

Frequently asked questions on section 198 of Companies Act, 2013

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Background

Section 198 of the Companies Act, 2013 ('Act') provides for a list of items along with their intended adjustments from the net profits which is already computed in accordance with the applicable accounting standards. It is important to understand the intent of these adjustments as well as the stage and manner so as to arrive at the net profits to be evaluated for the purpose of CSR obligations as well as the limits for managerial remuneration.

While we have a dedicated resource centre on CSR which can be accessed [here](#) as well as detailed FAQs on CSR which can be accessed [here](#), we thought of coming up with an exclusive resource on the adjustments enlisted under section 198 of the Act. In these FAQs, we have dealt with some of the most crucial items (unrealised profits, revaluation gains or losses, etc) that often create confusion in companies and also discussed the treatment of some of those items which have not been explicitly stated (*for instance, expected credit loss, provision for impairment, merger related expenses etc.*) in section 198 besides providing detailed explanation to the adjustment items under the said provisions.

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Scope and applicability

1. What is the scope of section 198 of the Act?

Ans: Section 198 of the Act was section 349 under the erstwhile Companies Act, 1956. The same has been enacted to re-assess the net profits of a company so as to be applied for computing CSR applicability and obligations as well as managerial remuneration.

2. What is the broad manner of computation of profit u/s 198 of the Act?

Ans: The profit / loss appearing in the (P)&(L) of a company is prepared as per the applicable accounting standards which also accounts for unrealized gains / losses (*for instance gain on financial instruments pursuant to change in fair market value*) or profits which are not regular in nature. Section 198 operates to remove such gain / losses from the net profit already arrived by making further adjustments. The objective is to arrive at the profit figures which have regular and realized components.

Broadly speaking, section 198 provides:

- a. **Sums which can form part of the net profits [refer sub-section (2)]** - Already credited as per applicable accounting standards so no further credit needed.
- b. **Sums which cannot form part of the net profits [refer sub-section (3)]** - Already credited, however, not permitted, therefore, to be debited afresh.
- c. **Sums which have to be deducted from the net profits [refer sub-section (4)]** - Already debited as per applicable accounting standards so further debit needed.
- d. **Sums which cannot be deducted from the net profits [refer sub-section (5)]** - Already debited, however, not permitted, therefore, to be credited afresh.

An illustrative table providing for the manner of computation of net profit u/s 198 is given below:

Description	Amount
Profit After Tax (PAT)	
Add/ Less items specified below	
Credit to be given to items specified under sub-section (2)	
Credit not to be given to items specified under sub-section (3)	

Description	Amount
Deduct items specified under sub-section (4)	
Non-deductible items specified under sub-section (5)	
Net Profit as per section 198 = [A] - [B]- [C] + [D]	

3. **The format of P&L as provided under Schedule III of the Act does not mention the term “net profits”, rather, uses terms like “profits before tax”, “profits after tax” etc. So, should one take PBT or PAT as a starting point for computing profit u/s 198?**

Ans: In general parlance, it is profits after tax which is taken as net profits. However, for the purpose of computation of profit u/s 198, one may refer to clause (a) of sub-section (5) of section 198 of the Act that clearly states that the income-tax and super-tax payable by the company under the IT Act shall not be deducted while computing the net profits as per Section 198. Therefore, one needs to start with net profits before deduction of any tax expenses thereto, which would mean that one needs to consider “profits before tax” or PBT for the said purposes. The position has also been clarified by the MCA *vide* its [FAQs](#) issued on 25th August, 2021

4. **What is the use of the profit calculated u/s 198?**

Ans: The limits of managerial remuneration u/s 197 r/w Schedule V and the minimum CSR obligations as well as the CSR applicability, all of these are determined based on the net profit calculated u/s 198. It is to be noted that, while the profit for determining managerial remuneration is taken for the relevant financial year in which the remuneration is to be paid, for CSR purposes, the average profit of the preceding three financial years is considered.

