Opinion

Considering Capital Reserve for Calculation of Net Worth of a Company

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

A. Facts of the Case

1. A company (hereinafter referred to as 'the querist company') is a subsidiary company of a 100% Government of Gujarat undertaking, engaged in generation of electricity and having installed capacity of 6394 MW.
2. The querist has submitted the following background and facts with regard to the query raised:
   - A Ltd. has submitted a bid in consortium with B Ltd. against 'Request for Qualification (RFQ) for Tender' regarding selection of Mines Developer-cum-Operator (MDO) of Gare Pelma Sector I coal block floated by the company.
   - A Ltd. is a wholly owned step–down subsidiary of C Ltd.
   - In this connection, A Ltd. filed its net worth certificate based on audited financials of 31st March, 2015. This certificate was filed in connection with the requirement of the RFQ that bidder and each consortium member should have net worth equal to or more than 100% of paid up capital.
   - This query highlights key issues in net worth, clarifications submitted by A Ltd. on queries raised by the querist company and financials of A Ltd. for the year ended 31st March, 2011 and 31st March, 2015.
3. The querist has informed that A Ltd. has submitted the following calculation of its net worth:

Particulars	Revised Net Worth (AUD million)
Paid-up Share Capital	5.76
Add : Free Reserves - Capital Reserves	409.32
- Accumulated losses - Misc. Expenditure not written off (w/o) - Deferred Expenditure not w/o	(335.16) - -
Net Worth	**79.92**

The clarification of A Ltd. on 'Capital Reserve' reads as under (Ref: Certificate dated 14th September, 2016):

> "This is attributable to a meeting of creditors of the company convened and held on 24th February, 2011 pursuant to Section 439A of the Companies Act, wherein it was resolved that D Energy Group Pty. Ltd. (Seller) and the company would execute a Deed of Company Arrangement to effect the sale of the company to C Ltd.
>
> The sale to C Ltd. was completed on 28th February, 2011 whereupon all creditor claims against the company was transferred to the Seller, other than certain excluded claims. As per the Deed of Company Arrangement, the creditors' liability of AUD 409.323 million was waived off. This extinguishment of the liabilities was treated as 'Other Comprehensive Income' in the books of the company and the same was captured in the 'Capital Reserve' for the year ending 31st March, 2011."

Besides, A Ltd. has entered into a deed of arrangement separately for this purpose. It should be noted that A Ltd. was transferred by D Energy Group Pty Ltd. to C Limited. Pursuant to the transfer, all creditors of A Ltd. were transferred to the seller, namely, D Energy Group Pty Ltd. except certain excluded claims. These creditors retained by A Ltd. waived off their claims and the same was credited by A Ltd. to 'Capital Reserves'. Such reserve, according to the querist, is also on account of restructuring exercise and therefore, it should not form part of the 'net worth' under the criteria prescribed by RFQ. When this is excluded from 'net worth', then A Ltd. will not have positive net worth computed as under and the 'net worth' criteria does not get fulfilled:

Particulars	Revised Net Worth (AUD million)
Paid-up Share Capital	5.76
Add : Free Reserves - Capital Reserves	-

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Particulars	Revised Net Worth (AUD million)
- Accumulated losses	(335.16)
- Misc. Expenditure not written off (w/o)	-
- Deferred Expenditure not w/o	-
Net Worth	**(329.40)**

