Query No. 12

Subject: ***Capital contributions from owners without issuance of shares – whether to be included in Net Owned Funds.***[1]

A. Facts of the Case

1. XYZ, a European public limited company headquartered in United Kingdom (UK) with its principal activity to transact as an insurer /reinsurer, prepares its financial statements in accordance with applicable UK GAAPs, the UK Companies Act 2006 (CA06) and is regulated by the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). XYZ is a group company of XYZ Group plc. XYZ Group plc, through its subsidiaries, is a global insurance and reinsurance company providing property, casualty and specialty products to industrial, commercial and professional firms, insurance companies, and other enterprises throughout the world. The group, headquartered in Ireland, has approximately 7000 employees and about 60 offices across the globe. The group has $13.7 billion in equity and over $11 billion of gross premium written during the year 2015.

2. XYZ has applied for reinsurance branch license as per Insurance Regulatory and Development Authority of India (Registration and Operations of Branch Offices of Foreign Reinsurers other than Lloyd's) Regulations, 2015 (hereinafter referred to as IRDAI Branch Office Regulations), notified in October 2015. One of the eligibility criteria for the applicant is to have Net Owned Funds (NOF) of INR 5000 crore, which is defined under the IRDAI Branch Office (BO) Regulations as follows:

> *"Net Owned Fund (NOF) shall consist of*
>
> *i) paid up equity capital,*
> *ii) free reserves,*
> *iii) securities premium account*
> *sum of which is reduced by*
> *iv) accumulated losses,*
> *v) book value of intangible assets,*
> *..."*
>
> (Emphasis supplied by the querist)

The audited financial statements of XYZ as at December 31, 2015, prepared under the UK GAAP, has following items as 'Capital and Reserves':

Particulars	**Amount as contained in XYZ Financial Statement**	**Amount (INR 000) @ RBI Reference Rate of 72.5010**

[1] Opinion finalised by the Committee on 21.7. 2016

	(€ 000)	
Called up Capital	*259,157*	*18,789,142*
Capital Contribution Account	*892,463*	*64,704,460*
Profit and Loss Account	*336190*	*(24,374,111)*
Capital and Reserves	***815,430***	***59,119,490***

The balance sheet of XYZ has some contribution from its 'parent company' - XYZ (UK) Holdings Limited (parent company of XYZ) which has been recognized as 'capital contribution' in accordance with the UK accounting principles.

3. The IRDAI has raised a query regarding the nature of 'capital contribution' and whether the same is eligible to be included in the aforesaid definition of net owned fund as per IRDAI BO Regulations.

4. The querist has stated that the parent company of XYZ having regard to the capital strength and solvency has been making contributions to XYZ ('the Applicant') from time to time to enhance its capital position. These contributions are actual transfer of investment, cash or both and not notional transfers. These contributions are accounted for in the books of parent company as 'investment in group undertaking'. These contributions are without any contractual obligation to repay (as supported by an email from the parent company). The funds made available to XYZ by the parent company is to be utilized at the discretion of the Board of XYZ and cannot be demanded back by the parent company although the Board of XYZ can decide to pay dividend to the parent company in order to return any surplus cash that may be available. XYZ records such contributions as an increase in the equity categorized under 'Capital & Reserve'. As per the accounting practices followed in United Kingdom where a company receives consideration from one or more shareholders without any contractual obligation to repay it (a gift or capital contribution), this is an increase in equity.

5. Further, XYZ ('the Applicant') being an insurer/reinsurer is regulated by Prudential Regulation Authority (PRA) and Financial Conduct Authority of UK. The PRA recognises capital contribution as a part of Core Tier 1 Capital under the head 'Profit and Loss Account and other Reserves'. As per principles laid under the UK generally accepted accounting principles (GAAPs) and UK Companies Act, distributable profits include a company's accumulated, realised profits less accumulated and realised reserves. It should be noted that the term 'realised' is not defined under the UK accounting principles and is subject matter of interpretation. Section 853(4) of the 2006 Act says that "References to "realised profits" and "realised losses", in relation to a company's accounts, are to such profits or losses of the company as fall to be treated as realised in accordance with principles generally accepted at the time when the accounts are prepared, with respect to the determination for accounting purposes of realised profits or losses". In addition, as per the querist, specific examples of realised profits have been provided under the Act which includes gift (such as a 'capital contribution') received in the form of qualifying consideration. Therefore, capital contributions or gifts are regarded as realised profits for the recipient company (XYZ) if they are received in cash or as an asset that is readily convertible to cash. If they are not received in qualifying consideration, the amount is unrealised, although it

might become realised if the consideration is converted into qualifying consideration, or the asset is depreciated or sold.

