Corporate Governance in Central PSUs: The Case of Energy Efficiency Services Ltd. on Qualified Financial Statements

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This case deals with the state of financial affairs in a sizeable central PSU, namely, **Energy Efficiency Services Ltd. (EESL)**. Financial issues and discipline are at the heart of corporate governance mechanism. Within that the emphasis of the regulators and law-makers has been on requiring the companies *to move towards a regime of unqualified financial statements*. While going through the EESL annual report 2019-20, being the latest as posted on company's website https://eeslindia.org (as on 15th July, 2021), it was noticed that the auditors' report contained 9 qualifications, a number that is quite large. Hence this case is devoted to issues of financial discipline, financial control systems, role of audit committee/ internal auditors/statutory auditors and that of the executive management in the financial governance.

Energy Efficiency Services Ltd.

Founded in 2009, **EESL was** promoted by Ministry of Power, as a JV of four Navratna PSUs, namely, **NTPC, PFC, REC** and **Power Grid**. EESL, on its website, claims to be a super Energy Service Company (ESCO), which enables consumers, industries and governments to effectively manage their energy needs through energy efficient technologies.

Equity of EESL is not listed. However, Non-convertible bonds issued by it are listed on BSE. *Corporate governance norms as per the Companies Act, 2013 are applicable to the company*. The following matrix provides a glimpse of scale of size and operations of EESL.

	Rs.in crores			Rs. in crores	
	2019-20	2018-19		2019-20	2018-19
Equity	983.33	675.20	Revenue from operations	1797.09	1837.65
Domestic borrowing	3328.87	2353.23	Other income	76.01	98.02
International borrowings	2175.99	1292.60	**Total revenue**	**1873.10**	**1935.67**
Total resources	**6488.19**	**4321.03**	PBT	**21.00**	**171.12**
Increase in resources	**2167.16**	.....	PAT	**26.99**	94.88
			Diluted EPS (₹)	**0.29**	1.19
Source: Annual reports.					

It may be noted that during 2019-20:

1. Increase in total resources at the command of the company: Rs. 2176.16 crores.
2. Despite that, decrease in total revenue: Rs. 62.57 crores. And
3. Decrease in PBT by a staggering Rs. 150.12 crores in comparison to 2018-19.
4. Performance very dismal and further down.
5. 2019-20 PAT more than PBT (due to tax credit).

Qualified Financial Statements

EESL's 2019-20 audit report contained the following 9 qualifications (Q1 to Q9):

Q1: Compiling certain data and reconciling assets, liabilities and revenues

A. **Qualification:**

The Company is in the process of – compiling certain data and reconciling the amounts billable, receivable & payable under the various agreements entered into with various States, Urban Local Bodies (ULB's) and other organizations under its Energy Service Company (ESCO) model and other projects, verification of stores and assets under the scheme & otherwise and reconciliation as to assets to be installed, assets installed pending capitalization & assets capitalized (including capitalization of related direct & indirect cost including salaries, interest on loans/ bonds and forex gain/loss etc.) and assets against which revenue is booked (as per applicable Indian Accounting Standards) as per the agreements.

B. **Auditors' comments:**
   - We are unable to comment upon the differences that may exist and their impact on various account heads such as Capital Work in Progress, Property Plant & Equipment, Inventories, Trade Receivable / Payable, revenue recognition and any other consequential impact on the statement if any, pending completion of such verification and reconciliation. (Refer Note No. 3 b)).
   - This was also a **subject matter of Qualification in the previous auditor's report** on the standalone financial statements for the year ended 31st March 2019.

Q2: Outstanding trade receivables

A. **Qualification:**
   - Trade receivables are due from government-controlled entities and other customers. Significant amount of Rs. 103,564.26 Lakhs is outstanding for the period of more than 360 days as on 31st March 2020 (Rs. 60,454.34 Lakhs for the previous year ended 31.03.2019).
   - The company has represented that the Company earns its revenue mainly from government-controlled entities (both central and state government) and hence risks attached to such receivables are considered to be insignificant and for rest of the customers, the Company does an assessment/evaluation of credit risk based on factors such as ageing of dues, specific credit circumstances, nature and credit worthiness of the non-government-controlled entities/customers.
   - The company has not furnished any records or evidences to demonstrate that such an evaluation and assessment has been carried out. However, a provision of Rs. 849.61 lakhs in respect of amount outstanding for more than 360 days as on 30.09.2019 from non-government controlled entities have been made and no further provision have been made for the period ended 31.03.2020.

B. **Auditors' comments:**
   - Therefore, we are unable to quantify the impact on the statement on account of any possible allowance on doubtful trade receivables due to expected credit loss once such evaluation is done. (Refer Note No. 41(a)(iii).
   - This was also a subject matter of Qualification in the previous auditor's report on the standalone financial statements for the year ended 31st March 2019.

