APPLICATION OF GUIDANCE NOTES

LEARNING OUTCOMES
After studying this chapter, you will be able to:

▪ Comprehend the concept of Guidance Notes.
▪ Understand the provisions of the Guidance Notes specified in the syllabus
▪ Solve the practical problems based on application of Guidance Notes.

CHAPTER OVERVIEW

Guidance Notes are primarily designed to provide guidance to members of ICAI on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. In recent years, several Guidance Notes on accounting aspects have been issued promptly responding to the need for accounting guidance on contemporary issues, which arise due to amendments in laws and other developments related to economic reforms in the country. These Guidance Notes are issued by the Council of the ICAI from time to time. Guidance Notes are recommendatory in nature. The list of applicable guidance notes on accounting aspects (covered in Intermediate Paper 5 Syllabus) have been discussed in detail in this chapter.

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1. INTRODUCTION

Guidance Notes are primarily designed to provide guidance to members of ICAI on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. In recent years several Guidance Notes on accounting aspects have been issued promptly responding to the need for accounting guidance on contemporary issues, which arise due to amendments in laws and other developments related to economic reforms in the country. These Guidance Notes are issued by the Council of the ICAI from time to time.

Guidance Notes are recommendatory in nature. A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is satisfied that in the circumstances of the case, it may not be necessary to do so. Similarly, while discharging his attest function, a member should examine whether the recommendations in a guidance note relating to an accounting matter have been followed or not. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary.

2. STATUS OF GUIDANCE NOTES

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

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

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

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

Accounting Standard vis-à-vis Guidance Notes

Accounting Standards seeks to describe the accounting principles, the valuation techniques and methods of applying the accounting principles in the preparation and presentation of financial statements so that they give true and fair view.

Guidance notes seeks to provide guidance in some specific matters which are already dealt with by the accounting standards. It aims are clarifying the issues which needs special attention or where there are more than one treatment possible of the same item.

Accounting Standards are the basis on which the accounting world operates and are compulsorily required to be complied with. If any deviations found, it the responsibility of the Accounting and Auditing Professional to report the matter to the higher authorities. The auditor may even qualify the report if the deviation is material. In contrast to this guidance note are the leading paths to the professional on some matters which may need special attention. It is at the discretion of the professional to take the note into consideration. He may even seek to not abide by the Guidance Note, if the situation so warrant. No qualification needed in the report if one does not follow guidance note.

3. GUIDANCE NOTES ON ACCOUNTING ASPECTS

The following is the list of applicable guidance notes on accounting aspects (covered in Intermediate Paper 5 Syllabus):

1. Guidance Note on Terms Used in Financial Statements.
2. Guidance Note on Accrual Basis of Accounting.
6. Guidance Note on Accounting for Real Estate Transactions (revised 2012)

The students are advised to go through the bare text of these Guidance Notes which are given in handbook on Accounting Pronouncements. Students may also check the following link for the full text of the Guidance Notes on our Institute’s website:
http://www.icai.org/post.html?post_id=1399

4. AN OVERVIEW OF GUIDANCE NOTES

The list of applicable guidance notes on accounting aspects (covered in Intermediate Paper 5 Syllabus have been discussed in detail in the succeeding paras.

4.1 GUIDANCE NOTE ON TERMS USED IN FINANCIAL STATEMENTS

The objective of this guidance note is to facilitate a broad and basic understanding of the various terms as well as to promote consistency and uniformity in their usage. The terms have been defined in this guidance note, keeping in view their usage in the preparation and presentation of the financial statements. Some of these terms may have different meanings when used in the context of certain special enactments. The definitions of the terms in this guidance note do not spell out the accounting procedure and are not prescriptive of a course of action. For the definition of terms used in financial Statements, the students are advised to refer the bare text of this Guidance Note.

4.2 GUIDANCE NOTE ON ACCRUAL BASIS OF ACCOUNTING.

Introduction:

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.

There are three bases of accounting in use, viz., (i) accrual (ii) cash and (iii) hybrid. Section 128 of the Companies Act, 2013, makes it obligatory on all companies to maintain their accounts on accrual basis and according to the double entry system of accounting.

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.

**Meaning of Accrual Basis of Accounting**

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”

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’.”

**Reasons for Accrual Basis of Accounting**

1. 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.

2. Receipts and payments of the period will not coincide with the buying producing or selling events and other economic events that affect entity performance.

3. The goal of Accrual basis of accounting is to follow the Matching concept of Income and Expenditure so that reported net income measures an enterprise’s performance during a period instead of merely listing its cash receipts and payments.

4. 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.
5. Important point of difference between accrual and accounting based on cash receipts and outlay is in timing of recognition of revenues, expenses, gains and losses.

**Features of Revenue Recognition AS-9**

- 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.

- Recognition of revenue requires revenue should be measurable and that at the time of sale or rendering of services or the use of resources of the enterprises by others it would not be unreasonable to expect ultimate collection. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

**If recognition of revenue is postponed due to uncertainties**

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., and 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. 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.
APPLICATION OF GUIDANCE NOTES

PERFORMANCE SHOULD BE REGARDED AS ACHIEVED WHEN?

Sale of goods

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

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

Rendering of Services

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.

Note: 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.

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The recognition of interest, royalties and dividends are as follows-

- **Sources**
  - (A) Interest
    - 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.
  - (B) Royalty
    - 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.
  - (C) Dividends
    - Dividends from investments in shares accrue when the owner’s right to receive payment is established.

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

**Rules for Expense Recognition**

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”.

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

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**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.

**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.

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**Expenses Relating to Future Period**

- **Prepaid Expenses**
  - Expenses of future periods paid in current accounting period is known as prepaid expenses

- **Outstanding Expenses**
  - Expenses of the current year, for which payment has not yet been made, are charged to the profit and loss account for the current accounting period.
Recognition of Assets and Liabilities

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.

