



STUDY NOTE - 1

COMPANIES ACT 1956

This Study Note includes

- Meaning and Nature of a Company
- Characteristics of a Company

1.1 DEFINITION OF A COMPANY

A company is a voluntary association of persons formed for some common purpose, with capital divisible in parts known as shares, and with a limited liability. It is a creation of law and is sometimes known as artificial person created by law, i.e. it is regarded by the law as a person just as a human being. But it has no physical existence.

As per the Companies Act 1956, a company is defined as ‘a company means a company formed and registered under this Act or an existing company as defined in clause [ii] [Section 3 (1)]

Lord Justice Lindley defines a company as, ‘By a company is mean an association of many persons who contribute money or money’s worth of common stock and employ it for a common purpose. The common stock so contributed is denoted in money and is the capital of the company. The persons who contribute it or to whom it belongs are members. The proportion of capital to which each member is entitles is his share. Such shares are always transferable although the right of such transfer can be more or less restricted.’

According to Honey, ‘ a company is an incorporated association which is an artificial person created by law having a separate entity with a perpetual succession and common seal.’

1.2 CHARACTERISTICS OF A COMPANY

A company form of organization has proved to be very useful in the modern days. The main reasons are [I] capacity to raise large amount of capital from the public and [II] principle of limited liability. In case of partnership organizations as well as in the case of sole trading organizations, there is a principle of unlimited liability. This means that if the assets of the business are not sufficient to pay off the liabilities of the business, the personal property and assets of the partners or the proprietors can be utilized for the payment of the liabilities of the business. However in the case of the company, the liability of shareholders is limited to the amount of the face value of the shares they have purchased. Therefore they need not pay anything extra even if the company goes into liquidation. [Companies with unlimited liability can be established but this a very rare case] A company has the following features, which distinguish it from other type of organizations.

a) Separate Entity: One of the most important features of a company is that it has a separate



legal status from its members or shareholders. Actually the shareholders are the owners of the company but they are different from the company itself. The property of the company is not the property of the shareholders. Similarly shareholders may come and go but a company remains as it is. The following case laws will clarify the point further.

- ❖ In AB Pvt. Ltd., there are two shareholders, A and B. These shareholders are different and their company is different. Unfortunately if both of them die in an accident, their company will not die. Its existence will remain intact and its existence can be put to an end only when it is liquidated officially.
 - ❖ In a landmark case of Soloman Vs Soloman, the principle of separate legal existence was upheld by the court. The facts of the case were, one Mr. S sold his boot business to a newly formed company for \$ 30, 000. His wife, one daughter and four sons took up one share of \$ 1 each. S took 23, 000 shares of \$ 1 each and \$ 10, 000 debentures in the company. The debentures gave S a charge over the assets of the company. Subsequently when the company was wound up, the assets were found to be worth \$ 6000 and liabilities worth \$ 17000 out of which \$10000 were due to S for debentures. Balance \$ 7000 were due to other unsecured creditors. It was held that S and his company are separate and so S has a priority over other unsecured creditors.
 - ❖ In Lee v/s Lee's Air Farmings Ltd., the same principle was upheld. In this case one Mr. L was the principle shareholder in his company. He appointed himself as the Managing Director of his company. Incidentally he was also a pilot and when he was on the flight of his company's aeroplane for some official work, his plane crashed and he died in the accident. His widow claimed for compensation as he was on official duty at the time of his death. This claim was opposed on the ground that L and his company are one and the same as he is the principle shareholder and hence no compensation should be payable. However it was held that in spite of being principle shareholder, L and his company are not the same but two separate entities. Therefore compensation should be paid to L's widow as L has died while performing his official duty. Thus from these examples, it will be abundantly clear that the company is different from its members or shareholders. However in certain cases, a court may disregard this principle to find out the unscrupulous persons who are taking undue advantage of the corporate personality. This is known as 'Lifting or piercing the veil of the company'. It is explained in a later part of this chapter.
- b) **Perpetual Succession And Common Seal:** A company has a perpetual succession. It is created by a process of law and it ceases to exist by the process of law only. Shareholders may change but the company's existence is not affected by this change. Similarly it has a common seal. In other words a company is an artificial person created by law and all that a person can do, a company can do under its common seal.
- c) **Capital:** A company is incorporated with an authorized share capital, which is the maximum amount of share capital, which can be raised by it in its lifetime unless it is changed subsequently. Out of this authorized share capital, some amount of capital as per the needs of the company is offered to the members of the public. The amount of capital is divided into small parts, which are called as shares. A company can issue a] Equity shares,



which are also called as ordinary shares and b] Preference shares. According to Companies Act, an equity share is that share, which is not a preference share. A preference share is a share, the holder of which, has a priority of receiving dividend ahead of equity shareholders and also a priority regarding repayment of capital when the company goes into liquidation.

- d) **Transferability of Shares:** The shares of a company are freely transferable in case of a public limited company. The directors can refuse transfer of shares only if they conclude that after registering the transfer, the management of company may be passed in the hands of undesirable persons and that will be prejudicial to the interest of the company. In case of a private limited company, the shares are not freely transferable. Now-a-days due to Depository Services and De-mat type of trading of shares, transfer of shares of public limited company has become even more simple.
- e) **Limited Liability:** As mentioned earlier, the liability of members of the shareholders of a limited company is limited. This means that if the face value of a share is Rs.100 and a shareholder has purchased 10 such shares, the total value of the holding will be Rs.1000. Once this amount is paid by the shareholder, he need not pay an additional amount even at the time of winding up of the company. This principle of limited liability has made the company form of organization very popular. However as per Companies Act, 1956, a company with unlimited liability can be incorporated but then there will not be any difference between a partnership and such a company. Therefore these types of companies are very rare or virtually non-existent.
- f) **Capacity to sue and to be sued:** A company is an artificial person created by law as said earlier. It has a capacity to sue others in case of any offence committed against it. Similarly it can be sued by others if it has committed any offence against any party.

Difference Between A Company And Partnership

The difference between a limited company and partnership is as follows.

- I. A partnership is governed by the Indian Partnership Act while a limited company is governed by the Companies Act 1956
- II. Minimum of number of partners required to form a partnership is two while the maximum number of partners is ten in case of banking business and twenty in case of other businesses. In case of private limited companies, minimum number of members is two and maximum number is 50 excluding employees. For public limited companies, the minimum number of members is 7 while there is no restriction on maximum number of members.
- III. Liability of partners in case of partnership firms is unlimited. This means that if the business assets are less than the business liabilities, private assets of partners can be attached for payment of business debts. In case of limited companies, the liability of members is limited to the face of value of shares purchased by them.



- IV. A company has a separate legal entity from its members. A partnership firm does not have such separate entity from its partners.
- V. The affairs of a company are managed by its directors, or managing directors or manager while its members cannot have any right to take part in its management. In case of partnership firm, every partner has the right to take part in the management of the firm unless the partnership agreement provides otherwise.
- VI. Shares in a limited company are freely transferable, barring shares of a private limited company. A partner cannot transfer his shares without the consent of all partners.
- VII. A partnership firm can do anything as per the agreement between the partners. On the other hand, a company's powers are defined by the Memorandum of Association.
- VIII. A partner is an agent of his firm and his acts are binding on the firm as long as he acts within the scope of his authority and in the course of ordinary course of the business. On the other hand, a member is not an agent of his company and therefore cannot bind the company by his acts.
- IX. If a member of a limited company has given some debt to the company, he can claim the same proportionately from the assets of the company at the time of its winding up. But a partner, who has given any loan to the firm, cannot have any priority over other creditors.
- X. Insolvency of firm means insolvency of all the partners. On the other hand, winding up of an insolvent company do not mean insolvency of its members.
- XI. Any partner may at any time dissolve a partnership firm unless it is for a specific period of time. Similarly it is also dissolved due to insolvency or death of a partner. A company has a perpetual succession. Members may come and go, but a company is not liquidated. Even if all members of a company die, the company does not die. A company can only be liquidated by operation of law when it is wound up as per Company Law provisions.



STUDY NOTE - 2

FORMATION OF A COMPANY

This Study Note includes

- Introduction- Formalities Regarding the Formation of a Company
- Incorporation of a Company
- Provisions of law regarding Pre-incorporation Contracts
- Promoter

2.1 INTRODUCTION

A company is an artificial person created by law. It has a separate identity from its members and also a perpetual succession. In order to bring a company in existence, certain formalities laid down in the Companies Act must be completed. A company comes into existence after getting the certificate of incorporation. This certificate of incorporation is a conclusive evidence of the fact that the company has come into existence. In this chapter, the formalities, which are to be completed for achieving the certificate of incorporation as well as legal consequences of incorporation and the position of promoters is discussed.

2.2 INCORPORATION OF A COMPANY

For establishing a public limited company, there is a need of at least 7 members while in case of a private limited company, minimum 2 members are required for its incorporation. For getting a certificate of incorporation from the Registrar of Companies, the following documents along with the requisite registration fees are to be filed with the Registrar of Companies.

- i. The Memorandum of Association duly signed by the subscribers. [Minimum 7 in case of public limited companies and 2 in case of private limited companies]
- ii. The Articles of Association duly signed by the subscribers.
- iii. If a company wishes to appoint a Managing Director, or a whole time Director, the copy of the agreement made between the company and the concerned person proposed to be appointed as a Managing Director or a whole time Director.
- iv. In case of a public limited company, the list of persons who have agreed to act as first directors of the company along with their consent letters and also with a letter of undertaking about of purchase of qualification shares from the proposed company.
- v. A declaration stating that all the formalities under the Companies Act are fulfilled. This declaration is to be signed at least by one of the following persons.
 - An advocate practicing in High Court or Supreme Court or,



- An Attorney or a pleader entitled to appear before a High Court or,
- A Company Secretary or a Chartered Accountant who is in whole time practice or
- A person named in the Articles as a director, manager or secretary of the company.

CERTIFICATE OF INCORPORATION:

After filing the necessary documents, and after the completion other necessary formalities like the payment of fees etc, the Registrar will examine all these documents. This is done by the Registrar in order to satisfy himself that all the documents are submitted properly and provisions of Companies Act are complied with in a satisfactory manner. After the Registrar has satisfied himself about these things, he will issue a certificate of incorporation to the company certifying that the company has satisfied all conditions of incorporation and it has been incorporated. This certificate is known as 'Certificate of Incorporation' and is one of the most important documents in the life- time of the company.

The importance of the certificate of incorporation is that it is conclusive evidence about the birth of the company. The date, which is mentioned on this certificate, is the date on which the company is born. Similarly this certificate is conclusive evidence that all the formalities laid down under the Companies Act have been duly completed and the prior proceedings cannot be questioned or inquired as regards any regularity and the certificate cannot be disputed or challenged on any grounds whatsoever. Consider the following example in this respect.

In case of one of the companies, six out of seven signatures made on the Memorandum of Association were forged. The validity of the certificate of incorporation was challenged on this ground. However it was held that the certificate of incorporation was conclusive evidence and cannot be challenged on any ground. The validity of the certificate of incorporation thus remains intact despite the forgery.

The following are the legal effects of registration.

- The company becomes a legal entity with a perpetual succession and a common seal. The members may come and go but the company will remain as it is.
- Another important effect of incorporating a company is that as it is separate legal entity, its property is not the property of the shareholders. A company is an artificial person created by law and hence whatever a person can do, a company can do it. It can hold property, sign contracts [through directors and officers] but its property is not the property of the shareholders and similarly its liabilities are not the liabilities of the shareholders. After getting a certificate of incorporation a private company can commence business immediately but a public company has to obtain a certificate to commence business for starting business.

2.3 PRELIMINARY OR PRE-INCORPORATION CONTRACTS

The job of floating a company is done by the persons who are known as 'Promoters' of the company. It is customary for the promoters to enter into contract with third parties. The question, which arises is that whether a company is bound by the pre-incorporation contracts? If



no, whether these contracts can be ratified after the company comes into existence? The answers to both these questions are as follows.

- The first and the most important thing is that the company is not bound by pre-incorporation contracts. The reason is that at the time of entering into such contracts, the company was not in existence. Even if these contracts are made by the promoters on behalf of the company, still the promoters do not have any powers to enter into any contract on behalf of the company who is yet to come into existence. The promoters cannot act as agents for principal who is not in existence.
- Example: P and Q are the promoters of a company known as PQ Pvt. Ltd. At the time of incorporation of the company but before getting the certificate of incorporation, they entered into a contract with L to purchase his land for the company and assured him that the payment will be made by the company after its incorporation. After the company comes into existence, it refuses to honor the commitment to L. In such situation, L do not have any right to enforce the contract on the company as the pre-incorporation contracts are not binding on the company.
- A company also cannot enforce the preliminary contracts against third parties. Thus in the above example, if L would have refused to give the possession of his land to the company, the company also could not have enforced the contract on L as it is a pre-incorporation contract. Similarly ratification of the preliminary or pre-incorporation contract is also not possible. Again referring back to the example, the company cannot ratify the contract made with L after its incorporation. The promoters who are thus entering into such contracts prior to incorporation are personally liable to third parties. Such a contract is deemed to have been entered into by the promoters personally. If at all the company wants to abide by the terms of the contract, it will have to enter into a fresh contract with fresh terms and conditions and consideration.
- Sections 15 and 16 of the Specific Relief Act 1963, provide that specific performance of such contracts can be enforced against the company provided the company has accepted the contract and has communicated such an acceptance to the another party to the contract.

2.4 PROMOTER

A promoter is a person who does the groundwork or the preliminary work to bring a company into existence. It is a term used to describe a person, who undertakes, does and goes through all the necessary and other preliminary activities with an objective of bringing the company into existence. A promoter is expected to do the work of selecting the name of a company, preparing the memorandum of association as well as articles of association, nominating directors, auditors, secretaries etc. of the company, arranging the payment of prescribed fees for obtaining registration and doing any other work for bringing the company into existence.

As far as the legal position of a promoter is concerned, the company law is silent about this



aspect. However it has been accepted that a promoter stands in a fiduciary relationship with the company. Fiduciary relationship implies a relationship of utmost good faith. This means that a promoter should not make any profits at the expense of the company. If he makes any secret profit at the cost of the company, the company can compel him to account for the same and return it to the company.

It is also expected from a promoter that he should give benefits of any negotiations to the company. Thus where he purchases some property for the company, he cannot rightfully sell that property to the company at a higher price than the purchase price. If he does so, he will be liable to pay back the price to the company and the company can rescind the contract. If a promoter fails to disclose the amount of profit made by him, the company can take legal action against him and recover damages from him.



STUDY NOTE - 3

MEMORANDUM OF ASSOCIATION

This Study Note includes

- Introduction : Meaning and Importance of Memorandum of Association
- Form the contents of Memorandum of Association
- Alteration in Medmorandum of Ultra-vires, and its implications
- Doctrine of Ultra-Vires

3.1 INTRODUCTION AND DEFINITION

3.1.1 Definition

The Memorandum of Association is a document, which contains the fundamental rules regarding the constitution and activities of the company. It is the basic document, which lays down how the company is going to be constituted and what work it shall undertake. The purpose of memorandum is to enable the members of the company, its creditors and the public to know that its powers are and what is the range of its activities. The memorandum contains rules regarding the capital structure, the liability of the members, the objects of the company and all other important matters relating to the company. In other words the memorandum defines and confines the powers of the company. Alterations to the memorandum of association are possible only after certain formalities are completed.

3.1.2 Importance of Memorandum of Association

The memorandum shows the range of the enterprise. It is the foundation on which the superstructure of the company has been built up. It enables the shareholders, creditors and outsiders to show the permitted activities of the company. It is to be remembered that Articles of Association and Memorandum of Association are public documents, which may be inspected by anybody at the office of the Registrar of Companies. Any person dealing with a company presumed to have constructive notice of the contents. The members of the company are also entitled to have copies of the memorandum as well as articles on payment of a small fee.

3.2 FORM AND CONTENTS OF MEMORANDUM

As per Section 13 of the Companies Act, 1956, the Memorandum of Association shall contain the following particulars.

- I. Name Clause: A company cannot adopt a name by which another company is registered. If by inadvertence, mistake or otherwise, a name is selected which is too similar to the name of an existing company or closely resembles to it, the name must be changed. If the



name of a company closely resembles to the name of an existing company, it may mislead the members of public. In such a case, the court will direct the change of the name of the company. A company cannot use a name, which is considered undesirable by the Central Government. Under the Names and Emblems Act, companies cannot use certain names. These names include, name, emblem or official seal of the United Nations Organization, the World Health Organization, the United Nations Educational, Scientific and Cultural Organization, the Indian National Flag, the name, emblem or seal of the Central Government and State Governments, the names, emblem or official seal of the President of India or Governor of any State.

The Memorandum shall state the name of the company with 'limited' as the last word of the name in case of a public limited company, and with 'private limited' as the last words of the name in case of a private company. In case of a company, which has been formed for the promotion of art, science, religion etc. the Central Government may permit, by a license the omission of the word 'limited' or the words 'private limited' from the name.

As per section 147, every company shall,

- Point or affix its name and the address of its registered office on the outside of every office or place in which its business is carried on,
 - Have it engraved in legible characteristics on its seal and
 - Have its name and the address of its registered office mentioned in legible characters in all business letters, billheads, negotiable instruments, invoices, receipts etc.
- II] Registered Office Clause: As per section 146 of the Companies Act 1956, every company shall have a registered office from the day on which it begins to carry on business or as from the 30th day from its incorporation whichever is earlier. All communications and notices are to be addressed to that registered office. If there is any change in the registered office, notice of the change should be given to the Registrar within 30 days of such change.
- III] Objects Clause: This is one of the important clauses of the Memorandum. Adequate care should be taken to see that the drafting of this clause is done in clear words so that there is absolutely no ambiguity in the same. The object clause of every company has to state a] Main objects b] Other objects and c] Other objects not mentioned in a]
- IV] Capital Clause: The Memorandum of a company, which is having share capital shall state the amount of share capital with which the company is registered and the division of the same into shares of a fixed amount. The capital with which a company is registered is called as 'Authorized' or 'Nominal' capital. This is the maximum amount of share capital, which a company can raise during its lifetime unless it is subsequently changed by amending the Memorandum. The shares issued by a company can only be equity or preference. However a private company, which is not a subsidiary of a public company may issue shares of any kind and with disproportionate voting rights.
- V] Liability Clause: The Memorandum of a company limited by shares or by guarantee shall also state that the liability of its members is limited. This means that the members will be



required to pay only the amount of shares that they have purchased and in case of company limited by guarantee, the amount for which they have given guarantee.

- VI] Association Clause: This clause states that, 'We, the several persons whose names and addresses are subscribed, are desirous of being formed into a company in pursuance of this Memorandum of Association, and we respectively agree to take the number of shares in the capital of the company set opposite our respective names.' This is followed by the names, addresses and descriptions of the subscribers and the number of shares taken by each one of them. Each subscriber has to take at least 1 share.

The Memorandum must be printed, divided into paragraphs numbered consecutively and signed by each subscriber. It shall be signed by at least 7 subscribers in the case of a public limited company and by at least 2 members in case of a private limited company. The signature of each subscriber shall be attested by at least 1 witness who cannot be any of the other subscribers.

3.3 ALTERATIONS IN MEMORANDUM

Memorandum of Association is an important document for a company. It can be changed or altered but for any change or alteration there should be a proper procedure followed. This procedure is given below.

- i. Change of Name: A company may change its name by a special resolution and with the approval of Central Government. A change of name, which merely involves the deletion or addition of the word 'private' on the conversion of a private company into a public company or vice versa does not require the approval of Central Government. If through inadvertence or otherwise, a company is registered by a name which in the opinion of the Central Government is identical with or too nearly resembles to the name of an existing company, the company a] may change its name by ordinary resolution and with the previous approval of the Central Government b] shall change the name if the Central Government so directs within 12 months of its first registration or the registration with new name. In such cases the change shall have to be made within 2 months from the direction by ordinary resolution. The Registrar will issue a new certificate of incorporation after the change.
- ii. Change of Registered Office: The provisions in this regard are as follows.
 - a. Change of registered office from one place to another in the same city: All that is required in this case is to give a notice within 30 days of the change of the Registrar.
 - b. Change of registered office from one city to another city in the same state: A special resolution is to be passed in a general meeting and copy of the same should be given within 30 days with the Registrar of companies. Within 30 days of the change of office, notice must be given to the Registrar about the new location.
 - c. Change of registered office from one state to another: A special resolution should be passed in a general meeting and confirmation from National Company Law Tribunal



should be obtained. Before allowing the alteration, the Tribunal shall satisfy itself that sufficient notice has been given to every person whose interests will be affected by such shifting and consent of creditors has been obtained. The Tribunal shall also issue notice to Registrar of Companies and hear any objections if any. After listening to all these parties, the Tribunal may confirm the alteration. A certified copy of the order of the Tribunal confirming the alteration together with a printed copy of the Memorandum as altered shall within 3 months from the date of the order, be filed by the company with the Registrar. The Registrar shall register the same and certify the registration within one month from the date of filing of such documents.

- iii. Alteration of Object: The object clause of the Memorandum can be changed for the purpose of enabling the company,
- To carry on its business more economically or more efficiently.
 - To attain its main purpose by new or improved means
 - To enlarge or change the local area of operation
 - To carry on some business which under existing circumstances may conveniently or advantageously be combined with the objects specified in the Memorandum.
 - To restrict or abandon any of the objects specified in the Memorandum.
 - To sell or dispose of the whole, or any part of the undertaking of the company or
 - To amalgamate with other company or body of persons.

The following procedure should be adopted for the alteration of object clause in the Memorandum

- A special resolution must be passed.
- A petition should be filed with the National Company Law Tribunal for confirmation of the change.
- The consent of the creditors of the company should be obtained or their claims paid off or secured.
- Notice should be given to the Registrar of companies so that he can appear before the Tribunal and state his objections and suggestions if any.
- After the Tribunal has confirmed the alteration, a certified copy of the Tribunal's order together with a printed copy of the Memorandum as altered shall be filed with the Registrar within 3 months of the date of the order.
- The certificate of the Registrar of Companies is conclusive evidence of the alteration and its validity. The alteration takes effect after it is registered. If no registration is made within 3 months, the alteration and the entire proceedings connected herewith become void.



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- iv. Change in liability clause: A company limited by guarantee or shares cannot alter its liability clause so as to impose any additional liability on the members or to make them compulsory to take additional shares unless all the members agree in writing to such a change.
 - v. Change in capital clause: The procedure to be followed for change in capital clause is discussed in detail in the chapter of 'Share Capital'.

3.4 DOCTRINE OF ULTRA VIRES

As mentioned in the first paragraph of this chapter, a Memorandum of Association defines and confines the powers of the company. A company can operate within the scope of the authority given to it by the Memorandum of Association and by the Companies Act 1956. A company should carry on the business to fulfill the objects mentioned in the Memorandum as well as objects, which are incidental to these objects. Every other action by the company is 'ultra vires'. Ultra means beyond and vires means powers and therefore ultra virus means 'beyond powers'. An ultra vires contract is null and void and not binding on the company at all. Even the entire body of shareholders cannot ratify such contracts. The objective behind putting these restrictions is as follows.

- It must be ensured that the capital of the company is applied to the fulfillment of the objects, which are laid down in the Memorandum. The capital has come from shareholders and it should not be utilized for ultra virus purposes.
- Capital of the company is a sort of security to the creditors. Therefore in order to protect creditors, it should be ensured that the capital should not be applied for any unauthorized use.
- It should be remembered that an ultra vires act, which is ultra vires to the directors but intra vires to Articles or Memorandum, the shareholders can ratify the same. Similarly if it is done irregularly, it can be validated by the consent of the shareholders provided it is within the powers of the company. Another important thing is that a company has the right to protect the property of the company, which is acquired as a result of ultra virus contract.
- If an act or transaction is ultra vires the Articles, the company can ratify it by altering the Articles by a special resolution. Again if the act is done irregularly, it can be validated by the consent of shareholders provided it is within the powers of the company.



STUDY NOTE - 4

ARTICLES OF ASSOCIATION

This Study Note includes

- Intorduction- Meaning, Contents and Importance of Articles
- Provisions of Company Law regarding the Articles of Association
- Provisions of Company Law regarding the amendment in Articles of Association
- Doctrine of Constructive Notice
- Doctrine of Indoor Management
- Difference between the Memorandum and Aricles of Association

4.1 INTRODUCTION

In a lifetime of a company, three documents play an important role. The first one is the Company Law, the second one is Memorandum of Association and the third one is Articles of Association. As described in the previous chapter, the Memorandum of Association is a document, which defines and confines the powers of a company. By going through the Memorandum, the outsiders get an idea about the powers of the company, its objects, registered office etc. Articles of Association on the other hand, are the rules regarding the internal management of a company. In order to run the administration of a company smoothly, it is essential to have set of rules, which will be followed by everyone working with the company. These rules are incorporated in the Articles of Association. The Articles are subordinate to the Memorandum in importance. Therefore these rules are made in conformity of the objects outlined in the Memorandum. The contents of Articles as well as other relevant provisions are discussed in the following paragraphs.

4.1.1 Contents of Articles

Articles of Association usually have the following contents.

- Share capital, types of shares, rights of shareholders, and meetings of shareholders.
- Calls on shares
- Procedure for forfeiture of shares
- Lien on shares
- Provisions regarding transfer and transmission of shares
- Issue of share warrants
- Issuing of shares at premium or discount



- Surrender of shares
- Alteration of share capital
- Procedure to take poll at a meeting
- Quorum at a meeting
- Directors, their appointment, and qualification shares
- Removal of a director
- Remuneration of Manager, Secretary and Managing Director
- Dividends and bonus shares
- Provisions regarding Accounts and Audit
- Borrowing powers
- Winding up.

4. 2 PROVISIONS REGARDING ARTICLES OF ASSOCIATION

Articles are subordinate not only to Memorandum of Association but also to the Company Law. Therefore Articles should not contain any provision, which is contrary to the Memorandum of Association or Company Law. In other words, regulations framed in the Articles should not go beyond the powers given to the company by the Memorandum and the Company Law.

- The following types of companies shall have their own Articles
 - Companies with unlimited liability
 - Companies limited by guarantee
 - Private companies limited by shares.
- The Articles shall be signed by the subscribers to the Memorandum and registered along with the Memorandum.
- In case of a company with unlimited liability, along with other particulars, the Articles must contain the following points.
 - The number of members with which the company is registered.
 - Amount of share capital if the company has the share capital
 - In the Articles of a company limited by guarantee, the following particulars must be added.
 - Number of members with which, the company is registered.



- For a private limited company having a share capital, the following contents must be present in the Articles
- Restriction on transfer of shares
- Limiting the number of members to fifty excluding employee members
- Prohibiting public appeal for subscribing to any shares or debentures of the company.

For a public limited company, there is an option given and accordingly it can adopt model Articles given in Table A of the Companies Act. This model can be accepted with or without modifications. Alternatively the company can prepare its own Articles of Association.

Articles should be printed, divided into paragraphs and signed by the subscribers to the Memorandum. Articles printed on computer are also accepted.

4.3 AMENDMENTS TO THE ARTICLES OF ASSOCIATION

A company has a right to alter or amend the Articles. Such an amendment must be made by passing a special resolution in a general meeting. A copy of the amended Articles must be filed with the Registrar of companies within thirty days from such an amendment. Copy of the special resolution must also be filed with the Registrar. The power to amend the Articles has got the following limitations.

- I. The Articles should not be altered in such a manner so as to make it inconsistent either with the provisions of the Company Law or the Memorandum of Association. As described above, the Articles are subordinate to both, the Company Law and the Memorandum. If the provisions in the Articles are inconsistent with either of the two, such provisions will be invalid.
- II. Amendment in Articles should not result in increasing the liability of the members. The liability of members of a company is limited to the amount [face value] of the shares that they have purchased. This cannot be increased unless all the members agree to such an alteration in writing. However where the company is club or an association, increase in the subscription or membership charges can be effected by alteration in the Articles.
- III. The alteration or amendment in the Articles should not sanction anything illegal. Legal acts, which are not expressly prohibited by the Memorandum can be inserted by alteration to Articles.
- IV. It is essential to pass a special resolution for altering the Articles. The reason behind this provision must be that for any alteration maximum number of shareholders should give their consent. Even clerical errors in the Articles should be corrected by passing a special resolution.
- V. The alteration must be for the benefit of the company. Not only the procedure should be followed while amending the Articles, but it should be ensured that the alteration is really



bona fide and for the benefit of the company. If the alteration is beneficial only for a class of shareholders or if it is likely to result in oppression on the minority shareholders, the court may restrain the company from carrying on such an alteration.

- VI. Any alteration, which results in empowering the Board of Directors with a power to expel a member is not valid. The reason is that such a provision is against the provisions of the Companies Act regarding the rights of members.
- VII. A company is not prevented from altering the Articles even if such an alteration would result in breach of a contract with a third party. The affected party may claim damages for breach of contract. If monetary compensation is not an adequate remedy, the court may restrain the company from altering its Articles.
- VIII. The courts do not have any power to amend the Articles. It is the company, which can alter the Articles. Even the clerical errors or drafting errors can be rectified only by the company. The court can only declare some clauses to be ultra virus.
- IX. Alteration in the Articles may with retrospective effects. Even it may result in losses to some members, it will be perfectly valid.

4.4 DOCTRINE OF CONSTRUCTIVE NOTICE

Memorandum of Association and Articles of Association are extremely important documents for a company. These documents are to be filed with the Registrar of Companies along with other documents for incorporating a company. The office of Registrar is a public office and therefore the documents like Memorandum and Articles are also public documents. Anybody can have the access to these documents. An outsider who is dealing with the company is expected to read these documents before entering into any contract with the company. If later on it is found out that a particular contract is outside the scope of the authority given by the Memorandum or Articles, there will be no remedy open against the company as it will be presumed that an outsider has read these documents. Thus the Doctrine of Constructive Notice prevents an outsider from alleging that he did not know that the Memorandum and Articles of the company.

4.5 DOCTRINE OF INDOOR MANAGEMENT

The Doctrine of Constructive Notice protects a company from outsiders. There is one limitation to that doctrine. The Doctrine of Indoor Management is an exception to the Doctrine of Constructive Notice. The Doctrine of Constructive Notice provides that an outsider must read the Memorandum and Articles of a company. But he is not expected to do more. As far as internal procedures are concerned, an outsider is entitled to presume that everything has been done according to the procedures laid down and there is no irregularity. An outsider cannot find out what is going inside the doors as the doors of the management are closed to an outsider. Therefore protection to such an outsider becomes necessary. Thus while the Doctrine of Constructive Notice is a protection to the company against an outsider, the Doctrine of Indoor



Management is protection to the outsiders against the company. The following landmark case explains the point.

- **Royal British Bank v/s Turquand:** The directors of a company had issued a bond to T. As per the Articles of the Company, the directors were authorized to issue the bonds provided that they were authorized by a resolution passed in the general meeting of the shareholders. No such resolution was passed by the company and the company refused to pay the amount on maturity stating that the contract is void due to non-passing of such a resolution. It was held that T can recover the amount of bond as he is entitled to presume that such resolution has been passed. But even this doctrine has got some exceptions. In these exceptional situations, the doctrine of indoor management is not applicable. These exceptions are given below.
- **Knowledge of irregularity:** If a person dealing with the company has knowledge of irregularity, he cannot claim defense of indoor management. Suppose A Ltd. lent money to B Ltd. on a mortgage of its assets. The procedure laid down in the Articles for such transactions was not complied with. The directors of both the companies were the same. In this case the lender had notice of irregularity and therefore the mortgage was not binding.
- **Negligence:** Where a person dealing with the company could have discovered the irregularity but due to his negligence, he was not able to do the same, doctrine of indoor management is not applicable. Thus the protection under this rule is not available. In one of the cases, a person accepted a transfer of a company's property from the accountant. It was held that the transfer was void as such a transaction was apparently beyond the scope of the accountant's authority. The person should have verified whether the accountant has such an authority or not.
- **Forgery:** The doctrine of indoor management is not applicable where a person relies upon a document that turns out to be a forged since nothing validate forgery. A company cannot be hold liable for forgeries committed by its officers.
- **Acts Outside The Scope Of Apparent Authority:** If an officer of a company enters into a contract with a third party and if the act of the officer is beyond the scope of his authority, the company is not bound.



