

## **Query No. 20**

**Subject: Consideration of Capital Reserve, Risk Fund & Reserve for calculation of Net Worth of a Company.<sup>1</sup>**

### **A. Facts of the Case**

1. A company (hereinafter referred to as the ‘company’), is an ISO 9001:2008 certified Government of India (GoI) enterprise working under Ministry of Micro, Small and Medium Enterprises (MSME). The company is engaged in the business of promotion and development of the micro, small and medium sector industries in India, which is done by way of financial assistance, marketing of their produce, procurement of raw materials, training, and a host of other related activities. Also, in exercise of the powers conferred on the Reserve Bank of India (RBI) by section 45 IA of the Reserve Bank of India Act, 1934, the Company has been granted certificate of registration to commence / carry on the business of non-banking financial institution (NBFC) without accepting public deposits.

2. The Querist has stated that all central public sector enterprises (CPSEs) (holding as well as subsidiaries), without exception, are required to sign Memorandum of Understanding (MoU); while the apex/holding companies will sign MoUs with their administrative Ministries/Departments, the subsidiary companies will sign MoUs with their respective apex/holding companies on the same lines as MoU is signed between a CPSE and Government of India. Those CPSEs who do not stick to Department of Public Enterprises (DPE) schedule for signing of MoU will have their MoU performance rated as “Poor”.

3. The Querist has informed that annual targets of the CPSEs are set at the beginning of the year wherein financial targets (static parameters) and non-financial targets are determined. Financial parameters and targets in MoU are fixed using DPE's definitions as appearing in guidelines issued by DPE. The non-financial targets are specific, measurable, attainable, results-oriented, tangible. One of the parameters in the MoU involves the calculation of net worth for PAT/Net Worth and (earning before interest and tax) EBIT/Average capital employed.

4. The Querist has also informed that evaluation of MoU of the CPSE is done at the end of the year on the basis of actual achievements vis-à-vis the MoU targets by DPE. CPSEs (holding as well as subsidiaries) are required to submit performance evaluation reports on the basis of audited data to DPE, after approval of the board of CPSE and through the administrative Ministries/Departments within the stipulated time period.

*The abstract of DPE Guidelines for MoU for the year 2015-16 for Central Public Sector Enterprises as provided by the querist:*

5. As per DPE Guideline No. M-03/0012/2014-DPE(MoU) dated 07.10.2014,

*Net Worth: 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. Reserve for the purpose means Reserves and Surplus.*

*Capital Employed: Capital employed shall comprise of net worth and long term*

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<sup>1</sup> Opinion finalised by the Committee on 10.11.2017 and 11.11.2017.

*borrowings but excluding Capital Work-in-Progress (CWIP) and all investments made. However, deferred tax assets (net) shall not be form part of Capital Employed.*

6. *Company's Views*

- (i) Since the activities are for promotion and development of the small and medium sector industries in India, the Central and State Governments provide grants and subsidies to the company:
  - (a) For purchasing capital assets to be used in training centers for promotion and development of the small and medium sector industries in India or their respective regions.
  - (b) To meet revenue expenses for promotion and development of the small and medium sector industries in India or their respective regions.
- (ii) The querist has mentioned that in accordance to the Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'): which are mandatory to be followed by companies to prepare their financial accounts under section 211 (3C) of Companies Act, 1956/ Section 129 of Companies Act, 2013:

Any amount released by the GoI towards purchase of any fixed assets in the corporation is treated as "Grants of the nature of Promoters' contribution" in terms of provisions of AS 12 on 'Accounting for Government Grants'. This has been stated in the accounting policies at s.no. 14 of the annual accounts, wherein it is mentioned that "the grant to the extent of expenditure incurred is recognised as income in the statement of income and expenditure. In case of capital grant the expenditure incurred is reduced from the recognised income by creating capital reserve". This is appropriately depicted in the balance sheet under 'Shareholders funds'.

AS-12 on 'Accounting for Government Grants' of ICAI stipulates two broad approaches to be followed for accounting treatment for government grants i.e. capital approach and the income approach.

Capital approach inter-alia includes grants in the nature of promoter's contribution whereas income approach inter-alia includes grants related to specific fixed assets nature or revenue nature.

