

Query No. 20

Subject: Accounting treatment and disclosure of Debit Balance of Capital Reserve arising on merger.¹

A. Facts of the Case

1. A Company (hereinafter referred to as ‘the Company’) is a public limited Company incorporated in India on 24th February 1986 with its registered office in Delhi, India. The Company is listed on the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE). The Company is engaged in manufacture of steel tubes and pipes and has 11 manufacturing plants spread across India. The Company has 5 subsidiaries and 1 step-down subsidiary.

2. The Board of the Company had decided to merge S Ltd., wholly owned subsidiary of the Company and T Ltd., step-down subsidiary with the Company and the effective date of the merger was April 1, 2021. The Company received the approval of Hon’ble National Company Law Tribunal (NCLT) on October 14, 2022 and the Company filed the certified true copy of above order with the Registrar of Companies (ROC) on October 31, 2022. Accordingly, the effect of the merger would be given in the financial statements of the Company for the year ended 31st March, 2023.

3. The querist has stated that both S Ltd. and T Ltd. were acquired subsidiaries. The Company had presented goodwill in respect of these subsidiaries in the consolidated financial statements of the Company amounting to Rs. 23 crore (For S Ltd.) and Rs. 114 crore (For T Ltd.) aggregating to Rs. 137 crore before the above merger. The Company proposes to account for the above merger of S Ltd. and T Ltd. with the Company under ‘Common Control’ transactions as per Indian Accounting Standard (Ind AS) 103, ‘Business Combinations’ under ‘Pooling of Interest Method’. Below are the details of assets, liabilities and reserves acquired and resultant capital reserve:

Particulars	S Ltd.	T Ltd.	Total
Value of Assets acquired	366	456	822
Less: Value of Liabilities acquired	150	152	302
Less: Value of Reserves acquired	210	298	508
Net Assets (net of reserves) acquired	6	6	12
Shares issued on merger to minority shareholders			5
Cancellation of Investments and inter-company transactions			289
(Capital Reserve) / Goodwill			(282)

4. There is difference in view in presentation and disclosure of above capital reserve between the statutory auditors and the management of the Company on this matter. The statutory auditors are of the view that the goodwill of Rs. 137 crore as appearing in the consolidated financials shall continue to appear in the merged financial statements and

¹ Opinion finalised by the Committee on 11.7.2023.

accordingly, the debit balance of capital reserve should be Rs. 145 crore (Rs. 282 crore - Rs. 137 crore). The Company is of the view that the debit balance of capital reserve shall be Rs. 282 crore. The basis of the conclusion for the Company's management and the statutory auditors are given below.

5. *Management's View*

The management is of the view that the difference of liabilities and reserves over the assets and consideration/investments aggregating to Rs. 282 crores should be shown in negative side of capital reserve based on the below guidance:

1. Paragraph 12 of Appendix C, 'Business combinations of entities under common control' of Ind AS 103, 'Business Combinations' and
2. Question 45 of Education Material on Ind AS 103, issued by the erstwhile Ind AS Implementation Group under Accounting Standards Board of the Institute of Chartered Accountants of India (ICAI)

Paragraph 12 of Appendix C of Ind AS 103

"The identity of the reserves shall be preserved and shall appear in the financial statements of the transferee in the same form in which they appeared in the financial statements of the transferor. Thus, for example, the General Reserve of the transferor entity becomes the General Reserve of the transferee, the Capital Reserve of the transferor becomes the Capital Reserve of the transferee and the Revaluation Reserve of the transferor becomes the Revaluation Reserve of the transferee. As a result of preserving the identity, reserves which are available for distribution as dividend before the business combination would also be available for distribution as dividend after the business combination. *The difference, if any, between the amount recorded as share capital issued plus any additional consideration in the form of cash or other assets and the amount of share capital of the transferor shall be transferred to capital reserve and should be presented separately from other capital reserves with disclosure of its nature and purpose in the notes.*"

Question 45 of Education Material on Ind AS 103

"If, in a common control business combination, the consideration paid is in excess of the share capital of the transferor and the transferee company does not have any reserves, where should the difference be recognised?"