4.6 DIFFERENCE BETWEEN THE MEMORANDUM AND ARTICLES OF ASSOCIATION

The following is the difference between the Memorandum of Association and Articles of Association.

Memorandum of Association	Articles of Association
1. It is the charter of the company and indicates various things like name, objects, capital, liability etc.	1. They are the regulations for the internal management of the company.
2. It defines and confines the areas of operations of the company	2. Articles are the rule for carrying the objects of the company as set out in the Memorandum.
3. As it is a charter of the company, it is the supreme document.	3. They are subordinate to the Memorandum. In case of any conflict between the two, Memorandum shall prevail
4. Every company must have a Memorandum	4. A limited company by shares may accept Table A as its Articles with or without modifications.
5. Alterations to Memorandum must be according to the laid down in the Act. In some cases approval of National Company Law Tribunal is required.	5. Alterations in Articles are comparatively easy as they can be altered by special resolutions keeping in mind certain limitations.
6. Any act done by the company by going beyond the Memorandum is ultra virus and cannot be ratified even by whole of shareholders.	6. Any act of the company, which is ultra virus the Memorandum can be ratified by the shareholders.



1. LEGAL EFFECTS OF MEMORANDUM AND ARTICLES:

The legal implications of these documents are as follows.

- **Members to the company:** Each member is bound by the provisions of the Memorandum and Articles of Association. In other words each member is bound to the company to abide by the Memorandum and Articles.
- **Company to the members:** As members are bound to the company by provisions of Memorandum and Articles, the company is bound to the members. A company is bound to function within the framework of the Memorandum and Articles. Any ultra virus action proposed by the company can be prevented by any member by claiming injunction.
- **Members inter se:** As between the members inter se, Memorandum and Articles constitute a contract between them and are also binding on each member as against the other or others.
- **Company to outsiders:** The Articles do not constitute any binding contract between the company and an outsider. An outsider cannot take advantage of the Articles to lodge a claim thereon against the company.



STUDY NOTE - 5

PROSPECTUS

This Study Note includes

- Introduction
- Prospectus-Meaning
- Contents of Prospectus
- Mis-statement in Prospectus
- Statement in Lieu of Prospectus

5.1 INTRODUCTION

One of the features of a limited company is that it can raise funds through share capital, debentures and also by inviting public deposits from public. In case of a public limited company, it can appeal to the members of public to invest money in the company by printing and issuing a document, which is known as 'Prospectus'. However a private limited company is prohibited from making a public appeal for the subscription of its shares or debentures and also for inviting public deposits. Hence it need not issue prospectus. The main objective behind issuing prospectus is to give information about the overall affairs of the company. In other words it is a document, which gives information about the 'prospects' of a company. It is a very important document and the contents of the same are mentioned clearly in the Companies Act. Any false or misleading information given in the prospectus knowingly will attract a severe punishment to all concerned persons. Hence it should be drafted very carefully. The meaning, objectives, contents and other relevant provisions relating to prospectus are discussed in detail in this topic.

5.2 PROSPECTUS – MEANING

Section 2 (36) of the Companies Act 1956, defines prospectus as, 'Any document described or issued as a prospectus and includes any notice, circular, advertisement or other document inviting deposits from the public or inviting offers from the public for the subscription or purchase of shares in, or debentures of a body corporate'.

On analyzing the definition, the following feature of prospectus emerge,

- 1) Prospectus is a document in writing. An oral invitation to subscribe for the shares or debentures or for inviting public deposits is not a prospectus.
- 2) It is an invitation to offers from the public for the subscription or purchase of shares or debentures or inviting of public deposits. Whether shares have been 'offered to public' is a matter of fact and will depend on the circumstances of a particular case. It is difficult to say exactly how many persons constitute public. Public includes, 'any section of the public, whether elected as members or debenture holders, or as clients of the persons issuing the prospectus or in any other manner.' This means that if a prospectus is issued to all shareholders or to general public, it will be called as issued to public.



- 3) The prospectus should contain prescribed information as mentioned in the law.
- 4) A prospectus issued by or on behalf of a company or in relation to an intended company, shall be dated, and that date unless the contrary is proved, be taken as the date of publication of the prospectus.

3. REGISTRATION OF A PROSPECTUS:

A prospectus can be issued by or on behalf of a company only when a copy thereof has been delivered to the Registrar for registration. The registration must be made on or before the date of publication thereof. The copy must be signed by every person who is named therein as director or proposed director of the company or his authorized agent.

5.3 CONTENTS OF PROSPECTUS

Every prospectus issued by or on behalf of a company or by or on behalf of any person who is or has been engaged or interested in the formation of a company shall state the matters as specified in Part I of Schedule II and set out the reports specified in Part II of that Schedule and the said Part I and II shall have effect subject to the provisions contained in Part III of that Schedule. [Section 56] The details of the contents are given below.

I. Part I of Schedule II

1. General Information: a) Name and address of registered of the company b) Consent of the Central Government for the present issue and declaration of the Central Government about non responsibility for financial soundness or correctness of statements d) Provisions relating to the punishment for fictitious applications e) Declaration about refund of the issue if minimum subscription of 90% is not received within 90 days from closure of the issue f) Date of opening of the issue g) Date of closing issue, date of earliest closing of the issue h) Name and addresses of trustee under debenture trust deed i) Rating from CRISIL or any rating agency obtained for the proposed debenture / preference shares. If no rating has been obtained, this fact should be stated j) Underwriting of the issue, names and addresses of the underwriters and the amount underwritten by them.
2. Capital Structure of the Company: Information about authorized, issued, subscribed, and paid up capital, size of the present issue giving separately reservation for preferential allotment to promoters and others, paid up capital after the present issue and after conversion of the debentures if applicable.
3. Terms of the present issue
4. Particulars of the present issue such as objects, project costs, means of financing including contribution of promoters.
5. Company, Management and Project: Information about the company as well as directors and the project undertaken.
6. Particulars in regard to the company and other listed companies under the same management



7. Outstanding litigation if any pertaining to certain matters.
8. Management perception of risk factors such as sensitivity to the foreign exchange rate fluctuations, difficulty in availability of raw materials or in marketing of products, cost / time overruns etc.

II. Part II of Schedule II:

A] General Information:

1. Consent of directors, auditors, solicitors / advocates, managers to the issue, registrar to the issue, bankers to the company, bankers to the issue
2. Experts' opinion obtained if any
3. Change if any in the directors and auditors during the last 3 years and reasons thereof
4. Authority for the issue and details of the resolution passed for the issue
5. Procedure and time schedule for allotment and issue of certificates.
6. Names and addresses of the Company Secretary, Legal Adviser, Lead Managers, Co-managers, Auditors, Bankers to the company, Bankers to the issue and Brokers to the issue.

B. Financial Information:

1. Report by the auditors: A report by the auditors of the company with respect to its profits and losses [distinguishing items of non recurring nature] and assets and liabilities and the rates of dividends paid by the company during the preceding five financial year. If, however, no accounts have been made up in respect of any part of the period of 5 years, ending on a date 3 months before the issue of the prospectus, the report shall contain a statement of that fact. If the company has subsidiaries, the report shall, in addition, deal with either the combined profits and losses and assets and liabilities of the subsidiaries or each of the subsidiary, so far as they concern the members of the company.
2. Report by the Accountants: A report by the accountants [who shall be qualified under the Act for appointment of auditor of a company and who shall be named in the prospectus] on the profits or losses of the business for the preceding 5 financial years, and on the asset and liabilities of the business on a date, which shall not be more than 120 days, before the date of the issue of the prospectus. This report is to be given if the proceed of the issue of the shares or debenture are to be applied directly in the purchase of any business.

A similar report on the accounts of a body corporate by an accountant, who shall be named in the prospectus if the proceeds of the issue are to be applied in the purchase of shares of the body corporate so the body corporate becomes a subsidiary of the acquiring company.

Principal terms of loans and assets charged by the company.

C. Statutory and Other Information: This will include the following.



1. Minimum subscription
2. Expenses of the issue giving separately fees payable to Advisers, Registrars to the issue, Managers to the issue, Trustees for the debenture holders.
3. Underwriting commission and brokerage
4. Previous issue for cash
5. Previous public or rights issue if any during the last 5 years, giving the particulars of date of allotment including the closing date, date of refunds and date of listing on the stock exchange and premium if any on each share, which had been issued within 2 years preceding the date of the prospectus
6. Commission or brokerage on previous issue
7. Issue of share otherwise than cash
8. Debentures and redeemable preference shares and other instruments issued by the company outstanding as on the date of prospectus
9. Option to subscribe
10. Details of purchase of property
11. Details of directors, proposed directors, whole-time directors, their remuneration, appointment and remuneration of managing directors, interests of director, their borrowing powers and qualification shares.
12. Rights of members regarding voting, dividend, lien on shares and the process for modification of such rights and forfeiture of shares
13. Restriction, if any, on transfer and transmission of shares / debentures
14. Revaluation of assets, if any during last 5 years
15. Material contracts and inspection of documents.

Part III of schedule II – provisions applying to parts I and II of schedule II

1. Every person shall, for the purposes of this Schedule be deemed to be a vendor who has entered into any contract, absolute or conditional, for the sale or purchase of any property to be acquired by the company in any case where, a) the purchase money is not fully paid at the date of the issue of the prospectus, b) the purchase money is to be paid or satisfied, wholly or part, out of the proceeds of the issue offered for subscription by the prospectus, c) the contract depends for its validity or fulfillment on the result of that issue.
2. In the case of a company, which has been carrying on business for less than 5 financial years, reference to 5 financial years means reference to that number of financial years for which business has been carried on.



3. Reasonable time and place at which copies of all balance sheets, and profit and loss accounts on which the report of the auditors is based and material contracts and other documents may be inspected.
4. 'Year' means financial year
5. STATEMENT BY EXPERTS:

Section 57 of the Companies Act states that a prospectus inviting persons to subscribe for shares in or debentures of a company shall not include a statement purporting to be made by an expert, unless the expert is a person, who is not and has not been, engaged or interested in the formation or promotion, or in the management, of the company. In other words, the expert should be totally impartial so that his statement will be totally unbiased. Section 58 states that, a prospectus inviting of persons to subscribe for shares in or debentures of a company and including a statement purporting to be made by an expert shall not be issued unless the expert has given his written consent to the statement and has not withdrawn such consent before the delivery of a copy of the prospectus for registration. The expert should also give a statement in writing that he has not withdrawn his consent to the statement and the same is appearing in the prospectus.

5.4 MIS-STATEMENT IN PROSPECTUS

A prospectus is an important document in the administration of a company. It contains a very crucial information as described above. A company has to take care that the entire information given in the prospectus should be true and not false. A company should not induce people in investing in the company by making a false and misleading statement purposely. Hence in a landmark case of *Brunswick and Canada Railway and Land Company V/s Muggeridge* [1860], it was mentioned that, 'Those who issue prospectus holding out to the public the great advantage, which will accrue to persons, who will take shares in a proposed undertaking, and inviting them to take share on the faith of the representations therein contained, are bound to state everything with strict and scrupulous accuracy and not only to abstain from stating as fact that which is not so, but to omit no one fact within their knowledge, the existence of which might in any degree affect the nature or extent and quality of the privileges and advantages, which the prospectus holds as inducement to take shares'. In other words, it means that there should be a full and true disclosure of all the facts concerned, in the prospectus. A fraud is committed by not only making a false or misleading statement knowingly but also by concealing vital information, which has bearing on the judgment of a common man and hence utmost care should be taken to ensure that the prospectus contains true information so that it will not be misleading. This is in fact the 'golden rule' of framing the prospectus. If there is any misstatement of a material fact in a prospectus, the liabilities arising out of this, are discussed below.

Civil Liability for Mis-Statement in Prospectus

If there is a misstatement or withholding of a material information in a prospectus, and if it has influenced any shareholder to purchase shares he has the right to treat the contract as cancelled [Rescission of contract] and claim damages from the company whether the statement is fraudulent or an innocent one. He shall also have remedies against the directors, promoters and experts. All these points are discussed below.



- A] Rescission of Contract: If there is a misstatement in the prospectus i.e. if the statements are false or fraudulent or if some material information is withheld, he can apply to the Court for the rescission of the contract. However he should apply within reasonable time and before the company goes into liquidation. He will also have to surrender the shares and his name will be removed from the register of members. After completing these formalities, he will get his money back along with the interest. However, it should be noted that the right of rescission shall be available to the shareholder only in the event of the following.
- i. The statement must be a material misrepresentation of fact. In other words, the statement should be false and misleading about the facts. It should be remembered that there is a difference between an honest opinion and statement of fact. Thus when it is mentioned that due to the hard work and efficiency of directors, the profits of the company are expected to reach a certain figure, it becomes a statement of opinion. On the other hand, if a prospectus states that 'certain persons have agreed to become directors of the company', it can be material misrepresentation if it prove to be a false statement. A shareholder can avail of the right to rescission of a contract if there is a material misrepresentation.
 - ii. The statement must have induced the shareholder to take the shares. Though it is very difficult to prove that the shareholder has been induced to take the shares on the basis of the misstatement in the prospectus, it will have to be dependent on the circumstances of each case. The crucial point is that if the statement is such as it would influence a common man, the Tribunal will infer that it influenced the applicant. If the applicant's acts show, that he did not rely on the statement, he is not entitled to rescind.
 - iii. The statement must be untrue. A statement included in a prospectus is deemed to be untrue if it is misleading in the form and context in which it is included. In one of the leading case [Rex V/s Lord Kyslant], a prospectus was issued by a company, stating that the company had paid a dividend every year between 1921 and 1927 [years of depression] thus giving the impression of a financially stable company. Actually, the company was able to pay dividends in all these years out of the accumulated profits and it has incurred a heavy loss during each of the years from 1921 to 1927. This fact was suppressed. It was held that the prospectus was 'false' as it conveyed a false impression.
 - iv. The deceived shareholder is an allottee and he must have relied on the statement made in the prospectus. If a person purchases share in the open market, he has no rights against the company.
 - v. The omission of material fact must be misleading before rescission is granted. If the omission is misleading, then only the rescission is granted.
 - vi. The proceedings for rescission must be started as soon as possible. There is a well known statement that 'delay defeats equity', which means that the proceedings against the company must start at the earliest, i.e. as soon as after the person comes to know about the cheating, otherwise, he will loose the right of action against the company.



- B] Claim for damages: Any person induced by a fraudulent statement in a prospectus to take shares is entitled to sue the company for damages. He must prove all the above mentioned aspects for claiming damages. He cannot, both retain the shares and get damages against the company. He must show that he has repudiated the contract for shares and has not acted as shareholder after discovering the fraud or misrepresentation.
- C] Remedies against the directors, promoters and experts: Damages can be claimed for any loss or damage to the subscribers for any shares or debentures on the faith of a prospectus containing untrue statements against the following persons.
- i. Directors at the time of issue of the prospectus.
 - ii. Persons who have authorized themselves to be named as directors in the prospectus
 - iii. Promoters and
 - iv. Persons who have authorized the issue of the prospectus.

These persons can be held liable for compensation for misstatement in prospectus, and for non-compliance with section 56 as well as under general law including Contract Act for fraud.

Criminal Liability

Under section 63 (1), where a prospectus includes any untrue statement, every person, who authorized the issue of the prospectus shall be punishable, with imprisonment for a term, which may extend to two years, or with fine, which may extend to fifty thousand rupees or with both. However, if he is able to prove that such statement was immaterial or that he had reasonable ground to believe the same that the statement was true, he will not be held responsible under this section. Section 63 (2) states that if a person has given the consent required by section 58 to the inclusion therein of a statement purporting to be made by him as an expert or the consent required by sub section (3) of section 60, then he shall not be deemed to have authorized the issue of a prospectus.

5.5 STATEMENT IN LIEU OF PROSPECTUS

A public company has to issue a prospectus if the shares or debentures are offered to the public. However a public company may not offer shares or debentures to general public but arranges to get money from private sources, it need not issue a prospectus to the public. In such cases, the company need not issue prospectus. Instead of that, 'Statement in lieu of prospectus' should be issued with contents as mentioned in Schedule III of the Act. A company having a share capital, and which does not issue a prospectus shall not allot any of its shares or debentures unless at least 3 days before the allotment of shares or debentures, it files with the Registrar a statement in lieu of prospectus. Every person, who is named as director in the statement should sign this statement and the statement shall be in the form and have the contents as mentioned in Schedule III of the Act. This section is not applicable to a private company.



STUDY NOTE - 6

SHARE CAPITAL

This Study Note includes:

- Introduction
- Types of Share Capital
- Alteration of Share Capital
- Reduction of Share Capital
- Variation of Shareholders Rights
- Further Issue of Capital

6.1 INTRODUCTION

Capital is required for any business, whether run by a sole proprietor or by a partnership organization or by a private or public limited company. A limited company raises capital by issue of shares. A public limited company can make a public appeal for the offer of its shares and debentures, while a private limited company cannot make a public appeal for the sale of its shares or debentures. Various types of share capital and the provisions of the Companies Act 1956 regarding the increase and decrease of share capital are explained in detail in the following paragraphs.

6.2 TYPES OF SHARE CAPITAL

The following are the types of share capital.

- I] **Authorized:** This is the maximum amount of share capital that a company can raise during its life time unless it is subsequently increased. This amount is mentioned in the Memorandum of Association of the company. The amount of authorized capital is divided into different types of shares and can be increased in future in case there is a need.
- II] **Issued Capital:** This is a part of the authorized capital, which is offered to the public for subscription. Normally, a company do not issue the entire capital in one installment and hence, certain portion of the authorized capital is offered to the public for subscription. For example, if ABC Ltd. is formed with an authorized capital of Rs.500 crores, divided into equity shares of Rs.100 each, which means that there are 5 crores shares of Rs.100 each, it may offer in the beginning shares of Rs.200 crores of Rs.100 each, which will be the issued share capital of this company.
- III] **Called Up Capital:** A company do not call the entire amount of the share capital in a single installment. For example, if the face value of a share is Rs.100, it may called in



installments, i.e. on application, allotment and on first and final call as decided by the Board of Directors. The amount called up on each share is the called up capital. For example, if the face value of a share is Rs.100 and as on 31st March 2008, Rs.50 has been called up, the called up capital will be Rs.50 per share.

- IV] **Paid Up Capital:** The entire amount of called up capital may not be received by the company. There may be some outstanding amount on shares. The amount actually received is known as paid up capital. For example, if amount called up is Rs.50 per share on 10000 shares and actual amount received is Rs.50 on 9000 shares only. The paid up capital will be Rs.50 X 9000 shares, i.e. Rs.450000.
- V] **Uncalled Capital:** This is the amount of capital, which is not called up. Thus in the above example, if the face value of share is Rs.100 and Rs.50 has been called up, the balance of Rs.50 is the uncalled capital. The company may call this amount in the future as per their requirements.
- VI] **Reserve Capital:** This is also uncalled capital but this amount can be called up only in the event of winding up of the company. A company may pass a special resolution decide to call a certain portion of its uncalled capital only in the event of the winding up of the company. [Section 99] Therefore this amount cannot be called during the lifetime of the company. Such capital is called as 'Reserve Capital' and it cannot be turned into uncalled capital without the sanction of the Court. The company is prohibited from charge reserve capital and similarly it cannot cancel such capital.

6.3 ALTERATION OF SHARE CAPITAL

A company can alter its share capital by various methods. As per Section 94 of the Companies Act 1956, a limited company having a share capital, may alter its share capital if authorized by its Articles of Association in the following manner.

- I] Increase its authorized capital by issuing new shares
- II] Consolidate its shares, either all the shares or certain number of shares into shares of larger amount. For example, if a company has shares of the face value of Rs.10, it may consolidate them into shares of Rs.100 each by consolidating 10 shares of Rs.10 each into one share of Rs.100 each.
- III] Convert its fully paid up shares into stock or vice versa
- IV] Sub-divide its shares, either all of them or a part thereof into shares of smaller denomination. For example, if face value of shares is Rs.100 each, they may be divided into 10 shares of Rs.10 each. Thus number of shares will increase but the total amount of share capital will remain the same.
- IV] A company can also cancel shares, which has not been taken up and the impact of the same is that the authorized capital will be reduced to that extent.

**PROCEDURE FOR ALTERATION:**

A company can alter its share capital in any of the above manner by passing an ordinary resolution in a general meeting. Cancellation of shares as per Section 94, shall not be deemed to be a reduction of share capital under the Companies Act. The company shall have to give the notice of alteration of capital to the Registrar within 30 days after effecting the change. However for reduction of share capital, there is a stringent procedure which should be followed. The procedure is given in the following paragraphs.

6.4 REDUCTION OF SHARE CAPITAL

Share Capital of a company is an extremely important component and is looked upon as a security for the creditors as well as for the shareholders. Therefore, reduction of share capital shall not be permitted unless it is as a result of,

- I] Forfeiture of shares or under statutory authority
- II] Strictly as per the procedure laid down in the Articles of Association. Any reduction of capital contrary to the principle is illegal and ultra vires.

PROCEDURE FOR REDUCTION OF SHARE CAPITAL:

The following are the provisions relating to the reduction of share capital.

I. Section 100 (1) provides that, subject to the confirmation by the Tribunal, a company limited by shares or a company limited by guarantee and having a share capital, may reduce its share capital if authorized by its articles of association and by passing a special resolution by any of the ways as mentioned below.

- a) Extinguish or reduce the liability on any of its shares in respect of share capital not paid up
 - b) Either with or without extinguishing or reducing liability on any of its share capital, cancel any paid up share capital, which is lost or is unrepresented by available assets or
 - c) Either with or without extinguishing or reducing liability on any of its shares, pay of any paid up share capital, which is in excess of the wants of the company and it may amend the memorandum of association by reducing the amount of share capital and of its shares accordingly.
- II. After passing a special resolution to that effect, it may apply by petition, to the Tribunal for an order confirming the reduction.
- III. Where the proposed reduction of share capital involves either the diminution of liability in respect of the unpaid share capital or the payment to any shareholder of any paid up share capital, and in any other case, if the Tribunal so directs, the following provisions shall be applicable subject to the provisions of sub section (3). Section 101 (2)



- a) Every creditor of the company shall be entitled to object the reduction.
- b) The Tribunal shall prepare a list of creditors who are entitled to object and may publish notices fixing a day or days within which creditors not entered on the list should claim to be entered on the list.
- c) Where a creditor, who is entered on the list of the creditors, whose claim is not settled or has not determined and hence does not consent to the reduction, the Tribunal may dispense with the consent of that creditor, on the company securing payment of his debt or claim by proper appropriation of the relevant amounts.
- IV] The Tribunal may direct that provisions of the above sub section (2) shall not be applicable to any class or classes of creditors if it feels it appropriate.
- V] If the Tribunal is satisfied that if the interests of all creditor, who are entitled to take objection have been properly protected, it may order confirming the reduction of share capital on certain terms and conditions as it may deem fit. [Section 102 (1)]
- VI] The Tribunal may pass an order directing the company to add the words 'and reduced' after the name of the company for a specific period. [Section 102 (2)]
- VII] The Tribunal may also direct the company to publish the reasons for reduction or such other information in regard thereto with a view to give the information to the public. [Section 102 (3)]
- VIII] Where a company has been ordered to add to its name, the words 'and reduced', those words shall, until the expiration of the period specified in the order, be deemed to be part of the name of the company.
- IX] The Registrar shall register the order given by the Tribunal and minute of reduction on receipt of the certified copy of the same and shall certify the registration of order and minute.

6.5 VARIATION OF SHAREHOLDERS' RIGHTS

According to section 106 of the Companies Act, the rights attached to any class of shares may be varied with the consent in writing of the holders of not less than 3/4th of the issued shares of that class or with the sanction of the special resolution passed at a separate meeting of the holders of the issued shares of that class provided that such provision exists in the memorandum or articles of association of that company. If such provision does not exist, a company can effect such changes provided the terms of issue of the particular class of shares do not prohibit such variation. Section 106 is applicable where a company has issued shares of different class.

6.5.1 RIGHTS OF DISSENTIENT SHAREHOLDERS :

Section 107 gives the following rights to the dissentient shareholder if any.

- I. If the rights attached to any class of shares are varied as per the provisions of section 107 as mentioned above if some of the shareholders are not consenting to such variation, the



holders of at least 10% of the issued shares of that class, who has not so consented to such variation, may apply to the Tribunal for cancellation of the variation and till the Tribunal confirms the variation, it shall not have any effect.

- II. An application to this effect shall be made to the Tribunal within 21 days of passing the resolution, and may be made on behalf of the shareholders who want to apply, by any one of them duly authorized in writing by them.
- III. After receipt of such an application and hearing of the same, if the Tribunal is satisfied that the variation would unfairly prejudice the shareholders of the class represented by the applicant, disallow the variation, otherwise it shall confirm the variation.
- IV. The decision of the Tribunal on such an application shall be final.
- V. The company shall, within thirty days after the receipt of the order, make an application along with the order to the Registrar. In case of any default, the company and every officer of the company, who is in default, shall be punishable with a fine, which may extend to five hundred rupees.

6.7 FURTHER ISSUE OF CAPITAL

A company can issue further share capital as per the provisions of Section 81. This section provides for further issue of capital through allotment of new share [Rights issue] and also through conversion of debentures or loans into shares. Both these aspects are discussed below.

I] Rights Issue: Section 81 (1) provides that, where at any time after the expiry of two years from the formation of a company or at any time after the expiry of one year from the allotment of shares in that company made for the first time after its formation, whichever is earlier, it is proposed to increase the subscribed capital of the company by allotment of further shares, then,

- a) Such issue shall be offered to the persons who, at the date of offer, are holders of the equity shares of the company in the same proportion as far as possible
- b) The offer shall be given by notice specifying the number of shares offered and limiting a time not being less than fifteen days from the date of the offer within which the offer, if not accepted, will be deemed to have been declined.
- c) A person, who is the holder of the shares, can renounce the shares offered to him or any of them in favor of any other person if the articles of association do not provide otherwise. The notice, mentioned above, shall include a clause to that effect subject to the provisions of the articles of association.
- d) After the expiry of the time specified in the notice, or on receipt of an earlier intimation from the person to whom such notice is given that he declines to accept the shares offered, the Board of Directors may dispose them off in such a manner as they think most beneficial to the company.



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- e) New shares may be offered to outsiders or any persons if a special resolution to that effect is passed by the company. Such an offer can be made by an ordinary resolution also with the approval of the Central Government. If the existing shareholders to whom the offer is made, refuse to accept the shares, new shares may be offered to outsiders. If the new shares are issued within 2 years from the formation of the company or 1 year of the allotment made for the first time, these new shares may be offered to outsiders.
- II] Conversion of Debentures of Loans into shares: As per provisions of Section 81 [Sub sections (4) to (7)], a company can convert debentures or loans into shares. The sections provide that where a company has taken any loans from the Central Government by issuing any debentures or otherwise, the Central Government may, in the public interest, convert such debentures or loans into shares of the company. The terms and conditions of such a conversion shall be as per determined by the Central Government. The terms and conditions shall be determined by the Central Government after considering various aspects like financial position of the company, terms of issue of the debentures or the terms of loans as the case may be, the rate of interest payable on the debentures or the loans, the capital of the company, its loan liabilities, its reserves, and its profits during the preceding 5 years and the current market price of the shares in the company. A copy of every order proposed to be issued by the Central Government shall be put in front of Each House of Parliament.

The authorized capital of the company shall stand increased after passing of the order to that effect by the Central Government.



STUDY NOTE - 7

SHARES

This Study Note includes

- Introduction - Meaning and types of shares
- Legal provisions regarding various aspects - allotment, calls, forfeiture of shares etc.

7.1 INTRODUCTION

In the previous study notes, we have seen the meaning of 'Company', its types and the formation procedures and formalities. A company raises its capital by issue of shares as well as by issue of debentures and raising term loans. In this topic, we will see the procedure regarding the issue of shares and the accounting methods. These are explained in the following paragraphs.

7.1.1 Definition

The total capital of a company is divided into units of small denominations. One unit is called as a 'share'. For example, if the total capital of a company is Rs.50,00,000 and it is divided into a unit of Rs.10 each, there will be 5,00,000 number of shares, each one of them of Rs.10 each. Thus we can say that the company has 5,00,000 shares of Rs.10 each. According to Companies Act 1956, section 2 [46], share has been defined as a share in the share capital of the company and includes stock except where a distinction between stock and share is expressed or implied. Shares must be numbered so that they may be identified, these are movable property and are transferable in the manner provided by the Articles of Association.

7.1.2 Types of Shares

Under the Companies Act, 1956, a company can issue three types of shares.

- I] Preference Shares
- II] Equity Shares
- III] Sweat Equity Shares

These types of shares are discussed below.

- I] Preference Shares: Preference shares are defined as those, which have a preferential right regarding,
 - A] Payment of dividend at a fixed rate during the life of the company and,
 - B] Return of capital when the company goes into liquidation.



It should be noted that the preference shareholders have a preferential right regarding the dividend over the equity shareholders when the dividend is paid. They do not have any right to get the dividend. Preference shareholders do not have voting right but they can exercise the same when their dividend is in arrears for more than two years in case of cumulative preference shares and for more than three years in case of non-cumulative preference shares. The following are the types of preference shares.

- i. **Cumulative Preference Shares:** A preference share is a cumulative preference share when the arrears of dividend are accumulated and such arrears are paid in priority as and when dividends are paid and in priority to the equity shareholders. For example, if a company is not able to pay dividends for two years due to insufficient profits, the arrears of this dividend will be paid when the dividends are declared in the third year. In other words, the preference shareholders do not lose the dividend even if it is not paid in some years due to insufficiency of profits. However if the company goes into liquidation, arrears of dividends are not payable unless they are either declared or Articles of Association contain express provision in this respect.
 - ii. **Non-cumulative Preference Shares:** A non-cumulative Preference Share is a share where the dividends do not accumulate. In other words, if dividend is not paid for a particular year, it will lapse.
 - iii. **Participating Preference Share:** The holder of these types of shares get a right to participate in the residual profits left after paying the preference and equity dividend.
 - iv. **Non-participating Preference Shares:** The holder of these types of shares do not have the right to participate in the residual profits left after paying the preference and equity dividend.
 - v. **Convertible Preference Shares:** A convertible Preference Share is that share which can be converted into Equity Share
 - vi. **Non-convertible Preference Share:** This type of share is not convertible into Equity Share
 - vii. **Redeemable Preference Share:** A redeemable Preference Share is a share, which is redeemable as per provisions of Section 80 of Companies Act 1956. It should be noted that no company limited by shares shall issue any Preference Share, which is redeemable after the expiry of a period of ten years from the date of its issue. Any Preference Share, called irredeemable, issued by a company before the commencement of the Companies [Amendment] Act 1988, shall be redeemed by the company within a period of five years from such commencement or which is not redeemable before expiry of 10 years from the date of issue shall be redeemed by the company on the date on which such share is due for redemption or within a period of 10 years from such commencement, whichever is earlier. Thus maximum period for redemption of the existing Preference Shares is 10 years.
- II] **Equity Shares:** An Equity Share is that share which is not a Preference Share. This means that the holders of Equity Shares do not have any preferential rights of receiving dividends. They will receive dividend only after the preference dividend has been paid. They also do not have any priority over Preference Shares regarding the repayment of capital at

the time of liquidation of the company. Equity shareholders, however have voting rights. The following are the points of difference between the Equity Shares and Preference Shares.

Sr. No.	Main Point	Equity Shares	Preference Shares
01	Voting Rights	Have the voting rights in general meetings of the company on all matters	Have no voting rights, however can vote when the dividend is in arrears for more than two years in case of cumulative preference shares and for more than three years in case of non cumulative preference shares.
02	Payment of dividend	No priority regarding dividend, gets dividend only after the preference dividend is paid	Have priority regarding dividend over equity shares as and when dividend is paid
03	Conversion	Cannot be converted	Can be converted into equity shares

04	Rate of dividend	Rate of dividend may fluctuate depending on the profits	Rate of dividend is fixed
05	Arrears of dividend	Arrears of dividend cannot accumulate	Arrears are accumulated in case of cumulative preference shares
06	Redemption	Cannot be redeemed during the life time of the company	Redemption can be made during the life time of the company

III] Sweat Equity Shares: A company may issue Sweat Equity Shares as per the provisions of Section 79 A of the Companies [Amendment] Act 1999. The relevant provisions are as follows.