Concept of Materiality

(a) The Companies Act, 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.

(b) 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.

(c) 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 ₹ 100 even though it is expected to be used for more than one year.

**Change in the Basis of Accounting**

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.

**Auditor’s Responsibility**

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:

- Whether proper books of account as required by law have been kept by the company
- Whether the accounts give the information required by this Act in the manner so required and give a true and fair view of:
4.3 GUIDANCE NOTE ON ACCOUNTING FOR CORPORATE DIVIDEND TAX

Corporate Dividend Tax (CDT) is in addition to the income-tax chargeable in respect of the total income of a domestic company and was introduced under The Finance Act, 1997. The Guidance Note on Accounting for Corporate Dividend Tax explains the salient features of Corporate Dividend tax (CDT). As per the Guidance Note, 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. 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.

The Salient Features of CDT as are follows:

I. CDT is chargeable to the domestic company declaring or distributing dividend in India on or after 1st day of June 1997

II. It is the tax in addition to income tax

III. The dividend may be paid out of current profits or accumulated profits

IV. The rate of CDT is 15% plus 12% surcharge as increased by education cess.

V. CDT should 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. No Credit should be allowed towards payment of CDT. It should be treated as the final payment of tax on the dividends.
VIII. The expression ‘dividend’ should have the same meaning as is given to ‘dividend’ in clause (22) of Section 2 but should not include sub-clause (e) thereof.

**Accounting for CDT**

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**

- The 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’.

- 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**

- According to the matching concept of accounting CDT liability should be recognised in the same period as the dividend concerned is recognised.

- CDT liability should be disclosed below the line item dividend as follows:

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<td>Dividend</td>
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<td>Corporate Dividend tax thereon</td>
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- Provision for Corporate Dividend Tax should be disclosed separately under the head ‘Provisions’ in the balance sheet.
4.4 GUIDANCE NOTE ON ACCOUNTING FOR EMPLOYEE SHARE-BASED PAYMENTS

This Guidance Note establishes financial accounting and reporting principles for employee share-based payment plans, viz., employee stock option plans, employee stock purchase plans 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.

For accounting purposes, employee share-based payment plans are classified into the following categories:

- Equity-settled: Under these plans, the employees receive shares.
- Cash-settled: Under these plans, the employees receive cash based on the price (or value) of the enterprise's shares.
- 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.

An employee 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 here in below is based on the fair value method.

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 this Guidance Note. 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. 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.

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. 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. Vesting conditions, other than market conditions, should not be taken into account when estimating the fair value of the shares or stock options at the grant date. Instead, vesting conditions should be taken into account by adjusting the number of shares or stock options included in the measurement of the transaction amount so that, ultimately, the amount recognised for employee services received as consideration for the shares or stock options granted is based on the number of shares or stock options that eventually vest. Hence, on a cumulative basis, no amount is recognised for employee services received if the shares or stock options granted do not vest because of failure to satisfy a vesting condition (i.e., these are forfeited), e.g., the employee fails to complete a specified service period, or a performance condition is not satisfied.

To apply the requirements of the Guidance Note, 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. 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. 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.

For cash-settled employee share-based payment plans, 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 is required to re-measure the fair value of the liability at each reporting date and at the date of settlement, with any changes in value recognised in profit or loss for the period.

For employee share-based payment plans in which the terms of the arrangement provide either the enterprise or the employee with a choice of whether the enterprise settles the transaction in cash or by issuing shares, the enterprise is required to account for that transaction, or the components of that transaction, as a cash-settled share-based payment plan if, and to the extent that, the enterprise has incurred a liability to settle in cash (or other assets), or as an equity-settled share-based payment plan if, and to the extent that, no such liability has been incurred.

Accounting for employee share-based payment plans is based on the fair value method. There is another method known as the ‘Intrinsic Value Method’ for valuation of employee share-based payment plans. Intrinsic value, in the case of a listed company, is the amount by which the quoted market price of the underlying share exceeds the exercise price of an option. In the case of a non-listed company, since the shares are not quoted on a stock exchange, value of its shares is determined on the basis of a valuation report from an independent valuer. For accounting for employee share-based payment plans, the intrinsic value may be used, mutatis mutandis, in place of the fair value as described in the Guidance Note.

Apart from the above, the Guidance Note also deals with various other significant aspects of the employee share-based payment plans including those related to performance conditions, modifications to the terms and conditions of the grant of shares or stock options, reload feature, graded vesting, earnings-per-share implications, accounting for employee share-based payments administered through a trust, etc. The Guidance Note also recommends detailed disclosure requirements. The appendices to the Guidance Note provide detailed guidance on measurement of fair value of shares and stock options, including determination of various inputs to the option-pricing models and examples to illustrate application of various principles recommended in the Guidance Note.

**Illustration 1**

*A Company has its share capital divided into shares of ₹10 each. On 1st April, 2016, it granted 10,000 employees’ stock options at ₹40, when the market price was ₹130. The*
options were to be exercised between 16th December, 2016 and 15th March, 2017. The employees exercised their options for 9,500 shares only; the remaining options lapsed. The company closes its books on 31st March every year.

Show Journal Entries.

Solution

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**Note:** The students are advised to refer Chapter 3 “Accounting for Employee Stock Option Plan” for the practical problems based on this Guidance Note.
4.5 GUIDANCE NOTE ON ACCOUNTING FOR CREDIT AVAILABLE IN RESPECT OF MINIMUM ALTERNATIVE TAX UNDER THE INCOME-TAX ACT, 1961

Introduction

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.

Applicability

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.

Thus, 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.