Response:

Paragraph 12 of Appendix C to Ind AS 103 states as follows:

"12 The identity of the reserves shall be preserved and shall appear in the financial statements of the transferee in the same form in which they appeared in the financial statements of the transferor. Thus, for example, the General Reserve of the transferor entity becomes the General Reserve of the transferee, the Capital Reserve of the transferor becomes the Capital Reserve of the transferee and the Revaluation Reserve of the transferor becomes the Revaluation Reserve of the transferee. As a result of preserving the identity, reserves which are available for distribution as dividend before the business combination would also be available for distribution as dividend after the business combination. The difference, if any, between the amount recorded as share

capital issued plus any additional consideration in the form of cash or other assets and the amount of share capital of the transferor shall be transferred to capital reserve and should be presented separately from other capital reserves with disclosure of its nature and purpose in the notes.”

Where the transferee company does not have any reserves (including capital reserve), a literal reading of paragraph 12 of the Appendix C might suggest that the adjustment should be made to capital reserve. However, where the consideration is in excess of the carrying value of the net assets (including the reserves), the difference can be adjusted to either revenue reserve(s) or capital reserve (subject to the approvals required if any e.g. for capital reduction). If the transferee company has no reserves or has inadequate reserves, the debit should be to a account appropriately titled (e.g., Amalgamation Adjustment Deficit Account). The nature of such a reserve is akin to Debit balance in Profit and loss account. The balance in the account should be presented as part of reserves. A disclosure note explaining the nature of this account should be given in the financial statements.”

(Emphasis supplied by the querist.)

6. *Statutory Auditors' view*

The statutory auditors are of view that goodwill of Rs. 137 crore as appearing in consolidated financials of the Company before merger shall be continued to be accounted as goodwill in post-merger standalone and consolidated financial statements of the Company. The difference of Rs. 282 crore and Rs. 137 crore, i.e., Rs. 145 crore shall be presented as debit balance of the capital reserve account in the financial statements. They have also referred to Issue 2 of ITFG Clarification Bulletin 9, issued by the erstwhile Ind AS Transition Facilitation Group (ITFG) of Ind AS Implementation Committee of the ICAI which is reproduced as follows:

Issue 2 of ITFG Bulletin 9

“As per Appendix C, *Business Combinations of Entities under Common Control of Ind AS 103, Business Combinations*, in case of common control business combinations, the assets and liabilities of the combining entities are reflected at their carrying amounts.

(A) For this purpose, should the carrying amount of assets and liabilities of the combining entities be reflected as per the books of the entities transferred or the ultimate parent in the following situations:

Situation 1: A Ltd. has two subsidiaries B Ltd. and C Ltd. B Ltd. merges with C Ltd.

Situation 2: B Ltd. is the subsidiary of A Ltd. B Ltd. merges with A Ltd.

(B) Further, also state whether the effect of the above business combination is required to be eliminated in the consolidated financial statements of A Ltd.

Response: (A) Situation 1: Paragraph 9 of Appendix C of Ind AS 103, states as follows:

“9 The pooling of interest method is considered to involve the following:

- (i) *The assets and liabilities of the combining entities are reflected at their carrying amounts.*
- (ii) *No adjustments are made to reflect fair values, or recognise any new assets or liabilities. The only adjustments that are made are to harmonise accounting policies.*
- (iii) *The financial information in the financial statements in respect of prior periods should be restated as if the business combination had occurred from the beginning of the preceding period in the financial statements, irrespective of the actual date of the combination. However, if business combination had occurred after that date, the prior period information shall be restated only from that date.”*

Further paragraphs 11 and 12 of Appendix C of Ind AS 103 state as follows:

“11 The balance of the retained earnings appearing in the financial statements of the transferor is aggregated with the corresponding balance appearing in the financial statements of the transferee. Alternatively, it is transferred to General Reserve, if any.