- i. A company may issue Sweat Equity Shares of a class of shares already issued if the following conditions are fulfilled, namely
 - ❖ The issue of these shares is authorized by a special resolution passed by the company in the general meeting.
 - ❖ The resolution shall specify the number of shares, current market price, consideration if any and the class or classes of directors or employees to whom such equity shares are to be issued.
 - ❖ Not less than one year has, at the date of the issue elapsed since the date on which the company was entitled to commence the business.
 - ❖ The sweat equity shares of a company whose equity shares are listed on a recognized stock exchange are issued in accordance with the regulations made by the Securities Exchange Board of India in this behalf. However in the case of a company whose equity shares are not listed on any recognized stock exchange, the sweat equity shares are issued in accordance with the guidelines as may be prescribed.

7.2 LEGAL PROVISIONS REGARDING VARIOUS ASPECTS - ALLOTMENT, CALLS, FORFEITURE OF SHARES ETC.

7.2.1. Allotment of Shares

The procedure for allotment starts after the company receives application money on the shares offered to the public. Inviting applications is thus the first step and it is an invitation to offer.



The offer given by the applicants is either accepted or accepted in part or rejected. Allotment of shares in response to the applications is an acceptance of the offer given by the applicants and thus the contract between the company and the applicants is formed. Allotment of shares must be valid in the sense; the provisions of the Companies Act 1956 must be followed while allotting the shares to the applicants. The relevant provisions are as follows.

7.2.2 Allotment – Legal Provisions

The following are the provisions of the Companies Act regarding allotment of shares.

- a) Allotment shall not be made of any share capital of a company offered to the public for subscription, unless the amount stated in the prospectus as the minimum amount [minimum subscription] has been subscribed and the sum payable on application for the amount so stated has been paid to and received by the company, whether in cash or by cheque or other instrument, which has been paid.
- b) The amount payable on application of each share shall not be less than five per cent of the nominal [face] value of the share.
- c) All moneys received from applicants for shares shall be deposited and kept deposited in a Scheduled Bank till the certificate to commence the business is obtained under section 149 or if the certificate is already obtained till the amount of minimum subscription has been received by the company.
- d) If these conditions mentioned above have not been complied with on the expiry of 120 days after the first issue of the prospectus, all moneys received from applicants for shares shall be forthwith repaid to them without interest and interest @ 6% shall be charged if the amount is not repaid within 130 days after the first issue of the prospectus. It should be noted that the directors of the company, jointly and severally liable to pay the amount of interest at 6% per annum. A director shall not be so liable if he proves that the default in the repayment of money was not due to any misconduct or negligence on this part.
- e) Any condition purporting to require or bind any applicant for shares to waive compliance with any requirement of this section shall be invalid.
- f) The aforesaid conditions shall not apply in relation to any allotment of shares subsequent to the first allotment of shares offered to the public for subscription.
- g) A company, which has issued prospectus, shall not make any allotment of shares or debentures until the beginning of the fifth day after that on, which the prospectus is first so issued or such later time, if any, as may be specified in the prospectus. However, where, after a prospectus is first issued generally, a public notice is given by some person responsible under section 62 for the prospectus, which has the effect of excluding, limiting or diminishing his responsibility, no allotment shall be made until the beginning of the fifth day after that on, which such public notice is first given.
- h) The beginning of the fifth day or such later time as mentioned in the above point (g) in both the cases, is mentioned as 'the time of opening of the subscription list'.



- i) An application for shares in or debentures of, a company, which is made in pursuance of a prospectus issued generally shall not be revocable until after the expiry of the fifth day after the time of the opening of the subscription list or the giving, before the expiry of the said fifth day by some person responsible under section 62 for the prospectus, of a public notice having the effect under that section of excluding, limiting or diminishing the responsibility of the person giving it.
- j) In case of a company, which does not issue prospectus, but a statement in lieu of prospectus is issued, the company shall not allot any shares or debentures to the public, unless at least three days, before the first allotment of its shares or debentures, there has been delivered to the Registrar for registration a statement in lieu of prospectus signed by every person, who is named therein as a director or proposed director of the company or by his agent authorized in writing in the prescribed form and having contents as prescribed in Part I of Schedule III and , in cases mentioned in Part II of that Schedule, setting out the reports specified therein, and the said Parts I and II shall have effect subject to the provisions contained in Part Iii of that Schedule. Any adjustments made in these schedules shall be duly mentioned in writing and a written statement signed by the persons making such adjustments. [Section 70 (1)] This section shall not apply to a private company. Any contravention to this will attract a penalty for the company and every director who willfully authorizes or permits the contravention, which may extend to Rs.10, 000.
- k) Every company, which intends to offer shares or debentures to the public for subscription by the issue of prospectus, shall before such issue, make an application to one or more recognized stock exchanges for permission for the shares and debentures intending to be so offered to deal with in the stock exchange or each stock exchange. [Section 73] Where a prospectus, whether issued generally or not, states so, any allotment made on an application, in pursuance of such prospectus shall, whenever made, be void if the permission has not been granted by the stock exchange or each of the stock exchange as the case may be, before the expiry of ten weeks from the date of closing of the subscription lists. However if an appeal is made against the order of the stock exchange refusing the permission, such allotment shall not be void until the dismissal of the appeal.
 - Where such permission has not been applied or has been applied but not granted, the company shall forthwith repay all the moneys received from the applicants in pursuance of the prospectus within a period of eight days after the company becomes liable to repay the money. If any such money is not repaid within eight days, the company and every director of the company who is officer in default will be jointly and severally liable to repay that money with interest not less than 4% and not more than 15% as may be prescribed, having regard to the length of the period of delay in making the repayment of such money.
 - Where such permission has been granted and the money received from applicants for shares or debentures are in excess of the aggregate of the application moneys relating the issue of such shares or debentures, in respect of which the allotment is to be made, the company shall repay forthwith the excess application money without interest. If such moneys are not repaid within eight days, from the day the company



becomes liable to pay it, the company and every director of the company, who is officer in default shall, on and from the expiry of the eighth day, be jointly and severally liable to repay that money with interest at such rate, not less than 4% and not more than 15% as may be prescribed, having regard to the length of the period of delay in making the repayment of such money.

- ❑ All moneys received as mentioned above shall be kept in a separate bank account maintained in a Scheduled Bank until the permission is granted or when an appeal has been preferred against the refusal, till the disposal of such an appeal. If permission has been refused, the moneys become immediately payable as mentioned above. If default is made in complying these provisions, the company and every officer of the company who is in default, shall be punishable with a fine, which may extend to Rs.50000.
 - ❑ Amount standing to the credit of the bank account as mentioned above, shall be used only for the following purposes and not for any other purpose.
 - ❖ Adjustments against allotment of shares, where the shares have been permitted to be dealt in on the stock exchange or each stock exchange specified in the prospectus.
 - ❖ Repayment of moneys received from applicants in pursuance of the prospectus, where shares have not been permitted to be dealt in on the stock exchange or each stock exchange specified in the prospectus, as the case may be, or where the company is for any other reason unable to make the allotment of shares.
 - ❑ For the purpose of this section, it shall be deemed that permission has not been granted if the application for permission, where made, has not been disposed of within the time specified in sub section (1)
- 1) In reckoning for the purpose of the aforesaid sections, the fifth day or the eighth day after another day, any intervening day, which is a public holiday under the Negotiable Instruments Act 1881, shall be disregarded and if the fifth or eighth day itself is a public holiday, the next preceding day shall be taken.

7.2.3 Effect Of Irregular Allotment

An allotment made by a company in contravention of the above- mentioned provisions shall be voidable at the instance of the applicant,

- ❑ Within two months after the holding of the statutory meeting of the company and not later or,
- ❑ In any case, where the company is not required to hold a statutory meeting or where the allotment is made after the holding of the statutory meeting, within two months after the date of the allotment and not later.
- ❑ The allotment shall be voidable as aforesaid, notwithstanding that the company is in course of winding up.



- ❑ Any director of a company, who willfully contravenes, or willfully authorize or permits the contravention of any of the provisions mentioned above in respect of the allotment, he shall be liable to compensate the company and the allottee respectively for any loss, damages or costs, which the company or the allottee may have sustained or incurred thereby.

7.2.4 Return as to Allotments

- 1) A company having share capital and making allotment of the shares shall file a return within 30 days thereafter, stating in the same, the number and nominal amount of shares allotted, the names, addresses and occupations of the allottees and the amount if any paid or due and payable on each shares. Shares allotted for cash and if cash is not received on the same, shall not be included in this return.
- 2) The contract in writing with the allottees in case fully paid or partly paid shares are issued for consideration other than cash. The return shall show the nominal value and the number of shares allotted, the extent to which they are to be treated as paid up and the consideration for which they have been allotted. If the contract is not reduced in writing, the company shall within thirty days after the allotment, file with the Registrar, the prescribed particulars of the contract with the proper stamp duty.
- 3) In case of bonus shares, the return shall state the number and nominal value of shares, along with the names, addresses and occupations of the allottees and a copy of the resolution authorizing the issue shall be enclosed.
- 4) In case of shares issued at discount, a copy of the resolution authorizing the issue together with the a copy of the order of the Tribunal sanctioning the issue and where the maximum rate of discount exceeds 10%, a copy of the order of the Central Government permitting the issue at the higher percentage.

7.2.5 Issue of Shares at Premium and Discount

Issue of Shares at Premium

A company can issue shares at premium, which means issue of shares at more than face value. For example, a share of the face value of Rs.10 may be issued at Rs.15, which means there is a premium of Rs.5 per share. The following are the provisions of the Companies Act 1956 regarding the shares issued at premium. [Section 78]

- 1) The amount equal to the amount of premium received on issue of shares shall be transferred to an account to be called as 'Securities Premium Account' and the provisions of the Act, relating to the reduction of the share capital of a company shall, except as provided in this section, apply as if the Securities Premium Account were paid up share capital of the company.
- 2) The Securities Premium Account shall be applied by the company –
 - a) In paying up the unissued shares of the company to be issued to the members of the company as full paid bonus shares.



- b) In writing off the preliminary expenses of the company.
 - c) In writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company.
 - d) In providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company.
- 3) Where a company has, before the commencement of this Act, issued any shares at a premium, this section shall apply as if the shares had been issued after the commencement of the Act.

Shares Issued at Discount

A company can issue shares at discount, which means receiving of less amount as compared to the face value of the shares. For example, if the face value of shares is Rs.10 and if it is issued at a discount of 10%, it means that the amount receivable on each share will be Rs.9. The provisions of the Companies Act 1956 regarding the issue of shares at discount are as follows. [Section 79]

- 1) A company shall issue shares at discount as per the provisions of the section 79
- 2) A company may issue shares at discount of a class already issued if the following conditions are fulfilled.
 - i. Issue of shares at discount should be authorized by a resolution passed by the company in general meeting and sanctioned by the Central Government.
 - ii. The maximum rate of discount is specified in the resolution. However the Central Government shall not sanction any resolution if the maximum rate of discount specified in the resolution exceeds 10% unless it is of the opinion that the higher rate of discount may be allowed in the special circumstances.
 - iii. Not less than one year has at the date of the issue have elapsed since the date on which the company was entitled to commence business.
 - iv. The shares to be issued at a discount are issued within two months after the date on which the Central Government sanctions the issue or within any extended time as allowed by the Central Government.
- 3) A company may apply to the Central Government for sanctioning the issue of shares at discount after passing a resolution authorizing the issue of shares at a discount.
- 4) Particulars of the discount allowed shall be disclosed in the prospectus. Any such discount not written off at the date of issue of the prospectus shall also be mentioned. Any default committed shall attract a penalty to the company and every officer of the company who is in default, which may extend to Rs.500.



7.2.6 Calls on Shares

Section 91 of the Companies Act 1956 provides that where any calls are to be made on shares, such calls shall be made on uniform basis on all shares of the same class.

7.2.7 Transfer of Shares:

One of the features of a company is the transferability of its shares. Shares of a public limited company are transferable freely, while in case of private limited companies, there can be restrictions on the same. The procedure for share transfer is mentioned in the Articles of Association of a company. Legal provisions of transfer of shares are discussed below. [Section 108]

- 1) For registering transfer of shares or debentures, a proper instrument of transfer, which is duly stamped and executed by or on behalf of transferor and by or on behalf of transferee, should be delivered to the company. The instrument should contain the names, addresses and occupations of the transferor and transferee and should be submitted along with the share or debenture certificates or if no such certificates are in existence, along with the letter of allotment of shares or debentures.
- 2) Every instrument shall be in the prescribed form and before it is signed by the transferor and before any entry is made therein, shall be presented to the prescribed authority, which shall stamp or otherwise endorse thereon the date on which it is presented. [Section 108 (1 A)]
- 3) Every instrument getting stamped or getting endorsed, and complete in all respect and executed by or on behalf of the transferor and the transferee, be delivered to the company within a period of 12 months from the date of such presentation in case of shares and debentures are dealt in or quoted on a recognized stock exchange.
- 4) In any other case, the instrument of transfer shall be delivered to the company within a period of 2 months of such presentation to the prescribed authority.
- 5) Every body corporate or bodies corporate under the same management, holding, whether singly or in the aggregate, ten per cent or more of the nominal value of the subscribed equity share capital of any other company shall, before transferring one or more of such shares, give to the Central Government an intimation of its or their proposal to transfer of such shares, and every such intimation shall include a statement regarding the particulars of the shares to be transferred, the names and addresses of the person/s to whom the transfer is to be made and the shareholding of the transferee if any in the concerned company and any such particulars as may be prescribed. [Section 108 B (1)]
- 6) If the Central Government is of the opinion that as a result of transfer mentioned in the above section 108 B (1), a change in the composition of the Board of Directors of the company is likely to take place and such a change would be prejudicial to the interests of the company or the public interest, it may direct that the shares should not be transferred to the proposed transferee. [Section 108 B (2) (a)]



- 7) Where such shares are held in a company engaged in any industry specified in Schedule XV, such shares shall be transferred to the Central Government or to such corporation owned or controlled by that Government as may be specified in that direction. [Section 108 B (2) (a)]
- 8) As per the direction of the Central Government, the shares mentioned in the above point, shall be transferred to the Central Government or the specified corporation as the case may be and the Central Government or the specified corporation as the case may be, shall pay cash to the body corporate equal to the market value of such shares. [The market value means in the case of shares quoted on the registered stock exchange, the values quoted on such stock exchange on the date immediate preceding date on which the order for transfer is made and in any other case, such value as may be mutually agreed upon between the holder of the share and the Central Government or the specified corporation or in the absence of such an agreement, as decided by the Court. [Section 108 B (3)]
- 9) If there is no dispute, the market value shall be paid forthwith. If there is a dispute, an estimated value shall be paid by the Central Government or the concerned corporation forthwith and the balance shall be paid within 30 days from the date of settlement of dispute by the Court.
- 10) If the Central Government does not give any direction under sub section 1 of Section 108 [Mentioned in point no.5] the provisions in the sub section (2) shall not apply.
- 11) Transfer of Shares of Foreign Companies: Section 108 C provides for restrictions on the transfer of shares of foreign companies. According to this section, no body corporate or bodies corporate under the same management, which holds or hold in the aggregate, ten per cent or more of the nominal value of the equity share capital of a foreign company, having an established place of business in India, shall transfer any share in such foreign company to any citizen in India or any body corporate incorporated in India except with the previous approval of the Central Government and such previous approval shall not be rejected unless the Central Government is of the opinion that such transfer would be prejudicial to the public interest.
- 12) Direction by the Central Government for Refusal of Transfer: According to section 108 D, the Central Government has the power to direct a company to refuse transfer of shares. Sub section (1) of section 108 C provides that if the Central Government is satisfied that due to transfer of share or a block of shares of a company, there will be change in the controlling interest of the company and such change would be prejudicial to the interest of the company or to the public interest, it may direct the company not to give effect to the transfer. However if the transfer of shares or a block of shares has already been recorded, the Central Government shall direct the transferee or his nominee, not to exercise the voting rights or other rights attached to these shares. If the transfer is not registered, the Central Government shall direct the transferor or his nominee not to exercise any voting right or any rights attached to the shares. Where the Central Government directs for not to register the transfer of shares or block of shares, the shares or block of shares shall stand re transferred to the person from whom it was acquired, and the amount paid by the trans-



feree for the acquisition shall be repaid to the transferor. [Section 108 D (2)] If the refund is not made within thirty days from the direction given by the Central Government, the Central Government shall direct the transferor to refund of the amount, on the application of the person entitled for such refund. After making such refund, the person to whom such shares or block of shares have been re transferred shall be entitled to the voting or other rights attached to such shares or block of shares. The Central Government shall have to communicate its approval to the transfer of shares within a period of sixty days for any application made under section 108 A or 108 C and if the same has not been accorded within this time limit, the approval shall be deemed to have been granted.

- 13) **Penalty for Offences:** If any person or body corporate contravenes with any provisions regarding the transfer of shares, it shall be punishable with a fine, which may extend to Rs.50000.
- 14) **Application for Transfer:** According to section 110 (1), an application for the registration of transfer of the shares or other interest of a member in a company may be made by either by the transferor or transferee. If the transfer is for partly paid shares, the company before registering the transfer, shall give notice to the transferee for procuring a no objection from him within a period of two weeks from the receipt of the notice. The notice shall have to be served by a registered post.

7.2.8 Transmission of Shares:

There is a difference between transfer of shares and transmission of shares. While result of both of them is the same, transfer is for value while transmission means transfer of title of shares to a nominee on the death of the original owner of the shares. The provisions of Companies Act 1956, regarding the transmission of shares are as follows. [Section 109 B]

- 1) A person becomes nominee of shares under section 109 A. The procedure is that any holder of shares or debentures nominates a person as his nominee by declaration in a prescribed form. The result of nomination is that the shares or debentures standing in the name of the holder shall vest in the name of nominee in the even of death of the original holder. If the nominee is a minor, the holder of the share shall have to nominate a person in whom the shares or debenture shall vest in the even of his death during the minority of the nominee.
- 2) On the death of the original holder, the nominee shall have to produce evidence of his nomination and he can either choose to become shareholder or transfer his shares as the deceased shareholder or debenture holder would have been made as the case may be.
- 3) If the nominee elects to become shareholder, he shall give a notice to the company about his intention to become shareholder accompanied by the death certificate of the original shareholder / debenture holder.
- 4) All restrictions, limitations and provisions of the Act relating to the right to transfer and the registration of transfer of shares or debentures shall be applicable to any such notice and transfer.



- 5) A person becoming shareholder by virtue of his nomination shall be entitled to all membership rights including dividends and voting rights after he is registered as member but not before that.
- 6) The Board of Directors may give a notice to such nominee either to elect to become member or transfer his shares. If no reply is received within 90 days of the serving of such notice, the Board shall withhold payment of all dividends, bonuses or other moneys payable in respect of the shares or debentures until the requirements of the notice have been complied with.

7.2.9 Appeal Against Refusal for Registration: [Section 111]

- 1) If a company refuses to register transfer or transmission of shares in pursuance of power given to it by the articles of association or otherwise, it must inform to the transferor and transferee within two months from the date of lodging the instrument of transfer. [Section 111 (1)]
- 2) The transferor or transferee or the person who has given intimation of transmission, may appeal to the Tribunal within two months of the receipt of notice of refusal or when no notice has been sent, within four months of lodging the instrument of transfer.
- 3) A person may also appeal to the Tribunal for rectification of register of members if either his name is entered into the register of members without sufficient cause or after having registered in the register, is without sufficient cause omitted there from or a default is made or unnecessary delay is made in entering in the register the fact that the person has become member or has ceased to be the member.
- 4) After hearing the appeal, the Tribunal shall either allow or dismiss such appeal and give appropriate directions to the company.
- 5) If any default is made by the company in giving effect to the orders of the Tribunal, the company and every officer in default shall be punishable with a fine, which may extend to Rs.10000 and up to Rs.1000 per day for every day after the first day after which the default continues.

7.2.10 Share Certificates:

3. **SHARE WARRANTS:** Share Warrant is a bearer instrument. A public company, limited by shares can issue share warrant for its fully paid up shares provided it is authorized by the articles of association and with the previous approval of the Central Government. The holder of the warrant shall be entitled to the shares therein specified, and the company may provide, by coupons or otherwise, for the payment of the future dividends on the shares specified in the warrant. The following are the provisions in this respect of the Companies Act 1956.
 - 1) On the issue of a share warrant, the company shall strike out of its register of members, the name of the member who is now holder of the share warrant and shall enter in that register the following particulars.



- a) The fact of the issue of the warrant.
 - b) A statement of the shares specified in the warrant, distinguishing each share by its member and,
 - c) The date of issue of the warrant.
- 2) The bearer of the share warrant shall be entitled to cancel the share warrant as per the procedure laid down in the articles of association and after payment of the prescribed fees to the Board of Directors.

7.2.11 Forfeiture of Shares

If a shareholder defaults in the payment of the installments in the issue price of a share called by the company, the Board of Directors may decide to forfeit the shares held by the defaulting shareholders by following the procedure as laid down in the Articles of Association of the company. In the absence of the Articles of Association, Table A requires that a notice of 14 days is to be given before the forfeiture is made and if the shareholder fails to pay the dues within this period, the Board of Directors, may be passing resolution in the Board meeting, decide to forfeit the shares. As a result of forfeiture, the shares are cancelled and the name of the concerned shareholder is struck off the Register of Members. Forfeited shares can be re-issued by the company if they are not cancelled.

7.2.12 Surrender of Shares

BUY BACK OF SHARES: Section 77A (1) of the Companies Act, provides for power of a company to buy back of its shares or other securities. Subject to the provisions of 77A, sub section 2 and section 77B, a company may purchase its own shares or other specified securities [called as buy back] out of,

- i. Its free reserves, or
- ii. The securities premium account or
- iii. The proceeds of any shares or other specified securities.

Buy-back of shares shall not be allowed out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.

Section 77A, sub section (2) provides that buy back of shares as mentioned in sub section (1) above, shall be effected subject to the following provisions.

- (2)
- a) The buy back is authorized by the articles of association.
 - b) A special resolution has been passed in the general meeting of the company authorizing the buy back. This clause shall not be applicable, where the buy back is or less than 10% of the total paid up equity capital and free reserves of the company and such buy back has been authorized by the Board by means of a resolution passed at its meeting.

No offer of buy back shall be made within a period of three hundred and sixty five days reckoned from the date of the preceding offer of buy back if any.



- c) The buy back is either 25% or less than 25% of the total paid up capital and free reserves of the company. Buy back of equity shares in a financial year shall not exceed 25% of its total paid up equity capital in the financial year.
- d) The debt equity ratio of the company should not be more than 2:1 after such buy back. [Equity will include capital + Free reserves] However, the Central Government may provide for a higher ratio under this clause for a class or classes of companies. Debt for this clause includes all secured and unsecured debts.
- e) All the shares subject to buy back should be fully paid up.
- f) The buy back of shares or other securities listed on any stock exchange should be as per the regulations made by the Securities and Exchange Board of India.
- g) The buy back of the shares or other specified securities other than those specified in (f) should be as per the prescribed guidelines.

Sub section (3) provides that, the notice of the meeting at which special resolution is proposed to be passed; shall be accompanied by an extra ordinary statement stating,

- a) A full and complete disclosure of all material facts
 - b) The necessity for buy back
 - c) The class of security intended to be purchased under the buy back
 - d) The amount to be invested under the buy back and
 - e) The time limit for completion of buy back.
- (4) Every buy back shall be completed within a period of 12 months from the date of passing a special resolution
- (5) The buy back under sub section (1) may be,
- a) From the existing security holders on a proportionate basis or
 - b) From the open market or
 - c) From the odd lots or
 - d) By purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.
- (6) Where the company has passed a special resolution under clause (b) of sub section (2) or the Board has passed a resolution under the first proviso to clause (b) of that sub section to buy back of its own shares or other securities under this section, it shall before making such buy back, file with the Registrar and the SEBI, a declaration of solvency in the form as may be prescribed and verified by an affidavit to the effect that the Board has made full enquiry into the affairs of the company as a result of which, they have formed an opinion that it is capable of meeting its liabilities and will not be rendered insolvent within a period of one year of the date of declaration adopted by the Board, and signed by at least two directors of the company, one of whom shall be the managing director, if any. Such declaration shall not be required if the shares of a company are not listed on any stock exchange.



- (7) After buy back of its own securities, the company shall extinguish and physically destroy the securities so brought back within seven days of the last date of completion of buy back.
- (8) When a company has made a buy back of its shares or other specified securities, it shall not make any fresh issue of the shares of the same kind or other specified securities within a period of six months except by way of bonus shares or in the discharge of subsisting obligations such as conversion of warrants, stock option schemes, sweat equity or conversion of preference shares or debentures into equity shares.
- (9) A register of the securities purchased, giving details of the consideration paid for the buy back, the date of cancellation of securities, the date of extinguishing and physically destroying of securities and such other particulars as may be specified shall be maintained by the company.
- (10) A return showing the prescribed particulars of buy back shall be filed by the company with the Registrar within 30 days of the date completion of buy back.
- (11) Any default made in complying with the above mentioned provisions, shall attract a punishment, which shall be imprisonment up to 2 years or with a fine which may extend to Rs.50000 or with both to the company or any officer of the company who is in default.

Section 77AA provides that, when a company purchases its own shares out of free reserves, then an amount equal to the nominal value of shares so purchased, shall be transferred to the capital redemption reserve account and details of such transfer shall be disclosed in the Balance Sheet.

Section 77B, prohibits buy back of in certain circumstances. This section provides that,

- (1) No company shall directly or indirectly purchase its own shares or other specified securities,
 - a) Through any subsidiary company including its own subsidiary companies or
 - b) Through any investment company or group of investment companies or
 - c) If a default by the company in repayment of deposit or interest payable thereon, redemption of debentures or preference shares or payment of dividend to any shareholder or repayment of any term loan or interest payable thereon to any financial institutions or bank is subsisting.
- (2) No company shall directly or indirectly purchase its own shares or other specified securities in case such company has not complied with the provisions of sections 159, 207 and 211.

DIVIDENDS:

1. **INTRODUCTION:** Dividend is a part of profit, which is distributed among the shareholders in proportion to the shares held by them. A company has to strike a balance between too liberal dividend policy and too conservative dividend policy. The Companies Act



1956 does not make it compulsory for a company to pay dividend on equity shares. Similarly there are no restrictions also on the rate of dividend declared by a company. In case of preference shares, the rate of dividend is fixed as per the terms of issue. If the preference shares are cumulative preference shares, dividend on the same goes on accumulating. Thus if in a particular year, the company is not able to declared dividend and in the next year, it is able to do so, the preference shareholders will get the dividend of the current year along with the arrears of the previous year. There are exhaustive provisions in the Companies Act 1956, regarding the declaration of dividends. These provisions are discussed in the following paragraphs.

2. **DIVIDENDS – LEGAL PROVISIONS:** The following are the provisions regarding the declaration and payment of dividends.
 - I] No dividend shall be declared or paid by a company for any financial year except out of profits of the company for that year arrived at after providing depreciation in accordance with the provisions of sub-section (2) of section 205. Dividends can also be paid out of profits of the company for any previous financial year or years arrived at after providing for depreciation as per the provisions of the sub-section mentioned above or can paid be paid out of both, current years profit as well as the previous years profit or out of moneys provided by the Central Government or State Government for the payment of dividend in pursuance of a guarantee given by that Government.
 - II] The Board of Directors recommends the dividends. The recommendation is to be approved by the annual general meeting by passing an ordinary resolution. The annual general meeting can suggest reduction in the rate of dividend as recommended by the Board of Directors, but it cannot suggest increase in the rate of dividend.
 - III] The Board of Directors may declare interim dividend. Interim dividend is a dividend declared between two annual general meetings. Interim dividend does not require the sanction of the annual general meeting.
 - IV] The amount of dividend including the interim dividend if any shall be deposited in a separate bank account within five days from the date of declaration of such dividend.
 - V] After the commencement of Companies [Amendment] Act 1974, no dividend shall be declared or paid by a company for any financial year out of profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of sub-section (2) except after the transfer to the reserves of the company of such percentage of its profits for that year, not exceeding ten per cent, as may be prescribed. However, a company can transfer voluntarily more than ten per cent of the profits to reserves in accordance with the rules, which may be made by the Central Government in this regard.
 - VI] Dividends shall be payable only in cash.
 - VII] Dividends shall be paid only to the registered shareholder or to his order or to his banker. In case a share warrant has been issued as per section 114, the dividend shall



be paid to the bearer of such warrant or to his bankers.

VIII] Where any instrument of transfer of shares has been delivered to any company for registration and the transfer of such shares has not been registered by the company, it shall,

- a) Transfer the dividend on such share to the special account as mentioned in section 205 A unless the company is authorized by the registered holder of such share in writing to pay such dividend to the transferee specified in the instrument of transfer and,
- b) Keep in abeyance in relation to such shares any offer of rights shares as per section 81 and any issue of fully paid up bonus shares.

IX] Dividends shall be paid within 30 days from the date of declaration. If it remains unpaid to or unclaimed by any shareholder, who is entitled to the dividend, the company shall within 7 days of the expiry of such period transfer the total amount of such unpaid or unclaimed dividend to a special account to be called as, 'Unpaid Dividend Account of — Company Ltd./Pvt.Ltd.

X] Any amount transferred to 'Unpaid Dividend Account' and remaining unpaid or unclaimed for a period of seven years from the date of such transfer shall be transferred by the company to the Fund established under sub-section (1) of section 205 C. [Section 205 C sub section (1)]

XI] At the time of transfer of such amount of the unpaid or unclaimed dividend to the fund, mentioned above, the company shall furnish to the prescribed authority or committee as the Central Government may appoint, a statement showing the amounts of such transfer, the names and last known addresses of the concerned persons entitled to receive the amount and the nature of his claim and other particulars as may be prescribed. The company shall be entitled to get a receipt of all such amounts deposited in the funds and the receipt shall be an effective discharge of the company in respect thereof.

XII] If a company declares dividend but does not pay the same within 30 days or the dividend warrant has not been posted within 30 days from the date of declaration, to any shareholder who is entitled to such dividend, every director shall be punishable with a simple imprisonment of a term, which may extend to 3 years and shall also be liable to a fine of Rs.1000 per day for every day during which such default continues of the director is knowingly a party to such default. The company shall also be liable to pay simple interest of 18% per annum during the period for which such default continues. [Section 207]

XIII] Under the following circumstances, there shall be no offence under the above section.

- ❖ Where the dividend could not be paid by reason of the operation of any law.
- ❖ Where shareholder has given directions to the company regarding the payment of the dividend and those directions cannot be complied with



- ❖ Where there is a dispute regarding the right to receive the dividend.
- ❖ Where the dividend has been lawfully adjusted by the company against any sum due to it from the shareholder or
- ❖ Where, for any other reason, the failure to pay dividend or to post the warrant within the period aforesaid was not due to any default on the part of the company
- ❑ **PAYMENT OF INTEREST OUT OF CAPITAL:** As per the provisions of section 208, a company has the power of payment of interest out of capital in certain cases. The provisions are summarized as given below.
- ❑ Sometimes shares of a company are issued for raising money to defray the expenses of the construction of any work or building or the provision of any plant, which cannot be made profitable for a long period. In such cases, the company may pay interest on the paid up capital on certain conditions and restrictions as mentioned in sub sections (2) to (7). The amount of such interest can be charged to capital as part of the cost of construction of the work or building or the provision of the plant. The conditions and restrictions as mentioned in sub sections (2) to (7) are as follows.
 - a) Such payment should be authorized by the articles or by a special resolution.
 - b) There should be a prior sanction of the Central Government for the payment though it is sanctioned by the articles or by a special resolution.
 - c) Before sanctioning the payment, the Central Government may conduct an inquiry by appointing a person, who is required to submit a report to the Central Government. Such an inquiry will be made at the expenses of the company and the Central Government may ask the company to furnish security towards the payment of the costs of the inquiry.
 - d) The period for which the payment is to be made shall be determined by the Central Government and it shall not exceed beyond the close of the half year next after half year during which the work or building has been actually completed or the plant provided.
 - e) The rate of interest shall not exceed in no case, four per cent per annum or such other rate as the Central Government may direct and published in the official gazette.
 - f) The payment of interest shall not operate as a reduction of the amount paid up on the shares in respect of which it is paid.



