Technical Guide on

Accounting for Microfinance Institutions

Research Committee

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

NEW DELHI

Published in 2008

Price : Rs. 150.00

ISBN : 978-81-8441-111-9

Published by : The Publication Department on behalf of Dr. Avinash Chander, Technical Director, The Institute of Chartered Accountants of India, ICAI Bhawan, Indraprastha Marg, New Delh-110 002

Printed at : Sahitya Bhawan Publications, Hospital Road, Agra -282 003
September/2008/2000 Copies

Foreword

Microfinance institutions (MFIs) serve those at the bottom of the economic pyramid, i.e., the poor who have little or virtually no access to financial services. In order to help them to raise their income levels and standard of living, MFIs provide various financial services of small amounts. MFIs often receive grants and loans from national and international organisations for the performance of their activities. In the present times, the microfinance sector is widely gaining importance.

With MFIs serving the vulnerable sections of society and also receiving funds for their functioning, there is a need for greater transparency of its operations by way of sound accounting and reporting by MFIs. Further, MFIs exist in various legal forms which are following diverse accounting practices. Keeping this in view, a need has been felt to develop accounting and financial reporting framework based on sound accounting principles for MFIs. To address this need, the Research Committee of the Institute of Chartered Accountants of India decided to bring out a 'Technical Guide on Accounting for Microfinance Institutions'. I am happy that the Research Committee has formulated this Technical Guide to provide guidance to the preparers and auditors of financial statements of MFIs when faced with several accounting issues involved in the microfinance sector.

I am sure that this publication would be extremely beneficial not only to the members of the Institute but also to others concerned.

New Delhi
July 28, 2008

CA. Ved Jain
President

Preface

Microfinance institutions (MFIs) provide vital financial services to the economically deprived members of the society. At present, the microfinance sector is a growing industry with many MFIs operating in the country. Different accounting practices exist in the microfinance sector due to various legal forms of the MFIs. Further, large amount of grants and funds entering the microfinance sector and involvement with the poor and their money, warrant a high level of transparency of operations of MFIs by way of sound accounting and financial reporting by MFIs. Therefore, to address this need, the Research Committee constituted a Study Group on Accounting for Microfinance Institutions. As result of several fruitful deliberations in the Study Group, the Research Committee has brought out the Technical Guide on Accounting for Microfinance Institutions.

This Technical Guide on Accounting for Microfinance Institutions primarily focuses on suggesting an accounting and financial reporting framework for the MFIs for presentation of true and fair view of the state of affairs and the operating results of the activities in the financial statements. The Technical Guide discusses salient features and principal requirements of various Accounting Standards followed by issues that may arise in the course of their application by MFIs.

On behalf of the Research Committee, I would like to place on record my deep appreciation of the members of the Study Group, namely CA. V. Rethinam, Convenor of the Study Group who is an eminent member of profession from New Delhi, Shri R. K. Mukherjee, Shri Prabhakara S., CA. Sitaram Rao, CA. Jayshree Vyas and CA. V. Nagarajan for their invaluable inputs which have given the present shape to this Technical Guide.

I would also like to thank Ms. Purva Gupta, Management Trainee, for her contribution in the preparation of the basic draft and Dr. Avinash Chander, Technical Director, and Dr. Rashmi Goel, Secretary, Research Committee, for giving this Technical Guide its final shape and form.

I truly believe and trust that this Technical Guide will go a long way in establishing sound accounting and reporting system in the MFI sector and would be of immense utility to the members and others concerned.

New Delhi
July 14,2008

CA. Harinderjit Singh
Chairman
Research Committee

Contents

1
Introduction

1.1 Everyone needs finance. The poor too need and use financial services all the time. They save and borrow to take advantage of business opportunities, invest in home repairs and improvements and meet various seasonal expenses. However, the poor lack access to regular, cheap and effective means of credit. Most of the formal traditional banks are not designed to lend to those who do not already have financial assets, but to those who do. The world’s poorest people do not have a collateral to receive loans. The traditional banks are not generally interested in issuing small and frequent loans as required by the poor since the transaction costs are high leaving the poor with no other option but to borrow from informal ways which often have serious limitations in terms of cost, risk and convenience. Moneylenders, for instance, frequently charge usurious interest rates on loans to the poor, cheating them of their hard earned savings and throwing them in a vicious cycle of poverty. Buying goods on credit is far more expensive than paying in cash. Local rotating savings and credit circles take deposits and give loans only at rigid time intervals and in strict amounts, and often result in the loss of members’ money.

1.2 To offer financial services to the poor, microfinance or ‘banking for the poor’ as it is often called emerged in the 1970s that disapproved all conventional thinking. Social innovators believed that the poor are not unbankable as previously considered. Many poor people have skills that can quickly become an income producing activity. Once given an opportunity they can use financial services and support from local enterprises called microfinance institutions to start or expand microbusiness and transform their own lives. In fact, the microfinance clients have proved to be excellent creditors with a high repayment rate ranging from 95 to 98 percent.

1.3 The pioneering efforts in the direction of microfinance have been made by Professor Muhammad Yunus, the Nobel Peace Laureate for the year 2006, who founded the Grameen Bank in Bangladesh to give very small loans to women who organised themselves into small groups to help, reinforce and supervise one another. The success of the Grameen Bank has been followed by its business model being replicated by numerous microfinance institutions throughout the world, spanning Latin America, Africa, the Middle East and Asia.

MICROFINANCE: DEFINITIONS, SCOPE AND FEATURES

1.4 Microfinance involves providing financial services of small amounts of money to the impoverished, especially to the women. It is a term of recent origin that has gradually replaced the term 'microcredit' which involved providing (very) small loans to low-income people and the enterprises owned by them. Microcredit refers to 'credit only', whereas microfinance refers to 'credit plus'. Microfinance comprises microcredit as well as savings products, pensions, money transfer services, housing loans, insurance, emergency and other private loans, etc., to the poor. The term 'microfinance' is reflective of at least two elements which were not captured by the earlier debates and concerns on the subject of rural credit. These are: (i) an emphasis on savings and other financial services apart from loans; and (ii) professionalism of the management of small loans and savings programmes as part of a perceived need for sound accounting, financial portfolio management and decision-making for a microfinance institution.

1.5 The Task Force set up by the National Bank for Agriculture and Rural Development (NABARD) has suggested the working definition of microfinance as **"Provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi-urban and/or urban areas for enabling them**

to raise their income levels and improve living standards." The emphasis of support under microfinance is on the poor in 'pre-micro-enterprise' stage for building up their capacities to handle larger resources. No specific limit for 'small' amount of financial services is envisaged. However, the Reserve Bank of India's Microcredit Special Cell has proposed a ceiling of Rs. 25,000 on microfinance as constituting the limit per borrower outstanding at any time. It suggests that the ceiling may be suitably hiked to, say, Rs. 40,000 in case of graduated borrowers after a successful track record of two-three years.

1.6 Microfinance operations usually involve:

- Making small and flexible loans according to clients' requirements, repayment capacities and cash flows;
- Providing secure deposit facilities to the poor, thereby allowing them to save as and when they have surpluses;
- Including collateral substitutes, such as group guarantees and compulsory savings;
- Encouraging repeat and larger loans based on repayment performance; and
- Continuous monitoring and following up to ensure timely repayment of loans.

1.7 A microfinance institution (MFI) is an enterprise that offers financial services to persons at the bottom of the economic pyramid, i.e., the poor. They exist in many forms, i.e., not-for-profit organisations, mutual benefit MFIs and for-profit MFIs. The lending activities of microfinance institutions are characterised by physical collateral-free loans of small amounts delivered to the clients at their doorstep. The world over, initiatives by MFIs have enabled the poor to gain greater access to financial services, particularly credit thereby diversifying their livelihood and contributing to raising their incomes. It has also allowed the poor to accumulate assets and has contributed towards their security. In India too, microfinance has had a very significant impact.

1.8 There are certain factors that characterise microfinance and knowledge of the same facilitates a better understanding of the intricacies of microfinance. These include:

- **Serve the poorest section of society**, especially women who have the least means and access to credit. The very poor who are not covered by the traditional banking system qualify for microfinance services. The purpose is to achieve the social objective of enabling the poor to become economically self-reliant and independent.

- **Focus on micro**, wherein, financial services of very small amounts at regular intervals are provided.

- **Social collaterals**, such as peer pressure replace the physical collateral. Borrowing is generally group based wherein if a borrower defaults, the entire group is typically penalised and sometimes barred altogether from taking further loans. This peer pressure encourages borrowers to be selective about their peer group members and to repay loans in full and on time, resulting in higher than 95 percent repayment rates industry-wide.

- **Client friendly delivery system**, wherein, the MFIs usually go to their clients to provide loans, other services and receive payments, rather than requiring their clients to come to them. In addition, MFI staff members share vital information and resources to improve their clients' overall well being.

- **Broader than microcredit**, i.e., microfinance represents something more than microcredit. It is not limited only to loans, but is based on a whole gamut of financial services such as savings, insurance, housing loans and remittance transfers. Microfinance is often accompanied by non-financial and other business services like capacity building, forward and backward linkages, etc., provided mainly for enhancing the productivity of credit.

- **Recycling of loans**, wherein, loans with cycles being usually shorter than that of traditional commercial loans-typically six months to a year with payments plus interest, due weekly/monthly are recycled as another loan when repaid. Shorter loan cycles and weekly/monthly payments help the borrowers stay current and not become overwhelmed by large payments.

- **High rate of interest**, i.e., higher than that charged by traditional banks to cover the cost of providing very small, frequent and collateral-free risky credit to the very poor in far flung areas. It also covers the cost of managing group meetings and providing information on social services, personal development, health and other critical information that helps clients improve their lives and the future of their families. However, the interest rate is still significantly lower than what many borrowers used to pay previously to local moneylenders.

- **Large number of transactions in cash**-this is another peculiar characteristic of MFIs which needs special mention. Many MFIs operate using group lending methodologies such as self-help groups, i.e., SHGs (see chapter 2) which essentially comprise people who are economically disadvantaged. The meetings of these groups take place on a periodic basis such as weekly/monthly, etc. The administrative personnel of MFIs attend all the meetings and arrange for disbursement and recoveries of loans which generally takes place in cash (and not by cheques). In this respect, it may be highlighted that since the transactions are in cash and in large volume, it is quite essential that the internal control systems and MIS (Management Information System) reporting of such MFIs are properly designed and followed up. Some of the MFIs have designed the system with a proper support of both hardware and software at even the most basic level in villages. If a high level of infrastructure, both in terms of hardware and software are not provided, then it would become extremely difficult to ensure a proper accounting of the transactions.

MICROFINANCE SECTOR IN INDIA

1.9 While technology and finance hold the key to ameliorate poverty, the poor in India do not have adequate access to the formal banking sector. The credit requirement of the poor in India has been estimated by the World Bank to be around Rs. 50,000 crore per annum in 2002[1]. This translates in a large demand for microfinance services in India.

1.10 Post 1969, with the nationalisation of banks, India entered into a phase of social banking, where the expansion of branches to rural areas was guided and encouraged by the government. The government not only regulated branch expansion, but also put in place a system of compulsory lending to the priority and weaker sections of the society. So the financial services sector in this phase (i.e., the period prior to 1991) was highly regulated by the state, as a result of which the role played by market incentives was severely circumscribed. It is only after the liberalisation policies initiated after 1991 that we are experiencing a comeback of market incentives in guiding the business strategy for banks. Government now achieves its social goals (towards reducing poverty) by use of stipulated priority sector lending and various schemes run by government with the help of banks, like Integrated Rural Development Programme (now SGSY[2]), differential interest rate schemes, credit to agriculture, kisan credit cards, etc.

1.11 The formal banking sector in India has one of the largest branch networks in the world with close to 50,000 commercial

---

[1] Data is as per Report of the Steering Committee on Microfinance and Poverty Alleviation, the Eleventh Five Year Plan.

[2] *Swarnajayanti Gram Swarozgar Yojana.*

bank outlets, 14,420 Regional Rural Bank outlets and 90,000 primary agricultural cooperative societies. Yet, the All India Debt and Investment Survey 2003 shows that though the overall share of institutional credit to rural households has gone up steadily, households in the lower asset groups were more dependent on non-institutional credit. RBI data shows that the number of small borrower accounts (of up to Rs. 25,000) in the banking system has fallen from 5.6 million in March 1994 to about 5.0 million in March 1997.

1.12 It was in the early 1990s that for the first time self-help groups (SHGs) started emerging in the country, mostly as a result of not-for-profit organisation/non-governmental organisation (NPO/NGO) initiatives. MYRADA[3] was one of the pioneers of the concept of SHGs in India. These SHGs were large enough for the banks to have transactions with, and were also very responsive and flexible to the needs of their members. While MYRADA did not directly intervene in the credit market for the poor, it facilitated 'banking with micro institutions established and controlled by the poor'.

1.13 The early nineties also witnessed the rise of several microfinance institution initiatives as some prominent MFIs such as SHARE were conceived during this period.

1.14 In 1992, the SHG-bank linkage programme was formally launched by NABARD, which circulated guidelines to banks for financing SHGs under a pilot project, aimed at financing SHGs across the country through the banking system. The good repayment rate gave the bank the confidence to continue financing SHGs in the coming years. This encouraged the Reserve Bank of India to include financing to SHGs as a mainstream activity of banks under their priority sector lending in 1996. The Government of India bestowed national priority to the programme through its

---

[3] MYRADA, originally an acronym for Mysore Resettlement and Development Agency, is an NPO providing technical assistance and funding in southern India.

recognition of microfinance, and mentioned it in the Union Budget of 1999.

1.15 Since then the SHG-bank linkage programme has become an innovative strategy for mainstreaming rural banking. By end of March 2007, the SHG-bank linkage programme has covered over 40.95 million households who have cumulatively availed bank loans of Rs. 83,071.66 million.

1.16 Concurrently, in 1993, the Rashtriya Mahila Kosh[4] was established to accelerate the flow of credit to self-employed women in the unorganised sector. It is worth mentioning here that the SEWA Cooperative Bank, operating in Gujarat with similar objectives since 1974, is arguably the first microfinance programme in India. The Bank has been viable right from its inception and is an ideal example of a community-owned sustainable financial service delivery vehicle.

1.17 Microfinance received greater recognition in 1998 when SIDBI[5] set up the 'Foundation for Microcredit' with an initial capital of Rs. 100 crore. Earlier, the passing of the Mutually Aided Cooperative Societies Act (MACS Act) by Andhra Pradesh in 1995, followed by some other states, also acted as a stimulant and many new microfinance initiatives came up under the MACS Act. In addition to the success of the SHG-bank linkage programme, alternative microfinance initiatives following Grameen and/or SHG methodology or at times individual lending models have also become successful.

1.18 During 2005-06, Government of India decided to re-designate the existing Microfinance Development Fund (MFDF) as **Microfinance Development and Equity Fund (MFDEF).** It also decided to enhance the fund size from the existing amount of Rs.

---

[4] Also known as The National Credit Fund for Women, the Rashtriya Mahila Kosh (RMK) was set up in March 1993 as an independent registered society by the Department of Women & Child Development in Government of India's Ministry of Human Resource Development with an initial corpus of Rs. 31 crore.

[5] Small Industries Development Bank of India.

100 crore to Rs. 200 crore. It was decided that the Reserve Bank of India, NABARD and the commercial banks would contribute the additional amount of Rs. 100 crore in the same proportion as earlier (40:40:20). The objective of the re-designated fund is to facilitate and support the orderly growth of the microfinance sector through diverse modalities for enlarging the flow of financial services to the poor particularly for women and vulnerable sections of society consistent with sustainability. Some of the other major and relatively recent developments in the microfinance sector are as below:

(a) *External Commercial Borrowing (ECB).* In wake of expanding business and a greater need for funds, not-for-profit organisations (NPOs) engaged in microfinance activities have been allowed by the Reserve Bank of India to raise ECB upto USD 5 million during a financial year.

(b) *Social Venture Capital Funds.* Not only are the new private sector banks and the foreign banks competing with each other to fund microfinance institutions (MFIs), but also now MFIs may even have access to equity social venture capital funds, which had been surveying and accessing the Indian market till recently, and have now started investing.

(c) *Partnership Model*. Due to an MFI's access to rural clients, the partnership model emerged where the MFI acts as a service agent on behalf of a bank. The partnership model was initiated by ICICI bank. In this model the loan portfolio of the bank is handled by the MFI for the bank but the same is represented in the balance sheet of the bank. In this manner, the bank retains control over the assets, i.e., the loan portfolio and the MFI receives fees/ commission for rendering the services. However, this model is slowly being discontinued.

(d) *Banking Facilitator and Banking Correspondent Model.* In order to enable banks to achieve greater outreach of their financial services to the poor, the Reserve Bank of

India, in January 2006 announced the Banking Facilitator and Banking Correspondent model. Under these models, banks are allowed to appoint MFIs as agents. MFIs appointed as Business Facilitators (BFs) provide non-financial services, such as, identification of borrowers, processing and submission of applications to banks, etc. On the other hand, MFIs acting as Business Correspondents (BCs) provide financial services as ‘pass through’ agents for disbursal of small value credit, recovery of principal/collection of interest or sale of micro insurance/mutual fund products, etc. The loan amount, however, remains in the books of the bank. The banks need not obtain prior permission of RBI for appointing BCs and BFs, however they are required to conduct thorough due diligence before appointing BFs/BCs, and as principals, are responsible for customer service and control operations.

(e) *Micro Financial Sector (Development and Regulation) Bill, 2007.* Seeing the growth in the microfinance sector, in order to create environment friendly policy for microfinance services in the country, the microfinance bill was introduced in the Lok Sabha on March 20, 2007. The bill is intended to provide a formal statutory framework for the promotion, development and regulation of the microfinance sector. Some of the salient features of this bill are as follows:

- Entrusts the function of development and regulation of the microfinance sector to the National Bank of Agriculture and Rural Development (National Bank)

- Defines various entities engaged in the activity of microfinance

- Defines various categories of beneficiaries of microfinance services such as eligible clients including self-help groups (SHGs)

- Provides for acceptance of thrift, i.e., savings by microfinance organisations registered by the National Bank subject to such terms and conditions as may be prescribed

- Provides for registration of microfinance organisations that undertake thrift

- Provides for functions and powers of the National Bank in relation to thrift services and other microfinance services

SCOPE AND OBJECTIVE OF THE TECHNICAL GUIDE

SCOPE

1.19 This Technical Guide covers all institutions that provide microfinance including federations of SHGs, mutual benefit institutions such as co-operatives, etc. Therefore, the Technical Guide applies to institutions that are exclusively providing microfinance services and institutions that are engaged in microfinance along with other activities (hereinafter referred as 'multi-service MFIs'). In case of multi-service MFIs, this Technical Guide provides guidance primarily for the microfinance activities provided by them.

OBJECTIVE

1.20 It is essential for enterprises engaged in microfinance to adhere to sound accounting and reporting standards. International donor agencies, not to mention various commercial banks and capital markets, are increasingly demanding a high standard of accounting and reporting from microfinance institutions that they support. Relevant accounting and other data provided by the financial statements are also essential if institutions are to monitor their own performance properly, both in terms of their financial sustainability and their success in reaching the poor.

1.21 With respect to the above, the objective of this Technical Guide is to recommend a standardised framework for the preparation and presentation of financial statements of MFIs, so that they are able to meet the common information needs of various stakeholders. In this regard, an attempt has been made to examine the feasibility of:

(a) applying the accrual system of accounting to MFIs;

(b) applying the Accounting Standards formulated by the Institute of Chartered Accountants of India to MFIs;

(c) developing formats of financial statements for MFIs; and

(d) recommending the disclosures of relevant non-financial information by MFIs.

1.22 In addition to the above, recommendations have been made, where required, on the basis of existing best practices amongst MFIs.

2
Operational Aspects

TYPICAL FEATURES OF MFIs

ORGANISATIONAL OBJECTIVES

2.1 Microfinance institutions envision a society that supports a sustainable and vibrant financial and development environment where every poor has the ability to access financial services at competitive terms as well as skills and linkages in order to maximise his/her livelihood opportunities.

2.2 Microfinance institutions, irrespective of their legal forms and operating models have the common mission – make the poor economically self-reliant. Microfinance as a sector aims primarily to reduce poverty through increases in income; allowing the poor to build assets and helping them reduce their vulnerability against external shocks.

2.3 MFIs aim to achieve their mission through the provision of different financial services – credit, savings, insurance, remittances, and non-financial services – marketing linkage, technical support services, etc. MFIs concentrate on microfinance activities and try to adopt products, procedures and policies which enable them to provide these services in a sustainable manner.

2.4 These institutions use microfinance services as a sustainable tool in alleviating poverty and to facilitate livelihoods for the poor. MFIs have successfully mobilised the poor into self-help groups (SHGs) and other forms of groups, made credit accessible, changed the image of the poor of being non-bankable and helped them to mobilise their own savings. In times to come, MFIs are expected to increase their level of impact, diversify their services and products and improve their performance.

DIVERSITY

2.5 Diversity in microfinance institutions exists in terms of their legal forms, operating methodologies, institutional objectives, and the banks' funding they receive. Some enterprises exclusively concentrate on microfinance services as a development intervention while some provide microfinance services as a component of their package of development programs. There are enterprises that operate on a for-profit basis while many others operate with a motive of not-for-profit.

2.6 **Diversity in operating methodologies/delivery models:** In recent years, MFIs have emerged as promising institutions to meet the consumption and micro enterprise demands of the poor. However, in India, the demand characterised by diverse needs of low-income households, the varied nature of local economies and the geographical diversities have led to the emergence of multiple operating models in microfinance. India hosts a wide range of microfinance delivery models. These models range from the indigenous SHG model to the adapted Grameen methodology. These models are explained below:

- **Self-Help Group model (SHG):** The SHG model is the dominant microfinance operating methodology in India. SHGs are small (membership of 10 to 20 persons) informal groups that have socially and economically homogenous membership of poor people drawn from the same hamlet or nearby hamlets. Often the composition is exclusively male or female. The members are self-selected, with the liberty to choose their group depending on their level of affinity with the other potential members. The groups meet regularly, mostly weekly, at an appointed time and place and carry out its financial transactions of savings and credit. The group mobilises savings among its members (only) and makes need-based loans to members (only) out of the pool of funds created.

It may be mentioned that owing to their small size, SHGs are somewhat limited in the financial services that they can provide to the members of the group. This limitation is overcome by Federations of self-help groups which bring together several SHGs. Federations, when registered usually come under the Societies Registration Act, 1860, and each federation has between 1000 to 3000 members. Among other things, Federations enable SHGs to access and manage external funds, help in promotion of newer SHGs and also the strengthening of existing groups through capacity building inputs, facilitate inter-group exchange (both financial and non-financial), and assisting SHGs in loan recovery. Paucity of funds and idle money which have been the problems in SHGs models have been spontaneously solved by Federations, which have helped to (a) productively channelise the idle money of SHGs, where demand for loans is much lower than their available money supply and (b) enable SHGs where natural demand for loans is greater than the available credit, to access more funds.

- **Grameen model:** This model as the name suggests was initially promoted by the well-known Grameen Bank of Bangladesh. Grameen MFIs undertake individual lending but all borrowers are required to form five member groups or joint liability groups (JLGs). The groups, in turn, get together with six to nine other neighbouring groups to form a center. Each borrower's credit-worthiness is determined by the overall credit worthiness of the group. Loans are given to individual members upon the recommendations of the group. This feature distinguishes it from the SHG model in which the loan is given to the group, which on-lends to members. Generally, savings are a compulsory component of the loan repayment schedule but do not determine the magnitude or timing of the loan.

- **Hybrid model:** Some MFIs display the characteristics of both the Grameen and the SHG model. There are some MFIs that follow both the Grameen and the SHG model catering to individual market segments, while a few MFIs follow individual banking methodologies, in addition to group-based methods to provide financial services. These MFIs use diverse methodologies according to the peculiarity of the market segment. Some MFIs registered as section 25 companies offer both individual and group loans.

- **Joint Liability Group (JLG):** The JLG model is an individual lending model with co-guarantees from similarly placed other individuals. The composition of a JLG is usually of five individuals as co-guarantors to each other's loans.

- **Individual Banking model:** This model involves the provision of financial services by MFIs to individual clients.

2.7 **Diversity in terms of banks' funding to microfinance:** SHG-bank linkage is the largest microfinance program in India where the banks lend to a SHG that further on-lends to its members. In the last few years, direct finance by MFIs has grown at a very fast rate where MFIs borrow from wholesalers (commercial banks) and retail to the poor borrowers.

2.8 **Diversity in legal forms:** Since microfinance was taken up mainly as a development initiative rather than as a commercial activity, the not-for-profit organisations (NPOs) that were registered either as societies, trusts or section 25 companies, did not think of looking at alternative institutional forms for providing these services. As the scale of operations of microfinance activities started growing and, along with that, the desirability of undertaking such activity on a for-profit basis started coming into focus, the larger institutions started to feel the need for a transformation in their legal structure. As a result, MFIs in India can now be found in the form of Non-Banking Financial Companies (NBFCs) as well. The different legal forms of microfinance institutions in India are covered in later paragraphs.

FUNDING OF MFIs

IMPORTANCE OF LONG-TERM SUSTAINABILITY

2.9 The need for microfinance is overwhelming and the positives of its impact are undeniable. The macro-economic conditions, such as an inflation economy with stable interest rates, favour the growth and scaling up of sustainable microfinance. MFIs such as SHARE have not only made an impact on the lives of the poor but they have also made profits, proving that sustainable microfinance achieves excellent social results.

2.10 Given the vast unmet demand for microfinance services, institutional level sustainability becomes very important. Sustainable organisations have a structure and a set of incentives that let them operate on a sustainable basis. Sustainable organisations are permanent because their operations are repeatable. They can meet their current obligations without shrinking in real terms. A *self-sustainable* institution is sustainable without outside help. However, sustainable is not the same as subsidy independent. If subsidy independence implied sustainability, then no private firm would go bankrupt. In terms of microfinance business, sustainable MFIs would imply MFIs that help the poor without hurting their own ability to serve the poor in the future.

2.11 Funding and long-term financial sustainability are the important challenges that the microfinance sector faces. An MFI's funding sources can be broadly divided into two categories:

- Internal income generation, and
- External funding sources.

2.12 The above categorisation of funding sources implies that an MFI can finance atleast a part of its activities and programmes, as also its growth, from internally generated resources. With regard to funding, the reality is that external funding can never be fully sustainable, as in the recent times, the long-term donor funding to the microfinance sector has shrunk and, therefore, MFIs must address the twin issues of local resource mobilisation and long-term financial sustainability.

INTERNAL INCOME GENERATION

2.13 Efficient use of funds, effective use of human resources, management of portfolio quality, etc., decide the generation of income from microfinance operations. Since microfinance institutions, in principle, should become self-reliant as far as the financial income and expenditure is concerned, effective yield on portfolio and return on assets are important.

2.14 Internal income generation has a relation with the operational self-sufficiency of an institution. Operational self-sufficiency measures the ability of an MFI to meet all its operational and financial costs out of its income from operations. Since the donor funding to the MFIs is drying, the MFIs need to rely more on its internal revenue generation to fund their operations and growth and thus become more self-reliant. But still there are many enterprises in India which receive substantial amount of grants from local and foreign donors especially for their other development programs. In such a situation there is a tendency on the part of the enterprises to subsidise their microfinance program. The calculation of actual program viability of such an enterprise requires attention as far as the accounting treatment of the donor funds and cross subsidisation is concerned.

2.15 An MFI can generate internal financial resources in the following ways:

- *Income from loan portfolio*: It is the income that an MFI derives from its lending operations. This includes interest and fee income. Interest income can be further divided into interest on current (regular), past-due and restructured loans outstanding. Apart from the provision of loans, MFI also render other financial services such as remittances, insurance etc., and earns income in respect of the same.

- *Investment income*: The second income for an MFI is from its prudent investments. Investments are usually excess (idle) cash invested by the MFI into fixed deposits, savings bank accounts, marketable securities, etc.

2.16 It may be noted that in case of a multi-service MFI, apart from income from the microfinance operations, income is also generated from other activities undertaken by such an MFI. For instance, income may arise from services such as health, literacy training, etc., provided by such an MFI.

EXTERNAL FUNDING SOURCES

2.17 There are a number of ways in which an MFI can generate funds from external sources. They are described below:

- *Promoter's contribution*: For any legal form, MFI can accumulate fund as promoter's contribution. This could be either as a donation for not-for-profit entities or as share capital for profit earning.

- *Equity/Share Capital*: Equity capital is an investment instrument primarily for earning return on a regular basis. In the recent times, private equity has started flowing into the microfinance sector, i.e., venture capitalists and other investment agencies are seen to invest in large MFIs which work on a profit model and have strong fundamentals. Most of private equity investors who have invested in microfinance institutions have unique features like long term investment, achieving high social returns, improving the loan portfolio size of MFIs so as to enable them to reach more unbankable clients on a continuing basis. Some examples of the private equity investments in Indian microfinance are Karnataka based Grameen Koota which has received investment from Aavishkaar Goodwell and SHARE Microfin Ltd. which has received investment from Legatum and Aavishkaar Goodwell.

- *Commercial Debt*: As a whole, 78% of the total microfinance loan portfolio in India is financed from commercial borrowings. These borrowings come from commercial banks, development banks and other local and foreign funding agencies for the purpose of on-lending to clients.

- *Retained earnings from program operation*: By way of provision in the profit and loss statement (or income and expenditure account) some MFIs retain part of their earnings and accumulate them in the balance sheet as retained earnings.

- *Grants from international and national donor agencies*: These are either as a revolving grant or as a grant for operational deficit, or could be grants for program support.

- *Grants from government*: Government integrates different development programs with microfinance and by way of grants the microfinance institutions are supported. Though this is not significant in terms of volume, it has contributed to many MFIs to move forward.

- *Promotion funds/subsidised funds from SIDBI and NABARD*: SIDBI provides both grants and revolving funds to on-lend to the ultimate clients. It also provides transformation loan to MFIs, which is convertible to equity. NABARD, for linking SHGs to banks provides promotional grant to Self Help Promotion Institutions (SHPIs). NABARD also supports with revolving fund directly to the microfinance institutions.

- *Corporate Donors:* With the corporate world increasingly identifying with social causes, MFIs especially those in the not-for-profit sector receive contributions from corporates by way of donations in cash or kind, etc. A spin-off advantage available to corporates is the income-tax benefits they get in respect of contributions made to NPO-MFIs, which have exemption certificates under the applicable sections of the Income-tax Act, 1961.

IMPORTANCE OF AN APPROPRIATE FINANCIAL MIX

2.18 It is clear that the twin channels of SHG-bank linkages and MFIs are serving only a fraction of the total demand. The SHG-bank linkage channel has been the dominant channel in the past; however, the MFI channel has become increasingly significant in the last few years and currently accounts for at least 20% of the total outstanding microfinance loan portfolio. The increase in the loan portfolio of MFIs would imply that the increase in their outstanding liabilities on account of on-lending debts matches the increase in their loan portfolio. In order to compensate this erosion in net-worth and still maintain capital adequacies at comfortable levels, MFIs taken as a whole would require external equity support. This supply side analysis reveals that short-term on-lending funds needed by the sector could be easily met by the banking sector. Guarantee funds may find an emerging niche to assist the growth of upcoming MFIs.

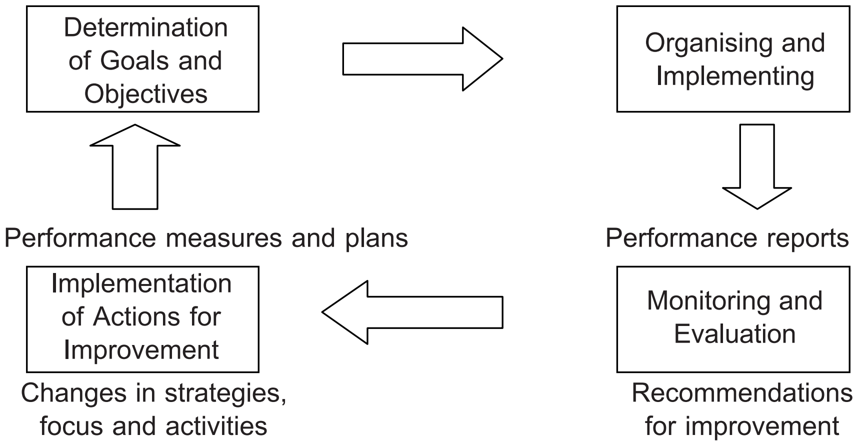
2.19 The long-term capital needs of MFIs are likely to be met by equity or securities with equity like features, such as preferred equity or subordinated loans. While the government has made provisions for equity capital through the Union Budget of 2005, and some private equity funds have also emerged in the horizon; it appears that more policy incentives need to be created for attracting equity capital into the sector. Long-term capital needs could be met only by creating special purpose vehicles, as except some minor provisions by leading banks, no specific provision exists for long-term capital.

2.20 Despite the various sources to fulfill the short-term and long-term capital needs of an MFI, over-reliance on any one or even two sources could be dangerous and could lead to a financial crunch or even jeopardise its long-term sustainability. Thus, ideally an MFI should develop a long-term financial sustainability strategy and identify an appropriate financing mix, with a balanced focus on about four to five funding sources. The factors to be considered while working out an appropriate mix could include cost of raising funds and the MFI's inherent strength in procuring funds from specified sources. Once an appropriate financing mix has been decided, the MFI should work on developing its competencies in procuring funds as per the identified financing sources.

MANAGEMENT FUNCTIONS IN MFIs

2.21 The management function in an MFI is not different from that in other commercial entities. The management function primarily denotes staff responsibilities. An MFI's staff is responsible for supporting the process of developing strategy by providing information about the ground realities and the spectrum of options that are available. They are also responsible for implementing the strategy, once approved by the governing board, as also responsible for translating the board decisions into action and for administering the systems and procedures needed to get results. They help ensure that the mechanics of the governance process run smoothly. Leadership is the connecting thread that binds all this together.

22.22 The whole management function comprises planning, organising, implementing and control function as depicted in the following diagram:



The planning function provides the framework for establishing the overall purpose or the mission of the MFI. It includes developing goals and objectives, strategies for their achievement and allocation of resources to carry out those strategies.

The organising function provides structure, delineates the roles and responsibilities as also authority and accountability for accomplishing the work.

The implementation function provides mechanisms and produces the work effort.

The control function comprising monitoring and evaluation, provides the framework for measuring results, performance and evaluating and correcting implementation performance.

PERFORMANCE MEASUREMENT IN MFIs

2.23 Performance measurement of MFIs is extremely important to gauge the extent to which they are achieving their objectives and also for defining their future strategies. In the recent few years, microfinance has experienced a significant shift from being an "intervention" made up of short-term development programs to being a full-fledged "industry" composed of permanent institutions. This push, by donors, bankers and practitioners alike, towards organisational sustainability has led to professionalism of the sector, wherein microfinance institutions strive to apply commercial principles to their context and uniqueness of operations in order to become sustainable and self-sufficient.

2.24 Earlier impact and outreach (i.e., disbursing credit to large numbers of poor) used to be the main goals for a microfinance program, but now-a-days portfolio quality and institutional viability have also gained due importance as indicators of success. Microfinance is now being seen as an industry whose objective is to provide a wide range of financial services to poor households, the informal sector, micro-enterprises, and others with no or little access to the formal banking system. Consequently, wholesale bank/donor-funded projects are increasingly geared towards strengthening the foundation and infrastructure of the overall microfinance industry, in addition to the traditional provision of one-on-one technical assistance to the microfinance institutions itself.

2.25 As the sector is growing in diversity of operations and outreach, transparency is becoming more important. An initiative on MFI specific financial performance standards and reporting to accelerate the scope of transparency has been undertaken by Sa-Dhan, an Association of Community Development Financial Institutions.

2.26 The MFIs are also encouraged by Development Finance Institutions (DFIs) and commercial banks to increase the depth of disclosures as instruments to their partnership. Small Industries Development Bank of India (SIDBI), a DFI took an initiative to reach out to Chartered Accountants with accounting disclosure issues. Banks are providing impetus to MFIs in their partnership to enhance the depth of transparency.

LEGAL FRAMEWORK

2.27 There are three broad categories of the legal forms that an MFI can take:

- Not-for-profit microfinance institutions including:
    - Enterprises registered under Societies Registration Act, 1860, or similar State Acts;
    - Enterprises registered under Indian Trusts Act, 1882; and
    - Not-for-profit companies registered under section 25 of Companies Act, 1956.
- Mutual benefit microfinance institutions including:
    - Co-operative Societies (including MACS); and
    - Co-operative Banks.
- For-profit microfinance institutions including:
    - Non-Banking Financial Companies (NBFCs) registered under the Companies Act, 1956 and regulated by the Reserve Bank of India; and
    - Local Area Banks (LABs).

2.28 Of the 1,000+ MFIs in the country today, perhaps 400-500 continue to operate in the form of registered societies or trusts[1]. Another 300-400 MFIs in India operate as co-operatives either under the conventional state-level co-operative acts, the national level multi-state co-operative legislation or under the new state-level mutually aided co-operative acts (MACS Act)[2]. There are

[1] M-Cril's estimates for the number of MFIs. M-Cril is a microfinance rating agency.

[2] The actual number of primary thrift and credit co-operative societies in India is very high, close to one lakh, but a large proportion of these are defunct and mostly very small. The number of 300-400 here only estimates the number of co-operative institutions that are likely to have more than 100 members.

now many significant Mutually Aided Co-operative Thrift Societies (MACTS) in Andhra Pradesh, which, therefore, account for the bulk of the 300-400 number cited above.

2.29 More recently, a trend to register MFIs as companies has emerged. Some are registered as not-for-profit companies under section 25 of the Companies Act, 1956, at least partially to take advantage of the Reserve Bank of India's exemption from registration for such companies providing microfinance services. However, these are still relatively new in number.

2.30 Another form of registration that indicates a bolder, overtly commercial (and in the long term, institutionally more sustainable) approach to microfinance is the establishment of a for-profit company followed by registration with the RBI as an NBFC. A number of MFIs are considering this route and a few have either already transformed into NBFCs or are in the process of doing so. Some of the largest MFIs in the country now operate as for-profit NBFCs.

ENTERPRISES REGISTERED UNDER SOCIETIES REGISTRATION ACT, 1860

2.31 NPOs involved in microfinance activities are mostly registered under the Societies Registration Act, 1860. Since these enterprises were established as voluntary, not-for-profit organisations, their microfinance activities were also established under the same legal umbrella.

