options contract written off on exercise of the option)			

In the books of the seller/writer, i.e., Mr. B

1. The following entries may be passed at the time of exercise of the Call Option by the buyer:

Bank A/c	Dr.	Rs. 23,000	
To Equity Shares of XYZ Limited A/c			Rs. 23,000
(Being shares delivered on exercise of the Call Option)			
Equity Stock Option Premium A/c	Dr.	Rs. 1,500	
To Profit and Loss A/c			Rs. 1,500
(Being the premium on the options contract recognised as income on exercise of the option)			

2. The following entries may be passed at the time of exercise of the Put Option by the buyer:

Equity Shares of ABC Limited A/c	Dr.	Rs. 55,000	
To Bank A/c			Rs. 55,000

(Being shares acquired on exercise of the Put Option)

Equity Stock Option Premium A/c	Dr.	Rs. 4,000	
To Profit and Loss A/c			Rs. 4,000

(Being the premium on the options contract recognised as income on exercise of the option)

GN(A) 18 (Issued 2005)

Guidance Note on Accounting for Employee Share-based Payments

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

INTRODUCTION

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

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

SCOPE

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

4. For the purposes of this Guidance Note, a transfer of shares or stock options of an enterprise by its shareholders to its employees is also an employee share-based payment, unless the transfer is clearly for a purpose other than payment for services rendered to the enterprise. This also applies to transfers of shares or stock options of the parent of the enterprise, or shares or stock options of another enterprise in the same group[1] as the enterprise, to the employees of the enterprise.

5. For the purposes of this Guidance Note, a transaction with an employee in his/her capacity as a holder of shares of the enterprise is not an employee share-based payment. For example, if an enterprise grants all holders of a particular class of its shares the right to acquire additional shares or stock options of the enterprise at a price that is less than the fair value of those shares or stock options, and an employee receives such a right because he/she is a holder of shares or stock options of that particular class, the granting or exercise of that right is not subject to the requirements of this Guidance Note.

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

DEFINITIONS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

ACCOUNTING

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

(a) *Equity-settled:* Under these plans, the employees receive shares.

(b) *Cash-settled:* Under these plans, the employees receive cash based on the price (or value) of the enterprise's shares.

(c) *Employee share-based payment plans with cash alternatives*: Under these plans, either the enterprise or the employee has a choice of whether the enterprise settles the payment in cash or by issue of shares.

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

EQUITY-SETTLED EMPLOYEE SHARE-BASED PAYMENT PLANS

Recognition

10. An enterprise should recognise as an expense (except where service received qualifies to be included as a part of the cost of an asset) the services received in an equity-settled employee share-based payment plan when it receives the services, with a corresponding credit to an appropriate equity account, say, 'Stock Options Outstanding Account'. This account is transitional in nature as it gets ultimately transferred to another equity account such as share capital, securities premium account and/or general reserve as recommended in the

subsequent paragraphs of this Guidance Note.

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

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

Determination of vesting period

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

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

Measurement

15. Typically, shares (under ESPPs) or stock options (under ESOPs) are granted to employees as part of their remuneration package, in addition to a cash salary and other

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

Determining the fair value of shares or stock options granted

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

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

Treatment of vesting conditions

18. Vesting conditions, other than market conditions, should not be taken into account when estimating the fair value of the shares or stock options at the grant date. Instead, vesting conditions should be taken into account by adjusting the number of shares or stock options included in the measurement of the transaction amount so that, ultimately, the amount recognised for employee services received as consideration for the shares or stock options granted is based on the number of shares or stock options that eventually vest. Hence, on a cumulative basis, no amount is recognized for employee services received if the shares or stock options granted do not vest because of failure to satisfy a vesting condition (i.e., these are forfeited[2]), 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.

[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.

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

Treatment of a reload feature

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

After vesting date

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

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

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

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

24. The enterprise should recognise, as a minimum, the services received measured at the grant date fair value of the shares or stock options granted, unless those shares or stock

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

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

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

(b) Similarly, if the modification increases the number of shares or stock options granted, the enterprise should include the fair value of the additional shares or stock options granted, measured at the date of the modification, in the measurement of the amount recognised for services received as consideration for the shares or stock options granted, consistent with the requirements in (a) above. For example,

if the modification occurs during the vesting period, the fair value of the additional shares or stock options granted is included in the measurement of the amount recognised for services received over the period from the modification date until the date when the additional shares or stock options vest, in addition to the amount based on the grant date fair value of the shares or stock options originally granted, which is recognised over the remainder of the original vesting period.

(c) If the enterprise modifies the vesting conditions in a manner that is beneficial to the employee, for example, by reducing the vesting period or by modifying or eliminating a performance condition (other than a market condition, changes to which are accounted for in accordance with (a) above), the enterprise should take the modified vesting conditions into account when applying the requirements of paragraphs 18 to 20.