STUDY NOTE - 8

ACCOUNTS AND AUDIT

This Study Note includes

- Introduction
- Legal Provisions regarding Audit
- Powers and duties of Auditors
- Cost Audit
- Special Audit

8.1 INTRODUCTION

So far we have seen the provisions of the Companies Act 1956 regarding the 'Accounts'. Now in this chapter, we will be discussing the provisions of the law regarding 'Audit'. It is mandatory for a limited company to get the accounts audited before they are presented to the Annual General Meeting. The word 'Audit' has come from the word 'Audire', which means to hear. Objectives of audit are as follows. In this chapter, we propose to discuss the legal provisions of the Companies Act 1956 regarding audit of its accounts. These provisions are discussed below.

8.2 LEGAL PROVISIONS REGARDING AUDIT

The following are the provisions of Companies Act regarding audit.

A] Appointment and Remuneration of Auditors:

- I] The first auditor or auditors of the company shall be appointed by the Board of Directors within one month of the date of registration of the company, and the auditor / auditors so appointed shall hold office until the conclusion of the first annual general meeting. [Section 224 (5)]

It can be understood from the above section that the authority to appoint the first auditor/s vests with the Board of Directors. Actually the authority to appoint auditor/s is with the annual general meeting, but since in case of the first auditor/s it is not practically possible, the authority is given to the Board of Directors.

The Company Law further provides that,

- a) the company may, at a general meeting, remove any such auditor or all or any of such auditors and appoint in his or their place any other person or persons who have been nominated for appointment by any member of the company and of whose nomination notice has been given to the members of the company not less than fourteen days before the date of the meeting and,



- b) if the Board fails to exercise its powers under this sub section, the company in general meeting may appoint the first auditor or auditors.
- II] As the first auditor/s will hold the office till the conclusion of the first annual general meeting, every company shall, at each annual general meeting appoint an auditor or auditors to hold office from the conclusion of that meeting until the conclusion of the next annual general meeting, and shall give intimation to every auditor or auditors appointed within seven days of the appointment.
- III] The remuneration to be paid to the auditor or auditors shall be decided by the annual general meeting except in case of an auditor appointed by the Board or Central Government, the remuneration may be fixed by the Board or by the Central Government.
- IV] Subject to the provisions of Sub-section [1-B] and Section 224-A, at any annual general meeting, a retiring auditor, by whatsoever authority appointed, shall be re-appointed, unless,
- i) he is not qualified for re-appointment
 - ii) he has given the company a notice in writing of his unwillingness to be re-appointment
 - iii) a resolution has been passed at that meeting appointing somebody instead of him or providing expressly that he shall not be re-appointed, or
 - iv) where a notice has been given of an intended resolution to appoint some person or persons in the place of the retiring auditor, and by reason of the death, incapacity or disqualification of that person or all those persons, as the case may be, the resolution cannot be proceeded with.
- V] If at an annual general meeting, no auditors are appointed or re-appointed, the Central Government may appoint a person to fill the vacancy.
- VI] The company shall, within seven days of the Central Government's powers mentioned above, becoming exercisable, give notice of that fact to that Government, and if a company fails to give such notice, the company and every officer of the company who is in default, shall be punishable with fine, which may extend to five hundred rupees.
- VI] If there is any casual vacancy in the office of an auditor, the Board may fill up the same. However the remaining auditor or auditors may continue to Act during such vacancy. If the vacancy is caused by resignation of an auditor, the vacancy shall be filled only by the company in the general meeting. Any auditor appointed in such a casual vacancy shall hold office until the conclusion of the next annual general meeting.
- B] Appointment Of An Auditor By Special Resolution:** An auditor is appointed by the company in annual general meeting by an ordinary resolution. However in the following case, an auditor is to be appointed by special resolution only.

In the case of a company in which not less than 25% of the subscribed capital is held, whether singly or in any combination, by –



- a) A public financial institution or a Government company or Central Government, or
- b) Any financial or other institution established by any Provincial or State Act, in which a State Government holds not less than fifty one per cent of the subscribed share capital, or
- c) A nationalized bank or an insurance company carrying on general insurance business.

In such case, the appointment or re-appointment at each annual general meeting of an auditor shall be made by a special resolution.

C] Restrictions on the appointment of Auditors: A company shall not appoint or re-appoint any person, who is in full time employment elsewhere or firm as its auditor if such person or firm is, at the date of such appointment or re-appointment, holding appointment as auditor of more than the specified number of companies. The specified number of companies is as follows.

- a) In the case of a person or firm holding appointment as auditor of a number of companies, each of which has a paid up share capital of less than rupees twenty five lakhs, twenty such companies.
- b) In any other case, twenty companies, out of which not more than ten shall be companies each of which, has a paid up share capital of rupees twenty five lakhs or more.
- c) In the case of a firm of auditors, specified number of companies shall be construed as the number of companies specified for every partner of the firm who is not in full time employment elsewhere.

D] Qualifications And Disqualifications of Auditors: Section 226 makes provisions regarding the qualifications and disqualifications of an auditor. These provisions are as follows.

- I. A person shall not be qualified for appointment as auditor of a company unless he is a chartered accountant within the meaning of the Chartered Accountants Act of 1949. [Section 226 (1)]
- II. A firm, where all partners are chartered accountants can also be appointed as auditors of a company.
- III. The person should be holder of a Certificate of Practice from the Institute of Chartered Accountants of India.
- IV. The following persons shall not be eligible of being appointed as auditors of a company.
 - ☐ A body corporate
 - ☐ An officer or employee of the company
 - ☐ A person, who is a partner or who is in the employment, of an officer or employee of the company



- ❑ A person who is indebted to the company for an amount exceeding rupees one thousand or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding one thousand rupees.
 - ❑ A person holding any security of that company after a period of one year from the date of commencement of the Companies [Amendment] Act, 2000
- V. A person shall also not be qualified for appointment as auditor of a company if he is, by virtue of sub section (3), disqualified for appointment as auditor of any other body corporate, which is that company's subsidiary or holding company or a subsidiary of that company's holding company, or would be so disqualified if the body corporate were a company.
- VI. If an auditor becomes subject, after his appointment, to any of the disqualifications mentioned above, he shall be deemed to have vacated his office as such.

8.3 POWERS AND DUTIES OF AUDITORS

Section 227 of the Companies Act specifies the powers and rights of an auditor. Accordingly the rights and powers of an auditor are as follows.

- 1) Every auditor shall have a right to access at all times to the books and accounts and vouchers of the company, whether they are kept at the head office or elsewhere. He shall also be entitled to require from the officers of the company such information and explanations as required by him. [Section 227 (1)]
- 2) The auditor shall have the right to inquire about the following. [Section 227 (1A)]
 - a) Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members.
 - b) Whether transactions of the company, which are represented merely by book entries are not prejudicial to the interests of the company.
 - c) Where the company is not an investment company within the meaning of section 372 or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than at which they are purchased by the company.
 - d) Whether loans and advances made by the company have been shown as deposits.
 - e) Whether personal expenses have been charged to revenue account
 - f) Where it is stated in the books and papers of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.



- 3) The auditor has the right to make a report to the members of the company on the accounts examined by him and on every balance sheet and profit and loss account and on every other document examined by him. The report shall state whether, in his opinion and to the best of his information and according to the explanations given to him, the said accounts give the information as required by the Act in the prescribed manner and give a true and fair view of the state of affairs of the company as regards to the balance sheet and in the case of profit and loss account, of the profit or loss due for its financial year.
- 4) The auditor shall have a right to visit branch office and have a right to access the books of accounts and vouchers maintained at the branch office.
- 5) The auditor shall have a right to receive notice of the annual general meeting and to attend the same.
- 6) The auditor shall have the right to receive remuneration for auditing the accounts of a company.

DUTIES OF AUDITORS: The following are the duties of auditors.

- 1) The auditor of a company should acquaint himself with the articles of association and memorandum of association of the company as well as with the Companies Act.
- 2) The auditor has to perform his work in a professional manner and he should exercise reasonable care and skill in the performance of his duties. He need not be suspicious all the time but whenever he feels that a particular matter is suspicious, he should probe the same thoroughly. It is said that, 'an auditor should be watch dog and not a blood hound'.
- 3) An important duty of an auditor is to make a report on the accounts of the company and submit the same to the members in an annual general meeting. It should be noted that the auditor is appointed by the members in the annual general meeting and he is accountable to them. He has to state in his report, whether the accounts of the company show a true and fair view of the affairs of the company.
- 4) In addition to the above mentioned duties, the auditor has the other duties like preparation of statutory report, certifying specified things in the prospectus and providing assistance in investigation.

8.4 COST AUDIT

The Companies Act, under section 209 (1) (d), has incorporated a provision that proper books of cost accounts should be maintained in the case of companies engaged in production, processing, manufacturing or mining activities indicating utilization of materials, labour and other items of cost as may be prescribed by the Central Government. This provision is in addition to the information relating to all sums of moneys received and spent, all sales and purchases of goods and assets and liabilities of a company.

Section 233 (b) provides that where in the opinion of the Central Government, it is necessary



so to do in relation to any company required under section 209 (1) (d) to keep prescribed cost accounts, it may direct that an audit of cost accounts of the company of the company shall be conducted in such a manner as may be specified in the order by an auditor who shall be a Cost Accountant within the meaning of the Cost and Works Accountants Act 1959. The auditor under this section shall be appointed by the company in accordance with the provisions of sub section 1 b of section 224. An audit conducted under this section shall be in addition to an audit conducted by an auditor appointed under section 224. A person shall be qualified for appointment as a cost auditor of a company if he satisfies the following conditions.

- a) He is a cost accountant within the meaning of the Cost and Works Accountants Act 1959
- b) He has obtained from the Council of the Institute of Cost and Works Accountants of India, a certificate of practice under section 7 of the Cost and Works Accountants Act 1959.
- c) A firm of cost accountants can also be appointed as Cost Auditor provided all the partners of the firm are qualified to be appointed as Cost Auditor as per the aforesaid qualifications. In such case, any partner may Act in the name of the firm.

The following are the disqualifications of a cost auditor. The following persons cannot be appointed as cost auditors.

- a) A body corporate
- b) An officer or employee of the company
- c) A person, who is a partner or who is in the employment of an officer or employee of the company.
- d) A person who is indebted to the company for an amount exceeding Rs.1000 or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding Rs.1000
- e) A person is also not qualified for appointment as a cost auditor of a company, if he is disqualified under any of the above four clauses, for appointment as a cost auditor of any other body corporate or would be so disqualified if that body corporate were a company, which is, that company's subsidiary or its holding company or a subsidiary of its holding company.
- f) A person appointed under section 224 as an auditor of a company [Financial Auditor] shall not be appointed or reappointed as cost auditor of that company. A person is also not qualified for appointment as cost auditor if he is in full time employment elsewhere or if he has already accepted cost audit assignments of 20 companies.

8.5 SPECIAL AUDIT

Under section 233 A, Central Government has the powers to direct special audit in certain cases. These powers are discussed below.

I. Where the Central Government is of the opinion that,

- ❑ The affairs of the company are not being managed in accordance with the sound business principles or prudent commercial practices or
- ❑ The company is being managed in a manner likely to cause serious injury or damage to the interests of the trade, industry or business to which it pertains or
- ❑ The financial position of any company is such as to endanger its solvency,

The Central Government may at any time by order direct that a special audit of the company's accounts for such period or periods as may be specified in the order, shall be conducted and may by the same or a different order appoint either a chartered accountant in practice or the company's auditor himself to conduct such a special audit.

- II] The special auditor shall have the same powers and duties in relation to the special audit as an auditor of a company under section 227.
- III] The report of the special auditor shall, as far as may be, include all the matters required to be included in an auditor's report under section 227 and if the Central Government so directs, shall also include a statement on any other matter, which may be referred to him by that Government.
- IV] The Central Government may direct any person to provide all the necessary information for the purpose of conducting the special audit.
- V] On receipt of such report, the Central Government may take such action on the report as it feels it necessary in accordance with the provisions of this Act or any other law for the time being in force.
- VI] The expenses of and incidental to any special audit under this section including the auditor's remuneration shall be determined by the Central Government and paid by the company. In case of default, the expenses shall be recovered from the company.



STUDY NOTE - 9

MEMBERSHIP OF A COMPANY

This Study Note includes

- Introduction - Meaning of 'Membership' of Company
- Legal Provisions about the 'Membership'

9.1 INTRODUCTION - MEANING OF 'MEMBERSHIP' OF COMPANY

One of the distinguishing features of company form of organization from other organizations like partnership concerns is that a company has a share capital, which is contributed by different persons known as 'shareholders' or 'members'. Though the terms 'members' and 'shareholders' are used interchangeably, there is a difference between the two in case of a company, which is not having a share capital or a company who has issued share warrants. A person holding share warrant is a shareholder but he will not be a member of that company. Various legal provisions regarding membership of a company are discussed in this chapter in the following paragraphs.

9.1.1 Difference Between Member and Shareholder

A registered shareholder is a member of a company but a registered member shall not be a shareholder of a company, as the company may not have share capital. Another point of difference between the member and shareholder is that a person who is holding share warrant is shareholder but not a member.

9.1.2 Persons Eligible to Become Member of a Company

Subject to the provisions of the memorandum and articles of association of a company, any person who is competent to contract can be a member of a company. The following persons can be members of a company.

- Partnership firms:** A partnership firm may hold shares in a company in the individual names of the partners. Since the separate existence of a partnership firm is not recognized by the law, a firm cannot hold the shares in its name. However partners can hold shares jointly in their names.
- Company:** A company can hold shares of another company provided it is permitted by its articles and memorandum of association. However, a company cannot be member of itself. In other words, a company cannot hold the shares of itself. There are provisions regarding buy back of shares of a company but as per the law, the shares which are purchased by the company should be cancelled immediately.
- Foreigner:** There are no restrictions on a foreigner becoming a member of the company. The Law shall prevent him from being a member only if he is alien enemy.



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- iv. Insolvent: An insolvent can be a member and as long as his name appears in the register of members, he is a member and is entitled to vote even though his shares may be in the custody of official receiver or assignee.

9.2 LEGAL PROVISIONS ABOUT THE 'MEMBERSHIP'

A person can become a member of a company in any of the following ways.

- i. A person can become a member in regular course by making application for getting shares and getting the allotment of shares. An application for shares is an offer made by the person to the company and when the allotment is made, the acceptance is given and the contract is complete. Thus membership can be obtained by application and allotment.
- ii. A person may not apply for getting shares from the company, but he can acquire membership by getting shares transferred in his favor by another person. A person may purchase shares in the open market and thus become member by registering transfer of shares in his name.
- iii. Subscribers to the memorandum of association of a company become members of a company.
- iv. Membership can also be acquired by transmission of shares. If a person holding shares of a company, dies, the shares standing in his name are transmitted in favor of his legal heirs. Thus the legal heirs become the members of the company.
- v. Every person, holding equity share capital of a company and whose name is entered as beneficial owner in the records of a depository shall be deemed to be a member of the concerned company.

9.2.2 Termination of Membership

A member ceases to be a member either by his own Act or as per the provisions of the Companies Act. If shares are transferred or forfeited or if the company sells his shares under some provisions in its articles or if he rescinds the contract made with the company, the concerned person shall cease to be the member of the company.

9.2.3 Members' Register:

As per section 150 of the Companies Act, every company shall keep a register of its members and the following particulars shall be recorded in the same.

- ❖ Name and address as well as occupation of the member
- ❖ Shares held by each member and the amount paid or agreed to be paid on those shares
- ❖ The date on which, each person was entered in the register as a member
- ❖ Date on which the member has ceased to be a member



9.2.4. Index of Members

The provisions of section 151 are as follows.

- 1) Every company having more than fifty members shall keep an index, which may be in the form of a card index, of the names of the members of the company and shall, within fourteen days after the date on which any alteration is made in the register of members, make the necessary alteration in the index.
- 2) The index shall, in respect of each member, contain a sufficient indication to enable the entries relating to that member in the register to be readily found.
- 3) The index shall, at all times, be kept at the same place as the register of members.
- 4) If any default is made in complying the provisions of this section, the company and every officer of the company who is in default, shall be punishable with fine, which may extend to five hundred rupees.
- 5) The register and index of beneficial owners maintained by a depository under section 11 of the Depositories Act 1996 shall be deemed to be an index of members and register and index of debenture holders, as the case may be, for the purposes of this Act. [Section 152 A]

9.2.5 Closing the Register: [Section 154]

A company may close the register of members [register of debenture holders also] for a period not exceeding 45 days in a year and not exceeding 30 days at any one time. Actually the Company Law does not make it mandatory for a company to close the register. It is the requirement of the stock exchanges that a company has to close the registers for the purpose of registering transfer and for the purpose of declaring and payment of the dividends. A notice of not less than 7 days shall be required to be given by the company by way of advertisements in some newspaper, which has circulation in the district where the registered office of the company is situated.

9.2.6 Foreign Register:

Section 157 of the Companies Act makes provisions regarding the foreign register. The provisions are as follows.

- ❖ A company, which has a share capital or which has issued debentures may, if so authorized by its articles, keep in any State or country outside India, a branch register of members or debenture holders resident in that State or country. This register is called as a foreign register in this Act.
- ❖ The company shall within thirty days from the date of the opening of any foreign register, file with the Registrar notice of the situation of the office, where such register is kept and in the event of any change in the situation of such office or of its discontinuance, as the case may be, file notice with the Registrar of such change or discontinuance. [Section 157]



(2)]

- ❖ In case of any default made in complying with the requirements of the above sub section (2), the company and every officer of the company who is in default, shall be punishable with fine which may extend to Rs.500 for every day during which the default continues.
- ❖ A foreign register shall be deemed to be part of the company's register of members or of debenture holders as the case may be. [Section 158 (1)]
- ❖ A foreign register shall be kept, shall be open to inspection and may be closed, and extracts may be taken there from and copies thereof may be required as per the relevant provisions of the Act. A newspaper advertisement should be given before the register is closed. [Section 158 (2)]
- ❖ Subject to the provisions of the Act, a company may by its articles make such regulations as it thinks fit in regard to its foreign registers.

9.2.7 Power To Rectify Register

Section 164 provides that the register of members as well as the register of debenture holders and the annual returns, certificates and statements as mentioned in sections 159 to 161 is an important prima facie evidence of any matter contained in the same. Thus it can be understood that the register of members is a valuable document for the company as well as for the creditors. Entry in the register of members is actually displaying the rights and liabilities of the members. Sometimes there may be some discrepancies in the entries made in this register or sometimes there may be need to rectify the same due to various reasons. Rectification of members register, thus becomes necessary in the following cases. [Section 111]

1. Where a persons' name is wrongfully removed from the register of members
2. Where a person is included to buy shares by misrepresentation
3. Where there is no valid allotment of shares, e.g where there is allotment without observing the provisions of articles
4. Where the allotment is not made within a reasonable time or where it is irregular
5. Where transfer of shares has been improperly registered or where a company improperly neglects or refuses to register a transfer
6. Where shares have been improperly surrendered to a company by a member and the company claims to have his name restored.
7. Where shares have been transferred to avoid liability
8. Where shares have been issued at a discount improperly
9. Where shares have been forfeited improperly
10. Where a forged transfer has been registered
11. Where the application for shares is conditional and the condition precedent is not fulfilled.



STUDY NOTE - 10

DIRECTORS

This Study Note includes

- Introduction
- Various Provisions of Company Law regarding appointment, qualifications
- Board of Directors
- Duties of Directors
- Contracts in which directors are Interested
- Managing Directors and Managers
- Remuneration of Directors

10.1 INTRODUCTION

We have discussed in the earlier chapters that the real owners of the company are the shareholders. However as they are large in numbers and also spread over a wide geographical area, it is impossible for them to pay attention to the day-to-day administration of the company. Hence they elect their representatives, who are called as 'directors' of the company. They can be called as 'brains' of the company. A company is an artificial person created by law. There is no physical existence to a company. It doesn't have a body or soul and hence cannot act on its own. It has to act only through the directors who are the elected representatives of the shareholders. Thus director's position in company administration is extremely important. There are exhaustive provisions regarding their appointment, powers and duties, position, removal etc. in the Companies Act 1956. These provisions are discussed in detail in the following paragraphs.

Who is a Director?

According to section 2 (13) of the Companies Act 1956, a director includes any person occupying the position of a director, by whatever name called. Thus it is clear that merely the designation as a director does not mean that the person is indeed a director. What really matters is the functions discharged by him. If a person is discharging the duties and functions of a director, he will be called as a director even though his designation may be different. Thus a person who has control over the direction, conduct and management of the business of the company is the director of the company. The Companies Act also provides that only individuals can be directors. A body corporate, association of persons or firm cannot function as director of a company.

Number of Directors

As per section 252 of the Companies Act, every public company [except a public company, which has become such by virtue of section 43 A] shall have at least three directors. A public company having,



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- a) a paid up capital of five crore rupees or more,
 - b) one thousand or more small shareholders, may have a director elected by such small shareholders in the manner as may be prescribed. [For this section, small shareholders means a shareholder holding shares of nominal value of twenty thousand rupees or less in a public company to which this section applies.]

Every other company shall have two directors.

- ❑ Subject to the provisions of sections 252, 255 and 259, a company can increase or decrease the number of directors by passing an ordinary resolution in a general meeting within the limits fixed by its articles of association. According to the section 259, in the case of a public company or a private company, which is a subsidiary of a public company, any increase in the number of its directors, except,
- ❑ In the case of a company, which was in existence on the 21st day of July 1951, an increase, which was within the permissible maximum under its articles as in force on that date, and
- ❑ In the case of a company, which came or may come into existence after that date, an increase, which is within the permissible maximum under its articles as first registered,

Shall not have any effect unless approved by the Central Government and shall become void, if and in so far as, it is disapproved by the Central Government.

Who can be a Director?

The Company Law provides for the disqualifications of a person for being appointed as a director of any company. As mentioned in the above paragraph, only individuals can become directors and a body corporate or a firm or an association of persons cannot be appointed as director or directors. As per section 274 (1) any person shall not be capable of being appointed as a director of company if –

- a. He has found to be of unsound mind by a Court of competent jurisdiction and the finding is in force.
- b. He is an undischarged insolvent.
- c. He has applied to be adjudicated as an insolvent and his application is pending.
- d. He has been convicted by a Court of any offence involving moral turpitude and sentenced in respect thereof to imprisonment for not less than six months, and a period of five years has not been elapsed from the last date of expiry of the sentence.
- e. He has not paid any call in respect of shares of the company held by him, whether alone or jointly with others, and six months have elapsed from the last day fixed for the payment of the call.
- f. An order disqualifying him for appointment as director has been passed by a Court in pursuance of section 203 and is in force, unless the leave of the Court has been obtained for his appointment in pursuance of that section or,
- g. Such person is already a director of a public company which,



- A] has not filed the annual accounts and annual returns for any continuous three financial years commencing on and after the first day of April 1999 or
- B] Has failed to repay its deposit or interest thereon on due date or redeem its debentures on due date or pay dividend and such failure continues for one year or more.

Provided that such person shall not be eligible to be appointed as a director of any other public company for a period of five years from the date on which such public company, in which, he is a director failed to file annual accounts and annual returns under sub-clause (a) or has failed to repay its deposit or interest or redeem its debentures on due date or pay dividend referred to in clause (B) above.

As per section 274 (2), the Central Government may remove, by notification in the official gazette, the disqualification mentioned in clause (d) or clause (e) as mentioned above either generally or in relation to any company or companies.

Additional grounds of disqualifications may be prescribed by the Articles of Association of a private company, which is not a subsidiary of a public limited company.

10.2 VARIOUS PROVISIONS OF COMPANY LAW REGARDING APPOINTMENT, QUALIFICATIONS

We have seen in the earlier paragraphs, that the directors are the elected representatives of the shareholders. They are elected in the general meeting of the shareholders. However there are certain issues like the appointment of first directors, subsequent appointment, directors retiring by rotation, appointment of additional directors, casual vacancies of the directors etc. Section 253 provides that no company shall appoint or re-appoint any individual as director of a company unless he has been allotted a Director Identification Number under section 266 B] The provisions of the Company Law regarding these matters are discussed in the following paragraphs.

Appointment of First Directors

The first directors of the company are to be appointed and not elected as the general meeting will be held after the completion of a year. Normally the names of the first directors are mentioned in the articles of association of a company. However if the names of the directors are not mentioned in the articles, the subscribers to the memorandum of association or their majority shall decide the names and the numbers of the first directors. If first directors are not appointed even in this manner, the subscribers to the memorandum themselves shall be deemed to be the directors of the company, until the directors are duly appointed in accordance with section 255. [Section 254] These directors shall hold office till the first annual general meeting.

Subsequent Appointment

Section 255 provides that at least $\frac{2}{3}$ rd of the total number of directors of a public company or a private company, which is a subsidiary shall be liable to retire by rotation every year,



unless the articles of the said company provides for retirement of all directors at every annual general meeting. Sub-section 2 of section 255 provides that the remaining directors in case of such company and the directors in case of private limited company, which is not a subsidiary of a public company, shall, in the absence of a provision to the contrary, in the articles of association, shall also be appointed by the company in a general meeting.

Retirement By Rotation: Section 256 has made exhaustive provisions regarding the retirement of directors by rotation. These provisions are as follows.

- (1) One third of the directors, who are appointed as per the provisions of section 255, shall be liable for retirement by rotation in the first and subsequent annual general meeting held after their appointment. If the number of directors is not three or in multiples of three, the number nearest to three shall be taken.
- (2) The directors to retire by rotation, at every annual general meeting, shall be those, who have been longest in the office since their last appointment. However, if some directors have been appointed on the same day, the director retiring by rotation shall be decided either by mutual agreement or in the absence of the same by drawing lots.
- (3) At the annual general meeting at which, a director retires as mentioned above, the company may fill up the vacancy by appointing the retiring director or any other person.
- (4) If no such appointments are made and the vacancy is not filled up and the meeting does not expressly resolve not to fill up the vacancy, the meeting shall stand adjourned till the same day in the next week, at the same time and place. If the day is a public holiday, the meeting shall be held on the next succeeding day, which is not a public holiday at the same time and place.
- (5) If the vacancy is not filled up even in the adjourned meeting, and the meeting also has not expressly resolved not to fill up the vacancy, the retiring director shall be deemed to have been re-appointed at the adjourned meeting, unless –
 - i. At that meeting or at the previous meeting, a resolution for the re-appointment of such director has been put up and lost.
 - ii. The retiring director has communicated in writing his unwillingness to be so re-appointed.
 - iii. He is not qualified or disqualified for appointment.
 - iv. A resolution, whether special or ordinary is required for his appointment or re-appointment in virtue of any provision of this Act.

According to Section 257 (1), a person other than retiring director shall also be eligible to be appointed as director at any general meeting. The section further provides that in such cases, he or some member intending to propose him has to give a notice of not less than 14 days before the date of meeting, duly signed by him signifying his candidature for the office of the director along with a deposit of Rs.500. The amount of deposit shall be refunded to the person if he is elected as director. The company shall serve notice individually to its members



informing them about the candidature of such a person at least seven days before the date of meeting. If serving of notice is not possible for the company, it shall advertise about the notice in at least two newspapers circulating in the place, where the registered office of the company is situated. One of the newspapers should be published in English language and the other one in the regional language of that place.

Appointment as Additional Directors

Section 260 empowers the Directors to appoint Additional Directors if the power is given to them by the Articles of Association. Such additional directors shall hold office only up to the date of the next annual general meeting. If due to some reason, the annual general meeting is not held or cannot be held, the additional director shall vacate his office on the day on which the annual general meeting would have been held. The number of directors and additional directors together shall not exceed the maximum strength fixed for the Board by the articles.

Casual Vacancy

The Board of Directors have the power to fill up the casual vacancy caused in the Board. Section 262 provides that in the case of a public company or a private company, which is a subsidiary of a public company, if the office of any director appointed by the company in general meeting is vacated before his term of office will expire in normal course, the casual vacancy may be filled up by the Board of Directors in their meeting subject to the provisions of the articles of association. Any person so appointed shall hold office only up to the date up to which the director in whose place the casual appointment is made, would have held the office if it had not been vacated.

Alternate Director

Section 303 provides that an alternate director can be appointed by the Board of Directors if it is authorized by the articles of association or by a resolution passed in the annual general meeting. He shall act as alternate director in the place of the original director in his absence for a period of at least 3 months, from the State in which the meetings of the Board are normally held.

Appointment by Proportional Representation

Section 265 provides that the articles of association of a public company or a private company, which is a subsidiary of a public company may provide for appointment of directors by proportional representation. This provision is made basically for providing representation to all segments of the shareholders. The section further provides that the articles may provide for appointment of not less than $\frac{2}{3}$ rd of the total number of directors by proportional representation. The appointment can be made either by a single transferable vote or by a system of cumulative voting or other wise. The appointment is to be made once in every three years and interim casual vacancies being filled in according to the other relevant provisions.



Appointment by third parties

The articles of association of a company may, under certain circumstances, give power to the debenture holders or other creditors like banker to appoint their nominees on the Board of Directors. The number of directors so appointed shall not exceed $1/3^{\text{rd}}$ of the total number of directors. They are not liable for retiring by rotation.

Appointment by Central Government

As per section 408, the Central Government can appoint such number of directors on the Board of the company as the Tribunal may order in writing, to safeguard the interests of the company or its shareholders. The appointment shall be for not more three years on any one occasion. The purpose of this appointment is to prevent the affairs of the company from being conducted either in the manner-

- a) Which is oppressive to any members of the company, or
- b) Which is prejudicial to the interests of the company or to public interest

The Tribunal may pass the above order on a reference made to it by the Central Government or on the application of,

- a) Not less than 100 members of the company or
- b) Members of the company holding not less than $1/10^{\text{th}}$ of the total voting power therein.

Any director appointed by the Central Government shall not be required to hold any qualification shares nor shall his period of office be liable to termination by retirement of directors by rotation. Any such director may be removed by the Central Government from his office and another person may be appointed in his place.

Restrictions on The Appointment of Director: [Section 266]

We have discussed the legal provisions regarding the appointment of directors. The Company Law provides certain restrictions on the appointment of directors. Certain legal formalities are to be completed before a person can work as director. These restrictions are as follows.

A person shall not be capable of being appointed as director of a company and shall also not be named as a director or proposed director in the prospectus unless before the registration of the Articles or the publication of the prospectus or the filing of the statement in lieu of prospectus, as the case may be, he or his agent authorized in writing, has –

- i. Signed and filed with the Registrar a consent in writing to Act as such director, and has,
- ii. Signed the memorandum for his qualification shares if any or taken his qualification shares if any from the company and paid or agreed to pay for them or
- iii. Signed and filed with the Registrar an undertaking in writing to take from the company his qualification shares, if any and pay for them or



- iv. Made and filed with the Registrar an affidavit to the effect, that his qualification shares are registered in his name.

This section does not apply to a private limited company.

Number of Directorship

As per the section number 275, no person shall save otherwise provided in section 276, hold office at the same time as director in more than 15 [fifteen] companies. Thus the limit of holding directorship is 15 companies. Section 276 (1) provides that, any person holding office as director in more than 15 companies, immediately before the commencement of the Companies [Amendment] Act 2000 shall, within two months from such commencement,

- a) Choose not more than fifteen of those companies as companies in which he wishes to continue to hold the office of director,
- b) Resign his office as director in the other companies and
- c) Intimate the choice made by him under clause (a) to each of the companies in which he was holding the office of director before such commencement, to the Registrar having jurisdiction in respect of each such company and also to the Central Government.

Section 276 (2) provides that any resignation made in pursuance of clause (b) of sub section (1) shall become effective immediately on the dispatch thereof to the company concerned. Sub section (3) of section 276 provides that no such person shall act as director in more than fifteen companies after the expiry of two months from the commencement of the Companies [Amendment] Act 2000.