2.32 The Societies Registration Act, 1860, is an all-India Act but many states have, while applying the Act modified some of its clauses with certain additions. A few states have enacted their own Societies Registration Act, e.g., the Karnataka Societies Registration Act, 1960; the Andhra Pradesh Societies Registration (Validation) Act, 1959, etc. Hence, a society can be registered either under the Central Act or the respective State Act, wherever the State Act is applicable.

2.33 The Societies Registration Act, 1860 states, "a society can be formed for the promotion of literature, science or the fine arts or the diffusion of useful knowledge/political education or for charitable purposes". Various state governments have amended these purposes from time to time. However, *charitable activities* continue to form the core of the stated purpose of the Act in each of these cases. Considering the public nature of microfinance activities and the widely accepted notion of it working for the relief of poverty and for benefit to the community, microfinance activities are interpreted by most of civil society as being charitable for the purpose of this Act. Under this law, as pre-requisite, the registered society would, however, need to mention microfinance clearly as an activity it would be taking up as part of its 'charity' work – as one of the objectives in its Memorandum of Association.

ENTERPRISES REGISTERED UNDER INDIAN TRUSTS ACT, 1882

2.34 Some MFIs are registered under the Indian Trusts Act, 1882 either as public charitable trusts or as private, determinable trusts with specified beneficiaries/members.

2.35 In accordance with section 6 of the Indian Trusts Act, 1882, the essential constituents of a trust are:

- three parties – the author, trustees and beneficiary;
- declaration of a trust;
- certainty of the subject matter of a trust; and
- certainty of the objects of the trust.

2.36 According to section 3 of the Act, the person who reposes or declares confidence in another person, in some property for the benefits of the beneficiary, is called the 'author' or 'settlor' of the trust. The author is the creator of the trust; he gives birth to the trust. Under the section 7 of the Indian Trusts Act, 1882, a trust may be created by any person competent to contract. In the context of MFIs, the author of the trust is an individual with the intention of providing financial services to the poor. He arranges for funds from various sources and then deploys the funds to the trust for the sake of the beneficiaries.

2.37 Section 3 of the Act also defines a trustee as a person who, while holding legal ownership and/or possession of, or dominion over, the subject matter of the trust, is bound to allow the beneficial enjoyment of the property to be reaped by another, called the beneficiary. In the context of an MFI, the typical trustees consist of the board or the governing body of the institution that takes policy decisions on behalf of the board and, thereby, holds responsibility for the functioning of the trust.

NOT-FOR-PROFIT COMPANIES REGISTERED UNDER SECTION 25 OF COMPANIES ACT, 1956

2.38 An enterprise given a license under section 25 of the Companies Act, 1956, is allowed to be registered as a company with limited liability. It is also eligible for exemption from some of the provisions of the Companies Act, 1956. For companies that are already registered under the Companies Act, 1956, if the central government is satisfied that the objects of that company are restricted to the promotion of commerce, science, art, religion, charity or any other useful purpose; and the constitution of such company provides for the application of funds or other income in promoting these objects and prohibits payment of any dividend to its members, then it may allow such a company to register under section 25 of the Companies Act. There are no specific requirements as far as net owned fund (NOF) is concerned in case of a section 25 company. It could be a zero capital company with some specified guarantee by the promoters.

2.39 Further, the RBI issued a notification that sections 45-IA and 45-IC of the RBI Act, 1934, will not apply to companies registered under section 25 of the Companies Act. This exemption effectively means that section 25 companies can take up the activity of microfinance without the permission or registration with RBI given these are providing credit not exceeding Rs. 50,000 for a business enterprise and Rs. 1,25,000 for meeting the cost of a dwelling unit to any poor person for enabling him to raise his level of income and standard of living. Deposits, however, are not permitted without such registration with the RBI.

CO-OPERATIVE SOCIETIES (INCLUDING MUTUALLY AIDED CO-OPERATIVE SOCIETIES (MACS) UNDER MUTUALLY AIDED CO-OPERATIVE SOCIETIES ACT ENACTED BY STATE GOVERNMENT)

2.40 An enterprise undertaking microfinance for the mutual benefit of its members can be organised as a co-operative society. A co-operative society can be formed by registering under the Co-operative Societies Act of the respective state or under the Multi-State Co-operative Societies Act (MSCA), 2002 for societies having a multi-state presence.

2.41 In recent times, the shift has been towards a MACS form of co-operative society, the reason being the inability of the State Co-operative Acts to provide for an enabling framework for emergence of business enterprises owned, managed and controlled by the members for their own development. Therefore, several State Governments have enacted the Mutually Aided Co-operative Societies (MACS) Act for enabling promotion of self-reliant and vibrant co-operative societies based on thrift and self-help. MACS enjoy the advantages of operational freedom and virtually no interference from the government because of the provision in the Act that societies under the Act cannot accept share capital or loan from the State Government. Thus, many states have brought out the new Co-operative Acts providing more autonomy and making them free from government interference. Similarly, some states have brought amendments in their existing co-operatives societies acts with the aforesaid purposes. Such act was first enacted in the Andhra Pradesh and has functioned as a model for many states that have brought fresh legislations to effect changes in their state co-operative society acts. Some of the states have gone a step further and brought in reforms that have far reaching implications for the functioning of MFIs. Noted among these states are Orissa, Bihar, Madhya Pradesh and Karnataka. The Orissa Act allows the SHGs to become members of co-operative societies while the other state acts do not have this provision.

CO-OPERATIVE BANKS (BANKING REGULATION ACT AS APPLICABLE TO CO-OPERATIVES)

2.42 When we refer to MFIs under banking regulations we refer to the various forms of co-operative banks. They are State Co-operative Banks, District Central Co-operative Banks and Primary Co-operative Banks (Urban Co-operative Banks-UCBs). The State Co-operative Banks and Central Co-operative Banks form part of the three-tier rural co-operative credit structure promoted by the state governments and NABARD. The relevant category of co-operative banks suitable for MFIs is Primary Co-operative Banks (PCBs). A Primary Co-operative Bank is defined under Banking Regulation Act, 1949 as “a co-operative society other than a primary agricultural credit society:

a. the primary objective of or principal business of which is the transaction of banking business;

b. the paid up capital and reserves of which are not less than one lakh rupees; and

c. the bye-laws of which do not permit admission of any other co-operative society as a member.”

2.43 Urban Co-operative Banks or PCBs are registered under the Co-operative Societies Act of the respective governments. UCBs having a multi-state presence are registered under the Multi-State Co-operative Societies Act (MSCA) 2002. The RBI is the regulatory and supervisory authority of UCBs for their banking operations, while their managerial and administrative aspects remain under the respective state governments (for banks registered under the State Co-operative Societies Act), or the central government (for the banks registered under the MSCA 2002).

NON-BANKING FINANCIAL COMPANIES

2.44 NBFCs have played an important role in the Indian financial sector for a long time, fulfilling the gap in the demand and the supply of financial services, particularly from small clients. As per the section 45-I of the RBI Act, an NBFC is a company, which carries on any of the following activities, as its business or part of its business:

- Lending;
- Receiving of deposits (as the principal business);
- Acquisition of shares, stocks or other securities;
- Hire-purchase or leasing;
- Insurance;
- Chit funds; and
- Lotteries.

2.45 As per this definition, if a company undertakes microfinance, it automatically becomes an NBFC and all related regulations apply.

2.46 **Pre-requisite for carrying on business of an NBFC:** As per sub-section 1 of section 45-IA of the RBI Act, no NBFC can commence or carry on the business of a non-banking company without complying with the following two essential pre-requisites:

- Obtaining a certificate of registration from RBI; and
- Having Net Owned Funds (NOF): shareholder equity + internally generated reserves of Rs. 200 lakh.

2.47 These requirements are cumulative and not alternative. As such, if a for-profit company wants to carry out microfinance operations, it must comply with the above requirements. Though RBI prescribes a set of compliance norms (prudential and non-prudential) for all NBFCs, these are more rigorous (prudential) for NBFCs accepting public deposits. However, prudential norms are not applicable to the companies, which are not accepting public deposits.

2.48 The definition of public deposits given in the RBI Act, 1934 is exclusive rather than inclusive. Section 45-I (bb) of the Act defines 'deposits' in general terms to include any receipt of money by way of deposit or loan or in any other form. The Act then excludes the following items from the definition:

- Amounts raised by way of share capital;
- Amounts contributed as capital by partners of a firm;
- Amounts received from scheduled banks, co-operative banks or other notified financial institutions;
- Amounts received in the ordinary course of business, by way of, security deposits, dealership deposit, earnest money or advance against orders for goods, properties or services;
- Amounts received from registered moneylenders, provided that such moneylender is not a company; and
- Amounts received by way of subscription in respect of a chit.

2.49 Paragraph 2(1)(xii) of the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998[3],

[3] The directions on acceptance of public deposits by Non-Banking Financial Companies were issued by Reserve Bank of India on January 31, 1998, vide Notification No. DFC. 118 / DG (SPT)-98. The said Notification was duly updated as on June 30, 2007.

also excludes certain deposits from the definition of public deposits. These are amounts received

- from the Central Government or any State Government or under its guarantee, or received from a local authority or a foreign Government or any foreign citizen, authority or person;
- from institutions like IDBI, LIC, GIC, SIDBI, ICICI, IFCI, ADB, IFC or any other institutions specified by RBI;
- from one company to another company;
- as subscription to any shares, stocks, bonds or debentures;
- from a director/shareholder of a private company, or a private company which has become a public company under Section 43A of the Companies Act, 1956, subject to the director/shareholder furnishing a declaration to the effect that the amount has not been given out of borrowed funds or from the amounts accepted from others;
- by the issue of bonds/debentures secured by the mortgage of a immovable property or any other asset of the company or with the option to convert them into shares provided that the amount of such secured bonds/ debentures shall not exceed the market value of such immovable property/other assets;
- from the promoters by way of unsecured loan;
- from a Mutual Fund governed by the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996;
- as hybrid debt or subordinate debt the minimum maturity period of which is not less than sixty months;

- from a relative of a director of an NBFC; and

- by issuance of commercial paper, in accordance with the guidelines issued by the Bank, vide Circular No. IECD. 3/08.15.01/2000-2001 dated October 10, 2000.

Barring these exclusions, all receipts of an NBFC come under the category of public deposits.

LOCAL AREA BANKS (LABs)

2.50 The Local Area Banks are set up in the private sector, regulated by the RBI to bridge the gap in credit availability and strengthen the institutional framework in the rural and semi-urban areas to provide efficient and competitive financial intermediation in their area of operations. LABs are registered as a public limited company under the Companies Act, 1956 and licensed under the Banking Regulation Act, 1949. A Local Area Bank can be started with a minimum paid up capital of Rs. 5 crore with the area of operation restricted to a maximum of three geographically contiguous districts. Krishna Bhima Samruddhi, a Local Area Bank promoted by BASIX in Andhra Pradesh, is the only LAB which is into the business of microfinance on a large scale and has achieved operational efficiency in terms of profits and a high credit deposit ratio.

OWNERSHIP

2.51 The ownership issue of microfinance institutions is closely related to its legal form. Therefore, ownership of MFIs is as diverse as its legal form. It varies from not-for-profit society/trust with less defined ownership to promoters' equity based for-profit companies. There are also member-based entities like co-operatives to serve its members either on a for-profit basis or not-for-profit basis like section 25 companies.

2.52 Governance of MFIs registered as societies and trusts is mostly informal. Equity investment in such institutions is not possible due to lack of ownership and its not-for-profit nature. Such institutions depend on the donor funds as well as subsidised and commercial loans from banks and financial institutions.

2.53 On the other hand, entities like co-operative societies, co-operative banks, and companies registered under section 25 of the Companies Act and NBFCs do have owners. Hence, equity capital that becomes the financial under-pinning of their operations is possible. Owned funds organisations, therefore, consist of sum of shareholders' equity and surpluses from operations. It may be noted that such enterprises rarely have donor grants.

GOVERNANCE IN MFIs

2.54 Governance in an MFI, like in any other enterprise, is the responsibility of its governing body. Governance is a process by which the governing body, through the management, guides an enterprise in fulfilling its mission and protects the enterprise's assets. The issue of governance in MFIs becomes relevant as these institutions provide services, which though micro in nature are related to the poor. Thus, as MFIs expand their outreach and increase their assets, a clear articulation of the functions of their governing body is essential for effective governance.

2.55 Major responsibilities of the governing body can be grouped into the following four categories:

- The governing body has legal obligations that revolve around ensuring compliance with the institution's bye-laws, procedures, and other legal requirements. The governing body may be held liable for the institution's activities.

- The governing body must ensure management accountability by hiring competent professionals, establishing clear goals for these executives and closely monitoring their performances, and confronting weaknesses when they surface.

- The governing body is responsible for setting policy and providing strategic direction to the MFI. The governing body must work closely with the management in carrying out this role to ensure congruence between the institution's strategic thinking and its operations.

- The governing body must assess its own performance on a regular basis. It is the governing body's responsibility to maintain continuity in its ranks, to renew its membership with new members/directors, and to evaluate its own processes for decision making.

2.56 The governance structures of MFIs originate from the patterns of ownership, which are of three types – absence of owners (NPOs), member-users as owners (co-operatives) and investors as owners (companies). In India, the vast majority of MFIs are not-for-profit organisations (NPOs) registered as trusts (under Indian Trusts Act, 1882) or societies (under Societies Registration Act, 1860). As such an MFI does not have real owners, commitment to the institutional mission drives the Board of Trustees (the governing body in case of trusts and societies) to fulfill their duties responsibly. In case of both co-operatives and companies, the governance structure comprises elected members/shareholders represented by the Board of Directors.

DONOR REQUIREMENTS

2.57 As already mentioned donor funds are one of the sources of funding for the microfinance institutions. These donations could come from individuals, corporates, trusts, foundations and donor agencies. Many times, MFI receive donations or grants that are subject to specified restrictions on the way they are to be spent or applied. The restriction could be by way of specifying the program for which it is meant, the time frame within which it is to be spent, or methodology of applying the funds.

2.58 Donor requirements and, in case of multilateral grants, the donor country laws play a vital role in MFI funding, since the restrictions imposed on the funds place a major responsibility in terms of accounting for the same.

2.59 Donors may sometimes also specify requirements in terms of policies, procedures and systems to be followed for the application of funds granted. In today's changing scenario, donors are becoming more demanding and specify a number of requirements to ensure effective application of the donations made. Some of the key donor requirements which could govern the application of donor grants are mentioned below:

- Clear definition of goals and objectives.
- Clear definition of output and outcome indicators.
- Effective monitoring and evaluation systems.
- Effective human resource management systems.
- Equal opportunity policy (including gender issues).
- Sound financial management systems.
- Effective internal controls.
- Effective information and reporting systems.

MICROFINANCE OPERATION EXPENSES

2.60 The donor funds that are available to an MFI are not only limited but also restricting. Thus, the funds for on-lending to microfinance clients can be obtained either by obtaining wholesale loans from the formal sector or by building up their own surpluses. This is possible only if MFIs charge their clients not only the full cost of providing services but also a small additional amount that enables them to generate a surplus and build up their net worth. However, the costs incurred by MFIs tend to be high in comparison with typical financial intermediation costs of banks for significantly larger loans. The small loan size of MFIs spread over a large client base and doorstep delivery of credit leads to high transaction costs.

2.61 Microfinance institutions normally incur three types of costs while delivering financial services to clients:

- Operating costs are incurred by the MFIs in delivering credit to the clients including visits to the clients, completing paper work, disbursing loans and collecting repayments. This includes the cost of minimising risk through monitoring and follow-up of disbursed loans, exercising internal control and undertaking external audit of the MFIs.

- Risk costs are the cost of portfolio losses incurred in spite of undertaking every effort to minimise it. They are the provisioning expenses reserved to meet the possible losses. These represent non-cash operating expenses for an MFI.

- The third cost that MFIs incur is the cost of funds. This cost is incurred in borrowing or raising funds for on-lending to microfinance clients. Funds here mean the borrowed funds as well as the interest bearing savings, if any.

2.62 Operating costs actually translate into personnel costs and administrative costs. Personnel costs include staff salaries, bonus and benefits plus taxes borne by the MFIs. Personnel costs usually represent the largest operating expense for an MFI. Administrative costs include all the non-financial expenses directly related to provision of financial services by the MFIs including the costs of travel, staff training, depreciation, rent, utilities, advertisement and consulting fees. The cost of funds includes interest, fees and commissions on all liabilities.

TAXATION FOR MFIs

2.63 The Income-tax Act, 1961, is a central legislation which, *inter alia*, affects all MFIs in India. The following paragraphs discuss taxation for various categories of MFIs.

TAXATION IN CASE OF SOCIETIES AND TRUSTS

2.64 Microfinance institutions registered under the Societies Registration Act, 1860 and Indian Trusts Act, 1882 as societies and trusts respectively are subject to common rules of taxation under the Income-tax Act, 1961.

2.65 Section 11 of the Income-tax Act, exempts the income of charitable societies and trusts from the charge of tax on the fulfillment of certain conditions. Apart from this, sections 12, 12A, 12AA and 13 and certain clauses of section 10 of the Act also govern the issue of taxation of such enterprises.

2.66 Since the object of microfinance may be considered a charitable function, local assessing officers of the Income-tax Department often exempt the income from microfinance activities from income tax. However, MFIs need to apply to the income tax authorities to get this exemption. The wealth of these institutions however, is subjected to wealth tax of 1 per cent of the net value of the wealth with the basic exemption of Rs. 15 lakh.

2.67 For availing exemption under sections 11 and 12, a Society/ Trust engaged in microfinance is required to fulfill the following conditions:

- **Registration:** For registration under section 12A with the Commissioner of Income-tax, the Society or Trust should apply within one year from the date of creation of Society or Trust, in Form No. 10A (in duplicate) along with the memorandum of association or bye-laws of the Society in original or the document evidencing creation of the Trust, together with a copy thereof and two copies of the accounts of the Society/Trust relating to three previous years (or for the year during which the Society or Trust was in existence, in case of a new Society).

- **Compulsory Audit:** Where the total income of the Society/Trust exceeds Rs. 50,000 in any previous year, the accounts of such Society/Trust are required to be audited and the audit report which shall be in Form No. 10B is required to be furnished along with the return.

- **Application of income:** If the Society/Trust has applied the entire income or atleast a specified percentage of income for the year (presently 85 per cent) for charitable purposes (microfinance in case of MFIs), the whole of the income shall be exempt from tax.

TAXATION IN CASE OF SECTION 25 COMPANIES

2.68 Being an entity engaged in not-for-profit activites and not sharing its surplus amongst shareholders, section 25 companies are exempt from paying tax under section 12(1) of the Income-tax Act, 1961. This is a major benefit for section 25 companies. In order to avail this exemption, organisations need to apply to the Commissioner of Income-tax (as mentioned in paragraphs 2.66 and 2.67).

2.69 For the microfinance institutions falling in the not-for-profit category (i.e., societies, trusts, and section 25 companies) section 115BBC of the Income-tax Act, 1961 relating to anonymous donation is also applicable among other provisions of the Act. According to the Act, “anonymous donation” means any voluntary contribution referred to in sub-clause (iia) of clause (24) of section 2, where a person receiving such contribution does not maintain a record of the identity indicating the name and address of the person making such contribution and such other particulars as may be prescribed. The anonymous donation received by any enterprise for charitable purpose other than religious cause shall be included in the total income of the enterprise and taxed at the rate of 30 per cent.

TAXATION IN CASE OF CO-OPERATIVE SOCIETIES (INCLUDING MACS)

2.70 Co-operative societies, including MACS are subject to taxation on their annual surpluses as per the guidelines on the Income-tax Act.

TAXATION IN CASE OF CO-OPERATIVE BANKS

2.71 Co-operative Banks need to pay income tax as per the provisions of the Income-tax Act, 1961. Their income is subject to taxation and any surplus over the expenses, before the payment of dividend and provision to reserves is taxed as per the provisions laid down in the Income-tax Act.

TAXATION IN CASE OF NBFCs AND LABs

2.72 Non-Banking Financial Companies and Local Area Banks need to follow the norms of taxation as laid down in the Income-tax Act. They are subject to taxation on their surpluses as per the regulations.

ACCEPTANCE OF FOREIGN CONTRIBUTIONS

2.73 Acceptance of foreign contribution by MFIs is regulated by the Foreign Contribution (Regulation) Act, 1976 (FCRA) which is a federal/central piece of legislation that affects all persons and associations uniformly throughout India. This Act defines foreign contribution as donations, delivery or transfer made by any foreign source of any currency (whether Indian or foreign), articles or any foreign security. Thus, foreign contribution includes gifts in kind from a foreign source. Foreign contribution also includes contribution received from one or more persons/enterprises within India whose original source is foreign.

2.74 In order to access foreign contributions from international funding organisations or any other foreign source, MFIs need to make applications in Form FC-8 of FCRA to the Secretary, Ministry of Home Affairs, New Delhi. Once registered with the Ministry of Home Affairs, these enterprises have to agree to receive such foreign contribution only through one of the branches of a bank as it may specify in its application for registration. All such registered enterprises need to submit, within a period of four months from the closure of the financial year, intimation in Form FC-3 (as per the format prescribed in FCRA), in duplicate, to the Central Government as to the following:

a. amount of each foreign contribution received by it;

b. the source from which the contribution was received; and

c. the manner in which it was utilised.

2.75 Provided that where such association obtains any foreign contribution through any branch other than the branch of the bank through which it has agreed to receive foreign contribution or fails to give such intimation within the prescribed time or in the prescribed manner, or gives any intimation which is false, the Central Government may, by notification in the Official Gazette, direct that such association shall not, after the date of issue of such notification, accept any foreign contribution without the prior permission of the Government.

2.76 All associations receiving foreign contribution are required to maintain separate accounts for such foreign contributions. The accounts must be maintained on a financial year basis from the first day of April each year and every such yearly account must be furnished in duplicate, to Secretary, Government of India, Ministry of Home Affairs, New Delhi, duly certified by a chartered accountant. All these enterprises must also get their accounts audited by a chartered accountant. Associations registered under the Act should file a 'Nil' return in the year or years when there is no receipt of foreign contribution. The auditor must certify and issue the following reports:

a. intimation of foreign contribution in Form FC-3;

b. balance sheet as on March 31^{st} of that year; and

c. statement of receipts and payments account for the year ending March 31.

2.77 The auditor has also to review the records including Form FC-6 (the articles of accounts) as well as Form FC-7 (securities account) as well as certify the receipts and utilisation of foreign contributions in kind such as vehicles, medicines, equipment, etc.

DEPOSIT MOBILISATION

2.78 The RBI Act, 1934 does not allow unincorporated bodies to accept deposits from the public. Thus, societies registered under Societies Registration Act, 1860 and trusts registered under Indian Trusts Act, 1882, are barred by law to even collect savings from their clients. As far as section 25 companies carrying on microfinance are concerned, since they are exempt from the requirement of registration with the RBI, deposit taking is not permitted. Mutual benefit MFIs, i.e., co-operative banks and co-operative societies are allowed to accept deposits, thus, they can accept savings from their members. In case of NBFCs, only rated NBFC-MFIs rated by approved credit rating agencies are permitted to accept deposits. The quantum of deposits that could be raised is linked to their net owned funds.

3

Accounting and Financial Reporting Framework

3.1 This Chapter deals with the existing accounting practices followed by MFIs and the suggested accounting framework, particularly the application of Accounting Standards formulated by the Institute of Chartered Accountants of India.

EXISTING ACCOUNTING PRACTICES

EXISTENCE OF VARIED FORMS OF MFIs

3.2 The microfinance sector in India is characterised by a variety of legal forms ranging from trusts, co-operatives to non-banking financial companies, where the provisions of the relevant statute govern each legal form. Thus, the preparation and the presentation of financial statements of MFIs are essentially statute driven. It has been observed that where the preparation and presentation of financial statements is statute driven, the compliance is more as per the letter of the relevant law than the spirit.

3.3 Most MFIs take the not-for-profit form, which are registered as trusts/societies under the Indian Trusts Act, 1882, and the Societies Registration Act, 1860, respectively. Many MFIs also take the route of co-operative societies based on mutually beneficial goals. In all these types of microfinance enterprises, supervision and regulation from a financial angle remains negligible or is virtually non-existing. Only the submission of their annual accounts and a report of their operations in prescribed formats to authorities under the Acts of their registration are needed. There is no statutory compulsion to comply with specified norms or instructions in respect of their microfinance activities encompassing granting of loans, etc. Only Non-Banking Financial Companies (NBFCs), Local Area Banks (LABs) and co-operative banks are considered as regulated financial institutions, which are subject to RBI regulations in respect of various guidelines on prudential norms, accounting practices, reserve requirements, etc.

3.4 Hence, diversity in the legal forms of MFIs and the absence of a single regulatory body to govern the microfinance activities undertaken by the MFIs have led to accounting practices that range from just rudimentary methods to well-established GAAP[1] practices. There is adoption of different basis of accounting by MFIs. For instance, current practices reveal that basis of accounting other than accrual is followed by many MFIs. Not only are varied accounting practices being followed by MFIs, but also it is difficult to know the exact accounting practices being followed by most MFIs especially the small NPO-MFIs.

LACK OF AWARENESS ON APPLICABILITY OF ACCOUNTING STANDARDS

3.5 Many MFIs such as Mutually Aided Co-operative Societies (MACS), trusts and societies because of their scale of operations are generally unaware of the benefits of adopting sound accounting practices based on generally accepted accounting principles (GAAPs), promulgated, *inter alia*, as Accounting Standards, in accounting for various transactions. There is also a lack of awareness on applicability of Accounting Standards formulated by the Institute of Chartered Accountants of India.

INFLUENCE OF VARIOUS LAWS

3.6 The existing accounting practices, especially the disclosure requirements in the microfinance sector are generally driven by

[1] Generally Accepted Accounting Principles.

the requirements of multiple laws rather than with a view to reflect a true and fair view of the state of affairs and results of the activities carried on by an MFI during the year. The various laws include the Income-tax Act, 1961, Foreign Contribution (Regulation) Act, 1976, Companies Act, 1956, Non-Banking Financial Company Regulations, etc. For instance, financial reports of trusts and societies are essentially prepared with the objective of availing tax exemptions under the Income-tax Act, 1961. It may be noted that disclosures and presentation of financial statements by MFIs are sometimes driven by the donor requirements.

3.7 As a result of the above factors, the existing accounting practices in the microfinance sector are characterised by the following:

- There is no standard basis of accounting being followed by MFIs. Cash, hybrid accrual, modified cash/accrual basis of accounting are being followed.

- The Accounting Standards, formulated by the Institute of Chartered Accountants of India, are generally not applied by all legal forms of MFIs.

- There is lack of uniformity in presentation of financial statements.

- There are different disclosure practices being followed by MFIs by virtue of the statutes governing them.

- There is diversity in terminology and accounting policies being adopted by MFIs.

3.8 From the above, it may be noted that the Accounting Standards formulated by the Institute for accounting and financial reporting purposes, are not followed by all forms of MFIs. As a result, financial reporting by MFIs lacks uniformity in the presentation of financial statements and different accounting and disclosure policies have been followed by different MFIs for the same or similar transactions. Thus, information provided by the financial statements of one MFI is not comparable with that provided by the financial statements of the other. This has given rise to confusion and misunderstanding among the users of financial information provided by MFIs.

3.9 Keeping in view the above, a need has been felt for laying down/developing comprehensive accounting and financial reporting framework for MFIs. This Chapter of the Technical Guide, accordingly, makes certain recommendations about the preparation and presentation of financial statements by MFIs. It may be emphasised that the various aspects of financial reporting – the information to be reported, the measurement bases to be adopted, types of reports and the frequency of reporting – would need to be reviewed in the light of the experience gained during the course of implementation of the recommendations made in this Technical Guide.

FINANCIAL REPORTING OBJECTIVES

3.10 The microfinance sector requires enterprises dealing in microfinance to have maximum transparency of their operations. The reasons are two-fold. Firstly, MFIs receive donor funding and loans. Secondly, they serve the most vulnerable section of the economy, i.e., the poor. Thus, transparency in financial reporting by MFIs is warranted to put the various stakeholders in the microfinance sector at ease and also to be useful towards tapping resources from outside the system.

3.11 Thus, the primary objective of financial reporting by MFIs is to provide information about their financial position, performance and cash flows that is necessary for variety of users to make informed decisions. To meet this objective, it is important to identify such users and the purposes for which they require financial information.

3.12 Financial reporting is a broad term that includes general purpose financial statements as well as other types of financial reports. It should be recognised that while general purpose financial statements (hereinafter referred to as ‘financial statements’) are a principal means of information for most users, they may not (due to their very nature) provide all the information that some of the users may need. While developing a framework for financial reporting by MFIs, it would, therefore, be necessary to identify what information can best be communicated through financial statements and what information needs to be communicated through other financial reports.

3.13 It is generally believed that the financial statements that reflect a true and fair view of the state of affairs as reflected by the Balance Sheet, the results of the operations (activities) of the MFI as reflected by the Profit and Loss Account (Income and Expenditure Account) and the cash flow position as reflected by the Cash Flow Statement would normally meet the requirements of various users. Therefore, the suggested framework of financial statements dealt with in this Chapter has been designed to meet the aforesaid objective.

USERS OF FINANCIAL REPORTS AND THEIR INFORMATION NEEDS

3.14 Many users are interested in the information provided in the financial statements of MFIs. Among present and potential users are taxpayers, grantors, creditors, employees, managers, directors and trustees, service beneficiaries, financial analysts and advisors, economists, governments and their agencies (such as taxing authorities, regulatory authorities, and legislators), the financial press and reporting agencies, and general public. The following groups are especially interested in the information provided by the financial reporting of an MFI:

(a) *Resource providers:* Resource providers include those who are directly compensated for providing resources – creditors (banks/lending institutions) and employees – and those who are not directly and proportionately compensated – donors.

(b) *Beneficiaries:* Beneficiaries are those who use and benefit from the services rendered by the MFI. Beneficiaries essentially include the rural poor (hereinafter referred as 'clients') to whom an MFI provides financial services. They might also include other enterprises dealing in microfinance to which MFIs provide technical and consultancy services.

(c) *Governing Bodies:* Governing bodies are responsible for setting policies and for overseeing and appraising managers of MFIs. Governing bodies include boards of directors/trustees and other bodies with similar responsibilities. These bodies are also responsible for reviewing the enterprise's conformance with various laws, restrictions, guidelines, or other items of a similar nature.

(d) *Managers:* Managers of an enterprise are responsible for carrying out the policy mandates of governing bodies and managing the day-to-day operations of an enterprise. Managers could include certain elected officials; managing executives appointed by governing bodies, such as executive directors; and staff, such as fund-raising and programme directors.

3.15 Present and potential users of the information provided by financial reporting by a particular MFI share a common interest in information about the services provided by the MFI, its efficiency and effectiveness in providing the services, and its ability to continue to provide the services.

3.16 Resource providers, such as banks/lending institutions, may be interested in that information as a basis for assessing financial sustainability and loan portfolio of the MFI to ensure that funds loaned to MFIs are serviced on time. Donors and grantors use information to determine how well the MFI has met its objectives, how funds are used for the purpose for which they were given, and whether to continue support. Employees/staff view an MFI as a source of payment for the services they supply and thus their interest stems from concern about the MFI's ability to generate cash flows to compensate them for the services rendered. Governing bodies also use information about services rendered to help them evaluate whether managers have carried out their policy mandates and to change or formulate new policies of the MFI. This information is also important to managers in evaluating the accomplishment of the responsibilities for which they are accountable to governing bodies, resource providers, and others. Beneficiaries (mostly clients) of services, who as a group are distinct from resource providers, share a direct interest in similar information.

3.17 Some users have specialised needs but also have the power to obtain the information they need. For example, donors and grantors who restrict the use of resources provided by them often stipulate that they be apprised periodically of the MFI's compliance with the terms and conditions of the gift or grant. Creditors also may be able to stipulate that certain specialised types of information be provided. Similarly, the statute under which the MFI is registered or other legislations which govern and regulate it, like the Income-tax Act, 1961, and the Foreign Contribution (Regulation) Act, 1976, may prescribe the reports that need to be periodically filed under the provisions of the respective Acts. General purpose financial statements are not intended to meet specialised needs of such users. Those users must use the information that is communicated to them by the MFI through special purpose reports directed at those kinds of needs.

3.18 Managers and to some extent, governing bodies commonly are described as 'internal users'. In addition to the information provided by financial reporting, they need a great deal of internal accounting information to carry out their responsibilities. Much of that information relates to particular decisions or to managers' exercise of their stewardship responsibility to ensure that resources are used for their intended purposes. Managers have the ability to determine the form and content of such additional information in order to meet their own needs. The reporting of such information, however, is beyond the scope of this Technical Guide.

BASIS OF ACCOUNTING

3.19 The term ‘basis of accounting’ refers to the timing of recognition of revenues, expenses, assets and liabilities in accounts. The commonly prevailing bases of accounting are

(a) cash basis of accounting; and

(b) accrual basis of accounting.

3.20 Under cash basis of accounting, transactions are recorded when the related cash receipts or cash payments take place. Thus, revenue (e.g., interest received on loans advanced) is recognised when cash is collected. Similarly, expenditure on acquisition and maintenance of assets used in rendering of services as well as on employee remuneration and other items is recorded when the related payments take place. The end-product of cash basis of accounting is a statement of receipts and payments that classifies cash receipts and cash payments under different heads. A statement of assets and liabilities may or may not be prepared.

3.21 Accrual basis of accounting is 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 deferral, allocations, depreciation and amortisation. This basis is also referred to as ‘Mercantile Basis of Accounting’.

3.22 Accrual basis of accounting attempts to record the financial effects of the transactions and other events of an enterprise 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. Accrual basis recognises that the economic events that affect an enterprise’s performance often do not coincide with the cash receipts and payments of the period. The goal of accrual basis of accounting is to relate the accomplishments (measured in the form of revenue) and the efforts (measured in terms of cost) so that the reported net income measures an enterprise’s performance during a period rather than merely listing its cash receipts and payments. Apart from income measurement, 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.

3.23 MFIs registered under the Companies Act, 1956, are required to maintain their books of account according to accrual basis as required in section 209(3)(b) of the said Act. If the books are not kept on accrual basis, it shall be deemed as per the provisions of the aforesaid section that proper books of account are not kept. Generally, non-company MFIs maintain their books of account on cash basis as it is considered simple.

3.24 Accrual is a scientific basis of accounting and has conceptual superiority over the cash basis of accounting. It is, therefore, recommended that all MFIs, including non-company MFIs, should maintain their books of account on accrual basis for all elements of financial statements.

ACCRUAL BASIS AND ACCOUNTING STANDARDS

3.25 Accounting is often said to be a social science. It operates in an open and ever-changing economic environment. The nature of transactions entered into by various enterprises and the circumstances surrounding such transactions differ widely. This characteristic of accounting measurements historically led to the adoption of different accounting practices by different enterprises for dealing with similar transactions or situations.

3.26 Comparability is one of the important qualitative characteristics of accounting information. This implies that the information should be measured and presented in such a manner that the users are able to compare the information of an enterprise through time and with similar information of other enterprises. Adoption of different accounting practices by different enterprises for similar transactions or situations tends to reduce the comparability of accounting information.

3.27 Recognising the need for bringing about a greater degree of uniformity in accounting measurements, the trend all over the world now is towards formulation of accounting standards to be adopted in preparation of accounting information and its presentation in financial statements. Accounting standards lay down the rules for measurement and presentation of accounting information by different enterprises.

3.28 In India, the Institute of Chartered Accountants of India has taken up the task of formulating accounting standards. These Accounting Standards are based on the fundamental accounting assumption of accrual. These Standards thus reflect what can be construed as proper application of accrual accounting to different types of transactions and events.

APPLICABILITY OF THE ACCOUNTING STANDARDS

3.29 The 'Preface to the Statements of Accounting Standards', issued by the Institute of the Chartered Accountants of India, states the following:

> "3.3 Accounting Standards are designed to apply to the general purpose financial statements and other financial reporting, which are subject to the attest function of the members of the ICAI. Accounting Standards apply in respect of any enterprise (whether organised in corporate, co-operative or other forms) engaged in commercial, industrial or business activities, irrespective of whether it is profit oriented or it is established for charitable or religious purposes. Accounting Standards will not, however, apply to enterprises only carrying on the activities which are not of commercial, industrial or business nature, (e.g., an activity of collecting donations and giving them to flood affected people). Exclusion of an enterprise from the applicability of the Accounting

Standards would be permissible only if no part of the activity of such enterprise is commercial, industrial or business in nature. Even if a very small proportion of the activities of an enterprise is considered to be commercial, industrial or business in nature, the Accounting Standards would apply to all its activities including those which are not commercial, industrial or business in nature."

3.30 In view of the above, as microfinance activities are of commercial nature even though the objective may be non-profit, the Accounting Standards formulated by the Institute of Chartered Accountants of India, are applicable to all enterprises carrying on such activities irrespective of their legal form and lending methodology. The Accounting Standards laid down by ICAI would help MFIs to maintain uniformity in the presentation of financial statements, proper disclosure and transparency. Thus, this Technical Guide recommends how to apply these accounting standards to MFIs keeping in view the peculiarities of their operations. It may be noted that while applying the Accounting Standards certain terms used in the Accounting Standards may need to be modified in the context of the corresponding appropriate terms for MFIs, e.g., where a standard refers to the 'statement of profit and loss', in the context of not-for-profit form of MFIs, it should be considered that the standard refers to the 'Income and Expenditure Account'.

3.31 Based on the above, it may be mentioned that in case of Not-for-Profit-Organisations which, along with providing various services are providing microfinance services, even if in a small proportion, recommendations contained in this Technical Guide should be followed.