For example: Say the profit computed u/s 198 for FY’21, 22 and 23 is 10 crore, 15 crore and 20 crores, respectively. Here, net profit of FY’23 *i.e.* 20 crores shall be relevant for the purpose of determining the limits of managerial remuneration for FY’23 itself. However, for the applicability of CSR for FY’24, net profits for FY’23 becomes relevant and for assessing the minimum CSR obligation for FY’24, average net profit of FY’23, FY’22 and FY’21 becomes relevant.

5. What is the intent of profit calculated u/s 198?

Ans: The underlying intent of Section 198 is to include only regular and sustainable profits or expenses and exclude any exceptional profits/ losses/ expenses or those arising from one-off activities. The rationale behind this is to ensure that the profit used for calculating managerial remuneration is not inflated by activities that are not part of the company's regular operations, meaning they are not sustainable in the normal course of business. Similarly, on the CSR front, section 198 ensures that profit is not reduced by unrealized / capital losses to achieve a reduced mandatory CSR obligation or similarly be inflated by the inclusion of either capital profits or unrealised gains.

6. Which types of companies need to calculate profits under Section 198?

Ans: As discussed above, the profit calculated u/s 198 is used for twin purposes *i.e.* managerial remuneration and CSR. While the provisions w.r.t managerial remuneration is applicable only to public companies (*including private companies which are deemed public companies*), the CSR provisions are applicable to both private and public companies.

Hence, computation of profit u/s 198 is relevant for both public and private companies [*if they are covered u/s 135(1) of the Act*].

Gains / losses of capital nature

7. What is meant by 'profit of capital nature' and what is the rationale of exclusion thereof in the profit?

Ans: Reference can be made here to ICAI's [Guidance Note on Terms used in Financial Statements](#) which defines 'capital profit' as *excess of the proceeds realized from the sale, transfer, or exchange of the whole or a part of a capital asset over its cost*. Capital assets have been further defined in the GN as assets, *including investments not held for sale, conversion or consumption in the ordinary course of business*.

8. X Ltd. has disposed of its immovable property. The details regarding the immovable property are given below. What shall be the amount of profit for which credit is permissible under section 198 for such sale?

Original cost of the fixed	100 crore
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asset	
Written down value of the asset	60 crore
Sale price	120 crore

Ans: Sub-clause (d) of sec. 198(3) provides that any profits from the sale of any immovable property or fixed assets of a capital nature is to be excluded from the profit. However, the proviso to the said clause provides that credit of profit is allowed in the P&L so far it is equal to the difference between original cost minus WDV of the asset.

This can be understood in the following manner:

- depreciation is a regular item in (P)&(L) and is therefore, revenue in nature;
- An asset is depreciated over the useful life of the assets;
- A fixed asset / immovable property being sold is a one off activity and of capital nature. Accordingly, any profit earned on such a sale is also a capital gain.
- However, a portion of the gain on such sale may represent the recovery of depreciation previously charged on the asset up to the date of sale.
- Since charging of depreciation till the sale would have reduced the profit in P&L, recovery of the depreciation on sale of such asset / property is permissible to be credited back to P&L.

Coming up to the illustration, here the profit is 60 crores (Sale price - WDV) and the difference between Original cost and WDV is 40 crores. Therefore, out of 60 crore of profit:

- a. 40 crores can form part of profit
- b. Balance 20 crores, if forming part of profit, has to be knocked off or in simple terms be reduced while computing profit u/s 198.

9. **Whether profits realised from sale of investments such as investments in mutual funds, government securities are to be considered as 'profit of capital nature'? Also, does tenure for which such securities are held relevant for determining the capital nature?**

Ans: Investment in government securities, mutual funds units etc. are made as treasury investments. These investments are not capital but revenue in nature and therefore, tenure of MF units / g-sec would not be relevant here. Having said that, any profit of capital nature, by virtue of being exceptional profit, is not required to be included in profit u/s 198, however, profits realised from sale of investments in mutual funds, government securities being revenue in nature be allowed to be part of net profits under the said section as well which again means that no additional adjustment required.

10. **Whether profit earned on divestment of shares in subsidiaries / associate companies is 'profit of capital nature' and required to be excluded?**

Ans: Disposal of investment in subsidiaries / associates is a one-off and strategic activity and not something which a company would do regularly / frequently. Hence, this qualifies as capital profit and therefore, is required to be excluded from profit u/s 198.