26. Furthermore, to apply the requirements of paragraph 24, if the enterprise modifies the terms or conditions of the shares or stock options granted in a manner that reduces the total fair value of the employee share-based payment plan, or is not otherwise beneficial to the employee, the enterprise should nevertheless continue to account for the services received as consideration for the shares or stock options granted as if that modification had not occurred (other than a cancellation of some or all the shares or stock options granted, which should be accounted for in accordance with paragraph 27). For example:

(a) if the modification reduces the fair value of the shares or stock options granted, measured immediately before and after the modification, the enterprise should not take into account that decrease in fair value and should continue to measure the amount recognised for services received as consideration for the shares or stock options based on the grant date fair value of the shares or stock options granted.

(b) if the modification reduces the number of shares or stock options granted to an employee, that reduction should be accounted for as a cancellation of that portion of the grant, in accordance with the requirements of paragraph 27.

(c) if the enterprise modifies the vesting conditions in a manner that is not beneficial to the employee, for example, by increasing the vesting period or by modifying or adding a performance condition (other than a market condition, changes to which are accounted for in accordance with (a) above), the enterprise should not take the modified vesting conditions into account when applying the requirements of paragraphs 18 to 20.

27. If the enterprise cancels or settles a grant of shares or stock options during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied):

(a) the enterprise should account for the cancellation or settlement as an acceleration of vesting, and should therefore recognize immediately the amount that otherwise would have been recognised for services received over the remaining vesting period.

(b) any payment made to the employee on the cancellation or settlement of the grant should be deducted from the relevant equity account (e.g., Stock Options Outstanding Account) except to the extent that the payment exceeds the fair value of the shares or stock options granted, measured at the cancellation/settlement date. Any such excess should be recognised as an expense.

(c) if new shares or stock options are granted to the employee as replacement for the cancelled shares or stock options, the enterprise should account for the granting of replacement shares or stock options in the same way as a modification of the original grant of shares or stock options, in accordance with paragraphs 24 to 26. For the purposes of the aforesaid paragraphs, the incremental fair value granted is the difference between the fair value of the replacement shares or stock options and the net fair value of the cancelled shares or stock options, at the date the replacement shares or stock options are granted. The net fair value of the cancelled shares or stock options is their fair value, immediately before the cancellation, less the amount of any payment made to the employee on cancellation of the shares or stock options that is deducted from the relevant equity account in accordance with (b) above.

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

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

CASH-SETTLED EMPLOYEE SHARE-BASED PAYMENT PLANS

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

Recognition

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

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

Measurement

32. For cash-settled employee share-based payment plan, the enterprise should measure the services received and the liability incurred at the fair value of the liability. Until the liability

is settled, the enterprise should remeasure the fair value of the liability at each reporting date and at the date of the settlement, with any changes in fair value recognised in profit or loss for the period.

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

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

EMPLOYEE SHARE-BASED PAYMENT PLANS WITH CASH

ALTERNATIVES

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

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

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

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

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

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

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

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

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

(a) If the enterprise elects to settle in cash, the cash payment should be accounted for as a deduction from the relevant equity account (e.g., Stock Options Outstanding Account) except as noted in (c) below.

(b) If the enterprise elects to settle by issuing shares, the balance in the relevant equity account should be treated as consideration for the shares issued except as noted in (c) below.

(c) If the enterprise elects the settlement alternative with the higher fair value (e.g., the enterprise elects to settle in cash the amount of which is more than the fair value of the shares had the enterprise elected to settle in shares), as at the date of settlement, the enterprise should recognise an additional expense for the excess value given, i.e., the difference between the cash paid and the fair value of the shares that would otherwise have been issued, or the difference between the fair value of the shares issued and the amount of cash that would otherwise have been paid, whichever is applicable.

INTRINSIC VALUE METHOD

40. Accounting for employee share-based payment plans dealt with heretobefore is based on the fair value method. There is another method known as the 'Intrinsic Value Method' for valuation of employee sharebased payment plans. Intrinsic value, in the case of a listed company, is the amount by which the quoted market price of the underlying share exceeds the exercise price of an option. For example, an option with an exercise price of 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 nonlisted company, since

the shares are not quoted on a stock exchange, value of its shares is determined on the basis of a valuation report from an independent valuer. For accounting for employee share-based payment plans, the intrinsic value may be used, *mutatis mutandis*, in place of the fair value as described in paragraphs 10 to 39.

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

RECOMMENDATION

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

GRADED VESTING

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

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

EMPLOYEE SHARE-BASED PAYMENT PLAN ADMINISTERED THROUGH A TRUST

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

(a) The enterprise allots shares to the trust as and when the employees exercise stock options.

(b) The enterprise provides finance to the trust for subscription to the shares issued by the enterprise at the beginning of the plan.

(c) The enterprise provides finance to the trust to purchase shares from the market at the beginning of the plan.

44. Since the trust administers the plan on behalf of the enterprise, it is recommended that irrespective of the arrangement for issuance of the shares under the employee share-based payment plan, the enterprise should recognise in its separate financial statements the

expense on account of services received from the employees in accordance with the recommendations contained in this Guidance Note. Various aspects of accounting for employee share-based payment plan administered through a trust under the arrangements mentioned above, are illustrated in Appendix VII, for the purpose of preparation of separate financial statements.

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

EARNINGS PER SHARE IMPLICATIONS

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

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

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

DISCLOSURES

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

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

during the period.

