

Query No. 38

Subject: Point of recognition of forfeited veethapalisa income under Ind AS framework.¹

A. Facts of the Case

1. A company (hereinafter referred to as ‘the Company’), fully owned by the Government of Kerala, was incorporated on 06.11.1969, under the Companies Act, 1956, primarily with a view to safeguard the interest of common man from the activities of unscrupulous chit operators and to provide safe investment opportunities to the society at large. Chit business in Kerala became much more organised, systematic and regulated after the advent of the Company, as till then, the market was dominated by private operators, most of whom were exploiting the gullible public for furtherance of their own vested interest. By and large, the rationale of having chit business being conducted in an organised and transparent manner in the State was achieved by establishing the Company, as evidenced by the growth of the Company over the past 5 decades.

Applicable Act, Regulator:

2. By virtue of doing chit business, the Company is categorised as Miscellaneous Non Banking Company (MNBC). The Company is a fully owned government company and is under the administrative control of Taxes (H) Department, Government of Kerala. In Kerala, Chit business was being regulated in accordance with the provisions of Kerala Chitties Act, 1975. Kerala Chitties Act, 1975 was repealed by the Chit Funds Act, 1982 which was introduced during May 2012 and at present, the Company is carrying out its chit business in accordance with the applicable provisions of the Chit Funds Act, 1982.

Audit:

3. The Company is subject to three types of audit every year, viz., internal audit, statutory audit and audit by the Comptroller and Auditor General of India (C&AG). As per section 139 of the Companies Act, 2013, the C&AG appoints auditors for all regions of the Company and also, audit gets carried out by C&AG under section 143(6) of the Companies Act, 2013.

About Chit Operation:

4. Chit is a transaction by or under which a person enters into an agreement with a specified number of persons that each one of them shall subscribe a certain sum of money by way of periodical instalments over a definite period and that each such subscriber shall, in his turn, as determined by lot or by auction, be entitled to the prize amount once during the tenure of the chitty. The various terms used in chit fund business under the Chit Funds Act, 1982 are the following:

1. “foreman” (section 2 (j)) means the person who under the chit agreement is responsible for the conduct of the chit and includes any person discharging the functions of the foreman under section 39.

2. “gross chit amount” (sala) (section 2(ja)) means the sum-total of the subscriptions payable by all the subscribers for any installment of a chit without any deduction of discount or otherwise.

¹ Opinion finalised by the Committee on 9.11.2023.

3. “prized subscriber” (section 2(n)) means a subscriber who has either received or is entitled to receive the [net chit amount].
4. “defaulting subscriber” (section 2(f)) means a subscriber who has defaulted in the payment of subscriptions due in accordance with the terms of the chit agreement.
5. “chit agreement” (variya) (section 2(c)) means the document containing the articles of agreement between the foreman and the subscribers relating to the chit.
6. “draw” (section 2(i)) means the manner specified in the chit agreement for the purpose of ascertaining the prized subscriber at any instalment of the chit.
7. “ticket” (section 2(s)) means the share of a subscriber in a chit.
8. “subscriber” (section 2 (r)) includes a person who holds a fraction of a ticket and also a transferee of a ticket or fraction thereof by assignment in writing or by operation of law.
9. “discount” (section 2(g)) means the sum of money which a prized subscriber is, under the terms of the chit agreement, required to forego and which is set apart under the said agreement to meet the expenses of running the chit or for distribution among the subscribers or for both.
10. “share of discount” (veethapalisa/dividend) (section 2(pa)) means the share of the subscriber in the amount of discount available under the chit agreement for rateable distribution among the subscribers at each instalment of the chit.
11. “non-prized subscriber” does not include a defaulting subscriber (section 2(k)).
12. “Termination of chits” (section 40):- A chit shall be deemed to have terminated, (a) when the period specified therefor in the chit agreement has expired provided the payment of dues to all the subscribers has been completed; or (b) when all the non-prized and unpaid prized subscribers and the foreman consent in writing to the termination of the chit and a copy of such consent is filed with the Registrar; or (c) where a foreman dies or becomes of unsound mind or is otherwise incapacitated and the chit is not continued in accordance with the provisions of the chit agreement.