Q3: Loss allowance on financial assets measured using life time expected credit losses

A. **Qualification:**
   - For Financial assets for which loss allowance is measured using life time expected credit losses in the Financial Statements, the Company has represented at Note No. 41(a)(iii) –

     "The company has customers with capacity to meet the obligations and therefore the risk of default is low. Further, management believes that the unimpaired amounts that are past due are still collectible in full, based on historical payment behaviour. However, the Company has recognised a provision for doubtful receivables of Rs.196.65 Lakhs during the year ended 31 March 2020 (31 March 2019: Rs. 196.65 Lakhs)".
   - The process of identification of cases and amount under litigation (including framing of policy for provisioning and follow-up) needs to be strengthened.
   - Further, the Company has not been able to demonstrate and produce any evidence that such cases were actually assessed/evaluated for ascertaining credit risk based on factors such as ageing of dues, specific credit circumstances, nature and credit worthiness of the customers as defined in the policy of the management for the purpose of creating allowance on such doubtful trade receivables due to expected credit loss in case of default.

B. **Auditors' comments:**
   - Therefore, we are unable to quantify the actual impact on the statement on account of further possible allowance on such doubtful trade receivables (which are under litigation for recovery) due to expected credit loss once such evaluation is done.
   - This was also a subject matter of Qualification in the previous auditor's report on the standalone financial statements for the year ended 31st March 2019.

Q4: Deferred 'Advertisement Expenses'-Non-compliance with Ind AS 38

A. **Qualification:**

   The company had deferred 'Advertisement Expenses' amounting to Rs. 4287.50 Lakhs in the previous years, from which it has charged an amount of Rs. 1071.88 Lakhs in the Statement of Profit & Loss for the period ended 30.09.2019, pertaining to earlier years, as Media/Advertisement Expenses and no further adjustments have been done in the statement of Profit & Loss for the period ended on 31.03.2020, as per the accounting policy of the company on 'Expenses related to awareness on UJALA Programme'.

B. **Auditors' comments:**
- The company continues to defer and carry the balance amount of Rs. 3215.62 Lakhs as Prepaid Expenditure shown under the head Other Current Assets in the Standalone Financial Statements contrary to the principles enunciated under Ind AS 38 on 'Intangible Assets', as per which such expenses should be charged to the Profit & Loss Account in the year it was incurred. (Refer Note No.16 (a)).
- This was also a subject matter of Qualification in the previous auditor's report on the standalone financial statements for the year ended 31st March 2019.

Q5: Capitalization of PPE: Non-compliance with Ind AS 16

A. **Qualification:**

The company has entered into agreements with Municipal Corporation for replacement of old conventional streetlights with LED Energy efficient streetlights. The Company carries certain amounts in CWIP pertaining to various projects which are under various stages of completion and have not been capitalized in the books of accounts, irrespective of the fact that the asset may be available for use / non – receipt of completion certificates from Municipal Corporation, which is inconsistent with the provisions of Ind AS 16 on Property Plant and Equipment wherein the projects need to be capitalized and depreciated when it is available for use.

B. **Auditors' comments:**

The impact of this cannot be ascertained by the company as it needs to carry out an exercise to ascertain the various projects where the asset is available for use but the completion certificate from the Municipal Corporation is pending. (Refer Note No. 3(c))

Q6: Revenue recognition based on certain assumptions

A. **Qualification:**

The Company has recognised revenue under agreements with ULB's based on certain assumptions / estimates like the start date of the project is taken as the date of completion specified in the first Completion Certificate received from the ULB, the actual expenses towards PMC, AMC, interest (including indirect finance costs), pre/post tax return on equity (in few cases) are more / at a certain percentage which is different from the percentage specified in the agreement. The company is in the process of analyzing all agreements to seek necessary clarifications on such and other matters and shall formalize all agreements accordingly.

B. **Auditors' comments:**

We are unable to comment upon the impact of these assumptions pending such clarifications and formalization of agreements. (Refer Note No. 31(b).

Q7: Trade receivables/payables subject to confirmation

A. **Qualification:**

Trade Payables and Trade Receivable (including related party transactions) are subject to confirmations and consequential adjustments that may arise on reconciliation.

B. **Auditors' comments:**

We are unable to comment upon the impact of the same on the standalone financial statements till such confirmation / reconciliations are carried out. (Refer Note 10(c), 20(a), 26(a)).

Q8: Fair valuation of financial assets/ liabilities

A. **Qualification:**

The company has undertaken the fair valuation of financial assets and financial liabilities, depicted in note 40, through an external agency.