Further, please note that subsidiary may also qualify as 'undertaking' under the provisions of the Act, in which case, it shall be covered under section 198(5)(c) which requires 'sale of undertaking or part thereof' to be excluded from the profit u/s 198.

11. **Whether profit earned on sale of shares held by a company in another company (which is not a subsidiary / associate / joint venture) is 'profit of capital nature' and required to be excluded?**

Ans:The profit earned on sale of shares held by a company other than for exercising control or significant influence is generally to participate in the appreciation in the share prices that may happen over a period of time given the market reputation. In these cases, one has to be if the holding period of the company in these shares is for a long time or only for the current period held for immediate sale and realise the profits. While in the former case, it would be appropriate to consider it as a part of capital profits whereas in the latter case, allow it to remain credited as a regular income from other than revenue from operations.

12. Z Investments Ltd is an NBFC-ICC with the primary activity of making investments in the securities of various listed and unlisted companies. The profits of the Company mainly consist of gains from the sale of various securities as well as premium earned on the redemption of various debt securities etc. Further, as a part of the corporate restructuring, the Company has divested its entire stake in its subsidiary company. Considering that the Company is an “investment company”, whether profit on sale of stake in a subsidiary will be considered as permissible credits in terms of section 198?

Ans: Refer our response to question no. 9 above. The fact that the company in question is an NBFC and acquires / disposes securities in its ordinary course of business is not relevant here since the shares of subsidiaries are held as strategic investment and not held for sale.

Fair value related

13. As on April 1, 2024, the value of investment in shares by XYZ Ltd. was 10 crores. At the end of the reporting period *i.e.* March 31, 2025, the shares were recorded at fair market value of 15 crores. Whether any adjustment for profit u/s 198 with respect to gain of 5 crores?

Ans: The gain pursuant to change in fair market value is 5 crores. However, the same is an unrealized gain and therefore is required to be knocked off from profit in accordance with section 198(3)(f) of the Act.

14. Whether any adjustment is required for gain (*realized and / or unrealized*) on equity instruments classified as ‘fair value through other comprehensive income’ (OCI)?

Ans: It is to be noted that items recorded under OCI are also called ‘below the line items’ since these incomes are shown just below the profit / loss in P&L statement and do not actually form part of the profit / loss arrived. Instead, it is carried to the balance sheet as a part of shareholders’ equity. Since, the items in OCI do not form part of the profit, there is no question of considering the items forming part of OCI in computation of profit u/s 198.

15. Sec 198(3)(e) and 198(5)(d) provides that credit shall not be given / amount shall not be deducted for— *any change in the carrying amount of an asset or a liability recognised in equity reserves including surplus in the P&L on measurement of the asset or the liability at FV.*

Do the aforesaid provisions refer to reserves created out of revaluation of assets *i.e.* revaluation reserve? If yes, then what amount is to be disallowed as a credit *i.e.* is it the amount which is credited to the revaluation reserve during the year or the balance as on date? Is there any other amount / reserve other than the revaluation reserve that may come within the purview of the above?

Ans: Changes in the carrying amount of certain assets/liabilities are recognised as “other comprehensive income”(OCI) which goes into shareholders’ equity as part of IFRS. For instance, change in the carrying value of financial assets treated as “available for sale” is held in OCI and is carried to the balance sheet as a part of shareholders’ equity. The idea of the above clauses is to exclude changes in fair value of assets/liabilities, including revaluation surplus on property, plant and equity from determination of profits.

Tax related

16. Whether Capital Gain Tax paid on sale of immovable property can be considered as part of “*Any tax notified by the Central Government as a tax on abnormal or excess profits*” and same can be reduced twice in calculating the net profit calculation?

Ans: The provisions specifically provide “*any tax notified by the Central Government as a tax on abnormal or excess profits*” and in our knowledge, presently there is no tax which has been notified by the Central Government for the purpose of this section, hence in our view tax paid on capital gain resulting from the sale of immovable property cannot be categorized as tax on excess or abnormal profits for the purposes of section 198(4)(d) of the Act.