Some of the other terms commonly used in chit fund business are as follows:

- (i) Prize amount means the chitty amount, whether payable in cash, kind or any other article of value less the discount; it includes, in the case of a fraction of a ticket, the difference between the proportionate chitty amount and the discount on the particular fraction of the ticket; when the prize is payable in movables it means the value thereof at the time it becomes payable.
- (ii) Forfeited veethapalisa (dividend) means the dividend forfeited in case of the prized subscriber who fails to pay the instalment within the due date.

Illustration of chit scheme:

- Assume a chit fund scheme with 40 members with each paying a monthly instalment of Rs. 2500.

- Duration of the chit will be 40 months (as there are 40 subscribers including foreman).
- Chitty sala will be Rs. 1,00,000 i.e., 40 subscribers @ Rs. 2500/-.
- Out of 40 tickets, one ticket is held by foreman. Foreman brings in his total contribution (i.e., Rs. 2500 * 40 months) upfront and the same gets adjusted over next 39 months. Remaining 39 members contribute their instalment on monthly basis.

Even though as per Act, a subscriber can bid upto 40%, the Company has internally set a cap of 30% for bidding. The subscriber who is in need of money will bid and the one who has bid the maximum would be given the prize money. If there are more than one subscriber bidding for the same amount, one subscriber from among them would be selected as winner by drawing lot.

- In this example, let us assume 3 subscribers A, B and C bid @ 30%. As there are more than one subscriber bidding for the same amount, draw would be held from among A, B and C and let's assume B becomes the winner.
- As subscriber B has bid for 30%, he will be entitled to Rs. 70,000 (less applicable GST on foreman commission and other incidental charges).
- Out of the amount of Rs. 30,000 (i.e. 30% foregone by "B"), Rs. 5,000 (5%) will be taken by the Company as foreman commission and remaining Rs. 25,000 will get divided equally among all 40 subscribers (including the foreman, i.e., the Company and subscriber "B" too).
- This amount of Rs. 625 (i.e. Rs. 25,000/40 subscribers) is the dividend entitlement of each subscriber and the same would be adjusted in their next instalment. So next month instalment for all subscribers would be Rs. 1,875 (i.e. Rs. 2,500 less Rs. 625 being the dividend (veethapalisa)).
- A prized subscriber who has availed prize money but does not pay the instalment on due date will not be eligible for dividend. Let us further assume there is a subscriber "D" in the said chit scheme who has already availed his prize money and thus he is a prized subscriber and "E" is a non prized subscriber (who has not availed his prize money yet).
- If subscriber "D" does not remit his chit instalment within the due date, his dividend (veethapalisa) of Rs. 625 will be forfeited. He will also have to pay interest for delayed remittance at applicable rate.
- If subscriber "E" who is a non prized subscriber fails to remit the subscription in time, he would be entitled to veethapalisa. However, default interest at applicable rate would be charged on the net subscription amount due (after allowing eligible Auction Veethapalisa/Dividend) till the date of remittance.

Forfeited veethapalisa:

5. Entitlement of foreman has been stated under rights of foreman under section 21 of the Chit Funds Act, 1982. It may be noted that the Act is silent about the entitlement of foreman over forfeited veethapalisa. As per section 21(1) of the Chit Funds Act, 1982, the foreman is entitled to foreman commission and interest, penalty if any, payable on any default in the

payment of instalments and to such other amounts as may be payable to him under the provisions of the chit agreement.