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 18.5 per cent 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 18.5 per cent 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.

Example:

The taxable income of Shinee Pvt. Ltd. computed as per the provisions of Income tax Act = ₹ 8,40,000.

Book profit of the company computed as per the provisions of section MAT 115JB = ₹ 18,40,000.

The tax liability of a company will be higher of: (i) Normal tax liability, or (ii) MAT.
The Normal tax rate applicable to an Indian company is 30% (plus cess and surcharge as applicable). That is the tax at the rate of 30% on ₹ 8,40,000 = ₹ 2,52,000 (plus cess)

Book profit of the company is ₹ 18,40,000. MAT Tax liability (excluding cess & surcharge) @ 18.5% on ₹ 18,40,000 = ₹ 3,40,400.

Thus, the tax liability of Shinee Pvt. Ltd. will be ₹ 3,40,400 (plus cess as applicable) because it is higher than the normal tax liability.

Features of Mat Credit

(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 ten succeeding assessment years from the year in which MAT credit becomes allowable (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.

Whether MAT credit is a deferred tax asset

“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.”

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.

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’**

Although MAT credit is not a deferred tax asset under AS 22 as discussed above, 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.

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.”

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 events, 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’.

**According to the Framework for Preparation and Presentation of Financial Statements**

“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.

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.

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.

The recognition of MAT credit 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 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**

If the Asset Recognition Criteria is met by MAT Credit 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 prepaid tax which would be adjusted against the normal income tax during the specified period. The asset may be reflected as ‘MAT credit entitlement’.

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.

**PROFIT AND LOSS**

According to paragraph 6 of Accounting Standards Interpretation (ASI) 6, ‘Accounting for Taxes on Income in the context 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.
Objective

The objective of this Guidance Note is to recommend accounting treatment for entities dealing in Real Estate as Sellers or Developers. The term ‘real estate’ refers to land as well as buildings and rights in relation thereto. Entities who undertake such activity are generally referred to by different terms such as ‘real estate developers’, ‘builders’ or ‘property developers’.

Scope

The Guidance Note covers all forms of transactions in real estate.

An illustrative list of transactions which are covered by this Guidance Note is as under

(a) Sale of plots of land (including long term sale type leases) without any development.

(b) Sale of plots of land (including long term sale type leases) with development in the form of common facilities like laying of roads, drainage lines and water pipelines, electrical lines, sewage tanks, water storage tanks, sports facilities, gymnasium, club house, landscaping etc.

(c) Development and sale of residential and commercial units, row houses, independent houses, with or without an undivided share in land.

(d) Acquisition, utilisation and transfer of development rights

(e) Redevelopment of existing buildings and structures.

(f) Joint development agreements for any of the above activities

The Guidance Note primarily provides guidance on application of percentage of completion method where it is appropriate to apply this method as explained in subsequent paragraphs as such transactions and activities of real estate have the same economic substance as construction contracts. For this purpose, the Guidance Note draws upon the principles enunciated in Accounting Standard (AS) 7, Construction Contracts. In respect of transactions of real estate which are in substance similar to delivery of goods principles enunciated in Accounting Standard (AS) 9, Revenue Recognition, are applied.
Guidance note on Real Estate does not cover the following transaction:

(a) Accounting Standard (AS) 10 Accounting for Fixed Assets
(b) Accounting Standard (AS) 12 Accounting for Government Grants
(c) Accounting Standard (AS) 19, Leases
(d) Accounting Standard (AS) 26, Intangible Assets,

This Guidance Note should be applied to all projects in real estate which are commenced on or after April 1, 2012 and also to projects which have already commenced but where revenue is being recognised for the first time on or after April 1, 2012. An enterprise may choose to apply this Guidance Note from an earlier date provided it applies this Guidance Note to all transactions which commenced or were entered into on or after such earlier date.

Definitions:

(a) Project: Project is the smallest group of units/plots/saleable spaces which are linked with a common set of amenities in such a manner that unless the common amenities are made available and functional, these units/ plots/ saleable spaces cannot be put to their intended effective use.

A larger venture can be split into smaller projects if the basic conditions as set out above are fulfilled. For example, a project may comprise a cluster of towers or each tower can also be designated as a project. Similarly, a complete township can be a project or it can be broken down into smaller projects.

(b) Project Costs – Project costs in relation to a project ordinarily comprise:

(i) Cost of land and cost of development rights: All the cost of acquisition of land, Development of land i.e. rehabilitation costs, registration charges, stamp duty, brokerage costs and incidental expenses.

(ii) Borrowing Cost: In accordance with AS 16, Borrowing Costs, which are incurred directly in relation to a project or which are apportioned to a project

(iii) Construction and development costs – These would include costs that relate directly to the specific project and costs that may be attributable to project activity in general and can be allocated to the project.

* The standard has been withdrawn subsequent to the issuance of AS 10 on Property, Plant and Equipment in 2016.
APPLICATION OF GUIDANCE NOTES

**Construction and development costs**

Relate directly to a specific project

The following costs should not be considered part of construction costs and development costs if they are material:

- General administration
- Selling costs;
- Research and development costs;
- Depreciation of idle plant and equipment;
- Cost of unconsumed or uninstalled material delivered at site; and
- Payments made to sub-contractors in advance of work performed.

(a) land conversion costs, betterment charges, municipal sanction fee and other charges for obtaining building permissions;
(b) site labour costs, including site supervision;
(c) costs of materials used in construction or development of property;
(d) depreciation of plant and equipment used for the project;
(e) costs of moving plant, equipment and materials to and from the project site;
(f) Costs of hiring plant and equipment;
(g) costs of design and technical assistance that is directly related to the project;
(h) Estimated costs of rectification and guarantee work, including expected warranty costs; and
(i) Claims from third parties.
The below cost are incurred on specific or general basis to the project. These are allocated to the project on rational and consistent basis.