It is pertinent to mention that in both the approaches the grant amount should be recognised in the profit and loss statement on a systematic and rational basis over the useful life of the assets. Further, such grants should be allocated to income over the periods and in the proportion in which depreciation on these assets is charged. The net effect of charging depreciation and recognition of grant amount is nil in the profit & loss statement.

It automatically follows that no depreciation is chargeable on such assets to the extent of the subsidy or grant.

It was also pointed that even in accordance to section 43 (1) of the Income Tax Act 1961 (which is reproduced here under for ready reference), enjoins a company to reduce the cost of an asset to the extent of grant or subsidy received from any other person or authority for acquiring such asset, either in full or part.

*“(1) “actual cost” means the actual cost of the assets to the assessee, reduced by that portion of the cost thereof, if any, as has been met directly or indirectly by any other person or authority”*

It automatically follows that no depreciation is chargeable on such assets to the extent of the subsidy or grant.

The Central Board of Direct Taxes, under the specific power granted to it under sub-section (2) of section 145 of the Income Tax Act 1961 has notified the income computational & disclosure standards vide notification no. SO 892(E), dated March 31, 2015.

In accordance to paragraphs 5 to 10 of the Income Computation and Disclosure Standard VII relating to the treatment of government grants and subsidies the grants relating to assets shall be deducted from actual cost of the asset or written down value of the block of assets.

Further where the grants not directly relatable to an asset acquired, then such grant shall be deducted on proportionate basis from the actual cost of the assets.

No depreciation is allowable on such assets to the extent of the subsidy or grant.

Therefore, the company, for the purposes of transparency and safeguarding the assets under its custody, has adopted the following procedure:

Record the acquisition of assets in its books under the classification “*Assets acquired out of government grants*”, on the debit side.

At the same time record the contra credit effect by creating a “*Capital Reserve*”.

However it will be evident from the foregoing that they are not surpluses created out of its earnings. Further, at the same time they are not liabilities payable by the company to third parties. Thus, they cannot be included in the non-current or current liabilities in the balance sheet.

Therefore, the company, in order to balance the value of “*Assets acquired out of government grants*” shown on the assets side has included both these reserves in the balance sheet under the grouping of ‘Reserves & Surplus’.

In this manner the company has complied with the requirements of law and at the same time achieved the objective of keeping a track of the assets acquired out of grants in its financial statements.

It has already been stated herein above that the company acquires capital assets fully out of grants granted by the government and other agencies.

It can be said that the company is holding the assets acquired from grants more in the capacity of a trustee for the purpose for which the grant was given.

- (iii) The company is in its ordinary course of business/activities grants financial assistance to MSMEs for their purchase of capital assets and raw materials etc.

It needs no elaboration that any person engaged in granting financial assistance has to invariably face certain delinquencies / bad debts. These are also referred to as Non Performing Assets (NPA).

The prudential norms, for those engaged financing activity requires provision

to be created, for delinquencies which is a normal feature.

It is gathered that this is similar to the provisioning required under section 45-IB of the Reserve Bank of India Act by non-banking financial companies.

Accordingly the company has created a 'Risk Fund' in its accounts.

The company faced with the same problem as in the case of assets acquired out of grants, has depicted the 'Risk Fund', which is primarily a provisioning for meeting delinquencies, under the heading of *Reserves & Surplus*.

In these circumstances it can be concluded that the "*Risk Fund*", is in fact a provision to meet anticipated liabilities and is not a free Reserve that can be distributed as profits or dividends.

- (iv) *Further, the querist has mentioned that the companies are required to create a Deferred Tax Liability / Asset in accordance to Accounting Standard AS 22.*

The deferred tax liability/asset are deemed as contingent liabilities / assets. The contra effect of the deferred tax liability/asset is given to reserves.

*In accordance to the Accounting Standard (AS) 22, while it is obligatory to create the deferred tax liability, it is not so for deferred tax asset. This is due to the accounting principle of prudence that while the contingent liabilities are to be recognised, it is not prudent to recognise a contingent asset.*

Since the company had a deferred tax asset –the realisation of which was not probable in the near future.

However the Comptroller and Auditor General of India (CAG) insisted on its creation, despite the fact that there is no certainty of its recovery / realization in the near future.

Therefore, the company had perforce created a deferred tax asset of Rs. 47.65 crores in the year ended on 31-3-2015, and hereby increased its profits to that extent by a contingent profit.

The Income tax Act does not recognize this as anything but of contingent nature.