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

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

(b) the number and weighted average exercise prices of stock options for each of the following groups of options:

   (i) outstanding at the beginning of the period;

   (ii) granted during the period;

   (iii) forfeited during the period;

   (iv) exercised during the period;

   (v) expired during the period;

   (vi) outstanding at the end of the period; and

   (vii) exercisable at the end of the period.

(c) for stock options exercised during the period, the weighted average share price at the date of exercise. If options were exercised on a regular basis throughout the period, the enterprise may instead disclose the weighted average share price during the period.

(d) for stock options outstanding at the end of the period, the range of exercise prices and weighted average remaining contractual life (comprising the vesting period and the exercise period). If the range of exercise prices is wide, the outstanding options should be divided into ranges that are meaningful for assessing the number and timing of additional shares that may be issued and the cash that may be received upon exercise of those options.

51. An enterprise should disclose the following information to enable users of the financial statements to understand how the fair value of shares or stock options granted, during the period, was determined:

(a) for stock options granted during the period, the weighted average fair value of those options at the grant date and information on how that fair value was measured, including:

   (i) the option pricing model used and the inputs to that model, including the weighted average share price, exercise price, expected volatility, option life (comprising the vesting period and the exercise period), expected dividends, the risk-free interest rate and any other inputs to the model, including the method used and the assumptions made to incorporate the effects of expected early exercise;

(ii) how expected volatility was determined, including an explanation of the extent to which expected volatility was based on historical volatility; and

(iii) whether and how any other features of the option grant were incorporated into the measurement of fair value, such as a market condition.

(b) for other instruments granted during the period (i.e., other than stock options), the number and weighted average fair value of those instruments at the grant date, and information on how that fair value was measured, including:

(i) if fair value was not measured on the basis of an observable market price, how it was determined;

(ii) whether and how expected dividends were incorporated into the measurement of fair value; and

(iii) whether and how any other features of the instruments granted were incorporated into the measurement of fair value.

(c) for employee share-based payment plans that were modified during the period:

(i) an explanation of those modifications;

(ii) the incremental fair value granted (as a result of those modifications); and

(iii) information on how the incremental fair value granted was measured, consistently with the requirements set out in (a) and (b) above, where applicable.

52. An enterprise should disclose the following information to enable users of the financial statements to understand the effect of employee share-based payment plans on the profit or loss of the enterprise for the period and on its financial position:

(a) the total expense recognised for the period arising from employee share-based payment plans in which the services received did not qualify for recognition as a part of the cost of an asset and hence were recognised immediately as an expense, including separate disclosure of that portion of the total expense that arises from transactions accounted for as equity-settled employee share-based payment plans;

(b) for liabilities arising from employee share-based payment plans:

(i) the total carrying amount at the end of the period; and

(ii) the total intrinsic value at the end of the period of liabilities for which the right of the employee to cash or other assets had vested by the end of the period (e.g., vested stock appreciation rights).

Appendix IX contains illustrative disclosures.

EFFECTIVE DATE

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

APPENDIX I

ESTIMATING THE FAIR VALUE OF SHARES OR STOCK OPTIONS GRANTED

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

SHARES

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

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

STOCK OPTIONS

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

5. The enterprise should consider factors that knowledgeable, willing market participants would consider in selecting the option pricing model to apply. For example, many employee

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

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

(a) the exercise price of the option;

(b) the life of the option;

(c) the current price of the underlying shares;

(d) the expected volatility of the share price;

(e) the dividends expected on the shares (if appropriate); and

(f) the risk-free interest rate for the life of the option.

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

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

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

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

Inputs to option pricing models

11. In estimating the expected volatility of and dividends on the underlying shares, the objective is to approximate the expectations that would be reflected in a current market or negotiated exchange price for the option. Similarly, when estimating the effects of early exercise of employee stock options, the objective is to approximate the expectations that an outside party with access to detailed information about employees' exercise behaviour would develop based on information available at the grant date.

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

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

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

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

Expected early exercise

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

17. The means by which the effects of expected early exercise are taken into account depends upon the type of option pricing model applied. For example, expected early exercise

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

18. Factors to consider in estimating early exercise include:

(a) the length of the vesting period, because the stock option typically cannot be exercised until the end of the vesting period. Hence, determining the valuation implications of expected early exercise is based on the assumption that the options will vest. The implications of vesting conditions are discussed in paragraphs 18 to 20 of the text of the Guidance Note.

(b) the average length of time similar options have remained outstanding in the past.

(c) the price of the underlying shares. Experience may indicate that the employees tend to exercise options when the share price reaches a specified level above the exercise price.

(d) the employee's level within the organisation. For example, experience might indicate that higher-level employees tend to exercise options later than lower-level employees (discussed further in paragraph 21 of this Appendix).

(e) expected volatility of the underlying shares. On average, employees might tend to exercise options on highly volatile shares earlier than on shares with low volatility.