12 The identity of the reserves shall be preserved and shall appear in the financial statements of the transferee in the same form in which they appeared in the financial statements of the transferor. Thus, for example, the General Reserve of the transferor entity becomes the General Reserve of the transferee, the Capital Reserve of the transferor becomes the Capital Reserve of the transferee and the Revaluation Reserve of the transferor becomes the Revaluation Reserve of the transferee. As a result of preserving the identity, reserves which are available for distribution as dividend before the business combination would also be available for distribution as dividend after the business combination. The difference, if any, between the amounts recorded as share capital issued plus any additional consideration in the form of cash or other assets and the amount of share capital of the transferor shall be transferred to capital reserve and should be presented separately from other capital reserves with disclosure of its nature and purpose in the notes.”

In accordance with the above, it may be noted that the assets and liabilities of the combining entities are reflected at their carrying amounts. Accordingly, in accordance with paragraph 9 (i) of Appendix C of Ind AS 103, in the separate financial statements of C Ltd., the carrying values of the assets and liabilities as appearing in the standalone financial statements of the entities being combined, i.e. B Ltd. & C Ltd. in this case shall be recognised.

Situation 2:

In this case, since B Ltd. is merging with A Ltd. (i.e. parent) nothing has changed and the transaction only means that the assets, liabilities and reserves of B Ltd. which were appearing in the consolidated financial statements of Group A immediately before the merger would now be a part of the separate financial statements of A Ltd. Accordingly, it would be appropriate to recognise the carrying value of the assets, liabilities and reserves pertaining to B Ltd as appearing in the consolidated financial statements of A Ltd. Separate financial statements to the extent of this common control transaction shall be considered as a continuation of the consolidated group.

(B) Paragraph B86 of Ind AS 110, *Consolidated Financial Statements*, states as follows:

“Consolidation procedures

B86 Consolidated financial statements:

- (a) *combine like items of assets, liabilities, equity, income, expenses and cash flows of the parent with those of its subsidiaries.*
- (b) *offset (eliminate) the carrying amount of the parent’s investment in each subsidiary and the parent’s portion of equity of each subsidiary (Ind AS 103 explains how to account for any related goodwill).*
- (c) *eliminate in full intragroup assets and liabilities, equity, income, expenses and cash flows relating to transactions between entities of the group (profits or losses resulting from intragroup transactions that are recognised in assets, such as inventory and fixed assets, are eliminated in full). Intragroup losses may indicate an impairment that requires recognition in the consolidated financial statements. Ind AS 12, Income Taxes, applies to temporary differences that arise from the elimination of profits and losses resulting from intragroup transactions.”*

In accordance with the above, all intra-group transactions should be eliminated in preparing consolidated financial statement in accordance with Ind AS 110. The legal merger of a subsidiary with the parent or legal merger of fellow subsidiaries is an intra-group transaction and accordingly, will have to be eliminated in the Consolidated Financial Statements of the Parent.

Accordingly, in both the given situations, the effect of legal merger should be eliminated while preparing consolidated financial statements of A Ltd.”

Statutory auditors have given to the Company the specific reference of opening paragraph of Situation 2 above where it says *“it would be appropriate to recognise the carrying value of the assets, liabilities and reserves pertaining to B Ltd as appearing in the consolidated financial statements of A Ltd. Separate financial statements to the extent of this common control transaction shall be considered as a continuation of the consolidated group.”* (Emphasis supplied by the querist.)

As per auditors, the interpretation of above lines is that goodwill and reserves which were appearing in consolidated financial statements before impact of merger, shall now be carried forward in the standalone and consolidated financial statements of the Company and hence, pre-merger goodwill amount of Rs. 137 crore shall continue to be shown as goodwill in the post-merger standalone and consolidated financial statements.

7. The management disagrees with the above view of auditors due to following reasons:

- As per the management, the above paragraph as referred by auditors implies that assets, liabilities and reserves as pertaining to B Ltd. (S Ltd. and T Ltd. in extant case) and appearing in its standalone financial statements shall be carried forward in the consolidated financial statements. Goodwill is never appearing in assets of B Limited and hence cannot be carried forward to the post-merger standalone or consolidated financial statements of A Limited (the Company in the extant case).