Section 277 provides that where a person already holding the office of director in fifteen companies is appointed, after the commencement of the Companies Amendment Act 2000 as a director of any other company, the appointment –

- a) Shall not take effect unless such person has within fifteen days thereof, effectively vacated his office as director in any of the companies in which he was already a director and
- b) Shall become void immediately on the expiry of the fifteen days if he has not, before such expiry, effectively vacated his office as director in any of the companies aforesaid.

Section 277 (2) provides that where a person already holding the office of director in fourteen companies or less is appointed, after the commencement of the Companies [Amendment] Act 2000, as a director of other companies, making the total number of his directorship more than fifteen, he shall choose the directorships which he wishes to continue to hold or to accept, so however that the total number of directorships, old and new, held by him, shall not exceed fifteen. None of the new appointments of director shall take effect until such choice is made, and all the new appointments shall become void if the choice is not made within fifteen days of the day on which the last of them was made.

Section 278 (1) provides that for the calculation of number of directorships for the purpose of sections 275, 276 and 277, the following companies shall be excluded.



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- a) A private company, which is neither a subsidiary nor a holding company of a public company
 - b) An unlimited company
 - c) An association not carrying on business for profit or which prohibits the payment of a dividend
 - d) A company in which such person is only an alternate director, that is to say, a director who is only qualified to Act as such during the absence or incapacity of some other director.

It should be noted that in making the calculation aforesaid, any company referred to in clauses a, b, and c of sub section (1) shall be excluded for a period of three months from date on which the company ceases to fall within the purview of those clauses.

Any person who holds office, or acts as a director of more than fifteen companies in contravention of the above mentioned provisions, shall be punishable with a fine, which may extend to fifty thousand rupees in respect of each of those companies after the first fifteen. [Section 279]

Vacation of Office by Directors

According to section 283 of the Companies Act, the office of the director shall become vacant if,

- a. If he fails to hold the qualification shares if any required by the articles of association of the company, within two months of his appointment
- b. He is adjudicated to be of unsound mind.
- c. He has applied to be adjudicated as an insolvent
- d. He is convicted by a Court of any offence involving moral turpitude and sentenced in respect thereof to imprisonment for not less than six months
- e. He fails to pay any call in respect of shares of the company held by him within six months from the last date fixed for the payment of the call.
- f. He absents himself from 3 consecutive meetings of the Board of directors or from all meetings of the Board for a consecutive period of 3 months, whichever is longer, without obtaining leave of absence from the Board
- g. He fails to make disclosures to the Board of directors with regard to any contracts with the company, in which he is directly or indirectly interested.
- h. He becomes disqualified by an order of the Tribunal from being a director on the ground of having been convicted of an offence in connection with the promotion, formation or management of the company or found guilty of fraud or misfeasance in relation to its winding up proceedings



- i. He is removed before the expiry of his period of office by an ordinary resolution
- j. Having been appointed a director by virtue of his holding any office or employment in the company, he ceases to hold such office or other employment in the company.

Position Of Directors

Directors are the representative of shareholders and are expected to conduct the affairs of the company in an efficient manner. A question arises about their exact position. The question is whether they are officers of the company or trustees of the company or whether they are agents or whether they perform all these roles? It is very difficult to answer these questions in the context of the law. However, the position of directors can be examined from all these angles. This is discussed in the following paragraphs.

- I] Directors are the elected representatives of the shareholders as mentioned above. They have to run the management of the company. They have to use the property of the company in a judicious way and in the best interests of the shareholders. Thus the role that they play is that of trustees. They are treated as trustees of the property of the company as well as that of the money of the company and also of the powers vested to them. In using the property and money of the company, they should not allow their personal interests to clash with that of the company's interests. They have to refund to the company any of its money or property, which they have improperly paid away or transferred. Similarly the powers given to them by the Law as well as by the articles of association of the company should not be used for their personal interests. It should be remembered that they are the trustees for the company and not the trustees for the third parties.

Actually, directors are not the real trustees but quasi-trustees mainly because,

- ❖ The ownership of the property and money of the company is not entrusted to them
- ❖ Their functions differ from the functions of the trustees
- ❖ Their duties of care are not as onerous as those of trustees.

- II] Directors as Agents: Though a company is an artificial person created by law, it can Act only through the elected representatives of the shareholders, i.e. board of directors. Thus the directors are the agents of the company. The company acts through them and hence the relationship between the directors and the company is that of agent and principal. The acts of the agents are the acts of the principal and therefore the directors' actions are binding on the company. However as per the law of agency, if the directors exceed their powers and take some actions, these actions are not binding on the company. The company may ratify them if it feels it necessary. Thus in the eyes of law, directors are the agents of the company.
- III] Directors as Officers: The Company Law, treats the directors as officers of the company. [Section 2(30)] Therefore, they are liable for penalties if there is any non-compliance or violation of the provisions of the Company Law.



- IV] Directors as Employees: Directors are elected representatives of the shareholders and not entitled for any benefit, which are allowed to the employees of the company. However, they can be full time employees of the company by entering into a special contract with the company regarding the employment. For example, a managing director or a whole time director is an employee of the company and any director can occupy these positions and become the employee of the company.

Removal of Directors

Directors can be removed by the company, Central Government as well as by the Tribunal. The relevant provisions of the Company Law are as follows.

- I] Removal by the Company/Shareholders: [Section 284] – A company may, by ordinary resolution, remove a director before the expiry of his period of office. However this section shall not apply to, a director appointed by the Central Government under section 408. This provision shall also be not in the case of a private company, authorize the removal of a director, holding the office for life on the 1st day of April 195, whether or not he is subject to retirement under an age limit by virtue of the articles or otherwise. This provision shall also be not applicable where the company has availed itself of the option given to it under section 265 to appoint not less than two thirds of the total number of directors according to the principle of proportional representation.

Procedure for Removal: A company has to follow a procedure for removal of director before the expiry of his term. According to section 284 (2), a special notice shall be required of any resolution to remove a director under this section, or to appoint somebody instead of the director so removed at the meeting in which he is removed. The concerned director shall be given an opportunity to be heard at the meeting. A vacancy created by the removal of the director under this section may, if he has been appointed by the company in general meeting or by the Board of Directors in pursuance to section 262, be filled by the appointment of another director in his place in the meeting at which he is removed provided a special notice has been given of the resolution. The person so appointed in the place of the removed director shall hold the office until the date up to which his predecessor would have held office if he had not been removed as aforesaid.

- II] Removal by Central Government: According to section 388 [B to C], the Central Government, may in certain circumstances, remove managerial personnel from office on the recommendation of the Tribunal. The Central Government may use this power where in its opinion there are circumstances suggesting,
- ❖ That any person concerned in the conduct and management of the affairs of the company is or has been guilty of fraud, misfeasance, persistent negligence or default in carrying out his obligations and functions under the law or breach of trust or
 - ❖ That the business of the company is not or has not been conducted and managed by such person in accordance with sound business principles or prudent commercial practices or



- ❖ That the company is or has been conducted and managed by the person concerned in a manner, which is likely to cause, or has caused serious injury or damage to the interest of the trade, industry or business to which such company pertains, or
- ❖ That the business of the company is or has been conducted and managed by the persons concerned with intent to defraud its creditors, members or any other person or otherwise for a fraudulent or unlawful purpose or in a manner prejudicial to public interest.

The person/s against whom a case is presented shall be given an opportunity of being heard and then suitable decision will be taken,

III] Removal by Tribunal: The Tribunal has the power to remove a director as per section 402. The law provides that where an application has been made to the Tribunal under section 397 or 398 for prevention of oppression or mismanagement respectively and if the Tribunal finds that relief should be granted, it may terminate, set aside or modify any agreement between the company and the managing director or any other director or the manager. The concerned person, who is so removed cannot claim damages against the company or compensation for the loss of office. He cannot be appointed in any managerial capacity in the company, without the permission of the Tribunal for a period of five years from the date of the order.

10.3 BOARD OF DIRECTORS

The Board of Directors has been given various powers by the Company Law. Some of these powers are to be exercised only at the general meeting while the rest can be exercised by passing a resolution in a board meeting. Therefore it becomes essential that the board meets regularly to transact the business, which is essential to run the administration of the company smoothly. The Company Law has provisions regarding the board meeting. These provisions are discussed here.

- ❖ Section 285, provides that in the case of every company, a meeting of its Board of Directors shall be held at least in every three months and at least four such meetings shall be held every year. According to the direction of the Central Government, the provisions of this section may not be applicable to any company or class of companies.
- ❖ Notice of the meeting shall be given to all the directors in writing who are in India and the notice shall be given at his usual address in India. Failure to give notice shall attract penalty of Rs.1000 for every officer whose duty is to give notice as mentioned above.
- ❖ The quorum for the board meeting shall be $1/3^{\text{rd}}$ of its total strength [any fraction contained in that one third being rounded off as one] or two directors, whichever is higher. It should be noted that 'interested director' shall not be counted for deciding the quorum for the meeting]



- ❖ If a meeting of the board of directors could not be held for want of quorum, the meeting shall automatically stand adjourned till the same day next week, at the same time and place or if that day is a public holiday, till the next succeeding day, which is not a public holiday, at the same time and day. [Section 288(1)]
- ❖ The provisions of section 285 shall not be deemed to have been contravened merely by reason of the fact that a meeting of the Board, which has been called in compliance with the terms of that section could not be held for want of a quorum. [Section 288(2)]
- ❖ A resolution to be passed by circulation shall be deemed to have been passed if it is circulated to all members not being less than the quorum along with necessary papers [members of the board or its committee and those in India] and has been approved by such of the directors as are then in India or by a majority of such of them as are entitled to vote on the resolution.
- ❖ Acts done by a person as a director shall be valid, notwithstanding that it may afterwards be discovered that his appointment was invalid by reason of any defect or disqualification or had terminated by virtue of any provisions contained in this Act or in the article. However any act done by a director after his appointment was found invalid by reason of any defect or disqualification or had been terminated due to any reason mentioned in this Act shall be invalid. [Section 290]

Powers of The Board of Directors

The Board of Directors of a company is responsible for the management and administration of the company. It is but natural that they are given sufficient powers to run the company successfully. However it is also necessary to put some restrictions on their powers, otherwise there is a possibility of misuse of the same. The Company Law, therefore provides for general powers which can be exercised by the board in accordance with the provisions in the articles and memorandum and certain powers are to be exercised only by the sanction of the shareholders at the meeting. These powers are discussed in the following paragraphs.

- I] **General Powers:** As per section 291(1), the Board of directors of a company shall be entitled to exercise all such powers and do all such acts and things as the company is authorized to exercise and do. It is further provided that these powers shall be subject to the provisions of memorandum and articles of association of a company. Section 291(2) provides that no regulation made by the company in general meeting shall invalidate any prior act of the Board, which would have been valid if that regulation had not been made.
- II] **POWERS TO BE EXERCISED BY BOARD ONLY AT MEETING:** Section 292 (1) provides that the Board of directors of a company shall exercise the following powers on behalf of the company, and it shall do so only by means of resolutions passed at meeting of the Board.



- a) The power to make calls on the shareholders in respect of money unpaid on their shares
- b) The power to authorize the buy back of shares
- c) The power to issue debentures
- d) The power to borrow moneys otherwise than on debentures
- e) The power to invest the funds of the company and
- f) The power to make loans

The Board may, by a resolution passed at a meeting, delegate to any committee of directors, the managing director, the manager or any other principal officer of the company or in the case of a branch office of the company, a principal officer of the branch office, the powers specified in clauses [c], [d] and [e] of sub section (2) specified below.

Sub section (2) of section 292 provides that every resolution delegating the power referred to in clause [c] above, shall specify the total amount outstanding at any time up to which moneys may be borrowed by the delegate.

Similarly every resolution mentioned in [d], [e] and [f] shall specify the maximum amounts to be specified in respect of the loans and investments.

III] POWERS TO BE EXERCISED WITH THE APPROVAL OF THE COMPANY IN GENERAL MEETING: According to section 293 (1), the Board of directors of a public company or of a private company, which is a subsidiary of a public company, shall not except with the consent of such public company or subsidiary in the general meeting-

- a) Sell, lease or otherwise dispose of the whole, or substantially the whole of the undertaking of the company, or where the company owns more than one undertaking, of the whole or substantially the whole of any such undertaking
- b) Remit or give time for the repayment of any debt due by a director [except in the case of renewal or continuance of an advance made by a banking company to its director in the ordinary course of business]
- c) Invest, otherwise than in trust securities, the amount of compensation received by the company in respect of compulsory acquisition, after the commencement of this Act of any such undertaking as referred in clause (a) or of any premises or properties used for any such undertaking and without which it cannot be carried on or can be carried on only with difficulty or only after a considerable time
- d) Borrow moneys after the commencement of this Act, where the moneys borrowed, together with the moneys already borrowed by the company [apart from the temporary loans obtained from the company's bankers in the ordinary course of business] will exceed the aggregate of the paid up capital of the company and its free reserves, that is to say, reserves not set apart for any specific purpose.



- e) Contribute, after the commencement of this Act, to charitable and other funds not directly relating to the business of the company or the welfare of its employees, any amount the aggregate of which will in any financial year, exceed fifty thousand rupees or five percent of its average net profits as determined in accordance of section 349 and 350 during the three financial years immediately preceding whichever is greater.
- f) Every resolution passed by the company in general meeting to borrow moneys shall specify the total amount up to which moneys may be borrowed by the Board of directors. Likewise every resolution passed by the company in general meeting to contribute to charitable and other funds shall specify the total amount, which may be contributed to charitable and other funds in any financial year.

Political Contributions: [Section 293 A]

Companies can give political contributions to the political parties or for political purpose to any person directly or indirectly out of their profits. However there are some restrictions on these contributions, which are as follows.

- a) Political contributions to any political parties or to persons for political purposes are prohibited for Government companies and other companies which are in existence for less than 3 years
- b) Any amount or aggregate of the amounts so contributed by a company in any financial year shall not exceed 5% of its average net profits during the three immediately preceding financial years.
- c) Before any such contribution is made by the company, a resolution authorizing the making of the contribution shall be passed at a meeting of the Board of directors. Such resolution shall be deemed to be justification in law for the making of the contributions authorized by it.
- d) The company shall disclose in its profit and loss account the amount or amounts of such contributions during the financial year to which that account relates giving the particulars of the total amount contributed and the name of the party or persons to which or to whom such amount has been contributed.

10.4 DUTIES OF DIRECTORS

General duties of directors are discussed below.

- a) **Fiduciary Duties:** There is a fiduciary relationship between the company and the directors. Hence the directors have to perform duties, which are of fiduciary nature. These duties include,
 - ❖ Exercising their powers honestly and bona fide for the benefit of the company as a whole and
 - ❖ Not to place themselves in a position in which, there is a conflict between their duties



to the company and their personal interests. They must not make any secret profits out of their position. If they indeed make any secret profits, they will have to account for it to the company.

❖ These duties are owed to the company and not to the individual shareholders.

- b) Duties of care, skill and diligence: Directors should carry out their duties with reasonable care and exercise such degree of skill and diligence as is reasonable expected of persons of their knowledge. The standard of care, skill and diligence depends upon the nature of company's work, business and circumstances of the case.
- c) Other duties of directors include attending Board meetings as well as to disclose his interest in a contract and not to delegate his functions except to the extent authorized by the Act or the constitution of the company.

10.5 CONTRACTS IN WHICH DIRECTORS ARE INTERESTED

According to section 297 (1), except with the consent of the Board of directors of a company, a director of the company or his relative, a firm in which such a director or relative is a partner, any other partner in such a firm, or a private company of which the director is a member or director shall not enter into any contract with the company,

- a) For the sale, purchase or supply of any goods, materials or services or
- b) After the commencement of this Act, for underwriting the subscription of any shares in, or debentures of the company.
- c) In case of a company having a paid up share capital of not less than one crore rupees, no such contract shall be entered into except with the previous approval of the Central Government.

According to section 297 (2), the sub section (1), clause a shall not affect,

- a) The purchase of goods and materials from the company, or the sale of goods and materials to the company, by any director, relative, firm, partner or private company as aforesaid for cash at prevailing market prices or
- b) Any contract or contracts between the company on one side and any such director, relative, firm, partner or private company on the other for sale, purchase or supply of any goods, materials and services in with either the company or the director, relative, firm, partner or private company as the case may be, regularly trades or does business, provided the cost of goods or services do not exceed Rs. Five thousand rupees in aggregate.
- c) In the case of a banking or insurance company any transaction in the ordinary course of business of such company with any director, relative, firm, partner or private company as aforesaid.



- d) When the value of goods or services exceed Rs. Five thousand in the aggregate in any year comprised in the period of the contract, the consent of the Board shall be obtained at a meeting within three months of the date on which the contract was entered into.
- ❖ According to section 299, every director of a company, who is directly or indirectly concerned or interested in a contract or proposed contract entered into, or to be entered into, by or on behalf of the company, shall disclose the nature of his concern or interest at a meeting of the board of directors. In case of a proposed contract, such disclosure shall be made by a director at the meeting of the Board at which the question of entering into the contract or agreement is first taken into consideration. In the case of any other contract or arrangement, the required disclosure shall be made at the first meeting of the Board held after the director becomes interested in the contract. For this purpose, the director concerned shall give a notice to the Board to this effect. This is deemed to be sufficient disclosure of the interest.
 - ❖ A director of a company must not place himself in a position in which his personal interest clashes with his duty. Therefore he should not take part in the discussion of or vote as a director on any contract or arrangement in which he is directly or indirectly interested unless authorized by the articles. In case he votes, his vote would not be counted. Even his presence shall not be taken into consideration while computing the quorum for the meeting. Every director who knowingly contravenes with these provisions, shall be punishable with fine which may extend to Rs.50000.
 - ❖ Register of Contracts: As per section 301, every company shall keep one or more register in which shall be entered separately particulars of all contracts entered into by the company in which any of the directors is interested. The following particulars, to the extent they are applicable in each case, shall be given in the register.
 - a) The date of the contract or arrangement
 - b) The names of the parties thereto
 - c) The principal terms and conditions thereof
 - d) The date on which it was placed before the board of directors and
 - e) The names of the directors voting for and against the contract and the names of those remaining neutral.
 - f) The register aforesaid shall be placed before the next meeting of the Board of directors and shall then be signed by all the directors present at the meeting. The register shall be kept at the registered office of the company and shall also be open to the inspection of any member of the company and extracts may be taken there from and copies of the same may be required by any member of the company.

Director Identification Number

According to section 266 A, every individual, intending to be appointed as director of a company or director of a company appointed before the commencement of the Companies [Amendment] Act, 2006, shall make an application for allotment of Director Identification



Number to the Central Government in such form and manner [including electronic form] along with such fees as may be prescribed. Such an application shall be made within 60 days of the commencement of this Act.

Section 266 B provides that the Central Government shall, within one month from the receipt of the application, allot a Director Identification Number to an applicant, in such manner as may be prescribed. The Identification Number shall be only one and no director shall apply, obtain or possess another identification number. The identification number shall be informed to the company or all companies wherein he is a director within one month of the receipt of the number. The number shall also be informed to the Registrar within one week of the receipt of the number. Every person or company, while furnishing any return, information or particulars as are required to be furnished under this Act, shall quote the Director Identification Number in such returns, information or particulars in case such return, information or particulars relate to the director or contain any reference to the director.

10.6 MANAGING DIRECTORS AND MANAGERS

A managing director is a director who is entrusted with substantial powers of management, which would not otherwise be exercisable by him. These powers may be conferred upon him by virtue of an agreement with the company or a resolution passed by the company in a general meeting or by its Board of directors or by virtue of its memorandum or articles of association.

The term 'Managing Director' includes a director occupying the position of a managing director, by whatever name called. But the power to do administrative acts of a routine nature when so authorized by the Board such as the power to affix the common seal of the company to any document or to draw and endorse any cheque on the account of the company or to draw and endorse any negotiable instrument or to sign any share certificate or to direct registration of transfer of any share, shall not be included within substantial powers of the management. The managing director shall exercise his power subject to superintendence, control and direction of its Board of directors. He is a whole time director and is the chief executive of the company.

Appointment: Every public company or a private company, which is a subsidiary of a public company, having a paid up share capital of Rs.5 crores or more shall have a managing or whole time director or a manager. [Section 269] Various other provisions are as follows.

- a) Prior approval of the Central Government shall be required for the appointment of managing director if the appointment is not according to the conditions prescribed in schedule XIII. Schedule XIII also prescribes the remuneration payable to the managerial persons.
- b) If prior approval of the Central Government is required, an application should be made within 90 days from the date of appointment to the Central Government.
- c) The Central Government shall not accord its approval to the application unless it is satisfied that the managing or whole time director or the manager is a fit and proper person, and the terms and conditions of his appointment are fair and just.



- d) If the appointment is not approved by the Central Government, the person so appointed shall have to vacate his office immediately on the receipt of the order from the Central Government. If he fails to do so, he shall be punishable with a fine which may extend to Rs.5000 for every day during which he omits or fails to vacate his office.

Disqualifications of Managing Director: According to section 267, no person, shall be appointed as a managing director or whole time director who,

- a) Is an un-discharged insolvent, or has at any time been adjudged an insolvent
- b) Suspends, or has at any time suspended payment to his creditors or makes or has at any time made, composition with them or
- c) Is or has at any time been, convicted by a Tribunal of an offence involving moral turpitude.
- d) Disqualifications of a director also apply to a managing or whole time director.
- e) A person may be appointed as a managing director in a public company or in a private company which is a subsidiary of a public company, provided he is not holding the office of the managing director or the manager in any other company including a private company which is not a subsidiary of a public company. He can, however hold such office in any number of private companies which are not subsidiaries of public companies. A public company, or a private company, which is a subsidiary of a public company may appoint or employ a person as its managing director if he is the managing director or manager of one and not more than one company including a private company, which is a subsidiary of a public company. But any such appointment shall be approved by a resolution passed at a meeting of the Board of directors with the consent of all the directors present at the meeting. Specific notice of such a meeting and the resolution shall also be given to all the directors then in India.
- f) The term of office of a managing director or whole time director shall not exceed 5 years at a time. There is nothing to prohibit re-appointment, re-employment or the extension of the term of office of the managing director. But any such new term shall not be sanctioned earlier than 2 years from the date on which it is to come into force. [Section 317] This section shall not be applicable to a private company.

Manager

According to section 2 [24], manager means 'An individual who has the management of the whole or substantially the whole of the affairs of a company'. A manager is subject to the superintendence, control and direction of the Board of directors. Manager includes a director or any other person occupying the position of a manager, by whatever name called and whether under a contract of service or not. The following are the provisions of the Company Law regarding the appointment of manager.

- a) A firm or body corporate cannot be appointed as a manager
- b) A person shall not be appointed as a manager if he is an un discharged insolvent or



has at any time within the preceding five years been adjudged as insolvent or has suspended payment to his creditors within the preceding five years or is or has at any time within the preceding five years been convicted by a Court in India of an offence involving moral turpitude.

- c) A company shall not appoint a person as a manager if he is already a manager or a managing director of another company. However a company may appoint a person as a manager if he is the manager or managing director of any other but only one company. This appointment shall have to be made by a resolution passed at a meeting of the Board of Directors with the consent of all the directors present at the meeting.
- d) The manager of a company shall be subject to the overall limits of managerial remuneration. Such remuneration shall not exceed 5% of the net profits of the company without the approval of the Central Government. Any increase in the remuneration shall require the prior approval of the Central Government.
- e) Office of manager cannot be assigned.
- f) A manager shall not be appointed for a term exceeding five years at a time.

10.7 REMUNERATION OF DIRECTORS

There are elaborate provisions in the Company Law regarding the remuneration payable to the directors. These provisions are given below.

- 1) The remuneration payable to the directors of a company, including any managing or whole time director shall be determined in accordance with and subject to the provisions of section 198 and this section, either by the articles of the company or by a resolution or, if the articles so required, by a special resolution, passed by the company in general meeting and the remuneration payable to any such director determined as aforesaid shall be inclusive of the remuneration payable to such director for services rendered by him in any other capacity. Any remuneration for services rendered by any such director in any other capacity shall not be so included if the services rendered are of a professional nature and in the opinion of the Central Government, the director possesses the requisite qualifications for the practice of the profession. [Section 309(1)]
- 2) A director may receive remuneration by way of a fee for each meeting of the Board of a committee thereof, attended by him [Sub section 2]
- 3) A director, who is either in the whole time employment of the company or a managing director may be paid remuneration either by way of a monthly payment or at a specified percentage of net profits of the company or partly by one way and partly by the other. Without the sanction of the Central Government, such remuneration shall not exceed five percent of the net profits of the company for one such director and if there is more than one director, ten percent for all of them.[Sub section 3]



- 4) A director who is neither in the whole time employment of the company nor a managing director may be paid remuneration either by way of monthly, quarterly or annual payment with the approval of the Central Government or by way of commission if the company authorizes such payment by a special resolution. Such remuneration shall not exceed one percent of the net profits of the company if the company has a managing or whole time director or a manager and three percent of the net profits of the company in other case. Any excess remuneration than the above mentioned percentages shall be allowed if the company in general meeting with the prior approval of the Central Government has authorize the payment.[Sub section 4]
- 5) The net profits referred to in 3 and 4 above, shall be computed in the manner referred to in section 198 sub section (1) [Sub section 5]
- 6) If any director draws or receives, directly or indirectly, by way of remuneration any such sums in excess of the limit prescribed by this section or without the prior approval of the Central Government, where it is required, he shall refund such sums to the company and until such sum is refunded, hold it in trust for the company. [Sub section 5A]
- 7) The company shall not waive the recovery of any sum refundable to it under sub section 5A unless permitted by the Central Government.
- 8) No director of a company who is in receipt of any commission from the company and who is either in the whole time employment of the company or a managing director shall be entitled to receive any commission or other remuneration from any subsidiary of such company.[Sub section 6]
- 9) The provisions of this section shall not apply to a private company unless it is a subsidiary company of a public company.[Sub section 9]



STUDY NOTE - 11

COMPANY MEETINGS

This Study Note includes:

- Introduction
- Types of Company Meetings
- Essentials of a Valid Meeting
- Types of Resolutions
- Other Aspects
 - Proxies
 - Voting at the Meeting
 - Resolutions

11.1 INTRODUCTION

The corporate system of business organization is essentially democratic in structure. Officials acting under the orders of the Board of Directors, which is the executive head of the company, carry on the business of the company. But the directors are elected to the Board by the shareholders of the company and must abide by the wishes of the shareholders as expressed in resolutions passed in meetings convened for the purpose. The shareholders are subject to the provisions of Memorandum of Association and Articles of Association, the final authority as regards the affairs of the company. The shareholders cannot interfere in the day-to-day administration of the company. But they can elect Directors who will carry on the administration in the manner desired by them. Also there are many matters, which are beyond the powers of the Board of Directors to decide and which must be placed before the shareholders for decision. Meetings of shareholders are held for this purpose and the decisions of shareholders are expressed in the form of resolution.

11.2 TYPES OF MEETINGS

The following are the types of company meetings.

A. Shareholders' Meetings

- Statutory Meeting
- Annual General Meeting
- Extra-ordinary General Meeting

B. Creditors' Meetings

C. Debenture holders' Meetings

D. Meetings of Directors

Provisions of Company Law regarding these meetings are discussed in the following paragraphs.

A. Shareholders' Meetings:

I] Statutory Meetings:

- Every public company limited by shares and every company limited by guarantee and having a share capital, must within a period of not less than one month and not more than six months from the date at which the company is entitled to commence business, hold a general meeting of members to discuss a report by directors, known as statutory report, which contains particulars relating to the formation of company.
- Statutory Report: This is a report drafted by director and certified as correct by at least two of them [including managing director where there is one] A copy of the report must be sent to every member at least 21 days before the date of the meeting. A copy is also to be sent to the Registrar for registration. Section 165 [3] provides that the statutory report must contain the following particulars.
 - I. The total number of shares fully paid up and partly paid up allotted.
 - II. The total amount of cash received by the company in respect of the shares
 - III. An abstract of the receipts, classifying them according to source and mentioning the expenses incurred for commission, brokerage etc.
 - IV. The names, address and occupations of directors, auditors, manager and secretary and changes of the names, addresses etc.
 - V. Particulars of contracts, which are to be submitted to the meeting for approval with proposed modifications if any.
 - VI. Details of underwriting contracts if any
 - VII. Calls in arrears from directors and others
 - VIII. Particulars of commission and brokerages paid to directors and managers.



Particulars as regards cash in the statutory report are to be certified as correct by the auditors of the company.

The members of the company who are present at the meeting are at liberty to discuss any matter relating to the formation irrespective of previous notice is given or not. But no resolution can be passed of which notice has not been given in accordance with the provisions of the Act.

If default is made in complying with the provisions of Section 165, every director or other officer of the company who is in default shall be punishable with fine, which may extend to Rs.500.

II] Annual General Meeting :

General meeting of a company means a meeting of its members for specified purposes. There are two kinds of general meetings. The first one is the Annual General Meeting and the second one is the other general meeting. The legal provisions about the Annual General Meeting are summarized below.

- The first annual general meeting of a company may be held within a period of not more than 18 months from the date of its incorporation. If such a meeting is held within this period, it shall not be necessary for the company to hold any annual general meeting in the year of its incorporation or in the following year. Subject to this provision, a company must hold an annual general meeting each year. Not more than 15 months shall elapse between the date of one annual general meeting and the next. The Registrar may for any special reason, extend the time of holding an annual general meeting [other than the first annual general meeting] by a period not exceeding 3 months. The notice, by which an annual general meeting is called, must specify it as such. Every annual general meeting shall be called during business hours, on a day, which is not a public holiday, at the registered office of the company or at some other place within the town or village where the registered office is situated. The Central Government may exempt any class of companies from the provisions mentioned in this paragraph. The time of holding of annual general meeting may be fixed by the articles of the company. A public company or a private company, which is a subsidiary of a public company, may be a resolution passed in one general meeting, fix the time for its subsequent general meetings. Other private companies may do so by a resolution agreed to by all the members thereof.
- A general meeting may be called by giving not less than 21 days notice in writing. The annual general meeting may be called with a shorter notice if it is agreed to by all the members entitled to vote in the meeting.

III] Extra-ordinary General Meetings :

Any meeting of shareholders other than statutory meeting and annual general meeting is an extra ordinary general meeting. As per Company Law, even though Board of Directors is the highest authority in case of a company administration, there are limitations on their powers.

There are several powers given to the Board of Directors, which are to be exercised only with the consent of the shareholders in a general meeting. If there is an urgent issue on which shareholders' sanction is to be obtained and if it is advisable to wait till the next annual general meeting, an extra ordinary general meeting is called. This meeting can be called by any one of the following parties.

- ❖ Board of Directors: The Board of Directors on their own or on the request of specified number of shareholders can call this meeting. For this meeting a notice of 21 days is to be given though a shorter notice than this may also be given under certain circumstances.
- ❖ The Board of Directors can be compelled to call extra ordinary general meeting upon a request or requisition made for it, under the following conditions. The requisition must be signed by members holding at least 1/10th of the paid up capital of the company and in the case of companies not having share capital, by members holding at least 1/10th of the total voting powers. The requisition must set out the matters, which will be considered at the meeting. The Board must, within 21 days of the receipt of a valid requisition, issue a notice for the holding of the meeting on a date fixed within 45 days of the receipt of the requisition. If the Board does not hold the meeting as aforesaid, the requisitionists can call a meeting to be held on a date fixed within 3 months of the date of the requisition. Resolutions, properly passed at this meeting called by requisitionists are binding on the company.

11.3 ESSENTIALS OF A VALID MEETING

The following are the essentials of a valid meeting.

I] Proper Authority :

The meeting must be convened by a proper authority. The Board of Directors is the proper authority to convene a meeting by passing a resolution in their meeting, about convening a meeting.

II] Notice :

Notice of every meeting must be given to a) all members entitled to vote up on the matters which are proposed to be dealt with the meeting. b) The persons on whom the share of any deceased or insolvent members may have devolved and c) Auditor or auditors of the company. If notice of a meeting is not given to every person entitled to receive notice, any resolution passed in the meeting shall be invalid.

Length of the notice: As per the section 171 (1), notice of a general meeting should be given at least 21 days before the date of the meeting and in writing. However, a shorter notice may be given in the following cases.