Generally, other chit companies in Kerala treat each chit as a separate scheme and the Company too is following the same methodology and a chit is treated as closed only when the entire dues therein have been realised. Thus, forfeited veethapalisa is not recognised as income as and when the same is forfeited but only when the chit gets terminated. The overall default in the chit gets reduced from the forfeited veethapalisa and the net amount is considered as income.

Accounting entries being passed now:

(i) At the time of remitting instalment by a prized subscriber

Auction Veethapalisa A/c (Liability) dr.

To Forfeited Veethapalisa (Liability)

(ii) At the time of termination of chitty

Forfeited Veethapalisa A/c (liability) dr.

To Forfeited Veethapalisa income

Rationale and Case Laws:

6. Following the prudential principle of income recognition, wherein gains are recognised only if occurrence is certain, the Company considered forfeited veethapalisa as income only at the time of termination of chit. As the calculation involves determination of auction discount forfeited from the subscribers as reduced by the default under respective chitties, the amount to be recognised as revenue is correctly ascertainable only on termination of respective chitties and, therefore, the Company decided to follow the completed contract method to arrive at income while following mercantile system of accounting in respect of expenditure and other components of income from chitty operations. It may also be noted that the default occurs in chits during the entire period of each chit and the overall quantum of default in a chit is ascertainable only on termination of the chit.

The ITAT in its Order dated 8/8/2013 clearly specifies that undistributed veethapalisa and the amount due from the defaulting subscriber can be ascertained after the completion of the time period of each chit. Further, as per judgment of the Hon'ble High Court of Madras in the case of M/s. Shriram Chits and Investment Pvt. Ltd. V/s Assistant Commissioner of Income Tax (DTR 144), it is clearly specified that "Every chit being an independent transaction involving a series of activities and susceptible to uncertainties in the payment of subscription, the revenue recognition from the business become determinable only at the end of a particular chit transaction".

7. It is also understood that the Technical Guide on Accounting and Auditing for Chit Funds, issued by the Research Committee of the Institute of Chartered Accountants of India (ICAI) requires recognition of forfeited auction discount and fixed discount (also called dividend) on termination of Chit Fund Scheme after retaining in the said accounts an amount equivalent to the amount outstanding in the prized subscribers' account as receivable.

Consistently followed method of income recognition:

8. The querist has stated that the same practice was followed by the Company consistently from the introduction of the Chit Funds Act, 1982, and is being continued even after the migration to Ind AS during financial year (F.Y.) 2018-19. Ind AS 115, 'Revenue from Contracts with Customers', paragraph 44 states that "An entity shall recognise revenue for a performance obligation satisfied over time only if the entity can reasonably measure its progress towards complete satisfaction of the performance obligation. An entity would not be able to reasonably measure its progress towards complete satisfaction of a performance obligation if it lacks reliable information that would be required to apply an appropriate method of measuring progress". According to the querist, if the Company recognises the forfeited veethapalisa as income before termination of chitty, it would be against the prudential principle of income recognition and result in overstatement of income.

9. Divergent views arose regarding the point of recognition of forfeited veethapalisa as income, i.e., whether the forfeited veethapalisa should be recognised as income as and when default occurs, or at the time of actual remittance of instalments by a defaulting prized subscriber, or at the time of termination of chitty.

B. Query

10. Based on the above facts, the querist has sought the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India (ICAI) on the following issues:

- (a) The point of recognition of forfeited veethapalisa as income, i.e.,
 - (i) when default occurs, or
 - (ii) at the time of actual remittance of instalments by a defaulting prized subscriber, or
 - (iii) at the time of termination of chitty.
- (b) The entries required to be passed in books of account.
- (c) The disclosure in financial statements.
- (d) If change is necessitated in the method of accounting, whether it would be treated as change in accounting policy.

