Exposure Draft

Guidance Note on Transfer of Capital Reserve

(Last date of comments: 20th April, 2023)

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Research Committee of the Institute of Chartered Accountants of India invites comments on any aspect of this Exposure Draft of the 'Guidance Note on Transfer of Capital Reserve'. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

Comments should be submitted in writing to the Secretary, Research Committee, The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi – 110002, to be received not later than 20th April, 2023. Comments can also be sent by e-mail at research@icai.in

Executive summary

1. Certain Ind AS require capital reserve to be created toward unrealised profits arising from certain transactions or other events. However, currently, there is no specific guidance on their subsequent transfer to retained earnings or other free reserve.

2. The Guidance Note sets out principles for transfer of capital reserve to free reserve, including the timing when such transfer can be made.

3. Any reserve created as per the requirements of the Companies Act or other applicable law cannot be transferred to other reserve except as per the requirements of the applicable law. Few other reserves, which are purely capital in nature, e.g., capital profit on reissuance of forfeited shares, cannot be transferred to free reserves/ retained earnings as underlying transaction is completed.

4. For capital reserves created as per the requirements of Ind AS or erstwhile Accounting Standards, the amount can be transferred to retained earnings or other free reserves when the following two conditions are met:

   (i) The company has realised the underlying amount.

   (ii) The amount has become available for distribution under the law.

5. The amount may be transferred either proportionately each or at end on sale of the asset.

6. Specific disclosures are required in the year of transfer.

7. This Guidance Note would come into effect in respect of Capital Reserve appearing in the books of accounts retrospectively.

1. Certain Indian Accounting Standards (Ind AS) notified under the Companies (Indian Accounting Standards) Rules, 2015 (as amended) require capital reserve to be created toward unrealised profits arising from certain transactions or other events. However, currently, there is no specific guidance on their subsequent transfer to retained earnings or other free reserve. The purpose of this Guidance Note is to clarify on this aspect by providing appropriate guidance on the matter.

Scope

2. The Guidance Note sets out principles for transfer of capital reserve to free reserve, including the timing when such transfer can be made. This Guidance Note deals only with transfer of capital reserve to free reserve/ retained earnings. It does not deal with whether the amount so transferred can be utilised for payment of dividend, issue of bonus shares or any other purpose. The utilisation for dividend, issue of bonus shares or any other purpose is a legal matter and will continue to be dealt with as per the applicable requirements of the Companies Act, 2013 (as amended) (hereinafter referred to as "the Act") and other applicable laws, if any. It may be noted that section 63 of the Companies Act, 2013 (as amended) deals with the Issue of Bonus Shares. As per the proviso to sub-section (1) of section 63, no issue of bonus shares shall be made by capitalising reserves created by the revaluation of assets.

Creation of Capital Reserve

3. The following Ind AS specifically require creation of capital reserve:

(a) Ind AS 103 *Business Combination* states that in extremely rare circumstances, an acquirer will make a bargain purchase in a business combination such that fair value of net assets acquired exceeds consideration paid and amount of non-controlling interest, i.e., there is a negative goodwill. As a first step, Ind AS 103 requires entire purchase price allocation to be reassessed to determine whether bargain purchase really exists. If it continues to exist, the acquirer shall recognise the resulting gain in other comprehensive income (OCI) on the acquisition date and accumulate the same in equity as capital reserve. However, if there is no clear evidence of the underlying reasons for classifying the business combination as a bargain purchase, the acquirer will recognise negative goodwill amount directly in equity as capital reserve. In either case, negative goodwill amount gets credited to capital reserve on the acquisition date.

(b) As per Appendix C to Ind AS 103 *Common Control 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 …".

(c) Similar to Ind AS 103, as per Ind AS 28 *Investment in Associates and Joint Ventures*, on acquisition of investment in associate/ joint venture, any excess of entity's share of the net fair value of investee's identifiable assets and liabilities over the cost of the investment is recognised either through OCI or directly in equity as capital reserve in the period in which the investment is acquired.

4. Given below are few more examples where capital reserve can arise under Ind AS:

(a) A parent has given interest free loan to its subsidiary. Ind AS 109 *Financial Instruments* requires both parent and subsidiary to recognise loan at fair value, i.e., present value of future cash flows discounted using market rate of interest. In the financial statements of subsidiary, difference between loan received and fair value is generally treated as capital reserve. Over the tenure of loan, interest on fair value loan is recognised and charged to the Statement of Profit and Loss (P&L) using original discount rate such that loan amount is equal to amount repayable on due date. Thus, amount originally recognised as capital reserve is charged to P&L as interest expense.