- (v) As per Section 123 of Companies Act, 2013,

- No dividend shall be declared or paid by a company for any financial year except out of the profits of the company for that year arrived at after providing for depreciation.
- No dividend shall be declared or paid by a company from its reserves other than free reserves.

The above referred reserves (Capital Reserves, Risk Fund and on account of Deferred Tax asset) are not to be considered as free or distributable reserves under the Companies Act. The primary reason for it is that they are not reserves created out of actual profits earned.

It is in this context the definition of Net Worth is given in sub-section 57 of section 2 of the Companies Act 2013 is termed, which is reproduced hereunder for ready reference:

“(57) "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”

It will be observed from the above definition that it excludes certain types of reserves which by their nature are those reserves, which are not distributable to the shareholders.

Accordingly, the reserves not belonging to the shareholders as distributable are to be excluded.

7. The querist has referred to the views of the Hon’ble Supreme Court in the case of CIT Vs J H Gotla (1985) 156 ITR 323 on to the matter of interpretation of Statutes. Relevant portion beginning from page 339, is reproduced hereunder for ready reference:

*“In the case of Varghese v. ITO [1981]131 ITR 597, emphasized that a statutory provision must be so construed, if possible, that absurdity and mischief may be avoided.*

*Where the plain literal interpretation of a statutory provision produces a manifestly unjust result which could never have been intended by the Legislature, the court might modify the language used by the Legislature so as to achieve the intention of the Legislature and produce a rational construction. The task of interpretation of a statutory provision is an attempt to discover the intention of the Legislature from the language used. It is necessary to remember that language is at best an imperfect instrument for the expression of human intention. It is well to remember the warning administered by judge Learned Hand that one should not make a fortress out of the dictionary but remember that statutes always have some purpose or object to accomplish and sympathetic and imaginative discovery is the surest guide to their meaning.”*

*If the purpose of a particular provision is easily discernible from the whole scheme of the Act, which in this case is to counteract the effect of the transfer of assets so far as computation of income of the assessee is concerned, then bearing that purpose in mind, we should find out the intention from the language used by the Legislature and if strict literal construction leads to an absurd result, i.e., a result not intended to be sub-served by the object of the legislation found in the manner indicated before, then if another construction is possible apart from strict literal construction, then that construction should be preferred to the strict literal construction. Though equity and taxation are often strangers, attempts should be made that these do not remain always so and if a construction results in equity rather than in injustice, then such construction should be preferred to the literal construction. Furthermore, in the instant case, we are dealing with an artificial liability created for counteracting the effect only of attempts by the assessee to reduce tax liability by transfer. It has also been noted how for various purposes the business from which profit is included or loss is set off is treated in various situations as the assessee's income. The scheme of the Act as worked out has been noted before.”*

Taking a cue from what principle the Hon’ble Supreme court has held in above case, if the reserves which are not distributable or are reserves (*Capital Reserves*) created to give contra effect to assets acquired from grants and subsidies, which should have been made nil in accounts as per the Companies Act and the income tax act or provisions (Risk Fund) loosely grouped as reserves are to be excluded.

Then only one can arrive at the correct or true net worth.

8. Computation of net worth from capital plus free reserves (reserves after excluding reserves that are not available for distribution as dividends) is as under, on the basis of the audited balance sheet as on 31<sup>st</sup> March 2016 of the company is as under:

<i>PARTICULARS</i>	<i>Rs in lakhs</i>	
a) Capital	53,298.80	
b) Reserves & Surplus	22,608.54	
c) Total Shareholder funds	<u>75,907.34</u>	
<i>Less Non -distributable reserves</i>		
d) Capital Reserves	1,414.97	
e) Risk Fund	1,077.04	
f) Reserve created for Deferred Tax Assets	<u>5,228.48</u>	<u>7,720.49</u>
g) Net Worth		<u>68,186.85</u>

Now let us consider the ordinary meaning of net worth which, is the value by which, the value of all owned assets exceed the value of liabilities to outsiders or third parties.

Accordingly, the total of the assets after excluding the miscellaneous expenses and losses (to the extent not written off) and the aggregate of liabilities to outsiders will be the net worth.

Further any assets, which are not realisable, or are held as funds held in trust are to be excluded.