4. The querist has stated that 'capital reserve' should not form part of 'net worth'. The querist has invited attention to the fact that the 'net worth' is not supposed to include any reserves arising on account of amalgamation, etc. The 'net worth' definition of RFQ reads as under:
   "Net Worth shall mean as aggregate value of the paid up share capital and all reserves created out of the profits and securities premium account, after deducting the aggregate value of the accumulated losses, deferred expenditure and miscellaneous expenditure not been written off, as per the audited balance sheet, but does not include reserves created out of revaluation of assets, write-back of depreciation and amalgamation. Bidder and each consortium member should have net worth equal to or more than 100% of paid up share capital."
   The 'net worth' definition as per the Companies Act, 2013 reads as under:
   > "Net Worth means the aggregate value of the paid-up share capital and all reserves created out of the profits and securities premium account, after deducting the aggregate value of the accumulated losses, deferred expenditure and miscellaneous expenditure not written off, as per the audited balance sheet, but does not include reserves created out of revaluation of assets, write-back of depreciation and amalgamation."
   From this, it is clear that 'net worth' is supposed to include *reserves created out of profits only* (emphasis supplied by the querist). Besides, it should not include reserves created out of amalgamation, restructure, etc. The intention itself is clear that only earned profits should form part of the 'net worth'. In the present case, A Ltd. has included profits arising on claims waived by creditors. This does not signify income earned by A Ltd.; rather, this projects inefficiency on the part of A Ltd. who is unable to discharge its claims. This signifies that A Ltd. was not earning sufficient profits to repay its claims. 'Net worth' should include earning sufficient profits to repay its claims. 'Net worth' should include profits which are earned by the company and which arose through normal business operations. Besides, the RFQ requires 'net worth' criteria to be fulfilled so as to ascertain strength of the participants. If such 'net worth' would include claims written back by the company, it does not portray strength of A Ltd. but its execution weakness. Therefore, according to the querist, as per definition of 'net worth' as given in the Tender, as per Companies Act, 2013 and as per Indian Accounting Standards, such write back should not form part of the 'net worth' in order to determine eligibility of A Ltd.
5. The querist has further submitted that such write back is accounted as 'Other Comprehensive Income' and then transferred to 'Capital Reserves'. Had it been on revenue account, it should have been accounted as normal profit and loss and should have formed part of 'Reserves' and not 'capital reserves'. Hence, such 'capital reserves' should be excluded from computation of 'net worth'. Net worth is most suggestive whether a company will continue to carry on business or not or will effectively discharge its contractual obligations and this requires the existence of genuine and real business profit and not anything arisen out of such adjustment or some waiver of liabilities which may pertain to even capital items and which are not recurring business profit earned out of the business activities.
6. The querist has also raised concerns about doubtful 'Going Concern' of A Ltd. It should be noted that A Ltd. is continuously making losses. Considering this, statutory auditor of A Ltd. has disclosed following in the audit report of A Ltd. for the year ended 31st March, 2015:
   > *"Without qualifying our opinion, we draw attention on Note 2 in the financial report which indicates that the consolidated entity incurred a net loss of $25.13 million during the year ended 31st March 2015 and, as of that date, the Company's current liabilities exceeded its current assets by $36.26 million. These conditions, along with other matters*

as set forth in Note 2, indicate the existence of a material uncertainty which may cast significant doubt about the Company's ability to continue as a going concern and therefore, the Company may be unable to realise its assets and discharge its liabilities in the normal course of business, and at the amounts stated in the financial report".

This, according to the querist, casts significant doubt on sustainability of A Ltd. Further, the querist has also drawn attention to the financial position of C Group of which A Ltd. is a part. The following table summarises consolidated financial position of the C Group:

₹(in crores)

As on 31st March Particulars	2012	2013	2014	2015
Share Capital	238.97	239.24	239.24	245.09
Reserves and Surplus	4467.09	3433.22	1218.30	(692.86)
Net Worth	4706.05	3672.46	1457.54	(447.77)

7. From this, as per the querist, it may be appreciated that even the group does not appear to be in a position to support the going concern status of A Ltd. Also in the annual report of C Group, the financial data of A Ltd. is shown as under:

₹(in crores)

As on 31st March Particulars	2012	2013	2014	2015
Net Profit/(Loss)	(282.90)	(391.20)	(714.00)	(946.00)

Considering this also, the bid should not be accepted. From the data which are available in the published balance sheet, it is absolutely clear that at a group level, there is a negative net worth and at individual level, the auditors have clarified in very clear terms which is stated hereinabove. The auditors have emphatically stated that the company (A Ltd.) will not be able to carry on the business if it is not supported by the group parent company. When this statement is read together with the group position as on 31st March, 2015, it becomes clear that because of the negative net worth, even at the group level, the group will not be able to support and the entire business may come to a standstill. This will adversely affect the ability to carry on the business. The auditors' observations, according to the querist, are very serious so far as the ability to carry on the business is concerned.

