Valuation of Investments

The following is the brief version of an opinion given by the Expert Advisory Committee of the Institute in response to query sent by a member. This is being published for the information of readers.

Expert Advisory Committee

A. Facts of the Case

1. A public sector undertaking is registered under the Companies Act, 1956, and has been recognised as a public financial institution under section 4A of the Companies Act, 1956.
2. An investment of Rs. 2.50 crore (25% of the equity of Rs. 10 crore) was made by the company in another company (hereinafter referred to as the 'investee company') in 1991. The other shareholders of the investee company comprise an Indian bank, holding 51% and general public, holding 24% of the equity.
3. According to the querist, as per the accounting policy of the company, investment in equity shares listed on the Mumbai Stock Exchange as on the balance sheet date are shown under 'Aggregate of quoted investments' and diminution in their value is provided for in the case of companies not paying dividend. The accounting policy is reproduced below:

"Long term investments are carried at cost less any other-than-temporary diminution in value, determined separately for each individual investment. Equity shares quoted in Mumbai Stock Exchange as on the date of Balance Sheet are shown under 'Aggregate of quoted investment' and diminution in their value is provided for in the case of companies not paying dividend. Investment in shares of unquoted companies where commercial production has not started or companies which are making profit, the investments are considered at cost and where accumulated losses are more than their paid-up share capital and reserves, or no information is available about working/status of the company, the respective investment is valued at Rupee one only."

Keeping the above accounting policy in view, the company has valued the shares of the investee company at the price quoted on the Mumbai Stock Exchange as on 31.3.2004 and the diminution in value was accounted for accordingly in the accounts for the year 2003-2004.

4. The querist has informed that on a perusal of the balance sheet of the investee company, it is noticed that its net worth is negative due to accumulated losses. In the past, there was a proposal from the investor bank to take over the assets and liabilities of the investee company and to wind it up. This issue of taking over the assets and liabilities of the investee company was discussed and accordingly, a proposal was put up to the Board of Directors of the company in question, which decided not to agree to the take-over of the assets and liabilities of the investee company by the investor bank.
5. As per the querist, during the course of audit of accounts for the year 2003-2004, a query was raised by the Comptroller and Auditor General of India (C&AG) that since the net worth of the investee company is negative, the investment should be valued at zero instead of valuing it at the price prevailing on the Mumbai Stock Exchange as on the balance sheet date. Moreover, the C&AG also stated that the valuation should have been made in accordance with the equity method as prescribed under Accounting Standard (AS) 23, 'Accounting for Investments in Associates in Consolidated Financial Statements', issued by

the Institute of Chartered Accountants of India, since the company has 'significant influence' to participate in the financial and/or operating policy decisions of the investee company as it holds more than 20% of the voting power and the disclosures as required under paragraphs 22 to 25 of AS 23 should also be made.

6. According to the querist, the company has replied that AS 23 is not applicable to the company in case of its investments in the investee company in view of the following:
   (a) As per the 'Objective' paragraph of AS 23, the Standard is applicable to the investments in associates to reflect their effect on the financial position and operating results of a group.
   (b) As per AS 23, the term 'consolidated financial statements' means the financial statements of a group presented as those of a single enterprise.
   (c) As per AS 23, a group is a parent and all its subsidiaries.

The querist has argued that since the company in question is neither a parent of the investee company in question nor is a subsidiary of the company, the company in question and the investee company do not constitute a group and keeping this in view, consolidated financial statements are not required to be prepared for these companies.

B. Query

7. The querist has sought the opinion of the Expert Advisory Committee on the following issues:
   (a) Whether the valuation of the investment in shares at a price prevailing on the Mumbai Stock Exchange as per the accounting policy of the company is correct.
   (b) Whether the investment should be valued at zero in view of negative net worth irrespective of the price prevailing on the Mumbai Stock Exchange, i.e., as per the equity method prescribed in AS 23.
   (c) Whether AS 23 is applicable to the company since the company does not have any subsidiary.