C. Points considered by the Committee

11. The Committee notes that the basic issue raised by the querist relates to the timing of recognition of forfeited veethapalisa (termed as 'dividend' by the querist) on account of default by a prized subscriber in the books of account prepared for the chit fund under Ind AS framework. The Committee has, therefore, considered only this issue and has not examined any other issues that may arise from the Facts of the Case, such as, accounting for foreman's commission, accounting for monthly instalments/subscriptions, accounting for default by non-prized subscribers, accounting for discount, whether the foreman is legally entitled to forfeited veethapalisa, preparation of financial statements of chit fund, etc. The Committee, while opining, has referred to Indian Accounting Standards (Ind AS), notified under the Companies (Indian Accounting Standards) Rules, 2015, as revised or amended from time

to time since the querist has raised the query in the context of the said standards. The Committee has not examined the requirements of the Technical Guide on Accounting and Auditing for Chit Fund Business, which has been issued in the year 2004 under the Accounting Standards (AS) framework by the Research Committee of the ICAI. The querist has also referred to certain court rulings and ITAT pronouncements in the Facts, however, the Committee has only looked into the issue purely from an accounting perspective and has not looked into or interpreted the regulatory or legal requirements and implications under various applicable legal enactments, such as, Income-tax Act, the Chit Funds Act, etc.

12. The Committee notes that Ind AS 115, 'Revenue from Contracts with Customers' states the following:

“5 An entity shall apply this Standard to all contracts with customers, except the following:

...

(c) financial instruments and other contractual rights or obligations within the scope of Ind AS 109, *Financial Instruments*,

...”

The Committee notes from the above that Ind AS 115 is not applicable to financial instruments and other contractual rights or obligations within the scope of Ind AS 109, 'Financial Instruments'.

13. The Committee further notes that Ind AS 32, 'Financial Instruments: Presentation' states the following:

“11 The following terms are used in this Standard with the meanings specified:

***A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.*”**

“A *financial liability* is any liability that is:

(a) a contractual obligation:

(i) to deliver cash or another financial asset to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

...”

The Committee notes from the facts provided by the querist that a chit is a transaction by or under which a person enters into an agreement with a specified number of persons that each one of them shall subscribe a certain sum of money by way of periodical instalments over a definite period and that each such subscriber shall, in his turn, as determined by lot or by auction, be entitled to the prize amount once during the tenure of the chitty. The Committee also notes that veethapalisa (termed as 'dividend' by the querist) is the amount which is payable periodically (say monthly) by the Chit Fund to all subscribers as their share in the

surplus arrived by deducting the prize amount, foreman's commission and expenses from the total instalment amount received from subscribers; the said share of a prized subscriber is liable to be forfeited in case the prized subscriber fails to pay the instalment within the due date as per the Chit agreement. Thus, the amount payable by the chit fund arising from a chit agreement as veethapalisa would be a financial liability as per Ind AS 32. Accordingly, the recognition and derecognition requirements of financial liabilities and any consequential gain (income) /loss (expense) under Ind AS 109, 'Financial Instruments', would be applicable for the recognition and derecognition of the obligations of the chit fund including any consequential gain (income) /loss (expense).

14. The Committee further notes that as per the contractual terms of the chit fund scheme/agreement, this veethapalisa financial liability is settled when the same is adjusted against the monthly instalments of the subscribers. In this regard, the Committee notes that Ind AS 109 states the following:

“3.3.1 An entity shall remove a financial liability (or a part of a financial liability) from its balance sheet when, and only when, it is extinguished—ie when the obligation specified in the contract is discharged or cancelled or expires.”

“3.3.3 The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss.”

“B3.3.1 A financial liability (or part of it) is extinguished when the debtor either:

- (a) discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services; or
- (b) is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor. (If the debtor has given a guarantee this condition may still be met.)”

From the above, the Committee notes that Ind AS 109 requires an entity to derecognise (i.e. remove from its statement of financial position) a financial liability when, and only when, it is 'extinguished', that is, when the obligation specified in the contract is discharged, cancelled, or expires. This will be generally achieved when the debtor (viz., the fund) either discharges the liability by paying the creditor (viz., the subscriber), or, is legally released from primary responsibility for the liability either by process of law or by the creditor.