Usual working charges / regular income

17. What is meant by the term ‘*usual working charges*’?

Ans: Usual Working charges refer to those regular and ordinary expenditures which are required to be incurred during the day to day affairs of a company as well as not

constitute any unrealised or extra-ordinary in nature and therefore, charged against the profit. Hence, it should be deducted while calculating net profit. Though there could be several common examples, what constitutes a usual working charge would depend on the facts and circumstances of the case, particularly in relation to the day-to-day operations of the company.

18. Whether income earned by a company from subsidiaries by way of dividend shall require any adjustment u/s 198?

Ans: A dividend is a return on the investment made in shares and is supposed to be received to shareholders on atleast an annual basis unless the company is not in profit or retains its earnings for future growth. However, if such a subsidiary is also covered under section 135 of the Act, then for the purpose of computation of net profits for the purpose of CSR obligation, such income will have to be ignored. The said adjustment is not applicable for the net profit computed to determine the limits on managerial remuneration.

19. Whether insurance premium paid for D&O Insurance undertaken pursuant to reg. 25 of Listing Regulations is required to be knocked off from profit u/s 198?

Ans: Sec. 198(4)(n) requires *any sum paid by way of insurance against the risk of meeting any liability such as is referred to in clause (m)* to be deducted from the profit. Insurance premium paid for D&O Insurance is well covered under this clause (n) of 198(4). Since the premium paid would have been deducted already in P&L, no further adjustment is required to be made for the premium paid.

20. Whether any adjustment is required to be made u/s 198 for commission paid to employees hired on part-time basis?

Ans: Section 198(4)(b) provides that any bonus or commission paid or payable to any company's staff, or to any engineer, technician or person employed or engaged by the company, whether on a whole-time or on a part-time basis shall be allowed to be deducted while computing net profit as per Section 198. Since effect has already been given to the expenditure, no further deduction shall be required in net profit computation as per Section 198.

21. Whether expected credit loss ('ECL') recorded in P&L can be considered as a usual working charge u/s 198(4)(a) of the Act?

Ans: ECL is essentially a way of estimating future credit losses, even on loans that appear to be fully performing at the time of such analysis . It is based on expected delays or defaults, and the estimated loss is recorded as a charge to the profit and loss account, based on a 12-month probability of default. The computation of ECL is based on specific accounting principles and probability of credit losses and therefore, even though the amount booked under ECL is not an actual loss but given the calculated estimate is likely to be considered as a usual working expense.

A counterpoint to the above view is that if we look at the nature, it is clear that while it is imperative for companies to compute ECL at the time of origination as well as at the end of every reporting period, it is important to note that there is no loss or default in the actual sense. This means that the amount computed as ECL has not been an actual default or realized loss.

22. What shall be the treatment in the following case if a company takes the view that ECL is an unrealized loss?

Year 1	Amount (in INR)	Year 2	Amount (in INR)
PBT	1000	PBT	1200
Depreciation	20	Depreciation	20
ECL	40	ECL	35
Loss on sale of fixed assets	15	Actual bad debt	15
		Profit on sale of equity shares	25

Ans: Having regard to the view that ECL is an unrealized loss, it is required to be ignored in 198 computation. Accordingly, it shall be reversed.

Year 1	Amount (in INR)	Year 2	Amount (in INR)
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PBT	1000	PBT	1200
<u>Add:</u>		<u>Add:</u>	
ECL	40	ECL	35
Loss on sale of fixed assets	15	<u>Less:</u> Profit on sale of equity shares	(25)
PBT u/s 198	1055	PBT u/s 198	1210

Notes:

1. Depreciation and actual bad debt has not been adjusted again as it has already been deducted under normal profit computation.
2. Capital gains and losses have been adjusted/ reversed under the computation.

23. What shall be the adjustments in the following scenario if ECL is considered a usual working charge u/s 198(4)(a) of the Act?