6. The querist has also stated that under Indian Companies Act (Companies Act 2013), the expression 'net owned fund' is not defined, however, it would be worthwhile to refer to the definition of the term 'net worth'. Net Worth is defined under the Companies Act, 2013, as "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". Further, the term 'free reserves' is defined under the Companies Act, 2013 as follows:

> *"free reserves means such reserves which, as per the latest audited balance sheet of a company, are available for distribution as dividend:*
> Provided that—
>> *(i) any amount representing unrealised gains, notional gains or revaluation of assets, whether shown as a reserve or otherwise, or*
>> *(ii) any change in carrying amount of an asset or of a liability recognised in equity, including surplus in profit and loss account on measurement of the asset or the liability at fair value,*
>
> *shall not be treated as free reserves."*
>
> (Emphasis supplied by the querist)

According to the querist, the above-mentioned definition of free reserves is in alignment with the definition of 'realised profits' as provided under the UK accounting principles.

7. In light of the above analysis, the querist is of the view that capital contribution is in the nature of equity which could be classified as free reserve under the IRDAI BO regulations' definition of NOF on account of following:

- The amount of capital contribution is received in cash or as an asset that is readily convertible to cash.
- There are no legal or other restrictions on the ability of the enterprise to distribute or otherwise apply its equity.
- The board of the company may decide to pay dividend to the parent company to remit surplus cash and thus it reflects the fact that parties with ownership interests in the company have rights in relation to the receipt of dividend. Also, this meets the definition of 'Free reserves' under the Indian Companies Act, 2013.

B. Query

8. On the basis of the above, the querist has sought an opinion from the Expert Advisory Committee as to whether the 'capital contribution' as included in the financial statements of XYZ meets the criteria of 'free reserves'/equity to be considered for determination of 'Net Owned Fund' under Indian GAAPs.

C. Points considered by the Committee

9. The Committee notes from the facts of the case that XYZ (UK) Holdings Ltd., which is a parent company has made capital contribution to the company (XYZ) (which is a European public limited company and has applied for reinsurance branch license in India). XYZ has not issued shares to the parent company with regard to the capital contribution. In this context, an issue has been raised by the querist as to whether the capital contribution by the parent company to XYZ meets the criteria of 'free reserves'/equity to be considered by XYZ for determination of 'Net Owned Fund' under Indian GAAPs. 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, accounting for distribution of the capital contribution, etc. The Committee also wishes to point out that the opinion expressed hereinafter is purely from the perspective of accounting principles in India, viz., Indian GAAPs and not from legal perspective, such as, interpretation of Indian Companies Act, 2013, UK Companies Act, IRDAI BO Regulations, etc. Further, the Committee also wishes to point out that net owned funds may be defined by different authorities/regulators (for example, Insurance Regulatory and Development Authority of India in the extant case) for different purposes and, accordingly, the term defined for one purpose may not be relevant for other purposes. It may also be emphasized that the opinion expressed hereinafter is on the basis of the facts supplied by the querist.

10. At the outset, the Committee notes that the term 'net owned fund' has not been defined/explained specifically in the Indian GAAPs. However, it uses the terms, 'equity' and 'free reserves' and accordingly, the Committee has examined the issue only in the context of whether the capital contribution by the parent company can be considered for inclusion in the said terms. In this context, the Committee notes the following definitions as per the Guidance Note on Terms Used in Financial Statements and the following paragraphs of the Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India:

Guidance Note on Terms Used in Financial Statements

"15.06 Shareholders' Equity

The interest of the shareholders in the *net assets* of a corporate enterprise. However, in the case of liquidation it is represented by the residual *assets* after meeting prior claims."