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

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

21. Similar considerations apply when using a binomial or similar model. For example, the

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

Expected volatility

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

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

24 The expected annualised volatility of a share is the range within which the continuously compounded annual rate of return is expected to fall approximately two-thirds of the time. For example, to say that a share with an expected continuously compounded rate of return of 12 per cent has a volatility of 30 per cent means that the probability that the rate of return on the share for one year will be between –18 per cent (12% –30%) and 42 per cent (12% + 30%) is approximately two-thirds. If the share price is 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 (Rs.100 × $e_{-0.18}$) and Rs.152.20 (Rs. 100 × $e_{0.42}$) approximately two-thirds of the time.

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

(a) Implied volatility from traded stock options on the shares of the enterprise, or other traded instruments of the enterprise that include option features (such as convertible debt), if any.

(b) The historical volatility of the share price over the most recent period that is generally commensurate with the expected term of the option (taking into account the remaining contractual life of the option and the effects of expected early exercise).

(c) The length of time shares of an enterprise have been publicly traded. A newly listed enterprise might have a high historical volatility, compared with similar enterprises that have been listed longer. Further guidance for newly listed enterprises is given in paragraph 26 of this Appendix.

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

(e) Appropriate and regular intervals for price observations. The price observations should be consistent from period to period.

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

Newly listed enterprises

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

Unlisted enterprises

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

Expected dividends

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

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

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

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

Risk-free interest rate

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

Capital structure effects

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

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

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

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

APPENDIX II

Equity-Settled Employee

Share-based Payment Plans

ILLUSTRATION 1 : STOCK OPTIONS WITH SERVICE

CONDITION ONLY

(A) Accounting during the vesting period

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

Vesting Period	3 years
Exercise Period	3 years
Expected Life	5 years
Exercise Price	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:

   No. of options expected to vest

   = 300 x 1,000 x 0.97 x 0.97 x 0.97 = 2,73,802 options

   Fair value of options expected to vest

   = 2,73,802 options x Rs. 15 = Rs. 41,07,030

2. At the balance sheet date, since the enterprise still expects actual forfeitures to average

3 per cent per year over the 3-year vesting period, no change is required in the estimates made at the grant date. The enterprise, therefore, recognises one-third of the amount estimated at (1) above (i.e., 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 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:

Revised total fair value	Rs. 37,37,625
Revised cumulative expense at the end of	
year 2= (Rs. 37,37,625 x 2/3)	=Rs. 24,91,750
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 x 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:

Particulars	*Exercise Date Year-end 5*	*Exercise Date Year-end 6*
No. of employees exercising option	200	600

No. of shares issued on exercise @ 300per employee	60,000	1,80,000
Exercise Price received @ Rs. 50 per share	30,00,0000	1,80,000
Corresponding amount recognised in the 'Stock Options Outstanding A/c' @ Rs. 15 per option	9,00,000	27,00,000
Total Consideration	39,00,000	1,17,00,000
Amount to be recorded in 'Share Capital A/c' @ 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
Total	39,00,000	1,17,00,000

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

Year 5 Bank A/c Dr. 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)

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 twoyear 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.

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

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

By the end of year 3, 23 employees have left and the earnings of the enterprise have increased by 8 per cent, resulting in an average increase of 10.67 per cent per year.

Therefore, 419 employees received 100 shares each at the end of year 3.

Suggested Accounting Treatment

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

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

Particulars	Year 1	Year 2	Year 3
Length of the expected vesting period (at the end of the year)	2 years	3 years	3 years
No. of employees expected to meet vesting conditions	440 employees	417 employees	419 employees
No. of options expected to vest	44,000	41,700	41,900
Fair value of options expected to vest @ 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 recognized 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 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 × 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 × Rs. 25 × 1/5	4,00,000	4,00,000
2.	(80,000 options × Rs. 25 × 2/5) – Rs. 4,00,000	4,00,000	8,00,000
3.	(80,000 options × Rs. 25 × 3/5) – Rs. 8,00,000	4,00,000	12,00,000
4.	4 (80,000 options × Rs. 25 × 4/5) – Rs. 12,00,000	4,00,000	16,00,000
5.	(70,000 options × 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 shares.

Suggested Accounting Treatment

Paragraph 15 of the text of the Guidance Note provides that the enterprise should measure the fair value of the employee services received by reference to the fair value of the shares or stock options granted. To apply this requirement, it is necessary first to determine the type of instrument granted to the employees. Although the plan is described as an employee stock purchase plan (ESPP), some ESPPs include option features and are therefore, in effect, stock option plans. For example, an ESPP might include a 'lookback feature', whereby the employee is able to purchase shares at a discount, and choose whether the discount is applied to the share price of the enterprise at the date of grant or its share price at the date of purchase. Or an ESPP might specify the purchase price, and then allow the employees a significant period of time to decide whether to participate in the plan. Another example of an option feature is an ESPP that permits the participating employees to cancel their participation before or at the end of a specified period and obtain a refund of amounts previously paid into the plan.

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

Another factor to consider is the effect of post-vesting transfer restrictions, if any. Paragraph 3 of the Appendix I to the Guidance Note states that, if shares are subject to restrictions on transfer after vesting date, that factor should be taken into account when estimating the fair value of those shares, but only to the extent that the post-vesting restrictions affect the price that a knowledgeable, willing market participant would pay for that share. For example, if the shares are actively traded in a deep and liquid market, post-vesting transfer restrictions may have little, if any, effect on the price that a knowledgeable, willing market participant would pay for those shares.