B. **Auditors' comments:**

In the absence of adequate information / working of the same with the company, we are unable to comment upon the correctness of the fair values depicted in the said note and its consequential impact, if any, on the standalone financial statements of the company.

Q9: Unbilled revenue

A. **Qualification:**
- The company has booked the unbilled revenue of Rs.528.02 lakhs for Smart Meters installed in certain DISCOMs on estimation basis where formal agreements are yet to be executed.
- Further, the Company is in the process to seek clarifications/ amendments in a few agreements for extension of period, change in rates etc., the effects of which shall be considered in the year in which such amendments are finalized. The Company has appointed a vendor for SMNP System Integration on per meter basis, except for few items. The Company has booked expenses on per meter basis and is in process to modify and

formalize the terms of payments with the vendor to ensure that all payments are made proportionately on per meter basis.

B. Auditors' comments:

We are unable to comment upon the impact of the above, if any, on the financial statements pending execution of the formal agreements etc. (Refer Note No. 31(d)).

Emphasis of Matter: CAG's Advice on Provision for Subsidy Not Received

The auditors have also drawn attention to the following matter, among others, in the notes to the Standalone Financial Statements for which they state, "**Our opinion is not modified in respect of these matters.**"

- 'Note no. 41(a)(iii) which states that, the Comptroller & Auditor General of India (CAG) in their report dated 18th October 2017 issued to company had recommended provision of Rs.1650 lakhs on account of subsidy not received from Delhi Government/DERC. However, the Company has not made the said provision as the management is of the view that the recovery is being followed up with concerned authority, which is under review and the management is confident for recovery'.

Gravity of These Qualifications/ Emphasis of Matter

It may be noted that:

1. In 7 qualifications, auditors are not able to comment on the quantitative impact of these qualifications on profitability and financial position (Q1 to Q3, Q6 to Q9). Justification of not being able to comment? Making reasonable estimates and reliance thereon is a very well-accepted accounting policy.
2. In 1 case, Impact not ascertainable by the company (Q5).
3. Impact ascertained in 1 case (Q4).
4. Qualifications are very serious in nature and size. 'Company has not been able to demonstrate and produce any evidence' is an eye-opening observation by the auditors. Inadequacy of internal financial controls is quite visible.
5. 2 clear cases of non-compliance with the Ind AS (Q4 & Q5).
6. Opinion not modified for the long outstanding due provision despite the observation of CAG (Q9).
7. Impact of quantified qualifications on the profits not disclosed, as required.
8. Auditors state that Q1 to Q4 figured in the 2018-19 report also. Scanning of prior years' balance sheets reveals that they have been continuing from much earlier periods: Q1, Q2 & Q3 since 2017-18, Q4 since 2015-16 and emphasis of matter since 2016-17.

Impact of Audit Qualifications on the Profitability of EESL

What we can do is, carry out the impact of **quantified qualifications / emphasis of matter** on the profitability or how the statement of profit would look like if these qualifications did not exist or when corrected.

	Rs.in crores			
	Audited figures (as reported)	**Adjustments for audit qualification)**		**Adjusted Figures**
Revenue from operations	1797.09	Less: Unbilled revenue	5.28	1791.81
Other income	76.01			76.01
Total revenue	1873.10			1867.82
Total expenditure	1852.10	Add:		
		Advertising Exps.	32.16	
		Provision for o/s subsidy	16.50	1900.76
PBT	21.00			-32.94
Tax (credit)	(5.90)			(5.90)
Net profit	**26.90**		**Net loss.....**	**-27.04**
Weighted average number of equity shares	94.07			94.07
EPS	0.29			**-0.29**

Impact: Net profit gets converted to net loss of equal amount.

What will be the impact of Q2: Outstanding trade receivables (Rs. 1035.64 crores) and other qualifications where impact could not be worked out by the auditors? Any body's guess!

Interpretation

Let us leave the interpretation of these qualifications, in the context of financial corporate governance at EESL, which is otherwise very obvious, to the discerning readers, lenders, investors and analysts. They should form their own opinions on the strengths and weaknesses of corporate financial governance structures at EESL. They should take note of repetitiveness of the qualifications from year-to-year. They should take in to consideration the fact that EESL has large amounts of outstanding bonds which are listed at BSE and thus public has substantial interest in this company. Also to be take in to account is that EESL does not seem to have discussed the reason/s for sharp fall in its 2019-20 profitability in the directors/MDA report.

Note:
The views expressed here are those of the author solely. They do not represent views of his employer FORE School of Management. The case is meant for illustration and general public information only. Nowhere does it intend to express an opinion on the financial affairs of the company. No part of the discussion in this paper should be taken as an opinion.