Framework for the Preparation and Presentation of Financial Statements

"49 (c) *Equity* is the residual interest in the assets of the enterprise after deducting all its liabilities."

"64. Although equity is defined in paragraph 49 as a residual, it may be sub-classified in the balance sheet. For example, **funds contributed by owners**, reserves representing appropriations of retained earnings, unappropriated retained earnings and reserves representing capital maintenance adjustments may be shown separately. Such classifications can be relevant to the decision-making needs of the users of financial statements when they indicate legal or other restrictions on the ability of the enterprise to distribute or otherwise apply its equity. They may also reflect the fact that parties with ownership interests in an enterprise have differing rights in relation to the receipt of dividends or the repayment of capital." (Emphasis supplied by the Committee)

"69. Income and expenses are defined as follows:

(a) *Income* is increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, **other than those relating to contributions from equity participants**.

(b) *Expenses* are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants."

(Emphasis supplied by the Committee)

The Committee notes that the querist has stated in the facts of the case that these contributions are actual transfer of investment, cash or both and not notional transfers. These contributions are accounted for in the books of parent company as 'investment in group undertaking'. These contributions are *without any contractual obligation* to repay to the parent company. The funds made available to XYZ by the parent company is to be utilized at the discretion of the Board of XYZ and cannot be demanded back by the parent company although the Board of XYZ has discretion to return any surplus cash that may be available out of the capital contribution. Thus, since the capital contribution in the extant case is not a contractual obligation on the part of the company (XYZ) to repay the amount to the parent company; instead, there is a discretion with the Board of XYZ to return any surplus cash available with it out of the capital contribution, the Committee is of the view that it cannot be considered as liability, rather the same should be considered as 'equity'.

11. As far as the issue of considering 'contribution from parent company' as free reserves, purely from accounting perspective is concerned, while not interpreting the term for any legal purpose, the Committee notes the definitions of the term 'free reserves', 'reserve', capital reserve' and 'revenue reserve' as defined in the Guidance Note on the Terms used in Financial Statements as follows:

"6.13 Free reserve

A *reserve* the utilisation of which is not restricted in any manner."

"14.04 Reserve

The portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a *provision* for *depreciation* or diminution in the value of *assets* or for a known *liability*. The reserves are primarily of two types: *capital reserves* and *revenue reserves*."

"**3.10 Capital Reserve**

A *reserve* of a corporate enterprise which is not available for distribution as *dividend*."

"14.08 Revenue Reserve

Any *reserve* other than a *capital reserve*."

From the above, the Committee notes that free reserve is a reserve, viz., the portion of earnings, receipts and other surplus, which is *appropriated* by the management and the utilisation of which is not restricted in any manner. In this context, the Committee notes the wordings from the copy of the letter received by the XYZ from the parent company while making capital contribution, which is supplied by the querist for the perusal of the Committee as follows:

> "On behalf of the board directors of XYZ (UK) Holdings Ltd., I am pleased to inform that XYZ (UK) Holdings Ltd. intends to make a contribution to the surplus of the company in the amount of approximately USD 230,000,000 …
>
> The contribution may be utilised for the company's corporate purposes at the sole discretion of the directors of the company. The contribution is made as capital without the requirement for consideration, without condition, and not in return for any right, shares or charge over the assets or surplus of your company"

From the above, the Committee notes that although the use of the contribution is solely at the discretion of the directors of the company but it appears that it can be utilised only for corporate purposes and not for distribution amongst the owners. Therefore, it does not appear that utilisation of contribution is not restricted in any manner. Further, the Committee notes that such contribution has been disclosed in the balance sheet of XYZ as 'capital' contribution. Accordingly, the Committee is of the view that the contribution by the parent company in the extant case cannot be considered as 'free reserve' under Indian GAAPs.

D. Opinion

12. On the basis of the above, subject to considerations in paragraphs 9 and 10 above, the Committee is of the opinion that the capital contribution in the extant case can be considered as equity under Indian GAAPs. However, the contribution by parent company in the extant case cannot be considered as 'free reserve' under Indian GAAPs, as discussed in paragraph 11 above.

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