In this example, the shares are vested when purchased, but cannot be sold for five years after the date of purchase. Therefore, the enterprise should consider the valuation effect of the five-year post-vesting transfer restriction. This entails using a valuation technique to estimate what the price of the restricted share would have been on the purchase date in an arm's length transaction between knowledgeable, willing parties. Suppose that, in this example, the enterprise estimates that the fair value of each restricted share is Rs. 28. In this case, the fair value of the instruments granted is Rs. 4 per 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 expnse 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 recognise the services received over the three-year period based on the original vesting conditions. Hence, the enterprise ultimately recognizes 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 x 300 x 0.97 x 0.97 x 0.97	=	2,73,802 SARs

Provision required at the year-end

2,73,802 SARs x Rs. 15.30 x 1/3	=	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 x 300 x 0.94 x 0.94 x 0.94	=	2,49,175 SARs
Provision required at the year-end		
2,49,175 SARs x Rs. 16.50 x 2/3	=	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 employees x 300 SARs		2,52,000 SARs
No. of SARs exercised at the year-end		
400 employees x 300 SARs		1,20,000 SARs
No. of SARs outstanding at the year-end		1,32,000 SARs
Provision required in respect of SARs outstanding at the year-end		
1,32,000 SARs x Rs. 19.20	=	Rs. 25,34,400
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		
42,000 SARs x Rs. 26.00	=Rs.10,92,000	
Total	Rs. 10,92,000	
Less: provision at the beginning of the year		Rs. (8,94,600)
Expense for the year	Rs. 1,97,400	

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

Employee compensation

expense A/c Dr. _________

To Provision for payment

of SARs A/c _________

(Being compensation expense recognised in respect of SARs)

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

Provision for payment of

SARs A/c Dr. _________

To Bank A/c _________

(Being cash paid on exercise of SARs)

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

Intrinsic Value Method

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

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 x 300 x 0.97 x 0.97 x 0.97	= 2,73,802 SARs
Provision required at the year-end	
2,73,802 SARs x Rs. 9.00 x 1/3	= 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 x 300 x 0.94 x 0.94 x 0.94	= 2,49,175 SARs
Provision required at the year-end	
2,49,175 SARs x Rs. 12.00 x 2/3	= 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 employees x 300 SARs	2,52,000 SARs
No. of SARs exercised at the year-end	
400 employees x 300 SARs	1,20,000 SARs
No. of SARs outstanding at the year-end	1,32,000 SARs
Provision required in respect of SARs outstanding at the year-end	
1,32,000 SARs x Rs. 16.00	= Rs. 21,12,000
Plus: Cash paid on exercise of SARs by employees	
1,20,000 SARs x Rs. 16.00	= Rs. 19,20,000
Total	Rs. 40,32,000
Accounting for Employee Share-based Payments 337	
Less: provision at the beginning of the year	Rs. (19,93,400)
Expense for the year	Rs. 20,38,600
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. 21.00	= Rs. 8,82,000
Plus: Cash paid on exercise of SARs	
90,000 SARs x Rs. 21.00 =	Rs. 18,90,000
Total	Rs. 27,72,000
Less: provision at the beginning of the year	Rs. (21,12,000)

Expense for the year	Rs. 6,60,000
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	
42,000 SARs x Rs. 26.00 =	Rs. 10,92,000
Total	Rs. 10,92,000
Less: provision at the beginning of the year	Rs. (8,82,000)
Expense for the year	Rs. 2,10,000

Appendix V

Employee Share-based Payment Plan with Cash Alternatives

Illustration : An enterprise grants to an employee the right to choose either a cash payment equal to the value of 1,000 shares, or 1,200 shares. The grant is conditional upon the completion of three years' service. If the employee chooses the equity alternative, the shares must be held for three years after vesting date. The face value of shares is 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 =	Rs. 50,000
Fair value of the equity component	
(Rs. 57,600 – Rs. 50,000) =	Rs. 7,600
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 __________

(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)

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

1. Since the options granted have a graded vesting schedule, the enterprise segregates the total plan into different groups, depending upon the vesting dates and treats each of these groups as a separate plan.

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

Vesting Date (Year-end)	Options expected to vest
1	300 options x 1,000 employees x 25% x 0.97 = 72,750 options
2	300 options x 1,000 employees x 25% x 0.97 x .97= 70,568 options
3	300 options x 1,000 employees x 50% x 0.97 x .97 x .97 =1,36,901 options
Total options expected to vest	2,80,219 options

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

Vesting Date (Year-end)	Expected Vesting (No. of Options)	Value per Option (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
	Total		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	Cost to be recognised		
(End of year)	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 option. In such a case, total compensation expense for the options expected to vest would be

Vesting Date (End of year)	Expected Vesting (No. of Options)	Value per Option (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
	Total		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	Cost to be recognised		
(End of year)	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

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.