MANDATORY VS. RECOMMENDATORY ACCOUNTING STANDARDS

3.32 MFIs registered under the Companies Act, 1956, such as section 25 companies, Non-Banking Financial Companies and Local Area Banks are required to comply with the Accounting Standards by virtue of sub-section (3A) of section 211 of the Companies Act, 1956. Sub-section (3B) of section 211 requires that where the Profit and Loss Account (Income and Expenditure Account) and Balance Sheet of a company do not comply with the Accounting Standards, the company shall disclose in its Profit and Loss Account (Income and Expenditure Account) and Balance Sheet the fact of such deviation, the reason thereof and the financial effect, if any, arising due to such deviation. Further, section 227(3)(d) requires the auditor to state whether Profit and Loss Account (Income and Expenditure Account) and Balance Sheet comply with the Accounting Standards referred to in sub-section (3C) of section 211. Sub-section (3C) of section 211 provides that for the purposes of this section, the expression 'accounting standards', means the standards of accounting recommended by the Institute of Chartered Accountants of India constituted under the Chartered Accountants Act, 1949 (38 of 1949), as may be prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards established under sub-section (1) of section 210A. Proviso to sub-section (3C) of the section provides that the standards of accounting specified by the Institute of Chartered Accountants of India shall be deemed to be the Accounting Standards until the Accounting Standards are prescribed by the Central Government under this sub-section. It may be noted that Accounting Standards 1 to 7 and 9 to 29 as recommended by the Institute of Chartered Accountants of India have been notified by the Central Government under Companies (Accounting Standards) Rules, 2006; in consultation with the NACAS vide Notification dated December 7, 2006 in the Official Gazette.

3.33 As far as non-company MFIs (including trusts, societies, co-operative form of MFIs) are concerned, since they are engaged in the commercial activity of giving loans on interest, Accounting Standards, formulated by the Institute of Chartered Accountants of India, are mandatory on the members of the Institute in the performance of their attest functions as per the relevant announcements made by the Institute of Chartered Accountants of India from time to time.

3.34 In respect of mandatory Accounting Standards, while carrying out an audit of general purpose financial statements under any law, it is the duty of the members of the Institute to examine whether the Accounting Standards have been complied with in the presentation of financial statements covered by their audit. In the event of any deviation from a mandatory Accounting Standard, it is their duty to make adequate disclosures in their audit reports so that the users of the financial statements may be aware of such deviations. In respect of a recommendatory Accounting Standard, the duty of members of the Institute is to examine whether the recommendations made in the Standard have been followed in the presentation of financial statements covered by their audit. If the same have not been followed, the members have to consider whether, keeping in view the circumstances of the case, a disclosure in the audit report is necessary. In other words, they have to exercise their professional judgement to determine whether the departures from the recommendatory Accounting Standards are justified under the circumstances or not.

3.35 As stated earlier, the Accounting Standards formulated by the Institute of Chartered Accountants of India are based on the fundamental accounting assumptions of accrual. Where the statute governing the enterprise requires the preparation and presentation of financial statements on accrual basis but the financial statements have not been so prepared, the auditor should qualify his report. On the other hand, where there is no statutory requirement for preparation and presentation of financial statements on accrual basis, and the financial statements have been prepared on a basis other than accrual the auditor should describe in his audit report, the basis of accounting followed, without necessarily making it a subject matter of a qualification. In such a case, the auditor should also examine whether those provisions of the accounting standards which are applicable in the context of the basis of accounting followed by the enterprise have been complied with or not and consider making suitable disclosures/qualifications in his audit report accordingly[2]. The following is an example of a disclosure in the audit report of an MFI which follows cash basis of accounting:

[2] The mandatory application of accounting standards in respect of certain non-corporate (announcement of the Council published in '*The Chartered Accountant*', January 1994, page 639).

"It is the policy of the MFI to prepare its financial statements on the cash receipts and disbursements basis. On this basis, revenue and the related assets are recognised when received rather than when earned, and expenses are recognised when paid rather than when the obligation is incurred. In our opinion, the financial statements give a true and fair view of the assets and liabilities from cash transactions of __________________ (Name of the MFI) at __________, and of the revenue collected and expenses paid during the year ended on the cash receipts and disbursements basis as described in Note X."

APPLICABILITY OF ACCOUNTING STANDARDS TO SMALL AND MEDIUM MFIs

3.36 So far, the Institute of Chartered Accountants of India has formulated 31 Accounting Standards out of which one Standard [viz., Accounting Standard (AS) 8, *Accounting for Research and Development*] is no longer in force and two Standards [viz., Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement* and Accounting Standard (AS) 31, *Financial Instruments: Presentation*] have been issued by the Institute, but become recommendatory from April 1, 2009 onwards. Accordingly, it may be noted that for the purposes of this Technical Guide, AS 30 and AS 31, as such have not been dealt with. For the purpose of applicability of Accounting Standards[3], pursuant to the notification[4] of the Accounting Standards by the Central Government, non-corporate[5] entities have been classified into three categories, viz., Level I, Level II and Level III, where the entities that fall within the meaning of the latter two categories are

[3] Applicability of Accounting Standards to Companies and Non-corporate Entities is given in the 'Harmonisation of Various Different Accounting Standards issued by the ICAI and the Accounting Standards notified by the Central Government' (Announcement of the Council published in '*The Chartered Accountant*', February 2008, page 1340).

[4] Refer paragraph 3.32.

[5] Non-corporate entities are those incorporated under acts other than Companies Act, 1956.

considered as Small and Medium-sized Enterprises (SMEs); and companies have been classified as Small and Medium Sized Companies (SMCs) and Non-SMCs. The criteria for classification of non-corporate entities and companies into the different categories, and the applicability of the individual Accounting Standards to non-corporate entities and companies are given in Appendix 2. It may be noted that one of the criteria for categorising SMEs/SMCs is turnover. In this regard, a question arises as to what should be considered as 'turnover of' for MFIs for this purpose. Turnover would mean the total amount of income earned by an MFI for the immediately preceding accounting period on the basis of audited financial statements, where the total income includes interest income earned on the loan portfolio disbursed as well as income generated from the provision of other financial services.

ISSUES IN APPLICATION OF ACCOUNTING STANDARDS

3.37 As recommended earlier in the Chapter, all MFIs should follow the Accounting Standards formulated by the Institute. Issues that are likely to arise in the course of application of Accounting Standards to MFIs are discussed hereinafter.

3.38 To facilitate an understanding of the requirements of Accounting Standards, their salient features and principal requirements are explained below, followed by a discussion on the major issues that may arise in the course of application of each Standard to MFIs. It may be emphasised that the ensuing discussion on the requirements of the Standards is not intended to be exhaustive; as mentioned, the discussion is confined to the principal requirements of each Standard. While applying an Accounting Standard in a practical situation, reference should be made to the original text of the Standard. It may also be emphasised that the discussion on the issues in the application of Accounting Standards is intended to address only the peculiar problems that may arise in the course of application of Accounting Standards to MFIs.

3.39 A concern is often expressed that given the accounting expertise available with MFIs, adoption of Accounting Standards, some of which contain onerous requirements, would be too cumbersome for small and medium-sized MFIs. Thus, MFIs that satisfy the criteria laid down for identifying SMEs/SMCs are required to follow the Accounting Standards applicable to SMEs/SMCs (details of which are given in Appendix 2).

AS 1, DISCLOSURE OF ACCOUNTING POLICIES

AS 1 defines accounting policies as “the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements”. The Standard recognises that due to the varying circumstances in which enterprises operate, different accounting policies may be adopted by different enterprises. In order that the users of financial statements can evaluate properly the working results and the financial position of an enterprise, the Standard requires the disclosure of significant accounting policies adopted in the preparation and presentation of financial statements.

Salient Features and Principal Requirements

1. All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed so as to promote a better understanding of the financial statements of an enterprise and facilitate a more meaningful comparison between financial statements of different enterprises.

2. The disclosure of significant accounting policies should form part of the financial statements and the significant accounting policies should normally be disclosed at one place.

3. Going concern, consistency, and accrual are the fundamental accounting assumptions which underlie the preparation and presentation of financial statements.

Going concern assumption implies that the enterprise has neither the intention nor the necessity of closing down or curtailing materially the scale of its operations. Thus, an enterprise is assumed to continue operations for the foreseeable future.

Consistency assumption implies that accounting policies are consistent from one period to another.

Accrual assumption signifies that revenues and costs are 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.

4. If the fundamental accounting assumptions are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

5. The major considerations in selecting accounting policies are prudence, substance over form, and materiality.

Prudence refers to the accounting convention according to which profits are not anticipated but recognised only when realised. Provision is made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.

Substance over form implies that the accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely by their legal form.

Materiality implies that financial statements should disclose all items the knowledge of which might influence the decisions of the users of the financial statements.

6. The following are examples of the areas in which different accounting policies may be adopted by different enterprises:

- Methods of depreciation, depletion and amortisation
- Treatment of expenditure during construction
- Conversion or translation of foreign currency items
- Valuation of inventories
- Treatment of goodwill
- Valuation of investments
- Treatment of retirement benefits
- Recognition of profit on long-term contracts
- Valuation of fixed assets
- Treatment of contingent liabilities

It should be noted that the above list of examples is not intended to be exhaustive.

Applicability of AS 1 to MFIs

A clear statement of significant accounting policies is necessary irrespective of the type of enterprise presenting the financial statements. Accordingly, the financial statements of an MFI should disclose, at one place, all significant accounting policies followed for the preparation and presentation thereof.

Where a basis of accounting other than accrual has been followed, a disclosure in this regard should be made.

It is recommended that amongst others, the following accounting policies may be disclosed by MFIs given the nature of their operations:

(i) Recognition of revenue in respect of interest income on loans advanced.

(ii) Accounting for grants and donations received.

(iii) Provisioning and write-off policy for loan losses.

(iv) Restructuring of loans.

It may be noted that the provisioning policy and the write-off policy are very critical policies for every MFI and thus they should be very clearly described. With regard to the provisioning policy, MFIs should among other things, disclose in detail the method for calculating the amount of provision for probable loan losses. Reference may also be made to 'Applicability of AS 4 to MFIs'. In case of the write-off policy, in particular, the description must explicitly identify when a loan is first considered past-due, how long it takes a loan to enter the write-off status after it has been defined past-due; and when write-offs are actually carried out during the reporting period.

AS 2, VALUATION OF INVENTORIES

AS 2 applies to the valuation of all inventories except work-in-progress arising under construction contracts including directly related service contracts; work-in-progress arising in the ordinary course of business of service providers; shares, debentures and other financial instruments held as stock-in-trade; and producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries.

Salient Features and Principal Requirements

1. Inventories should be valued at the lower of cost and net realisable value. In this context, cost of inventories comprises all

costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition. Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

2. The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards, and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

3. The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour.

4. Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include overheads other than production overheads or the costs of designing products for specific customers in the cost of inventories. Interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are, therefore, usually not included in the cost of inventories.

5. In determining the cost of inventories in accordance with paragraph 1 above, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:

(a) abnormal amounts of wasted materials, labour, or other production costs;

(b) storage costs, unless those costs are necessary in the production process prior to a further production stage;

(c) administrative overheads that do not contribute to bringing the inventories to their present location and condition; and

(d) selling and distribution costs.

6. The costs of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects should be assigned by specific identification of their individual costs.

7. The costs of inventories, other than those dealt with in paragraph 6 above, should be assigned by using the first-in, first-out (FIFO), or weighted average cost formula. The formula used should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.

8. AS 2 further provides that techniques for the measurement of the cost of inventories, such as the standard cost method or the retail method, may be used for convenience if the results approximate the actual cost.

9. The comparison of cost with net realisable value is done on an item-by-item basis. In some circumstances, however, it may be appropriate to group similar or related items, e.g., when items of inventory relate to the same product line that have similar purposes or end uses and are produced and marketed in the same geographical area and cannot be practically evaluated separately from other items in that product line. It is not appropriate to compare cost and net realisable value based on a classification of inventory, for example, finished goods, or all the inventories in a particular business segment.

10. Material and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost.

11. The financial statements should disclose:

(a) the accounting policies adopted in measuring inventories, including the cost formula used; and

(b) the total carrying amount of inventories and its classification appropriate to the enterprise.

Applicability of AS 2 to MFIs

This Standard is normally not relevant for an MFI, as inventories within the definition of AS 2 do not arise in a typical microfinance business. However, this Standard assumes importance in case of a multi-service MFI engaged in microfinance along with other developmental activities. For instance, where an NPO-MFI along with microfinance is carrying on any trading/manufacturing activity and has inventories at the year-end that are:

(a) held for sale in the ordinary course of business;

(b) in the process of production for such sale; or

(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services;

the inventories should be valued at lower of cost and net realisable value.

A question as to the applicability of AS 2 may arise in case of a multi-service MFI which apart from delivering microfinance services may be engaged in the manufacture or purchase of certain items for the purpose of distributing them to

beneficiaries either free of cost or at a nominal amount. In such a scenario, it is felt that since such items are not held for the purpose of sale or in the process of production for such sale or they are not in the form of materials or supplies to be consumed in the production process or in the rendering of services of commercial, industrial or business nature, such items cannot be considered as inventories within the meaning of AS 2. In view of this, it is recommended that such items should be valued at the lower of cost or replacement cost, if available.

In certain cases, such enterprises may also receive items from donor agencies either free of cost or at a nominal charge for distribution to beneficiaries or for sale. As some part of these items may remain undistributed/unsold, at the year end, such enterprises should disclose market prices or estimated net realisable values of such items, lying at the year-end, in the notes to accounts, along with the quantitative details.

AS 3, CASH FLOW STATEMENTS

Information about the cash flows of an enterprise is useful in providing users of financial statements with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an enterprise to generate cash and cash equivalents and the timing and certainty of their generation.

Salient Features and Principal Requirements

1. An enterprise should prepare a cash flow statement and present it in addition to the balance sheet and profit and loss account.

2. Cash comprises cash on hand and demand deposits with banks. Cash equivalents are “short term, highly liquid investments that are readily convertible into known amounts of cash and which

are subject to an insignificant risk of changes in value". Thus, an investment is a cash equivalent only if it is readily convertible to a known amount of cash, is subject to an insignificant risk of changes in value, and has a short maturity of, say, three months or less from the date of acquisition. Investments in shares are excluded from cash equivalents unless they clearly satisfy the above criteria, i.e., they are, in substance, cash equivalents; for example, preference shares of a company acquired shortly before their specified redemption date (provided there is only an insignificant risk of failure of the company to repay the amount at maturity).

3. Cash flow statement should report cash flows during the period classified by operating, investing and financing activities.

Operating activities are "the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities". Examples of cash flows from operating activities are cash receipts from the sale of goods/rendering of services, royalties, fees and commissions, and cash payments to suppliers for goods and services and to employees. Cash payments or refunds of income taxes are also part of cash flows from operating activities unless they can be specifically identified with financing and investing activities.

Investing activities are "the acquisition and disposal of long-term assets and other investments not included in cash equivalents". Examples of cash flows arising from investing activities are cash payments/receipts arising from acquisition or construction/disposal of fixed assets (including intangibles), cash payments/receipts arising from acquisition/disposal of shares, warrants or debt instruments of other enterprises (other than payments for those instruments considered to be cash equivalents and those held for dealing or trading purposes), cash payments for advances and loans made to third parties and receipts arising from the repayment thereof (other than those arising from advances and loans made by a financial enterprise).

Financing activities are "activities that result in changes in the size and composition of the owners' capital (including preference share capital in the case of a company) and borrowings of the enterprise". Examples of cash flows arising from financing activities are cash proceeds from issuing shares, debentures, loans, notes, bonds, and other short or long-term borrowings, and cash repayments of amounts borrowed.

4. Cash flows from operating activities should be presented in cash flow statement using either direct method or indirect method.

Under the direct method, major classes of gross cash receipts and gross cash payments are disclosed. These may be worked out either:

(a) from the accounting records of the enterprise [i.e., by analysing accounts relating to cash, bank (only those available on demand) and short term liquid investments qualifying as cash equivalents]; or

(b) by adjusting sales, cost of sales and other items in the statement of profit and loss for:

  (i) changes during the period in inventories and operating receivables and payables;

  (ii) other non-cash items; and

  (iii) other items for which the cash effects are investing or financing cash flows.

Under the indirect method, the net cash flow from operating activities is determined by adjusting net profit or loss for the effects of:

(a) changes during the period in inventories and operating receivables and payables;

(b) non-cash items such as depreciation, provisions, deferred taxes, and unrealised foreign exchange gains and losses; and

(c) all other items for which the cash effects are investing or financing cash flows.

5. Cash flows arising from investing activities and those arising from financing activities should be classified separately. Under each, major categories of gross cash receipts and cash payments should be shown separately.

6. The following cash flows may be reported on a net basis:

(a) cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the enterprise, e.g., acceptance and repayment of demand deposits by a bank, funds held for customers by an investment enterprise; and

(b) cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short, e.g., advances made for, and the repayments of, principal amounts relating to credit card customers, and short-term borrowings, for example, those which have a maturity period of three months or less.

7. The cash flows associated with extraordinary items should be classified as arising from operating, investing or financing activities as appropriate and separately disclosed.

8. Cash flows arising from transactions in a foreign currency should be recorded in an enterprise's reporting currency by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the cash flow. A rate that approximates the actual rate may be used if the result is substantially the same as would be the case if the rates at the dates of the cash flows were used. The effect of changes in exchange rates on cash and cash equivalents held in a foreign currency represents unrealised gains/losses which are not cash flows. However, the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency should be reported as a separate item in the cash flow statement in order to

reconcile cash and cash equivalents at the beginning and the end of the period.

9. Cash flows from interest received, dividends received, interest paid and dividends paid should be disclosed separately. Barring financial enterprises, cash flows arising from interest paid should be classified as cash flows from financing activities whereas interest and dividends received should be classified as cash flows from investing activities. Dividends paid should be classified as cash flows from financing activities.

10. Cash flows arising from taxes on income should be seperately disclosed and classified as cash flows from operating activities unless they can be specifically identified with financing or investing activities.

11. Investing and financing transactions that do not require the use of cash or cash equivalents should not be included in a cash flow statement. Examples of such transactions are the acquisition of fixed assets on deferred payment basis or against issue of shares, and conversion of debt to equity. Such transactions should, however, be disclosed appropriately elsewhere in the financial statements.

12. An enterprise should disclose the components of cash and cash equivalents and should present a reconciliation of the amounts in its cash flow statement with the equivalent items reported in the balance sheet.

13. An enterprise should disclose, together with a commentary by the management, the amount of significant cash and cash equivalent balances held by the enterprise that are not available for use by it, e.g., cash and cash equivalent balances held by a branch of the enterprise that operates in a country where exchange controls or other legal restrictions apply as a result of which the balances are not available for use by the enterprise.

14. An enterprise may also disclose other relevant information, together with a commentary by the management, such as the

amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities, the aggregate amount of cash flows that represent increases in operating capacity, etc.

Applicability of AS 3 to MFIs

The information presented in a cash flow statement is useful for economic decision making as it provides a basis for assessing the ability of an enterprise to generate cash and cash equivalents. In case of microfinance institutions, cash flow statements are helpful in determining the sustainability of the microfinance operations. Net result of the various types of flows indicates whether the activities are being financed from grants and loans obtained or through the operating activity of lending micro loans and providing other financial services. Therefore, MFIs should present a cash flow statement as a part of their financial statements and the same should be presented in accordance with AS 3. It must be noted that though microfinance institutions that fall within the category of SMEs/SMCs are not mandatorily required to present cash flow statements, it is recommended for all forms of microfinance institutions since they deal with cash/money as their stock.

AS 4, CONTINGENCIES[6] AND EVENTS OCCURRING AFTER THE BALANCE SHEET DATE

AS 4 deals with the treatment in the financial statements of contingencies and events occurring after the balance sheet.

---

[6] Pursuant to AS 29, *Provisions, Contingent Liabilities and Contingent Assets,* becoming mandatory in respect of accounting periods commencing on or after 1-4-2004, all paragraphs of this Standard that deal with contingencies stand withdrawn except to the extent they deal with impairment of assets not covered by other Indian Accounting Standards. For example, impairment of receivables (commonly referred to as the provision for bad and doubtful debts) would continue to be covered by AS 4.

Salient Features and Principal Requirements

1. A contingency is defined as "a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events". Thus, contingencies are conditions or situations at the balance sheet date, the financial effect of which would be determined by future events which may or may not occur.

2. The amount of a contingent loss should be provided for by a charge in the statement of profit and loss account if:

   (a) it is probable that future events will confirm that, after taking into account any related probable recovery, an asset has been impaired or a liability has been incurred as at the balance sheet date, and

   (b) a reasonable estimate of amount of the resulting loss can be made.

If either of the above conditions is not met (i.e., either the loss is not probable, or the loss is probable but its amount cannot be reasonably estimated), the following information should be disclosed in the financial statements, unless the possibility of loss is remote:

   (a) the nature of the contingency;

   (b) the uncertainties which may affect the future outcome; and

   (c) an estimate of the financial effect, or a statement that such an estimate cannot be made.

3. Contingent gains should not be recognised in the financial statements.

4. Events occurring after the balance sheet date are "those significant events, both favourable and unfavourable, that occur

between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company, and, by the corresponding approving authority in the case of any other entity".

5. Events occurring after the balance sheet date are of two types. The first type of events are those which provide further evidence for estimation of amounts relating to conditions that existed at the balance sheet date. For example, information may be available in May that a debtor was insolvent as on March 31 (the date of the balance sheet) and only 25 paise for every rupee would be realised from his estate. This event assists in determining the amount of bad debts. In the second category are those events which are indicative of conditions that arose subsequent to the balance sheet date. These events, thus, do not relate to conditions existing at the balance sheet date. An example of such an event is the decline in market value of investments after the balance sheet date.

6. Assets and liabilities should be adjusted for events of the first type, i.e., those which provide further evidence for the estimation of amounts relating to conditions that existed at the balance sheet date. Thus, in the above case, 75% of the amount owed by the debtor should be written off as a bad debt on March 31.

7. As a general rule, events of the second type normally do not require either adjustment of assets and liabilities or disclosure in the financial statements. However, in some case, such events may indicate that the enterprise ceases to be a going concern, e.g., destruction of a major production plant by fire after the balance sheet date. If the events after the balance sheet date indicate that the going concern assumption is not appropriate, assets and liabilities should be adjusted.

8. Disclosure should be made in the report of the approving authority (e.g., report of the board of directors in case of a company) of those events occurring after the balance sheet date that represent material changes and commitments affecting the financial position of the enterprise. The disclosure to be made in this regard should

specify the nature of the event and an estimate of its financial effect. Where an estimate of the financial effect cannot be made, this fact should be stated.

Applicability of AS 4 to MFIs

The loan portfolio is usually an MFI's largest and most important asset. In a microfinance business, defaults are expected to arise on the loan portfolio resulting in a loss to the enterprises dealing in microfinance, thus a clear reporting in this area is crucial. Thus, a provision for the probable loan losses is important because in its absence, the profit and loss account will underestimate the true costs of an MFI's operations and thus overestimate its profitability. Similarly, unless there is a provision for loans that are likely to become uncollectible, the balance sheet will overstate the true value of the loan portfolio and the MFI's net worth. Accordingly, as a matter of prudent policy, to offset the risk of loss in loan portfolio, all MFIs should create a loan loss provision[7] (provision for doubtful debts) by way of a charge in the profit and loss account in accordance with the requirements of AS 4 (see paragraph 2 given above). To reiterate, such a loan loss provision recognises probable loan losses as a result of default in the MFI's loan portfolio so that the true value of the loan portfolio is fairly stated.

As regards the amount of the provision, MFIs usually determine the amount of the provision for loan losses on the basis of an

[7] It may be mentioned here that it has been observed that the usage of the terms *provision* and *reserve* in connection with loan losses by the microfinance industry is not standardised and thus can be confusing for the users of the financial statements. The term *reserve* refers to an appropriation made from earnings, receipts or other surplus of an enterprise for general or a specific purpose after deducting all expenses which include provisions and others. As distinguished from this, the term *provision* refers to an amount written off or retained by way of providing for depreciation or diminution in the value of assets or retained by way of providing for any known liability, the amount of which cannot be determined with substantial accuracy. As loan losses lead to a reduction in the value of an MFI's loan portfolio, the same should be provided for by means of a *loan loss provision*. Henceforth, for the purpose of this Technical Guide, the term *loan loss provision* will be used.

aging analysis of loan accounts and allocation of risk rates based on historical default rate or best practices. However, it may be noted that Non-Banking Financial Companies (NBFCs) and Local Area Banks (LABs) are subject to various prudential norms issued by the Reserve Bank of India and this implies that MFIs constituted as NBFCs and LABs are required to create loan loss provisions as per the norms specified by RBI.

In an 'aging analysis' all outstanding loans are reviewed and classified according to various age groupings with the due date being the base point for determining age, i.e., how many days past-due the most recent payment is and then assigning a different percentage to be provisioned for each category, depending on the perceived level of risk. This is explained by way of an illustrative loan loss provision matrix given below, containing the loan aging schedule and the corresponding provisioning rate:

Loan Loss Provision Matrix

Loan Status	Provision Rate
Regular	0%
1-30 days past due	10%
31-60 days past due	25%
61-90 days past due	50%
91-180 days past due	75%
181-365 days past due	90%
>365 days past due	100%

Multiplying the volume of loans outstanding in each category with the corresponding provisioning rate gives the amount to be provisioned under each category and the total amount of loan loss provision to be charged to the profit and loss account is the sum of the provision amounts under each age category. It may be mentioned here that the loan loss provision matrix given above is illustrative in nature, and MFIs, depending on their loan repayment cycle, etc., may make a provision on a weekly or monthly basis and not necessarily in terms of days.

However, it may be emphasised that such a loan loss provision matrix may not always necessarily give the correct amount of the loan loss provision. In this connection, attention is drawn towards Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*, which has been issued by the Institute and which has initially been made recommendatory from 1-4-2009 onwards. As per AS 30, the amount of the provision for a loan loss (which in other words provides for impairment of loan accounts) is calculated as the difference between the loan's carrying amount and the present value of estimated future cash flows discounted at the original effective interest rate on the loan.

Write off of loan losses (Derecognition of Loans)

It may be noted that a bad loan should not be written off from the books of account until the MFI's contractual right to receive cash flows from that loan expires. Thus, in case of the above illustration, even if the loan has been past due for 365 days resulting in the creation of a 100% loan loss provision for the loan, the loan will not be written off until the MFI's contractual right to receive cash flows from that loan expires. Accordingly, till the fulfillment of this criterion, the loan will continue to exist in the books.

AS 5, NET PROFIT OR LOSS FOR THE PERIOD, PRIOR PERIOD ITEMS AND CHANGES IN ACCOUNTING POLICIES

AS 5 deals with disclosure in the profit and loss account of (a) significant items arising in the course of ordinary activities of the enterprise; (b) extraordinary items; (c) prior period items; (d) changes in accounting estimates; and (e) changes in accounting policies.

Salient Features and Principal Requirements

1. 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.

2. The following components of the net profit or loss for a period should be disclosed on the face of the profit and loss account:

(a) profit or loss from ordinary activities; and

(b) extraordinary items.

3. Extraordinary items should be disclosed in the profit and loss account as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be disclosed separately in the profit and loss account in a manner that its impact on current profit or loss can be perceived.

Extraordinary items are "income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly". Two criteria should thus be considered for determining whether an item is extraordinary or not. First, it should arise from events or transactions which are distinct from the ordinary activities of the enterprise. Ordinary activities are "activities which are undertaken by an enterprise as part of its business and such related activities in which the enterprise engages in furtherance of, incidental to, or arising from, these activities". Second, the item should not be expected to recur frequently or regularly. The Standard recognises that virtually all items of income and expense included in the determination of net profit or loss arise in the course of the ordinary activities of an enterprise and, therefore, it is only on rare occasions that an event or transaction gives rise to an extraordinary item. Also, whether an event or transaction is clearly distinct from the ordinary activities of the enterprise is determined by the nature of the event or transaction in relation to the business ordinarily carried on by the enterprise rather than by the frequency with which such events are expected to occur. In other words, merely because an item recurs infrequently, it does not qualify to be an extraordinary item if it is related to the business ordinarily carried on by the enterprise.

4. When items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately. Examples of situations which may give rise to such items are the write-down of inventories to net realisable value as well as the reversal of such write-downs, disposals of items of fixed assets and long-term investments, litigation settlements, and reversals of provisions (provided, of course, that they have a material impact). Disclosure of items of the above nature can be made on the face of the profit and loss account or in the notes to the financial statements.

5. The nature and amount of prior period items should be separately disclosed in the profit and loss account in a manner that their impact on the current profit or loss can be perceived.

Prior period items are defined as “income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods”. Thus, prior period items are only those items which represent correction of errors or omissions in the preparation of the financial statements of one or more prior periods. Adjustments related to prior periods that are determined in the current period (e.g., wage arrears payable to the workers as a result of a retrospective wage revision during the current period) are not prior period items.

Prior period items are normally included in the determination of net profit or loss for the current period. Alternatively, they may be shown in the profit and loss account after determination of current net profit or loss.

6. Accounting estimates (for example, useful lives of depreciable assets, provision for bad and doubtful debts) made in one accounting period may need revision in a subsequent period in the light of changes in the circumstances on which such estimates

were based, or as a result of new information, more experience or subsequent developments. The effect of a change in an accounting estimate should be included in the determination of net profit or loss in the period of the change if the change affects the period only (e.g., a change in the estimate of the amount of doubtful debts), or in the period of the change and future periods if the change affects both (e.g., a change in the estimated useful life of a depreciable asset).

7. The nature and amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods, should be disclosed. If it is impracticable to quantify the amount, this fact should be disclosed.

8. A change in an accounting policy should be made only if–

(a) the adoption of a different accounting policy is required

(i) by statute; or

(ii) for compliance with an accounting standard; or

(b) it is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise.

9. A change in an accounting policy which has a material effect should be disclosed. 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. Where the effect of such change is not ascertainable, wholly or in part, the fact should be indicated. If a change made in an accounting policy 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.

Applicability of AS 5 to MFIs

This Standard lays down requirements for accounting for prior period items, extraordinary items, changes in accounting policies and changes in accounting estimates in the Profit and Loss Account (Income and Expenditure Account in case of NPO-MFIs) so that the users of financial statements may be able to make meaningful comparisons of performance of the enterprise over time and also with other enterprises. In presenting the Profit and Loss Account (Income and Expenditure Account), the MFIs should comply fully with the requirements of this Standard.

AS 6, DEPRECIATION ACCOUNTING[8]

Salient Features and Principal Requirements

1. The depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset.

'Depreciable assets' are assets which are expected to be used during more than one accounting period, have a limited useful life, and are held by an enterprise for use in the production or supply of goods and services, or for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.

'Depreciable amount' of a depreciable asset refers to the historical cost, or the revalued amount, as reduced by the estimated residual value. Thus, if an item of plant and machinery is purchased for Rs. 5,00,000 and its residual value is estimated to be Rs. 10,000, the depreciable amount would be Rs. 4,90,000.

---

[8] From the date of Accounting Standard (AS) 26, *Intangible Assets*, becoming mandatory for the concerned enterprises, AS 6 stands withdrawn insofar as it relates to the amortisation (depreciation) of intangible assets.

'*Useful life'* of a depreciable asset is either the period over which it is expected to be used by the enterprise, or the number of production or similar units expected to be obtained from the use of the asset by the enterprise.

2. The depreciation method selected should be applied consistently from period to period. The selection of the method depends on the type of asset, the nature of its use and the circumstances prevailing in the business. A combination of more than one method of depreciation can also be used, provided it is followed consistently.

3. A change from one method of providing depreciation to another should be made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. When a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method should be charged or credited (as the case may be) to the profit and loss account for the year in which the method of depreciation is changed.

4. The useful life of a depreciable asset should be estimated after considering the following factors:

(a) expected physical wear and tear;

(b) obsolescence;

(c) legal or other limits on the use of the asset.

The useful life of a depreciable asset may be shorter than its physical life. The determination of the useful life is a matter of estimation. In many cases, the statute governing an enterprise may lay down the basis for determining the useful life. In such a case, the management can charge a higher depreciation if, on a consideration of various factors, it estimates that the useful life of an asset is shorter than that envisaged under the provisions of the relevant statute. If, however, the management estimates that the actual useful life of the asset is longer than that envisaged under the statute, it should provide depreciation over the useful life as envisaged under the statute.

5. The useful lives of major depreciable assets or classes of depreciable assets may be reviewed periodically. If, as a result of such a review, there is a revision of the useful life, the unamortised depreciable amount (the written down book value minus the estimated residual value) should be charged over the revised remaining useful life.

6. Any addition or extension which becomes an integral part of the existing asset should be depreciated over the remaining useful life of that asset. Alternatively, depreciation on such addition or extension may be provided at the rate applied to the existing asset. However, where an addition or extension retains its separate identity and is capable of being used after the existing asset is disposed of, depreciation on the same should be provided independently on the basis of an estimate of its own useful life.

7. Where the historical cost of a depreciable asset has undergone a change, depreciation should be provided on the revised unamortised depreciable amount prospectively over the residual useful life of the asset.

8. Where a depreciable asset is revalued, provision for depreciation should be based on the revalued amount and on the estimate of the remaining useful life of such asset. If the effect of revaluation on the amount of depreciation is material, the same should be disclosed separately in the year in which revaluation is carried out.

9. Where a depreciable asset is disposed of, scrapped, retired, etc., the net surplus or deficiency, if material, should be disclosed separately.

10. The historical cost or the revalued amount of each class of depreciable assets should be disclosed in the financial statements. The total depreciation for the period for each class of assets, as well as the related accumulated depreciation, should be similarly disclosed. The depreciation methods as well as the depreciation rates or the useful lives of the assets if they are different from the principal rates prescribed by the law governing the entity should also be disclosed.

Applicability of AS 6 to MFIs

Depreciation is an important item of expense. Under-provision or over-provision of depreciation would vitiate the true and fair view presented by the financial statements. Therefore, all enterprises dealing in microfinance, irrespective of their legal status are required to provide depreciation in accordance with the requirements of AS 6. The rates of depreciation that these enterprises are required to follow should be in accordance with the expected useful life of the assets. For the MFIs registered under the Companies Act, 1956, the rates of depreciation as specified in Schedule XIV to the Act are applicable. It is suggested that other forms of MFIs may also refer to the rates of depreciation given in Schedule XIV to the said Act after taking into consideration the useful life of the assets and their conditions of use and follow the Schedule XIV rates as the minimum rates of depreciation.

Where a fixed asset is received in the grant or donation, no depreciation is required to be provided since the asset is required to be recorded at nominal value of Rs. 1 (see Accounting Standard (AS) 12, *Accounting for Government Grants*). However, if the asset is given at concessional rates, the depreciation charged to the profit and loss account will be based on the acquisition cost of such an asset to the MFI. It has been observed that where specified fixed assets (depreciable) are acquired from grants specifically given for such purposes, microfinance institutions, charge the depreciation as applicable to the grants capitalised in capital

reserve. Such an accounting treatment is incorrect and in respect of the same the requirements of AS 12 should be followed.

AS 7, CONSTRUCTION CONTRACTS[9]

The objective of this Standard 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.

Salient Features and Principal Requirements

1. A *fixed price contract* is defined as "a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses".

2. A *cost plus contract* is defined as "a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus percentage of these costs or a fixed fee".

3. While accounting for construction contracts, contract revenue should comprise:

   (a) the initial amount of revenue agreed in the contract; and

   (b) variations in contract work, claims and incentive payments:

[9] Accounting Standard (AS) 7, *Construction Contracts* (revised 2002), comes into effect in respect of all contracts entered into during accounting periods commencing on or after 1-4-2003 and is mandatory in nature from that date. Accordingly, Accounting Standard (AS) 7, *Accounting for Construction Contracts,* issued in December 1983, is not applicable in respect of such contracts.

(i) to the extent that it is probable that they will result in revenue; and

(ii) they are capable of being reliably measured.

4. Contract costs should comprise:

(a) costs that relate directly to the specific contract;

(b) costs that are attributable to contract activity in general and can be allocated to the contract; and

(c) such other costs as are specifically chargeable to the customer under the terms of the contract.

5. As a general rule, 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 10.

6. In the case of a fixed price contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:

(a) total contract revenue can be measured reliably;

(b) it is probable that the economic benefits associated with the contract will flow to the enterprise;

(c) both the contract costs to complete the contract and the stage of contract completion at the reporting date can be measured reliably; and

(d) the contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates.

7. In the case of a cost plus contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:

(a) it is probable that the economic benefits associated with the contract will flow to the enterprise; and

(b) the contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.

8. 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 10.

9. When the uncertainties that prevented the outcome of the contract being estimated reliably no longer exist, revenue and expenses associated with the construction contract should be recognised in accordance with paragraph 5 rather than in accordance with paragraph 8.

10. When it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately.

11. An enterprise should disclose in its financial statements:

(a) the amount of contract revenue recognised as revenue in the period;

(b) the methods used to determine the contract revenue recognised in the period; and

(c) the methods used to determine the stage of completion of contracts in progress.

12. An enterprise should also disclose the following for contracts in progress at the reporting date:

(a) the aggregate amount of costs incurred and recognised profits (less recognised losses) upto the reporting date;

(b) the amount of advances received; and

(c) the amount of retentions.

13. An enterprise is required to present:

(a) the gross amount due from customers for contract work as an asset; and

(b) the gross amount due to customers for contract work as a liability.

14. The gross amount due from customers for contract work is the net amount of:

(a) costs incurred plus recognised profits; less

(b) the sum of recognised losses and progress billings

for all contracts in progress for which costs incurred plus recognised profits (less recognised losses) exceeds progress billings.

15. The gross amount due to customers for contract work is the net amount of:

(a) the sum of recognised losses and progress billings; less

(b) costs incurred plus recognised profits

for all contracts in progress for which progress billings exceed costs incurred plus recognised profits (less recognised losses).

Applicability of AS 7 to MFIs

MFIs generally do not act as contractors, therefore, as such the applicability of this Standard to MFIs is limited but where an MFI undertakes a construction activity as a contractor, the provisions of this Standard apply in their entirety.

AS 9, REVENUE RECOGNITION

Salient Features and Principal Requirements

1. Revenue from sale of goods should be recognised when all the following conditions are fulfilled:

(a) the seller of the 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 to a degree usually associated with ownership;

(b) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods; and

(c) it is not unreasonable to expect ultimate collection of the consideration.

2. In a transaction involving rendering of services, revenue should be recognised on the basis of the performance of the services. If the performance consists of the execution of more than one act, revenue should be recognised proportionately by

reference to the performance of each act (i.e., on the basis of proportionate completion method). If performance consists of the execution of a single act, or if it consists of the performance of more than one act and the acts yet to be performed are very significant in relation to the transaction as a whole, revenue should be recognised only on the completion of performance of the sole or the final act (i.e., on the basis of completed service contract method).

In either case, revenue from services should be recognised only when no significant uncertainty exists regarding the amount of the consideration that will be derived from rendering the service and about its ultimate collectability.