- ❑ In the case of an annual general meeting, if all the members entitled to vote agree to that effect and



- ❑ In case of any other meeting, if members of the company who are holding 95% of the paid up share capital, where the company has share capital and where the company do not have share capital holders of 95% of the total voting power of the company agree to that effect.

Contents and Manner of service of notice: Every notice of a meeting of a company, shall specify the place and the day and hour of the meeting and shall contain a statement of the business to be transacted in the same. According to section 173 (1), in case of an annual general meeting, all business to be transacted at the meeting shall be deemed to be special, with the exception of business relating to a) Consideration of accounts, balance sheet and the reports of the board of directors and auditors. b) Declaration of dividends c) Appointment of directors in the place of those retiring and d) the appointment of, and the fixing of the remuneration of the auditors and in case of any other meeting, all business shall be deemed to be special.

For every special business, an explanatory statement setting out all the material facts concerning each such item of business should be included in the notice. [Section 173 (2)]

III] Quorum :

Quorum is the minimum number of members, which must be present in the meeting to make the meeting a valid one. Provisions regarding quorum are given in the section 174 and are given below.

- ❑ Unless the articles provide otherwise, in case of public limited company [Except the deemed public company under section 43 A] the quorum shall be five members personally present and in case of a private limited company, the quorum shall be two members present personally.
- ❑ If within half an hour from the time appointed for holding a meeting of the company, a quorum is not present, the meeting, if called upon the requisition of members, shall stand dissolved. [Section 174 (3)]
- ❑ In any other case, the meeting shall stand adjourned to the same day in the next week, at the same time and place or to such other day and at such other time and place as the board may decide. [Section 174 (4)]
- ❑ If at the adjourned meeting also, a quorum is not present, within half an hour from the time appointed for holding the meeting, the members present shall be a quorum. [Section 174 (5)]
- ❑ The above sub sections 3, 4, and 5 shall be subject to the provisions of the articles of the company.

IV] Chairman :

Unless the articles of association provide otherwise, the members personally present at the meeting shall elect one of themselves to be the chairman thereof by show of hands. If poll is demanded for election of a chairman, it shall be taken immediately as per the provisions of the Act, the chairman elected by show of hands, exercising all powers of the chairman under the



said provisions. If some other person is elected chairman as a result of the poll, he shall be the chairman of the meeting. [Section 175 (1) to (3)]

V] Minutes :

Minutes are records of the business transacted at the meeting. Provisions of section 193 are summarized below.

- i. Every company shall prepare minutes of all proceedings of every general meeting and of all proceedings of every board meeting as well as the meeting of committee of the board within 30 days of the date of such meeting.
- ii. The book in which the record of the proceedings of a meeting is kept is known as the minute book. Separate minutes books are required to be kept for shareholders general meetings of the company and directors meetings and usually there are also separate minute books for committee meetings of the board of directors. The page of every minute book shall be consecutively numbered. There should not be any attaching or pasting of papers of proceedings of a meeting in the minute book in any case.
- iii. Each page of the minute book, which records proceedings of a board meeting shall be initialed or signed by the chairman of the meeting of the same meeting or the next succeeding meeting. The last page of the record of proceedings of each meeting in the minutes book shall be dated and signed. This has to be done,
 - ❑ In the case of a board or a committee meeting, by the chairman of the same or the next succeeding meeting and
 - ❑ In case of a general meeting, by the chairman of the same meeting within 30 days of the meeting, or in the event of death or inability of that chairman within 30 days of the meeting, by the director duly authorized by the board for that purpose.
- iv. The minutes of a meeting shall contain a fair and correct summary of the proceedings of the meeting, so that the absentee shareholders may be in a position to form some reliable idea of what transpired at these meetings. All appointments of officers made at any of the meetings aforesaid shall also be included in the minutes of the meeting.
- v. Minutes of meetings kept in accordance with the provisions of section 193 shall be evidence of the proceedings recorded therein and shall be conclusive of the facts stated therein.

11.4 OTHER ASPECTS

The other aspects regarding the meeting are discussed below.

I] Proxies :

As per section 176 (1), any member of a company, who is entitled to attend and vote at a meeting of the company shall be entitled to appoint another person [whether a member or not] as his proxy to attend and vote instead of himself, but the proxy shall not have any right to



Speak at the meeting. A member of a private company shall not be entitled to appoint more than one proxy. A proxy shall not be entitled to vote except on a poll. Section 176 (2) provides that in every notice calling a meeting of a company, which has a share capital, or the articles of a company provide so, there shall be a statement given prominently stating that a member entitled to attend and vote is entitled to appoint a proxy or more than one proxies wherever allowed, to attend and vote instead of himself and that a proxy need not be a member. The duly filled in proxy forms should be deposited with the company at least 48 hours before the start of the meeting. Any provision in the articles of a public company or a private company, which is a subsidiary of a public company, making it compulsory to file the proxy forms before more than 48 hours shall be invalid. The instrument appointing a proxy, shall be in writing and be signed by the appointer or his attorney duly authorized in writing or if the appointer is a body corporate, be under its seal or be signed by an officer or an attorney duly authorized by it.

II] Voting at the meeting :

There are several occasions, when a voting is to be arranged at the meeting. The following methods of voting are used for this purpose.

- i. Voting by show of hands: As per section 177, at any general meeting, a resolution put to vote at the meeting, shall unless a poll is demanded under section 179, be decided by show of hands. Declaration given by the chairman regarding the declaration of result of voting by show of hands shall be conclusive. [Section 178]
 - ii. Voting by Poll: Before or on declaration of the result of voting on any motion by show of hands, a poll may be taken by the chairman of the meeting either on his own accord or on the demand made to that effect by the persons specified below.
 - ❑ In case of a public company having a share capital, a poll shall be taken on a demand by any member or members present in person or by proxy and holding at least 1 / 10th of the total voting power in respect of the resolution or on which an aggregate sum of Rs.50000 has been paid up.
 - ❑ In the case of a private company, having a share capital, by one member having the right to vote on the resolution and present in person or by proxy if not more than seven such members are personally present, and by two such members present in person or by proxy if more than seven members are present personally.
 - ❑ In the case of any other company, by any member or members present in person or by proxy and having not less than one tenth of the total voting power in respect of the resolution.
 - ❑ Demand for poll can be withdrawn at any time by the person or persons who made the demand.
- A poll demanded on a question or adjournment or the appointment of a chairman shall be taken forthwith. In any other case it shall be taken within 48 hours of the demand for poll. [Section 180]

- A poll is complete when its result is ascertained and not on an earlier day when the votes were cast. Where a poll is taken, the meeting is regarded as continuing until the ascertainment of the result of the poll. A meeting reconstituted after a poll is in continuance of the same meeting and a poll itself is part of the meeting.
- The chairman of the meeting has the power to regulate the manner in which a poll is to be taken. The most commonly followed method is 'ballot paper' on which the members record their decision, i.e. for or against the motion. The result of the poll shall be declared by the chairman. [Section 185]

III] Resolutions :

A] Ordinary Resolution: A resolution is an ordinary resolution when at a general meeting, the notice has been given, votes cast [whether by show of hands or on a poll as the case may be], in favor of the resolution [including the casting vote if any of the chairman] by members, who are entitled so to do, vote in person, or where proxies are allowed by proxy, exceed the votes, if any, cast against the resolution by members so entitled and voting. [Section 189 (1)] In other words, for passing an ordinary resolution a simple majority is required. Thus when in a general meeting, 100 members are present and entitled to vote and out of these 100 members, if 51 vote for the resolution and 49 vote against the same, the resolution is passed. Some of the occasions where ordinary resolution is required are as follows.

- Passing of annual accounts and balance sheet along with report of the Board of Directors.
- Appointments of first and subsequent directors
- Issue of shares at a discount
- Alteration of share capital
- Declaration of dividends
- Appointing auditors and fixing his remuneration

B] Special Resolution: A special resolution is the resolution, which has the following features.

- The intention to propose the resolution as a special resolution has been duly specified in the notice calling the general meeting.
- The votes cast in favor of the resolution are at least 75% of the total votes cast in connection with the resolution.
- The notice and agenda include an explanatory statement setting out all material facts concerning the subject matter of the special resolution including the nature of concern or interest of every director and the manager if any shall be annexed to the notice of the meeting.



- A copy of every special resolution together with the copy of the explanatory statement should be filed with the Registrar within 30 days of the passing of the resolution.
- Some of the occasions where special resolution is required are given below.
 - ❖ Alteration of memorandum for changing the place of registered office from one State to other with the permission of the Tribunal.
 - ❖ Change of name of the company
 - ❖ Alteration of the articles of association
 - ❖ Payment of interest out of capital
 - ❖ Applying to the Court to wind up of a company.

C] Resolution Requiring Special Notice : This is not a separate type of resolution as such. It is actually an ordinary resolution for which a special notice is required to be given. Section 190 (1) provides that where the Act or articles provides so, a special notice of not less than 14 days should be given for certain resolutions 14 days before the meeting in which a resolution is moved, exclusive of the day on which the notice is served or deemed to be served and the day of the meeting. Sub section (2) of section 190 provides that, on receipt of the notice, the company shall give its members notice of the resolution in the same manner as it gives notice of the meeting, or if that is not possible, shall give them notice thereof, either by advertisement in a newspaper having an appropriate circulation or any other mode allowed by the articles not less than seven days before the meeting. A special notice is required for a resolution in the following cases.

- ❖ Appointment of an auditor other than the retiring auditor
- ❖ Provision that a retiring auditor shall not be re-appointed
- ❖ Removal of a director before the expiry of his period
- ❖ Appointment of a director in place of one who is removed.

Additional grounds in respect of which a special notice is required may be provided in the articles of association of the company.

D] Resolutions passed at adjourned meetings : [Section 191] – Where a resolution is passed at an adjourned meeting of,

- a) A company,
- b) The holders of any class of shares in a company or
- c) The Board of Directors of a company,



The resolution shall, for all purposes, be treated as having been passed on the date on which it was in fact passed and shall not be deemed to have been passed on any earlier date.

E] Passing of resolution by Postal Ballot : [Section 192 A] – A listed public company may and in the case of resolutions relating to such business as the Central Government may, by notification, declare to be conducted only by postal ballot, shall, get any resolution passed by means of a postal ballot, instead of transacting the business in general meeting of the company. Where a company decides to pass any resolution by resorting to postal ballot, it shall send a notice to all the shareholders, along with a draft resolution explaining the reasons therefore and requesting them to send their assent or dissent in writing on a postal ballot within a period of 30 days from the date of posting of the ballot. The notice shall be sent by registered post or by any other method as may be prescribed by the Central Government on this behalf, and shall include with the notice, a postage prepaid envelop for facilitating the communication of the assent or dissent of the shareholders to the resolution within the said period. If a resolution as assented to by a majority of the shareholders by means of postal ballot, it shall be deemed to have been duly passed at a general meeting convened in that behalf.



STUDY NOTE - 12

BORROWING POWERS

This Study Note includes:

- Introduction
- Borrowing Capacity
- Legal Consequences of Ultra Vires Borrowings
- Charges - Fixed and Floating Charges and its legal Provision of the Same
- Debentures

12.1 INTRODUCTION

A company raises funds to run the business by issuing share capital. Funds are also raised through internal sources i.e. undistributed profits and reserves. In addition to these sources, a company can also raise funds through borrowings. Every company, unless prohibited by its memorandum or articles has implied power to borrow money for the purpose of its business. It also has the power to give security for the loan by creating a mortgage or charge on its property. A non- trading company, on the other hand has no implied power to borrow. It requires express power to do so and must be incorporated in the articles of association of that company. The relevant provisions regarding borrowing and creation of charge are discussed in this chapter.

12.2 HOW MUCH A COMPANY CAN BORROW?

Though a company has power to borrow, it does not mean that it can borrow without any limits as such. A company should consider its capacity to service the borrowings before an amount is borrowed. The Law also puts certain restrictions on the borrowings made by a company. When a company has express or implied power to borrow, it can borrow subject to the limits set by the memorandum or articles of association. A public company having a share capital cannot exercise borrowing power unless the certificate of commencement of business is obtained by it. [Section 149 (1)]

CONSEQUENCES OF EXCESS BORROWINGS :

As long as the borrowings are within the limits, there are no legal problems as such. However if the company borrows more amounts than permitted by its memorandum or articles, it is called as ultra vires borrowing. [Ultra means beyond and vires means powers, thus ultra vires means beyond the powers of the company] Sometimes the borrowings may be within the limits set by the memorandum or articles but it may be beyond the scope of authority of the directors. Thus in this case the borrowings are intra vires to the company but are ultra vires to the directors. There are legal implications of both these types of borrowings. These implications are discussed below.



12.3 LEGAL CONSEQUENCES OF ULTRA VIRES BORROWINGS

If the borrowings are ultra vires the company, it is totally void. Actually there is no debt at all for the company and if at all some securities are given, they also become void. Thus in other words, the lenders have no right to recover the debt against the company. Therefore it is always advisable for the lenders to make sure that the loans given by them are within the powers of the company, otherwise they will lose the amount of loan given to the company. However, even in the case of ultra vires borrowings, the lenders have some rights. These rights are as follows.

12.3.1 LENDERS' RIGHTS IN CASE OF ULTRA VIRES BORROWINGS :

The lenders have the following rights when it is ultra vires borrowings.

- i. **Injunction:** This right is exercisable when the company has not spent the money borrowed as a result of ultra vires borrowings. A lender can go to the Tribunal and claim injunction restraining the company from spending the money borrowed. However, once the company has spent the money, this remedy is lost.
- ii. **Subrogation:** If the money borrowed as a result of the ultra vires borrowings has been used to pay some intra vires borrowings, the lender of the ultra vires borrowings takes the place of the intra vires lender to the extent of the loan repaid. This is known as principle of subrogation. In other words, the lender of the ultra vires borrowings enters into the shoes of the lender of the intra vires lender and to that extent the amount of loan becomes intra vires. Thus for example, if A has given some loan to a company of Rs.1000000, which is ultra vires and if out of the same, Rs.500000 are used to repay an intra vires loan, Rs.500000 of the ultra vires borrowings becomes intra vires borrowing and the A can claim the repayment of the same. Remaining amount, however remains as ultra vires borrowings.
- iii. **Identification and Tracing:** If it is possible for the lender to identify the money lent by him, or any property purchased with it, he can trace the same and claim it. However, this is possible only when the company has not spent the money and it is still in the hands of the company.
- iv. **Claim for damages:** The lender of the ultra vires borrowings, may claim compensation or damages for breach of authority against the directors of the company. However the doctrine of constructive notice applies here. If it was possible for the lender to find out from the memorandum or articles about the borrowing powers and the ultra vires borrowings, the lender cannot claim damages for the same.

12.3.2 BORROWING BEYOND AUTHORITY OF DIRECTORS BUT INTRA VIRES THE COMPANY:

Sometimes, the borrowings made by the company is ultra vires the directors but intra vires the company. In such cases, the directors of the company have exceeded their authority but the borrowing is not beyond the powers of the company as such. In these cases, the borrowing can be ratified and thus becomes valid. However if the company refuses to ratify the same, as per the law of agency, if the third party knows that the agent has exceeded the authority, there is no



remedy available to the third party. Thus the lender cannot recover the amount. However, if the directors have not followed some of the internal procedures, the rule laid down in the doctrine of indoor management [Royal British Bank V/S Turquand] becomes applicable, and the lender can recover the amount.

12.4 CHARGES

As discussed in the earlier in this chapter, power to borrow money includes power to give security for the borrowings. A Charge is a kind of security given by the company to its creditors. A charge includes 'mortgage'. Charge can be created on the assets of the company or on the entire undertaking of the company. A charge can be 'Fixed' or 'Floating'. A fixed charge is on a particular asset of a company. For example, a company can create charge on asset like plant and machinery or land and building or any other fixed asset of the company. A company can use the asset as usual, but if it wants to dispose it off, the permission of the lender will have to take for the same. On the other hand, a floating charge is an equitable charge, which is created on some class of property, which is constantly changing. For example, a company can create a floating charge on inventory, debtors, receivables etc. A company can deal with these assets as usual during the course of business. A floating charge crystallizes into a fixed charge if the company goes into liquidation or ceases to carry on business or a receiver is appointed or a default is made in paying the principal as well as interest on the borrowings.

12.4.1 REGISTRATION OF CHARGES :

As mentioned earlier, a company can create fixed or floating charge on its assets. Certain charges created by the company must be registered with the Registrar, otherwise, they will be void against the liquidator or creditor. These charges are as follows. [Section 125]

- (1)
 - a) A charge for the purpose of securing issue of debentures
 - b) A charge on the uncalled capital of the company
 - c) A charge on any immovable property, wherever situated or any interest thereon
 - d) A charge on the book debts of the company
 - e) A charge, not being a pledge, on any movable property of the company
 - f) A floating charge on the undertaking or any property of the company including stock in trade
 - g) A charge on calls made but not paid
 - h) A charge on ship or any share in a ship
 - i) A charge on the goodwill, on a patent or a license under a patent on a trade mark or on a copyright or a license under a copyright.
- (2) A charge created out of India and comprising solely property situated outside India
- (3) Charge created in India but comprising of property outside India.



A charge must be registered with the Registrar within a period of 30 days from the date of creation of the same. However an extension of 30 days may be given by the Registrar on payment of prescribed fees if he is satisfied that there is a genuine cause for the delay.

12.4.2 EFFECTS OF NON- REGISTRATION :

Certain charges created by the company must be registered with the Registrar as mentioned above. However if the company fails to register the charge the legal implications of the same are as follows.

- I. The charge becomes void as against the liquidator and creditor.
- II. The money becomes payable immediately.
- III. When a charge becomes void for non-registration, no right of lien can be claimed on the documents of title as they are only ancillary to, and were delivered pursuant to, the charge
- IV. There shall be penalties due to non registration of charges.

12.4.3 DATE OF NOTICE OF CHARGE :

As per section 126, where any charge on any property of a company required to be registered under section 125 has been so registered, any person acquiring such property or any part thereof, or any share or interest therein, shall be deemed to have notice of the charge as from the date of such registration.

12.4.4 REGISTER OF CHARGES :

The provisions of section 130 regarding the maintenance of register of charges are as follows.

- 1) The Registrar shall, in respect of each company, cause to be kept a register containing the particulars of all the charges requiring registration under this part. [Sub section (1)]
- 2) Every company shall forward to the Registrar for being entered in the register kept under sub section (1) the particulars of all the charges requiring registration under this Part in such form and manner and after payment of prescribed fees.
- 3) The particulars of the charges mentioned above shall be relate to, in the case of charge to the benefit of which, the holders of a series of debentures are entitled, such particular as are specified in the relevant sections and in the case of any other cases, the following particulars shall be given.
 - a) If the charge is a charge created by the company, the date of its creation, and if the charge was a charge on the existing on property, acquired by the company, the date of acquisition of the property
 - b) The amount secured by the charge
 - c) Short particulars of the property charged
 - d) The persons entitled to the charge.



- 4) The pages of the register shall be consecutively numbered and the Registrar shall cause to keep the register in a prescribed form and also prescribe the manner in which the documents are to be filed and sign or initial every page of such register.
- 5) After entering the particulars of all the charges required, the Registrar shall return the instrument if any or the verified copy thereof, as the case may be, filed in accordance with the provisions of this Part to the persons filing the same.
- 6) The register kept as per the provisions of this section shall be open to inspection by any person on payment of prescribed fees.
- 7) The Registrar shall keep a chronological index, in the prescribed form and with the prescribed particulars of the charges registered with him. [Section 130]
- 8) The Registrar shall give a certificate under his hand of the registration of any charge registered in pursuance of this Part, stating the amounts thereby secured, and the certificate shall be conclusive evidence that the requirement of this Part as to registration have been complied with. [Section 131]

12.4.5 MEMORANDUM OF SATISFACTION :

[Section 138 to 140] – After a charge has been created and registered, the debt has got to be paid or satisfied by the company. When the charge is paid off or satisfied in full, the company shall give a notice of this fact to the Registrar within 30 days from the date of such payment or satisfaction. On receipt of such an information, the Registrar shall inform the holder of the charge of the fact of the payment or satisfaction of the charge. The Registrar shall further call upon the holder of the charge to show cause within a period not exceeding 14 days, why payment or satisfaction should not be recorded as intimated to him. If no cause is shown or if the holder of the charge raises no objection, the Registrar shall enter in the register of charges a memorandum of satisfaction recording this fact. If cause is shown or any objection is raised by the holder of the charge, the Registrar shall record a note to that effect in the register and inform the company accordingly.

12.4.6 REGISTER OF CHARGES AT THE COMPANY:

According to Section 143 every company has to keep at its registered office, a register of charges and enter therein all charges specifically affecting the property of the company and all floating charges on the undertaking or on any property of the company, giving in each case,

- a) Short particulars of the property charged
- b) The amount of charge and
- c) Except in the case of securities of bearer, the names of the persons entitled to the charge

If any officer of the company knowingly omits, or willfully authorizes or permits the omission of any entry, required to be made as per the above particulars, he shall be punishable with a fine which may extend to Rs.5000.



12.4.7 RIGHT TO INSPECT COPIES OF INSTRUMENTS CREATING CHARGES AND COMPANY'S REGISTER OF CHARGES :

As per provisions of section 144 (sub sections 1 to 4), the copies of the instruments creating charges kept in pursuance of section 136, and the register of charges kept in pursuance of section 143, shall be open during the business hours [subject to reasonable restrictions as the company in general meeting may impose, so that not less than 2 hours in each day are allowed for inspection] to the inspection of any creditor or member of the company without fee at the registered office of the company. The company may charge fees for each inspection. If inspection is refused, the company and every officer of the company, who is in default, shall be punishable with a fine which may extend to Rs.500 and a further fine, which may extend to Rs.200 for every day during which the refusal continues. The Central Government may also by order compel an immediate inspection of the said copies or register. [Section 144 (4)]

12.5 DEBENTURES

The borrowing powers of the company have been discussed in the above paragraphs. Now, we will be discussing, one of the popular form of borrowing, i.e. the debentures. A company can borrow money through the sale of debentures. A 'Debenture' is actually an acknowledgement of a debt, which is taken by the company from the debenture holders. Section 2 [12] of the Companies Act defines debenture as 'debenture includes debenture stock, bonds and any other securities of a company, whether constituting a charge on the asset of the company or not.' A company can issue debentures of various types. These types are discussed below.

12.5.1 TYPES OF DEBENTURES :

The following are the types of debentures

- a) **Bearer Debentures:** These debentures are also called as 'unregistered' and are payable to the bearer. These debentures are freely transferable from one person to another and the bearer is entitled to the interest as well as to the principal amount of the same.
- b) **Registered Debentures:** The holders of these debentures are registered with the company and hence they are called as registered debentures. The registered holders of debentures can transfer these debentures to other persons in the similar fashion of transfer of shares. The transfer is to be registered with the company. Registered debentures are not negotiable instruments while the bearer debentures are negotiable instruments.
- c) **Secured Debentures:** Debentures which create some charge on the property of the company are known as secured debentures. The charge may be a fixed charge or a floating charge
- d) **Unsecured Debentures:** These debentures have no charge, either fixed or floating on the assets of the company. In other words, no asset is offered as security to them and hence they are called as unsecured debentures.
- e) **Redeemable Debentures:** These debentures are redeemable after the particular period for which they are issued is over. These debentures may be re-issued after their redemption.



- f) Irredeemable Debentures: A debenture is irredeemable if either there is no fixed period for the redemption or the repayment of it is made conditional on the happening of an event which may not happen for an indefinite period or may happen only in certain specified and contingent events, for example the winding up of the company.
- g) Convertible Debentures: These debentures give an option to the holders to convert them into preference or equity shares at stated rates of exchange after a certain period. If the holders, exercise this option, the debentures get converted, otherwise they can accept cash.
- h) Non Convertible Debentures: These debentures do not give an option to the holders of conversion.

12.5.2 ISSUE OF DEBENTURES AT DISCOUNT :

Debentures can be issued at a discount, unless the articles provide otherwise. There are no formalities required to be completed like the ones prescribed in case shares are issued at discount. But the particulars of the debentures issued at discount or any allowance or commission in relation to the debentures issued at a discount are to be filed with the Registrar for registration. Interest payable on debentures may be paid out of capital. Convertible debentures cannot be issued at a discount because it will be an indirect way of issuing shares at discount. A company cannot issue debentures carrying voting rights at any meeting of the company.

12.5.3 DEBENTURE HOLDERS' ACTIONS :

A debenture holder is a creditor of a company. The company owes him the interest on the amount of the debenture as well as the principal amount, which is to be repaid after the expiry of the period for which they are issued. However sometimes, some companies may commit default in paying either the interest or the principal amount or both. In such cases, the debenture holders have some legal remedies against the company. However the positions of the secured and unsecured debentures are different. In case of unsecured debentures, their position is similar to that of the unsecured creditors. The unsecured debenture holders may sue for their principal and interest. They may also file a petition under section 439 for the winding up of the company by the Tribunal on the ground specified in section 433 (e) that is the company is unable to pay its debts.

As regards to the secured debentures, they have the following remedies in addition to both the remedies mentioned above.

- a) A secured debenture holder may sue on behalf of himself and all other debenture holders of the same class to obtain payment and enforce his security by sale. This is known as 'debenture holders action' and if several debenture holders sue separately, the Tribunal can consolidate their suits into one.
- b) Appointment of Receiver: A Receiver may be appointed if the conditions of issue of debentures give the secured debenture holders the powers to appoint the Receiver. On the appointment of the Receiver, the assets become specifically charged in favor of the debenture holders and the powers of the company to deal in them in the ordinary course of business cease although the company continues to exist until it is wound up.



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- c) Foreclosure: He may apply to the Tribunal for foreclosure of the company's rights to redeem the debentures. Foreclosure is a process by which the mortgagor, failing to repay the money lent on the security of a property, is compelled to forfeit his rights to redeem the property.
 - d) Sale: A secured debenture holder may sell the property charges as security if an express power to do so is contained in the terms of issue of the debentures. He may also have the property sold through trustees if such power is given by the debenture trust deed.
 - e) Proof for the balance: If the company is insolvent and his security is insufficient, he may value his security and prove for the balance. As an alternative, he may surrender his security and prove for the whole amount of his debt.



STUDY NOTE - 13

OPPRESSION AND MISMANAGEMENT

This Study Note includes:

- Introduction
- Meaning of Oppression
- Prevention of Oppression
- Meaning of Mismanagement
- Right to Apply U/S 399
- Powers of Tribunal
- Alteration of Memorandum and Articles of Association of the Company
- Powers of Central Government to Prevent Oppression or Mismanagement
- Principle of Majority Rule

13.1 INTRODUCTION

The affairs of a company are conducted in a democratic manner, which indicates that the majority rule shall prevail. Shareholders of a company are the real owners, however due to their large numbers and spread in a large geographical area, they are not able to take part in the day-to-day administration of the company. Therefore, they elect their representatives, who are known as 'Directors'. The board of directors have wide powers as per the Companies Act 1956. However, some of the powers given to the Board of Directors are to be exercised with the consent of the shareholders in a general meeting. In any general meeting, majority rule shall prevail as laid down in the landmark case of 'Foss V/s Harbottle', which has been explained in the previous chapter. However, it is possible that there might be injustice on the minority at the hands of majority. This may lead into 'oppression' on the minority. In such cases there must be some remedy available to the minority to challenge the majority. Similarly if there is mismanagement of a company, there must be protection given to the minority shareholders to prevent the mismanagement. Hence the Companies Act 1956 has made exhaustive provisions to prevent oppression and mismanagement. These provisions are discussed in detail in the following paragraphs.

13.2 WHAT IS 'OPPRESSION'?

In a landmark judgment, Justice Lord Cooper has observed that, 'The essence of the matter seems to be that the conduct complained of should be at the lowest and involve a visible departure from the standards of fair dealing, and a violation of the conditions of fair play on which every shareholder who entrusts his money to the company is entitled to rely.' Thus oppression should be such that it warrants winding up of the company, however, winding up may



not protect the interests of the party affected by such oppression and hence some other type of relief becomes necessary.

13.3 PREVENTION OF OPPRESSION

Section 397 of the Companies Act provides that,

- (1) Any members of a company, who complain that the affairs of the company are being conducted in a manner prejudicial to the public interest or in a manner oppressive to any member or members may apply to the National Company Law Tribunal for an order under this section, provided such members have a right so to apply in virtue of section 399.
- (2) If, on any application under sub-section (1), the Tribunal is of the opinion,
 - (a) that the affairs of the company are being conducted in a manner prejudicial to the public interest or in a manner oppressive to any member or members and,
 - (b) that to wind up the company would unfairly prejudice such member or members, but otherwise the facts would justify the making up of a winding up order on the ground that it was just and equitable that the company would be wound up.

The Tribunal may, with a view to bringing to an end, the matters complained or, make such order as it thinks fit.

Thus, if we analyze the above provisions, the following points emerge.

- I. There must be an act or acts done by the company, which are against the interest of the public or are oppressive to any member or members.
- II. The act or acts are such that winding up of the company in the given circumstances will be perfectly justifiable. This indicates the seriousness of the act of oppression.
- III. However, considering the interests of the member or members, the winding up order would affect the interest of such member or members in an adverse manner. This means that the remedy will be worst than the disease.
- IV. Requisite number of members applies to the Tribunal, complaining about the oppression or any other act or acts, which are prejudicial to the public interest.



13.4 MISMANAGEMENT

Regarding mismanagement also, the Tribunal may provide relief as per the provisions of section 398. This section provides that,

- (1) Any members of a company who complain -
 - (a) that the affairs of the company are being conducted in a manner prejudicial to public interest or in a manner prejudicial to the interests of the company, or
 - (b) that a material change (not being a change brought about by, or in the interests of, any creditors including debenture holders or any class of shareholders of the company) has taken place in the management or control of the company, whether by an alteration in its Board of Directors or managers or in the ownership of the company's shares, or if it has no share capital, in its membership, or in any other manner whatsoever, and that by reason of such change, it is likely that the affairs of the company will be conducted in a manner prejudicial to the public interest or in a manner prejudicial to the interests of the company, may apply to the Tribunal for an order under this section, provided that the members have a right to apply in virtue of section 399.

(2) If, on any application under sub-section (1), the Tribunal is of the opinion that the affairs of the company are being conducted as aforesaid or that by reason of any material change as aforesaid in the management or control of the company, it is likely that the affairs of the company will be conducted as aforesaid, the Tribunal, may, with a view to bringing to an end or preventing the matters complained of or apprehended, make such order as it thinks fit.

Thus it is clear from the above provisions that if there is any case of mismanagement of a company, the Tribunal can provide relief to rectify the same. However, the Tribunal will act on the request made by specific number of members and the relevant provisions given in section 399 are given below.

13.5 RIGHT TO APPLY UNDER SECTION 399

As mentioned in the above paragraph, the Tribunal will act on the request made by specified number of members. The provisions of section 399 are as follows.

- (1) The following members of a company shall have the right to apply under section 397 or section 398
 - (a) In the case of the company having a share capital, not less than one hundred members of the company or not less than $1/10^{\text{th}}$ of the total number of members, whichever is less, or any member or members holding not less than one tenth of the issued share capital of the company, provided that the applicant or applicants have paid all calls and other sums due on their shares.



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- (b) In the case of the company not having share capital, not less than one fifth of the total number of its members.
- (2) For the purpose of sub-section (1), where any share or shares are held by two or more persons jointly, they shall be counted only as one member.
- (3) Application can be made by any one of the members on behalf of others, after obtaining their consent in writing.
- (4) The Central Government may, if in its opinion circumstances exist, which make it just and equitable so to do, authorize any member or members of the company to apply to the Tribunal under section 397 or 398, notwithstanding that the requirements of clause (a) or clause (b) as the case may be, of sub-section (1) are not fulfilled.
- (5) The Central Government, may ask such member or members to pay security deposit towards the payment of any costs, if the Central Government feels it necessary to do so.

It should be remembered that the Central Government may itself apply to the Tribunal for an order under section 397 and 398 or authorize any person to apply on its behalf.