(a) Insurance;

(b) Costs of design and technical assistance that is not directly related to a specific project;

(c) Construction or development overheads; and

(d) Borrowing costs

**Project Revenues**

Project revenues include revenue on sale of plots, undivided share in land, sale of finished and semi-finished structures, consideration for construction, consideration for amenities and interiors, consideration for parking spaces and sale of development rights.

Project revenues are measured as the consideration received or receivable. The measurement of project revenues is affected by a variety of uncertainties that depend on the outcome of future events. The estimates often need revision as events occur and uncertainties are resolved. Therefore, the amount of project revenue may increase or decrease from one reporting period to the next.
**Accounting for Real Estate Transactions**

- Contract for sale of Land (Without any development)

- All the principles of AS 9 Revenue is to be applied to completed sale

- The application of principles of AS 9 in respect of sale of goods requires recognition of revenues on completion of the transaction/activity when the revenue recognition process in respect of a real estate project is completed

- Contract for construction, development or sale of units that are not complete at the time of entering into agreements for construction, development or sale

- Also for sale of plot with development

- In case of construction sales, the seller usually enters into an agreement for sale with the buyer at initial stages of construction.

- This agreement for sale is also considered to have the effect of transferring all significant risks and rewards of ownership to the buyer provided the agreement is legally enforceable and subject to the satisfaction of conditions which signify transferring of significant risks and rewards even though the legal title is not transferred or the possession of the real estate is not given to the buyer.

- Revenue in such cases is recognised by applying the percentage of completion method on the basis of the methodology explained in AS 7, Construction Contracts.
Contract for sale of Land

All the conditions of AS 9 Revenue are to be satisfied:

- All significant risks and rewards of ownership and the seller retains no effective control of the real estate to a degree usually associated with ownership.
- The seller has effectively handed over possession of the real estate unit to the buyer forming part of the transaction.
- No significant uncertainty exists regarding the amount of consideration that will be derived from the real estate sales; and
- It is not unreasonable to expect ultimate collection of revenue from buyers.

Construction Contract

Where many contracts are entered for a single construction, when a component is completed, but significant performance in respect of remaining components of the project is pending, revenue in respect of such an individual contract should not be recognised until the performance in respect of remaining components of the project is pending.

Application of Percentage Completion Method

The percentage completion method should be applied in the accounting of all real estate transactions/activities in the situations described i.e., where the economic substance is similar to construction contracts and also for the sale of developed plots.

This method is applied when the duration of the project is beyond 12 months i.e. commencement and completion fall in different accounting periods.

This method is applied when the outcome of a real estate project can be estimated reliably and when all the following conditions are satisfied:

- Total project revenues can be estimated reliably;
- It is probable that the economic benefits associated with the project will flow to the entity;
- The project costs to complete the project and the stage of project completion at the reporting date can be measured reliably; and
- The project costs attributable to the project can be clearly identified and measured reliably so that actual project costs incurred can be compared with prior estimates.
APPLICATION OF GUIDANCE NOTES

Under Percentage completion Method there is a rebuttable presumption that the outcome of a real estate project can be estimated reliably and that revenue should be recognised under the percentage completion method only when the events in (a) to (d) below are completed.

(a) All the critical approvals necessary for commencement of the project have been obtained

(b) If the expenditure incurred on the construction and development costs is less than 25%, nothing is recognised as in the profit and loss A/C of the contract.

(c) At least 25% of the saleable project area is secured by contracts or agreements with buyers.

(d) At least 10% of the contract consideration as per the agreements of sale or any other legally enforceable documents are realised at the reporting date in respect of each of the contracts and it is reasonable to expect that the parties to such contracts will comply with the payment terms as defined in the contracts. To illustrate - If there are 10 Agreements of sale and 10% of gross amount is realised in case of agreements, revenue can be recognised with respect to these agreements only.

The recognition of project revenue by reference to the stage of completion of the project activity should not at any point exceed the estimated total revenues from ‘eligible contracts’/other legally enforceable agreements for sale.

When it is probable that total project costs will exceed total eligible project revenues, the expected loss should be recognised as an expense immediately. The amount of such a loss is determined irrespective of:

(a) Commencement of project work; or

(b) The stage of completion of project activity.
When development rights are sold or transferred, revenue should be recognised when both the following conditions are fulfilled:

(a) Title to the development rights is transferred to the buyer; and
(b) It is not unreasonable to expect ultimate realisation of revenue.

**Transactions with Multiple Elements:**

- An enterprise may contract with a buyer to deliver goods or services in addition...
APPLICATION OF GUIDANCE NOTES

2.31

to the construction/development of real estate [e.g. property management services, sale of decorative fittings (excluding fittings which are an integral part of the unit to be delivered), rental in lieu of unoccupied premises, etc.]. In such cases, the contract consideration should be split into separately identifiable components including one for the construction and delivery of real estate units.

♦ The consideration received or receivable for the contract should be allocated to each component on the basis of the fair market value of each component.

♦ The accounting of each of the components should be in accordance with AS 9 Revenue Recognition or AS 7 Construction Contracts.

Disclosure
An entity should disclose:
(a) the amount of project revenue recognised as revenue in the reporting period;
(b) The methods used to determine the project revenue recognised in the reporting period; and
(c) The method used to determine the stage of completion of the project.

An entity should also disclose each of the following for projects in progress at the end of the reporting period:
A. the aggregate amount of costs incurred and profits recognised (less recognised losses) to date;
B. the amount of advances received;
C. the amount of work in progress and the value of inventories; and
D. Excess of revenue recognised over actual bills raised (unbilled revenue)

4.7 GN(A) 29 GUIDANCE NOTE ON TURNOVER IN CASE OF CONTRACTORS

This Guidance Note deals with the issue whether the revenue recognised in the financial statements of contractors as per the requirements of Accounting Standard (AS) 7, Construction Contracts (revised 2002), can be considered as ‘turnover’.

