CASE STUDY 9

Economic Survey for 2023-24 has been presented to the Parliament. According to the survey, "the Indian Economy, however, appears to have moved on after its encounter with the pandemic, staging a full recovery ahead of many nations and positioning itself to ascend to the pre-pandemic growth path". It is also stated that agencies worldwide continue to project India as the fastest growing major economy.

This could be possible with TEAM (Together Everyone Achieves More) efforts. The participants of this Team are the Central Government, State Governments, industry and the people of this country.

There has been a tectonic shift in policies of the government. The emphasis of the present government has been to stimulate entrepreneurship so that more and more people become job givers rather than job seekers. This has also resulted in providing impetus and encouragement to the youth of the nation to pursue their entrepreneurial dreams.

One such case of entrepreneurial dreams is of Manu and Tanu, two friends who always aspired to have their own business ventures when they complete their education. They both completed MBA from top business schools in India and were working in large corporates with big pay packages.

Whilst they always wanted to pursue business ideas, nothing came their way which enticed them to start their entrepreneurial journey. Meanwhile, Manu who was interested in economic policy and defence related matters came across a write up which described the shift in the policy by the present government in defence sector. The new policy emphasised on giving priority to the indigenous market players and reserving more than 500 items for domestic manufacturing, was a lucrative business chance, he thought.

Though Manu and Tanu were in contact, it had been couple of years since they met. Manu met Tanu and discussed this idea of business potential in defence sector and how they could start something of their own. They believed there is a lot of scope in domestic as well as in global market, if they could manufacture the ancillary items used in defence equipment.

Having realised their true calling, both resigned from their high paying jobs to start their own venture. In 2021, they incorporated a company called M&A Private Ltd, with both of them being the shareholders and directors of the Company. Gradually, when the business started growing, they brought in Shyam as a shareholder and director. Presently, Shyam holds 12% of the equity share capital while Manu and Tanu hold 44% each. The Company is able to fund its operations internally without seeking any outside funds.

As both Tanu and Manu had business acumen and strategic vision, they wanted to rely on a professional who can guide them on accounting, law and compliance matters and give expert

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advice at various points in time as required by business. They appointed their long-time friend and a tenured financial professional, Ajim as the Chief Financial Officer (CFO) of the Company.

During one of the board meetings, while briefing about the audit status, the CFO informed the directors that the financial statements for the current year would be prepared as per the Indian Accounting Standards (Ind AS). In the audit kick-off meeting held in March 2024, the following points were discussed by the CFO, while Tanu and Manu, added their insights:

(A) Shyam is a director on the Board of Directors and holds 12% equity shares of the Company. As Shyam had some financial emergency, Tanu and Manu wanted to support him by giving loan of ₹ 5 Lakhs from the Company. CFO mentioned that the Company had an accumulated profit of ₹ 7.5 Lakhs as on the date of loan to Shyam. It is pertinent to note that Shyam is also a Partner in Shyamlal & Co, with a 30% profit sharing therein. During the current year, the Company made an advance of ₹ 2 Lakhs to Shyamlal & Co. towards procurement of materials.

(B) The Company also purchases goods from entities registered under Micro, Small and Medium Enterprises Act, 2006. The CFO of the Company provides the following information of trade payable to Micro and Small Enterprises:

Not due	*₹ 7 lakhs (out of which ₹ 3 lakhs are disputed)*
Due less than 1 year	*₹ 12 lakhs (out of which ₹ 2 lakhs are disputed and in arbitration)*
1-2 years	*₹ 3 lakhs disputed*
More than 2 years	*Nil*

During the year, the Company paid an interest of ₹ 2.50 lakhs in terms of section 16 of the Micro, Small and Medium Enterprises Development Act, 2006 and ₹ 1.5 Lakhs were paid beyond the appointed day and the interest due of ₹ 10,000 was not paid.

(C) M&A Private Ltd acquired 100% of the shares of another company P&T Private Ltd. The negotiations for this acquisition commenced on 1st January 2023 and the agreement was finalised on 1st March 2023. While M&A Private Ltd obtained the power to control P&T Private Ltd.'s operations on 1st March 2023, the agreement states that the acquisition is effective from 1st January 2023 and that M&A Private Ltd is entitled to all profits after that date. In addition, the purchase price is based on P&T Private Ltd.'s net assets as at 1st January 2023. The final settlement of consideration was made on 1st May 2023.