(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)

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	
Paid-up Capital:	
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:

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
Total Consideration	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
Total	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 employeesagainst 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	
Paid-up Capital:	
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 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)

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		
Paid-up Capital:		
12,70,000 equity shares of Rs. 10 each	1,27,00,000	
Less: Amount recoverable from ESOP Trust	27,00,000	1,00,00,000
(face value of 2,70,000 share allotted to the Trust)		
Stock Options Outstanding Account	40,50,000	

Reserves and Surplus		
Securities Premium Account	2,98,50,000	
Less: Amount recoverable from ESOP Trust	1,48,50,000	1,50,00,000
(Premium on 2,70,000 share allotted to the Trust)		

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:

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 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

(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	
Paid-up Capital:	
12,70,000 equity shares of Rs. 10 each fully paid (Of the above, 2,70,000	1,27,00,000

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:

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	
Paid-up Capital:	
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'.

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)

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		
Paid-up Capital:		
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	
Add: Amount transferred from the Stock		
Options Outstanding Account	35,10,000	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, computations of diluted EPS are based on the actual number of options granted and not yet forfeited.

(b) For calculating diluted EPS, no adjustment is made to the net profit attributable to equity shareholders as there are no expense or income that would result from conversion of ESOPs to the equity shares.

(c) For calculating diluted EPS, the enterprise assumes the exercise of dilutive options. The assumed proceeds from these issues are considered to have been received from the issue of shares at fair value. The difference between the number of shares issuable and the number of shares that would have been issued at fair value are treated as an issue of equity shares for no consideration

(d) As per paragraph 47 of this Guidance Note, the assumed proceeds to be included for computation, mentioned at (c) above, include (i) the exercise price; and (ii) the unamortized compensation cost related to these ESOPs, attributable to future services.

(e) The enterprise calculates the basic and diluted EPS as below:

Particulars	Year 1	Year 2
Net profit before amortisation of ESOP		
cost	Rs. 25,00,000	Rs. 28,00,000
Less: Amortisation of ESOP cost	(Rs. 13,50,000)	(Rs. 13,50,000)
[(900 employees × 300 options × Rs. 10)/2]		
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	2,70,000
[1,000 employees [2,85,000× 300		
options – options – (50 employees (50 employees		
× 300 options)] × 300 options)]		
Unamortised compensation cost per	Rs. 5	Rs. 0
option	[Rs. 10 – Rs. 10/2]	
Number of dilutive potential equity	10,000	45,000

shares [2,85,000 –[2,70,000 –({(2,85,000 * 50)		
(2,70,000 + (2,85,000 * 50)/60)]* 5)}/57)]		
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

An example has been given in this appendix to illustrate the disclosure requirements in paragraphs 49 to 52 of the text of the Guidance Note. The students are advised to refer this appendix from the compendium of Guidance Notes.

GN(A) 20 (Issued 2005)

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 India[1] .)

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.

(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:

“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	xxx	xxx
Fringe Benefits Tax	xxx	xxx
Profit after tax		xxx

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 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—

(*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;

(*v*) being the expenditure on advertisement by way of signs, art work, painting, banners, awnings, direct mail, electric spectaculars, 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 subsection

(1) of section 1I5WB, 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 subsection

(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" 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 benefit 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.

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Guidance Note on Accounting for Credit Available in respect of Minimum Alternative Tax under The Income-tax Act, 1961

(The following is the text of the Guidance Note on Accounting for Credit Available in Respect of Minimum Alternative Tax Under the Income-tax Act,1961, issued by the Council of the Institute of Chartered Accountants of India.)

INTRODUCTION

1. The Finance Act, 1997, introduced section 115JAA in the Income-tax Act, 1961 (hereinafter referred to as the 'Act') providing for tax credit in respect of MAT paid under

section 115JA (hereinafter referred to as 'MAT credit') which could be carried forward for set-off for five succeeding years in accordance with the provisions of the Act. Section 115JA was inserted by the Finance Act, 1996, w.e.f. 1.4.1997. The said section provided for payment of Minimum Alternative Tax (hereinafter referred to as 'MAT') by certain companies, where the total income, as computed under the Income-tax Act, 1961, in respect of any previous year relevant to the assessment year commencing on or after 1st day of April, 1997, but before the 1st day of April, 2001, was less than 30% of its book profit. In such a case, the total income of the company chargeable to tax for the relevant previous year was deemed to be an amount equal to thirty per cent of its book profit.

2. The Finance Act, 2000, w.e.f. 1.4.2001, introduced section 115JB according to which a company is liable to pay MAT under the provisions of the said section in respect of any previous year relevant to the assessment year commencing on or after the 1st day of April, 2001. The MAT under this section is payable where the normal income-tax payable by such company in the previous year is less than 7.5 per cent (10 per cent proposed by the Finance Bill, 2006) of its book profit which is deemed to be the total income of the company. Such company is liable to pay income-tax at the rate of 7.5 per cent (10 per cent proposed by the Finance Bill, 2006) of its book profit.

The Finance Act, 2005, inserted sub-section (1A) to section 115JAA, to grant tax credit in respect of MAT paid under section 115JB of the Act with effect from assessment year 2006-07.