The amount of contract revenue recognised as revenue in the statement of profit and loss as per the requirements of AS 7 (revised 2002), should be considered as ‘turnover’.

Revenue’ is a wider term. For example, within the meaning of Accounting Standard
(AS) 9, Revenue Recognition, the term ‘revenue’ includes revenue from sales transactions, rendering of services and from the use by others of enterprise resources yielding interest, royalties and dividends. The term ‘turnover’ is used in relation to the source of revenue that arises from the principal revenue generating activity of an enterprise. In case of a contractor, the construction activity is its principal revenue generating activity. Hence, the revenue recognised in the statement of profit and loss of a contractor in accordance with the principles laid down in AS 7 (revised 2002), by whatever nomenclature described in the financial statements, is considered as ‘turnover’.

Whether the revenue recognised in the financial statements of contractors as per the requirements of Accounting Standard (AS) 7, Construction Contracts (revised 2002), can be considered as ‘turnover’.

- This method is used as the contract initiation and contract completion falls in different accounting periods. So it is important to recognise revenue and cost in the Profit and Loss statement as and when the work is completed.

- AS-7 prescribes recognition of Revenue based on the work completion which is known as Percentage of Completion Method which requires completion of recognition of revenue by reference to the stage of completion of a contract.

The paragraph dealing with the ‘Objective’ of AS 7 (revised 2002) provides as follows:

**Objective**

The objective of this Statement is to prescribe the accounting treatment of revenue and costs associated with construction contracts. Because of the nature of the activity undertaken in construction contracts, the date at which the contract activity is entered into and the date when the activity is completed usually fall into different accounting periods. Therefore, the primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which construction work is performed. This Statement uses the recognition criteria established in the Framework for the Preparation and Presentation of Financial Statements to determine when contract revenue and contract costs should be recognised as revenue and expenses in the statement of profit and loss. It also provides practical guidance on the application of these criteria.

From the above, it may be noted that AS 7 (revised 2002) deals, inter alia, with the allocation of contract revenue to the accounting periods in which construction work is performed.
Example

IRB LTD is engaged in constructing a massive tunnel in Kashmir. The contract revenue will be ₹ 200 lacs and the time taken to complete will be approximately 3 years. In 1st year the company has spent an amount of ₹ 50 lacs on the contract and the company estimates that the company is supposed to spent ₹ 110 lacs more in the next 2 years. As per engineers certificate (physical construction certified) 40% of the work has been carried out.

Solution

Under the survey method the engineers have provided their judgment of the percentage of work completed and it is 40%.

Based on costs incurred to date and total costs the percentage of completion comes out to be:

Percentage of work completed = ₹ 50 lacs ÷ (₹ 50 Lacs + ₹ 110 lacs) = 31.25%.

Total costs include costs incurred to date and costs expected to be incurred over the remaining period.

Based on the percentage of completion calculated using cost date we determine than revenue of ₹ 62.5 lacs has been earned (31.25% multiplied by ₹ 200 lacs total contract value).

Further, paragraphs 21 and 31 of AS 7 (revised 2002) provide as follows:

“21. When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date. An expected loss on the construction contract should be recognised as an expense immediately in accordance with paragraph 35.”

“31. When the outcome of a construction contract cannot be estimated reliably:

(a) Revenue should be recognised only to the extent of contract costs incurred of which recovery is probable; and

(b) Contract costs should be recognised as an expense in the period in which they are incurred.

An expected loss on the construction contract should be recognised as an expense immediately in accordance with paragraph 35.

Example of Construction contract when outcome cannot be estimated

L & T Ltd negotiated a two-year project that started in the latter half of the year. At the
end of the year the company is not sure of making profit or loss as there are uncertainties surrounding the project’s completion.

The company’s records show that costs during the year amount to ₹ 700,000 and no cash had yet been received. What should the accounting entries be regarding the contract at the year end?

Solution

During the year, as costs have been incurred, the natural double entries occurring would have been:

Purchases ₹ 700,000 Dr.
Bank/payables ₹ 700,000

Since outcome of a contract cannot be measured reliably, revenue to the extent of contract costs incurred (of which recovery is probable) is recognised i.e. ₹ 700,000.

4.8 GUIDANCE NOTE ON SCHEDULE III TO THE COMPANIES ACT, 2013

Introduction

Schedule III to the Companies Act, 2013 (‘the Act’) provides the manner in which every company registered under the Act shall prepare its Balance Sheet, Statement of Profit and Loss and notes thereto. In the light of various economic and regulatory reforms that have taken place for companies over the last several years, there was a need for enhancing the disclosure requirements under the Old Schedule VI to the Act and harmonizing and synchronizing them with the notified Accounting Standards as applicable (‘AS’/‘Accounting Standard(s)’). Accordingly, the Ministry of Corporate Affairs (MCA) had issued a revised form of Schedule VI on February 28, 2011 and this has formed the basis for the Schedule III of Companies Act, 2013. As per the Act and rules / notifications thereunder, the Schedule applies to all companies for the Financial Statements to be prepared for the financial year commencing on or after April 1, 2014.