(D) M&A Private Ltd also holds 70% stake of issued equity share capital of SAGE Ltd. and 45% of issued redeemable preference shares. This acquisition was made on 31st

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December 2023. Issued and paid-up equity and preference share capital of SAGE Ltd as on 31st March 2023 is ₹ 15 Crores and ₹ 5 Crores respectively. Balance in the Statement of Profit and Loss for the year ended 31st March 2024 is ₹ 25 Crores. All the book values of assets and liabilities were same as their fair values except for an item of Property, Plant and Equipment (PPE). The carrying amount, at the time of acquisition by M&A Private Ltd, of PPE is ₹ 3 crores and its fair value was ₹ 6.20 Crores. No adjustment for fair-value has been done in the books of SAGE Ltd.

(E) Anu is also a director of M&A Private Ltd, who was going on world tour for a period of 5 months. In his absence, he wishes to appoint his friend Kumar, as an alternate director of M&A Private Ltd on his behalf. The Articles of Association of the Company allows the appointment of alternate director.

(F) M&A Private Ltd enters into a seven-year service contract with a customer NP Ltd for an amount of ₹ 21 Lakhs i.e. ₹ 3 Lakhs per year. The standalone selling price for one year contract at inception of the contract is ₹ 3 Lakhs per year. M&A Private Ltd. accounts for the contract as a series of distinct services. At the beginning of the Seventh year, the parties agree to modify the contract as follows:

- the fees for the seventh year is reduced to ₹ 2.7 Lakhs and
- NP Ltd agrees to extend the contract for another seven years for ₹ 16.80 Lakhs i.e. ₹ 2.40 Lakhs per year.

The standalone selling price for one year of service at the time of modification is ₹2.10 Lakhs.

I. Multiple Choice Questions

1. The CFO says that the tax auditor wants to treat the loan of ₹ 5 Lakhs to Shyam and advance of ₹ 2 Lakhs to Shyamlal & Co. as deemed dividend. Is it appropriate?

   (a) Both the loan of ₹ 5 Lakhs and advance of ₹ 2 Lakhs will not be treated as deemed dividend as both are repayable.

   (b) The loan of ₹ 5 Lakhs and advance of ₹ 2 Lakhs will be treated as deemed dividend only to the extent of ₹ 90,000 i.e. 12% of the accumulated profit.

   (c) Both the loan and advance will not be treated as deemed dividend as his interest in the Company is only 12%.

   (d) The loan will be taxable as deemed dividend, but the advance given to Shyamlal & Co. will not be treated as deemed dividend since it is a business advance.

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2. CFO states that the interest paid to the MSME vendors is allowed as a business expenditure and should be reported accordingly in the tax returns:

   (a) The interest of ₹ 2.60 Lakhs will be deductible, as it is business expenditure.

   (b) The interest of ₹ 1.95 Lakhs will be deductible, as 75% of the interest paid to MSME vendors will be allowed as a deduction.

   (c) The interest of ₹ 2.50 Lakhs paid to MSME vendors will not be allowed as deduction from computation of income, as the Micro, Small and Medium Enterprises Act, 2006 specifically prohibits such deduction.

   (d) The interest of ₹ 1.25 Lakhs will be deductible, as 50% of the interest paid to MSME will be allowed as a deduction.

3. As per Ind AS 103, what is the date of acquisition of P&T Private Ltd. by M&A Private Ltd. for the purposes of business combination?

   (a) 1st January 2023

   (b) 1st March 2023

   (c) Either of 1st January 2023 or 1st March 2023 at the choice of M & A Private Ltd.

   (d) 1st May 2023

4. Compute the amount of non-controlling interest of SAGE Ltd as on 31st March 2023:

   (a) ₹ 15.68 Crores

   (b) ₹ 12.00 Crores

   (c) ₹12.96 Crores

   (d) ₹ 14.75 Crores

5. Whether Anu has a right to appoint alternate director in his absence:

   (a) Claim made by Anu to appoint Kumar as alternate Director is valid, as the Articles of Association of M&A Private Ltd provide for appointment.

   (b) Claim made by Anu to appoint Kumar as alternate Director is not valid, as the authority to appoint alternate Director vests with the Board of Directors only and that too subject to Articles of Association.

   (c) Kumar cannot be appointed as alternate director in place of Anu, since his absence will be of less than six months.