13.6 POWERS OF TRIBUNAL

- The Tribunal has powers under section 397 or 398, to pass any order, which may provide for,
 - (a) The regulation of the conduct of the company's affairs in future.
 - (b) The purchase of the shares or interests of any members of the company by other members thereof or by the company.
 - (c) In the case of a purchase of its shares by the company as aforesaid, the consequent reduction of its share capital
 - (d) The termination, setting aside or modification of any agreement, howsoever arrived at, between the company on the one hand and any of the following persons, on the other, namely,
 - i. The Managing Director
 - ii. Any other director
 - iii. The manager,

Upon such terms and conditions as may, in the opinion of the Tribunal, be just and equitable in all the circumstances of the case.

- (e) The termination or setting aside of any agreement shall not be done unless due notice is given to the concerned party and as regards the modification, unless the consent of the concerned party is obtained. Whenever, there is a termination, setting aside or modifi-



cations in an agreement, the order directing so, shall not give rise to any claim whatever against the company by any person for damages or for compensation for loss of office or in any other respect, either in pursuance of the agreement or otherwise. [section 407 (1) (a)] The Managing Director or other directors or manager whose agreement is so terminated shall not eligible to be appointed as Managing Director or other director or manager for a period of 5 years from the date of passing of such an order without the approval of the Tribunal. Such approval shall not be granted unless notice of the intention to apply for leave has been served on the Central Government and that Government has been given an opportunity of being heard in this matter. [section 407 (3)]

- (f) The setting aside of any fraudulent preference made within 3 months before the date of the application. The period of 3 months should be a clear period of 3 months between the date of transfer and that of application.
 - (g) Any other matter for which, in the opinion of the Tribunal, it is just and equitable that provision should be made.
- The Tribunal has the powers under section 409 for prevention of change in management, i.e. Board of Directors. If the managing director or any director or manager of a company complains to the Tribunal that as a result of a change in the ownership of shares, a change in the Board of Directors is likely to take place and such change would prejudicially affect the affairs of the company, the Tribunal may order that no such change in the Board of Directors or membership of the company can be made, without its prior approval. The Tribunal shall however satisfy itself by an inquiry as it thinks fit that such an order is necessary. It may also make an interim order to the effect before making or completing the inquiry. Section 409 does not apply to a private company unless it is a subsidiary of a public company.

INTERIM ORDER :

As per section 403, the Tribunal can pass an interim order before passing a final order for regulation of the conduct of the company's affairs as it may feel just and equitable.

13.7 ALTERATION OF MEMORANDUM AND ARTICLES OF ASSOCIATION OF THE COMPANY

The company can make suitable alterations in the Memorandum and Articles of Association, if the order given by the Tribunal under section 397 or 398 makes any alterations in these documents. However such alteration in these documents must be strictly in accordance with the order and for such alteration and should not be inconsistent with the order. Any such alteration, which is consistent with the order shall not require any prior approval of the Tribunal and shall be deemed to have done according to the provisions of the Act. [Section 404 (1) and (2)] The company should file a certified copy of the amended memorandum and articles of association with the Registrar within 30 days of this alteration for registration. [Section 404 (3)] If any default is made in the compliance of the provisions of sub-



section 3, the company and every officer of the company, who is in default shall be punishable with fine, which may extend to fifty thousand rupees.[Section 404 (4)]

13.8 POWERS OF CENTRAL GOVERNMENT TO PREVENT OPPRESSION OR MISMANAGEMENT

Under the provisions of the section 408, the Central Government has the powers to take steps for prevention of oppression and mismanagement.

- ❑ Section 408, sub-section 1 provides that the Central Government can appoint such number of persons to hold office of directors of the company, as may be directed by the Tribunal by its order in writing. Such persons are appointed to safeguard the interests of the company, or its shareholders or the public interest and the period for which they shall hold the office shall not be more than three years. The Tribunal may pass such an order on a reference made by the Central Government or on an application of not less than one hundred members of the company or of the members of the company, holding not less than one-tenth of the total voting powers therein and is satisfied after an inquiry that such an appointment or appointments are necessary to prevent the oppression and mismanagement in the company. The directors so appointed shall not be required to hold qualification shares, nor shall they retire by rotation. However, they can be removed or replaced by the Central Government. Section 408 (5) provides that no change in the Board of Directors made after a person is appointed or directed to hold the office as a director or additional director shall have effect unless confirmed by the Tribunal. The Central Government may require the persons appointed as the directors or additional directors in pursuance of this section to report to the Central Government from time to time with regard to the affairs of the company.
- ❑ Section 388 –B to 388-E empower the Central Government to remove managerial persons from office on the recommendation of the Tribunal. [Please refer to the chapter of ‘Directors’ for details of the same]

13.9 PRINCIPLE OF MAJORITY RULE

The management of a company is run on democratic principle. This means that, shareholders elect their representative, i.e. directors by voting in the annual general meeting. The directors are thus elected representatives of the shareholder and are responsible for the management and administration of the company. They have been given powers to conduct the business of the company in an efficient manner. However there are limitations on the power of the director and there are several areas, where decision are to be taken only after the sanction of the general meeting. These decisions are taken on the basis of majority, whether simple or three forth. Thus democratic principles are followed in running the company. However, there is a possibility that this majority rule may be misused and may be used to oppress the minority. The principle that the will of the majority should prevail and bind the minority is known as the principle of majority. It was laid down in the landmark judgment in the case of Foss V/S Harbottle, which is given below.



In this case, two minority shareholders, in a company alleged that its directors were guilty of buying their own land for the use of the company and thus paid themselves a higher price than its value. This action of the directors resulted into a loss to the company and minority shareholders decided to take action for damages against the directors. However in a general meeting it was decided by the majority shareholders that no action should be taken against the directors. The minority shareholders filed a suit, which was dismissed by the Court on the ground that the acts of directors were capable of confirmation by the majority of members and held that if something wrong is done to the company, the company itself should take the action and not the minority shareholders.

Thus the above decision upholds the majority rule and the important benefit is that the principle of majority rule is upheld. It is but fair that the majority wish should prevail. Similarly unnecessary litigations at the will of minority have been averted. Thus this decision is a landmark in several respect.

However there are instances where the majority rule has oppressed the minority shareholders. If there is an oppression and mismanagement and if it is proved, the protection of majority rule shall not prevail. Thus in the following situations, the majority rule principle shall not be applicable and the minority rights shall be protected. These are known as exceptions to the rule laid down in the case of *Foss V/S Harbottle*. These exceptions are given below.

- 1) When the majority does any Act, which is ultra vires or illegal, the minority shareholders can take action against the majority wish and prevent them from doing so.
- 2) If the majority are perpetrating a fraud on minority, the minority can take against the majority.
- 3) Any Act, which is inconsistent with the articles of association can be challenged by the minority.
- 4) If any decision, which is to be taken by special resolution is in fact done by a simple majority, the minority can bring an action against the majority.
- 5) Minority shareholders can take action if any personal rights of an individual member have been infringed.
- 6) Minority shareholder may bring an action against the company, where there is a breach of duty by the directors and majority shareholders to the detriment of the company.
- 7) If there is mismanagement and oppression, the minority shareholders can bring legal action against the majority.

STUDY NOTE - 14

COMPROMISES, ARRANGEMENTS AND RECONSTRUCTION

This Study Note includes:

- Introduction
- Meaning of Compromises, Arrangements and Reconstruction
- Legal Provisions Concerning Compromises, Arrangement and Reconstruction and Amalgamation
- Inter Corporate Loans and Investments

14.1 INTRODUCTION

As a going concern, a company may have to make adjustments in the form of compromises, arrangements and also reconstruction of its business. Sometimes these adjustments are voluntary while sometimes there may be legal compulsion for the company to do so. Various legal provisions about these adjustments have been discussed in this topic in the following paragraphs.

14.2 MEANING OF COMPROMISES, ARRANGEMENTS AND RECONSTRUCTION

The various terms used in this topic have been defined as follows.

- ❖ **Compromises:** This term means settlement or adjustments of claims in dispute by mutual concessions. Thus in other words, compromise presupposes the existence of a dispute and it means settlement of the same by give and take policy. Compromise does not mean one-sided settlement but involves mutual sacrifices and concessions.
- ❖ **Arrangements:** As per section 390 the expression 'arrangements' includes a reorganization of the share capital of the company by the consolidation of shares of different classes, or by the division of shares into shares or different classes or by both these methods. [Section 390 b]
- ❖ **Reconstruction:** Reconstruction occurs when a company transfers the whole of its undertaking and property to a new company under an arrangement by which the shareholders of the old company are entitled to receive some shares or other similar interests in the new company.
- ❖ **Amalgamation:** Amalgamation takes place when two or more companies combine into one company. The shareholders in the amalgamating company become



substantially shareholders of the amalgamated company. Thus when A Ltd. and B Ltd. come together and a new company C Ltd. is formed, it is an amalgamation.

14.3 LEGAL PROVISIONS

14.3.1 COMPROMISES

When compromises are carried out by companies as going concern, the procedure is to be followed. [Section 391 to 393] According to the legal provisions, a compromise or arrangements may be proposed between a company and its creditors or any class of them or between a company and its members or any class of them. The following procedure is to be followed in case of such compromise or arrangements.

- I] Once a proposal for compromise or arrangement is made, the company or any creditor or member may apply to the Tribunal for a compromise.
- II] The Tribunal shall then direct the calling of a meeting of each class of creditors or each class of members. Before granting sanction to convene such a meeting, the Tribunal, shall satisfy itself that the scheme is reasonable and can be implemented by the company. The meeting shall be held and conducted in a manner as directed by the Tribunal.
- III] At the meeting, a resolution approving the compromise or arrangement shall be passed by a majority representing 3/4th in value of the creditors or members present at the meeting.
- IV] The Tribunal shall sanction any scheme, which is fair and reasonable and made in good faith for the benefit of each class of the members or creditors concerned.
- V] Once a compromise is sanctioned by the Tribunal, it becomes binding on all the creditors and members and in the case of a company, which is being wound up, on the liquidator and contributories of the company. However, the Tribunal, is not bound to sanction the compromise or arrangement unless it is satisfied that the company or any other person by whom application has been made has disclosed to the Tribunal all material facts relating to the company such as the latest financial position of the company, the latest auditor's report on the accounts of the company, the pending of any investigation proceedings in relation to the company under relevant sections.
- VI] The order of the Tribunal sanctioning the compromise shall have effect only when a certified copy of the order has been delivered to the Registrar for registration. A copy shall also be annexed to every copy of the memorandum issued after the certified copy has been filed.
- VII] The Tribunal has the authority to stay the commencement or continuation of any suit or proceedings against the company on such terms as it thinks fit, until the application is finally disposed off.

VIII] An appeal shall lie from any order made by the Tribunal exercising original jurisdiction under section 391 to the Tribunal empowered to hear appeals.

- ❖ When a company is being wound up subject to the supervision of the Tribunal, the liquidator has the powers under section 546 regarding the compromise or arrangements and he can exercise the same. The powers can be exercised with the sanction of a special resolution of the company. The liquidator may, with the necessary sanction take following actions.
 - i. Pay any classes of creditors in full
 - ii. Make any compromise or arrangement with creditors or persons claiming to be creditors
 - iii. Make compromise with the debtors where such debts arise as a result of calls or otherwise

An arrangement or compromise may also be entered into between a company about to be, or in the course of being wound up and its creditors. Such arrangement is binding on the company and on the creditors, if it is sanctioned by a special resolution of the company. The arrangement is subject to the right of appeal and hence any creditor or contributory may within 3 weeks from the completion of the arrangement, appeal to the Tribunal against it. The Tribunal may, as it thinks just, amend, vary or set aside the arrangement.

14.3.2 RECONSTRUCTION AND AMALGAMATION :

We have defined these terms earlier in this chapter. The procedure to be followed in case of reconstruction and amalgamation is discussed below.

PROCEDURE TO BE FOLLOWED :

The following procedure is required to be followed in case of reconstruction and amalgamation.

- i. Where a compromise or arrangement has been proposed for the purpose of reconstruction of a company, or its amalgamation with another company, the scheme shall be approved by the holders of 3/4th in value of shares concerned.
- ii. The scheme shall then be sanctioned by the Tribunal. The Tribunal may sanction the compromise or arrangement and pass orders for any of the following matters.
 - a) The transfer of the undertaking, property, and liabilities of the transferor company to the transferee company.
 - b) The allotment or appropriation by the transferee company of any shares, debentures, policies or other like interests in that company, which are to be allotted or appropriated under the contract



- c) The continuation by or against any transferee of any legal proceedings by or against the transferor company.
 - d) The dissolution, without winding up of any transferor company
 - e) The provision to be made for any persons who dissent from the compromise or arrangement and
 - f) Such incidental, consequential and supplemental matters as are necessary to secure that the reconstruction or amalgamation shall be fully and effectively carried out.
- iii. A compromise or arrangement proposed in connection with a scheme for the amalgamation of a company, which is being wound up, with any other company, shall be sanctioned by the Tribunal. However if the Tribunal has received a report from the Registrar that the affairs of the company have been conducted in a manner prejudicial to the interest of its members or to the public interest, it shall not sanction the compromise or arrangement. A similar report from the Official Liquidator is necessary before the Tribunal orders dissolution without winding up of any transferor company.
- iv. A certified copy of the Tribunal order should be filed with the Registrar within 30 days after the making of the order by the Tribunal.
- v. The Tribunal shall give the Central Government notice of every application made to it under section 391 or 394. It shall also take into consideration the representations made by the Central Government if any.

DISSENTING SHAREHOLDERS :

[Section 395] – About the rights of dissenting shareholders, provisions of section 395, provide the following.

- i. A scheme of reconstruction and amalgamation may involve the transfer of shares by one company to another company.
- ii. After the transferee company makes an offer to the shareholders of the transferor company to acquire their shares, the offer shall be approved within 4 months by holders of not less than 9/10th in value of the shares of the transferor company. In the computation of the 9/10th in the value of the shares, shares already held by the transferee company or its nominee or subsidiary shall not be counted.
- iii. When the acceptance of 9/10th in the value of the shareholders is duly received, the transferee company shall get the right to acquire the shares of the dissenting shareholders if any.
- iv. Within 2 months, after the expiry of the 4 months [period for approval], the transferee company shall give a notice to the dissenting shareholders that it desires to acquire their shares. The dissenting shareholders may apply to the Tribunal within 1

month of the notice. The Tribunal will interfere if the scheme appears to be oppressive, unjust, unfair or unconscionable or the consent of the majority has been obtained by fraud, deception or any other improper means. If no such application is made to the Tribunal, the transferee company shall be entitled to acquire the shares of all persons on whom the notice is served.

- v. When the transferee company acquires the shares and pays their price, the transferor company shall register the transferee company as the holder of those shares. Within one month of the date of such registration, the transferor company shall inform the dissenting shareholders of the fact of such registration and of the receipt of the amount or other consideration representing the price payable to them by the transferee company.
- vi. The transferor company shall pay into a bank account [separate] the money received from the transferor company and shall hold the money in trust for its shareholders.

14.3.3 AMALGAMATION OF COMPANIES IN NATIONAL INTEREST :

[Section 396] Where the Central Government is satisfied that it is essential in the public interest that two or more companies should amalgamate, it may be order notified in the Official Gazette, provide for the amalgamation of these companies into a single company. The amalgamated company shall have such constitution, property, powers, rights, interests, authorities and privileges and shall be subject to such liabilities, duties and obligations as may be specified in the order. The order of the Central Government may provide for the continuation by or against the transferee company of any legal proceedings pending by or against any transferor company. It may also contain such consequential, incidental and supplemental provisions as may be necessary to give effect to the amalgamation. Every member of creditor including a debenture holder, of each of the companies before amalgamation shall have, as nearly as may be, the same interest in or right against the amalgamated company as he had in the company of which he was originally a member or creditor. If his rights in the new company are in any manner less, he shall be entitled to compensation, which shall be assessed by the prescribed authority. Every such assessment shall be published in the Official Gazette.

Any person aggrieved by the assessment of compensation may, within 30 days from the date of publication of the assessment in the Official Gazette, prefer an appeal to the Tribunal. Thereupon the assessment of the compensation shall be made by the Tribunal. Copies of every order made under section 396, shall at the earliest after it has been made, be laid before both Houses of Parliament.



14.4 INTER CORPORATE LOANS AND INVESTMENTS

According to section 372 A,(1) no company, shall directly or indirectly,

- a) Make any loan to any other body corporate
- b) Give any guarantee, or provide security in connection with a loan made by any other person to, or to any other person by, any body corporate and,
- c) Acquire, by way of subscription, purchase or otherwise the securities of any other body corporate,

Exceeding sixty percent of its paid up share capital and free reserves, or one hundred per cent of its free reserves, whichever is less.

It is further provided that where the loans or guarantee or investments made exceed the above mentioned percentages, further loans or guarantee or investments should be given only after passing a special resolution in a general meeting, authorizing these further loans, guarantees or investments.

The Board of directors may give guarantee, without being previously authorized by a special resolution if,

- a) A resolution is passed in the meeting of the Board authorizing to give guarantee in accordance with the provisions of this section
- b) There exists exceptional circumstances which prevent the company from obtaining previous authorization by a special resolution passed in a general meeting for giving a guarantee and
- c) The resolution of the Board under clause (a) is confirmed within twelve months, in a general meeting of the company or the annual general meeting held immediately after passing of the Board's resolution, whichever is earlier.
- d) The notice of such resolution shall indicate clearly the specific limits, the particulars of the body corporate in which the investment is proposed to be made, or loan or security or guarantee to be given, the purpose of the investment, loan or security or guarantee, specific sources of funding and such other details.
- e) No loan or investment shall be made or guarantee or security given by the company unless the resolution sanctioning it is passed at a meeting of the Board with the consent of all the directors present at the meeting and the prior approval of the public financial institution referred to in section 4A, where any term loan is subsisting, is obtained.
- f) No loan to any body corporate shall be made at a rate of interest lower than the prevailing bank rate, being the standard rate made public under section 49 of the Reserve Bank of India Act 1934.

- g) No company, which has defaulted in complying with the provisions of section 58 A, shall directly or indirectly,
- i. Make any loan to any body corporate
 - ii. Give any guarantee, or provide security, in connection with a loan made by any other person to, or to any other person by, any body corporate and
 - iii. Acquire by way of subscription, purchase or otherwise the securities of any other body corporate, till such default is subsisting.
- h) Every company shall keep a register showing the following particulars in respect of every investment or loan made, guarantee given or security provided by it in relation to any body corporate under sub section (1) mentioned above.
- i. The name of the body corporate
 - ii. The amount, terms and purpose of the investment or loan or security or guarantee
 - iii. The date on which the investment or loan has been made and
 - iv. The date on which the guarantee has been given or security has been provided in connection with a loan.
- i) The register referred above, shall be kept at the registered office of the company concerned and shall be open to inspection at such office and extracts may be taken there from and copies thereof may be required by any member of the company to the same extent, in the same manner and on payment of the same fees as in the case of the register of members of the company and the provisions of section 163 A shall apply accordingly.



Study Note - 15

WINDING UP

This Study Note includes

- Introduction
- Modes of winding up of a company
- Compulsory winding up
- Voluntary Winding up

15.1 INTRODUCTION

Winding up or liquidation means closure of the company or dissolution of the company. It represents the last stage in the life of a company. During winding up, the assets of the company are sold out, book debts realized and the liabilities are settled. If some amount still remains after the satisfaction of all the creditors, the preference shareholders paid and the equity shareholders are paid at the end depending on the amount available. For completing the entire process, an administrator called as liquidator is appointed and he is responsible for disposing of all the assets, and distributing the proceedings amongst various claimants including creditors and the shareholders. Various legal provisions regarding winding up are discussed below.

15.2 MODES OF WINDING UP

The following are the modes of winding up.

- I] Winding up by the Tribunal [Section 433 to 483] Also called as Compulsory Winding Up
- II] Voluntary Winding Up [Section 484 to 521] This winding up may be,
 - Members' Voluntary Winding Up or
 - Creditors' Voluntary Winding Up

We will take up each of the types of the winding up for a detailed discussion. We will start with the Winding Up by The Tribunal or Compulsory Winding Up.

15.2.1 Winding Up By The Tribunal or Compulsory Winding Up:

This winding up, as the name suggests is a compulsory winding up as ordered by the Tribunal. However even this winding up cannot be ordered unless there are compelling reasons for the same. It can be ordered in the following cases.

- A] Special Resolution: If members of a company pass a special resolution in a general meeting, the Tribunal may order for winding up of a company. However, when members pass a resolution like this, they may prefer a voluntary winding up, which is less costly and less time consuming and hence winding up petition under this section are extremely rare.



- B] Default in holding Statutory Meeting or filing of Statutory Report: Petition under this section should be made either by the Registrar or by a contributory. Petition can be made after the expiry of 14 days from the date on which the statutory meeting should have been held. Usually the Tribunal shall order to hold a statutory meeting and file the statutory report instead of taking extreme step of ordering winding up under this section.
- C] Failure to commence, or suspension of business: [Section 433 (c)] The Tribunal exercises power in this case if the company do not show any intention of commencing the business. However, if the company fails to commence business within one year from the incorporation or suspends operation for a complete one year, the Tribunal may not order winding up if there are reasonable prospects of the company commencing the business within a reasonable time or there are good reasons for the delay.
- D] Reduction in Membership: [Section 433 (d)]- There are statutory limitations on the number of members in case of a public company and a private company. Accordingly in case of a private company the minimum number is 2 and in the case of public company the minimum number is 7. If the number of members in case of these companies, fall below the statutory minimum, the company may be ordered to be wound up by the Tribunal. In case the number falls below the statutory minimum and the company continues the business for more than six months, and every member is aware of this fact, they are held as severally liable for the payment of the whole of the debts of the company contracted after those six months.
- E] Inability to pay debts: [Section 433 (e)] – A company may be wound up by the Tribunal, if it is unable to pay its debts. However it should be established that the company really is unable to pay its debts. Temporary suspension of payment of debt cannot be a ground for ordering the winding up of a company. If the company neglects the demand for payment to a creditor or when a decreed bet is unsatisfied or when the company is facing commercial insolvency, it may be inferred that the company is unable to pay its debts and accordingly the Tribunal may order winding up of the company.
- F] Just and Equitable: [Section 433 (f)] –If it is just and equitable in the opinion of the Tribunal, the company may be wound up as per order of the Tribunal. However the opinion of the Tribunal must be based on facts. The principle of just and equitable does not have a definition as such. It may rest with the judicial discretion of the Tribunal depending the facts and circumstances of each case.

Petition: [Section 439]

The winding up procedure commences after a petition is made to the Tribunal. The petition may be made by any of the following parties.

- A] Company: A company may itself make a petition to the Tribunal for winding up. A special resolution to that effect must have been passed in a general meeting of a company. However as explained in one of the earlier points, a company may not make petition under this section, as it is more convenient to have a voluntary winding up rather than a compulsory winding up.



- B] Creditor/s: [Section 439 (1) (b)] – Any creditor/s may file a petition for winding up of a company to the Tribunal. Creditor includes not only the persons to whom a debt is due at the time of the petition of winding up but also every other person, who is having a pecuniary claim against the company, whether actual or contingent and such persons are competent to file a petition for winding up of a company.
- C] Contributory/Contributories: [Section 439 (1) (c)]- A contributory means a person who is liable to contribute to the assets of the company on the event of its being wound up and includes the holder of shares, which are fully paid up. He can present a petition for winding up of a company, even though he may be the holder of fully paid up shares or that the company may have no assets at all, or may have no surplus assets left for distribution among the shareholders after the satisfaction of its liabilities. A contributory can file a petition for winding up on the following grounds.
- If the number of membership is reduced below the statutory minimum or
 - He is an original allottee of the shares or
 - He has held his shares for any 6 out of the previous 18 months or
 - The shares have devolved on him through the death of a former holder.
- D] All Prior Parties: All prior parties described above, i.e. the company, creditors, contributories can file petition either together or individually.
- E] Registrar: [Section 439 (1) (e)] – Petition by Registrar can be made on the following grounds.
- If default is made by the company in delivering the statutory report to the Registrar or in holding the statutory meeting.
 - If the company does not commence its business within a year from its incorporation, or suspends its business for a whole year
 - If the number of members is reduced in the case of a public company below 7 and in the case of a private company below 2.
 - If the company is unable to pay its debts
- F] Central Government: [Section 439 (1) (f)] – If the Central Government, on the report given by the inspectors appointed under section 235, is of the opinion that, the business of the company is being conducted with an intention to defraud its creditors, members or other persons or for a fraudulent purpose or there is an oppression to any of its members or the purpose behind the formation of the company itself was fraudulent or unlawful, or persons connected with the management of the company have been guilty of fraud, misfeasance or other misconduct towards the company or its members, it can apply to the Tribunal for winding up of the company.

Commencement of Winding Up: The important question that is to be answered is what is the effective date of commencement of winding up? Section 441 (1) provides that where, before



the presentation of the petition for the winding up of a company by the Tribunal, a resolution has been passed by the company for voluntary winding up, the winding up of the company shall be deemed to have commenced at the time of the passing of the resolution and unless the Tribunal, on proof of fraud or mistake, thinks fit to direct otherwise, all proceedings taken in the voluntary winding up shall be deemed to have validly taken. According to section 441 (2), in any other case, the winding up of a company by the Tribunal, shall be deemed to commence at the time of the presentation of the petition for the winding up. Every petition for winding up a company shall be advertised 14 days before the hearing, stating the date on which the petition was presented and the names and addresses of petitioners.

Powers of the Tribunal: The Tribunal shall have the following powers under section 443 (1). The section provides that on hearing the petition, the Tribunal may,

- Dismiss it, with or without costs or
- Adjourn the proceedings conditionally or unconditionally or
- Make any interim order that it thinks fit or
- Make an order for winding up of the company with or without costs or any other order it may think fit.

The Tribunal shall not refuse to make a winding up order on the ground only that the assets of the company have been mortgaged to an amount equal to or in excess of those assets, or that the company has no assets.

Winding Up Order: Consequences: As a result of the winding up order by the Tribunal, the following legal provisions apply.

- i. Intimation to Official Liquidator and Registrar: The Tribunal may pass an order of winding up of a company. After passing such an order, it shall immediately inform to the Official Liquidator and Registrar about the order of winding up
- ii. Discharge Notice: The order of winding up shall be deemed to be notice of discharge to the officers and employees of the company, except when the business of the company is continued. Where a servant of the company is on a contract of service for a fixed term and that term has not expired on the date of the order of the winding up of the company, the order operates as a wrongful discharge and damages are allowed for breach of contract of service and the servant is free from his agreement not to compete with the company.
- iii. Staying of suits: When the Tribunal makes an order for winding up, no suit or other legal proceedings shall be commenced against the company except by leave of the Tribunal. The pending suits shall also not be proceeded without the permission of the Tribunal.

STEPS IN WINDING UP BY THE ORDER OF TRIBUNAL:

- **Appointment of Official Liquidator**
- 1) According to section 448 (1), after the passing of an order of liquidation by the Tribunal, there shall be an Official Liquidator, who,



- a) may be appointed from a panel of professional firms of chartered accountants, advocates, company secretaries, cost and works accountants or firm having a combination of these professions, which the Central Government shall constitute for the Tribunal, or
 - b) may be a body corporate consisting of such professionals as may be approved by the Central Government from time to time, or
 - c) may be a whole time or part time officer appointed by the Central Government.
 - d) Before appointing the Official Liquidator, the Tribunal may give due regard to the views or opinion of the secured creditors and workmen.
- 2) The terms and conditions for the appointment of the Official Liquidator, and the remuneration payable to him shall be –
- a) Approved by the Tribunal for those appointed under clause a and b of sub section (1), subject to a maximum remuneration of five percent of the value of debt recovered and realization of sale of assets.
 - b) Approved by the Central Government for those appointed under clause c of sub section (1) in accordance with the rules made by it in this behalf.
- 3) Where the Official Liquidator, is an officer appointed by the Central Government under clause c, of sub section (1), the Central Government may also appoint, if considered necessary, one or more Deputy Official Liquidators or Assistant Official Liquidators to assist the Official Liquidator in the discharge of his functions, and the terms and conditions for the appointment of such Official Liquidators and the remuneration payable to them shall also be in accordance with the rules made by the Central Government
- 4) All references to the Official Liquidator in the Act shall be construed as reference to the Official Liquidator specified in sub section (1) or to the Deputy Official Liquidator or Assistant Official Liquidator referred in the sub section (3) mentioned above.
- 5) The amount of the remuneration payable shall form part of the winding up order made by the Tribunal and be treated as first charge on the realization of the assets and be paid to the Official Liquidator or to the Central Government, as the case may be.
- 6) The Official Liquidator, shall conduct proceedings in the winding up of a company and perform such duties in reference thereto as the Tribunal may specify in this behalf.
- 7) On a winding up order being made by the Tribunal, the Official Liquidator shall by virtue of his office, become the liquidator of the company. [Section 449]
- 8) At any time after the presentation of a winding up petition and before the making of a winding up order, the Tribunal may appoint the Official Liquidator to be the liquidator provisionally. [Section 450] A provisional liquidator is as much a liquidator in winding up. The name 'provisional liquidator' is only a label, he has the same powers and has the same duties as those of the liquidator. Before appointing a provisional liquidator, the

Tribunal shall give a notice to the company and give a reasonable opportunity to it to make its representations. If the Tribunal thinks fit, it may dispense with such notice, but in that case, it shall in writing record the special reasons for not giving the notice. On a winding up order being made by the Tribunal, the Official Liquidator shall cease to hold office as provisional liquidator and shall become the liquidator of the company.

Duties of Liquidator: In discharging the function of the liquidator, he has to perform the following duties.

- 1) The liquidator shall conduct the proceedings in winding up and perform the duties as directed by the Tribunal.
- 2) He will have to submit a preliminary report to the Tribunal immediately after the receipt of the statement of affairs and not later than six months from the date of the order of winding up by the Tribunal. The report shall contain details regarding the following. a) The amount of capital issued, subscribed, and paid up and the estimated amount of assets and liabilities. b) If the company has failed the cause of the failure and c) Whether in his opinion, further inquiry is desirable as to any matter relating to the promotion, formation or failure of the company or the conduct of the business thereof.
- 3) The Official Liquidator may, if he thinks fit, make further reports, stating the manner in which the company was promoted or formed. He may further state if any fraud has been committed by any person in company's promotion or formation, or since the formation thereof. He may also state any other matters which it is desirable to bring to the notice of the Tribunal.
- 4) It shall be the duty of the provisional liquidator /liquidator to take into his custody all the property, effects and actionable claims to which the company is entitled. As long as there is no liquidator, all the property and effects of the company shall be deemed to be in the custody of the Tribunal.
- 5) The liquidator shall, in the administration of the assets of the company and the distribution thereof among creditors, have regard to any directions which may be given by resolution of the creditors or contributories at any general meeting or by the committee of inspection. Any directions by the creditors or contributories at any general meeting shall override any directions given by the committee of inspection.
- 6) The liquidator may apply to the Tribunal for proper directions in relation to any matter arising in the winding up. He shall also use his discretion in the administration of the assets of the company and in the distribution thereof among the creditors.
- 7) If required, the liquidator may summon general meetings of the creditors or contributories whenever he thinks it fit for the purpose of ascertaining their wishes. He shall have to summon these meetings, if the creditors or contributories requested in writing to do so by not less than 1/10th in value of the creditors or contributories as the case may be.
- 8) It shall be the duty of the liquidator, to keep proper books for making entries or recording minutes of the proceedings at meetings and such other matters as may be prescribed. Any



creditor or contributory, subject to the directions of the Tribunal, may inspect such books personally or by his agent.

- 9) Another important duty of the liquidator is prepare the accounts of the company. The Companies Act provides that the liquidator shall, at such times as may be prescribed but at least twice each year during his tenure of office, present to the Tribunal an account of receipts and payments as liquidator. The account shall be in the prescribed form, shall be made in duplicate and shall be duly verified. The Tribunal shall cause the accounts to be audited. One copy of the accounts duly audited, shall be filed and kept by the Tribunal. The other copy of the account shall be delivered to the Registrar for filing. Each copy shall be open to the inspection of any creditor, contributory or persons interested. A summary of the audited accounts shall be prepared by the liquidator and shall be sent to every creditor and contributory. The Tribunal may waive this provision.
- 10) The Tribunal, may at the time of making an order for the winding up of a company or at any time, direct that there shall be appointed a committee of inspection to act with the liquidator.
- 11) The liquidator, shall within two months of the expiry of each year from the commencement of winding up, file a statement duly audited by a qualified auditor of the company with respect to the proceedings in, and position of, the liquidation. The statement shall be filed, in the case of a winding up by the Tribunal, in Tribunal and in the case of voluntary winding up, with the Registrar.