3. Revenue arising on account of the use of enterprise resources by others should be recognised as follows provided no significant uncertainty as to measurability or collectability exists:

(a) Interest should be recognised on a time proportion basis taking into account the principal outstanding and the rate applicable.

(b) Royalties should be recognised on accrual basis in accordance with the terms of the relevant agreement.

(c) Dividends should be recognised when the right of the enterprise to receive the dividend payment is established.

4. Where, at the time of sale or the rendering of the service, the ultimate collection of revenue cannot be assessed with reasonable certainty, revenue recognition should be postponed, till the time when it is reasonably certain that the ultimate collection will be made. When such uncertainty arises after the making of the sale or rendering of the service, it is more appropriate to make a provision than to adjust the revenue recorded originally.

Applicability of AS 9 to MFIs

Microfinance institutions should follow the requirements of this Standard in their entirety for recognition of revenue arising from the provision of financial services, and use by others of their resources yielding interest, royalties and dividends. In a microfinance business, main source of revenue is in the form of interest income on loans advanced to clients. Interest income on the loans advanced is the income that a microfinance enterprise derives from its lending operations. As per AS 9, interest income is to be accounted on an accrual basis. This implies that an MFI would recognise income on that interest also which has become due but not yet collected as well as on those interest which has accrued but not yet become due.

It is important to note that interest income from investments should be disclosed separately from the interest income of the loan portfolio in the financial statements. Such a disclosure would be useful to the users of these statements.

In addition to the interest charged, some MFIs also charge their clients with certain fee for rendering various services associated with loans disbursed by the MFIs. The fees charged may be stated as a percentage of the loan amount or a flat amount. MFIs may also charge fees for rendering technical and consultancy services to other enterprises dealing in microfinance such as for rendering operational and administrative services. In all these scenarios, the related fee income arising should be also accounted for in accordance with the requirements of AS 9 for rendering of services (refer paragraph 2 given above).

The principles of AS 9 also apply for the recognition of revenue arising from the sale of goods and rendering of services other than microfinance by a multi-service MFI.

AS 10, ACCOUNTING FOR FIXED ASSETS[10]

Salient Features and Principal Requirements

1. A *fixed asset* is defined as "an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business".

2. Stand-by equipment and servicing equipment are normally capitalised. Machinery spares are usually charged to the profit and loss statement as and when consumed. However, if such spares can be used only in connection with an item of fixed asset and their use is expected to be irregular, it may be appropriate to allocate the total cost on a systematic basis over a period not exceeding the useful life of the principal item.

3. The financial statements should disclose, *inter alia*, the gross book value of fixed assets. The gross book value of a fixed asset should be either its historical cost or a revalued amount.

4. The cost of a fixed asset should be determined as below:

   (a) The cost of a purchased fixed asset should comprise its purchase price and any attributable cost of bringing the asset to its working condition for its intended use.

   (b) The cost of a self-constructed fixed asset should comprise those costs that relate directly to the specific asset and those that are attributable to the construction activity in general and can be allocated to the specific asset.

---

[10] From the date of Accounting Standard (AS) 26, *Intangible Assets*, becoming mandatory for the concerned enterprises, the relevant paragraphs of AS 10 that deal with patents and know-how, stand withdrawn and, therefore, the same are omitted from this Standard.

(c) When a fixed asset is acquired in exchange or in part exchange for another asset, the asset acquired should be recorded either at fair market value or at the net book value of the asset given up, adjusted for any balancing payment or receipt of cash or other consideration. Fair market value is the price that would be agreed to in an open and unrestricted market between knowledgeable and willing parties dealing at arm's length who are fully informed and are not under any compulsion to transact. Fair market value may be determined by reference either to the asset given up or the asset acquired, whichever is more clearly evident. Similarly, a fixed asset acquired in exchange for shares or other securities in the enterprise should be recorded at its fair market value, or the fair market value of the securities issued, whichever is more clearly evident.

(d) Where several fixed assets are purchased for a consolidated price, the consideration should be apportioned to various assets on a fair basis as determined by component valuers.

5. When a revaluation is made, either an entire class of assets should be revalued, or the selection of assets for revaluation should be made on a systematic basis. This basis should be disclosed. The revaluation should not result in the net book value of the revalued assets being greater than the recoverable amount of those assets. When a fixed asset is revalued upwards, any accumulated depreciation existing at the date of the revaluation should not be credited to the profit and loss account.

6. An increase in net book value arising on revaluation of fixed assets should be credited directly to owners' interests under the head 'revaluation reserve'. However, to the extent that such increase is related to and not greater than a decrease arising on a revaluation previously recorded as a charge to the profit and loss account, it may be credited to the profit and loss account. A decrease in net

book value arising on revaluation of fixed assets should, on the other hand, be charged directly to the profit and loss account except to the extent that such a decrease is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilised, it may be charged directly to that account.

7. Subsequent expenditure related to an item of fixed asset should be added to its book value only if it increases the future benefits from the existing asset beyond its previously assessed standard of performance.

8. Material items retired from active use and held for disposal should be stated at the lower of their net book value and net realisable value and shown separately in the financial statements.

9. A fixed asset should be eliminated from the financial statements on disposal or when no further benefit is expected from its use and disposal.

10. Any profit or loss arising from retirement or disposal of fixed assets should be dealt with as below:

(a) Losses arising from the retirement or gains or losses arising from disposal of a fixed asset which is carried at cost should be recognised in the profit and loss account.

(b) Where a previously revalued item of fixed asset is disposed of, any loss or gain (i.e., the difference between net disposal proceeds and the net book value) should be charged or credited to the profit and loss account. However, to the extent that such a loss is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilised, it may be charged directly to that account.

11. Goodwill should be recorded in the books only when some consideration in money or money's worth has been paid for it. Whenever a business is acquired for a price which is in excess of the value of the net assets of the business taken over, the excess should be termed as 'goodwill'.

12. The following disclosures should be made in the financial statements:

(a) gross and net book values of fixed assets at the beginning and end of the accounting period along with additions, disposals, acquisitions and other movements during the year;

(b) expenditure incurred on account of fixed assets in the course of construction or acquisition; and

(c) revalued amounts substituted for historical costs of fixed assets, the method adopted to compute the revalued amounts, the nature of indices used, the year of any appraisal made, and whether an external valuer was involved in carrying out the revaluation.

Applicability of AS 10 to MFIs

The microfinance institutions have many fixed assets such as vehicles, buildings, land, computers and other office equipment. The principles enunciated in AS 10 regarding accounting for fixed assets would apply equally to MFIs as to other enterprises. Thus, an MFI should follow the requirements of this Standard in its entirety. Where the fixed assets are received in a grant or a donation, it should be accounted for as per AS 12, *Accounting for Government Grants.*

AS 11, THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES[11]

AS 11 should be applied by an enterprise in accounting for transactions in foreign currencies and in translating the financial statements of foreign operations. This Standard also deals with accounting for foreign currency transactions in the nature of forward exchange contracts.

Salient Features and Principal Requirements

1. *Exchange difference* is defined as "the difference resulting from reporting the same number of units of a foreign currency in the reporting currency at different exchange rates".

2. *Foreign operations* is defined as "a subsidiary, associate, joint venture or branch of the reporting enterprise, the activities of which are based or conducted in a country other than the country of the reporting enterprise".

3. *Forward exchange contract* is defined as "an agreement to exchange different currencies at a forward rate".

4. *Forward rate* is defined as "the specified exchange rate for exchange of two currencies at a specified future date".

5. *Integral foreign operation* is defined as "a foreign operation, the activities of which are an integral part of those of the reporting enterprise".

---

[11] Accounting Standard (AS) 11, *The Effects of Changes in Foreign Exchange Rates* (revised 2003), comes into effect in respect of accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date. The revised Standard supersedes Accounting Standard (AS) 11, *Accounting for the Effects of Changes in Foreign Exchange Rates* (1994), except that in respect of accounting for transactions in foreign currencies entered into by the reporting enterprise itself or through its branches before the date this Standard comes into effect, AS 11 (1994) will continue to be applicable.

6. *Non-integral foreign operation* is defined as a "foreign operation that is not an integral foreign operation".

7. '*Monetary items'* are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money.

8. '*Non-monetary items'* are assets and liabilities other than monetary items.

9. As a general rule, a foreign currency transaction should be recorded, on initial recognition in the reporting currency, by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction. Besides the use of actual exchange rate as at the date on which the relevant transactions occurs, the Standard also allows for practical reasons the use of a rate that approximates the actual rate at the date of the transaction; for example, an average rate for a week or month may be applied to all transactions that occur during such period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is unreliable.

10. At each subsequent balance sheet date:

(a) foreign currency monetary items should be reported using the closing rate. However, in certain circumstances, the closing rate may not reflect with reasonable accuracy the amount in reporting currency that is likely to be realised from, or required to disburse, a foreign currency monetary item at the balance sheet date, e.g., where there are restrictions on remittances or where the closing rate is unrealistic and it is not possible to effect an exchange of currencies at that rate at the balance sheet date. In such circumstances, the relevant monetary item should be reported in the reporting currency at the amount which is likely to be realised from, or required to disburse, such item at the balance sheet date;

(b) non-monetary items which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of the transaction; and

(c) non-monetary items which are carried at fair value or other similar valuation denominated in a foreign currency should be reported using the exchange rates that existed when the values were determined.

11. Exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise, with the exception of exchange differences dealt with in accordance with paragraph 12 below.

12. Exchange differences arising on a monetary item that, in substance, forms part of an enterprise's net investment in a non-integral foreign operation should be accumulated in a foreign currency translation reserve in the enterprise's financial statements until the disposal of the net investment, at which time they should be recognised as income or as expenses in accordance with paragraph 17.

13. A foreign operation that is integral to the operations of the reporting enterprise carries on its business as if it were an extension of the reporting enterprise's operations. For example, such a foreign operation might only sell goods imported from the reporting enterprise and remit the proceeds to the reporting enterprise.

14. In contrast, a non-integral foreign operation accumulates cash and other monetary items, incurs expenses, generates income and perhaps arranges borrowings, all substantially in its local currency. It may also enter into transactions in foreign currencies, including transactions in the reporting currency.

15. The financial statements of an integral foreign operation should be translated using the principles and procedures in

paragraphs 9 to 12 as if the transactions of the foreign operation had been those of the reporting enterprise itself.

16. In translating the financial statements of a non-integral foreign operation for incorporation in its financial statements, the reporting enterprise should use the following procedures:

(a) the assets and liabilities, both monetary and non-monetary, of the non-integral foreign operation should be translated at the closing rate;

(b) income and expense items of the non-integral foreign operation should be translated at exchange rates at the dates of the transactions; and

(c) all resulting exchange differences should be accumulated in a foreign currency translation reserve until the disposal of the net investment.

17. On the disposal of a non-integral foreign operation, the cumulative amount of the exchange differences which have been deferred and which relate to that operation should be recognised as income or as expenses in the same period in which the gain or loss on disposal is recognised.

18. When there is a change in the classification of a foreign operation, the translation procedures applicable to the revised classification should be applied from the date of the change in the classification.

19. The consistency principle requires that foreign operation once classified as integral or non-integral is continued to be so classified. However, a change in the way in which a foreign operation is financed and operates in relation to the reporting enterprise may lead to a change in the classification of that foreign operation. When a foreign operation that is integral to the operations of the reporting enterprise is reclassified as a non-integral foreign operation, exchange differences arising on the translation of non-monetary assets at the date of the reclassification are accumulated

in a foreign currency translation reserve. When a non-integral foreign operation is reclassified as an integral foreign operation, the translated amounts for non-monetary items at the date of the change are treated as the historical cost for those items in the period of change and subsequent periods. Exchange differences which have been deferred are not recognised as income or expenses until the disposal of the operation.

20. An enterprise may enter into a forward exchange contract or another financial instrument that is in substance a forward exchange contract, which is not intended for trading or speculation purposes, to establish the amount of the reporting currency required or available at the settlement date of a transaction. The premium or discount arising at the inception of such a forward exchange contract should be amortised as expense or income over the life of the contract. Exchange differences on such a contract should be recognised in the statement of profit and loss in the reporting period in which the exchange rates change. Any profit or loss arising on cancellation or renewal of such a forward exchange contract should be recognised as income or as expense for the period.

21. A gain or loss on a forward exchange contract to which paragraph 20 does not apply should be computed by multiplying the foreign currency amount of the forward exchange contract by the difference between the forward rate available at the reporting date for the remaining maturity of the contract and the contracted forward rate (or the forward rate last used to measure a gain or loss on that contract for an earlier period). The gain or loss so computed should be recognised in the statement of profit and loss for the period. The premium or discount on the forward exchange contract is not recognised separately.

22. An enterprise should disclose:

(a) the amount of exchange differences included in the net profit or loss for the period; and

(b) net exchange differences accumulated in foreign currency translation reserve as a separate component of shareholders' funds, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.

23. When the reporting currency is different from the currency of the country in which the enterprise is domiciled, the reason for using a different currency should be disclosed. The reason for any change in the reporting currency should also be disclosed.

24. When there is a change in the classification of a significant foreign operation, an enterprise should disclose:

(a) the nature of the change in classification;

(b) the reason for the change;

(c) the impact of the change in classification on shareholders' funds; and

(d) the impact on net profit or loss for each prior period presented had the change in classification occurred at the beginning of the earliest period presented.

Applicability of AS 11 to MFIs

With microfinance gaining momentum and MFIs upscaling their operations, foreign sources are continuously being tapped for funds. MFIs are increasingly entering into various arrangements with enterprises/agencies of other nations giving rise to foreign currency transactions. For instance, grants/ funds may be received from international donor organisations or loans may be issued by foreign financial institutions.

As MFIs maintain their financial statements in Indian Rupees, all such transactions in foreign currency should be translated in Indian Rupees and accounted for in accordance with the requirements of AS 11. Accordingly, the transactions in foreign currency should be recognised at the exchange rate prevalent

on the date of such transactions. Monetary assets and liabilities denominated in foreign currency are to be translated into the exchange rate prevailing at the close of the financial year and net gain or loss (exchange differences) should be recognised in the profit and loss account.

AS 12, ACCOUNTING FOR GOVERNMENT GRANTS

Salient Features and Principal Requirements

1. *Government grants* are "assistance by government in cash or kind to an enterprise for past or future compliance with certain conditions". Government, for this purpose, includes government agencies and similar bodies whether local, national or international.

2. Government grants should not be recognised until there is reasonable assurance that (a) the grants will be received, and (b) the enterprise will comply with the conditions attached to them.

3. A government grant given for the acquisition of a specific fixed asset should be accounted for in either of the following ways:

   (a) The grant should be shown in the balance sheet as a deduction from the gross value of the relevant fixed asset.

   (b) Alternatively, the gross value of the fixed asset should be left undisturbed. Instead, where the grant relates to a non-depreciable asset, e.g., freehold land, it should be credited to capital reserve. However, if a grant related to a non-depreciable asset requires the fulfillment of certain obligations, the grant should be credited to income over the same period over which the cost of meeting such obligations is charged to income; the deferred income balance should be shown separately in the financial statements. On the other hand, if the grant relates to a depreciable asset, it should be treated as deferred income which should be recognised in the profit and loss account by allocating it over the periods and in proportions in which depreciation on the asset concerned is charged.

4. Government grants having the characteristics of promoters' contribution (e.g., grants given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay, as in the case of Central Investment Subsidy Scheme) should be credited to capital reserve.

5. Government grants in the form of non-monetary assets (such as fixed assets) given at a concessional rate should be accounted for on the basis of their acquisition cost. In case a non-monetary asset is given free of cost, it should be recorded at a nominal value (e.g., rupee one).

6. Government grants given with reference to the revenue of the enterprise should be recognised on a systematic basis in the profit and loss account over the periods necessary to match them with the related costs which they are intended to compensate. Such grants should either be shown separately under 'other income' or deducted in reporting the related expense.

7. In some cases, a government grant may be receivable by an enterprise as compensation for expenses or losses incurred in a previous accounting period, or for providing immediate financial support to the enterprise with no further related costs. Such grants should be recognised and disclosed in the profit and loss account of the period in which they are receivable.

8. The amount refundable in respect of a grant related to revenue should be applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount should be charged to profit and loss statement. The amount refundable in respect of a grant related to a specific fixed asset should be recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. In the first alternative, i.e., where the book value of the asset is increased,

depreciation on the revised book value should be provided prospectively over the residual useful life of the asset.

9. The following disclosures should be made in the financial statements:

(a) the accounting policy adopted for government grants, including the methods of presentation in the financial statements; and

(b) the nature and extent of government grants recognised in the financial statements, including grants of non-monetary assets given at a concessional rate or free of cost.

Applicability of AS 12 to MFIs

An enterprise engaged in the business of microfinance receives grants from the government and its agencies. The receipt of grants by a microfinance institution is significant in the preparation of its financial statements on two counts. Firstly, if a grant has been received, an appropriate method of accounting thereof is necessary. Secondly, it is desirable to give an indication of the extent to which the recipient microfinance institution has benefited from such a grant during the reporting period. Hence, lies the importance of accounting for government grants, which is given in AS 12, and is applicable in its entirety to all microfinance institutions. The accounting treatment prescribed in AS 12 is based on the nature of grants and the purpose for which they are received.

MFIs also receive donations and grants from sources other than the government, e.g., donor agencies, individual donors and corporate bodies. The principles of accounting enunciated in AS 12 should also be followed in respect of donations and grants from such donors.

According to the principles laid down in AS 12, donations and grants should not be recognised until there is reasonable assurance that:

(i) **the MFI will comply with the conditions attached to them; and**

(ii) **the donations and grants will be received.**

A mere promise from the government and other donor agencies as to the donation/grant does not provide reasonable assurance that the grant will be received and, therefore, does not require its recognition. The microfinance institution should recognise a grant/donation in its financial statements only at the stage it attains reasonable assurance, on the basis of all available evidence, that the grant/donation will be received. If there is no reasonable assurance that the donation/grant, or any part thereof, will be received, recognition of such donation/grant, or a part thereof, should be postponed. However, the fact that collection of donation/grant has been delayed does not necessarily mean that reasonable assurance does not exist. The donation/grant, the recognition of which has been postponed as suggested heretobefore, should be recognised only in the period in which reasonable assurance is attained that the donation/grant will be received. In some cases, the reasonable assurance will be attained only when cash is actually received. In such a case, recognition of donation/grant on receipt basis does not mean that the MFI has not followed accrual basis of accounting.

Grants/donations are received by a microfinance institution for various purposes such as to acquire fixed assets, to meet operating expenses, to be used for lending to microfinance clients.

As per the requirements of AS 12, grants/donations in the form of non-monetary assets, such as, land, building or any other asset received at a concessional rate should be accounted for at their acquisition cost to the MFI and those given free of cost should be recorded at a nominal value of Rs. 1.

Grants/donations related to revenue include grants/donations

provided by donors and others towards salaries and other operational expenses. Where a microfinance institution receives such grants, it is recommended that both the grants (to the extent utilised during the period) and the relevant expenses should be disclosed separately in the profit and loss account. Such a disclosure would be useful in appreciating the operations undertaken by the MFI during the period.

Similarly, in case microfinance institutions receive grants/ donations to acquire/construct specific fixed assets, it is recommended that it should be accounted for as per paragraph 3(b) given above.

AS 13, ACCOUNTING FOR INVESTMENTS

Salient Features and Principal Requirements

1. *Investments* are "assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise".

2. An enterprise should disclose current investments and long term investments distinctly in its financial statements. A *current investment* is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made. A *long term investment* is an investment other than a current investment.

3. The cost of an investment should include acquisition charges such as brokerage, fees and duties. Where an investment has been purchased on cum-dividend or cum-interest basis, the interest or dividend received subsequently should be allocated between pre-acquisition and post-acquisition periods. The interest or dividend relating to the pre-acquisition period represents a recovery of cost and should, accordingly, be deducted in arriving at cost.

If an investment is acquired, or partly acquired, by the issue of shares or other securities, the acquisition cost should be the fair value of the securities issued (which in appropriate cases may be indicated by the issue price as determined by statutory authorities).

If an investment is acquired in exchange for another asset, the acquisition cost of the investment should be determined by reference to the fair value of the asset given up. Alternatively, the acquisition cost of the investment may be determined with reference to the fair value of the investment acquired if it is more clearly evident.

4. Investments classified as current investments should be carried in the financial statements at the lower of cost and fair value.

5. The term *'fair value'* refers to the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction. The fair value of investments for which an active market exists is determined with reference to their market value. For example, in the case of shares which are actively traded on a stock exchange, the fair value may be determined on the basis of stock exchange quotations. Where an active market does not exist, fair value is determined in some other rational manner.

6. The comparison of cost and fair value for determining the carrying amount of current investments should be made either on an individual investment basis (i.e., cost and fair value should be compared separately for each investment) or by category of investment (i.e., cost of an entire category of investments such as preference shares should be compared with its fair value).

7. Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution should be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually.

8. Investment properties (land and buildings held as investments) should be accounted for as long term investments.

9. Where long-term investments are reclassified as current investments, transfers should be made at the lower of cost and carrying amount at the date of transfer. Where investments are reclassified from current to long-term, transfers should be made at the lower of cost and fair value at the date of transfer.

10. Any reduction in the carrying amount and any reversals of such reductions should be charged or credited to the profit and loss statement.

11. On disposal of an investment, the difference between the carrying amount and net disposal proceeds should be charged or credited to income. When disposing of a part of the holding of an individual investment, the carrying amount to be allocated to that part is to be determined on the basis of the average carrying amount of the total holding of the investment.

12. Further classification of current and long-term investments should be as specified in the statute governing the enterprise. In the absence of a statutory requirement, such further classification should disclose, where applicable, investments in:

(a) Government or Trust securities

(b) Shares, debentures or bonds

(c) Investment properties

(d) Others – specifying nature.

13. The following disclosures should be made in the financial statements:

(a) the accounting policies for determination of carrying amount of investments;

(b) classification of investments;

(c) the amounts included in profit and loss statement for:

(i) interest, dividends (showing separately dividends from subsidiary companies), and rentals on investments showing separately such income from long term and current investments;

(ii) profits and losses on disposal of current investments and changes in the carrying amount of such investments; and

(iii) profits and losses on disposal of long term investments and changes in the carrying amount of such investments;

(d) significant restrictions on the right of ownership, realisability of investments or the remittance of income and proceeds of disposal;

(e) the aggregate amount of quoted and unquoted investments, giving the aggregate market value of quoted investments;

(f) other disclosures as specifically required by the statute governing the enterprise.

Applicability of AS 13 to MFIs

As MFIs invest their surplus cash in fixed deposits, securities, etc., the requirements of this Standard should be followed by them in their entirety. However, it may be noted that MFIs constituted as Non-Banking Financial Companies and Local Area Banks while accounting for investments should give due consideration to the requirements as regards the same given in the prudential norms issued by the Reserve Bank of India.

AS 14, ACCOUNTING FOR AMALGAMATIONS

AS 14 deals with accounting for amalgamations and the treatment of any resultant goodwill or reserves. The Standard is directed principally to companies although some of its requirements also apply to financial statements of other enterprises.

Salient Features and Principal Requirements

1. *Amalgamation* means an amalgamation pursuant to the provisions of the Companies Act, 1956 or any other statute which may be applicable to companies.

2. The Standard classifies amalgamations into following two categories:

   (a) amalgamation in the nature of merger; and

   (b) amalgamation in the nature of purchase.

3. An amalgamation should be considered to be *an amalgamation in the nature of merger* when all the following conditions are satisfied:

   (i) All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.

   (ii) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.

   (iii) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.

   (iv) The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.

(v) No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

4. An amalgamation should be considered to be *an amalgamation in the nature of purchase*, when any one or more of the conditions specified in paragraph 3 is not satisfied.

5. When an amalgamation is considered to be an amalgamation in the nature of merger, the following accounting treatment (*pooling of interest method*) should be followed in the preparation of financial statements of transferee enterprise:

(a) the assets, liabilities and reserves (whether capital or revenue or arising on revaluation) of the transferor company should be recorded at their existing carrying amounts and in the same form as at the date of the amalgamation. The balance of the Profit and Loss Account of the transferor company should be aggregated with the corresponding balance of the transferee company or transferred to the General Reserve, if any.

(b) If, at the time of the amalgamation, the transferor and the transferee companies have conflicting accounting policies, a uniform set of accounting policies should be adopted following the amalgamation. The effects on the financial statements of any changes in accounting policies should be reported in accordance with AS 5.

(c) The difference 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 company should be adjusted in reserves.

6. When an amalgamation is considered to be an amalgamation in the nature of purchase, the following accounting treatment (*purchase method*) should be followed in the preparation of financial statements of transferee enterprise:

(a) the assets and liabilities of the transferor company should be incorporated at their existing carrying amounts or, alternatively, the consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation. The reserves (whether capital or revenue or arising on revaluation) of the transferor company, other than the statutory reserves, should not be included in the financial statements of the transferee company except as stated in (d) below.

(b) Any excess of the amount of the consideration over the value of the net assets of the transferor company acquired by the transferee company should be recognised in the transferee company's financial statements as goodwill arising on amalgamation. If the amount of the consideration is lower than the value of the net assets acquired, the difference should be treated as Capital Reserve.

(c) The goodwill arising on amalgamation should be amortised to income on a systematic basis over its useful life. The amortisation period should not exceed five years unless a somewhat longer period can be justified.

(d) Where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with, statutory reserves of the transferor company should be recorded in the financial statements of the transferee company. The corresponding debit should be given to a suitable account head (e.g., 'Amalgamation Adjustment Account') which should be disclosed as a part of 'miscellaneous expenditure' or other similar category in the balance sheet. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account should be reversed.

7. The consideration for the amalgamation should include any non-cash element at fair value. In case of issue of securities, the value fixed by the statutory authorities may be taken to be the fair value. In case of other assets, the fair value may be determined by reference to the market value of the assets given up. Where the market value of the assets given up cannot be reliably assessed, such assets may be valued at their respective net book values.

8. Where the scheme of amalgamation provides for an adjustment to the consideration contingent on one or more future events, the amount of the additional payment should be included in the consideration if payment is probable and a reasonable estimate of the amount can be made. In all other cases, the adjustment should be recognised as soon as the amount is determinable [see Accounting Standard (AS) 4, *Contingencies and Events Occurring after the Balance Sheet Date*].

9. For all amalgamations, the following disclosures should be made in the first financial statements following the amalgamation:

(a) names and general nature of business of the amalgamating companies;

(b) effective date of amalgamation for accounting purposes;

(c) the method of accounting used to reflect the amalgamation; and

(d) particulars of the scheme sanctioned under a statute.

10. For amalgamations accounted for under the pooling of interest method, the following additional disclosures should be made in the first financial statements following the amalgamation:

(a) description and number of shares issued, together with the percentage of each company's equity shares exchanged to effect the amalgamation;

(b) the amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof.

11. For amalgamations accounted for under the purchase method, the following additional disclosures should be made in the first financial statements following the amalgamation:

(a) consideration for the amalgamation and a description of the consideration paid or contingently payable; and

(b) the amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof including the period of amortisation of any goodwill arising on amalgamation.

Applicability of AS 14 to MFIs

The requirements of the Standard should be followed in their entirety, in case amalgamation/merger mentioned in the Standard takes place between two or more MFIs.

AS 15 (REVISED), EMPLOYEE BENEFITS[12]

AS 15(revised) prescribes accounting and disclosure for all employee benefits, except employee share-based payments[13]. It requires an enterprise to recognise a liability when an employee

[12] Pursuant to the decision of the Council of the Institute at its 265th meeting, AS 15 (revised 2005) comes into effect in respect of accounting periods commencing on or after December 7, 2006 (instead of April 6, 2006, as decided earlier) and is mandatory in nature from that date for all enterprises.

[13] The accounting for such benefits is dealt with in the Guidance Note on Accounting for Employee Share-based Payments issued by the Institute.

has provided service in exchange for employee benefits to be paid in the future; and an expense when the enterprise consumes the economic benefit arising from service provided by an employee in exchange for employee benefits.

Salient Features and Principal Requirements

1. The Standard identifies four categories of employee benefits:

   (a) short-term employee benefits, such as wages, salaries and social security contributions (e.g., contribution to an insurance company by an employer to pay for medical care of its employees), paid annual leave, profit-sharing and bonuses (if payable within twelve months of the end of the period) and non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees;

   (b) post-employment benefits such as gratuity, pension, other retirement benefits, post-employment life insurance and post-employment medical care;

   (c) other long-term employee benefits, including long-service leave or sabbatical leave, jubilee or other long-service benefits, long-term disability benefits and, if they are not payable wholly within twelve months after the end of the period, profit-sharing, bonuses and deferred compensation; and

   (d) termination benefits.

2. AS 15 (revised) requires an enterprise to recognise the undiscounted amount of short-term employee benefits when an employee has rendered service in exchange for those benefits.

3. Post-employment benefit plans are classified as either *defined contribution plans* or *defined benefit plans*. Under defined contribution plans, the enterprise's obligation is limited to the amount that it agrees to contribute to the fund and in consequence, actuarial

risk (that benefits will be less than expected) and investment risk (that assets invested will be insufficient to meet expected benefits) fall on the employee. AS 15 (revised 2005) requires that when an employee has rendered service to an enterprise during a period, the enterprise should recognise the contribution payable to a defined contribution plan in exchange for that service. All other post-employment benefit plans are defined benefit plans. Defined benefit plans may be unfunded, or they may be wholly or partly funded. In respect of defined benefit plans, AS 15 (revised 2005) requires an enterprise to:

(a) account not only for its legal obligation under the formal terms, but also for any other obligation that arises from the enterprise's informal practices;

(b) determine the present value of defined benefit obligations and the fair value of any plan assets with sufficient regularity that the amounts recognised in the financial statements do not differ materially from the amounts that would be determined at the balance sheet date;

(c) use the Projected Unit Credit Method to measure its obligations and related costs;

(d) attribute benefit to periods of service under the plan's benefit formula, unless an employee's service in later years will lead to a materially higher level of benefit than in earlier years;

(e) use unbiased and mutually compatible actuarial assumptions about demographic assumptions (such as, mortality, employee turnover) and financial assumptions (such as discount rate, future salary and benefit levels). Financial assumptions should be based on market expectations, at the balance sheet date, for the period over which the obligations are to be settled;

(f) determine the discount rate by reference to market yields at the balance sheet date on government bonds of a currency and term consistent with the currency and estimated term of the post-employment benefit obligations;

(g) deduct the fair value of any plan assets from the present value of the defined benefit obligation at the balance sheet date. Certain reimbursement rights that do not qualify as plan assets are treated in the same way as plan assets, except that they are presented as a separate asset, rather than as a deduction from the obligation;

(h) limit the carrying amount of a defined benefit asset so that it does not exceed the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan;

(i) recognise past service cost as an expense on a straight-line basis over the average period until the benefits become vested. To the extent that the benefits are already vested immediately following the introduction of, or changes to, a defined benefit plan, an enterprise should recognise past service cost immediately;

(j) recognise gains or losses on the curtailment or settlement of a defined benefit plan when the curtailment or settlement occurs;

(k) recognise immediately actuarial gains and losses in the statement of profit and loss as income or expense; and

(l) make disclosures regarding defined benefit plans.

4. AS 15 (revised 2005) requires a simplified method of accounting for other long-term employee benefits. This method differs from the accounting required for post-employment benefits insofar as that all past service cost is recognised immediately.

5. *Termination benefits* are employee benefits payable as a result of either: an enterprise's decision to terminate an employee's

employment before the normal retirement date; or an employee's decision to accept voluntary redundancy in exchange for those benefits. An enterprise should recognise termination benefits as a liability and an expense when, and only when:

(i) the enterprise has a present obligation as a result of a past event;

(ii) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(iii) a reliable estimate can be made of the amount of the obligation.

6. On first adopting AS 15 (revised 2005), the difference (as adjusted by any related tax expense) between the liability (on the date of first adoption) in respect of employee benefits other than defined benefits plans and termination benefits, determined as per AS 15 (revised 2005) and the liability that would have been recognised at the same date, as per the pre-revised AS 15, should be adjusted against the opening balance of revenue reserves and surplus.

7. On first adopting AS 15 (revised 2005), in respect of defined benefit plans, the difference (as adjusted by any related tax expense) between the transitional liability and the liability that would have been recognised at the same date, as per pre-revised AS 15, should be adjusted immediately, against opening balance of revenue reserves and surplus[14].

8. In respect of expenditure on termination benefits, though AS 15 (revised 2005) requires immediate expensing; as a transitory measure it is provided that where an enterprise incurs expenditure on termination benefits on or before 31st March, 2009, the enterprise

[14] A limited revision was made in 2007, pursuant to which an option has been given to charge additional liability arising upon the first application of the AS 15 (revised 2005) as an expense over a period upto 5 years.

may choose to follow the accounting policy of deferring such expenditure over its pay-back period. However, the expenditure so deferred cannot be carried forward to accounting periods commencing on or after 1st April, 2010.

Applicability of AS 15 (revised) to MFIs

The provisions of the Standard are applicable to MFIs in their entirety except to the extent of the exemptions/relaxations from certain measurement and disclosure requirements available to MFIs which fall within the meaning of SMEs/SMCs. For example, an MFI falling under the category of SMEs and whose average number of persons employed during the year is less than 50 is exempted totally from the application of actuarial method for defined benefit plans. For details of the various exemptions/relaxations available to SMEs/SMCs, Appendix 2 may be referred to.

AS 16, BORROWING COSTS

Salient Features and Principal Requirements

1. *Borrowing costs* are defined as “interest and other costs incurred by an enterprise in connection with the borrowing of funds”. Thus, apart from interest, borrowing costs would also include the following:

(a) commitment charges on bank borrowings and other short-term and long-term borrowings;

(b) amortisation of discounts or premiums relating to borrowings;

(c) amortisation of ancillary costs incurred in connection with the arrangement of borrowings;

(d) finance charges in respect of assets acquired under finance leases or under other similar arrangements; and

(e) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

2. Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. Other borrowing costs should be recognised as an expense in the period in which they are incurred. A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Examples of qualifying assets are manufacturing plants, power generation facilities, inventories that require a substantial period of time to bring them to a saleable condition, and investment properties. Other investments, and those inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired also are not qualifying assets.

3. The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made.

4. To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.

5. To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation should be determined by applying a capitalisation rate to the expenditure on that asset. The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the

purpose of obtaining a qualifying asset. The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period.

6. The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence when all the following conditions are satisfied:

(a) expenditure for the acquisition, construction or production of a qualifying asset is being incurred;

(b) borrowing costs are being incurred; and

(c) activities that are necessary to prepare the asset for its intended use or sale are in progress.

Expenditure on a qualifying asset includes only such expenditure that has resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities. Expenditure is reduced by any progress payments received and grants received in connection with the asset.

The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include technical and administrative work prior to the commencement of physical construction, such as the activities associated with obtaining permits prior to the commencement of the physical construction. However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place. For example, borrowing costs incurred while land is under development are capitalised during the period in which activities related to the development are being undertaken. However, borrowing costs incurred while land acquired for building purposes is held without any associated development activity do not qualify for capitalisation.

7. Capitalisation of borrowing costs should be suspended during extended periods in which active development is interrupted. However, capitalisation of borrowing costs is not normally

suspended during a period when substantial technical and administrative work is being carried out. Capitalisation of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. For example, capitalisation continues during the extended period needed for inventories to mature or the extended period during which high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographic region involved.

8. Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete.

9. The financial statements should disclose:

(a) the accounting policy adopted for borrowing costs; and

(b) the amount of borrowing costs capitalised during the period.

Applicability of AS 16 to MFIs

This Standard is relevant for microfinance institutions as they raise short-term and long-term loans, both commercial and concessional, from various sources to further on-lend to their clients and meet several operational expenses. Borrowing costs for microfinance institutions refer to interest and other charges incurred on debt/borrowings, i.e., interest to banks, financial institutions and others for money loaned by them to microfinance institutions. As per AS 16, all borrowing costs should be recognised as expenses in the period in which they are incurred except where such costs are directly

attributable to the acquisition, construction or production of qualifying assets. These costs should be capitalised as part of the costs of such assets. It may be noted that though MFIs normally do not borrow for the purpose of acquisition, construction, or production of assets, but where such a situation arises, the relevant accounting treatment as per AS 16 would be applicable.

AS 17, SEGMENT REPORTING

AS 17 establishes principles for reporting financial information, about the different types of products and services an enterprise produces (business segments) and different geographical areas in which it operates (geographical segments).

Salient Features and Principal Requirements

1. *Business segment* is defined as "a distinguishable component of an enterprise that is engaged in providing an individual product or service or a group of related products or services and that is subject to risks and returns that are different from those of other business segments. Factors that should be considered in determining whether products or services are related include:

(a) the nature of the products or services;

(b) the nature of the production processes;

(c) the type or class of customers for the products or services;

(d) the methods used to distribute the products or provide the services; and

(e) if applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities".

2. *Geographical segment* is defined as "a distinguishable component of an enterprise that is engaged in providing products

or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments. Factors that should be considered in identifying geographical segments include:

(a) similarity of economic and political conditions;

(b) relationships between operations in different geographical areas;

(c) proximity of operations;

(d) special risks associated with operations in a particular area;

(e) exchange control regulations; and

(f) the underlying currency risks".

3. *Reportable segment* is defined as a "business segment or a geographical segment identified on the basis of foregoing definitions for which segment information is required to be disclosed by this Standard".

4. The Standard also defines enterprise revenue, segment revenue, segment expense, segment asset and segment liability.

5. The dominant source and nature of risks and returns of an enterprise should govern whether its primary segment reporting format will be business segments or geographical segments. If the risks and returns of an enterprise are affected predominantly by differences in the products and services it produces, its primary format for reporting segment information should be business segments, with secondary information reported geographically. Similarly, if the risks and returns of the enterprise are affected predominantly by the fact that it operates in different countries or other geographical areas, its primary format for reporting segment

information should be geographical segments, with secondary information reported for groups of related products and services.

6. Internal organisation and management structure of an enterprise and its system of internal financial reporting to the board of directors and the chief executive officer should normally be the basis for identifying the predominant source and nature of risks and differing rates of return facing the enterprise and, therefore, for determining which reporting format is primary and which is secondary, except as provided in sub-paragraphs (a) and (b) below:

(a) if risks and returns of an enterprise are strongly affected both by differences in the products and services it produces and by differences in the geographical areas in which it operates, as evidenced by a "matrix approach" to managing the company and to reporting internally to the board of directors and the chief executive officer, then the enterprise should use business segments as its primary segment reporting format and geographical segments as its secondary reporting format; and

(b) if internal organisational and management structure of an enterprise and its system of internal financial reporting to the board of directors and the chief executive officer are based neither on individual products or services or groups of related products/services nor on geographical areas, the directors and management of the enterprise should determine whether the risks and returns of the enterprise are related more to the products and services it produces or to the geographical areas in which it operates and should, accordingly, choose business segments or geographical segments as the primary segment reporting format of the enterprise, with the other as its secondary reporting format.