In this regard, the Committee notes that, in the extant case, it is not clear as to whether, in case of default by a prized subscriber, the foremen is legally required to forfeit the withheld veethapalisa in respect of a defaulting prized subscriber immediately at the time of default or the same can be adjusted against the future instalments which may be paid by the prized subscriber. Therefore, the chit fund should consider the applicable legal requirements to determine when the veethapalisa has been forfeited i.e. whether there is legal extinguishment / legal release of the financial liability in respect of veethapalisa at the time of default by the prized subscriber or at a later date after a specified time of non-payment. The point of time when there is legal extinguishment / legal release would be the point of time at which the financial liability should be derecognised and the income should be recognised.

15. The Committee also notes the following requirements under Ind AS 107, 'Financial Instruments: Disclosures':

“20 An entity shall disclose the following items of income, expense, gains or losses either in the statement of profit and loss or in the notes:

(a) net gains or net losses on:

(i) financial assets or financial liabilities measured at fair value through profit or loss, showing separately those on financial assets or financial liabilities designated as such upon initial recognition or subsequently in accordance with paragraph 6.7.1 of Ind AS 109, and those on financial assets or financial liabilities that are mandatorily measured at fair value through profit or loss in accordance with Ind AS 109 (eg financial liabilities that meet the definition of held for trading in Ind AS 109). For financial liabilities designated as at fair value through profit or loss, an entity shall show separately the amount of gain or loss recognised in other comprehensive income and the amount recognised in profit or loss.

(ii)-(iv) [Refer Appendix 1]

(v) financial liabilities measured at amortised cost.

...

21 ²In accordance with paragraph 117 of Ind AS 1, *Presentation of Financial Statements*, an entity discloses material accounting policy information. Information about the measurement basis (or bases) for financial instruments used in preparing the financial statements is expected to be material accounting policy information.”

The Committee is of the view that the relevant disclosures under Ind AS 107 (including the above disclosures), and Schedule III to the Companies Act, 2013 shall be ensured by the chit fund.

16. The Committee further notes the following requirements of Ind AS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors':

“Prior period errors are omissions from, and misstatements in, the entity’s financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

(a) was available when financial statements for those periods were approved for issue; and

(b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

...”

² Substituted vide Notification No. G.S.R. 365(E) dated 30th March, 2016 and, thereafter, substituted vide Notification No. G.S.R. 242(E) dated 31st March, 2023.

- “41 Errors can arise in respect of the recognition, measurement, presentation or disclosure of elements of financial statements. Financial statements do not comply with Ind ASs if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity’s financial position, financial performance or cash flows. Potential current period errors discovered in that period are corrected before the financial statements are approved for issue. However, material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in the financial statements for that subsequent period (see paragraphs 42–47).
- 42 Subject to paragraph 43, an entity shall correct material prior period errors retrospectively in the first set of financial statements approved for issue after their discovery by:**
- (a) restating the comparative amounts for the prior period(s) presented in which the error occurred; or**
 - (b) if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented.”**

The Committee is of the view that since in the extant case, if the Company has been following an accounting treatment, which is different from that explained in paragraph 14 above, the same shall be dealt with as a prior period error as per the requirements of Ind AS 8 stated above.

D. Opinion

17. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 10 above:

- (a) As mentioned in paragraph 14 above, recognition of forfeited veethapalisa as income shall be at the point when there is legal extinguishment / legal release of the obligation of the chit fund to pay veethapalisa to the subscriber.
- (b) Refer (a) above.
- (c) The disclosures mentioned in paragraph 15, shall be furnished in the financial statements by the chit fund.
- (d) In the extant case, if a change is necessitated in the manner of accounting, the same shall be dealt with as a prior period error under Ind AS 8, as discussed in paragraph 16 above.