

Query No. 33

Subject: Considering Debenture Redemption Reserve (DRR) for calculation of Net Worth of a Company.¹

A. Facts of the Case

1. A company (hereinafter referred to as the ‘company’) is a public limited company and shares of the company are listed on National Stock Exchange and Bombay Stock Exchange. Over the years, the company has made various provisions towards reserves and others and it includes the reserve created under the head ‘Debenture Redemption Reserve’ (DRR). DRR created out of profits of the company.

2. The querist has stated that ABC Ltd. has issued notice inviting tender for the construction of Hydro Mechanical Package of a Hydroelectric Project (60 MW). One of the eligibility criteria for the company towards the net worth of the company responding to the invitation reads as under:

“The net worth shall be positive for the last three financial years which shall be calculated based on subscribed and paid up Share Capital plus Share premium plus free reserves plus Unallocated Balance/Surplus amount of profit and Loss account less (a) expenses not written off, (b) Accumulated losses in Profit and Loss account, if not reduced from reserves and surplus. The revaluation reserves, Capital reserves, and amount of intangible asset like goodwill etc. will not be taken into account while calculating Net Worth”.

3. From the plain reading of the above eligibility criteria relating to Net Worth, it consists of two parts:

(a) First part states that following are to be included in net worth.

- a. Subscribed and paid up Share capital
- b. Share premium
- c. Free Reserves
- d. Unallocated Balance/Surplus amount of profit and loss account less expenses not written off and accumulated losses in the profit & loss account.

(b) Second part states that following cannot be included in net worth:

- a. Revaluation reserves,
- b. Capital reserves, and
- c. amount of intangible asset like goodwill etc.

From the above mentioned criteria for computation of net worth, it can be concluded that out of various provisions made in the Balance Sheet, only the items mentioned in second part will not form part of net worth. As such, the DRR created by the Company will be part of net worth and it will not be reduced as per definition of net worth.

Further, as per the first part, free reserves will be part of the net worth and as per the discussion held with designated officials of ABC Ltd., DRR will not be part of free reserves. However, free reserve has not been defined under notice inviting tender documents.

4. For computation of net worth, the querist has made reference to definition of net worth which has been defined by various authorities. Relevant extracts of definition of net worth is given here under:

¹ Opinion finalised by the Committee on 4.4.2018 and 5.4.2018.

Section 2(57) of Companies Act, 2013 defines Net Worth 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”

Section 3(1)(ga) of the Sick Industrial Companies (Special Provisions) Act 1985

“Net Worth means the sum total of the paid up capital and free reserves.

Explanation – For the purposes of this clause, “free reserves” means all reserves credited out of the profits and share premium account but does not include reserves credited out of re-evaluation of assets, write back of depreciation provisions and amalgamation.”

Guidance Note on “Terms Used in Financial Statements issued by the Institute of Chartered Accountants of India” defines Net Worth and Net Assets as per following definitions :

“11.08 Net Worth

See **Net Assets”**

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**.

Further, free reserves are defined under Companies Act, 2013 as

Section 2(43): “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.

B. Query

5. In view of the said facts and the circumstances given here above, the querist has sought opinion of the Expert Advisory Committee on the following issues:

- (i) In view of the definition of Free Reserves under Companies Act 2013 which is for the purpose of distribution of dividend only and definition of Free reserves given in Sick Industrial Companies (Special Provisions) Act 1985 for the purpose of Net Worth, whether DRR, created by the company, is a part of free reserve or not for the purpose of computation of net worth as per the criteria prescribed under Notice Inviting Tender.

- (ii) As per the criteria prescribed under Notice Inviting Tender for working out the net worth, whether the exclusion of the reserves and other provisions be restricted to revaluation reserve, capital reserve & amount of intangible asset like goodwill etc. given in second part of definition of Net Worth given in Notice Inviting Tender, hence DRR be not deducted from Net Worth and is part of Net Worth.

C. Points considered by the Committee

6. The Committee notes from the Facts of the Case that the query is with regard to whether Debenture Redemption Reserve created out of profits of the company is a free reserve or not and also whether the same is to be considered as a part of networth as defined in invitation document. 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 Debenture Redemption Reserve, need and rationale for creation and maintenance of DRR etc. 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 Notice inviting tender or Companies Act, 2013 or Sick Industrial Companies (Special Provisions) Act, 1985, etc. The Committee also assumes that notice inviting tender does not mandate the application of definition under Companies Act, 2013. 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.

7. At the outset, the Committee considers it appropriate to note 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):

“6.13 Free Reserve

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

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, Free Reserve has been defined as a reserve which can be utilised freely without any restriction. The Committee also noted the nature and purpose of the reserve outlined in its financial statements for the year ended 31st March 2017 at page 141:

“The Company has recognised Debenture Redemption Reserve [DRR] as per the provisions of the Companies Act 1956. As per the provision, the Company shall credit adequate amount to DRR from its profits every year until such debentures are redeemed. The amount credited to DRR shall not be utilised by the Company except for the redemption of debentures.”

From the above the Committee noted that DRR cannot be utilised for any other purpose till such time as the Debentures are redeemed.

Accordingly, the Committee is of the view that DRR is not a free reserve.

Further 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. 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, DRR) 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

8. On the basis of the above, the Committee is of the following opinion on the issues raised by the querist in paragraph 5 above:

- (i) From the accounting perspective Debenture Redemption Reserve (DRR) is not a Free Reserve, as discussed in paragraph 7 above.
- (ii) Without examining the issue from legal perspective, such as, interpretation of the terms of Notice inviting tender or Companies Act, 2013 or Sick Industrial Companies (Special Provisions) Act, 1985, as discussed in paragraph 6 above, the Committee is of the view that purely from accounting perspective, net worth should include all reserves, as discussed in paragraph 7 above. However, the definition of Net worth given in 'Guidance Note on Terms Used in Financial Statements', issued by the Institute of Chartered Accountants of India (ICAI), differs from the definition of net worth given in notice inviting tender which intends to include only free reserves as a part of networth. Therefore, DRR not being a free reserve will not be included for the calculation of net worth.