Year 1	Amount (in INR)	Year 2	Amount (in INR)
PBT	1000	PBT	1200
Depreciation	20	Depreciation	20
ECL	40	ECL recovered	35
Loss on sale of fixed assets	15	Actual bad debt	15
		Profit on sale of equity shares	25

Ans: Since ECL is considered as a usual working charge in the present, it is a permissible deduction u./s 198 of the Act and therefore, it is not required to be reversed in the profit u/s 198. Accordingly, the calculator shall be as follows:

Year 1	Amount (in INR)	Year 2	Amount (in INR)
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PBT	1000	PBT	1200
<u>Add:</u>		<u>Less:</u>	
Loss on sale of fixed assets	15	Profit on sale of equity shares	25
-	-	-	-
PBT u/s 198	1015	PBT u/s 198	1185

Notes:

1. *Actual bad debt is not to be considered at the time of profit computation under the regular computation since it can be adjusted from the ECL already booked.*
2. *Capital gains and losses have been adjusted/ reversed under the computation.*

24. Whether any treatment is required u/s 198 computation for provision created for diminution of value of non-current investments?

Ans: Where a provision for diminution of non-current investments has been created, for the future loss to be incurred by the Company on sale of investments. Once such loss is actually incurred by the Company, the same, being losses of capital nature, will be covered as “non-permissible debits” under clause (c) of subsection (5) of Section 198 of the Act. In the instant case, while the loss has not yet been incurred pending the sale of the non-current investments, however, the provision for change in the carrying value of the said assets of the Company, will be covered under clause (d) of subsection (5) of Section 198. The same, being a non-permissible debit, will be required to be added back to the net profits, for the purposes of section 198 of the Act.

25. **S Ltd (transferee company) has acquired P Ltd (transferor company) by way of amalgamation of the same in the existing company. As a result of the amalgamation, S Ltd has created goodwill on account of the amalgamation. The said goodwill has been amortized in terms of applicable accounting standards. Further, S Ltd has incurred various expenditures in relation to the merger and debited the same to the profit & loss account. The Company wants to understand admissibility of the same as valid expenditures for the purpose of section 198 of the Act.**

Ans: In the first place, amortization of goodwill, to the extent the same is in accordance with Schedule II of the Act, will be allowed as permissible expenditure in terms of section 198(4)(k) and no adjustment is required to be made for the same.

Secondly, the merger related expenses may be generally considered as an expenditure in the nature of capital expenditure, since the same is for a strategic change in the corporate character of one or more companies. Therefore, the same will be required to be added back in terms of sub-section (5) of section 198 of the Act.

However, post implementation of Ind AS, the traditional concept of capital expense has lost relevance, except in case of acquisition of PPE, intangible assets, etc , the merger expense may not be treated as an expense relating to acquisition of fixed assets. In that sense, the merger expense will be required to be treated as a revenue expense.

26. **Z Ltd has profit before tax of Rs. 50 crores for FY 21-22. The Company had incurred an expenditure of Rs. 50 lacs during the FY 21-22 in CSR activities, and the said amount is debited to the profit & loss account for arriving at the profit before taxes. The Company is calculating adjusted net profits in accordance with section 198 for the purpose of computing the CSR obligation of the Company for FY 22-23. Is the CSR expenditure amount debited to the profit & loss account be required to be added back for the purpose of computation of adjusted net profits for CSR?**

Ans: The CSR expenditure incurred for FY 21-22 is not required to be added back to the profits to compute the CSR budget for the succeeding financial year. While CSR expenses is not an item u/s 198 of the Act, however, a doubt may arise on whether the same is required to be added back if the computation is compared with that of managerial remuneration calculation, the only other ground that requires adjustment of book profits in accordance with section 198.

However, it has to be noted that the calculation of managerial remuneration for a financial year, is based on the profits of the same financial year itself, while the computation of minimum obligation under CSR is based on the profits of the preceding financial years. Therefore, there is no addition of calculation of CSR budget, on the basis of profits prior to deduction of CSR expenses, since the CSR expenses have been incurred for a financial year different from the financial year for which the budget is being calculated.