3. The salient features of MAT credit under section 115JAA as applicable, in respect of tax paid under sections 115JA and 115JB, are as below:

(a) A company, which has paid MAT, would be allowed credit in respect thereof.

(b) The amount of MAT credit would be equal to the excess of MAT over normal income-tax for the assessment year for which MAT is paid.

(c) No interest is allowable on such credit.

(d) The MAT credit so determined can be carried forward for set-off for five succeeding assessment years from the year in which MAT credit becomes allowable. The Finance Bill, 2006, has proposed that credit in respect of MAT paid under section 115JB can be carried forward upto seven succeeding assessment years (hereinafter referred to as the 'specified period').

(e) The amount of MAT credit can be set-off only in the year in which the company is liable to pay tax as per the normal provisions of the Act and such tax is in excess of MAT for that year.

(f) The amount of set-off would be to the extent of excess of normal income-tax over the amount of MAT calculated as if section 115JB had been applied for that assessment year for which the set-off is being allowed.

ACCOUNTING TREATMENT

Whether MAT credit is a deferred tax asset

4. An issue has been raised whether the MAT credit can be considered as a deferred tax asset within the meaning of Accounting Standard (AS) 22, Accounting for Taxes on Income, issued by the Institute of Chartered Accountants of India. In this context, the following definitions given in AS 22 are noted:

"Timing differences are the differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods."

"Accounting income (loss) is the net profit or loss for a period, as reported in the statement of profit and loss, before deducting income tax expense or adding income tax saving."

"Taxable income (tax loss) is the amount of the income (loss) for a period,determined in accordance with the tax laws, based upon which income tax payable (recoverable) is determined."

5. From the above, it is noted that payment of MAT, does not by itself, result in any timing difference since it does not give rise to any difference between the accounting income and the taxable income which are arrived at before adjusting the tax expense, namely, MAT. In other words, under AS 22, deferred tax asset and deferred tax liability arise on account of differences in the items of income and expenses credited or charged in the profit and loss account as compared to the items of income that are taxed or items of expense that are allowed as deduction, for the purposes of the Act. Thus, deferred tax assets and deferred tax liabilities do not arise on account of the amount of the tax expense itself. In view of this, it is not appropriate to consider MAT credit as a deferred tax asset for the purposes of AS 22.

Whether MAT credit can be considered as an 'asset'

6. Although MAT credit is not a deferred tax asset under AS 22 as discussed above, yet it gives rise to expected future economic benefit in the form of adjustment of future income tax liability arising within the specified period. A question, therefore, arises whether the MAT credit can be considered as an 'asset' and in case it can be considered as an asset whether it should be so recognised in the financial statements.

7. The Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India, defines the term 'asset' as follows:

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

8. MAT paid in a year in respect of which the credit is allowed during the specified period under the Act is a resource controlled by the company as a result of past event, namely, the

payment of MAT. MAT credit has expected future economic benefits in the form of its adjustment against the discharge of the normal tax liability if the same arises during the specified period.

Accordingly, MAT credit is an ‘asset’.

9. According to the Framework, once an item meets the definition of the term ‘asset’, it has to meet the criteria for recognition of an asset so that it may be recognised as such in the financial statements. Paragraph 88 of the Framework provides the following criteria for recognition of an asset:

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

10. In order to decide when it is ‘probable’ that the future economic benefits associated with the asset will flow to the enterprise, paragraph 84 of the Framework, *inter alia*, provides as below:

“84. The concept of probability is used in the recognition criteria to refer to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the enterprise. The concept is in keeping with the uncertainty that characterises the environment in which an enterprise operates. Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence available when the financial statements are prepared.”

11. The concept of probability as contemplated in paragraph 84 of the Framework relates to both items of assets and liabilities and, therefore, the degree of uncertainty for recognition of assets and liabilities may vary keeping in view the consideration of ‘prudence’. Accordingly, while for recognition of a liability the degree of uncertainty to be considered ‘probable’ can be ‘more likely than not’ (as in paragraph 22 of Accounting Standard (AS) 29, ‘Provisions, Contingent Liabilities and Contingent Assets’) for recognition of an asset, in appropriate conditions, the degree may have to be higher than that. Thus, for the purpose of consideration of the probability of expected future economic benefits in respect of MAT credit, the fact that a company is paying MAT and not the normal income tax, provides a *prima facie* evidence that normal income tax liability may not arise within the specified period to avail MAT credit. In view of this, MAT credit should be recognised as an asset only when and to the extent there is convincing evidence that the company will pay normal income tax during the specified period. Such evidence may exist, for example, where a company has, in the current year, a deferred tax liability because its depreciation for the income-tax purposes is higher than the depreciation for accounting purposes, but from the next year onwards, the depreciation for accounting purposes would be higher than the depreciation for income-tax purposes, thereby resulting in the reversal of the deferred tax liability to an extent that the company becomes liable to pay normal income tax.

12. Where MAT credit is recognised as an asset in accordance with paragraph 11 above, the same should be reviewed at each balance sheet date. A company should write down the carrying amount of the MAT credit asset to the extent there is no longer a convincing evidence to the effect that the company will pay normal income tax during the specified period.