Ind AS is very clear on the treatment of such difference which needs to be shown as debit balance of capital reserve. The above referred ITFG only clarifies this.

- Also post-merger, the subsidiary Companies (S Ltd. and T Ltd.) cease to exist and hence, it would be incorrect to show the goodwill pertaining to these companies. Further, showing goodwill in the post-merger financial statements of the Company would unnecessarily inflate the reserves of the Company and hence, would not be a true and fair presentation of the financial statements of the Company.

B. Query

8. In view of the above, the opinion is sought from the Expert Advisory Committee of the ICAI as to whether the pre-merger consolidated goodwill of Rs. 137 crore shall continue to be shown in post-merger standalone and consolidated financial statements of the Company and only balance amount of Rs. 145 crore should be shown as debit balance of capital reserve or Rs. 282 crore shall be shown as debit balance of capital reserve.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised by the querist relates to whether the carrying value of goodwill of Rs. 137 crore, as appearing in the pre-merger consolidated financial statements shall continue to be shown in post-merger standalone and consolidated financial statements of the Company. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, effective date of merger from accounting perspective, measurement of the consideration for the business combination and measurement of the value of goodwill on consolidation and capital reserve on merger, impairment of goodwill, accounting for transactions with minority shareholders, measurement of assets and liabilities other than goodwill in the post-merger financial statements of A Ltd., etc. The Committee has examined the issue only from accounting perspective and has not considered the regulatory or legal classification and implications thereof including approvals required, if any, for example, for capital reduction due to debit balance of capital reserves, any impact on distributable reserves or dividend from Companies Act perspective, etc. Further, the opinion hereinafter has been expressed in the context of Indian Accounting Standards notified under the Companies (Indian Accounting Standards) Rules, 2015, as amended from time to time.

10. The Committee notes that Appendix C to Ind AS 103 states as follows:

“8 Business combinations involving entities or businesses under common control shall be accounted for using the pooling of interests method.

9 The pooling of interest method is considered to involve the following:

- (i) The assets and liabilities of the combining entities are reflected at their carrying amounts.
- (ii) No adjustments are made to reflect fair values, or recognise any new assets or liabilities. The only adjustments that are made are to harmonise accounting policies.
- (iii) The financial information in the financial statements in respect of prior periods should be restated as if the business combination had occurred

from the beginning of the preceding period in the financial statements, irrespective of the actual date of the combination. However, if business combination had occurred after that date, the prior period information shall be restated only from that date.

- 10 The consideration for the business combination may consist of securities, cash or other assets. Securities shall be recorded at nominal value. In determining the value of the consideration, assets other than cash shall be considered at their fair values.
- 11 The balance of the retained earnings appearing in the financial statements of the transferor is aggregated with the corresponding balance appearing in the financial statements of the transferee. Alternatively, it is transferred to General Reserve, if any.
- 12 The identity of the reserves shall be preserved and shall appear in the financial statements of the transferee in the same form in which they appeared in the financial statements of the transferor. Thus, for example, the General Reserve of the transferor entity becomes the General Reserve of the transferee, the Capital Reserve of the transferor becomes the Capital Reserve of the transferee and the Revaluation Reserve of the transferor becomes the Revaluation Reserve of the transferee. As a result of preserving the identity, reserves which are available for distribution as dividend before the business combination would also be available for distribution as dividend after the business combination. The difference, if any, between the amount recorded as share capital issued plus any additional consideration in the form of cash or other assets and the amount of share capital of the transferor shall be transferred to capital reserve and should be presented separately from other capital reserves with disclosure of its nature and purpose in the notes.”

The Committee notes from the above that business combination under common control (BCUCC) is to be accounted for using the pooling of interests method which inter alia involve reflecting the assets and liabilities of the combining entities at their carrying amounts. Further, the difference, if any, between the amount recorded as share capital issued plus any additional consideration in the form of cash or other assets and the amount of share capital of the transferor shall be transferred to capital reserve and should be presented separately from other capital reserves with disclosure of its nature and purpose in the notes.