7. Business and geographical segments of an enterprise for external reporting purposes should be those organisational units for which information is reported to the board of directors and to the chief executive officer for the purpose of evaluating the unit's

performance and for making decisions about future allocations of resources. except as provided in the paragraph given below.

8. If internal organisational and management structure of an enterprise and its system of internal financial reporting to the board of directors and the chief executive officer are based neither on individual products or services or groups of related products/services nor on geographical areas, sub-paragraph 6(b) above requires that the directors and management of the enterprise should choose either business segments or geographical segments as the primary segment reporting format of the enterprise based on their assessment of which reflects the primary source of the risks and returns of the enterprise, with the other as its secondary reporting format. In that case, the directors and management of the enterprise should determine its business segments and geographical segments for external reporting purposes based on the factors in the definitions stated above, rather than on the basis of its system of internal financial reporting to the board of directors and chief executive officer, consistent with the following:

(a) if one or more of the segments reported internally to the directors and management is a business segment or a geographical segment based on the factors in the definitions of terms stated above but others are not, sub-paragraph (b) below should be applied only to those internal segments that do not meet the definitions (that is, an internally reported segment that meets the definition should not be further segmented);

(b) for those segments reported internally to the directors and management that do not satisfy the definitions stated above, management of the enterprise should look to the next lower level of internal segmentation that reports information along product and service lines or geographical lines, as appropriate under the definitions stated above; and

(c) if such an internally reported lower-level segment meets the definition of business segment or geographical segment based on the factors given in the definitions stated above, the criteria given in the following paragraph for identifying reportable segments should be applied to that segment.

9. A business segment or geographical segment should be identified as a reportable segment if:

(a) its revenue from sales to external customers and from transactions with other segments is 10 per cent or more of the total revenue, external and internal, of all segments; or

(b) its segment result, whether profit or loss, is 10 per cent or more of:

(i) the combined result of all segments in profit, or

(ii) the combined result of all segments in loss, whichever is greater in absolute amount; or

(c) its segment assets are 10 per cent or more of the total assets of all segments.

10. A business segment or a geographical segment which is not a reportable segment as per the above paragraph may be designated as a reportable segment despite its size at the discretion of the management of the enterprise. If that segment is not designated as a reportable segment, it should be included as an unallocated reconciling item.

11. If total external revenue attributable to reportable segments constitutes less than 75 per cent of the total enterprise revenue, additional segments should be identified as reportable segments, even if they do not meet the 10 per cent thresholds stated above until at least 75 per cent of total enterprise revenue is included in reportable segments.

12. A segment identified as a reportable segment in the immediately preceding period because it satisfied the relevant 10 per cent thresholds should continue to be a reportable segment for the current period notwithstanding that its revenue, result, and assets all no longer meet the 10 per cent thresholds.

13. If a segment is identified as a reportable segment in the current period because it satisfies the relevant 10 per cent thresholds, preceding-period segment data that is presented for comparative purposes should, unless it is impracticable to do so, be restated to reflect the newly reportable segment as a separate segment, even if that segment did not satisfy the 10 per cent thresholds in the preceding period.

14. Segment information should be prepared in conformity with the accounting policies adopted for preparing and presenting the financial statements of the enterprise as a whole.

15. Assets and liabilities that relate jointly to two or more segments should be allocated to segments if, and only if, their related revenues and expenses also are allocated to those segments.

16. The disclosure requirements stated in paragraphs 17 and 18 below should be applied to each reportable segment based on primary reporting format of an enterprise.

17. An enterprise should disclose the following for each reportable segment:

(a) segment revenue, classified into segment revenue from sales to external customers and segment revenue from transactions with other segments;

(b) segment result;

(c) total carrying amount of segment assets;

(d) total amount of segment liabilities;

(e) total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets);

(f) total amount of expense included in the segment result for depreciation and amortisation in respect of segment assets for the period; and

(g) total amount of significant non-cash expenses, other than depreciation and amortisation in respect of segment assets, that were included in segment expense and, therefore, deducted in measuring segment result.

18. An enterprise should present a reconciliation between the information disclosed for reportable segments and the aggregated information in the enterprise financial statements. In presenting the reconciliation, segment revenue should be reconciled to enterprise revenue; segment result should be reconciled to enterprise net profit or loss; segment assets should be reconciled to enterprise assets; and segment liabilities should be reconciled to enterprise liabilities.

19. If primary format of an enterprise for reporting segment information is business segments, it should also report the following information for secondary segment:

(a) segment revenue from external customers by geographical area based on the geographical location of its customers, for each geographical segment whose revenue from sales to external customers is 10 per cent or more of enterprise revenue;

(b) the total carrying amount of segment assets by geographical location of assets, for each geographical segment whose segment assets are 10 per cent or more of the total assets of all geographical segments; and

(c) the total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets) by geographical location of assets, for each geographical segment whose segment assets are 10 per cent or more of the total assets of all geographical segments.

20. If primary format of an enterprise for reporting segment information is geographical segments (whether based on location of assets or location of customers), it should also report the following segment information for each business segment whose revenue from sales to external customers is 10 per cent or more of enterprise revenue or whose segment assets are 10 per cent or more of the total assets of all business segments:

(a) segment revenue from external customers;

(b) the total carrying amount of segment assets; and

(c) the total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets).

21. If primary format of an enterprise for reporting segment information is geographical segments that are based on location of assets, and if the location of its customers is different from the location of its assets, then the enterprise should also report revenue from sales to external customers for each customer-based geographical segment whose revenue from sales to external customers is 10 per cent or more of enterprise revenue.

22. If primary format of an enterprise for reporting segment information is geographical segments that are based on location of customers, and if the assets of the enterprise are located in different geographical areas from its customers, then the enterprise should also report the following segment information for each asset-based geographical segment whose revenue from sales to external customers or segment assets are 10 per cent or more of total enterprise amounts:

(a) the total carrying amount of segment assets by geographical location of the assets; and

(b) the total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets) by location of the assets.

23. In measuring and reporting segment revenue from transactions with other segments, inter-segment transfers should be measured on the basis that the enterprise actually used to price those transfers. The basis of pricing inter-segment transfers and any change therein should be disclosed in the financial statements.

24. Changes in accounting policies adopted for segment reporting that have a material effect on segment information should be disclosed. Such disclosure should include a description of the nature of the change, and the financial effect of the change if it is reasonably determinable.

25. An enterprise should indicate the types of products and services included in each reported business segment and indicate the composition of each reported geographical segment, both primary and secondary, if not otherwise disclosed in the financial statements.

Applicability of AS 17 to MFIs

MFIs operating in different geographical locations or involved in different kinds of service delivery programmes, which meet the definition of 'geographical segment' and 'business segment', should disclose segmental information according to the requirements of this Standard. It may be noted that though MFIs falling in the SME/SMC category are exempted from the requirements of this Standard, in the interest of transparency of the microfinance operations, it is recommended to give segment information in the financial statements.

The different business segments that are possible in a microfinance institution are:

- **Microfinance services, i.e., only providing loans and other financial services.**
- **Consultancy and Technical services, i.e., providing consultancy and support to other upcoming MFIs.**
- **Developmental Activities, i.e., carrying on developmental activities such as training, health care, literacy programmes, etc.**

Thus, from the above, it follows that a multi-service MFI which provides a range of activities along with engaging in microfinance activities should prepare and present segment information (provided that the risks and rewards of such activities are different from microfinance activities as required under AS 17). In India about 25% microfinance institutions are multi-service MFIs. Thus, such an MFI providing segment information as per AS 17 would help the users of the financial statements to visualise the correct picture of the microfinance scenario. However, it may be noted that where the provision of non-microfinance services is an integral part of their methodology for delivering microfinance services, for instance, MFIs may believe that business training for their clients is crucial to the clients' ability to repay their loans, then in such a case, segment reporting is not required. The method used to allocate shared costs or revenue between microfinance and non-microfinance services should be clearly explained. Dividing revenue between these two services is usually straightforward. Allocating expenses can be more difficult because many expenses are shared between the two types of services, such as certain office costs or the time of the employee/s that deal with both services. Thus, a reasonable allocation formula should be determined and disclosed.

AS 18, RELATED PARTY DISCLOSURES

AS 18 applies to reporting of related party relationships and transactions between reporting enterprise and its related parties.

Salient Features and Principal Requirements

1. This Standard deals with only the following types of related party relationships:

   (a) enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries);

   (b) associates and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture;

   (c) individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual;

   (d) key management personnel and relatives of such personnel; and

   (e) enterprises over which any person described in (c) or (d) is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.

2. The following are deemed not to be related parties:

   (a) two companies simply because they have a director in common, unless the director is able to affect the policies of both companies in their mutual dealings;

(b) a single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence; and

(c) the parties listed below, in the course of their normal dealings with an enterprise by virtue only of those dealings (although they may circumscribe the freedom of action of the enterprise or participate in its decision-making process):

(i) providers of finance;

(ii) trade unions;

(iii) public utilities;

(iv) government departments and government agencies including government sponsored bodies.

3. *Related party* has been defined as “parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions”.

4. *Related party transaction* is defined as “a transfer of resources or obligations between related parties, regardless of whether or not a price is charged”.

5. *Control* has been defined as

“(a) ownership, directly or indirectly, of more than one half of the voting power of an enterprise, or

(b) control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise, or

(c) a substantial interest in voting power and the power to direct, by statute or agreement, the financial and/or operating policies of the enterprise”.

6. *Significant influence* has been defined as “participation in the financial and/or operating policy decisions of an enterprise, but not control of those policies”.

7. In case a statute or a regulator or a similar competent authority governing an enterprise prohibits the enterprise to disclose certain information which otherwise is required to be disclosed, disclosure of such information is not warranted.

8. No disclosure is required in consolidated financial statements in respect of intra-group transactions. Disclosure of transactions between members of a group is unnecessary in consolidated financial statements because consolidated financial statements present information about the holding and its subsidiaries as a single reporting enterprise.

9. No disclosure is required in the financial statements of state-controlled enterprises as regards related party relationships with other state-controlled enterprises and transactions with such enterprises.

10. Name of the related party and nature of the related party relationship where control exists should be disclosed irrespective of whether or not there have been transactions between the related parties.

11. If there have been transactions between related parties, during the existence of a related party relationship, the reporting enterprise should disclose the following:

(i) the name of the transacting related party;

(ii) a description of the relationship between the parties;

(iii) a description of the nature of transactions;

(iv) volume of the transactions either as an amount or as an appropriate proportion;

(v) any other elements of the related party transactions necessary for an understanding of the financial statements;

(vi) the amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date; and

(vii) amounts written off or written back in the period in respect of debts due from or to related parties.

12. Items of a similar nature may be disclosed in aggregate by type of related party except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the reporting enterprise.

Applicability of AS 18 to MFIs

This Standard assumes importance because related parties may enter into transactions which unrelated parties would not enter into. Thus, a related party relationship could affect the financial position and operating results of the reporting enterprise. MFIs should, therefore, disclose the related party relationships and transactions in accordance with the requirements of AS 18. For instance, for the purposes of AS 18, trustees of a trust-form of an MFI and managing/whole time director(s) etc., in case of NBFC-form of an MFI would be considered as key management personnel and, accordingly, along with their relatives they would be treated as related parties. It may be noted that according to AS 18, relative, in relation to an individual, means the spouse, son, daughter, brother, sister, father and mother who may be expected to influence, or be influenced by, that individual in his/her dealings with the reporting enterprise. Related party transactions in an MFI may include the following:

(a) *Insider loans to persons with influence over an MFI's governance or management*. In such a scenario, the MFI should make full disclosures, including outstanding amounts, interest rates, collateral and repayment status.

(b) Services rendered to or received from associates, etc.

(c) Remuneration payable to key management personnel.

Some MFIs may fall in the Level III category of non-corporate entities, and are thus exempted from meeting the requirements of this Standard. However, due to the heavy implications of related party transactions on the functioning of microfinance institutions, it is recommended that disclosure as per AS 18 should be made by all MFIs, regardless of their legal form.

AS 19, LEASES

AS 19 applies to accounting for all leases except the following:

(a) lease agreements to explore for or use natural resources, such as oil, gas, timber, metals and other mineral rights; and

(b) licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights; and

(c) lease agreements to use lands.

Salient Features and Principal Requirements

1. *Lease* is defined as "an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time".

2. The definition of a lease includes agreements for the hire of an asset which contain a provision giving the hirer an option to acquire title to the asset upon the fulfillment of agreed conditions. These agreements are commonly known as hire purchase agreements. Hire purchase agreements include agreements under which the property in the asset is to pass to the hirer on the payment of the last instalment and the hirer has a right to terminate the agreement at any time before the property so passes.

3. The Standard classifies leases into the following two categories:

(a) finance lease; and

(b) operating lease.

4. A *finance lease* is a lease that transfers substantially all the risks and rewards incident to ownership of an asset to the lessee. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form. Examples of situations which would normally lead to a lease being classified as a finance lease are:

(a) the lease transfers ownership of the asset to the lessee by the end of the lease term;

(b) the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised;

(c) the lease term is for the major part of the economic life of the asset even if title is not transferred;

(d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and

(e) the leased asset is of a specialised nature such that only the lessee can use it without major modifications being made.

5. An *operating lease* is defined as "a lease other than a finance lease".

Financial Statements of Lessee

Finance leases

6. At the inception of a finance lease, the lessee should recognise the lease as an asset and a liability. Such recognition should be at an amount equal to the fair value of the leased asset at the inception of the lease. However, if the fair value of the leased asset exceeds the present value of the minimum lease payments from the standpoint of the lessee, the amount recorded as an asset and a liability should be the present value of the minimum lease payments from the standpoint of the lessee. In calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate should be used.

7. Lease payments should be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge should be allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period.

8. In the books of lessee, finance lease gives rise to a depreciation expense for the asset as well as a finance expense for each accounting period. The depreciation policy for a leased asset should be consistent with that for depreciable assets which are owned, and the depreciation recognised should be calculated on the basis set out in Accounting Standard (AS) 6, *Depreciation Accounting*. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset should

be fully depreciated over the lease term or its useful life, whichever is shorter.

9. The lessee should, in addition to the requirements of AS 10, *Accounting for Fixed Assets*, AS 6, *Depreciation Accounting*, and the governing statute, should disclose, *inter alia*, assets acquired under finance lease as segregated from the assets owned, and for each class of assets, the net carrying amount at the balance sheet date.

Operating leases

10. Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss of lessee on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

Financial Statements of Lessors

Finance leases

11. The lessor should recognise assets given under a finance lease in its balance sheet as a receivable at an amount equal to the net investment in the lease.

12. The recognition of finance income should be based on a pattern reflecting a constant periodic rate of return on the net investment of the lessor outstanding in respect of the finance lease.

Operating leases

13. The lessor should present an asset given under operating lease in its balance sheet under fixed assets.

14. Lease income from operating leases should be recognised in the statement of profit and loss on a straight line basis over the lease term, unless another systematic basis is more representative

of the time pattern in which benefit derived from the use of the leased asset is diminished.

15. The depreciation of leased assets should be on a basis consistent with the normal depreciation policy of the lessor for similar assets, and the depreciation charge should be calculated on the basis set out in AS 6, *Depreciation Accounting.*

16. The lessor should, in addition to the requirements of AS 6, *Depreciation Accounting*, and AS 10, *Accounting for Fixed Assets*, and the governing statute, should disclose, *inter alia*, for each class of assets, the gross carrying amount, the accumulated depreciation and the depreciation recognised in the statement of profit and loss for the period.

Sale and Leaseback Transactions

17. If a sale and leaseback transaction results in a finance lease, any excess or deficiency of sales proceeds over the carrying amount should not be immediately recognised as income or loss in the financial statements of a seller-lessee. Instead, it should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset.

18. If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss should be recognised immediately. If the sale price is below fair value, any profit or loss should be recognised immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used. If the sale price is above fair value, the excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.

Applicability of AS 19 to MFIs

MFIs may enter into lease agreements to acquire various assets, such as premises for carrying on its microfinance

activities. In such a scenario, MFIs are required to follow the requirements of this Standard in their entirety. However, it may be mentioned that MFIs which fall within the meaning of SME/SMC are exempted from certain disclosure requirements of AS 19 (Refer Appendix 2).

AS 20, EARNINGS PER SHARE

Salient Features and Principal Requirements

1. An enterprise should present basic and diluted earnings per share on the face of the statement of profit and loss for each class of equity shares that has a different right to share in the net profit for the period with equal prominence for all periods presented. Basic and diluted earnings per share are required to be disclosed, even if the amounts disclosed are negative (a loss per share).

2. Basic earnings per share should be calculated by dividing the net profit or loss for the period attributable to equity shareholders by the weighted average number of equity shares outstanding during the period.

3. For the purpose of calculating basic earnings per share, the net profit or loss for the period attributable to equity shareholders should be the net profit or loss for the period after deducting preference dividends and any attributable tax thereto for the period.

4. For the purpose of calculating basic earnings per share, the number of equity shares should be the weighted average number of equity shares outstanding during the period. The weighted average number of equity shares outstanding during the period and for all periods presented should be adjusted for events, other than the conversion of potential equity shares, that have changed the number of equity shares outstanding, without a corresponding change in resources, e.g., a bonus issue.

5. For the purpose of calculating diluted earnings per share, the net profit or loss for the period attributable to equity shareholders

and the weighted average number of shares outstanding during the period should be adjusted for the effects of all dilutive potential equity shares. The amount of net profit or loss for the period attributable to equity shareholders, as calculated in accordance with paragraph 3 above, should be adjusted by the following, after taking into account any attributable change in tax expense for the period:

(a) any dividends on dilutive potential equity shares which have been deducted in arriving at the net profit attributable to equity shareholders;

(b) interest recognised in the period for the dilutive potential equity shares; and

(c) any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.

6. For the purpose of calculating diluted earnings per share, the number of equity shares should be the aggregate of the weighted average number of equity shares calculated for computation of basic earnings per share and the weighted average number of equity shares which would be issued on the conversion of all the dilutive potential equity shares into equity shares. Dilutive potential equity shares should be deemed to have been converted into equity shares at the beginning of the period or, if issued later, the date of the issue of the potential equity shares.

7. For the purpose of calculating diluted earnings per share, an enterprise should assume the exercise of dilutive options and other dilutive potential equity shares of the enterprise. The assumed proceeds from these issues should be considered to have been received from the issue of shares at fair value. The difference between the number of shares issuable and the number of shares that would have been issued at fair value should be treated as an issue of equity shares for no consideration.

8. Potential equity shares should be treated as dilutive when, and only when, their conversion to equity shares would decrease net profit per share from continuing ordinary operations.

9. If the number of equity or potential equity shares outstanding increases as a result of a bonus issue or share split or decreases as a result of a reverse share split (consolidation of shares), the calculation of basic and diluted earnings per share should be adjusted for all the periods presented. If these changes occur after the balance sheet date but before the date on which the financial statements are approved by the board of directors, the per share calculations for those financial statements and any prior period financial statements presented should be based on the new number of shares. When per share calculations reflect such changes in the number of shares, that fact should be disclosed.

10. In addition to the disclosure required in earlier paragraphs, an enterprise should also disclose the following:

(i) where the statement of profit and loss includes extraordinary items (within the meaning of AS 5, *Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies*), the enterprise should disclose basic and diluted earnings per share computed on the basis of earnings excluding extraordinary items (net of tax expenses);and

(ii) (a) the amounts used as the numerators in calculating basic and diluted earnings per share, and a reconciliation of those amounts to the net profit or loss for the period;

(b) the weighted average number of equity shares used as the denominator in calculating basic and diluted earnings per share, and a reconciliation of these denominators to each other; and

(c) the nominal value of shares along with the earnings per share figures.

11. If an enterprise discloses, in addition to basic and diluted earnings per share, per share amounts using a reported component of net profit other than net profit or loss for the period attributable to equity shareholders, such amounts should be calculated using the weighted average number of equity shares determined in accordance with this Standard. If a component of net profit is used which is not reported as a line item in the statement of profit and loss, a reconciliation should be provided between the component used and a line item which is reported in the statement of profit and loss. Basic and diluted per share amounts should be disclosed with equal prominence.

Applicability of AS 20 to MFIs

Earnings per share is an important indicator of the performance of an enterprise and the disclosure of the same helps in evaluating the enterprise's performance in a better way. The provisions of this Standard are relevant for MFIs, though it is not applicable to all legal forms, such as MFIs registered as societies and trusts. Hence, an MFI whose equity shares or potential equity shares are listed on a recognised stock exchange or an MFI whose equity shares are not listed but which chooses to disclose its earnings per share must follow the requirements of this Standard in its entirety. It may also be noted that a company form of MFI which is required to give information under Part IV of Schedule VI to the Companies Act, 1956, should calculate and disclose earnings per share in accordance with AS 20, whether or not its equity shares or potential equity shares are listed on a recognised stock exchange in India.

It may also be noted that for MFIs which fall within the scope of SMEs/SMCs, there are certain relaxations with regard to AS 20 for which Appendix 2 may be referred.

AS 21, CONSOLIDATED FINANCIAL STATEMENTS

The Standard applies to the preparation and presentation of consolidated financial statements for a group of enterprises under the control of a parent and to the accounting for investments in subsidiaries in the separate financial statements of a parent.

Salient Features and Principal Requirements

1. *Subsidiary* is defined as “an enterprise that is controlled by another enterprise (known as the parent)”.

2. *Parent* is defined as “an enterprise that has one or more subsidiaries”.

3. *Control* is defined as:

“(a) the ownership, directly or indirectly through subsidiary(ies), of more than one-half of the voting power of an enterprise; or

(b) control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economic benefits from its activities”.

4. Control exists when the parent owns, directly or indirectly through subsidiary(ies), more than one-half of the voting power of an enterprise. Control also exists when an enterprise controls the composition of the board of directors (in the case of a company) or of the corresponding governing body (in case of an enterprise not being a company) so as to obtain economic benefits from its activities. An enterprise may control the composition of the governing bodies of entities such as gratuity trust, provident fund trust, etc. Since the objective of control over such entities is not to obtain economic benefits from their activities, these are not considered for the purpose of preparation of consolidated financial statements. For the purpose of this Standard, an enterprise is considered to control the composition of:

(i) the board of directors of a company, if it has the power, without the consent or concurrence of any other person, to appoint or remove all or a majority of directors of that company. An enterprise is deemed to have the power to appoint a director, if any of the following conditions is satisfied:

(a) a person cannot be appointed as director without the exercise in his favour by that enterprise of such a power as aforesaid; or

(b) a person's appointment as director follows necessarily from his appointment to a position held by him in that enterprise; or

(c) the director is nominated by that enterprise or a subsidiary thereof.

(ii) The governing body of an enterprise that is not a company, if it has the power, without the consent or the concurrence of any other person, to appoint or remove all or a majority of members of the governing body of that other enterprise. An enterprise is deemed to have the power to appoint a member, if any of the following conditions is satisfied:

(a) a person cannot be appointed as member of the governing body without the exercise in his favour by that other enterprise of such a power as aforesaid; or

(b) a person's appointment as member of the governing body follows necessarily from his appointment to a position held by him in that other enterprise; or

(c) the member of the governing body is nominated by that other enterprise.

5. A parent which presents consolidated financial statements should present these statements in addition to its separate financial statements and must consolidate all subsidiaries, domestic as well as foreign, except those mentioned in paragraph 6 below.

6. A subsidiary should be excluded from consolidation when:

(a) control is intended to be temporary because the subsidiary is acquired and held exclusively with a view to its subsequent disposal in the near future; or

(b) it operates under severe long-term restrictions which significantly impair its ability to transfer funds to the parent.

In consolidated financial statements, investments in such subsidiaries should be accounted for in accordance with AS 13, *Accounting for Investments*. The reasons for not consolidating a subsidiary should be disclosed in the consolidated financial statements.

7. In preparing consolidated financial statements, the financial statements of the parent and its subsidiaries should be combined on a line by line basis by adding together like items of assets, liabilities, income and expenses. In order that the consolidated financial statements present financial information about the group as that of a single enterprise, the following steps should be taken:

(a) the cost to the parent of its investment in each subsidiary and the parent's portion of equity of each subsidiary, at the date on which investment in each subsidiary is made, should be eliminated;

(b) any excess of the cost to the parent of its investment in a subsidiary over the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made, should be described as goodwill to be recognised as an asset in the consolidated financial statements;

(c) when the cost to the parent of its investment in a subsidiary is less than the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made, the difference should be treated as a capital reserve in the consolidated financial statements;

(d) minority interests in the net income of consolidated subsidiaries for the reporting period should be identified and adjusted against the income of the group in order to arrive at the net income attributable to the owners of the parent; and

(e) minority interests in the net assets of consolidated subsidiaries should be identified and presented in the consolidated balance sheet separately from liabilities and the equity of the parent's shareholders. Minority interests in the net assets consist of:

(i) the amount of equity attributable to minorities at the date on which investment in a subsidiary is made; and

(ii) the minorities' share of movements in equity since the date the parent-subsidiary relationship came in existence.

Where the carrying amount of the investment in the subsidiary is different from its cost, the carrying amount is considered for the purpose of above computations.

8. Intragroup balances and intragroup transactions and resulting unrealised profits are eliminated in full. Unrealised losses resulting from intragroup transactions are also eliminated unless cost cannot be recovered.

9. The financial statements used in the consolidation should be drawn upto the same reporting date. If it is not practicable to draw up the financial statements of one or more subsidiaries to such date and, accordingly, those financial statements are drawn up to

different reporting dates, adjustments should be made for the effects of significant transactions or other events that occur between those dates and the date of the parent's financial statements. In any case, the difference between reporting dates should not be more than six months.

10. Consolidated financial statements should be prepared using uniform accounting policies for like transactions and other events in similar circumstances. If it is not practicable to use uniform accounting policies in preparing the consolidated financial statements, that fact should be disclosed together with the proportions of the items in the consolidated financial statements to which the different accounting policies have been applied.

11. An investment in an enterprise should be accounted for in accordance with Accounting Standard (AS) 13, *Accounting for Investments*, from the date the enterprise ceases to be a subsidiary and does not become an associate.

12. Minority interests should be presented in the consolidated balance sheet separately from liabilities and the equity of the parent's shareholders. Minority interests in the income of the group should also be separately presented.

13. In a parent's separate financial statements, investments in subsidiaries should be accounted for in accordance with Accounting Standard (AS) 13, *Accounting for Investments*.

14. The following additional disclosures should be made in the consolidated financial statements:

(a) a list of all subsidiaries including the name, country of incorporation or residence, proportion of ownership interest and, if different, proportion of voting power held;

(b) where applicable:

(i) the nature of the relationship between the parent and a subsidiary, if the parent does not own, directly or indirectly through subsidiaries, more than one-half of the voting power of the subsidiary;

(ii) the effect of the acquisition and disposal of subsidiaries on the financial position at the reporting date, the results for the reporting period and on the corresponding amounts for the preceding period; and

(iii) the names of the subsidiary(ies) of which reporting date(s) is/are different from that of the parent and the difference in reporting dates.

Applicability of AS 21 to MFIs

An MFI may control another enterprise (which could be in any form of organisation) either through ownership of more than one-half voting power or through control over the governing body of the enterprise. In case such a control exists, the MFI would be considered as parent and the enterprise that is controlled by the MFI would be a subsidiary. In such a case, the MFI should prepare and present consolidated financial statements in accordance with the requirements of AS 21.

AS 22, ACCOUNTING FOR TAXES ON INCOME

AS 22 applies to accounting for taxes on income including the determination of the amount of the expense or saving related to taxes on income in respect of an accounting period and the disclosure of such an amount in the financial statements.

Salient Features and Principal Requirements

1. *Current tax* is defined as “the amount of income tax determined to be payable (recoverable) in respect of the taxable income (tax loss) for a period”.

2. *Deferred tax* is defined as “the tax effect of timing differences”.

3. *Timing differences* are defined as "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". Timing differences arise because the period in which some items of revenue and expenses are included in taxable income do not coincide with the period in which such items of revenue and expenses are included or considered in arriving at accounting income. Unabsorbed depreciation and carry forward of losses which can be set-off against future taxable income are also considered as timing differences.

4. *Permanent differences* are defined as "the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently".

5. Tax expense for the period, comprising current tax and deferred tax, should be included in the determination of the net profit or loss for the period. In other words, tax effects of timing differences are also included in the tax expense in the statement of profit and loss and as deferred tax assets (subject to the consideration of prudence) or as deferred tax liabilities, in the balance sheet.

6. Deferred tax is required to be recognised for all the timing differences, subject to the consideration of prudence in respect of deferred tax assets as set out in paragraphs 7 and 8 below.

7. Except in the situations stated in paragraph 8, deferred tax assets should be recognised and carried forward only to the extent that there is a reasonable certainty that sufficient future taxable income will be available against which such deferred tax assets can be realised.

8. Where an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realised.

9. At each balance sheet date, an enterprise re-assesses unrecognised deferred tax assets. The enterprise recognises previously unrecognised deferred tax assets to the extent that it has become reasonably certain or virtually certain, as the case may be, that sufficient future taxable income will be available against which such deferred tax assets can be realised.

10. Current tax should be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the applicable tax rates and tax laws.

11. Deferred tax assets and liabilities should be measured using the tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date.

12. Deferred tax assets and liabilities should not be discounted to their present value.

13. The carrying amount of deferred tax assets should be reviewed at each balance sheet date. An enterprise should write-down the carrying amount of a deferred tax asset to the extent that it is no longer reasonably certain or virtually certain, as the case may be, that sufficient future taxable income will be available against which deferred tax asset can be realised. Any such write-down may be reversed to the extent that it becomes reasonably certain or virtually certain, as the case may be, that sufficient future taxable income will be available.

14. An enterprise should offset assets and liabilities representing current tax if the enterprise:

(a) has a legally enforceable right to set off the recognised amounts; and

(b) intends to settle the asset and the liability on a net basis.

15. An enterprise should offset deferred tax assets and deferred tax liabilities if:

(a) the enterprise has a legally enforceable right to set off assets against liabilities representing current tax; and

(b) the deferred tax assets and the deferred tax liabilities relate to taxes on income levied by the same governing taxation laws.

16. Deferred tax assets and liabilities should be distinguished from assets and liabilities representing current tax for the period. Deferred tax assets and liabilities should be disclosed under a separate heading in the balance sheet of the enterprise, separately from current assets and current liabilities.

17. The break-up of deferred tax assets and deferred tax liabilities into major components of the respective balances should be disclosed in the notes to accounts. The nature of the evidence supporting the recognition of deferred tax assets should also be disclosed, if an enterprise has unabsorbed depreciation or carry forward of losses under tax laws.

Applicability of AS 22 to MFIs

The requirements of this Standard should be followed by MFIs in their entirety. In case of not-for-profit form of MFIs, normally some kinds of exemptions are allowed from the payment of income tax due to the nature of their charitable objects and non-profit motives. For the purposes of AS 22, such exemptions allowed to not-for-profit MFIs under the Income-tax Act, 1961, could be considered as permanent differences.

AS 23, ACCOUNTING FOR INVESTMENTS IN ASSOCIATES IN CONSOLIDATED FINANCIAL STATEMENTS

AS 23 deals with accounting for investments in associates in the consolidated financial statements of an investor. If an enterprise presents consolidated financial statements, it should account for investments in associates in the consolidated financial statements in accordance with AS 23.

Salient Features and Principal Requirements

1. An *associate* is defined as "an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor".

2. *Significant influence* is defined as "the power to participate in the financial and/or operating policy decisions of the investee but not control over those policies". Significant influence does not extend to power to govern the financial and/or operating policies of an enterprise. Significant influence may be gained by share ownership, statute or agreement. As regards share ownership, if an investor holds, directly or indirectly through subsidiary(ies), 20% or more of the voting power of the investee, it is presumed that the investor has significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly through subsidiary(ies), less than 20% of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

3. The existence of significant influence by an investor is usually evidenced in one or more of the following ways:

   (a) Representation on the board of directors or corresponding governing body of the investee;

   (b) participation in policy making processes;

   (c) material transactions between the investor and the investee;

   (d) interchange of managerial personnel; or

   (e) provision of essential technical information.

4. The *equity method* is defined as "a method of accounting whereby the investment is initially recorded at cost, identifying any goodwill/capital reserve arising at the time of acquisition. The carrying amount of the investment is adjusted thereafter for the post acquisition change in the investor's share of net assets of the investee. The consolidated statement of profit and loss reflects the investor's share of the results of operations of the investee".

5. An investment in an associate should be accounted for in consolidated financial statements under the equity method except when:

(a) the investment is acquired and held exclusively with a view to its subsequent disposal in the near future; or

(b) the associate operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor.

Investments in such associates should be accounted for in accordance with AS 13, *Accounting for Investments*. The reasons for not applying the equity method in accounting for investments in an associate should be disclosed in the consolidated financial statements.

6. An investor should discontinue the use of the equity method from the date that:

(a) it ceases to have significant influence in an associate but retains, either in whole or in part, its investment; or

(b) the use of the equity method is no longer appropriate because the associate operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor.

From the date of discontinuing the use of the equity method, investments in such associates should be accounted for in accordance with AS 13, *Accounting for Investments.* For this purpose, the carrying amount of the investment at that date should be regarded as cost thereafter.

7. Many of the procedures appropriate for the application of the equity method are similar to the consolidation procedures set out in AS 21, *Consolidated Financial Statements*. Furthermore, the broad concepts underlying the consolidation procedures used in the acquisition of a subsidiary are adopted on the acquisition of an investment in an associate.

8. Goodwill/capital reserve arising on the acquisition of an associate by an investor should be included in the carrying amount of investment in the associate but should be disclosed separately.

9. In using equity method for accounting for investment in an associate, unrealised profits and losses resulting from transactions between the investor (or its consolidated subsidiaries) and the associate should be eliminated to the extent of the investor's interest in the associate. Unrealised losses should not be eliminated if and to the extent the cost of the transferred asset cannot be recovered.

10. The most recent available financial statements of the associate are used by the investor in applying the equity method; they are usually drawn up to the same date as the financial statements of the investor. When the reporting dates of the investor and the associate are different, the associate often prepares, for the use of the investor, statements as at the same date as the financial statements of the investor. When it is impracticable to do this, financial statements drawn up to a different reporting date may be used. The consistency principle requires that the length of the reporting periods, and any difference in the reporting dates, are consistent from period to period.

11. When financial statements with a different reporting date are used, adjustments are made for the effects of any significant events or transactions between the investor (or its consolidated subsidiaries) and the associate that occur between the date of the associate's financial statements and the date of the investor's consolidated financial statements.

12. The investor usually prepares consolidated financial statements using uniform accounting policies for the like transactions and events in similar circumstances. In case an associate uses accounting policies other than those adopted for the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to the associate's financial statements when they are used by the investor in applying the equity method. If it is not practicable to do so, that fact is disclosed along with a brief description of the differences between the accounting policies.

13. If an associate has outstanding cumulative preference shares held outside the group, the investor computes its share of profits or losses after adjusting for the preference dividends whether or not the dividends have been declared.

14. If, under the equity method, an investor's share of losses of an associate equals or exceeds the carrying amount of the investment, the investor ordinarily discontinues recognising its share of further losses and the investment is reported at nil value. Additional losses are provided for to the extent that the investor has incurred obligations or made payments on behalf of the associate to satisfy obligations of the associate that the investor has guaranteed or to which the investor is otherwise committed. If the associate subsequently reports profits, the investor resumes including its share of those profits only after its share of the profits equals the share of net losses that have not been recognised.

15. Where an associate presents consolidated financial statements, the results and net assets to be taken into account are those reported in that associate's consolidated financial statements.

16. The carrying amount of investment in an associate should be reduced to recognise a decline, other than temporary, in the value of the investment, such reduction being determined and made for each investment individually.

17. An appropriate listing and description of associates including the proportion of ownership interest and, if different, the proportion of voting power held should be disclosed in the consolidated financial statements.

18. Investments in associates accounted for using the equity method should be classified as long-term investments and disclosed separately in the consolidated balance sheet. The investor's share of the profits or losses of such investments should be disclosed separately in the consolidated statement of profit and loss. The investor's share of any extraordinary or prior period items should also be separately disclosed.

19. The name(s) of the associate(s) of which reporting date(s) is/are different from that of the financial statements of an investor and the differences in reporting dates should be disclosed in the consolidated financial statements.

20. In case an associate uses accounting policies other than those adopted for the consolidated financial statements for like transactions and events in similar circumstances and it is not practicable to make appropriate adjustments to the associate's financial statements, the fact should be disclosed along with a brief description of the differences in the accounting policies.

Applicability of AS 23 to MFIs

All MFIs should account for investments in associates in the consolidated financial statements, where such statements are prepared as per AS 21, according to the equity method as per the requirements of this Standard.

AS 24, DISCONTINUING OPERATIONS

The Standard establishes principles for reporting information about discontinuing operations, thereby enhancing the ability of users of financial statements to make projections of an enterprise's cash flows, earnings-generating capacity, and financial position by segregating information about discontinuing operations from information about continuing operations.

Salient Features and Principal Requirements

1. A *discontinuing operation* is defined as "a component of an enterprise:

(a) that the enterprise, pursuant to a single plan, is:

(i) disposing of substantially in its entirety, such as by selling the component in a single transaction or by demerger or spin-off of ownership of the component to the enterprise's shareholders; or

(ii) disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually; or

(iii) terminating through abandonment; and

(b) that represents a separate major line of business or geographical area of operations; and

(c) that can be distinguished operationally and for financial reporting purposes."

2. Business enterprises frequently close facilities, abandon products or even product lines, and change the size of their work force in response to market forces. While those kinds of terminations generally are not, in themselves, discontinuing operations as per definition of the term, they can occur in connection with a discontinuing operation.

3. A reportable business segment or geographical segment as defined in AS 17, *Segment Reporting*, would normally satisfy criterion (b) of the definition of a discontinuing operation, that is, it would represent a separate major line of business or geographical area of operations. A part of such a segment may also satisfy

criterion (b) of the definition. For an enterprise that operates in a single business or geographical segment and therefore does not report segment information, a major product or service line may also satisfy the criteria of the definition.