Miscellaneous

- 27. If the shares are issued on premium then can such premium be included in the profit?**
Ans: The premium received on issue of shares forms part of '*securities premium reserve*' which is shown under shareholder's equity and does not form part of P&L account. Therefore, no adjustment is required to be made.
- 28. Would the answer to the above question be the same if the shares are issued by a non-banking financial company?**
Ans: The accounting treatment for premium received on the issue of shares is the same for an NBFC as for any other company — it is credited to the Securities Premium Reserve. Therefore, the treatment shall be the same for an NBFC as well.
- 29. Is there any carve out available to any company from clause (a) of sub-section (3)?**
Ans: Section 198(3)(a) requires profit by way of premium on shares / debentures to be knocked off from the profit calculated u/s 198. The premise of such knocking off is that such premium forms part of shareholders equity and not SPR. However, for an investing company whose principal business is acquisition of shares / debentures / securities, premium on shares / debenture would form part of its revenue and would therefore be credited to P&L. Hence, investment companies as referred to in clause (a) of the Explanation to section 186 are exempted from the application of clause (d) of sec. 198(3) of the Act.

30. Section 198(4)(l), which specifies sums required to deducted from profit, reads as — *the excess of expenditure over income, which had arisen in computing the net profits in accordance with this section in any year, in so far as such excess has not been deducted in any subsequent year preceding the year in respect of which the net profits have to be ascertained.*

Does this section require deducting the loss calculated u/s 198 for all previous years, if any, from profit calculated u/s 198 for the present financial year?

Ans: Yes, the understanding is correct. When a company has unabsorbed losses/ brought forward losses, the same indicates that the said company is not in a profitable position so as to carry out CSR activities or pay a handsome managerial remuneration. Therefore, the provision in question aims to set those unabsorbed losses/ brought forward losses against the profits made for the relevant financial year in which the computation is being made so as to arrive a position where the company has recovered from the losses and is in a profit position so as to carry out CSR activities / pay decent managerial remuneration.

In short, a company is required to keep carrying forward unadjusted section 198 losses until they are fully set off against Section 198 profits.

31. What shall be the net adjusted profit u/s 198 in the following scenario after making the adjustment u/s Section 198(4)(l) of the Act?

Profit	FY6	FY5	FY4	FY3	FY2	FY1
Profit calculated as per section 198 [prior to making adjustment under section 198(4)(l)]	85	80	-37.17	-9.95	-7.70	-1.09

Ans: Refer response to question above, the concerned company is required to keep carrying forward unadjusted section 198 losses until they are fully set off against Section 198 profits. Accordingly, the net adjusted profit for all the financial year shall be:

Profit	FY6	FY5	FY4	FY3	FY2	FY1
Profit calculated as per section	85	80	-37.17	-9.95	-7.70	-1.09

198 (prior to making adjustment under section 198(4)(l))						
Brought forward losses from previous year computed in accordance with section 198	0.00	-41.07	-18.75	-8.79	-1.09	0.00 ¹
Adjusted net profit in accordance with section 198(4)(l)	85.00	38.93	-55.92	-18.74	-8.79	-1.09

Here, all the losses are being set-off in the profit / loss calculated for the subsequent financial years. If there is no profit in the subsequent financial year then the brought forward loss of the previous financial year and loss of the present financial year shall be aggregated and set-off against the profit / loss of the financial year subsequent to the present financial year.

The chain of carrying forward of the losses will continue till the time profits of a financial year are sufficient enough to absorb the brought forward losses of all previous years.

In the table above, brought forward losses of FY1 to FY4 are set-off in FY5. In FY6, there were no brought forward losses as per sec. 198 computation and hence, no adjustment is required u/s section 198(4)(l) of the Act.

32. Clause (j) of section 198(4) requires *outgoings inclusive of contributions made under section 181* to be knocked off from the profit computation u/s 198. What can be included within the meaning of the term ‘outgoings’?

Ans: The term ‘outgoings’ under the said clause seemingly indicates regular or ordinary expenses which are to be considered as a part of day to day expenses. Further, as the clause combines contributions under section 181, it makes it clear that donations, charitable contributions, political contributions, or any other ordinary and expected expense of similar nature form part of permitted debits u/s 198 of the Act.

¹Assuming that FY1 is the first financial year from incorporation and therefore, there is no previous brought forward losses