

Query No. 34

Subject: Accounting treatment of share application money pending for allotment invested by holding company in subsidiaries.¹

A. Facts of the Case

1. Consequent to State Electricity Reforms Transfer Scheme 2000, the erstwhile State Electricity Board (SEB) was reorganised into three corporations namely State Power Corporation Ltd. (SPCL), State Vidyut Utpadan Nigam Ltd. and State Jal Vidyut Nigam Ltd. w. e. f. January 14, 2000. The City Electricity Supply Area was separated as a subsidiary company of SPCL and christened as the City Electricity Supply Company Limited (CESCO) vide State Transfer of K Zone Electricity Distribution Undertaking Scheme, 2000.

The State Power Corporation Ltd. (hereinafter referred to as 'the company') is dealing with bulk purchase and sale of electrical power in the State and had a turnover of Rs. 12,197.66 crore in the financial year (F.Y.) 2007-08. It purchases electricity from central generation utilities, state power generation utilities, independent power producers and also from private traders through bilateral purchases, etc. Further, it sells the electrical power to its wholly owned subsidiary companies holding distribution license under the Electricity Act, 2003. These distribution companies were created pursuant to the Transfer Scheme Notification passed by the State Government on August 12, 2003, wherein the distribution business of the company was vested in them.

2. The company is a Government company within the meaning of section 617 of the Companies Act, 1956 and is holding 100% shares in its subsidiaries, which are also

¹ Opinion finalised by the Expert Advisory Committee on 21.5.2013 and 22.5.2013.

Government companies (within the meaning of section 617 of the Companies Act, 1956), as 'Investments'. The company's 100% shareholding is with the Governor of the State.

3. The State Government infuses funds by way of equity contribution in the holding company, i.e., the company. These funds are used by the company as per the instructions of the State Government for investing in the shares of its subsidiary distribution companies for creation of capital assets, etc.

4. The funds received from the State Government are invested by the company in the subsidiary distribution companies as 'share application money'. The allotment process from share application money to share capital rests with the respective subsidiary distribution companies. Pending allotment of share application money, these subsidiary distribution companies have utilised such amounts in the creation of capital assets.

5. The auditors in the course of the audit observed that the subsidiary distribution companies have negative net worth and, accordingly, advised the company to make suitable provisions in the annual accounts for diminution in the value of investments in accordance with Accounting Standard (AS) 13, 'Accounting for Investments', considering that such investments in subsidiary distribution companies was made as long-term investment.

6. As per the advice of the auditors, the company made a provision for diminution in the value of investment upto the level of equity shares actually allotted by the subsidiary distribution companies subsequent to the close of the financial year till the date of approval of the accounts of the holding company.

7. The querist has stated that considering that till such time the allotment is made, the contract of contribution to share capital is not complete and the application money is therefore only a liability in the books of subsidiary companies, the provision for

diminution in the value of investments has not been made for the amount invested in subsidiary distribution companies which has not been allotted by the subsidiaries as equity in the name of the company till the date of approval of accounts.

8. The querist has also stated that the allotment of share application money by the subsidiary companies is pending as their accounts are in arrears and are yet to be audited.

9. At the time of organisation of the SEB in January, 2000 and then at the time of creation of successor distribution companies in August, 2003, the capital assets were allocated on historical cost basis. Such assets of subsidiary distribution companies have not been revalued since their inception. The company and the subsidiary distribution companies have undertaken the revaluation of their assets and this exercise is in progress.

10. According to the querist, considering that the revaluation of assets was in progress till the date of approval of accounts, the fair value of assets of the subsidiaries cannot be determined until and unless the revaluation process is completed and restated balance sheet is prepared. It was contended that since the real value of assets of subsidiary distribution companies is much higher than the book value, the diminution can be worked out only after a fair valuation of shares of distribution companies.

11. In view of the foregoing contentions, the company has made a provision for diminution in the value of investments made in subsidiary distribution companies upto the level of equity allotted by the subsidiary companies.

12. The company's accounting policy discloses the accounting treatment of investment as under:

“Investments:

4. Long-term investments in subsidiaries are valued at cost and provision is made for diminution, other than temporary, in the value of such investments."

13. *In the above context, Accountant General, the State under his Review Audit for the F.Y. 2007-08, has commented that the company should consider the amount of share application money (which has not been allotted till the approval of accounts of the company) also while making provisions for diminution in the value of investments. (Emphasis supplied by the querist.)*

B. Query

14. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

- (i) Whether share application money is to be considered for making provision for diminution in the value of investments even though the shares for the same are yet to be allotted.
- (ii) Whether share application money, in respect of which shares are allotted subsequent to the end of the financial year but before the adoption of accounts of the company, should be considered as share capital for the purpose of making the provision for diminution in the value of investments.
- (iii) For making provision for diminution in the value of investments, whether the company can consider the fact that the revaluation of assets is under progress and that the fair market value of assets would be higher than the historical value/cost of assets?