The requirements of the Schedule III however, do not apply to companies as referred to in the proviso to Section 129(1) of the Act, i.e., any insurance or banking company, or any company engaged in the generation or supply of electricity or to any other class of company for which a form of Balance Sheet and Statement of Profit and Loss has been specified in or under any other Act governing such class of company. It may be clarified that for companies engaged in the generation and supply of electricity, however, neither the Electricity Act, 2003, nor the rules framed
thereunder, prescribe any specific format for presentation of Financial Statements by an electricity company. Section 1 (4) of the Companies Act states that the Companies Act will apply to electricity companies, to the extent it is not inconsistent with the provisions of the Electricity Act. Keeping this in view, Schedule III may be followed by such companies till the time any other format is prescribed by the relevant statute.

**Objective and Scope**

The objective of this Guidance Note is to provide guidance in the preparation and presentation of Financial Statements of companies in accordance with various aspects of the Schedule III. However, it does not provide guidance on disclosure requirements under Accounting Standards, other pronouncements of the Institute of Chartered Accountants of India (ICAI), other statutes, etc.

In preparing this Guidance Note, reference has been made to the Accounting standards notified under Section 133 of the Companies Act, 2013 read together with Paragraph 7 of the Companies (Accounts) Rules, 2014 and various other pronouncements of the ICAI. The primary focus of the Guidance Note has been to lay down broad guidelines to deal with practical issues that may arise in the implementation of the Schedule III.

**Applicability**

As per the Government Notification no. S.O. 902 (E) dated 26th March, 2015, the Schedule III is applicable for the Balance Sheet and Statement of Profit and Loss to be prepared for the financial year commencing on or after April 1, 2014.

The Schedule III requires that except in the case of the first Financial Statements laid before the company after incorporation, the corresponding amounts for the immediately preceding period are to be disclosed in the Financial Statements including the Notes to Accounts. Accordingly, corresponding information will have to be presented starting from the first year of application of the Schedule III. Thus for the Financial Statements prepared for the year 2014-15(1st April 2014 to 31st March 2015), corresponding amounts need to be given for the financial year 2013-14.

If a company is presenting condensed interim Financial Statements, its format should also going forward conform to that used in the company’s most recent annual Financial Statements, i.e., the Schedule III of Companies Act, 2013.

The format of Balance Sheet currently prescribed under Clause 41 to the Listing Agreement is also based the format of Balance Sheet in the Schedule III.
The formats of the Balance Sheet and Statement of Profit and Loss prescribed under the SEBI (Issue of Capital & Disclosure Requirements) Regulations 2009 (‘ICDR Regulations’) is inconsistent with the format of the Balance Sheet/ Statement of Profit and Loss in the Schedule III. However, the formats of Balance Sheet and Statement of Profit and Loss under ICDR Regulations are “illustrative formats”. Accordingly, to make the data comparable and meaningful for users, companies should use the Schedule III format to present the restated financial information for inclusion in the offer document. Consequently, among other things, this will involve classification of assets and liabilities into current and non-current for earlier years presented as well.

**Summary of Schedule III - Main principles**

The Schedule III requires that if compliance with the requirements of the Act and/or the notified Accounting Standards requires a change in the treatment or disclosure in the Financial Statements as compared to that provided in the Schedule III, the requirements of the Act and/or the notified Accounting Standards will prevail over the Schedule. The Schedule III clarifies that the requirements mentioned therein for disclosure on the face of the Financial Statements or in the notes are minimum requirements. Line items, sub-line items and sub-totals can be presented as an addition or substitution on the face of the Financial Statements when such presentation is relevant for understanding of the company’s financial position and/or performance. The terms used in the Schedule III will carry the meaning as defined by the applicable Accounting Standards. For example, the terms such as ‘associate’, ‘related parties’, etc. will have the same meaning as defined in Accounting Standards notified under Companies (Accounting Standards) Rules, 2006. In preparing the Financial Statements including the Notes to Accounts, a balance will have to be maintained between providing excessive detail that may not assist users of Financial Statements and not providing important information as a result of too much aggregation. All items of assets and liabilities are to be bifurcated between current and non-current portions and presented separately on the face of the Balance Sheet. Such classification was not required by the Old Schedule VI, but was introduced in the Revised Schedule VI itself. There is an explicit requirement to use the same unit of measurement uniformly throughout the Financial Statements and notes thereon. Moreover, rounding off requirements (where opted for) have been changed to eliminate the option of presenting figures in terms of hundreds and thousands if turnover exceeds 100 crores.
Structure of the Schedule III

The Structure of Schedule III is as under:
I. General Instructions
II. Part I – Form of Balance Sheet
III. General Instructions for Preparation of Balance Sheet
IV. Part II – Form of Statement of Profit and Loss
V. General Instructions for Preparation of Statement of Profit and Loss
VI. General Instructions for the Preparation of Consolidated Financial Statements

Note: The students are advised to go through Schedule III to the Companies Act, 2013 which is given as Appendix in Module II of the Study Material.

Illustration 1

H Ltd. engaged in the business of manufacturing lotus wine. The process of manufacturing this wine takes around 18 months. Due to this reason H Ltd. has prepared its financial statements considering its operating cycle as 18 months and accordingly classified the raw material purchased and held in stock for less than 18 months as current asset. Comment on the accuracy of the decision and the treatment of the asset by H Ltd., as per the Schedule III.

Solution

As per Schedule III to the Companies Act, 2013, one of the criteria for classification of an asset as a current asset is that the asset is expected to be realised in the company’s operating cycle or is intended for sale or consumption in the company’s normal operating cycle.

Further, Schedule III to the Companies Act, 2013 defines that an operating cycle is the time between the acquisition of assets for processing and their realisation in cash or cash equivalents. However, when the normal operating cycle cannot be identified, it is assumed to have duration of 12 months.