4. A component can be distinguished operationally and for financial reporting purposes - criterion (c) of the definition of a discontinuing operation - if all the following conditions are met:

(a) the operating assets and liabilities of the component can be directly attributed to it;

(b) its revenue can be directly attributed to it;

(c) at least a majority of its operating expenses can be directly attributed to it.

5. Assets, liabilities, revenue, and expenses are directly attributable to a component if they would be eliminated when the component is sold, abandoned or otherwise disposed of. If debt is attributable to a component, the related interest and other financing costs are similarly attributed to it.

6. With respect to a discontinuing operation, the initial disclosure event is the occurrence of one of the following, whichever occurs earlier:

(a) the enterprise has entered into a binding sale agreement for substantially all of the assets attributable to the discontinuing operation; or

(b) the enterprise's board of directors or similar governing body has both (i) approved a detailed, formal plan for the discontinuance and (ii) made an announcement of the plan.

7. An enterprise should apply the principles of recognition and measurement that are set out in other Accounting Standards for the purpose of deciding as to when and how to recognise and

measure the changes in assets and liabilities and the revenue, expenses, gains, losses and cash flows relating to a discontinuing operation.

8. An enterprise should include the following information relating to a discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure event occurs:

(a) a description of the discontinuing operation(s);

(b) the business or geographical segment(s) in which it is reported as per AS 17, *Segment Reporting*;

(c) the date and nature of the initial disclosure event;

(d) the date or period in which the discontinuance is expected to be completed if known or determinable;

(e) the carrying amounts, as of the balance sheet date, of the total assets to be disposed of and the total liabilities to be settled;

(f) the amounts of revenue and expenses in respect of the ordinary activities attributable to the discontinuing operation during the current financial reporting period;

(g) the amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto; and

(h) the amounts of net cash flows attributable to the operating, investing, and financing activities of the discontinuing operation during the current financial reporting period.

9. When an enterprise disposes of assets or settles liabilities attributable to a discontinuing operation or enters into binding

agreements for the sale of such assets or the settlement of such liabilities, it should include, in its financial statements, the following information when the events occur:

(a) for any gain or loss that is recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation, (i) the amount of the pre-tax gain or loss and (ii) income tax expense relating to the gain or loss; and

(b) the net selling price or range of prices (which is after deducting expected disposal costs) of those net assets for which the enterprise has entered into one or more binding sale agreements, the expected timing of receipt of those cash flows and the carrying amount of those net assets on the balance sheet date.

10. In addition to the disclosures stated in above paragraphs, an enterprise should include, in its financial statements, for periods subsequent to the one in which the initial disclosure event occurs, a description of any significant changes in the amount or timing of cash flows relating to the assets to be disposed or liabilities to be settled and the events causing those changes.

11. The disclosures required by paragraphs 8, 9 and 10 should continue in financial statements for periods up to and including the period in which the discontinuance is completed. A discontinuance is completed when the plan is substantially completed or abandoned, though full payments from the buyer(s) may not yet have been received.

12. If an enterprise abandons or withdraws from a plan that was previously reported as a discontinuing operation, that fact, reasons therefor and its effect should be disclosed.

13. Any disclosures required by this Standard should be presented separately for each discontinuing operation.

14. The disclosures required by paragraphs 8, 9, 10, 11, 12 and

13 should be presented in the notes to the financial statements except the following which should be shown on the face of the statement of profit and loss:

(a) the amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto; and

(b) the amount of the pre-tax gain or loss recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation.

15. Comparative information for prior periods that is presented in financial statements prepared after the initial disclosure event should be restated to segregate assets, liabilities, revenue, expenses, and cash flows of continuing and discontinuing operations.

16. Disclosures in an interim financial report in respect of a discontinuing operation should be made in accordance with AS 25, *Interim Financial Reporting*, including:

(a) any significant activities or events since the end of the most recent annual reporting period relating to a discontinuing operation; and

(b) any significant changes in the amount or timing of cash flows relating to the assets to be disposed of or liabilities to be settled.

Applicability of AS 24 to MFIs

Since the information about the discontinuing operations would enhance the utility of the information presented in the financial statements, MFIs should present information about discontinuing operations in accordance with the requirements of this Standard. For the purposes of this Standard, each major programme/project carried on by the MFI may be considered as a separate major line of business. However,

MFIs that fall within the category of Level III of non-corporate entities need not apply this Standard.

AS 25, INTERIM FINANCIAL REPORTING

This Standard prescribes the minimum content of an interim financial report and prescribes the principles for recognition and measurement in a complete or condensed financial statements for an interim period. Timely and reliable interim financial reporting improves the ability of investors, creditors, and others to understand an enterprise's capacity to generate earnings and cash flows, its financial condition and liquidity.

Salient Features and Principal Requirements

1. *Interim period* is defined as "a financial reporting period shorter than a full financial year".

2. *Interim financial report* means "a financial report containing either a complete set of financial statements or a set of condensed financial statements (as described in this Standard) for an interim period".

3. An interim financial report should include, at a minimum, the following components:

   (a) condensed balance sheet;

   (b) condensed statement of profit and loss;

   (c) condensed cash flow statement; and

   (d) selected explanatory notes.

4. An enterprise may also present a complete set of financial statements in its interim financial report, rather than a set of condensed financial statements or may also include, in condensed interim financial statements, more than the minimum line items or

selected explanatory notes. The recognition and measurement principles set out in this Standard apply also to complete financial statements for an interim period.

5. If an enterprise prepares and presents a complete set of financial statements in its interim financial report, the form and content of those statements should conform to the requirements as applicable to annual complete set of financial statements.

6. If an enterprise prepares and presents a set of condensed financial statements in its interim financial report, those condensed statements should include, at a minimum, each of the headings and sub-headings that were included in its most recent annual financial statements and the selected explanatory notes. Additional line items or notes should also be included if their omission would make the condensed interim financial statements misleading.

7. If an enterprise presents basic and diluted earnings per share in its annual financial statements in accordance with AS 20, *Earnings Per Share*, basic and diluted earnings per share should be presented in accordance with AS 20 on the face of the statement of profit and loss, complete or condensed, for an interim period.

8. If an enterprise's annual financial report included the consolidated financial statements, the interim financial report includes both the consolidated financial statements and separate financial statements, complete or condensed.

9. An enterprise should include the following information, as a minimum, in the notes to its interim financial statements, if material and if not disclosed elsewhere in the interim financial report:

(a) a statement that the same accounting policies are followed in the interim financial statements as those followed in the most recent annual financial statements or, if those policies have been changed, a description of the nature and effect of the change;

(b) explanatory comments about the seasonality of interim operations;

(c) the nature and amount of items affecting assets, liabilities, equity, net income, or cash flows that are unusual because of their nature, size, or incidence (see paragraphs 12 to 14 of AS 5, *Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies*);

(d) the nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year or changes in estimates of amounts reported in prior financial years, if those changes have a material effect in the current interim period;

(e) issuances, buy-backs, repayments and restructuring of debt, equity and potential equity shares;

(f) dividends, aggregate or per share (in absolute or percentage terms), separately for equity shares and other shares;

(g) segment revenue, segment capital employed (segment assets minus segment liabilities) and segment result for business segments or geographical segments, whichever is the enterprise's primary basis of segment reporting (disclosure of segment information is required in an enterprise's interim financial report only if the enterprise is required, in terms of AS 17, *Segment Reporting*, to disclose segment information in its annual financial statements);

(h) material events subsequent to the end of the interim period that have not been reflected in the financial statements for the interim period;

(i) the effect of changes in the composition of the enterprise during the interim period, such as amalgamations, acquisition or disposal of subsidiaries and long-term investments, restructurings, and discontinuing operations; and

(j) material changes in contingent liabilities since the last annual balance sheet date.

The above information should normally be reported on a financial year-to-date basis. However, the enterprise should also disclose any events or transactions that are material to an understanding of the current interim period.

10. The disclosures required by other Accounting Standards are not required if an enterprise's interim financial report includes only condensed financial statements and selected explanatory notes rather than a complete set of financial statements.

11. Interim reports should include interim financial statements (condensed or complete) for periods as follows:

(a) balance sheet as of the end of the current interim period and a comparative balance sheet as of the end of the immediately preceding financial year;

(b) statements of profit and loss for the current interim period and cumulatively for the current financial year to date, with comparative statements of profit and loss for the comparable interim periods (current and year-to-date) of the immediately preceding financial year;

(c) cash flow statement cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.

12. The enterprises whose business is highly seasonal are encouraged to report financial information for the twelve months

ending on the interim reporting date and comparative information for the prior twelve-month period in addition to the information called for in the preceding paragraph.

13. If an estimate of an amount reported in an interim period is changed significantly during the final interim period of the financial year but a separate financial report is not prepared and presented for that final interim period, the nature and amount of that change in estimate should be disclosed in a note to the annual financial statements for that financial year.

14. An enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements.

15. An enterprise that reports half-yearly, uses information available by mid-year or shortly thereafter in making the measurements in its financial statements for the first six-month period and information available by year-end or shortly thereafter for the twelve-month period. The twelve-month measurements will reflect any changes in estimates of amounts reported for the first six-month period. The amounts reported in the interim financial report for the first six-month period are not retrospectively adjusted. The nature and amount of any significant changes in estimates is required to be disclosed.

16. An enterprise that reports more frequently than half-yearly, measures income and expenses on a year-to-date basis for each interim period using information available when each set of financial statements is being prepared. Amounts of income and expenses reported in the current interim period will reflect any changes in estimates of amounts reported in prior interim periods of the financial year. The amounts reported in prior interim periods are not retrospectively adjusted. The nature and amount of any significant changes in estimates is required to be disclosed.

17. Revenues that are received seasonally or occasionally within a financial year should not be anticipated or deferred as of an interim date if anticipation or deferral would not be appropriate at the end of the enterprise's financial year.

18. Costs that are incurred unevenly during an enterprise's financial year should be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year.

19. The measurement procedures to be followed in an interim financial report should be designed to ensure that the resulting information is reliable and that all material financial information that is relevant to an understanding of the financial position or performance of the enterprise is appropriately disclosed. While measurements in both annual and interim financial reports are often based on reasonable estimates, the preparation of interim financial reports generally will require a greater use of estimation methods than annual financial reports.

20. A change in accounting policy, other than one for which the transition is specified by an Accounting Standard, should be reflected by restating the financial statements of prior interim periods of the current financial year.

Applicability of AS 25 to MFIs

An MFI that presents interim financial reports must follow the requirements of this Standard in its entirety.

AS 26, INTANGIBLE ASSETS

AS 26 applies to accounting for intangible assets, except:

(a) intangible assets that are covered by another Accounting Standard;

(b) financial assets[15];

(c) mineral rights and expenditure on the exploration for, or development and extraction of, minerals, oil, natural gas and similar non-regenerative resources; and

(d) intangible assets arising in insurance enterprises from contracts with policyholders.

AS 26 applies to, among other things, expenditure on advertising, training, start-up, research and development activities. Research and development activities are directed to the development of knowledge. Therefore, although these activities may result in an asset with physical substance (for example, a prototype), the physical element of the asset is secondary to its intangible component, that is the knowledge embodied in it.

Salient Features and Principal Requirements

1. *Intangible asset* is defined as "an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes".

2. If an item covered by this Standard does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred. However, if the item is acquired in an amalgamation in the nature of purchase, it forms part of the goodwill recognised at the date of the amalgamation.

[15] A financial asset is any asset that is:

(a) cash;

(b) a contractual right to receive cash or another financial asset from another enterprise;

(c) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or

(d) an ownership interest in another enterprise.

3. Some intangible assets may be contained in or on a physical substance such as a compact disk (in the case of computer software), legal documentation (in the case of a license or patent) or film (in the case of motion pictures). The cost of the physical substance containing the intangible assets is usually not significant. Accordingly, the physical substance containing an intangible asset, though tangible in nature, is commonly treated as a part of the intangible asset contained in or on it.

4. In some cases, an asset may incorporate both intangible and tangible elements that are, in practice, inseparable. In determining whether such an asset should be treated under AS 10, *Accounting for Fixed Assets*, or as an intangible asset under this Standard, judgement is required to assess as to which element is predominant. For example, computer software for a computer controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as a fixed asset. The same applies to the operating system of a computer. Where the software is not an integral part of the related hardware, computer software is treated as an intangible asset.

5. The definition of an intangible asset requires that an intangible asset be identifiable. To be identifiable, it is necessary that the intangible asset is clearly distinguished from goodwill. An intangible asset can be clearly distinguished from goodwill if the asset is separable. An asset is separable if the enterprise could rent, sell, exchange or distribute the specific future economic benefits attributable to the asset without also disposing of future economic benefits that flow from other assets used in the same revenue earning activity. Separability is not a necessary condition for identifiability since an enterprise may be able to identify an asset in some other way.

6. An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. Market and technical knowledge may give rise to future economic benefits. An enterprise controls those benefits if, for example, the knowledge is protected by legal rights such as

copyrights, a restraint of trade agreement (where permitted) or by a legal duty on employees to maintain confidentiality. Specific management or technical talent is unlikely to meet the definition of an intangible asset, unless it is protected by legal rights to use it and to obtain the future economic benefits expected from it, and it also meets the other parts of the definition.

7. The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the enterprise.

8. An intangible asset should be recognised if, and only if:

(a) it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and

(b) the cost of the asset can be measured reliably.

9. An enterprise should assess the probability of future economic benefits using reasonable and supportable assumptions that represent best estimate of the set of economic conditions that will exist over the useful life of the asset.

10. An intangible asset should be measured initially at cost.

11. The cost of an intangible asset comprises its purchase price, including any import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), and any directly attributable expenditure on making the asset ready for its intended use. If an intangible asset is acquired in exchange for shares or other securities of the reporting enterprise, the asset is recorded at its fair value, or the fair value of the securities issued, whichever is more clearly evident.

12. Intangible asset acquired free of charge, or for nominal consideration, by way of a government grant should be accounted for in accordance with the requirements of AS 12, *Accounting for Government Grants*.

13. Cost of intangible asset acquired in exchange or part exchange of another asset is determined in accordance with the principles laid down in this regard in AS 10, *Accounting for Fixed Assets*.

14. Internally generated goodwill should not be recognised as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.

15. No intangible asset arising from research (or from the research phase of an internal project) should be recognised. Expenditure on research (or on the research phase of an internal project) should be recognised as an expense when it is incurred.

16. An intangible asset arising from development (or from the development phase of an internal project) should be recognised if, and only if, an enterprise can demonstrate all of the following:

(a) the technical feasibility of completing the intangible asset so that it will be available for use or sale;

(b) its intention to complete the intangible asset and use or sell it;

(c) its ability to use or sell the intangible asset;

(d) how the intangible asset will generate probable future economic benefits. Among other things, the enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;

(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and

(f) its ability to measure the expenditure attributable to the intangible asset during its development reliably.

17. Enterprise assesses the future economic benefits to be received from the asset using the principles stated in Accounting Standard on Impairment of Assets[16]. If the asset will generate economic benefits only in combination with other assets, the enterprise applies the concept of cash-generating units as set out in Accounting Standard on Impairment of Assets.

18. Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance should not be recognised as intangible assets.

19. The cost of an internally generated intangible asset is the sum of expenditure incurred from the time when the intangible asset first meets the recognition criteria. The cost of an internally generated intangible asset comprises all expenditure that can be directly attributed, or allocated on a reasonable and consistent basis, to creating, producing and making the asset ready for its intended use.

20. Expenditure on an intangible item should be recognised as an expense when it is incurred unless:

(a) it forms part of the cost of an intangible asset that meets the recognition criteria as laid down in this Standard; or

(b) the item is acquired in an amalgamation in the nature of purchase and cannot be recognised as an intangible asset. If this is the case, this expenditure (included in the cost of acquisition) should form part of the amount attributed to goodwill (capital reserve) at the date of acquisition (see AS 14, *Accounting for Amalgamations*).

[16] Accounting Standard (AS) 28, *Impairment of Assets*, specifies the requirements relating to impairment of assets.

21. Expenditures recognised as an expense when incurred include:

(a) expenditure on start-up activities (start-up costs), unless this expenditure is included in the cost of an item of fixed asset under AS 10. Start-up costs may consist of preliminary expenses incurred in establishing a legal entity such as legal and secretarial costs, expenditure to open a new facility or business (pre-opening costs) or expenditures for commencing new operations or launching new products or processes (pre-operating costs);

(b) expenditure on training activities;

(c) expenditure on advertising and promotional activities; and

(d) expenditure on relocating or re-organising part or all of an enterprise.

22. Expenditure on an intangible item that was initially recognised as an expense by a reporting enterprise in previous annual financial statements or interim financial reports should not be recognised as part of the cost of an intangible asset at a later date.

23. Subsequent expenditure on an intangible asset after its purchase or its completion should be recognised as an expense when it is incurred unless:

(a) it is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance; and

(b) the expenditure can be measured and attributed to the asset reliably.

If these conditions are met, the subsequent expenditure should be added to the cost of the intangible asset.

24. After initial recognition, an intangible asset should be carried at its cost less any accumulated amortisation and any accumulated impairment losses.

25. The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Amortisation should commence when the asset is available for use.

26. The useful life of an intangible asset may be very long but it is always finite. Uncertainty justifies estimating the useful life of an intangible asset on a prudent basis, but it does not justify choosing a life that is unrealistically short.

27. If control over the future economic benefits from an intangible asset is achieved through legal rights that have been granted for a finite period, the useful life of the intangible asset should not exceed the period of the legal rights unless:

(a) the legal rights are renewable; and

(b) renewal is virtually certain.

28. The amortisation method used should reflect the pattern in which the asset's economic benefits are consumed by the enterprise. If that pattern cannot be determined reliably, the straight-line method should be used. The amortisation charge for each period should be recognised as an expense unless another Accounting Standard permits or requires it to be included in the carrying amount of another asset.

29. The residual value of an intangible asset should be assumed to be zero unless:

(a) there is a commitment by a third party to purchase the asset at the end of its useful life; or

(b) there is an active market for the asset and:

(i) residual value can be determined by reference to that market; and

(ii) it is probable that such a market will exist at the end of the asset's useful life.

30. The amortisation period and the amortisation method should be reviewed at least at each financial year end. If the expected useful life of the asset is significantly different from previous estimates, the amortisation period should be changed accordingly. If there has been a significant change in the expected pattern of economic benefits from the asset, the amortisation method should be changed to reflect the changed pattern. Such changes should be accounted for in accordance with AS 5, *Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies*.

31. To determine whether an intangible asset is impaired, an enterprise applies Accounting Standard on Impairment of Assets[17].

32. In addition to the requirements of Accounting Standard on Impairment of Assets, an enterprise should estimate the recoverable amount of the following intangible assets at least at each financial year end even if there is no indication that the asset is impaired:

(a) an intangible asset that is not yet available for use; and

(b) an intangible asset that is amortised over a period exceeding ten years from the date when the asset is available for use.

The recoverable amount should be determined under Accounting Standard on Impairment of Assets and impairment losses recognised accordingly.

[17] Accounting Standard (AS) 28, *Impairment of Assets*, specifies the requirements relating to impairment of assets.

33. An intangible asset should be derecognised (eliminated from the balance sheet) on disposal or when no future economic benefits are expected from its use and subsequent disposal. Gains or losses arising from the retirement or disposal of an intangible asset should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognised as income or expense in the statement of profit and loss.

34. An intangible asset that is retired from active use and held for disposal is carried at its carrying amount at the date when the asset is retired from active use. At least at each financial year end, an enterprise tests the asset for impairment under Accounting Standard on Impairment of Assets and recognises any impairment loss accordingly.

35. The financial statements should disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets:

(a) the useful lives or the amortisation rates used;

(b) the amortisation methods used;

(c) the gross carrying amount and the accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period.

36. The financial statements should also disclose:

(a) if an intangible asset is amortised over more than ten years, the reasons why it is presumed that the useful life of an intangible asset will exceed ten years from the date when the asset is available for use. In giving these reasons, the enterprise should describe the factor(s) that played a significant role in determining the useful life of the asset;

(b) a description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the financial statements of the enterprise as a whole;

(c) the existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities; and

(d) the amount of commitments for the acquisition of intangible assets.

37. The financial statements should disclose the aggregate amount of research and development expenditure recognised as an expense during the period.

Applicability of AS 26 to MFIs

An MFI should follow the requirements in respect of recognition, measurement and disclosure of intangible assets as per AS 26. The following paragraphs highlight some peculiar scenarios which arise while applying AS 26 to an MFI.

Group formation expenditure

Initial expenditure is generally incurred on the formation of groups where an MFI follows a group-based approach, such as a self-help group methodology. Such expenditure includes all direct expenses including salary and traveling expenses of all the staff directly engaged in the formation and development of these groups. There is a general practice by MFIs to treat such group formation expenses as deferred revenue expenditure. Since this expenditure does not lead to the creation or acquisition of an intangible asset that can be recognised in the financial statements, in view of the principles of AS 26, such expenditure should be expensed in the year in which it is incurred by way of a charge to the profit and loss account (refer to paragraphs 20 and 21 as given above).

Capacity building expenses

Microfinance being a new emerging industry calls for a lot of investment in infrastructure. For instance, MFIs incur expenditures on training of staff for microfinance activities, on exploring new area/s etc. Expenditures of such type provide long-term benefits to an MFI. In accordance with AS 26, such expenditures which provide future economic benefits but do not lead to creating/acquiring of an intangible asset or other asset that can be recognised should be expensed in the profit and loss account when incurred (refer to paragraphs 20 and 21 as given above).

Computer Software Development Charges

Microfinance institutions generally use computer software/s for the purposes of management information system. Computer software for internal use by an MFI can be developed in-house or acquired from an outside agency and the same should be accounted for in accordance with the principles of AS 26. For instance, where it is acquired, the cost should be recognised as an asset if the recognition criteria are met (refer paragraphs 8 and 9). Expenditure arising from the research/preliminary phase in the internal generation of the software should be recognised as an expense when incurred. Internally generated software arising at the development stage should be recognised as an asset if it fulfills certain conditions given in paragraph 16. Also, for accounting the subsequent expenditure on computer software and the amortisation method to be adopted, the principles given in this Standard should be followed.

AS 27, FINANCIAL REPORTING OF INTERESTS IN JOINT VENTURES

AS 27 applies to accounting for interests in joint ventures and the reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors, regardless of the structures or forms under which the joint venture activities take place.

Salient Features and Principal Requirements

1. *Joint venture* is defined as "a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control".

2. *Joint control* is "the contractually agreed sharing of control over an economic activity". *Control* is "the power to govern the financial and operating policies of an economic activity so as to obtain benefits from it".

3. *Proportionate consolidation* is defined as "a method of accounting and reporting whereby a venturer's share of each of the assets, liabilities, income and expenses of a jointly controlled entity is reported as separate line items in the venturer's financial statements".

4. This Standard identifies three broad types of joint ventures – jointly controlled operations, jointly controlled assets and jointly controlled entities – which are commonly described as, and meet the definition of, joint ventures. The following characteristics are common to all joint ventures:

   (a) two or more venturers are bound by a contractual arrangement; and

   (b) the contractual arrangement establishes joint control.

5. The contractual arrangement establishes joint control over the joint venture. Such an arrangement ensures that no single venturer is in a position to unilaterally control the activity. The arrangement identifies those decisions in areas essential to the goals of the joint venture which require the consent of all the venturers and those decisions which may require the consent of a specified majority of the venturers.

6. The contractual arrangement may identify one venturer as the operator or manager of the joint venture. The operator does not control the joint venture but acts within the financial and operating policies which have been agreed to by the venturers in accordance with the contractual arrangement and delegated to the operator.

7. *Jointly controlled operations* involve the use of the assets and other resources of the venturers rather than the establishment of a corporation, partnership or other entity, or a financial structure that is separate from the venturers themselves. An example of a jointly controlled operation is when two or more venturers combine their operations, resources and expertise in order to manufacture, market and distribute, jointly, a particular product, such as an aircraft. Different parts of the manufacturing process are carried out by each of the venturers. Each venturer bears its own costs and takes a share of the revenue from the sale of the aircraft, such share being determined in accordance with the contractual arrangement.

8. In respect of its interests in jointly controlled operations, a venturer should recognise in its separate financial statements and consequently in its consolidated financial statements:

(a) the assets that it controls and the liabilities that it incurs; and

(b) the expenses that it incurs and its share of the income that it earns from the joint venture.

9. *Jointly controlled assets* involve the joint control, and often the joint ownership, by the venturers of one or more assets contributed to, or acquired for the purpose of, the joint venture and dedicated to the purposes of the joint venture. The assets are used to obtain economic benefits for the venturers. Each venturer may take a share of the output from the assets and each bears an agreed share of the expenses incurred. These joint ventures do not involve the establishment of a corporation, partnership or other entity, or a financial structure that is separate from the venturers

themselves. Each venturer has control over its share of future economic benefits through its share in the jointly controlled asset.

10. In respect of its interest in jointly controlled assets, a venturer should recognise, in its separate financial statements, and consequently in its consolidated financial statements:

(a) its share of the jointly controlled assets, classified according to the nature of the assets;

(b) any liabilities which it has incurred;

(c) its share of any liabilities incurred jointly with the other venturers in relation to the joint venture;

(d) any income from the sale or use of its share of the output of the joint venture, together with its share of any expenses incurred by the joint venture; and

(e) any expenses which it has incurred in respect of its interest in the joint venture.

11. *A jointly controlled entity* is a joint venture which involves the establishment of a corporation, partnership or other entity in which each venturer has an interest. The entity operates in the same way as other enterprises, except that a contractual arrangement between the venturers establishes joint control over the economic activity of the entity. A jointly controlled entity maintains its own accounting records and prepares and presents financial statements in the same way as other enterprises in conformity with the requirements applicable to that jointly controlled entity.

12. In a venturer's separate financial statements, interest in a jointly controlled entity should be accounted for as an investment in accordance with AS 13, *Accounting for Investments.*

13. In its consolidated financial statements, a venturer should report its interest in a jointly controlled entity using proportionate consolidation except

(a) an interest in a jointly controlled entity which is acquired and held exclusively with a view to its subsequent disposal in the near future; and

(b) an interest in a jointly controlled entity which operates under severe long-term restrictions that significantly impair its ability to transfer funds to the venturer.

Interest in such a jointly controlled entity should be accounted for as an investment in accordance with AS 13, *Accounting for Investments*.

14. Many of the procedures appropriate for the application of proportionate consolidation are similar to the procedures for the consolidation of investments in subsidiaries, which are set out in AS 21, *Consolidated Financial Statements*.

15. For the purpose of applying proportionate consolidation, the venturer uses the consolidated financial statements of the jointly controlled entity.

16. In case, the losses pertaining to one or more investors in a jointly controlled entity exceed their interests in the equity[18] of the jointly controlled entity, such excess, and any further losses applicable to such investors, are recognised by the venturers in the proportion of their shares in the venture, except to the extent that the investors have a binding obligation to, and are able to, make good the losses. If the jointly controlled entity subsequently reports profits, all such profits are allocated to venturers until the investors' share of losses previously absorbed by the venturers has been recovered.

17. A venturer should discontinue the use of proportionate consolidation from the date that:

(a) it ceases to have joint control over a jointly controlled

[18] Equity is the residual interest in the assets of an enterprise after deducting all its liabilities.

entity but retains, either in whole or in part, its interest in the entity; or

(b) the use of the proportionate consolidation is no longer appropriate because the jointly controlled entity operates under severe long-term restrictions that significantly impair its ability to transfer funds to the venturer.

18. From the date of discontinuing the use of the proportionate consolidation, interest in a jointly controlled entity should be accounted for:

(a) in accordance with Accounting Standard (AS) 21, *Consolidated Financial Statements*, if the venturer acquires unilateral control over the entity and becomes parent within the meaning of that Standard; and

(b) in all other cases, as an investment in accordance with Accounting Standard (AS) 13, *Accounting for Investments*, or in accordance with Accounting Standard (AS) 23, *Accounting for Investments in Associates in Consolidated Financial Statements*, as appropriate. For this purpose, cost of the investment should be determined as under:

(i) the venturer's share in the net assets of the jointly controlled entity as at the date of discontinuance of proportionate consolidation should be ascertained, and

(ii) the amount of net assets so ascertained should be adjusted with the carrying amount of the relevant goodwill/capital reserve as at the date of discontinuance of proportionate consolidation.

19. When a venturer contributes or sells assets to a joint venture, recognition of any portion of a gain or loss from the transaction should reflect the substance of the transaction. While the assets are retained by the joint venture, and provided the venturer has transferred the significant risks and rewards of ownership, the

venturer should recognise only that portion of the gain or loss which is attributable to the interests of the other venturers. The venturer should recognise the full amount of any loss when the contribution or sale provides evidence of a reduction in the net realisable value of current assets or an impairment loss.

20. When a venturer purchases assets from a joint venture, the venturer should not recognise its share of the profits of the joint venture from the transaction until it resells the assets to an independent party. A venturer should recognise its share of the losses resulting from these transactions in the same way as profits except that losses should be recognised immediately when they represent a reduction in the net realisable value of current assets or an impairment loss.

21. In case of transactions between a venturer and a joint venture in the form of a jointly controlled entity, the requirements of paragraphs 19 and 20 should be applied only in the preparation and presentation of consolidated financial statements and not in the preparation and presentation of separate financial statements of the venturer.

22. An investor in a joint venture, which does not have joint control, should report its interest in a joint venture in its consolidated financial statements in accordance with AS 13, *Accounting for Investments*, AS 21, *Consolidated Financial Statements* or AS 23, *Accounting for Investments in Associates in Consolidated Financial Statements*, as appropriate.

23. In the separate financial statements of an investor, the interests in joint ventures should be accounted for in accordance with Accounting Standard (AS) 13, *Accounting for Investments*.

24. Operators or managers of a joint venture should account for any fees in accordance with AS 9, *Revenue Recognition*.

25. A venturer should disclose the following information in its separate financial statements as well as in consolidated financial statements:

(a) aggregate amount of the following contingent liabilities, unless the probability of loss is remote, separately from the amount of other contingent liabilities:

  (i) any contingent liabilities that the venturer has incurred in relation to its interests in joint ventures and its share in each of the contingent liabilities which have been incurred jointly with other venturers;

  (ii) its share of the contingent liabilities of the joint ventures themselves for which it is contingently liable; and

  (iii) those contingent liabilities that arise because the venturer is contingently liable for the liabilities of the other venturers of a joint venture.

(b) aggregate amount of the following commitments in respect of its interests in joint ventures separately from other commitments:

  (i) any capital commitments of the venturer in relation to its interests in joint ventures and its share in the capital commitments that have been incurred jointly with other venturers; and

  (ii) its share of the capital commitments of the joint ventures themselves.

(c) a list of all joint ventures and description of interests in significant joint ventures. In respect of jointly controlled entities, the venturer should also disclose the proportion of ownership interest, name and country of incorporation or residence.

26. A venturer should disclose, in its separate financial statements, the aggregate amounts of each of the assets, liabilities, income and expenses related to its interests in the jointly controlled entities.

Applicability of AS 27 to MFIs

There may be instances where two or more MFIs jointly undertake or fund a certain project or activity which is considered as a jointly controlled operation. Similarly, two or more MFIs may jointly control an asset. In addition, an MFI may also have joint control in a jointly controlled entity with other enterprises that may be in any form of organisation. MFIs should report their interests in such joint ventures in separate as well as in the consolidated financial statements (prepared as per AS 21) in accordance with the requirements of this Standard.

AS 28, IMPAIRMENT OF ASSETS

The objective of AS 28 is to prescribe the procedures that an enterprise applies to ensure that its assets are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and AS 28 requires the enterprise to recognise an impairment loss. AS 28 also specifies when an enterprise should reverse an impairment loss and it prescribes certain disclosures for impaired assets.

AS 28 applies to accounting for the impairment of all assets carried at cost as also to the assets carried at revalued amounts in accordance with other applicable Accounting Standards. The Standard, however, does not apply to the following:

(a) inventories (see AS 2, *Valuation of Inventories*);

(b) assets arising from construction contracts (see AS 7, *Accounting for Construction Contracts*[19]);

[19] This Standard has been revised and titled as *Construction Contracts*. The revised AS 7 is summarised elsewhere in this Technical Guide.

(c) financial assets[20] including investments that are included in the scope of AS 13, *Accounting for Investments*; and

(d) deferred tax assets (see AS 22, *Accounting for Taxes on Income*).

Salient Features and Principal Requirements

1. *Recoverable amount* is defined as "the higher of an asset's net selling price and its value in use".

2. *Value in use* is defined as "the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life".

3. *Net selling price* is defined as "the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal".

4. *Costs of disposal* are defined as "incremental costs directly attributable to the disposal of an asset, excluding finance costs and income tax expense".

5. *Impairment loss* is defined as "the amount by which the carrying amount of an asset exceeds its recoverable amount".

6. *Cash-generating unit* is defined as "the smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets".

[20]A financial asset is any asset that is:

(a) cash;

(b) a contractual right to receive cash or another financial asset from another enterprise;

(c) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or

(d) an ownership interest in another enterprise.

7. *Corporate assets* are defined as "assets other than goodwill that contribute to the future cash flows of both the cash-generating unit under review and other cash-generating units".

8. An asset is impaired when the carrying amount of the asset exceeds its recoverable amount. Paragraphs 9 to 11 specify when recoverable amount should be determined. These requirements use the term 'an asset' but apply equally to an individual asset or a cash-generating unit.

9. An enterprise should assess at each balance sheet date whether there is any indication that an asset may be impaired. If any such indication exists, the enterprise should estimate the recoverable amount of the asset.

10. In assessing whether there is any indication that an asset may be impaired, an enterprise should consider, as a minimum, the following indications:

External sources of information

(a) During the period, an asset's market value has declined significantly more than that would be expected as a result of the passage of time or normal use;

(b) Significant changes with an adverse effect on the enterprise have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the enterprise operates or in the market to which an asset is dedicated;

(c) Market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially;

(d) The carrying amount of the net assets of the reporting enterprise is more than its market capitalisation;

Internal sources of information

(e) Evidence is available of obsolescence or physical damage of an asset;

(f) Significant changes with an adverse effect on the enterprise have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include plans to discontinue or restructure the operation to which an asset belongs or to dispose of an asset before the previously expected date; and

(g) Evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.

The above list is not exhaustive. An enterprise may identify other indications that an asset may be impaired and these would also require the enterprise to determine the asset's recoverable amount.

11. The concept of materiality applies in identifying whether the recoverable amount of an asset needs to be estimated. For example, if previous calculations show that an asset's recoverable amount is significantly greater than its carrying amount, the enterprise need not re-estimate the asset's recoverable amount if no events have occurred that would eliminate that difference. Similarly, previous analysis may show that an asset's recoverable amount is not sensitive to one (or more) of the indications listed in paragraph 10.

12. Recoverable amount is the higher of an asset's net selling price and value in use. It is not always necessary to determine both an asset's net selling price and its value in use. For example, if either of these amounts exceeds the asset's carrying amount, the asset is not impaired and it is not necessary to estimate the other amount.

13. If there is no reason to believe that an asset's value in use materially exceeds its net selling price, the asset's recoverable amount may be taken to be its net selling price. This will often be the case for an asset that is held for disposal.

14. Recoverable amount is determined for an individual asset, unless the asset does not generate cash inflows from continuing use that are largely independent of those from other assets or groups of assets. If this is the case, recoverable amount is determined for the cash-generating unit to which the asset belongs (see paragraphs 37 to 45), unless either:

(a) the asset's net selling price is higher than its carrying amount; or

(b) the asset's value in use can be estimated to be close to its net selling price and net selling price can be determined.

15. The best evidence of an asset's net selling price is a price in a binding sale agreement in an arm's length transaction, adjusted for incremental costs that would be directly attributable to the disposal of the asset.

16. If there is no binding sale agreement but an asset is traded in an active market, net selling price is the asset's market price less the costs of disposal. If there is no binding sale agreement or active market for an asset, net selling price is based on the best information available to reflect the amount that an enterprise could obtain, at the balance sheet date, for the disposal of the asset in an arm's length transaction between knowledgeable, willing parties, after deducting the costs of disposal.

17. Costs of disposal, other than those that have already been recognised as liabilities, are deducted in determining net selling price. Examples of such costs are legal costs, costs of removing the asset, and direct incremental costs to bring an asset into condition for its sale. However, termination benefits and costs associated with reducing or reorganising a business following the

disposal of an asset are not direct incremental costs to dispose of the asset.

18. Estimating the value in use of an asset involves the following steps:

(a) estimating the future cash inflows and outflows arising from continuing use of the asset and from its ultimate disposal; and

(b) applying the appropriate discount rate to these future cash flows.

19. In measuring value in use:

(a) cash flow projections should be based on reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the remaining useful life of the asset. Greater weight should be given to external evidence;

(b) cash flow projections should be based on the most recent financial budgets/forecasts that have been approved by management. Projections based on these budgets/forecasts should cover a maximum period of five years, unless a longer period can be justified; and

(c) cash flow projections beyond the period covered by the most recent budgets/forecasts should be estimated by extrapolating the projections based on the budgets/forecasts using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified. This growth rate should not exceed the long-term average growth rate for the products, industries, or country or countries in which the enterprise operates, or for the market in which the asset is used, unless a higher rate can be justified.

20. Estimates of future cash flows should include:

(a) projections of cash inflows from the continuing use of the asset;

(b) projections of cash outflows that are necessarily incurred to generate the cash inflows from continuing use of the asset (including cash outflows to prepare the asset for use) and that can be directly attributed, or allocated on a reasonable and consistent basis, to the asset; and

(c) net cash flows, if any, to be received (or paid) for the disposal of the asset at the end of its useful life.

21. Estimates of future cash flows and the discount rate reflect consistent assumptions about price increases due to general inflation. Therefore, if the discount rate includes the effect of price increases due to general inflation, future cash flows are estimated in nominal terms. If the discount rate excludes the effect of price increases due to general inflation, future cash flows are estimated in real terms but include future specific price increases or decreases.

22. Future cash flows should be estimated for the asset in its current condition. Estimates of future cash flows should not include estimated future cash inflows or outflows that are expected to arise from:

(a) a future restructuring to which an enterprise is not yet committed; or

(b) future capital expenditure that will improve or enhance the asset in excess of its originally assessed standard of performance.

23. Estimates of future cash flows should not include:

(a) cash inflows or outflows from financing activities; or

(b) income tax receipts or payments.