Presentation of MAT credit in the financial statements

Balance Sheet

13. Where a company recognises MAT credit as an asset on the basis of the considerations specified in paragraph 11 above, the same should be presented under the head 'Loans and Advances' since, there being a convincing evidence of realisation of the asset, it is of the nature of a pre-paid tax which would be adjusted against the normal income tax during the specified period. The asset may be reflected as 'MAT credit entitlement'.

14. In the year of set-off of credit, the amount of credit availed should be shown as a deduction from the 'Provision for Taxation' on the liabilities side of the balance sheet. The unavailed amount of MAT credit entitlement, if any, should continue to be presented under the head 'Loans and Advances' if it continues to meet the considerations stated in paragraph 11 above.

Profit and Loss Account

15. According to paragraph 6 of Accounting Standards Interpretation (ASI) 'Accounting for Taxes on Income in the context of Section 115JB of the Income-tax Act, 1961', issued by the Institute of Chartered Accountants of India, MAT is the current tax. Accordingly, the tax expense arising on account of payment of MAT should be charged at the gross amount, in the normal way, to the profit and loss account in the year of payment of MAT. In the year in which the MAT credit becomes eligible to be recognised as an asset in accordance with the recommendations contained in this Guidance Note, the said asset should be created by way of a credit to the profit and loss account and presented as a separate line item therein.

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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 requirement contained in paragraph 27 of AS 25 that an enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements.

7. Appendix B contains examples of computing weighted average annual effective tax rate.

Appendix A

EXTRACTS FROM APPENDIX 3 TO ACCOUNTING STANDARD (AS) 25, INTERIM FINANCIAL REPORTING

Measuring Income Tax Expense for Interim Period

8. Interim period income tax expense is accrued using the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate applied to the pre-tax income of the interim period.

9. This is consistent with the basic concept set out in paragraph 27 that the same accounting recognition and measurement principles should be applied in an interim financial report as are applied in annual financial statements. Income taxes are assessed on an annual basis. Therefore, interim period income tax expense is calculated by applying, to an interim period's pre-tax income, the tax rate that would be applicable to expected total annual earnings, that is, the estimated average effective annual income tax rate. That estimated average annual income tax rate would reflect the tax rate structure expected to be applicable to the full year's earnings including enacted or substantively enacted changes in the income tax rates scheduled to take effect later in the financial year. The estimated average annual income tax rate would be re-estimated on a year-to-date basis, consistent with paragraph 27 of this Statement. Paragraph 16(d) requires disclosure of a significant change in estimate.

10. To the extent practicable, a separate estimated average annual effective income tax rate is determined for each governing taxation law and applied individually to the interim period pre-tax income under such laws. Similarly, if different income tax rates apply to different categories of income (such as capital gains or income earned in particular industries), to the extent practicable a separate rate is applied to each individual category of interim period pre-tax income. While that degree of precision is desirable, it may not be achievable in all cases and a weighted average of rates across such governing taxation laws or across categories of income is used if it is a reasonable approximation of the effect of using more specific rates.

11. As illustration, an enterprise reports quarterly, earns 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)

	1st Quarter	2nd Quarter	3rd Quarter	4th 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% in Year 1 and 40% 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%. The estimated payment of the annual tax on Rs. 400 lakhs of earnings for the current year would be Rs. 120 lakhs {(Rs. 400 lakhs - Rs. 100 lakhs) x 40%}. Considering the loss carryforward, the estimated average annual effective income tax rate would be 30% {(Rs. 120 lakhs/Rs. 400 lakhs) x 100}. This average annual effective income tax rate would be applied to earnings of each quarter. Accordingly, tax expense would be as follows:

(Amount in Rs. lakhs)

	1st Quarter	2nd Quarter	3rd Quarter	4th 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 capital expenditure on acquisition of fixed assets during the year.					(50)
Estimated taxable income on which tax payable.					100
Applicable tax rate (say)					30%
Estimated current tax expense for the year.					30
Estimated deferred tax expense for the year (50x30/100)					15

Weighted Average Annual Effective Tax Rate (current tax)					30 x 100 = 17.14% 175
Weighted Average Annual Effective Tax Rate (deferred tax)					15 x 100 = 8.57% 175
Tax expense for the interim period Current tax Deferred tax Total	 (4.29) (2.14) (6.43)	 30 15 45	 (4.29) (2.14) (6.43)	 8.57 4.29 12.86	 29.99 15.01 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%
Estimated current tax expense for the year.					30
Estimated deferred tax expense for the year: (i) Defered tax liability on account of timing difference in depreciation (50x30/100) 15 (ii) Reversal of deferred tax asset (25x30/100) 7.5					22.5
Weighted Average Annual Effective Tax Rate (Current tax)					30 x 100 = 17.14% 175
Weighted Average Annual Effective Tax Rate (Deferred tax)					22.5 x 100 = 12.86% 175

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:

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

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:

	Income	Tax Expense
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
		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
Total tax expense for the year		= Rs. 30,000