As per the facts given in the question, the process of manufacturing of lotus wine takes around 18 months; therefore, its realisation into cash and cash equivalents will be done only when it is ready for sale i.e. after 18 months. This means that normal operating cycle of the product is 18 months. Therefore, the contention of the company’s management that the operating cycle of the product lotus wine is 18 months and not 12 months is correct.
Illustration 2

Combine Ltd. is a group engaged in manufacture and sale of industrial and consumer products. One of its division deals with the real estate. The real estate division is continuously engaged in leasing of real estate properties. The accountant showed the rent arising from leasing of real estate as ‘other income’ in the Statement of Profit and Loss. State, whether the classification of the rent income made by the accountant is correct or not in light of Schedule III to the Companies Act, 2013?

Solution

As per para 4 of the ‘General Instructions for preparation of Statement of Profit and Loss’ given in the Schedule III to the Companies Act, 2013, ‘other income’ does not include operating income. However, rent income arising from leasing of real estate properties is an operating income as Real Estate is one of the divisions of Combine Ltd. There is a separate head for operating income i.e. ‘Revenue from Operations’. Therefore, classification of rent income as ‘Other income’ in the Statement of Profit and Loss will not be correct. It would, in fact, be shown under the heading ‘Revenue from Operations’ only.

Illustration 3

Presented below is an extract of the Schedule of Secured and Unsecured Loans of Annual Report 2016-2017 of Super Star Ltd.

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Schedule No</th>
<th>As at 31st March, 2017 (₹)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan Funds</td>
<td></td>
<td></td>
</tr>
<tr>
<td>a) Secured Loans</td>
<td>3</td>
<td>6,07,114</td>
</tr>
<tr>
<td>b) Unsecured Loans - Short Term Banks</td>
<td></td>
<td>36,112</td>
</tr>
<tr>
<td></td>
<td></td>
<td>6,43,226</td>
</tr>
</tbody>
</table>

Schedule 3: Secured Loans

Term Loans from:
- Banks                           | 2,95,002     |
- Others                          | 3,12,112     |
                                 | 6,07,114     |

Other Information:

Current maturities of long-term loan from bank       ₹ 30,000
Current maturities of long-term loan from other parties ₹ 15,376

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APPLICATION OF GUIDANCE NOTES

There was no interest accrued/due as at end of the year.

Prepare appropriate note to accounts complying with the requirements of Schedule III to the Companies Act, 2013 on the basis of available information.

Solution

Balance Sheet of Super Star Ltd.
As on 31st March, 2017

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Note No</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-Current Liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long term borrowings</td>
<td>4</td>
<td>5,61,738</td>
</tr>
<tr>
<td>Current Liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Short term borrowings</td>
<td>5</td>
<td>36,112</td>
</tr>
<tr>
<td>Other current liabilities</td>
<td>6</td>
<td>45,376</td>
</tr>
<tr>
<td></td>
<td></td>
<td>6,43,226</td>
</tr>
</tbody>
</table>

Notes to Accounts

4. Long-Term Borrowings
   Term loans – Secured
     - from banks                      2,95,002
     - from other parties              3,12,112
     Less : Shown in current maturities of long-term debt (Refer Note 6) (45,376)
     5,61,738

5. Short-Term Borrowings
   (Unsecured – payable on demand)*
     - from bank                       36,112

6. Other Current Liabilities
   Current maturities of long-term debt
     From banks                        30,000
     From other                        15,376
     45,376

It is assumed the Note 1 is for ‘Significant Accounting Policies’, Note 2 for ‘Share Capital’, Note 3 for ‘Reserves and Surplus’.

* assumed that it is payable on demand
Illustration  4

Asta Ltd. has FCCBs worth ₹ 100 crore which are due to mature on 31st December 2016. While preparing the financial statements for the year ending 31st March 2016, it is expected that the FCCB holders will not exercise the option of converting the same to equity shares. How should the company classify the FCCBs on 31st March 2016? Will your answer be different if the company expects that FCCB holders will convert their holdings into equity shares of Astha Ltd.?

Solution

Schedule III to the companies Act, 2013 provides that:

“A liability should be classified as current when it satisfies any of the following criteria:

(a) it is expected to be settled in the company’s normal operating cycle;
(b) it is held primarily for the purpose of being traded;
(c) it is due to be settled within twelve months after the reporting date; or
(d) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments and do not affect its classification.”

In the present situation, Astha Ltd. does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date. The position will be same even when the FCCB holders are expected to convert their holdings into equity shares of Astha Ltd. Expectations cannot be called as unconditional rights. Thus, in both the situations, Astha Ltd. should classify the FCCBs as current liabilities as on 31 March 2016.

Illustration  5

The Balance Sheet of Appropriate Ltd. as at 31st March, 2016 is as follows:

<table>
<thead>
<tr>
<th>Equity &amp; Liabilities</th>
<th>Note No.</th>
<th>31st March, 2016</th>
<th>31st March, 2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share Capital</td>
<td>1</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Reserves and Surplus</td>
<td>2</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Employee stock option outstanding</td>
<td>3</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Share application money refundable</td>
<td>4</td>
<td>XXX</td>
<td>XXX</td>
</tr>
</tbody>
</table>
## APPLICATION OF GUIDANCE NOTES

<table>
<thead>
<tr>
<th>Non-Current Liabilities</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred tax liability (Arising from Indian Income Tax)</td>
<td>5</td>
<td>XXX</td>
</tr>
<tr>
<td>Current Liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trade Payables</td>
<td>6</td>
<td>XXX</td>
</tr>
<tr>
<td>Total</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-Current Assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fixed Assets - Tangible</td>
<td>7</td>
<td>XXX</td>
</tr>
<tr>
<td>Capital Work in progress (including capital advances)</td>
<td>8</td>
<td>XXX</td>
</tr>
<tr>
<td>Current Assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trade Receivables</td>
<td>9</td>
<td>XXX</td>
</tr>
<tr>
<td>Deferred Tax Asset (Arising from Indian Income Tax)</td>
<td>10</td>
<td>XXX</td>
</tr>
<tr>
<td>Profit and Loss (Debit balance)</td>
<td></td>
<td>XXX</td>
</tr>
<tr>
<td>Total</td>
<td>XXX</td>
<td>XXX</td>
</tr>
</tbody>
</table>

Comment on the presentation in terms of Schedule III to the Companies Act, 2013 and Accounting Standards notified by the Central Government.