24. Estimated future cash flows reflect assumptions that are consistent with the way the discount rate is determined. Otherwise, the effect of some assumptions will be counted twice or ignored. Because the time value of money is considered by discounting the estimated future cash flows, these cash flows exclude cash inflows or outflows from financing activities. Similarly, since the discount rate is determined on a pre-tax basis, future cash flows are also estimated on a pre-tax basis.

25. The estimate of net cash flows to be received (or paid) for the disposal of an asset at the end of its useful life should be the amount that an enterprise expects to obtain from the disposal of the asset in an arm's length transaction between knowledgeable, willing parties, after deducting the estimated costs of disposal.

26. Future cash flows are estimated in the currency in which they will be generated and then discounted using a discount rate appropriate for that currency. An enterprise translates the present value obtained using the exchange rate at the balance sheet date (described in Accounting Standard (AS) 11, *Accounting for the Effects of Changes in Foreign Exchange Rates*, as the closing rate).

27. The discount rate(s) should be a pre-tax rate(s) that reflect(s) current market assessments of the time value of money and the risks specific to the asset. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted.

28. When an asset-specific rate is not directly available from the market, an enterprise uses other bases to estimate the discount rate. The purpose is to estimate, as far as possible, a market assessment of:

(a) the time value of money for the periods until the end of the asset's useful life; and

(b) the risks that the future cash flows will differ in amount or timing from estimates.

29. As a starting point, the enterprise may take into account the following rates:

(a) the enterprise's weighted average cost of capital determined using techniques such as the Capital Asset Pricing Model;

(b) the enterprise's incremental borrowing rate; and

(c) other market borrowing rates.

These rates are adjusted to reflect the way that the market would assess the specific risks associated with the projected cash flows; and to exclude risks that are not relevant to the projected cash flows.

Consideration is given to risks such as country risk, currency risk, price risk and cash flow risk.

30. The discount rate is independent of the enterprise's capital structure and the way the enterprise financed the purchase of the asset because the future cash flows expected to arise from an asset do not depend on the way in which the enterprise financed the purchase of the asset.

31. An enterprise normally uses a single discount rate for the estimate of an asset's value in use. However, an enterprise uses separate discount rates for different future periods where value in use is sensitive to a difference in risks for different periods or to the term structure of interest rates.

32. If the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset should be reduced to its recoverable amount. That reduction is an impairment loss.

33. An impairment loss should be recognised as an expense in the statement of profit and loss immediately, unless the asset is carried at revalued amount in accordance with another Accounting Standard (see Accounting Standard (AS) 10, *Accounting for Fixed*

Assets), in which case any impairment loss of a revalued asset should be treated as a revaluation decrease under that Accounting Standard.

34. When the amount estimated for an impairment loss is greater than the carrying amount of the asset to which it relates, an enterprise should recognise a liability if, and only if, that is required by another Accounting Standard.

35. After the recognition of an impairment loss, the depreciation (amortisation) charge for the asset should be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

36. If an impairment loss is recognised, any related deferred tax assets or liabilities are determined under Accounting Standard (AS) 22, *Accounting for Taxes on Income*.

37. If there is any indication that an asset may be impaired, the recoverable amount should be estimated for the individual asset. If it is not possible to estimate the recoverable amount of the individual asset, an enterprise should determine the recoverable amount of the cash-generating unit to which the asset belongs (the asset's cash-generating unit).

38. The recoverable amount of an individual asset cannot be determined if:

(a) the asset's value in use cannot be estimated to be close to its net selling price (for example, when the future cash flows from continuing use of the asset cannot be estimated to be negligible); and

(b) the asset does not generate cash inflows from continuing use that are largely independent of those from other assets. In such cases, value in use and, therefore, recoverable amount, can be determined only for the asset's cash-generating unit.

39. If an active market exists for the output produced by an asset or a group of assets, this asset or group of assets should be identified as a separate cash-generating unit, even if some or all of the output is used internally. If this is the case, management's best estimate of future market prices for the output should be used:

(a) in determining the value in use of this cash-generating unit, when estimating the future cash inflows that relate to the internal use of the output; and

(b) in determining the value in use of other cash-generating units of the reporting enterprise, when estimating the future cash outflows that relate to the internal use of the output.

40. Cash-generating units should be identified consistently from period to period for the same asset or types of assets, unless a change is justified.

41. The recoverable amount of a cash-generating unit is the higher of the cash-generating unit's net selling price and value in use. For the purpose of determining the recoverable amount of a cash-generating unit, any reference in paragraphs 12 to 31 to 'an asset' is read as a reference to 'a cash-generating unit'.

42. The carrying amount of a cash-generating unit should be determined consistently with the way the recoverable amount of the cash-generating unit is determined.

43. Where assets are grouped for recoverability assessments, it is important to include in the cash-generating unit all assets that generate the relevant stream of cash inflows from continuing use. Otherwise, the cash-generating unit may appear to be fully recoverable when in fact an impairment loss has occurred.

44. An impairment loss should be recognised for a cash-generating unit if, and only if, its recoverable amount is less than its carrying amount. The impairment loss should be allocated to

reduce the carrying amount of the assets of the unit in the following order:

(a) first, to goodwill allocated to the cash-generating unit (if any); and

(b) then, to the other assets of the unit on a pro-rata basis based on the carrying amount of each asset in the unit.

These reductions in carrying amounts should be treated as impairment losses on individual assets and recognised in accordance with paragraph 33.

45. In allocating an impairment loss under paragraph 44, the carrying amount of an asset should not be reduced below the highest of:

(a) its net selling price (if determinable);

(b) its value in use (if determinable); and

(c) zero.

The amount of the impairment loss that would otherwise have been allocated to the asset should be allocated to the other assets of the unit on a pro-rata basis.

46. After the requirements in paragraphs 44 and 45 have been applied, a liability should be recognised for any remaining amount of an impairment loss for a cash-generating unit if that is required by another Accounting Standard.

47. An enterprise should assess at each balance sheet date whether there is any indication that an impairment loss recognised for an asset in prior accounting periods may no longer exist or may have decreased. If any such indication exists, the enterprise should estimate the recoverable amount of that asset.

48. In assessing whether there is any indication that an impairment loss recognised for an asset in prior accounting periods may no longer exist or may have decreased, an enterprise should consider, as a minimum, the following indications:

External sources of information

(a) The asset's market value has increased significantly during the period;

(b) Significant changes with a favourable effect on the enterprise have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the enterprise operates or in the market to which the asset is dedicated;

(c) Market interest rates or other market rates of return on investments have decreased during the period, and those decreases are likely to affect the discount rate used in calculating the asset's value in use and increase the asset's recoverable amount materially;

Internal sources of information

(d) Significant changes with a favourable effect on the enterprise have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, the asset is used or is expected to be used. These changes include capital expenditure that has been incurred during the period to improve or enhance an asset in excess of its originally assessed standard of performance or a commitment to discontinue or restructure the operation to which the asset belongs; and

(e) evidence is available from internal reporting that indicates that the economic performance of the asset is, or will be, better than expected.

49. Indications of a potential decrease in an impairment loss in paragraph 48 mainly mirror the indications of a potential impairment loss in paragraph 10. The concept of materiality applies in identifying whether an impairment loss recognised for an asset in prior accounting periods may need to be reversed and the recoverable amount of the asset determined.

50. An impairment loss recognised for an asset in prior accounting periods should be reversed if there has been a change in the estimates of cash inflows, cash outflows or discount rates used to determine the asset's recoverable amount since the last impairment loss was recognised. If this is the case, the carrying amount of the asset should be increased to its recoverable amount. That increase is a reversal of an impairment loss.

51. The increased carrying amount of an asset due to a reversal of an impairment loss should not exceed the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior accounting periods.

52. A reversal of an impairment loss for an asset should be recognised as income immediately in the statement of profit and loss, unless the asset is carried at revalued amount in accordance with another Accounting Standard (see Accounting Standard (AS) 10, *Accounting for Fixed Assets*) in which case any reversal of an impairment loss on a revalued asset should be treated as a revaluation increase under that Accounting Standard.

53. After a reversal of an impairment loss is recognised, the depreciation (amortisation) charge for the asset should be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

54. A reversal of an impairment loss for a cash-generating unit should be allocated to increase the carrying amount of the assets of the unit in the following order:

(a) first, assets other than goodwill on a pro-rata basis based on the carrying amount of each asset in the unit; and

(b) then, to goodwill allocated to the cash-generating unit (if any), if the requirements in paragraph 56 are met.

These increases in carrying amounts should be treated as reversals of impairment losses for individual assets and recognised in accordance with paragraph 52.

55. In allocating a reversal of an impairment loss for a cash-generating unit under paragraph 54, the carrying amount of an asset should not be increased above the lower of:

(a) its recoverable amount (if determinable); and

(b) the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior accounting periods.

The amount of the reversal of the impairment loss that would otherwise have been allocated to the asset should be allocated to the other assets of the unit on a pro-rata basis.

56. As an exception to the requirement in paragraph 50, an impairment loss recognised for goodwill should not be reversed in a subsequent period unless:

(a) the impairment loss was caused by a specific external event of an exceptional nature that is not expected to recur; and

(b) subsequent external events have occurred that reverse the effect of that event.

57. AS 28 does not permit an impairment loss to be reversed for goodwill because of a change in estimates (for example, a change

in the discount rate or in the amount and timing of future cash flows of the cash-generating unit to which goodwill relates).

58. The approval and announcement of a plan for discontinuance[21] is an indication that the assets attributable to the discontinuing operation may be impaired or that an impairment loss previously recognised for those assets should be increased or reversed. Therefore, in accordance with this Standard, an enterprise estimates the recoverable amount of each asset of the discontinuing operation and recognises an impairment loss or reversal of a prior impairment loss, if any.

59. For each class of assets, the financial statements should disclose:

(a) the amount of impairment losses recognised in the statement of profit and loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are included;

(b) the amount of reversals of impairment losses recognised in the statement of profit and loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are reversed;

(c) the amount of impairment losses recognised directly against revaluation surplus during the period; and

(d) the amount of reversals of impairment losses recognised directly in revaluation surplus during the period.

60. If an impairment loss for an individual asset or a cash-generating unit is recognised or reversed during the period and is material to the financial statements of the reporting enterprise as a whole, an enterprise should disclose:

[21] See Accounting Standard (AS) 24, *Discontinuing Operations*.

(a) the events and circumstances that led to the recognition or reversal of the impairment loss;

(b) the amount of the impairment loss recognised or reversed;

(c) for an individual asset:

    (i) the nature of the asset; and

    (ii) the reportable segment to which the asset belongs, based on the enterprise's primary format (as defined in AS 17, *Segment Reporting*);

(d) for a cash-generating unit:

    (i) a description of the cash-generating unit (such as whether it is a product line, a plant, a business operation, a geographical area, a reportable segment as defined in AS 17 or other);

    (ii) the amount of the impairment loss recognised or reversed by class of assets and by reportable segment based on the enterprise's primary format (as defined in AS 17); and

    (iii) if the aggregation of assets for identifying the cash-generating unit has changed since the previous estimate of the cash-generating unit's recoverable amount (if any), the enterprise should describe the current and former way of aggregating assets and the reasons for changing the way the cash-generating unit is identified;

(e) whether the recoverable amount of the asset (cash-generating unit) is its net selling price or its value in use;

(f) if recoverable amount is net selling price, the basis used to determine net selling price (such as whether selling price was determined by reference to an active market or in some other way); and

(g) if recoverable amount is value in use, the discount rate(s) used in the current estimate and previous estimate (if any) of value in use.

61. If impairment losses recognised (reversed) during the period are material in aggregate to the financial statements of the reporting enterprise as a whole, an enterprise should disclose a brief description of the following:

(a) the main classes of assets affected by impairment losses (reversals of impairment losses) for which no information is disclosed under paragraph 60; and

(b) the main events and circumstances that led to the recognition (reversal) of these impairment losses for which no information is disclosed under paragraph 60.

Applicability of AS 28 to MFIs

The requirements of this Standard should be followed by MFIs in their entirety except to the extent of certain relaxations which are provided to MFIs falling within the meaning of SME/ SMC (refer to Appendix 2).

AS 29, PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS[22]

The objective of AS 29 is to ensure that appropriate recognition criteria and measurement bases are applied to provisions and contingent liabilities and that sufficient information is disclosed in the notes to the financial statements to enable users to understand

[22] AS 29 came into effect in respect of accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date.

their nature, timing and amount. The objective of this Standard is also to lay down appropriate accounting for contingent assets.

Salient Features and Principal Requirements

1. The following terms are used in this Standard with the meanings specified:

A *provision* is a liability which can be measured only by using a substantial degree of estimation.

A *contingent liability* is:

(a) a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

(b) a present obligation that arises from past events but is not recognised because:

  (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

  (ii) a reliable estimate of the amount of the obligation cannot be made.

A *contingent asset* is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.

Present obligation - an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not.

Possible obligation - an obligation is a possible obligation if, based on the evidence available, its existence at the balance sheet date is considered not probable.

A *restructuring* is a programme that is planned and controlled by management, and materially changes either:

(a) the scope of a business undertaken by an enterprise; or

(b) the manner in which that business is conducted.

2. As a general rule, a provision should be recognised when:

(a) an enterprise has a present obligation as a result of a past event;

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised.

3. In almost all cases it will be clear whether a past event has given rise to a present obligation. In rare cases, for example in a lawsuit, it may be disputed either whether certain events have occurred or whether those events result in a present obligation. In case it is not clear whether a past event has given rise to a present obligation, an enterprise determines whether a present obligation exists at the balance sheet date by taking account of all available evidence, including, for example, the opinion of experts. The evidence considered includes any additional evidence provided by events after the balance sheet date. On the basis of such evidence:

(a) where it is more likely than not that a present obligation exists at the balance sheet date, the enterprise recognises a provision (if the recognition criteria are met); and

(b) where it is more likely that no present obligation exists at the balance sheet date, the enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (see paragraph 21).

4. As a general rule, an enterprise should not recognise a contingent liability. However, a contingent liability is disclosed, as required by paragraph 21, unless the possibility of an outflow of resources embodying economic benefits is remote.

5. Where an enterprise is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability. The enterprise recognises a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable, except in the extremely rare circumstances where no reliable estimate can be made.

6. An enterprise should not recognise a contingent asset since this may result in the recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.

7. A contingent asset is not disclosed in the financial statements. It is usually disclosed in the report of the approving authority (Board of Directors in the case of a company, and, the corresponding approving authority in the case of any other enterprise), where an inflow of economic benefits is probable.

8. The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. The amount of a provision should not be discounted to its present value. Also, the provision is measured

before tax; the tax consequences of the provision, and changes in it, are dealt with under AS 22, *Accounting for Taxes on Income*.

9. The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.

10. Future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.

11. AS 29 requires that gains from the expected disposal of assets should not be taken into account in measuring a provision.

12. Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provision.

13. In the statement of profit and loss, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.

14. Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.

15. A provision should be used only for expenditures for which the provision was originally recognised.

16. Provisions should not be recognised for future operating losses.

17. A provision for restructuring costs is recognised only when the recognition criteria for provisions set out in paragraph 2 are met. No obligation arises for the sale of an operation until the enterprise is committed to the sale, i.e., there is a binding sale agreement.

18. A restructuring provision should include only the direct expenditures arising from the restructuring which are those that are both:

(a) necessarily entailed by the restructuring; and

(b) not associated with the ongoing activities of the enterprise.

19. For each class of provision, an enterprise should disclose:

(a) the carrying amount at the beginning and end of the period;

(b) additional provisions made in the period, including increases to existing provisions;

(c) amounts used (i.e. incurred and charged against the provision) during the period; and

(d) unused amounts reversed during the period.

20. An enterprise should disclose the following for each class of provision:

(a) a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;

(b) an indication of the uncertainties about those outflows. Where necessary to provide adequate information, an enterprise should disclose the major assumptions made concerning future events, as addressed in paragraph 10; and

(c) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

21. Unless the possibility of any outflow in settlement is remote, an enterprise should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable:

(a) an estimate of its financial effect, measured under paragraphs 8-11;

(b) an indication of the uncertainties relating to any outflow; and

(c) the possibility of any reimbursement.

22. Where any of the information required by paragraph 21 is not disclosed because it is not practicable to do so, that fact should be stated. In extremely rare cases, disclosure of some or all of the information required by paragraphs 19-21 can be expected to prejudice seriously the position of the enterprise in a dispute with other parties on the subject matter of the provision or contingent liability. In such cases, an enterprise need not disclose the information, but should disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

Applicability of AS 29 to MFIs

This Standard assumes great importance to microfinance institutions, as various contingencies are likely to arise in the ordinary course of microfinance business. Hence, the requirements of this Standard should be followed by MFIs in their entirety, except to the extent of exemptions from certain disclosure requirements for MFIs that fall in the SME/SMC category (reference may be made to Appendix 2).

OTHER ACCOUNTING ISSUES PECULIAR TO MFIs

Securitisation deals by MFIs

3.40 In the recent times, MFIs have been observed to enter into securitisation deals for their loan portfolio. To account for a securitisation deal in the financial statements of an MFI, the requirements of Guidance Note on Accounting for Securitisation will be followed (reference can be made to Appendix 4). However, it may be noted that once Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*, becomes recommendatory from April 1, 2009, this Guidance Note will stand withdrawn and the provisions of AS 30 shall apply.

MFIs as pass through agents

3.41 In some cases, an MFI may act as an agent of a bank due to its relatively easy accessibility to the rural clients. It provides financial services as "pass through agent" for disbursal of micro loans, recovery of principal/collection of interest, etc. In such a case only the income/commission it receives for rendering such services should be accounted for in the financial statements of the MFIs. Other transactions indicating disbursal of loan, collection of interest should be recorded in accounts prepared on a memorandum basis.

FORMATS OF FINANCIAL STATEMENTS

3.42 The accounting process in an enterprise culminates in the preparation of its financial statements. The financial statements are intended to reflect the operating results and cash flows during a given period and the state of affairs at a particular date in a clear and comprehensive manner. It is through financial statements that financial information is communicated to various users to assist them in taking economic decisions concerning the reporting enterprise. The basic financial statements relevant to MFIs are Profit and Loss Account (Income and Expenditure Account), Cash

Flow Statement[23] and Balance Sheet and those notes and other statements and explanatory material that are an integral part of the financial statements. They may also include supplementary schedules and information based on or derived from, and expected to be read with such statements. Such schedules and supplementary information may deal with, for example, loans advanced, interest on loans advanced, etc. Financial statements do not, however, include reports by the governing body, for example, the trustees, statement by the chairman, discussion and analysis by management and similar reports that may be included in a financial or annual report.

3.43 The financial statements should disclose every material transaction and transactions of an exceptional and extraordinary nature. The financial statements should be prepared in conformity with relevant statutory requirements, the accounting standards and other recognised accounting principles and practices.

3.44 In the preparation and presentation of the financial statements, the overall consideration should be that they give a true and fair view of the financial position, performance and cash flows of the MFI as reflected by the Balance Sheet, Profit and Loss Account (Income and Expenditure Account) and Cash Flow Statement, respectively.

CONTENTS OF FINANCIAL STATEMENTS

3.45 Profit and Loss Account is a nominal account prepared by MFIs. In case of NPO-MFIs, Income and Expenditure Account is prepared in lieu of Profit and Loss Account. A Profit and Loss Account contains all revenues earned and expenses incurred by an MFI during an accounting period. The net result, i.e., the difference between revenues and expenses is depicted in the form

[23] It may be noted that though Accounting Standard (AS) 3, *Cash Flow Statements* is exempted for enterprises that fall within the meaning of SME/SMC (see Appendix 2) it is strongly recommended for all microfinance institutions given the nature of their operations.

of profit or loss for the period. For the preparation of Profit and Loss Account only revenue items are taken into consideration and capital items are totally excluded. Incomes received in advance and prepaid expenses at the end of the accounting period are also excluded while preparing this account and are disclosed as a liability and an asset, respectively, in the Balance Sheet. These are included as incomes and expenses in the accounting periods to which they relate.

3.46 The Balance Sheet of an MFI is a snapshot of its financial position at a given point of time. It reflects what the MFI owns and what is owed to it (assets), what it owes others (liabilities), and the difference between the two (net worth or equity). It provides an instant picture of an organisational position in terms of where all the funds have been obtained from (sources of funds) and where all the funds have been used (application of funds).

3.47 Under the Companies Act, 1956, companies are required to follow the Accounting Standards formulated by the Institute of Chartered Accountants of India and to prepare Balance Sheet and Profit and Loss Account (Income and Expenditure Account in case of companies not carrying business for profit) in the formats set out in Schedule VI to the Act, *or as near thereto as circumstances admit*. The various forms of MFIs incorporated as companies are section 25 companies, Non-Banking Financial Companies and Local Area Banks. In case of Non-Banking Financial Companies, in addition to the drawing up their formats as per the requirements of Companies Act, they are also required to meet the various directions issued by the Reserve Bank of India such as additional disclosures as per the Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions, 1998[24]. However, in case of Local Area Banks, they are required to obtain their banking license under the Banking Regulation Act, 1949 and by virtue of section 29 of this Act, they are required to prepare Balance Sheet and Profit and Loss Account as per the Forms set out in Third Schedule to the Act, or *as near thereto as circumstances admit* and the

[24] For instance, paragraph 9BB of the Directions provides a format and the particulars of a schedule to be annexed to the balance sheet of NBFCs.

provisions of the Companies Act apply insofar as they are not inconsistent with Banking Regulation Act. MFIs which are not registered under the Companies Act but the statute which governs them prescribes a format for the purpose of preparation of the financial statements, should prepare the financial statements in accordance with the requirements of the said statute. The Accounting Standards should also be followed by such MFIs as already discussed in this Chapter. For use by MFIs, which are not governed by any statute or for which the governing statute does not prescribe any formats, illustrative formats of financial statements are given in Appendix 1. The formats should be viewed as laying down the minimum rather than the maximum information that MFIs should present in their financial statements. Those MFIs who wish to present more detailed information are encouraged to do so. It may be mentioned here that keeping in mind the nature of microfinance which calls for maximum transparency of its operations to various users of the financial statements, some disclosures for all legal forms of MFIs are recommended in addition to disclosures as per Accounting Standards and relevant statutes. These disclosures are given as “Additional Recommendatory Disclosures for Microfinance Institutions” in Appendix 3.

Appendix 1

Illustrative Formats of Financial Statements

PART I – GENERAL INSTRUCTIONS AND ACCOUNTING PRINCIPLES

1. The two principal financial statements of an MFI, viz., Balance Sheet and Profit and Loss Account (Income and Expenditure Account) should be prepared on an accrual basis.

2. Accounting policies should be applied consistently from one financial year to the next. Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed. In case of a change in accounting policies which has a material effect in the current period, the amount by which any item in the financial statements is affected by such change, should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.

3. Provision should be made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information. Revenue should not be recognised unless (i) the related performance has been achieved; and (ii) no significant uncertainty exists regarding the amount of the consideration; and (iii) it is not unreasonable to expect ultimate collection. Grants and donations should not be recognised until there is reasonable assurance that

(i) the MFI will comply with the conditions attached to them; and (ii) the grants/donations will be received.

4. The accounting treatment and presentation in the Balance Sheet and the Profit and Loss Account (Income and Expenditure Account) of transactions and events should be governed by their substance and not merely by the legal form.

5. In determining the accounting treatment and manner of disclosure of an item in the Balance Sheet and/or the Profit and Loss Account (Income and Expenditure Account), due consideration should be given to the materiality of the item.

6. Notes to the Balance Sheet and the Profit and Loss Account (Income and Expenditure Account) should contain the explanatory material pertaining to the items in the Balance Sheet and the Profit and Loss Account (Income and Expenditure Account).

7. A statement of all significant accounting policies adopted in the preparation and presentation of the Balance Sheet and the Profit and Loss Account (Income and Expenditure Account) should be included in the MFI's financial statements. Where any of the accounting policies is not in conformity with Accounting Standards, and the effect of departure from Accounting Standards is material, the particulars of the departure should be disclosed, together with the reasons therefor and also the financial effect thereof except where such effect is not ascertainable.

8. If the information required to be given under any of the items or sub-items in these formats cannot be conveniently included in the Balance Sheet or the Profit and Loss Account (Income and Expenditure Account) itself, as the case may be, it can be furnished in a separate Schedule or Schedules to be annexed to and forming part of the Balance Sheet or the Profit and Loss Account (Income and Expenditure Account). This is recommended where items are numerous.

9. The Schedules referred to above, accounting policies and

explanatory notes should form an integral part of the financial statements.

10. The corresponding amounts for the immediately preceding financial year for all items shown in the Balance Sheet and the Profit and Loss Account (Income and Expenditure Account) should be given in the Balance Sheet or Profit and Loss Account (Income and Expenditure Account), as the case may be.

11. ‘Provision’ is a liability which can be measured only by using a substantial degree of estimation.

12. A cash flow statement should be annexed to the Balance Sheet showing cash flows during the period covered by the Profit and Loss Account (Income and Expenditure Account) and during the corresponding previous period.

13. Disclosures such as segment information and related party relationships and transactions should be made as per the requirements of the relevant Accounting Standards.

14. The disclosures suggested in the formats of the financial statements represent the minimum requirements. An MFI is encouraged to make additional disclosures[1].

[1] Reference may be made to Appendix 3 “Additional Recommendatory Disclosures for Microfinance Institutions”.

PART II

BALANCE SHEET AS ON MARCH 31,	***Sch***	**20X8**	**20X7**
SOURCES OF FUNDS:			
SHAREHOLDERS' FUNDS:			
Share Capital			
Reserves and Surplus			
LOAN FUNDS:			
Secured loans			
Unsecured loans			
DEFERRED TAX LIABILITY			
TOTAL			
APPLICATION OF FUNDS:			
LOAN PORTFOLIO (Net)			
INVESTMENTS			
DEFERRED TAX ASSETS			
CURRENT ASSETS, LOANS AND ADVANCES:			
Less: CURRENT LIABLITIES AND PROVISIONS:			
Current liabilities			
Provisions			
NET CURRENT ASSETS			
FIXED ASSETS			
Gross Block			
Less: Depreciation			
Net Block			
TOTAL			

Accounting Policies and Notes on Accounts

Notes:

1. In case of non-corporate MFIs such as societies and trusts, the term 'capital fund' is used in place of 'shareholders' funds' and the term 'capital' in place of 'share capital'.

2. Deferred income on account of grants/donations is shown after 'Reserves and Surplus' but before 'Secured Loans' with a suitable description, e.g., 'Deferred grants/donations'.

3. Secured and unsecured loans should be classified into loans and advances (including overdraft/cash credit) from banks and financial institutions, from directors, managers and related concern, etc., and from others.

4. Interest free loans should be disclosed separately from interest bearing loans. Interest accrued and due on loans (secured and unsecured) advanced to MFIs should be included under appropriate sub-heads.

5. The loan portfolio, i.e., loans outstanding should be classified into broadly three categories – regular loans outstanding, past-due loans outstanding, and restructured loans outstanding. The amount of the loan loss provision should also be disclosed.

6. A reconciliation of the accounts affecting the loan portfolio should be disclosed, including:

   (i) Loan portfolio at the beginning and the end of the period,

   (ii) Loan loss provision at the beginning and end of the period,

   (iii) Loan loss provision created during the period (by way of a charge to the profit and loss account), and

   (iv) Write-off of uncollectible loans (bad debts) during the period.

7. The nature of the investment (current or long term) and the mode of valuation (e.g., cost or fair value) should be disclosed. Current and long term investments should be distinguished between investment in Government or Trust Securities; investment in shares, debentures or bonds showing separately, shares fully paid-up and partly paid-up and also distinguishing the different classes of shares; and others. The aggregate amount of quoted and unquoted investments, giving the aggregate market value of quoted investments thereof should be shown.

8. As far as possible, current assets should be classified under interest accrued on investments; inventories; cash balance in hand; bank balances with scheduled banks; and bank balances with others. The mode of valuation of inventories should also be disclosed. Fair values of items on inventories received as non-monetary grants and donations, existing on the balance sheet date, should be disclosed in notes to accounts. Where any item constitutes ten per cent or more of total current assets, the nature and amount of such item may be shown separately.

9. Loans and advances should be classified into loans and advances to related concerns, directors, managers, etc.; advances recoverable in cash or in kind or for value to be received (e.g., advances to staff) and balances/deposits with electricity supply company, for telephone connection etc. (where payable on demand). Where any item constitutes ten per cent or more of total loans and advances, the nature and amount of such item may be shown separately.

10. Current liabilities should be classified into sundry creditors, related concerns, interest accrued but not due on loans (secured and unsecured), client deposits (voluntary and compulsory savings), expenses payable and other liabilities.

11. As far as possible, provisions should be classified into provision for taxation, proposed dividend, contingencies, staff benefits, loan losses and others.

12. Where any item constitutes ten per cent or more of total current liabilities and provisions, the nature and amount of such item may be shown separately.

13. As far as possible fixed assets of an MFI should be classified under land, buildings, leaseholds, plant and machinery, furniture and fittings, vehicles, computers, intangible assets and other office equipments. Under each head the original cost, and the additions thereto and deductions therefrom during the year, and the total depreciation written off or provided up to the end of the year should be stated. Separate disclosure under each head should be made in respect of donated assets (i.e., assets that have been received free of cost as non-monetary grant/donation by the MFI) and assets financed under a lease agreement.

14. Fair value and quantitative details of fixed assets received as non-monetary grants and donations, during the year, should be disclosed in the notes to accounts.

15. Fair value of all donated fixed assets, existing on the balance sheet date, should be disclosed in the notes to accounts. If it is not practicable to determine the fair values of the assets on each balance sheet date, then such values may be determined after a suitable interval, say, every three years. In such a case, date of determination of fair values shall also be disclosed along with the fair values of assets.

16. Restrictions, if any, on the utilisation of each asset should also be disclosed in the notes to accounts.

17. An MFI must disclose all its contingent liabilities such as in case of guaranteed loans, unless the possibility of an outflow of economic resources is remote.

PART III

PROFIT AND LOSS ACCOUNT (INCOME AND EXPENDITURE ACCOUNT) FOR THE YEAR ENDED MARCH 31, 20X8	Sch	March 31, 20X8	March 31, 20X7
INCOME:			
Income From Financial Services			
Interest on Loans			
Service Charges/Fees			
Insurance Commission			
Technical and Consultancy Fees			
Other Income			
Grants and Donations			
Interest on Investments			
Miscellaneous Income			
TOTAL			
EXPENDITURE:			
Financial Cost			
Personnel Cost			
Administrative and Other Operative Cost			
Depreciation			
Provision for Loan Losses			
Miscellaneous Expenses			
TOTAL			
Profit Before Tax			
Less: Provision For Taxation (including Fringe Benefit Tax)			
Current Tax			
Deferred Tax			

Profit After Tax			
Add: Profit brought forward from the previous years			
APPROPRIATION:			
Dividend to Shareholders			
Transferred to:			
Specific Funds			
General Reserve			
Balance carried forward to Balance Sheet			

PART IV – INSTRUCTIONS FOR PREPARING PROFIT AND LOSS ACCOUNT[2]

1. The Profit and Loss Account should disclose every material feature and should be so made out as to clearly disclose the result of the working of the MFI during the period covered by the account.

2. Donations and grants should be recognised only at a stage when there is a reasonable assurance that:

   (i) the MFI will comply with the conditions attached, and

   (ii) the donations and grants will be received.

3. Any item under which income exceeds 1 per cent of the total turnover/gross income of the MFI or Rs. 5,000/-, whichever is higher, should be shown as a separate and distinct item against an appropriate account head in the Profit and Loss Account. These items, therefore, should not be shown under the head ‘miscellaneous income’.

4. Any item under which expenses exceed 1 per cent of the total turnover/gross income of the MFI or Rs. 5,000/-, whichever is higher, should be shown as a separate and distinct item against an appropriate account head in the Profit and Loss Account. These items, therefore, should not be shown under the head ‘miscellaneous expenses’.

5. Depreciation should be provided so as to charge the depreciable amount of a depreciable asset over its useful life.

For the purposes of the above paragraph –

   (a) depreciable asset means an asset which

      (i) is expected to be used during more than one accounting period;

---

[2] Income and Expenditure Account in case of not-for-profit MFIs.

(ii) has a limited useful life; and

(iii) is held by an MFI for use in the provision of microfinance services and/or for production or supply of goods and other services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.

(b) depreciable amount of a depreciable asset means its original cost, or other amount substituted for original cost in the financial statements, less the residual value.

(c) useful life means either

(i) the period over which a depreciable asset is expected to be used by the MFI; or

(ii) the number of production or similar units expected to be obtained from the use of the asset by the MFI.

6. Fair value and quantitative details of items, being sold or being distributed free of cost or at nominal amount, that have been received as non-monetary grants and donations, should be disclosed as below, in the notes to accounts:

Balance at the beginning of the year

Add: Receipts during the year

Less: Distribution during the year

Sale during the year

Balance at the end of the year

Appendix 2

Applicability of Accounting Standards

(1) Criteria for classification of non-corporate entities as decided by the Institute of Chartered Accountants of India

Level I Entities

Non-corporate entities which fall in any one or more of the following categories, at the end of the relevant accounting period, are classified as Level I entities:

(i) Entities whose equity or debt securities are listed or are in the process of listing on any stock exchange, whether in India or outside India.

(ii) Banks (including co-operative banks), financial institutions or entities carrying on insurance business.

(iii) All commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds rupees fifty crore in the immediately preceding accounting year.

(iv) All commercial, industrial and business reporting entities having borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year.

(v) Holding and subsidiary entities of any one of the above.

Level II Entities (SMEs)

Non-corporate entities which are not Level I entities but fall in any one or more of the following categories are classified as Level II entities:

(i) All commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds rupees forty lakh but does not exceed rupees fifty crore in the immediately preceding accounting year.

(ii) All commercial, industrial and business reporting entities having borrowings (including public deposits) in excess of rupees one crore but not in excess of rupees ten crore at any time during the immediately preceding accounting year.

(iii) Holding and subsidiary entities of any one of the above.

Level III Entities (SMEs)

Non-corporate entities which are not covered under Level I and Level II are considered as Level III entities.

Additional requirements

(1) An SME which does not disclose certain information pursuant to the exemptions or relaxations given to it should disclose (by way of a note to its financial statements) the fact that it is an SME and has complied with the Accounting Standards insofar as they are applicable to entities falling in Level II or Level III, as the case may be.

(2) Where an entity, being covered in Level II or Level III, had qualified for any exemption or relaxation previously but no longer qualifies for the relevant exemption or relaxation in the current accounting period, the relevant standards or requirements become applicable from the current period and the figures for the

corresponding period of the previous accounting period need not be revised merely by reason of its having ceased to be covered in Level II or Level III, as the case may be. The fact that the entity was covered in Level II or Level III, as the case may be, in the previous period and it had availed of the exemptions or relaxations available to that Level of entities should be disclosed in the notes to the financial statements.

(3) Where an entity has been covered in Level I and subsequently, ceases to be so covered, the entity will not qualify for exemption/relaxation available to Level II entities, until the entity ceases to be covered in Level I for two consecutive years. Similar is the case in respect of an entity, which has been covered in Level I or Level II and subsequently, gets covered under Level III.

(4) If an entity covered in Level II or Level III opts not to avail of the exemptions or relaxations available to that Level of entities in respect of any but not all of the Accounting Standards, it should disclose the Standard(s) in respect of which it has availed the exemption or relaxation.

(5) If an entity covered in Level II or Level III desires to disclose the information not required to be disclosed pursuant to the exemptions or relaxations available to that Level of entities, it should disclose that information in compliance with the relevant Accounting Standard.

(6) An entity covered in Level II or Level III may opt for availing certain exemptions or relaxations from compliance with the requirements prescribed in an Accounting Standard:

Provided that such a partial exemption or relaxation and disclosure should not be permitted to mislead any person or public.

(7) In respect of Accounting Standard (AS) 15, *Employee Benefits*, exemptions/ relaxations are available to Level II and Level III entities, under two sub-classifications, viz., (i) entities whose average number of persons employed during the year is 50 or more, and (ii) entities whose average number of persons employed

during the year is less than 50. The requirements stated in paragraphs (1) to (6) above, mutatis mutandis, apply to these sub-classifications.

(2) Criteria for classification of companies under the Companies (Accounting Standards) Rules, 2006

Small and Medium-Sized Company (SMC) as defined in Clause 2(f) of the Companies (Accounting Standards) Rules, 2006:

(f) "Small and Medium Sized Company" (SMC) means, a company-

(i) whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;

(ii) which is not a bank, financial institution or an insurance company;

(iii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;

(iv) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and

(v) which is not a holding or subsidiary company of a company which is not a small and medium-sized company.

Explanation: For the purposes of clause (f), a company shall qualify as a Small and Medium Sized Company, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.

Non-SMCs

Companies not falling within the definition of SMC are considered as Non-SMCs.

Instructions

A. General Instructions

1. SMCs shall follow the following instructions while complying with Accounting Standards under these Rules:-

1.1 the SMC which does not disclose certain information pursuant to the exemptions or relaxations given to it shall disclose (by way of a note to its financial statements) the fact that it is an SMC and has complied with the Accounting Standards insofar as they are applicable to an SMC on the following lines:

"The Company is a Small and Medium Sized Company (SMC) as defined in the General Instructions in respect of Accounting Standards notified under the Companies Act, 1956. Accordingly, the Company has complied with the Accounting Standards as applicable to a Small and Medium Sized Company."

1.2 Where a company, being an SMC, has qualified for any exemption or relaxation previously but no longer qualifies for the relevant exemption or relaxation in the current accounting period, the relevant standards or requirements become applicable from the current period and the figures for the corresponding period of the previous accounting period need not be revised merely by reason of its having ceased to be an SMC. The fact that the company was an SMC in the previous period and it had availed of the exemptions or relaxations available to SMCs shall be disclosed in the notes to the financial statements.

1.3 If an SMC opts not to avail of the exemptions or relaxations available to an SMC in respect of any but not all of the Accounting Standards, it shall disclose the standard(s) in respect of which it has availed the exemption or relaxation.

1.4 If an SMC desires to disclose the information not required to be disclosed pursuant to the exemptions or relaxations available to the SMCs, it shall disclose that information in compliance with the relevant accounting standard.

1.5 The SMC may opt for availing certain exemptions or relaxations from compliance with the requirements prescribed in an Accounting Standard:

Provided that such a partial exemption or relaxation and disclosure shall not be permitted to mislead any person or public.