C. Points considered by the Committee

8. The Committee notes paragraphs 1 and 2 of AS 23, which provide as below:
   "***1. This Statement should be applied in accounting for investments in associates in the preparation and presentation of consolidated financial statements by an investor.***
   2. This Statement does not deal with accounting for investments in associates in the preparation and presentation of separate financial statements by an investor[1] ".

9. The Committee also notes from paragraph 7 (c) above that the company does not have any subsidiary. The Committee is, therefore, of the view that the company is not required to prepare consolidated financial statements since such financial statements are required to be prepared as per Accounting Standard (AS) 21, 'Consolidated Financial Statements', issued by the Institute of Chartered Accountants of India, only where a company has a subsidiary. Since the company is not required to prepare consolidated financial statements and as AS 23 is applicable for preparation of consolidated financial statements, the said Standard is not applicable to the company in question.

10. Insofar as the preparation of the separate financial statements of the company in question is concerned, Accounting Standard (AS) 13, 'Accounting for Investments', issued by the Institute of Chartered Accountants of India, is applicable to investments in all types of entities including the investee. The Committee is, accordingly, of the view that the value of the investments to be shown in the balance sheet of the company would be governed by the requirements of AS 13.

11. The Committee is of the view that for the purpose of valuation of investments as per the requirements of AS 13, investments should be classified into two catego-

1. Accounting Standard (AS) 13, 'Accounting for Investments', is applicable for accounting for investments in associates in the separate financial statements of an investor.

ries, namely, current investments and long term investments. Whereas the current investments are required to be valued at the lower of cost and fair value (paragraph 31 of AS 13), investments classified as long term investments should be valued at cost except where the provision for diminution is required to be made to recognise a decline, other than temporary, in the value of the investments (paragraph 32 of AS 13).

12. The Committee notes from paragraph 3 of the 'Facts of the Case' that the company is treating the investment in the investee company as a long term investment. The Committee is of the view that it is not always necessary that there is an other-than-temporary decline in the value of an investment in a company which is not paying dividend as stated in the accounting policy reproduced in paragraph 3 above. In other words, a decline in the value of an investment in a company not paying dividend can also be temporary. In this context, the Committee notes paragraph 17 of AS 13 which states, inter alia, as below:

"17. .....Indicators of the value of an investment are obtained by reference to its market value, the investee's assets and results and the expected cash flows from the investment. The type and extent of the investor's stake in the investee are also taken into account. Restrictions on distributions by the investee or on disposal by the investor may affect the value attributed to the investment."

Thus, the company will have to assess, keeping in view various other factors, e.g., probable recovery of the investee company in case it is incurring losses, based on the indicators mentioned in paragraph 17 of AS 13 reproduced above, whether the decline in the value of the investment is other than temporary.

13. The Committee notes that as far as the disclosures required under Part I of Schedule VI to the Companies Act, 1956, regarding the aggregate amount of company's quoted investments and market value thereof are concerned, it is a matter of additional disclosures separate from the value of investments reflected on the face of the balance sheet and that the market value of an investment as per such disclosures can be different from the value reflected on the face of the balance sheet, e.g., the investments may be valued at cost for the latter purpose.

D. Opinion

14. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 7 above:
    (a) The long term investment should be valued at cost less the decline in its value other than temporary. Thus, valuation of the investment based only at the price quoted at the Mumbai Stock Exchange may not necessarily be appropriate; the other indicators as mentioned in paragraph 17 of AS 13 reproduced above, should also be considered.
    (b) Since equity method of accounting, as prescribed in AS 23, is not applicable in the preparation of the separate financial statements of the company, the investment is not required to be valued by adopting the equity method of accounting.
    (c) AS 23 is not applicable to the company since the company is not required to prepare consolidated financial statements in view of the fact that it does not have a subsidiary.

Notes:

1. The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.
2. The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in twenty three volumes which are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.