### Solution

1. Share Capital’ and ‘Reserves and Surplus’ are required to be shown under the heading “Shareholders’ funds”, which have not been shown in the given balance sheet. Although it is a part of ‘Equity and Liabilities’ yet it must be shown under the head “Shareholders’ Funds”. The heading “Shareholders’ Funds” is missing in the balance sheet given in the question.

2. Reserves & Surplus is showing zero balance, which is not correct since there is. Debit balance of Statement of Profit & Loss. This debit balance of Profit and Loss should be shown as a negative figure under the head ‘Surplus’. The balance of ‘Reserves and Surplus’, after adjusting negative balance of surplus should be shown under the head ‘Reserves and Surplus’ even if the resulting figure is in the negative. It should be noted that Profit and Loss Debit Balance is not a part of current assets rather debit balance of Statement of Profit and Loss should be shown as a negative figure under the head ‘Surplus’ as per requirement of Schedule III to the Companies Act, 2013.
(3) As per Schedule III to the Companies Act, 2013, Employee Stock Option Outstanding A/c is part of Reserves and Surplus and should not be shown separately. Classification of Reserves and Surplus should be reflected is ‘Notes to Accounts’ for the same.

(4) Share application money refundable should be shown by way of note under the sub-heading “Other Current Liabilities”. As this is refundable and not pending for allotment, hence it is not a part of equity.

(5) Deferred Tax Liabilities has been correctly shown under Non-Current Liabilities. But Deferred tax assets and deferred tax liabilities, both, cannot be shown in balance sheet because only the net balance of Deferred Tax Liabilities or Asset is to be shown as per para 29 of AS 22, Appropriate Ltd. should offset Deferred Tax Asset & Deferred Tax Liabilities and the break-up of Deferred Tax Asset & Deferred Tax Liabilities into major components of the respective balance should be disclosed in ‘Notes to Account’. Deferred Tax Asset should be shown under Non-current Asset. It should be the net balance of Deferred Tax Asset after adjusting the balance of deferred tax liability.

(6) Under the main heading of Non-Current Assets, Fixed Assets are further classified as under:
   (i) Tangible assets
   (ii) Intangible assets
   (iii) Capital work in Progress
   (iv) Intangible assets under development.
   Keeping in view the above, the Capital Work-in Progress should be shown under Fixed Assets as Capital Work in Progress. The amount of Capital advances included in CWIP should be disclosed under the sub-heading “Long term loans and advances” under the heading Non-Current Assets.

TEST YOUR KNOWLEDGE

Question 1

Write short notes on:

(i) Graded vesting under an employee stock option plan.

(ii) Presentation of MAT credit in the financial statements.
Question 2

C Ltd. is a group engaged in manufacture and sale of industrial and FMCG products. One of their division also deals in Leasing of properties - Mobile Towers. The accountant showed the rent arising from the leasing of such properties as other income in the Statement of Profit and Loss.

Comment whether the classification of the rent income made by the accountant is correct or not in the light of Schedule III to the Companies Act, 2013.

ANSWERS/HINTS

Answer 1

(i) Graded vesting under an employee stock option plan: 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.

(ii) Presentation of MAT credit in the financial statements:

Balance Sheet: Where a company recognizes MAT credit as an asset on the basis of the considerations specified in the Guidance Note on Accounting for Credit Available in respect of Minimum Alternate Tax under the Income Tax Act, 1961, the same should be presented under the head ‘Loans and Advances’ since, there being a convincing evidence of realization 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’.

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

* As per Schedule III to the Companies Act, 2013, it should be presented under the head ‘Non-current Assets’ sub head ‘Long-term Loans and Advances’.

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continue to be presented under the head ‘Loans and Advances’ if it continues to meet the considerations stated in paragraph 11 of the Guidance Note.

**Profit and Loss Account:** According to explanation given for paragraph 21 of Accounting Standard 22, “Accounting for Taxes on Income” in the context of Section 115JB of the Income-tax Act, 1961, 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 statement of profit and loss in the year of payment of MAT. In the year in which the MAT credit becomes eligible to be recognized 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 statement of profit and loss and presented as a separate line item therein.

**Answer 2**

As per the “General Instructions for preparation of Statement of Profit and Loss” given in Schedule III to the Companies Act, 2013, “Other Income” does not include operating income. The term “Revenue from operations” has not been defined under Schedule III to the Companies Act, 2013. However, as per the Guidance Note on Schedule III to the Companies Act, 2013 this would include revenue arising from a company’s operating activities, i.e., either its principal or ancillary revenue-generating activities. Whether a particular income constitutes “Revenue from operations” or “Other income” is to be decided based on the facts of each case and detailed understanding of the company’s activities. The classification of income would also depend on the purpose for which the particular asset is acquired or held.

As per the information given in the question, C Ltd. is a group engaged in manufacture and sale of industrial and FMCG products and its one of the division deals in leasing of properties - Mobile Towers. Since its one division is continuously engaged in leasing of properties, it shall be considered as its principal or ancillary revenue-generating activities. Therefore, the rent arising from such leasing shall be shown under the head “Revenue from operations” and not as “other income”.

Hence, the presentation of rent arising from the leasing of such properties as “other income” in the Statement of Profit and Loss is not correct. It should be shown under the head “Revenue from operations”.

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