9. Computation of net worth by excluding liabilities to outsiders from assets value is as under, on the basis of the audited balance sheet as on 31<sup>st</sup> March 2016 of the company is as under:

<i>PARTICULARS</i>	<i>Rs in lakhs</i>	
a) Total assets side of Balance sheet		355,319.37
<i>Less</i>		
b) Assets created out of Grants, which were required to be made Nil as per the Companies Act and Income Tax Act but kept on assets side by giving contra effect	1,414.97	
c) Deferred Tax Assets -which are contingent assets -not realisable in near future	5,228.48	
d) Reduction in value of advances as financial assistance / Risk fund created under Govt. directions to CPSEs as provisioning for delinquencies	1,077.04	
		<u>7,720.49</u>
f) Sub- total (a less (b+c+d))		347,598.88
<i>Less Outside liabilities</i>		
g) Non Current liabilities	11,523.33	

h) Current liabilities	267,888.70	279,412.03
i) Net Worth (f less (g+h))		68,186.85

The above computation of net worth by both methods demonstrate this beyond doubt that the non-free/ non-distributable reserves described herein above have to be excluded for the reasons stated, as it will be observed that by both methods the net worth comes to the same amount.

10. It has been separately confirmed by the querist that the query would be answered only in the context of accounting principles and the Committee will lay down only the accounting principles for determination / computation of net worth and not compute the net worth as such.

### **B. Query**

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

- (a) Whether capital reserve, risk fund and reserve made on account of recognising deferred tax asset appearing in the balance sheet of the company are to be considered as a part of its net worth or are to be excluded.
- (b) Further what will be the company's net worth on the basis of its latest available audited accounts as of 31<sup>st</sup> March 2016?

### **C. Points considered by the Committee**

12. The Committee notes from the Facts of the Case that the query is with regard to whether capital reserve, risk fund and reserve made on account of recognising deferred tax asset are to be considered as a part of networth. 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 treatment of grant received, reserves created, creation of deferred tax asset etc. The Committee has also not considered the need and rationale for creation of various reserves as mentioned in the query and whether capital reserve, risk fund and reserve made on account of recognising deferred tax asset can be considered and classified as free reserve or distributable reserve under Companies Act, 2013, etc. The Committee would like to highlight that in the facts of the case many aspects have been referred to such as accounting treatment of grants received from the Government, creation of risk fund, creation of provision for doubtful debts, creation of deferred tax liability/asset etc. which may require separate and detailed examination from compliance point of view. However, since the querist is not seeking opinion on these aspects and sufficient facts are also not available with regard to these aspects, the Committee has not examined that whether comments made by the querist are in conformity with the relevant Accounting Standard(s) or applicable guidelines have been complied with or not. The Committee wishes to point out that the opinion expressed hereinafter is purely from the perspective of accounting principles, viz., Indian GAAP and not from legal perspective, such as, interpretation of the terms of DPE Guidelines or various Court judgments, as referred to by the querist or Companies Act, 2013 or Reserve Bank of India Act, Income Tax Act, etc. Further, the Committee can lay down only the accounting principles for determination of networth and not calculate the net worth as such. The Committee also 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.

13. At the outset, the Committee notes the definition of the following terms from the ‘Guidance Note on Terms Used in Financial Statements<sup>2</sup>’, issued by the Institute of Chartered Accountants of India (ICAI):

**“11.01 Net Assets**

The excess of the *book value of assets* (other than *fictional 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 risk fund or reserve made on account of recognising deferred tax asset. 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 some other specific purposes, the net worth may be defined by specifically considering the purpose for which it is to be used.

**D. Opinion**

14. On the basis of the above, the Committee is of the following opinion on the issues raised by the querist in paragraph 10 above:

- (i) Without examining the issue from legal perspective, such as, interpretation of the terms of DPE Guidelines, Companies Act, 2013, Reserve Bank of India Act, Income Tax Act, etc., as discussed in paragraph 12 above, the Committee is of the view that purely from accounting perspective, net worth should include reserves, as discussed in paragraph 13 above.
- (ii) As mentioned in paragraph 12 above the Committee can lay down only the accounting principles for determination of networth and not calculate the net worth as such, therefore this cannot be answered by the Committee.

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<sup>2</sup> Subsequently, on issuance of the ‘Glossary of Terms used in Financial Statements’ by the Research Committee of the ICAI on July 1, 2019, the Guidance Note on Terms Used in Financial Statements was withdrawn.