

**Query No. 34**

**Subject: Manner of appropriation to capital reserve and presentation/disclosure thereof.**<sup>1</sup>

**A. Facts of the Case**

1. A corporation is a Central Public Sector Undertaking under the Administrative Ministry of Social Justice and Empowerment and is registered under section 8 of the Companies Act, 2013. The accounts of the corporation are subject to audit by the statutory auditors appointed by the Comptroller and Auditor-General ('C&AG') of India under section 139(5) of the Companies Act, 2013 (hereinafter referred to as 'the Act'). The statutory auditors are responsible for expressing opinion on the financial statements under section 143 of the Act based on the independent audit in accordance with the standards on auditing prescribed under section 143(10) of the Act. The C&AG is required to conduct supplementary audit under section 143(6)(a) of the Act and to give its report.

2. The Corporation has embarked upon a modernisation plan which has been sanctioned by Government of India for a total approved outlay of Rs. 338.04 crore wherein the source of finance as per the Standing Finance Committee of the Administrative Ministry finalised in July 2015 was Rs. 200.00 crore from Grant-in-aid from the Ministry and the balance from internal accruals. The approval also mentions that any cost escalation and addition at the time of implementation is to be borne from out of the internal accruals.

3. During 2016-17, the management of the corporation thought it prudent to apportion a part of interest income (on corporation's contribution of Rs. 138.04 crore) to Capital Reserve and meet the escalations and its contribution from the reserve so created as a prudent business practice. Accordingly, Rs. 861.63 lakh were taken out of the interest income and credited to the Capital Reserve. (Copy of the annual report of the corporation for the financial year 2016-17 has been furnished by the querist for the perusal of the Committee).

4. The querist has drawn attention to paragraph 10.9.1 of the 'Guidance Note on Revised Schedule VI to the Companies Act, 1956'<sup>2</sup>, (hereinafter referred to as the 'Guidance Note'), issued by the Institute of Chartered Accountants of India, which clarifies that profits may be appropriated to free reserve as deemed appropriate by the management. Further, as per paragraph 8.1.2.9 of the Guidance Note, "Appropriations to the profit for the year (including carried forward balance) is to be presented under the main head "Reserve and Surplus". Unlike the current prevailing practice, under the Revised schedule VI, the Statement of Profit and Loss will no longer reflect any appropriations, like dividends transferred to Reserves, bonus share etc."

5. The corporation feels that the capitalisation of interest is appropriation and is covered by the above provisions of the Guidance Note and, therefore, has been shown in the main head "Reserve and Surplus" and interest income has accordingly been shown as such, which is in line with the Guidance Note.

6. The statutory auditors were of the opinion that the case does not fit in the Guidance Note and, hence, qualified the report as below:

"During the year 2016-17 a sum of Rs. 861.63 lakh has been credited under the head "Interest Capitalized for Modernization Expenses" by debiting Interest earned

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<sup>1</sup> Opinion finalised by the Committee on 4.4.2018 and 5.4.2018.

<sup>2</sup> This Guidance Note was subsequently revised as 'Guidance Note on Schedule III to the Companies Act, 2013', consequent to enactment of Companies Act, 2013.

account. Accordingly, Interest Income is under-stated to that extent and Capital Reserve overstated”.

7. The C&AG, while conducting supplementary audit, expressed that the qualification of the statutory auditors was not justified in view of management’s view of prudence and relevant paragraphs of the Guidance Note mentioned above. The impasse was resolved after resolving to approach the Expert Advisory Committee of the Institute of Chartered Accountants of India for its opinion. The top management is of the view that such appropriations are essential and prudent to the operations of the corporation in view of fluctuating receipt of grants for carrying out the main activity of the corporation and that amount from out of this reserve shall be used towards the internal accruals of the corporation required for the project.

#### **B. Query**

8. The querist has sought the opinion of the Expert Advisory Committee on continuance/discontinuance of appropriation till the proposed project is completed.

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

9. The Committee notes that the basic issue raised by the querist relates to manner of appropriation to capital reserve and presentation/disclosure thereof. The Committee has, therefore, considered only this issue and has not examined any other issue that may be contained in the Facts of the Case. From the copy of annual report for the financial year 2016-17 (also referred to as ‘current year’ hereinafter) furnished by the querist, the Committee notes that since the corporation in the extant case is a non-profit making corporation, it prepares balance sheet, statement of income and expenditure and cash flow statement. This is acceptable, since, as per sub-clause (ii) of clause (40) of section 2 of the Companies Act, 2013 (hereinafter referred to as ‘the Act’), in the case of a company carrying on any activity not for profit, the financial statements include an income and expenditure account for the financial year instead of profit and loss account. Further, from the copy of annual report for the financial year 2016-17 furnished by the querist, the Committee notes that for the said year, the company has followed Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as 2006 Rules) and not Companies (Indian Accounting Standards) Rules, 2015. Hence, the Committee has not considered the requirements of the Companies (Indian Accounting Standards) Rules, 2015 while expressing its views.

10. The Committee notes from the Facts of the Case that the management of the corporation has appropriated a portion of the interest income (on corporation’s contribution to the modernization plan) (hereinafter referred to as ‘interest appropriation’) for the current year to capital reserve to meet any cost escalation and addition at the time of implementation of the plan. The Committee notes that the format of Statement of Profit and Loss given in Division I of Schedule III to the Act does not mention any appropriation item on its face. As per Note 6 of the ‘General Instructions for Preparation of Balance Sheet’ given in Division I of Schedule III to the Act, Notes to Accounts should include a note on “Reserves and Surplus” which, inter alia, includes ‘Capital Reserve’ and ‘Surplus i.e., balance in Statement of Profit and Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves etc’. Further, additions to, and deductions from, each of the specified heads under ‘Reserves and Surplus’ since last balance sheet are to be shown. Further, Note 5(iv) of the ‘General Instructions for Preparation of Statement of Profit and Loss’ given in Division I of Schedule III to the Act requires the following disclosure to be made in the Notes to Accounts:

“(iv) (a) The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserve, but not including provisions made to meet any specific liability, contingency or commitment known to exist at the date as to which the balance sheet is made up.