B. Other Instructions

Rule 5 of the Companies (Accounting Standards) Rules, 2006, provides as below:

> "5. An existing company, which was previously not a Small and Medium Sized Company (SMC) and subsequently becomes an SMC, shall not be qualified for exemption or relaxation in respect of Accounting Standards available to an SMC until the company remains an SMC for two consecutive accounting periods."

(3) Applicability of Accounting Standards to Companies

(I) Accounting Standards applicable to all companies in their entirety for accounting periods commencing on or after 7th December, 2006

AS 1 Disclosures of Accounting Policies
AS 2 Valuation of Inventories
AS 4 Contingencies and Events Occurring After the Balance Sheet Date
AS 5 Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
AS 6 Depreciation Accounting
AS 7 Construction Contracts (revised 2002)
AS 9 Revenue Recognition
AS 10 Accounting for Fixed Assets
AS 11 The Effects of Changes in Foreign Exchange Rates (revised 2003)
AS 12 Accounting for Government Grants
AS 13 Accounting for Investments
AS 14 Accounting for Amalgamations
AS 16 Borrowing Costs
AS 18 Related Party Disclosures
AS 22 Accounting for Taxes on Income
AS 24 Discontinuing Operations
AS 26 Intangible Assets

(II) Exemptions or Relaxations for SMCs as defined in the Notification

(A) Accounting Standards not applicable to SMCs in their entirety:

AS 3 Cash Flow Statements
AS 17 Segment Reporting

(B) Accounting Standards not applicable to SMCs since the relevant Regulations require compliance with them only by certain Non-SMCs[1]:

(i) AS 21, Consolidated Financial Statements

(ii) AS 23, Accounting for Investments in Associates in Consolidated Financial Statements

(iii) AS 27, Financial Reporting of Interests in Joint Ventures (to the extent of requirements relating to Consolidated Financial Statements)

(C) Accounting Standards in respect of which relaxations from certain requirements have been given to SMCs:

(i) Accounting Standard (AS) 15, Employee Benefits (revised 2005)

(a) paragraphs 11 to 16 of the standard to the extent they deal with recognition and measurement of short-term accumulating compensated absences which are non-vesting (i.e., short-term accumulating compensated absences in respect of which employees are not entitled to cash payment for unused entitlement on leaving);

(b) paragraphs 46 and 139 of the Standard which deal with discounting of amounts that fall due more than 12 months after the balance sheet date;

(c) recognition and measurement principles laid down in paragraphs 50 to 116 and presentation and disclosure requirements laid down in paragraphs 117 to 123 of the Standard in respect of accounting for defined benefit plans. However, such companies should actuarially determine and provide for the accrued liability in respect

[1]AS 21, AS 23 and AS 27 (relating to consolidated financial statements) are required to be complied with by a company if the company, pursuant to the requirements of a statute/regulator or voluntarily, prepares and presents consolidated financial statements.

of defined benefit plans by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard. Such companies should disclose actuarial assumptions as per paragraph 120(l) of the Standard; and

(d) recognition and measurement principles laid down in paragraphs 129 to 131 of the Standard in respect of accounting for other long-term employee benefits. However, such companies should actuarially determine and provide for the accrued liability in respect of other long-term employee benefits by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard.

(ii) AS 19, Leases

Paragraphs 22 (c),(e) and (f); 25 (a), (b) and (e); 37 (a) and (f); and 46 (b) and (d) relating to disclosures are not applicable to SMCs.

(iii) AS 20, Earnings Per Share

Disclosure of diluted earnings per share (both including and excluding extraordinary items) is exempted for SMCs.

(iv) AS 28, Impairment of Assets

SMCs are allowed to measure the ‘value in use’ on the basis of reasonable estimate thereof instead of computing the value in use by present value technique. Consequently, if an SMC chooses to measure the ‘value in use’ by not using the present value technique, the relevant provisions of AS 28, such as discount rate etc., would not be applicable to such an SMC. Further, such an SMC need not disclose the information required by paragraph 121(g) of the Standard.

(v) AS 29, Provisions, Contingent Liabilities and Contingent Assets

Paragraphs 66 and 67 relating to disclosures are not applicable to SMCs.

(D) AS 25, Interim Financial Reporting, does not require a company to present interim financial report. It is applicable only if a company is required or elects to prepare and present an interim financial report. Only certain Non-SMCs are required by the concerned regulators to present interim financial results, e.g., quarterly financial results required by the SEBI. Therefore, the recognition and measurement requirements contained in this Standard are applicable to those Non-SMCs for preparation of interim financial results.

(4) Applicability of Accounting Standards to Non-corporate Entities (As on 1.4.2008)

(I) Accounting Standards applicable to all Non-corporate Entities in their entirety (Level I, Level II and Level III)

AS 1 Disclosures of Accounting Policies
AS 2 Valuation of Inventories
AS 4 Contingencies and Events Occurring After the Balance Sheet Date
AS 5 Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
AS 6 Depreciation Accounting
AS 7 Construction Contracts (revised 2002)
AS 9 Revenue Recognition
AS 10 Accounting for Fixed Assets

AS 11 The Effects of Changes in Foreign Exchange Rates (revised 2003)
AS 12 Accounting for Government Grants
AS 13 Accounting for Investments
AS 14 Accounting for Amalgamations
AS 16 Borrowing Costs
AS 22 Accounting for Taxes on Income
AS 26 Intangible Assets

(II) Exemptions or Relaxations for Non-corporate Entities falling in Level II and Level III (SMEs)

(A) Accounting Standards not applicable to Non-corporate Entities falling in Level II in their entirety:

AS 3 Cash Flow Statements
AS 17 Segment Reporting

(B) Accounting Standards not applicable to Non-corporate Entities falling in Level III in their entirety:

AS 3 Cash Flow Statements
AS 17 Segment Reporting
AS 18 Related Party Disclosures
AS 24 Discontinuing Operations

(C) Accounting Standards not applicable to all Non-corporate Entities since the relevant Regulators require compliance with them only by certain Level I entities:[2]

(i) AS 21, Consolidated Financial Statements
(ii) AS 23, Accounting for Investments in Associates in Consolidated Financial Statements

[2] AS 21, AS 23 and AS 27 (to the extent these standards relate to preparation of consolidated financial statements) are required to be complied with by a non-corporate entity if the non-corporate entity, pursuant to the requirements of a statute/regulator or voluntarily, prepares and presents consolidated financial statements.

(iii) AS 27, Financial Reporting of Interests in Joint Ventures (to the extent of requirements relating to Consolidated Financial Statements)

(D) Accounting Standards in respect of which relaxations from certain requirements have been given to Non-corporate Entities falling in Level II and Level III (SMEs):

(i) Accounting Standard (AS) 15, Employee Benefits (revised 2005)

(1) Level II and Level III Non-corporate entities whose average number of persons employed during the year is 50 or more are exempted from the applicability of the following paragraphs:

(a) paragraphs 11 to 16 of the standard to the extent they deal with recognition and measurement of short-term accumulating compensated absences which are non-vesting (i.e., short-term accumulating compensated absences in respect of which employees are not entitled to cash payment for unused entitlement on leaving);

(b) paragraphs 46 and 139 of the Standard which deal with discounting of amounts that fall due more than 12 months after the balance sheet date;

(c) recognition and measurement principles laid down in paragraphs 50 to 116 and presentation and disclosure requirements laid down in paragraphs 117 to 123 of the Standard in respect of accounting for defined benefit plans. However, such entities should actuarially determine and provide for the accrued liability in respect of defined benefit plans by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the

Standard. Such entities should disclose actuarial assumptions as per paragraph 120(l) of the Standard; and

(d) recognition and measurement principles laid down in paragraphs 129 to 131 of the Standard in respect of accounting for other long-term employee benefits. However, such entities should actuarially determine and provide for the accrued liability in respect of other long-term employee benefits by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard.

(2) Level II and Level III Non-corporate entities whose average number of persons employed during the year is less than 50 are exempted from the applicability of the following paragraphs:

(a) paragraphs 11 to 16 of the standard to the extent they deal with recognition and measurement of short-term accumulating compensated absences which are non-vesting (i.e., short-term accumulating compensated absences in respect of which employees are not entitled to cash payment for unused entitlement on leaving);

(b) paragraphs 46 and 139 of the Standard which deal with discounting of amounts that fall due more than 12 months after the balance sheet date;

(c) recognition and measurement principles laid down in paragraphs 50 to 116 and presentation and disclosure requirements laid down in paragraphs 117 to 123 of the Standard in respect of accounting for defined benefit plans. However, such entities may calculate and account for the accrued liability under the defined benefit plans by reference to some other rational method, e.g., a method based on the assumption that such benefits are payable to all employees at the end of the accounting year; and

(d) recognition and measurement principles laid down in paragraphs 129 to 131 of the Standard in respect of accounting for other long-term employee benefits. Such entities may calculate and account for the accrued liability under the other long-term employee benefits by reference to some other rational method, e.g., a method based on the assumption that such benefits are payable to all employees at the end of the accounting year.

(ii) AS 19, Leases

Paragraphs 22 (c),(e) and (f); 25 (a), (b) and (e); 37 (a) and (f); and 46 (b) and (d) relating to disclosures are not applicable to non-corporate entities falling in Level II.

Paragraphs 22 (c),(e) and (f); 25 (a), (b) and (e); 37 (a), (f) and (g); and 46 (b), (d) and (e) relating to disclosures are not applicable to Level III entities.

(iii) AS 20, Earnings Per Share

Diluted earnings per share (both including and excluding extraordinary items) is not required to be disclosed by non-corporate entities falling in Level II and Level III and information required by paragraph 48(ii) of AS 20 is not required to be disclosed by Level III entities if this standard is applicable to these entities.

(iv) AS 28, Impairment of Assets

Non-corporate entities falling in Level II and Level III are allowed to measure the ‘value in use’ on the basis of reasonable estimate thereof instead of computing the value in use by present value technique. Consequently, if a non-corporate entity falling in Level II or Level III chooses to measure the 'value in use' by not using the present value technique, the relevant provisions of AS 28, such as discount rate etc., would not be applicable to such an entity. Further, such an entity need not disclose the information required by paragraph 121(g) of the Standard.

(v) AS 29, Provisions, Contingent Liabilities and Contingent Assets

Paragraphs 66 and 67 relating to disclosures are not applicable to non-corporate entities falling in Level II and Level III.

(E) AS 25, Interim Financial Reporting, does not require a non-corporate entity to present interim financial report. It is applicable only if a non-corporate entity is required or elects to prepare and present an interim financial report. Only certain Level I non-corporate entities are required by the concerned regulators to present interim financial results, e.g., quarterly financial results required by the SEBI. Therefore, the recognition and measurement requirements contained in this Standard are applicable to those Level I non-corporate entities for preparation of interim financial results.

Appendix 3

Additional Recommendatory Disclosures for Microfinance Institutions

1. Microfinance institutions deal with the poor and with the money of the poor. This calls for the highest possible level of transparency of their working and operations. Thus, in addition to the various disclosures required as per the Accounting Standards, some additional disclosures are recommended for MFIs. These disclosures are essentially based on 'Disclosure Guidelines for Financial Reporting by Microfinance Institutions' given by the Consultative Group to Assist the Poor (CGAP[1]). These are given as follows:

(a) Basic information about the microfinance institution including:

(i) Legal status, the sustaining recognition under law in which the MFI stands registered or recognised,

(ii) Where special licensing is required (e.g., as a bank or as a non-banking financial company with the Reserve Bank of India), the sustaining status of the same,

[1] CGAP is an arm of World Bank which has specified disclosure norms for microfinance institutions. These are the international guidelines being followed by many microfinance institutions across the globe.

(iii) A brief note on business activities along with purpose and philosophy of the enterprise, particularly explaining the for-profit, not-for-profit motive of the enterprise,

(iv) Lending modalities, and

(v) Tax status of the enterprise.

(b) Fair values of all the assets, received as non-monetary grants, existing on the balance sheet date to be separately disclosed. If it is not practicable to determine the fair values of the assets on each balance sheet date, then such values may be determined after a suitable interval, say, every three years, and disclose the date of determination, along with the fair values.

(c) Fair value and details of the non-monetary grants and donations other than those given in (b) above which are received during the year to be separately disclosed provided that they are material. For example, a donor may pay the salary of an MFI's executive director or an MFI may occupy rent-free offices.

The term 'fair value' means the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction. The fair value of an asset would normally be the market price of the asset in an active, liquid and freely accessible market. The market price of an item can be the purchase price of the item donated, where the proof of purchase price is available, e.g., the donor has provided the invoice received from the supplier, declaration for customs duty purposes where the assets have been received from abroad, etc. In case the market price of the asset is not available then market price of a comparable asset may be used as fair value. It is recommended that the method of determination of fair value be also disclosed.

Where an MFI receives services in kind from donors, the fair value may be taken to be an estimate of the additional expense the MFI would incur in their absence. For example, an MFI may operate in an office that is provided rent-free by the municipality, in such a case the market rent it would otherwise have to pay may be taken as the fair value.

(d) Details of the services rendered by volunteers in respect of which no payment has been made.

(e) The following information may be provided on all loans advanced to an MFI that are material in relation to the total liabilities[2]:

(i) Source of the liability (name of the lending institution).

(ii) Terms of the loan: amount, repayment schedule (including grace periods), interest rate, fees and (if applicable) the foreign currency in which it is to be repaid.

(iii) Guarantee mechanisms used to obtain the loan, including the percentage of the loan covered by the guarantee.

(iv) Average outstanding principal balance of the loan during the reporting period calculated on a monthly or at least quarterly basis.

(v) Interest expense during the reporting period, including cash payments and accruals.

(vi) Full details of any arrears if the MFI has failed to

[2] MFIs often receive loans at below-market interest rates. As an MFI cannot depend on funding future growth with a continued flow of soft loans, it is important to know the extent to which an MFI is being subsidised through this mechanism. If interest amounts and rates are disclosed, it is possible to estimate how much more an MFI would have had to pay if the same loan was taken on commercial terms.

make a payment when due during the period or is not current on the loan at the end of the reporting period.

(f) Financial statements show financial information for both the current year as well as the previous year. They may also include a comment on any unusual movements, i.e., if a change in a significant account appears to be unusual or worrisome, a description of the reason for the change will be useful to the reader/user to assess the MFI's future prospects.

(g) The number of outstanding loan accounts at the beginning and at the end of the period may be disclosed.

(h) Loans generally available to all employees by an MFI may be reported showing the total amount, number, interest rate and degree of late payment on such outstanding loans. An MFI's policy on such type of loans may be described precisely.

(i) Sources of current period grants and donations to be disclosed.

(j) Cumulative amount of all donations and grants received till date to be disclosed.

(k) As the loan portfolio represents a valuable investment of an MFI, it is encouraged to prepare a Portfolio Report, which provides information about the lending and saving operations of the MFI and the quality of the loan portfolio.

(l) In addition to disclosing the policy governing write-off for loan losses, a description of how other accounts are affected by the write-offs may be disclosed.

Appendix 4

Guidance Note on Accounting for Securitisation

(The following is the text of the Guidance Note on Accounting for Securitisation, issued by the Council of the Institute of Chartered Accountants of India.)

INTRODUCTION

1. Securitisation is the process by which financial assets such as loan receivables, mortgage backed receivables, credit card balances, hire-purchase debtors, lease receivables, trade debtors, etc., are transformed into securities. Securitisation is different from 'factoring' in that 'factoring' involves transfer of debts without transformation thereof into securities. A securitisation transaction, normally, has the following features:

- Financial assets such as loan assets, mortgages, credit card balances, hire-purchase debtors, trade debtors, etc., or defined rights therein, are transferred, fully or partly, by the owner (the Originator) to a Special Purpose Entity (SPE) in return for an immediate cash payment and/or other consideration. The assets so transferred are the 'securitised assets' and the assets or rights, if any, retained by the Originator are the 'retained assets'.

- The SPE finances the assets transferred to it by issue of securities such as Pass Through Certificates (PTCs) and/ or debt securities to investors.

- A usual feature of securitisation is 'credit enhancement', i.e., an arrangement which is designed to protect the holders of the securities issued by an SPE from losses and/or cash flow mismatches arising from shortfall or delays in collections from the securitised assets. The arrangement often involves one or more of the following:

  - *Provision of cash collateral,* i.e., a deposit of cash which in specified circumstances can be used by the SPE for discharging its financial obligation in respect of the securities held by the investors.

  - *Over collaterisation,* i.e., making available to the SPE assets in excess of the securitised assets, the realisation of which can be used in specified circumstances to fund the shortfalls and/or mismatches in fulfilment of its financial obligations by the SPE.

  - *Recourse obligation* accepted by the Originator.

  - *Third party guarantee,* i.e., a guarantee given by a third party by accepting the obligation to fund any shortfall on the part of the SPE in meeting its financial obligations in respect of the securitisation transaction.

  - *Structuring of the instruments issued by an SPE into senior and subordinated securities* such that the senior securities (issued to investors) are cushioned by the sub-ordinated securities (issued normally to the Originator) against the risk of shortfalls in realisation of securitised assets. Payments on subordinated securities are due only after the amounts due on the senior securities are discharged.

- The Originator may continue to service the securitised assets (i.e., to collect amounts due from borrowers, etc.) with or without servicing fee for the same.

- The Originator may securitise or agree to securitise future receivables, i.e., receivables that are not existing at the time of agreement but which would be arising in future. In case of such securitisation, the future receivables are estimated at the time of entering into the transaction and the purchase consideration for the same is received by the Originator in advance. Securitisation can also be in the form of 'Revolving Period Securitisation' where future receivables are transferred as and when they arise or at specified intervals; the transfers being on prearranged terms.

A diagrammatic presentation of a typical securitisation transaction is given in Appendix I.

2. This Guidance Note deals with accounting for securitisation transactions in the books of Originator, specially addressing issues such as when to derecognise, fully or partly, the securitised assets; treatment of securitisation of future receivables; measurement of consideration received in the form of securities; etc. The Guidance Note also deals with accounting for securitisation transactions in the books of SPEs. Another issue dealt with relates to accounting for investments in the securities such as PTCs and/or debt securities issued by the SPE, in the books of Investors.

DEFINITIONS

3. The following terms are used in this Guidance Note with the meanings specified:

Call Option is an option that entitles the Originator to repurchase the financial assets transferred under a securitisation transaction from the SPE. The Option may be at a predetermined price or at a value to be determined, for example, fair value on the date of exercise of Call Option.

Clean-up Call Option is an option held by the servicer (who may be the Originator) to purchase the remaining transferred securitised assets or the remaining beneficial interests in the SPE if the amount of securitised assets or beneficial interests falls to a level at which the cost of servicing those assets or beneficial interests becomes burden some in relation to the benefits of servicing.

Interest Strip is a contractual arrangement to separate the right to all or part of the interest due on a debenture, bond, mortgage loan or other interest bearing financial asset from the financial asset itself.

Investor is the person who finances the acquisition of the securitised assets or of beneficial interest therein by subscribing to PTCs and/ or debt securities issued by an SPE.

Originator is an entity that owns the financial assets proposed to be securitised and initiates the process of securitisation in respect of such assets.

Pass Through Certificates (PTCs) are instruments acknowledging a beneficial interest in the securitised assets such that the payment of interest on such instruments and the repayment of the principal are directly or indirectly linked or related to realisations from the securitised assets.

Principal Strip is the right to the remainder of the financial asset net of all rights that have been stripped therefrom by one or more contractual arrangements such as by an Interest Strip.

Recourse Obligation is the obligation of the Originator to reimburse or compensate, fully or partly, the investors for, or otherwise bear the risk of, shortfalls, such as those, arising from:

- failure of debtors to pay or to pay when due; or

- pre-payments; or
- other defects in securitised financial assets.

Servicing Asset is a contract to service financial assets under which the estimated future revenues from contractually specified servicing fees, late charges and other related revenues are expected to more than adequately compensate the servicer (who may be the Originator) for performing the services. A servicing contract can be either:

- undertaken together with selling or securitising the financial assets being serviced; or
- purchased or assumed separately.

Special Purpose Entity (SPE) is an entity which acquires the financial assets under securitisation and normally holds them till maturity. SPE is an independent entity, usually constituted as a trust though it may be constituted in other forms, for example, as a limited company, formed with small capital for the specific purpose of funding the transaction by issue of PTCs or debt securities.

ACCOUNTING IN THE BOOKS OF ORIGINATOR

Derecognition of securitised asset

4. Securitised asset should be derecognised in the books of the Originator, if and only if, either by a single transaction or by a series of transactions taken as a whole, the Originator loses control of the contractual rights that comprise the securitised asset. The Originator loses such control if it surrenders the rights to benefits specified in the contract. Determining whether the Originator has lost control of the securitised asset depends both on the Originator 's position and that of the SPE. Consequently, if the position of either the Originator or the SPE indicates that the Originator has retained control, the Originator should not remove the securitised asset from its balance sheet.

5. The Originator has not lost control over the securitised asset, for example, where

(a) the creditors of the Originator are entitled to attach or otherwise deal with the securitised assets;

(b) the SPE does not have the right (to the extent it was available to the Originator) to pledge, sell, transfer or exchange for its own benefit the securitised asset;

(c) the Originator has the right to reassume control of the securitised asset except

(i) where it is entitled to do so by a Call Option, where such Call Option can be justified on its own commercial terms as a separate transaction between the SPE and the Originator, for instance, where the Call Option is exercisable at fair value of the asset on the date of exercise of the Option; or

(ii) where it is entitled to do so by a Clean-up Call Option.

6. Whether the Originator has lost control over the securitised asset should be determined on the basis of the facts and circumstances of the case by considering all the evidence available. It would be incorrect to hold that the derecognition criterion prescribed in paragraph 4 is not met in the following cases:

(a) The Originator continues to service the securitised asset. Such servicing by itself would not lead to a conclusion that the Originator has not lost control over the securitised asset.

(b) An obligation is cast on the Originator to repurchase the securitised asset at a predetermined price. Such an obligation is not an entitlement to reassume ownership available to the Originator. Notwithstanding such an obligation the securitised asset would be beyond the control of the Originator. The obligation accepted by the Originator should be accounted for in the manner indicated in paragraph 10 of this Guidance Note. However, where the Originator is both entitled and obligated to repurchase the securitised asset at a pre-determined price, the Originator is not considered to have lost control over the securitised asset and, therefore, the same should not be removed from the balance sheet of the Originator.

7. On derecognition, the difference between the book value of the securitised asset and consideration received should be treated as gain or loss arising on securitisation and disclosed separately in the statement of profit and loss. On the other hand, if the derecognition criterion as prescribed in paragraph 4 is not met, the asset should continue to be recognised in the books of the Originator and consideration received for the asset so transferred, should be accounted for as a borrowing secured there against.

8. The consideration received in a form other than cash, e.g., securities issued by the SPE, should be measured at the lowest of the

(a) the fair value of the consideration;

(b) the net book value of the securitised assets; and

(c) the net realisable value of the securitised assets.

In case the consideration has been received partly in cash and partly in a form other than cash, the non-cash component of the consideration should be measured at the lowest of the

(a) the fair value of the non-cash component;

(b) the net book value of the securitised assets as reduced by the cash received; and

(c) the net realisable value of the securitised assets as reduced by the cash received.

The fair value is the price that would be agreed upon between knowledgeable, willing parties in an arm's length transaction. Quoted market price in an active, liquid and freely accessible market, if available, is normally the best evidence of fair value. If quoted market price is not available, estimate of fair value may be based on the market prices of assets similar to those received as consideration. In case the market prices of similar assets are also not available, the estimate of fair value may be based on generally accepted valuation techniques such as the present value of estimated future cash flows. These techniques would require estimates and assumptions about various matters such as estimates of future revenues, future expenses and assumptions about interest rates, defaults and likely prepayments. Some of these estimations, e.g., estimation of future cash flows and discount rates may present significant difficulties. It would be necessary to make the best estimate based on reasonable and supportable assumptions and projections. All available evidence should be considered in developing the requisite estimate and assumptions.

9. In case the securitised assets qualify for derecognition, the entire expenses incurred on the transaction, say, legal fees, etc., should be expensed at the time of the transaction and should not be deferred. Where the securitised assets do not qualify for derecognition and, therefore, the consideration received in respect thereof is treated as a secured borrowing, such expenses should either be amortised over the term of the secured borrowing or recognised immediately in the statement of profit and loss.

10. If a securitised asset qualifies to be derecognised as per paragraph 4 and the Originator has accepted recourse or similar obligation, e.g., the Originator has granted a Put Option at a predetermined price to the SPE, then the contingent loss arising therefrom, should be accounted for as per Accounting Standard (AS) 4, 'Contingencies and Events Occurring After the Balance Sheet Date', issued by the Institute of Chartered Accountants of India. This would require that a provision be made for the contingent

loss arising from the obligation, where the criteria specified in the Standard in this regard are satisfied.

Future Receivables / Revolving Securitisation

11. Any purchase consideration received by the Originator on the securitisation of future receivables should be accounted for as an advance, since the assets proposed to be securitised would not be existing at the time of the agreement, but would arise in future. The cost of bringing these assets into existence would also be incurred in future. In such cases, the criterion for derecognition prescribed in paragraph 4 should be applied as and when the relevant assets come into existence. Till such time the amounts received, if any, on account of the proposed securitisation should be reflected as an advance. The other requirements of the Guidance Note also apply, mutatis mutandis, in case of securitisation of future receivables.

12. In case of revolving period securitisation where financial assets are transferred as and when they come into existence or at specified intervals and the purchase consideration is paid to the Originator at the time of such transfer, all requirements of this Guidance Note, except paragraph 11, apply.

Partial Derecognition

13. An Originator may transfer only a part of the financial asset in a securitisation transaction instead of transferring the complete asset. Such transfer may occur in two ways. One way is where a proportionate share of the asset is transferred. For example, the Originator may transfer a proportionate share of loan (including right to receive both interest and principal), in such a way that all future cash flows, profit/loss arising on loan will be shared by the Originator and the SPE in fixed proportions. A second way of transferring a part of a financial asset arises where the asset comprises the rights to two or more benefit streams, and the Originator transfers one or more of such benefit streams while retaining the others. For example, the Originator may securitise the Principal Strip of the loan while retaining the Interest Strip and

Servicing Asset.

14. If the Originator transfers a part of a financial asset while retaining the other part, the part of the original asset which meets the derecognition criterion as set out in paragraph 4 should be derecognised whereas the remaining part should continue to be recognised in the books. Similarly, if any new interest has been created as a result of securitisation transaction, such as a Call Option, the new interest should be recognised in the books in accordance with the relevant accounting principles.

15. If the Originator transfers a proportionate part of the asset, the previous carrying amount of the asset is apportioned among the part transferred and the part retained on the basis of proportion transferred and proportion retained. For example, if the Originator transfers 75% of an asset to the SPE, 75% of the carrying amount of the asset should be considered as securitised. Where the securitised part of the asset qualifies to be derecognised as per the requirements of paragraph 4, the entity would continue to recognise the remaining part of the asset at 25% of the carrying amount.

16. In case the asset comprises the rights to two or more benefit streams and one or more of such benefit streams is/are transferred while retaining the others, the carrying amount of such financial asset should be apportioned between the part(s) transferred and the part(s) retained on the basis of their relative fair values as on the date of transfer. The fair values of the parts should be determined on the basis described in paragraph 8. If fair value of the part of the asset that is retained cannot be measured reliably, that part should be valued at a nominal value of Re.1. Similarly, if any new financial asset, e.g., a call option, has been created as a result of securitisation transaction and its fair value cannot be measured reliably, initial carrying amount of the asset should be recognised at a nominal value of Re.1.

17. An example illustrating the computations and accounting treatment in case of partial derecognition is given in Appendix II to this Guidance Note.

ACCOUNTING IN THE BOOKS OF SPECIAL PURPOSE ENTITY

18. The SPE should recognise the asset received under a securitisation transaction, if the Originator loses control over the securitised asset on the basis of the criterion prescribed in paragraph 4. The asset so received should be recognised at the amount of consideration, if the consideration has been paid in cash. In case the consideration has been paid in a form other than cash, e.g., securities, the asset so received should be recorded either at its intrinsic value or at the fair value of the consideration, whichever is more clearly evident. If both the values are equally evident the asset should be valued at the lower of the two values.

19. If the beneficial ownership in the securitised asset has not been transferred to the SPE or the Originator has not lost control over the asset as per the requirements of paragraph 4, the SPE should not recognise the asset received. In such a case, the consideration paid should be recorded as a lending secured against the financial asset received under securitisation transaction.

20. The amount received by the SPE on issue of PTCs or other securities should be shown on the liability side of the balance sheet, with appropriate description, keeping in view the nature of securities issued.

ACCOUNTING IN THE BOOKS OF THE INVESTOR

21. The Investor should account for the PTCs and/or debt securities acquired by it as an investment in accordance with Accounting Standard (AS) 13, ‘Accounting for Investments’. However, where in case of an Investor, AS 13 is not applicable because of the Investor being specifically exempted from the application of AS 13, the investments in PTCs and/or other securities should be valued and accounted for as per the relevant accounting principles applicable to the Investor.

DISCLOSURES

22. In addition to the disclosures arising from recommendations made in paragraph 10, the following disclosures should be made in the financial statements of the Originator:

(i) The nature and extent of securitisation transaction(s), including the financial assets that have been derecognised.

(ii) The nature and the amounts of the new interests created, if any.

(iii) Basis of determination of fair values, wherever applicable.

23. The following disclosures should be made in the financial statements of the SPE:

(i) The nature of the securitisation transaction(s) including, in particular, a description of the rights of the SPE vis-à-vis the Originator whether arising from the securitisation transaction or a transaction associated therewith.

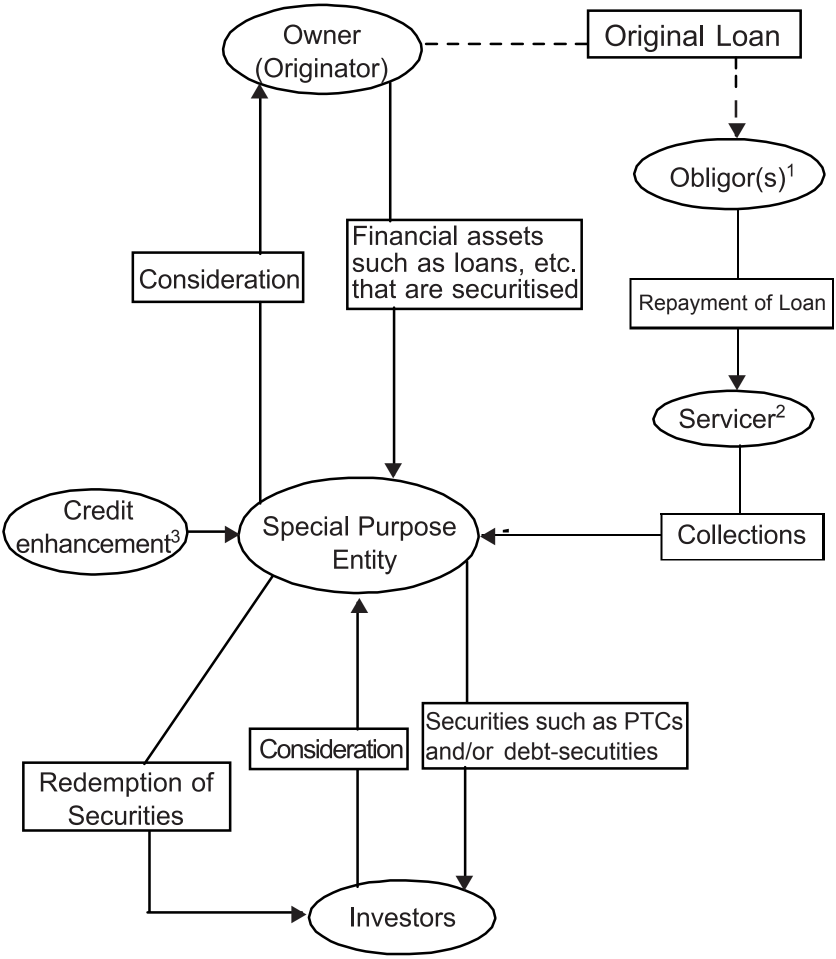
(ii) Basis of determination of fair values, wherever applicable.

24. The Investor should make disclosure of investments in PTCs and/or debt securities as required by Accounting Standard (AS) 13, 'Accounting for Investments'. However, where in the case of an Investor, AS 13 is not applicable because the Investor is specifically exempted from the application of AS 13, the Investor should make such disclosures as per the relevant requirements.

Appendix I

(This Appendix does not form part of the Guidance Note and is merely illustrative.)

Diagrammatic Presentation of a Typical Securitisation Transaction



---

[1] Obligor is an entity which has received a loan giving rise to the financial asset that is securitised by the Originator.

[2] can be the Originator also.

[3] may be provided either by the Originator or by any third party.

Appendix II

(This Appendix does not form part of the Guidance Note and is merely illustrative.)

Illustration of Computation and Accounting in Case of Partial Derecognition

1. Suppose Company 'C' holds Rs. 1,000/- of loans yielding interest @ 18% p.a. for their estimated lives of nine years. Considering the interest rate the fair value of these loans is estimated at Rs. 1,100/-. The company securitises the principal component of the loan plus the right to receive interest @ 14% to an SPE for Rs. 1,000/-. Out of the balance interest of 4%, it is stipulated that half of such balance interest, namely 2%, will be due to the company as fees for continuing to service the loans. The fair value of the servicing asset so created is estimated, after taking into account the costs likely to be incurred in servicing the loan, at Rs. 40. The remaining half of the interest is due to the company as an interest strip receivable, the fair value of which is estimated at Rs. 60.

2. Since the company has securitised the principal and a part of the interest, it is necessary to compute the cost attributable to various components assuming that the securitised components meet the derecognition criteria. This computation can be done by apportioning the carrying amount of the asset in the ratio of fair values as follows:

Fair value of securitised component of the loan

	Rs.	Rs.
Fair value of loan		1,100
Less: Fair value of servicing asset	40	
Fair value of interest strip	60	100
Fair value of securitised component of loan		1,000

Apportionment of carrying amount based on relative fair values

Particulars	Fair Values	%age based on Total Fair Value	Carrying Amount / Cost
Securitised component of loan	1000	91	910
Servicing Asset	40	3.6	36
Interest Strip Receivable	60	5.4	54
	1,100	100	1,000

3. The profit arising on securitisation should be computed as follows:

	Rs.
Net proceeds of securitisation	1,000
Less: Cost (apportioned carrying amount) of securitised component of loan	910
Profit on securitisation	90

4. Based on the above, the following journal entries would be passed in the books of the Originator:

		Rs.	**Rs.**
(a) *To record securitisation of principal plus right to 14% interest*			
Cash A/c	Dr.	1,000	
To Loans A/c (cost of securitised component)			910
To Profit on Securitisation			90
(b) *To record the creation of servicing asset and interest strip receivable*			
Servicing asset A/c	Dr.	36	
Interest strip A/c	Dr.	54	
To Loans A/c			90

Glossary

Clients:	Individuals served by the microfinance institutions-women and men from socially, economically and politically disadvantaged sections of society, including small and marginal farmers, oral lessees, tenants, sharecroppers, disadvantaged social groups, artisans, and persons engaged in small and tiny economic activities.
Client Deposits:	Includes both voluntary and forced/ compulsory client savings that are deposited with the MFI which it must return.
Collateral:	Assets pledged to secure the repayment of a loan. Asset provided to creditor as security for a loan.
Compulsory Savings:	Savings required as a condition for access to loan services.
Deferred Income:	Income received but not earned until all events have occurred. Deferred income is reflected as a liability.
External Reporting:	Reporting to shareholders/members and public etc., as opposed to internal reporting for management's benefit.
Grace Period:	An initial period after the disbursement of a loan during which a borrower is not

required to pay principal (or principal and interest).

Guaranteed loans: A pledge to cover the payment of debt or to perform some obligation if the person liable fails to perform. When a third party guarantees a loan, it promises to pay in the event of a default by the borrower.

Joint Liability Group: A joint-liability group is small group of borrowers (typically 4-5) who are jointly liable to an external lender (MFI) for the loan that they receive.

Loan Loss Provision: An amount set aside in the balance sheet to recognise probable future loan losses so that the true value of the loan portfolio is fairly stated. The provision is increased by additional provision created by way of a charge to the profit and loss account and is reduced by write-offs of uncollectible loans.

Loan Portfolio: The asset composed of the loans that borrowers owe to an MFI. The amount of the gross loan portfolio is the total unpaid principal balance of such loans, i.e., amount of all loans disbursed and not yet repaid or written off.

Material: Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements.

Monetary Items: Money held and assets and liabilities to be received or paid in fixed or determinable amounts of money.

Multi-service MFI:	An MFI that offers both financial (microfinance) and material non-financial services.
Net Loan Portfolio:	It is the gross loan portfolio less the loan loss provision. The net loan portfolio figure reflects only the principal due and does not include interest expected to be received.
On-lending:	Involves the MFI borrowing from banks and then lending that money to clients.
Past-due Loans Outstanding:	The total amount of loans outstanding which have amount past due. In other words, it represents outstanding balance of all overdue loans.
Personnel Cost:	Includes staff salaries, bonuses, and benefits incurred by the MFI for services rendered by its staff.
Portfolio Quality:	The extent to which loans in a portfolio are repaid in full and on time.
Quoted Investment:	Investment in respect of which a quotation or permission to deal on a recognised stock exchange has been granted.
Regular Loans Outstanding:	The total amount of loans outstanding at a point of time that are regular, i.e., with no late payments or defaults.
Replacement Cost:	Cost the enterprise would incur to acquire the asset.

Restructured Loans:	Problem loans in which the original terms are renegotiated. There are two possible cases–loans can be either refinanced or rescheduled. Rescheduling an outstanding loan involves changing the payment period and/or the size of payments. Refinancing a loan involves developing a new loan agreement before a previous one is completed. It can include increases in the principal amount, extension of the loan term, etc.
Secured loan:	Loan secured wholly or partly against an asset.
Soft loans:	A loan, typically from a donor or government, with a lower interest rate than that offered by commercial sources.
Thrift:	Savings of clients, who have become members of self-help groups, other than public deposits.
Unquoted Investment:	Investment other than quoted investment.
Voluntary Savings:	MFI client deposits held in accounts that are not tied to the availability of loans.
Write-off:	The elimination of an uncollectible/ irrecoverable loan amount from the loan portfolio in the balance sheet. Uncollectible loans are known as loan losses.