B. Query

8. Considering the above-mentioned facts and as per definition of net worth provided in RFQ document in the opinion of the querist, net worth of A Ltd. for the financial year ended 31st March, 2015 is negative, i.e., 329.40 AUD million. In view of the above, it is requested by the querist to give opinion whether contention of not considering capital reserve (created as above) for calculation of net worth of a company is appropriate in the l ight of Indian Generally Accepted A ccounting Principles (GAAPs) and accounting concepts.

C. Points considered by the Committee

9. The Committee notes from the Facts of the Case that A Ltd. has submitted a bid in consortium with B Ltd. against request for qualification (RFQ) for tender by the querist company. For this purpose, A Ltd. has filed its net worth certificate based on audited financials for 31st March, 2015 which includes capital reserve which was created as a result of waiver of certain creditors. The querist company is of the view that such reserve should not be included in calculation of net worth. In this background, the issue that has been raised is whether contention of not considering capital reserve (created as above) for calculation of net worth of the company (A Ltd.) is appropriate in the light of Indian GAAPs and accounting concepts. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, whether treating extinguishment of the liabilities as 'other comprehensive income' and then transfer it to 'capital reserve' is in accordance with the applicable Indian GAAPs or not, whether bid should be accepted or not, whether capital reserve can be considered and classified as free reserve, etc. Further, the Committee notes that the concerns have been raised in the Facts of the Case over the doubtful going concern of A Ltd., however, the financial statements of A Ltd. are apparently prepared on the basis of going concern assumption. Accordingly,

the Committee has examined the issue on the basis of existing financial statements that have been prepared and not on the basis of financial statements that may be prepared, considering the going concern assumption in the extant case to be inappropriate. Further, the Committee presumes that items appearing in the financials of A Ltd., as provided in the Facts of the Case have been accounted for/ reported considering the requirements of Indian GAAPs, although the figures for these items have been expressed in AUD currency and not in INR. The Committee also wishes to point out that the opinion expressed hereinafter is purely from the perspective of accounting principles, viz., Indian GAAPs and not from legal perspective, such as, interpretation of the terms of RFQ for Tender or Indian Companies Act, 2013, etc. or bidding perspective. Further, the Committee wishes to point out that net worth may be defined by different authorities/regulators for different purposes and, accordingly, the term defined for one purpose may not be relevant for other purpose.

10. At the outset, the Committee notes the definition of the following terms from the 'Guidance Note on Terms Used in Financial Statements', issued by the Institute of Chartered Accountants of India (ICAI):

"11.01 Net Assets

The excess of the *book value of assets* (other than *fictitious assets*) of an enterprise over its *liabilities*. This is also referred to as **net worth** or **shareholders' funds**."

"11.08 Net Worth

See **Net Assets**"

From the above, the Committee notes that the term, 'net worth' has been defined in terms of net assets which is excess of the book value of assets over liabilities. Thus, it does not exclude any kind of reserve–capital reserve or reserve created out of restructuring/ amalgamation. Accordingly, the Committee is of the view that purely from accounting perspective, net worth includes all reserves, whether capital or revenue. However, the Committee wishes to point out that whether a particular item (for example, capital reserve) is to be included or not in net worth would depend on the purpose for which such net worth is being computed, for instance, from the Companies Act, 2013 perspective, some specific reserves are excluded from the definition of net worth. Similarly, for bidding purposes, the net worth may be defined by an entity considering the purpose for which it is to be used.

D. Opinion

11. On the basis of the above and without examining the issue from legal perspective, such as, interpretation of the terms of RFQ for Tender or Indian Companies Act, 2013, etc., as discussed in paragraph 9 above, the Committee is of the view that purely from accounting perspective, net worth should include capital reserve, as discussed in paragraph 10 above.

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 Opinion is based on the facts supplied and in the specific circumstances of the querist. The Committee finalised the Opinion on January 16, 2017. The Opinion must, therefore, be read in the light of any amendments and/or other developments subsequent to the issuance of Opinion by the Committee.
3.	The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in thirty five volumes. A CD of Compendium of Opinions containing thirty five volumes has also been released by the Committee. These are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.
4.	Recent opinions of the Committee are available on the website of the Institute under the head 'Resources'.
5.	Opinions can be obtained from EAC as per its Advisory Service Rules which are available on the website of the ICAI, under the head 'Resources'. For further information, write to eac@icai.in.