(b) The aggregate, if material, of any amounts withdrawn from such reserves”

Further, the Committee notes the following paragraphs of the ‘Guidance Note on Schedule III to the Companies Act, 2013’ (hereinafter referred to as ‘the Guidance Note’), issued by the Institute of Chartered Accountants of India:

**“8.1.2.9. Surplus i.e. balance in Statement of Profit and Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves, etc.**

Appropriations to the profit for the year (including carried forward balance) is to be presented under the main head ‘Reserves and Surplus’. Under the Schedule III, the Statement of Profit and Loss will no longer reflect any appropriations, like dividends transferred to Reserves, bonus shares, etc.

...

**8.1.2.10. Additions and deductions since the last Balance Sheet to be shown under each of the specified heads:**

This requires the company to disclose the movement in each of the reserves and surplus since the last Balance Sheet.

....”

**“10.9 The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserve [Clause (a) of Note 5(iv)]**

**10.9.1** Disclosure is required for amounts set aside or proposed to be set aside to reserves out of the profits for the period. The said transfers can be in terms of the applicable statute under which the Financial Statements are prepared i.e., the Companies Act, 2013 or any other applicable statute e.g. Income Tax Act, 1961, or RBI Act, 1932, etc. Further, profits may also be appropriated to free reserves as deemed appropriate by the management.

**10.9.2. ...**

**10.10 The aggregate, if material, of any amounts withdrawn from such reserves [Clause (b) of Note 5 (iv):**

In case the company has made any withdrawals from any reserves created in terms of Clause (a) of Note 5(iv) above, the same is to be disclosed separately.

It may be noted that such setting aside as well as withdrawal from reserves is to be disclosed under applicable Line item of Reserves and Surplus, and not under the Statement of Profit and Loss since the same is an appropriation of profits and not a charge against revenue.”

The Committee further notes paragraph 5 of Accounting Standard (AS) 5, ‘Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies’ which provides as follows:

***“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.”***

11. From the above, the Committee notes that an item of income recognised in a period should be necessarily included in the determination of net profit or loss and that ‘appropriation of income’ arises only if the item of income is included in the Statement of Profit and Loss. In this regard, the Committee noted that paragraph 4 of the General Instructions For Preparation of Statement of Profit and Loss, of Division I of Schedule III to the Act requires the company to classify interest income as part of ‘Other Income’ in the Statement of Profit and Loss.

12. Accordingly, the Committee is of the view that as per present requirements of the Act and the 2006 Rules, interest income should be recognised and disclosed in the Statement of Profit and Loss. Further, the Committee is of the view that while amount to be appropriated may be linked to a particular item of income, the appropriation should be out of profit/surplus for the reporting period which is determined after including that particular item in the Statement of Profit and Loss. Hence, in the extant case, the correct method of appropriation is to first include the item of income in the Statement of Profit and Loss and then appropriate the required amount from the ‘Reserves and Surplus’ by way of a deduction from the ‘Surplus’ i.e., balance in the statement of income and expenditure (as per balance sheet) and as an addition to the designated reserve. The said deduction and addition should be described appropriately, for example, as ‘Transfer to capital reserve’ and ‘Transfer from surplus in the statement of income and expenditure’ respectively with disclosure of reasons for the said transfer. The reason could be, for example, to retain funds for meeting escalation in the modernisation plan expenses.

The Committee wishes to point out that the corporation, if so desires, may (but is not required to) make appropriation of a portion of surplus to capital reserve. Paragraph 10.9.1 of the Guidance Note merely states that profits may also be appropriated to free reserves as deemed appropriate by the management. It does not mention that profits cannot be appropriated to capital reserve. In fact, the title of paragraph 10.9 of the Guidance Note, which is based on the requirement of Division I of Schedule III of the Act, uses the term ‘reserves’.

13. The Committee notes that in the extant case, recognition of interest income in the statement of profit and loss and the appropriation to capital reserve is not made in the manner explained in paragraph 11 and 12 above. In the extant case, interest income is debited and ‘Interest Capitalized for Modernization Expenses’ is credited, which is exhibited as an element of capital reserve (see the discussion that follows in paragraph 14 below). This has the effect of understating interest income in the statement of profit and loss and, consequently, surplus for the current year. However, capital reserve is *not* overstated.

14. Further, from the copy of the annual report for the year 2016-17 furnished by the querist, the Committee notes that in Note 16 on ‘Other Income’, net interest income (after transfer to capital reserve) is shown, with further break-up of gross interest income and a deduction towards transfer to capital reserve but described as ‘Interest Capitalized for Corporation’s share in Modernization Plan’. This gives an impression as if a portion of interest income is credited to some asset(s) account, which has not happened in the extant case. Credit to capital reserve cannot be described as capitalisation. The Committee is of the view that creation of capital reserve cannot be considered as capitalisation of interest *income*.

#### **D. Opinion**

15. On the basis of the above, the Committee is of the opinion that the corporation can choose to continue or discontinue the appropriation to designated reserve as per the management's decision. However, the manner of appropriation and presentation/ disclosure followed at present is not correct. The same should be as explained in paragraphs 11 to 14 above.

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