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(d) Kumar cannot be appointed as alternate director in place of Anu, since his absence will be more than 3 months.

II. Descriptive Questions

6. As Tanu and Manu are not well versed with Ind AS, with reference to business combinations, they want to understand about:

   (i) Determination of acquisition date

   (ii) Ascertainment of control

7. The CFO believes that a loan to directors is prohibited under the Companies Act, 2013. Can M&A Private Ltd extend the proposed loan to Shyam? Comment.

8. The CFO wants to understand, how to record revenue at the end of seventh year as per Ind AS 115. Also, prepare a brief note explaining the accounting for revenue when the contract is modified.

ANSWERS TO THE CASE STUDY 9

I. Answers to the Multiple Choice Questions

1. **(d)** As per Section 2(22)(e) of the Income-tax Act, 1961, dividend includes -any payment by a company, not being a company in which the public are substantially interested, of any sum (whether as representing a part of the assets of the company or otherwise) made after the 31st day of May, 1987, by way of advance or loan to a shareholder, being a person who is the beneficial owner of shares (not being shares entitled to a fixed rate of dividend whether with or without a right to participate in profits) holding not less than ten per cent of the voting power, or to any concern in which such shareholder is a member or a partner and in which he has a substantial interest (hereafter in this clause referred to as the said concern) or any payment by any such company on behalf, or for the individual benefit, of any such shareholder, to the extent to which the company in either case possesses accumulated profits.

Hence, loan to director will be treated as deemed dividend and advance to firm will not be considered as deemed dividend, as it is a business advance.

2. **(c)** Section 23 of the MSMED Act lays down that an interest payable or paid by the buyer, under or in accordance with the provisions of this Act, shall not for the

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purposes of the computation of income under the Income-tax Act,1961 be allowed as a deduction

3. (b) Paragraph 8 of Ind AS 103 provides that acquisition date is the date on which the acquirer obtains control of the acquiree.

4. (a)

Share Capital	₹ in crores	NCI	₹ in crores
Equity	15	30%	4.5
Preference	5	55%	2.75
Profit	25	30%	7.5
Fair Value Adjustment	3.2	30%	0.96
Depreciation Adj	0.1	30%	-0.03
			15.68

5. (b) Section 161 of the Companies Act, 2013 vests the Board of Directors to appoint any person as an alternate director and not to the director during whose absence he is to act.

II. Answers to the Descriptive Questions

6. (i) **Determination of Acquisition Date: Paragraph 8 of Ind AS 103 provides the acquisition date as the date on which the acquirer obtains control of the acquiree. Further, Paragraph 9 of Ind AS 103,** clarifies that the date on which the acquirer obtains the control of the acquiree is generally the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree — the closing date.

However, the acquirer might obtain control on a date that is either earlier or later than the closing date. For example, the acquisition date precedes the closing date if a written agreement provides that the acquirer obtains control of the acquiree on a date before the closing date.

The acquisition date is a very important step in the accounting of business combination because it determines when the acquirer recognizes and measures the consideration, the assets acquired and liabilities assumed. The acquiree's results are consolidated from this date. **The acquisition date materially impacts the overall acquisition accounting, including post-combination earnings.**

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(ii) Ascertainment of Control:

Paragraphs 6 of Ind AS 110, "Consolidated Financial Statements", , states that an investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Further, para 7 of Ind AS 110 states that an investor controls an investee if and only if the investor has all the following:

(a) power over the investee;

(b) exposure, or rights, to variable returns from its involvement with the investee; and

(c) the ability to use its power over the investee to affect the amount of the investor's returns.

7. **Section 185** of the Companies Act, 2013 (the Act) imposes restrictions on the Company on providing of loans to directors of the Company. As per the exemption notified by the Ministry of Corporate Affairs, (MCA), Section 185 of the Act shall not apply to a Private Company in case of fulfillment of the following conditions:

(a) in whose share capital no other body corporate has invested any money;

(b) if the borrowings of such a company from banks or financial institutions or anybody corporate is less than twice of its paid-up share capital or fifty crore rupees, whichever is lower; and

(c) such a Company has no default in repayment of such borrowings subsisting at the time of making transactions under this section.