(b) A parent has given ESOP to employees of subsidiary. In such a case, Ind AS 102 *Share-based Payment* requires subsidiary to recognise ESOP expense over the vesting period. The corresponding amount is credited to capital reserve.

(c) Certain companies may have recognised capital reserve under the erstwhile Accounting Standards notified as the Companies (Accounting Standards) Rules, 2006 (as amended) and the same may have continued as it is on transition to Ind AS.

(d) As per the Guidance Note on Division II - Ind AS Schedule III to the Companies Act 2013 (GN Ind AS Schedule III), capital profit on reissue of forfeited shares is profit of a capital nature and, hence, it should be credited to capital reserve.

Capital reserve – Definition and available guidance

5. The Glossary of Terms Used in Financial Statements issued by the Institute of Chartered Accountants of India (ICAI) define the term 'capital reserve' as "a reserve of a corporate enterprise which is not available for distribution as dividend."

6. Though certain Ind AS require creation/ transfer of amount to capital reserve, they do not define this term. Nor they provide any clear guidance on subsequent transfer of amount to free reserve/ retained earnings. The Companies Act also does not contain any specific requirement on this topic, i.e., the Act is silent as to how such reserves once created should be used.

7. Ind AS Schedule III – Division II requires separate disclosure of capital reserve under the head 'Reserves and surplus'; however, it does not define the term. Nor it provides any clear guidance on its transfer to free reserves/ retained earnings subsequently. GN Ind AS Schedule III basically refers to definition given in the Glossary stated above and certain Ind AS requiring creation of capital reserve. It does not provide any further guidance on transfer. Overall, the Companies Act and existing literature is silent on this matter.

Position under IFRS

8. Ind AS were notified in India with a view to achieve convergence with International Financial Reporting Standards (IFRS). Thus, it may be relevant to also look at IFRS position also. IFRS do not contain any specific requirement on creation of capital reserve. In case of bargain purchase gain, IFRS 3 *Business Combinations* requires amount to be recognise in P&L at the acquisition date which immediately becomes part of retained earnings. In other cases, IFRS requires amount to be recognised as part of equity without specifying the head under which such amount should be credited. Hence, companies following IFRS have flexibility of deciding reserve under which amount should be credited. Implicitly, there is also a flexibility of transferring amount from one reserve to another at a later date.

Ind AS – Transfer between reserves

9. Though Ind AS is silent on transfer of capital reserves at a subsequent date, it allows such transfer in several other cases. Given below are few examples:

(a) As per Ind AS 16 *Property, Plant and Equipment,* the revaluation surplus included in equity in respect of an item of property, plant and equipment may be transferred directly to retained earnings when the asset is derecognised. This may involve transferring the whole of the surplus when the asset is retired or disposed of. However, some of the surplus may be transferred as the asset is used by an entity. In such a case, the amount of the surplus transferred would be the difference between depreciation based on the revalued carrying amount of the asset and depreciation based on the asset's original cost. Transfers from revaluation surplus to retained earnings are not made through profit or loss.

(b) As per Ind AS 19 *Employee Benefits,* remeasurements of the net defined benefit liability (asset) recognised in other comprehensive income shall not be reclassified to profit or loss in a subsequent period. However, the entity may transfer those amounts recognised in other comprehensive income within equity.

(c) As per Ind AS 102 *Share-based Payment* paragraph 23 dealing with after vesting date scenario for equity share-based payments, the entity shall make no subsequent adjustment to total equity after vesting date. For example, the entity shall not subsequently reverse the amount recognised for services received from an employee if the vested equity instruments are later forfeited or, in the case of share options, the options are not exercised. However, this requirement does not preclude the entity from recognising a transfer within equity, i.e., a transfer from one component of equity to another.

Hence, transfer within reserves is acceptable position under Ind AS.

Transfer of Capital Reserves

10. Any reserve created as per the requirements of the Act or other applicable law cannot be transferred to other reserve except as per the requirements of the applicable law. Regarding capital reserve created pursuant to Ind AS or the erstwhile Companies (Accounting Standards) Rules, 2006 (as amended), the following two views are possible:

(a) Capital reserve once created is in the nature of permanent capital for the Company. Hence, companies cannot utilise or transfer capital reserve to another reserve at a subsequent date, except with the regulatory approval, say, with the National Company Law Tribunal (NCLT) approval.

(b) Ind AS/ other applicable guidance require amount to be credited to capital reserve because they are unrealised and cannot be used for dividend distribution at this stage. However, except for few reserves, which are purely capital in nature, e.g.., capital profit on reissuance of forfeited shares, there is no permanent restriction on transfer. The amount can be transferred to the retained earnings or other free reserves when the following two conditions are met:

   (i) The company has realised the underlying amount. The timing when a reserve become realised depends on specific facts and need to be decided considering specific facts. Appendix to this Guidance Note contains some examples to explain this.