The Committee also notes that the terms ‘transferor’ and ‘transferee’ have been defined as separate entities in paragraph 2 of the Appendix C. Further, paragraph 11 of Appendix C does not require balances of retained earnings to be recognised as per the CFS. On the lines of paragraph 11, paragraph 12, inter alia, also requires that the identity of the reserves shall be preserved and shall appear in the financial statements of the transferee in the same form as they appeared in the financial statements of the transferor. Furthermore, paragraph 9(ii) of the Appendix states, inter alia, that adjustments to the assets and liabilities shall only be made to harmonise the accounting policies. Therefore, it may be argued that Appendix C contemplates recognising the amounts from the separate financial statements of the merging entities rather than the CFS and accordingly, carrying values as appearing in the separate financial statements of the subsidiary (transferee/combining entity) are to be taken; and if there is no goodwill recognised in the pre-merger financial statements of the subsidiary company and the step-down subsidiary company, no goodwill as appearing in the pre-merger

consolidated financial statements should be recognised in the post-merger financial statements of the Company.

However, in this regard, the Committee notes Issue 2 of ITFG Bulletin 9 as reproduced above and the Educational Material on Ind AS 103 Business Combinations (Question 43), which states as follows:

“Question 43

A Ltd. acquired the shares of B Ltd. on April 1, 2010. A Ltd. chooses to retrospectively adopt the requirements of Ind AS 103. Below are the details of purchase price allocation:

Particulars	As per AS-14 As per Ind AS 103	
	(figures in crores)	(figures in crores)
Purchase price	100	100
Net assets in the books of B Ltd.	60	80
Intangible assets	-	10
General reserve/ Goodwill	40	10

On 1 April 2013, B Ltd. merged with A Ltd. for zero consideration under a scheme of amalgamation.

For the year ended March 2014, A Ltd. had applied pooling of interest method under AS 14 and recognised the excess of consideration over net assets in general reserve. On date of transition to Ind AS, since A Ltd. has chosen to apply Ind AS 103 retrospectively, how should such excess be accounted for in the separate financial statements of A Ltd.?

Response

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In the instant case, though B Ltd. is merging with A Ltd. (its parent), in substance nothing has changed; the transaction only represents that the assets, liabilities and reserves of B Ltd. which were appearing in the consolidated financial statements of Group A immediately before the merger will now be a part of the separate financial statements of A Ltd.

Separate financial statements to the extent of this common control transaction shall be considered as a continuation of the consolidated group.

If A Ltd. opts to apply requirements of Ind AS 103 retrospectively (**subject to legal considerations**), it will account for the business combination using acquisition accounting on 1 April 2010. Consequently, following the purchase price allocation requirements of Ind AS 103, Entity A will recognise intangibles at INR 10 crores and goodwill at INR 10 crores.”

The Committee notes that as per the Educational Material and the ITFG Bulletin, in substance, there is no change due to the merger of a subsidiary at consolidated group level. The merger transaction only means that the assets, liabilities and reserves of subsidiary which were earlier appearing in the consolidated financial statements before the merger would subsequently be a part of the separate financial statements of the parent company. Accordingly, it may not be inappropriate to recognise the carrying value of the assets, liabilities and reserves pertaining to subsidiary, as appearing in the pre-merger consolidated financial statements of the parent company, in the post-merger financial statements of the parent company. Separate financial statements of the parent company to the extent of this common control transaction shall be considered as a continuation of the consolidated group as stated in Issue 2 of ITFG Bulletin 9 and Question 43 of Education Material on Ind AS 103. Therefore, it may also be argued in the extant case that the goodwill pertaining to the business represented by the wholly owned subsidiary company and step-down subsidiary company as appearing in pre-merger consolidated financial statements of the Company should be continued to be recognised in the post-merger financial statements of the Company.

D. Opinion

11. On the basis of above, the Committee is of the view that the treatment accorded by the Company to not recognise goodwill appearing in the pre-merger consolidated financial statements of the Company in the post-merger financial statements of the Company is also correct.