Analysis and Conclusion

In the given case, since the Company (M&A Private Limited) is in compliance with the above mentioned criteria. So it will be exempted from the applicability of Section 185 of the Act on it. So the restrictions marked on providing of loan under Section 185 of the Act will not be applicable on M&A Private Limited. **Hence, M&A Private Limited can extend the proposed loan to Shyam.**

ALTERNATE ANSWER

Section 185 of the Companies Act, 2013 imposes restrictions on the Company on providing of loans to directors.

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Accordingly,

(i) A Company is not permitted, to advance any loan, / any guarantee /any security in connection with any loan taken by,—

(a) **any director of Company**, or of a Company which is its holding company or any partner or relative of any such director; or

(b) **any firm** in which any **such director** or relative is a **partner.**

(ii) Relaxation: Subject to the specified conditions, a Company is permitted to:

- advance any loan or give any guarantee or provide any security in connection with any loan **taken by any person in whom any of the director of the company is interested.**

The expression "any person in whom any of the director of the company is interested" means—

(a) any **private company** of which any such director is a director or member;

(b) any **body corporate** at a general meeting of which **not less than twenty-five per cent** of the total voting power may be exercised or controlled by any such director, or by two or more such directors, together; or

(c) any **body corporate,** the Board of directors, managing director or manager, whereof is accustomed to act in accordance with the directions or instructions of the Board, or of any director or directors, of the lending company.

In the given instance, Shyam is a director on the BoD of the M&A Private Limited. Shyam had some financial emergency, so Tanu and Manu wanted to support him by giving loan of 5 lakhs from the company. Also Shya**m is a partner in Shyamlal & Co.**

Analysis and Conclusion

Accordingly, as per the stated provision, Loan is prohibited to be given to Shyam, a director in M&A Private Limited who is also partner in a firm, Shyamlal & Co. However subject to compliance of specified conditions mentioned in Section 185(2) of the Act, a Company is permitted to advance loan taken by any person in whom any of the director of the company is interested. As per the explanation, “any person in whom any of the director of the company is interested” includes any private company of which any such director is a director or member.

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As Shyam is a director in M&A Private Limited, so falling within the specified category, makes him eligible under the said Section to get the loan from M&A Private Limited. **Hence, M&A Private Limited can extend the proposed loan to Shyam.**

8. (i) Recording of revenue at the end of the seventh year as per Ind AS 115

In the given case, even though the remaining services to be provided are distinct, the modification should not be accounted for as a separate contract because the price of the contract did not increase by an amount of consideration that reflects the standalone selling price of the additional services.

The modification would be accounted for, from the date of the modification, as if the existing arrangement was terminated and a new contract created (i.e. on a prospective basis) because the remaining services to be provided are distinct.

M&A Pvt. Ltd. should reallocate the remaining consideration to all of the remaining services to be provided (i.e. the obligations remaining from the original contract and the new obligations). M&A Pvt. Ltd. will recognize a total of ₹ 19.50 lakhs (₹ 2.70 lakhs + ₹ 16.80 lakhs) over the remaining eight-year service period (one year remaining under the original contract plus seven additional years) or ₹ 2.4375 lakhs per year.

(ii) Brief note for accounting for revenue when the contract is modified:

Paragraphs 18 to 20 of Ind AS 115 deals with contract modification. It provides in certain circumstances to treat it as a separate contract. A contract modification is a change in the scope or price of the contract that is approved by the parties to the contract.

A contract modification is a change in the scope or price (or both) of a contract i.e. approved by the parties to the contract. The contract modification exists when parties to a contract approves a modification that either creates a new or changes existing enforceable rights and obligations of the parties to the contract. A contract modification could be approved in writing, by oral agreement or implied by customary business practices. If the parties to the contract had not approved to the contract modification, the entity shall continue to apply this standard to the existing contract until the contract modification is approved.

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Accounting for the modification

Once determination of contract being modified is established, the entity further determines its accounting either as a separate contract or as a termination of the old contract and the creation of a new contract, by making a cumulative catch-up adjustment to the original contract or a combination of the two.

An entity accounts for a contract modification as a separate contract if the modification

(1) increases the scope of the work promised under the original contract by adding new promised goods or services that are considered distinct, **and**

(2) the increase in the contract price reflects the stand-alone selling price of the additional goods or services.

If a modification adds a distinct good or service to a series of distinct goods or services that is accounted for as a single performance obligation, the modification is accounted for as a separate contract as long as the transaction price increases by the stand-alone selling price for those added goods or services.

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