   (ii) The amount has become available for distribution as dividend or issue of bonus shares under the Act or other applicable laws. Each company should evaluate whether amount is available for distribution basis its specific facts and consider involving legal professionals, if needed.

Till both these conditions are met, the amount should continue to be reflected as capital reserve.

11. View at (b) is more appropriate and should be applied. To support this view, it may be mentioned that since Ind AS is silent, the following paragraphs of Ind AS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* will apply and require guidance under other Ind AS and IFRS to be used. As already explained, other Ind AS and IFRS allow transfer of reserves based on realisation.

> "10. In the absence of an Ind AS that specifically applies to a transaction, other event or condition, management shall use its judgement in developing and applying an accounting policy that results in information that is:
>
> (a) relevant to the economic decision-making needs of users; and
>
> (b) reliable, in that the financial statements:
>
>   (i) represent faithfully the financial position, financial performance and cash flows of the entity;
>
>   (ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form;
>
>   (iii) are neutral, i.e., free from bias;

(iv) are prudent; and

(v) are complete in all material respects.

11. In making the judgement described in paragraph 10, management shall refer to, and consider the applicability of, the following sources in descending order:

(a) the requirements in Ind ASs dealing with similar and related issues; and

(b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Framework.

12. In making the judgement described in paragraph 10, management may also first consider the most recent pronouncements of International Accounting Standards Board and in absence thereof those of the other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature and accepted industry practices, to the extent that these do not conflict with the sources in paragraph 11."

12. Summary of recommendations

(a) Any reserve created as per the requirements of the Companies Act or other applicable law cannot be transferred to other reserve except as per the requirements of the applicable law. Few other reserves, which are purely capital in nature, e.g., capital profit on reissuance of forfeited shares, cannot be transferred to free reserves/ retained earnings as underlying transaction is completed.

(b) For capital reserves created as per Ind AS or the erstwhile Companies (Accounting Standards) Rules, 2006 (as amended), the amount can be transferred to the retained earnings or other free reserves only when below the following two conditions are met:

a. The company has realised the underlying amount. The timing when a reserve become realised depends on specific facts and need to be decided considering such specific facts. Appendix to this Guidance Note contain some examples to explain this.

b. The amount has become available for distribution under the Act or other applicable laws. Each company should evaluate whether amount is available for distribution basis its specific facts and consider involving legal professionals, if needed.

Till both these conditions are met, the amount should continue to be reflected as capital reserve.

(c) The amount as (b) above may be transferred either proportionately each year, i.e., proportionately as assets resulting in capital reserve are depreciated/ impaired/amortised or at end on sale of the asset.

(d) The NCLT Schemes approved under sections 230 to 232 of the Act. Hence, any reserve created under such schemes will also be dealt with using the same principles, i.e., the amount can be transferred to retained earnings or other reserve only if it has become realised and the amount can be used for distribution as per the applicable law.

(e) In each year of transfer, the Company should give a detailed disclosure with facts and including (i) amount of capital reserve, (ii) background of transaction, how it arose, (iii) year of its origination, (iv) how it become realised with details of subsequent transaction, and (v) amount that become realised and thereby transferred to free reserve/ retained earnings after appropriate approvals by Board of Directors/ members Audit Committee as applicable.

APPENDIX

This Appendix is an integral part of the Guidance Note.

The timing when a reserve become realised depends on specific facts and need to be decided considering specific facts. Given below are some examples to explain this:

(a) A company has bargain purchase gain resulting from business combination which is recognised in capital reserve. Bargain purchase has arisen mainly due to fair valuation of property, plant and equipment and intangible assets. The amount in capital reserve become realised as these assets are depreciated/impared by charge to P&L or on sale.

(b) A company has capital reserve arising from common control business combination approved by the NCLT because carrying amount of net assets acquired is more than face value of shares issued and identifiable reserves. The amount in capital reserve become realised as these assets are depreciated by charge to P&L or on sale.

(c) In case of interest free loan from parent, capital reserve arises due to fair value impact, amount becomes realised as interest cost is charged to P&L or when loan is repaid.

(d) A company has bargain purchase gain resulting from business combination which is recognised in capital reserve. Bargain purchase has arisen mainly due to fair valuation of land and investments which are not required to be depreciated. In such cases, balance in the capital reserve does not get transferred to General Reserves/ Retained Earnings during normal course as there is no depreciation/ amortisation of land or investment. Once the land and/ or investment is sold and the gains are realised, the balance in Capital Reserve become realised.