C. Points considered by the Committee

15. The Committee, while answering the query, has considered only the issues raised in paragraph 14 above and has not examined any other issue that may arise from the Facts of the Case, such as, recognition of share application money pending allotment in the financial statements of subsidiary companies, etc. Further, the Committee has presumed that the money has been given to the subsidiary companies as equity contribution and not as grant.

16. The Committee notes that the erstwhile SEB was restructured into three corporations one of which is the company. Further, its electricity distribution business has been divested to wholly owned subsidiary companies of the company. The company as well as its subsidiary companies are Government companies. The State Government infuses funds in the company, which the company uses as per the instructions of the State Government for investing in the shares of subsidiaries. Accordingly, the company has invested the funds received from the State Government as share application money in subsidiary companies some of which is pending for allotment. In this regard, the issue raised is that whether the provision for diminution in the value of investments should be made against the share application money even though the shares for the same are yet to be allotted as on the balance sheet date. The Committee notes the definition of the term 'Investments' as defined in AS 13, notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules') and 'Advance' as defined in the 'Guidance Note on Terms Used in Financial Statements', issued by the Institute of Chartered Accountants of India, as below:

AS 13

“3.1 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. Assets held as stock-in-trade are not ‘investments’.”

Guidance Note on Terms Used in Financial Statements

“1.17 Advance

Payment made on account of, but before completion of, a contract, or before acquisition of goods or receipt of services.”

From the above, the Committee is of the view that although the share application money pending for allotment may not give any benefits to the company (neither dividend, interest, rentals nor capital appreciation) till shares are allotted against it to the company, however, since in the extant case, the money has been given to the subsidiary companies, this application money for shares may be considered to be held ‘for other benefits’. Further, the Committee notes that the money so provided has been utilised by the companies for acquisition of capital assets and all the companies being State Government companies operate as per the instructions of the State Government. Also, paragraph 7 above indicates existence of a ‘contract of contribution to share capital’ against which shares have been allotted after the balance sheet date but before the approval of accounts. The Committee is of the view that all this indicates that irrespective of the fact that whether shares are allotted to the company or not, the money given as share application money would not be refundable to the company. Therefore, considering ‘substance over form’, the Committee is of the view that these are of the nature of long-term investments. Accordingly, provision for diminution in the value of investments other than temporary should be considered against the same. Further, the Committee is the view that it should be disclosed in the financial statements with an appropriate nomenclature and notes to accounts so as to give the correct picture of the situation, viz., shares are yet to be allotted against these investments. The Committee is also of the view that even if shares are

allotted against such application money after the balance sheet date, but before the adoption of accounts, there is no need for disclosing it as 'shares' till the date of allotment, as it is taking place in the subsequent year. However, additional disclosures regarding allotment (which takes place in subsequent year before adoption of accounts) may be made in the financial statements. The Committee is further of the view that had the subsidiary companies reserved the right to simply refund the money without allotting the shares then it should have been treated as an 'advance' rather than 'investment' till such shares are allotted to the company. The Committee is of the view that in that case also, the company should examine the recoverability of the said advance and, accordingly, an appropriate provision should be made against such advance as per the Generally Accepted Accounting Principles.

17. As regards making provision for diminution in the value of investments, the Committee notes paragraphs 17 and 32 of Accounting Standard (AS) 13, 'Accounting for Investments', notified under the Rules, as reproduced below:

“17. Long-term investments are usually carried at cost. However, when there is a decline, other than temporary, in the value of a long term investment, the carrying amount is reduced to recognise the decline. 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.”

“32. Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall 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.”

On the basis of the above, the Committee is of the view that in the case of long-term investments, only where there is a decline, other than temporary, in the value of investments, the carrying amount is reduced to recognise the decline. The Committee is further of the view that to determine whether there is a decline other than temporary, in the value of investments, an assessment should be made keeping in view the value of the assets of the subsidiaries, its results, the expected cash flows from the investment, etc. Such an assessment should be made on an individual investment basis. In determining the value of investment, fair value of the underlying assets of the subsidiaries may also be considered.

D. Opinion

18. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 14 above:

- (i) Yes, in the extant case, as discussed in paragraph 16 above, since the money would not be refundable to the company, share application money pending for allotment should be considered as long-term investment while making provision for diminution in the value of investments. Even if the share application money would have been refundable and as such, shown as 'advances', an appropriate provision should be made based on their recoverability as discussed in paragraph 16 above.

(ii) and (iii) Refer to paragraphs 16 and 17 above.