Powers of Liquidator: The following are the powers of the Liquidator.

- 1) Section 457 (1), provides that the liquidator in a winding up by the Tribunal, shall have the following powers, with the sanction of the Tribunal.
 - a) To constitute or defend any suit, prosecution, or other legal proceeding, civil or criminal, in the name and on behalf of the company
 - b) To carry on the business of the company so far as may be necessary for the beneficial winding up of the company
 - c) To sell the immovable and movable property and actionable claims of the company by public auction or private contract, with power to transfer the whole thereof to any person or body corporate, or to sell the same in parcels.
 - d) To sell whole of the undertaking of the company as a going concern.
 - e) To raise on the security of the assets of the company any money requisite
 - f) To do all such other things as may be necessary for winding up the affairs of the company and distributing of its assets.
- 2) Without the sanction of the Tribunal, the liquidator shall have the following powers.
 - a) To do all acts and to execute documents and deeds on behalf of the company under its seal.

- b) To inspect the records and returns of the company or the files of the Registrar without payment of any fees
 - c) To prove, rank and claim in the insolvency of any contributory for any balance against his estate and to receive dividends.
 - d) To draw, accept, make and endorse any bill of exchange, hundi or promissory note, on behalf of the company in the course of its business.
 - e) To take out, in his official name, letters of administration to any deceased contributory, and to do any other act necessary for obtaining payment of any money due from a contributory or his estate.
 - f) To appoint an agent to do any business which he is unable to do himself.
- 3) The liquidator shall have powers, exercisable in case of onerous contracts. The term 'onerous' means a right to property. The liquidator may, with the leave of the Tribunal, disclaim onerous contracts, and properties. This shall be done within 12 months after the commencement of the winding up, unless the Tribunal extends time.

Powers of Tribunal: The Tribunal has the following powers under the Companies Act in order to discharge the duties effectively for ensuring a smooth winding up.

- a) The Tribunal may at any time after making a winding up order on the application either of the Official Liquidator or of any creditor or contributory, stay the winding up proceedings.
- b) The Tribunal may settle the list of contributories who are liable to contribute to the assets of the company, with the power to rectify the register of members.
- c) The Tribunal may also order any contributory to pay money, due by him to the company apart from any call.
- d) The Tribunal has the power to make calls on all or any of the contributories for payment of any money, which it considers necessary to satisfy the debts and liabilities of the company for the expenses of winding up and for adjustment of the rights of the contributories.
- e) The Tribunal, may at any time after making, a winding up order, direct delivery to the liquidator of any money, property or books and papers in the custody or control of any contributory, trustee, receiver, banker, agent, officer or other employee of the company, to which the company is prima facie entitled.
- f) The Tribunal may fix a time within which creditors shall prove their debts or claims. It may exclude creditors not proving within the time from the benefit of any distribution made before those debts and claims are proved.
- g) The Tribunal has the power to summon any person in connection with the winding up of the company.



- h) If in the opinion of the Official Liquidator a fraud has been committed by any person in the promotion or formation of the company, or by any officer of the company in relation to the company since its formation, he shall make a report to the Tribunal. The Tribunal, in such cases may direct the person to appear before the Tribunal and examine him publicly regarding his conduct and dealings as an officer.
- i) The Tribunal has the powers to arrest a contributory if after the passing of the order of winding up, it believes that the contributory is in possession of property or books belonging to the company and there is a possibility that the contributory is likely to quit the country.
- j) In all the matters regarding the winding up, the Tribunal may convene meetings of creditors or contributories for the purpose of ascertaining their wishes.
- **Liquidation – Other Aspects:** The following are the other aspects of liquidation.
 - A. Statement Of Affairs: [Section 454]:** Within 21 days of the relevant date [date of the appointment of a provisional liquidator, or where no such appointment is made, the date of winding up order] the company shall submit a statement to the Official Liquidator as to the affairs of the company. The Tribunal, may in its discretion direct that the company need not submit this statement. This statement shall be in the prescribed form, verified by affidavit and contain the following particulars.
 - a) The assets of the company, stating separately the cash balance in hand and at the bank, if any and the negotiable securities, if any held by the company
 - b) Its debts and liabilities
 - c) The names, residences and occupations of its creditors, stating separately the amount of secured and unsecured debts, and in the case of secured debts, particulars of the securities given, whether by the company or an officer thereof, their values and the dates on which they were given.
 - d) The debts due to the company and the names, residences and occupations of the persons from whom they are due and the amount likely to be realized on account thereof.
 - e) Such further or other information as may be prescribed or as the Official Liquidator may require.
 - The statement shall be submitted and verified by one or more of the persons who are at the relevant date the directors and by the person who is at that date the manager, secretary or other chief officer of the company or by such of the persons hereinafter in this sub section mentioned, as the Official Liquidator, subject to the direction of the Tribunal, may require to submit and verify the statement, that is to say, persons
 - a) Who are or have been officers of the company
 - b) Who have taken part in the formation of the company at any time within one year before the relevant date



- c) Who are in the employment of the company, or have been in the employment of the company, within the said year and are in the opinion of the Official Liquidator, capable of giving the information required
 - d) Who are or have been within the said year officers of, or in the employment of a company, which is or within the said year was, an officer of the company to which the statement relates.
- The statement shall be submitted within twenty one days from the relevant date, or within such extended time not exceeding three months from that date as the Official Liquidator or the Tribunal, may for special reasons, appoint
 - Any person making, or concurring in making, the statement and affidavit required by this section, shall be allowed and shall be paid by the Official Liquidator or provisional liquidator, as the case may be, out of the assets of the company, such costs and expenses incurred in and about the preparation and making of the statement and affidavit as the Official Liquidator may consider reasonable, subject to an appeal to the Tribunal.
- B. Committee And Inspection:** The Tribunal may, at the time of making an order for the winding up of a company or at any time thereafter, direct that there shall be appointed a committee of inspection to Act with the liquidator. The liquidator shall then within two months from the date of such direction convene a meeting of the creditors of the company for the purpose of determining the membership of the committee. Within 14 days of the creditors' meeting, the liquidator shall call a meeting of the contributories to consider the decision of the creditors with respect to the membership of the committee. The contributories may accept the decision of the creditors with or without modification or reject it. If the contributories do not accept the decision of the creditors, the liquidator shall apply to the Tribunal for directions as to what shall be the composition of the committee and who shall be its members.
- C. Contributory:** The term 'contributory' means every person liable to contribute to the assets of the company in the event of its being wound up and includes the holder of any shares, which are fully paid up.

List of Contributories: The list of contributories shall be prepared in two parts, A and B

List A shall include the present members of the company, i.e. members whose names appear in the company's register of members at the time of the winding up of the company.

List B shall include the past members of the company, i.e. member who ceased to be members within one year preceding the commencement of the winding up of the company.

Liability of Contributories: The liability of the present members shall be limited to,

- a) In the case of company limited by shares, to the amount remaining unpaid on the shares and
- b) In the case of a company limited by guarantee, to the amount undertaken to be contributed by him to the assets of the company in the event of its being wound up.



A past member shall not be liable to contribute –

- a) If he ceased to be a member for one year or more before the commencement of winding up
- b) In respect of any debt or liability of the company contracted after he ceased to be a member
- c) If it appears to the Tribunal that the present members will be able to satisfy the contributions required to be made by them.

Where there have been several transfers of the same shares within a year before the winding up, the primary liability is that of the latest transferor in case of default by the A list contributories.

15.2.2 Voluntary Winding Up: Voluntary winding up means winding up by the members of the company or creditors of the company without the interference by the Tribunal. The following are the methods of voluntary winding up.

- i. By passing a ordinary resolution: If there is a fixed period for which a company has been established as per the articles of association, the company may by passing an ordinary resolution in a general meeting decide to wind up after the expiry of the specified period.
- ii. By Special Resolution: A company may at any time pass a special resolution that it be wound up voluntarily. No reasons need be given where the members pass a special resolution for the voluntary winding up of the company. Even the articles cannot prevent the exercise of this statutory right.
- iii. A voluntary winding up shall be deemed to commence at the time when the resolution, either special or ordinary is passed for its voluntary winding up.
- iv. The company shall have to give a notice within 14 days of the passing of the resolution for voluntary winding up of the company by advertisement in the Official Gazette and also in some newspaper circulating in the district of the registered office of the company.

A] Types of Voluntary Winding Up: A voluntary winding up may be,

- 1) Members' voluntary winding up or
- 2) Creditors' voluntary winding up

Provisions regarding these winding up are discussed below.

- 1) **Members' Voluntary Winding Up:** The following provisions are applicable in this case.
 - a) **Declaration of solvency:** In a voluntary winding up of a company if a declaration of its solvency is made in accordance with the provisions of sections 488, it is a members' voluntary winding up. The declaration shall be made by a majority of the directors at a meeting of the Board that the company has no debts or that it will be able to pay its

debts full within 3 years from the commencement of the winding up. The declaration shall be verified by an affidavit. The declaration shall have to be made when it is made within five weeks immediately before the date of the resolution and delivered to the Registrar for registration before that date and is accompanied by a copy of the report of the auditors of the company on profit and loss account of the company from the date of the last profit and loss account to the latest practicable date immediately before the declaration of solvency and the balance sheet of the company and a statement of the company's assets and liabilities as on the last mentioned date.

- b) Appointment and remuneration of liquidators: The company in general meeting shall appoint one or more liquidators for the purpose of winding up its affairs and distributing its assets. It shall also fix the remuneration, if any to be paid to the liquidator or liquidators. Any remuneration so fixed shall not be increased in any circumstances. The liquidator shall not start his work before his remuneration is fixed as mentioned above.
- c) On the appointment of the liquidator, all the powers of the Board of directors, the managing director, whole time director and the manager shall cease except when the company in general meeting or the liquidator may sanction them to continue.
- d) If a vacancy occurs by death, resignation or otherwise in the office of any liquidator appointed by the company, the company in general meeting may fill the vacancy. For this purpose a general meeting may be convened by any contributory or by the continuing liquidator or liquidators if any.
- e) The company shall give notice to the Registrar of the appointment of a liquidator or liquidators. It shall also give notice of every vacancy occurring in the office of liquidator and of the names of the liquidators appointed to fill every such vacancy. The notice shall be given by the company within 10 days of the event to which it relates.
- f) If the liquidator is at any time of the opinion that the company will not be able to pay its debts in full within the period stated in the declaration, he shall forthwith summon a meeting of the creditors. He shall lay before the meeting a statement of the assets and liabilities of the company. Thereafter the winding up shall become creditors' voluntary winding up.
- g) In the event of winding up continuing for more than one year, the liquidator shall call a general meeting of the company at the end of the first year from the commencement of the winding up. He shall also call a general meeting at the end of each succeeding year. He shall lay before the meeting an account of his actions and dealings and of the conduct of the winding up during the year.
- h) As soon as the affairs of the company are fully wound up, the liquidator shall make up an account of the winding up, showing how the winding up has been conducted and how the property of the company has been disposed of. He shall then call a general meeting of the company and lay before it, the accounts showing how the winding up has been conducted. The meeting shall be called by advertisement, which shall specify the time, place and object of the meeting and published not less than one month before



the meeting in the official gazette and also in some newspapers circulating in the district of the registered office of the company. Within one week, after the meeting, the liquidator shall send to the Registrar and the Official Liquidator a copy each of the account and shall make a return to each of them of the holding of the meeting and of the date thereof. If a quorum is not present at the final meeting, the liquidator shall make a return that the meeting was duly called but could not be held for want of quorum

The Registrar on receiving the account and return shall register them. The Official Liquidator, on receiving them, shall make a scrutiny of the books and papers of the company. The liquidator of the company and present officers shall give the Official Liquidator all reasonable facilities to make a scrutiny. On such scrutiny the Official Liquidator shall make a report to the Tribunal. If the report shows that the affairs of the company have been conducted in a manner not prejudicial to the interests of the members or to the public interest, then from the date of the submission of the report to the Tribunal, the company shall be deemed to be dissolved.

- i) If in the case of the members' voluntary winding up, the liquidator finds that the company is insolvent, there will be a duty of the liquidator to call a meeting of the company and of the creditors at the end of each year.

B. Creditors' Voluntary Winding Up: A voluntary winding up of a company in which a declaration of its solvency is not made is referred to as 'Creditors' Voluntary Winding Up'. The following are the provisions applicable to the Creditors' Voluntary Winding Up.

- i. The company shall call a meeting of the creditors of the company on the day on which the annual general meeting of the company is to be held and at which the resolution for voluntary winding up is to be proposed, or on the next day. It shall send notices of the meeting to the creditors by post simultaneously with the sending of the meeting of the company. It shall also cause notice of the meeting of the creditors to be advertised once at least in the Official Gazette and once at least in two newspapers circulating in the district of the registered office of the company. The Board of Directors of the company shall cause a full statement of the position of the company's affairs together with a list of the creditors and the estimated amount of their claims to be laid before the meeting. It shall also appoint one of their members to preside at this meeting. It shall be the duty of the director so appointed to attend the meeting and preside there at.
- ii. Notice of any resolution passed at a creditors' meeting shall be given by the company to the Registrar within 10 days of the passing thereof.
- iii. The creditors and the members at their respective meetings may nominate a liquidator. If they nominate different persons, the creditors nominee shall be the liquidator. But any director, member or creditor of the company may apply to the Tribunal for an order that the person nominated as liquidator by the company or any other person shall be the liquidator. The application shall be made to the Tribunal within 7 days after the date on which the nomination was made by the creditors. If no person is

nominated by the creditors, the person nominated by the members shall be the liquidator. Likewise if no person is nominated by the company, the person nominated by the creditors shall be the liquidator.

- iv. The creditors at their meeting may, if they think fit, appoint a committee of inspection consisting of not more than 5 persons. If such a committee is appointed, the company may also at a general meeting appoint not more than 5 members to the committee. However, the creditors may if they think fit, resolve that all or any of the persons appointed by the company ought not to be the members of the committee of inspection. If the creditors and members do not agree on a common list, the Tribunal may constitute a committee of inspection.
 - v. On the appointment of a liquidator, all the powers of the Board of directors shall cease. But the committee of inspection, or if there is no such committee, the creditors in general meeting may sanction the continuance of the Board.
 - vi. In case of any vacancy arising in the office of the liquidator due to death, resignation or otherwise, the creditors as per the directions of the Tribunal, may fill the vacancy in the general meeting.
 - vii. The liquidator shall call a general meeting of the company and a meeting of the creditors every year, within 3 months from the close of every year. This will be so if the winding up continues for more than 1 year. He shall lay before the meeting an account of his acts and dealings and of the conduct of the winding up during the preceding year and position of the winding up.
 - viii. As soon as the affairs of the company are fully wound up, the liquidator shall make up an account of the winding up showing how the winding up has been conducted and how the property of the company has been disposed of. He shall then call a general meeting of the company and a meeting of the creditors for the purpose of laying the account before the meeting and giving explanation thereof.
- **Consequences of Winding Up:** The following are the consequences of winding up.
 - 1] Shareholders / Members: In the case of a company, a shareholder is liable to pay the full amount up to the face value of the shares held by him. His liability continues even after the company goes into liquidation, but then he is known as contributory. A contributory may be present or past. In case of a company limited by guarantee, the members are liable to contribute up to the amount guaranteed by them.
 - 2] Creditors: When a company is solvent, all debts payable on a contingency and all claims against the company, present or future, certain or contingent, ascertained or sounding only in damages, shall be admissible to proof against the company. A just estimate of the value of such debts or claims shall be made. Where a solvent company is wound up, all claims of creditors, when proved are fully met.

Where a company is insolvent and it is being wound up, the same rule shall prevail as in the case of insolvency with regard to,



- a. Debts provable
- b. The valuation of annuities and future and contingent liabilities
- c. The respective rights of secured and unsecured creditors

The security of every secured creditor shall however, be deemed to be subject to a pari passu charge in favor of the workmen to the extent of the workmen's portion thereto. Where a secured creditor instead of relinquishing his security and proving his debt, opts to realize his security,

- a) The liquidator shall be entitled to represent the workmen and enforce the workmen's charge
 - b) Any amount realized by the liquidator by way of enforcement of the workmen's charge shall be applied proportionately for the discharge of workmen's dues.
 - c) The debt due to the secured creditor on the amount of the workmen's portion in his security shall rank parri passu with the workmen's dues.
 - d) All persons who in any such case would be entitled to prove for and receive dividends out of the assets of the company may come in under the winding up and make such claims against the company as they are entitled to make.
- 3) Preferential Payments: In a winding up, some unsecured debts are paid, subject to the provisions of the Act, in priority of others. These payments are known as preferential payments and are as follows.
- a) All revenues, taxes, cesses, and rates due to the Central Government or a State Government or to a local authority at the relevant date. The amount should have become due and payable within 12 months preceding the relevant date. Relevant date means in the case of a compulsory winding up of a company, the date on which a provisional liquidator is appointed or if he is not appointed, the date of the winding up order. In case the company had commenced to be wound up voluntarily before that date, relevant date means date of commencement of winding up voluntarily.
 - b) All wages or salary of any employee in respect of services rendered to the company and due for a period not exceeding four months within the 12 months before winding up. The amount shall not, in case of any one claimant, exceed such sum as may be notified by the Central Government in the Official Gazette.
 - c) All accrued holiday remuneration becoming payable to any employee on account of winding up.
 - d) All amounts due in respect of contributions payable during the 12 months, before the winding up order under the Employees State Insurance Act, 1948. This, however does not apply when the company is being wound up voluntarily for the purpose of reconstruction or amalgamation with another company.



- e) All amounts due in respect of any compensation or liability under the Workmen's Compensation Act 1923, in respect of death or disablement of any employee of the company.
 - f) All sums due to any employee from a provident fund, a pension fund, a gratuity fund or any other fund for the welfare of the employees maintained by the company.
 - g) The expenses of any investigation held in so far as they are payable by the company.
 - h) Advances made by a third person to pay wages or salary to any employee, or in the case of his death to any other person in his right on account of holiday remuneration, shall in a winding up, have the same priority as the persons to whom these payments are made out of money advanced have priority.
- 4) Employees: A winding up order shall be deemed to be a notice of discharge to the officers and employees of the company, except when the business of the company is continued. Such a discharge shall relieve them of all the obligations under their contract of service. A voluntary winding up shall also operate as a notice of discharge to the company's servants.

Defunct Company: A company is said to be 'defunct' when it is not carrying on business or when it is not in operation. If the company has ceased to carry on business, the Registrar may strike off the Register as a defunct company in accordance with the provisions of the Company Law.

A company shall be declared to a 'defunct' company after following a proper procedure. If the Registrar has reasonable cause to believe that a company is not carrying on business or is not in operation, he shall send to the company by post a notice inquiring whether the company is carrying on the business or not. If the Registrar do not receive an answer within one month of the sending this letter, he shall within 14 days after the expiry of the month, send to the company by registered post, a letter referring to the first letter and stating that no answer has been received. He shall further mention in the letter that if no reply is received to the second letter within one month, a notice will be published in the Official Gazette with a view to striking the name of the company off the Register.

If the Registrar receives an answer that the company is not carrying on any business or if no answer is received within one month of the sending of the second letter, he may publish in the Official Gazette and send to the company by a registered post, a notice that at the expiration of 3 months from the date of the notice, the name of the company shall be struck off the Registrar and the company may be dissolved. The company may, however, within three months show cause why it should not be dissolved.

The same procedure is also followed when the company is being wound up and the Registrar has reasons to believe that either no liquidator is acting or the affairs of the company has been wound up completely and no return has been submitted by the liquidator for a period of 6 consecutive months.

At the expiry of 3 months, mentioned in the notice aforesaid, the Registrar may strike the name of the company of the Register, unless cause to the contrary is previously shown by the company.



He shall then publish notice of this fact in the Official Gazette. It is on the publication in the Official Gazette of this notice that the company shall stand dissolve.

Name of the defunct company can be restored by the Tribunal as per the procedure laid down in the Act and this power lasts for 20 years. Restoration can be made on the application of any member or creditor who feels aggrieved by the name of the company having been struck off the Register. He may apply to the Tribunal within a period of 20 years from the date of publication in the Official Gazette. The Tribunal may order restoring the name if it is satisfied that at the time of striking off the name, the company was in fact in operation and was carrying on the business and it is just that the name of the company be restored in the Register.



STUDY NOTE - 16

RIGHT TO INFORMATION ACT

This Study Note includes

- Various Provisions Relating to Right to Information Act

A Bill to operationalise the right to information by setting out the practical regime for people to secure access to information under the control of public authorities, consistent with public interest, in order to promote openness, transparency and accountability and in relation to matters connected therewith or incidental thereto.

1. INTRODUCTION

- (1) This Act may be called the Right to Information Act 2004
- (2) It extends to the whole of India except the State of Jammu and Kashmir.
- (3) It shall come into force within 120 days of it being enacted.
- (4) Where State legislation exists dealing with the right to access information; a person will have the right to seek information under the State law as well as under this Act, if the information pertains to a subject under the State List in Schedule 7 of the Constitution of India.

- (5) Objectives of the Act:

The objectives of the Act are to -

- (i) give effect to the Fundamental Right to Information, which will contribute to strengthening democracy, improving governance, increasing public participation, promoting transparency and accountability and reducing corruption
- (ii) establish voluntary and mandatory mechanisms or procedures to give effect to right to information in a manner which enables persons to obtain access to records of public authorities in a swift, effective, inexpensive and reasonable manner.
- (iii) promote transparency, accountability and effective governance of all public authorities by, including but not limited to, empowering and educating all persons to:
 - understand their rights in terms of this Act in order to exercise their rights in relation to public authorities;
 - understand the functions and operation of public authorities; and effectively participating in decision making by public authorities that affects their rights.



In This Act, unless the context otherwise requires:

- (a) “appropriate Government” means in relation to a public authority established, constituted, owned, substantially financed by funds provided directly or indirectly or controlled-
 - (i) by the Union Government, the Union Government;
 - (ii) by the State Government, The State Government;
 - (iii) by the Union territory, The Union Government;
- (b) “competent authority” means-
 - (i) the Speaker in the case of the House of the People or the Legislative Assembly and the Chairman in the case of the Council of States or the Legislative Council;
 - (ii) The Chief Justice of India in the case of the Supreme Court;
 - (iii) The Chief Justice of the High Court in the case of a High Court;
 - (iv) The President or the Governor, as the case may be, in case of other authorities created by or under the Constitution;
 - (v) the administrator appointed under article 239 of the Constitution;
- (c) “Chief Information Commissioner” and “Information Commissioner” and “State Information Commissioner” means the authorities so appointed under this act
- (d) “right to information” means the right to access information held by, legally accessible by or under the control of any public authority and includes:
 - (i) Inspection of works, documents, records;
 - (ii) Taking notes and extracts and obtaining certified copies of documents or records;
 - (iii) Taking certified samples of material;
 - (iv) Obtaining information in the form of diskettes, floppies, tapes, video cassettes or in any other electronic mode or through printouts where such information is stored in a computer or in any other device.
- (e) “information” means any material in any form, including records, documents, file notings, memos, emails, opinions, advices, press releases, circulars, orders, logbooks, contracts, reports, papers, samples, models, data, material held in any electronic form and any information relating to a private body which can be accessed by a public authority under any law;
- (f) “prescribed” means prescribed by rules made under this Act by the appropriate Government or the competent authority, as the case may be;
- (g) “public authority” means any authority or body established or constituted,-



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- (i) by or under the Constitution;
 - (ii) by any law made by the appropriate Government, and includes any other body owned or controlled by the appropriate Government and includes panchayati raj institutions and other community bodies, like district councils, and village or locality durbars, performing public functions in areas notified under schedule 5 and 6 of the constitution.
- (h) “Public Information Officer” means the Public Information Officer appointed under sub-section (I and/or 1a of section 5;
- (i) “record” includes-
- (i) any document, manuscript and file;
 - (ii) any microfilm, microfiche and facsimile copy of a document;
 - (iii) any reproduction of image or images embodied in such microfilm (whether enlarged or not); and
 - (iv) any other material produced by a computer or by any other device.
- (j) “third party” means a person other than the person making a request for information and includes a public authority.

FREEDOM OF INFORMATION AND OBLIGATIONS OF PUBLIC AUTHORITIES

- 3. Subject to the provision of this Act, all persons shall have the right to information.
- 4. Every public authority shall-
 - (a) maintain all its records, duly catalogued and indexed, in a manner and form which facilitates the right to information as provided for in this Act, including ensuring that all records, covered by the Act that are appropriate to computerise, are within a reasonable time and subject to availability of resources, computerised and connected through a network all over the country on different system so that authorised access to such records is facilitated.
 - (b) publish within 6 months of this Act coming into force and thereafter update at least every 12 months-
 - (i) The particulars of its organisation, functions and duties.
 - (ii) The powers and duties of its officers and employees
 - (iii) Procedures followed during the decision making process, including chains of supervision and accountability.
 - (iv) The norms set by the public authority for the discharge of its functions.
 - (v) Rules, regulations, instructions, manual and records held by or under its control used



- by its employees for discharging its functions.
- (vi) A statement of the categories of documents that are held by or under the control of the public authority.
 - (vii) Particulars of any arrangement that exists for consultation with, or representation by, members of the public in relation to the formulation of policy in, or in the administration of, the public authority.
 - (viii) A statement listing all boards, councils, committees and other bodies constituted by two or more persons, that are part of, or that have been established for the purpose of advising, the public authority, and whose meetings are open to the public, or the minutes of whose meetings are available for public inspection;
 - (ix) A directory of their public servants, from the level of the head of the department or his/her equivalent and below;
 - (x) The monthly remuneration received for each position, including the system of compensation as established in regulations;
 - (xi) Information concerning the budget assigned to each agency, including all plans, proposed expenditures and reports on disbursement,
 - (xii) The design and execution of subsidy programs, including the amounts allocated to them, criteria for access, implementation details and beneficiaries.
 - (xiii) All concessions, permits or authorisations granted, with their recipients specified.
 - (xiv) All information available to the public authority in electronic form or capable of being reduced to electronic form which is not exempt under this Act, subject to availability of resources.
 - (xv) the details of facilities available to citizens for obtaining information, including if the public authority maintains a library or reading room that is available for public use, a statement of that fact including details of the address and hours of opening of the library or reading room; and
 - (xvi) the name, designation and other particulars of the Public Information Officer;
 - (xvii) such other information as prescribed by the appropriate government or Information Commissioner from time to time which would promote transparency across public authorities or in specific public authorities, as appropriate; on the basis that it shall be a constant endeavor of public authorities to take steps to provide as much information to the public suo moto at regular intervals through various means of communication so that the public have minimum resort to the use of this Act to obtain information.
- (c) publish all relevant facts concerning important decisions and policies that affect the public while formulating and announcing such decisions and policies;



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- (d) give reasons for its decisions, whether administrative or quasi-judicial to those affected by such decisions;
 - (e) before initiating any project, or formulating any policy, scheme, programme or law, publish or communicate to the public generally or to the persons affected or likely to be affected by these in particular, the facts available to it or to which it has reasonable access which in its opinion should be known to them in the best interests of natural justice and promotion of democratic principles.
 - (f) For the purpose of this section, information should be disseminated widely and in a form and manner which is easily accessible and comprehensible to the public. "Disseminated" shall mean appropriately making known to the public the information to be communicated through notice boards, newspapers, public announcements, media broadcasts, the internet or other such means and shall include inspection at all of the bodies offices. All materials shall be disseminated keeping in mind cost effectiveness, the local language and the most effective method of communication in that local area. Such information should be in easily accessible, with the Public Information Officer, where possible in electronic format, which shall be available free or at the cost of the medium, or in print at cost price.
5. (1) Every public authority shall for the purposes of this Act, designate as many officers as Public Information Officers, in all administrative units and offices under such authority, as are necessary to render the public body as accessible as reasonably possible for requesters of information, within one month of this Act coming into force.
- (a) An officer at each sub-divisional level or other appropriate sub-district level, shall be designated a Public Information Officer, within three months of this act coming into force, for the purposes of this Act. He/she shall receive all requests for information, and appeals, both under the state and the central acts, and pass them on to a designated authority for onward transmission to the relevant department/agency.
 - (b) Where applications/appeals are handed over at the sub divisional or sub-district level, an additional period of five days would be added to the time of response specified under this act, in order to enable the request/appeal to be communicated to the relevant authority.
- (2) Every Public Information Officer shall deal with requests for information and shall render reasonable assistance to any person seeking such information.
- (3) The Public Information Officer may seek the assistance of any other officer as he considers necessary for the proper discharge of his duties.
- (4) Any officer whose assistance has been sought under sub-section (3), shall render all assistance to the Public Information Officer seeking his/her assistance and be treated as a Public Information Officer for the purposes of the penalties provisions in this Act



6. (1) A person desirous of obtaining information shall make a request in writing or through electronic means in English or in the official language of the area in which the application is being submitted, to:
- (a) the Public Information Officer of the relevant public authority;
 - (b) other designated Public Information Officers, as specified in 5 (1a) specifying the particulars of the information sought by him / her. Provided that where such request cannot be made in writing the Public Information Officer shall render all reasonable assistance to the person making the request orally to reduce it in writing.
- 6 (2) An applicant for access to information shall not be required to give any reason for requesting access to that information or any other personal details except those necessary for contacting the applicant.
- 6 (3) (1) Where an application is made to a Public Authority for information:
- (a) which is held by another Public Authority; or
 - (b) the subject matter of which is more closely connected with the functions of another Public Authority, the first mentioned Public Authority shall transfer the application or such part of it as may be appropriate to that other Public Authority and shall inform the applicant immediately of the transfer.
- (2) A transfer of an application pursuant to subsection (1) shall be made as soon as practicable but not later than 5 days after the date of receipt of the application
- 7(1) Subject to section 5, sub section (1b) above and section 7, sub-section (3)(a) below, on receipt of a request under section 6, the Public Information Officer shall as expeditiously as possible and in any case within fifteen days of the receipt of the request, either provide the information requested on payment of such fee as may be prescribed or reject the request for any of the reasons specified in sections 8 and 9.
- Provided that where the information sought for concerns the life and liberty of a person, the same should be provided within forty-eight hours of the receipt of the request:
- 7(2) If a Public Information Officer fails to give the decision on a request for access to the requestor concerned within the period contemplated in s.7(1), the Public Information Officer would, for the purposes of this Act, be regarded as having refused the request.
- 7(3) Where it is decided to provide the information on payment of any further fee representing the cost of providing the information, the Public Information Officer shall send an intimation to the person making the request, giving:
- (a) the details of such fees as determined by him, showing the calculations as per the act, at prescribed rates, requesting him to deposit the fees, and the period intervening between the dispatch of the said intimation and payment of fees shall be excluded for the purpose of calculating the period of fifteen days referred to above;



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- (b) information concerning his/her rights with respect to review the decision as to the amount of fees charged and/or the form of access provided, including the contact details of the appellate body, time limits, process and any relevant forms.
- 7 (4) Where access to a record or a part thereof is to be given under this Act and the person to whom access is to be given has a sensory disability, the public authority will provide assistance to enable access to the information, including providing assistance with inspection as appropriate.
- 7(5)(a) Subject to sub-sections (b) and (c) below, where access to information is to be given in the form of printed copies, or copies in some other form, such as on tape, disk, film or other material, the applicant shall pay the prescribed fee.
- (b) Any fees payable by the applicant shall be reasonable, and shall in no case exceed the actual cost of copying the information or in the case of samples of materials the cost of obtaining the sample, and shall be set via regulations at a maximum limit taking account of the general principle that fees should not be set so high that they undermine the objectives of this Act in practice.
- (c) Notwithstanding subsection (a), where a public authority fails to comply with the time limits specified in section 7, any access to information to which the applicant is entitled pursuant to his request shall be provided free of charge.
- 7(6) Before taking any decision under sub-section (1), the Public Information Officer shall take into consideration the representation made by a third party under section 11.
- 7 (7) Where a request is rejected under sub-section (6), the Public Information Officer shall communicate to the person making request,
- (i) the reasons for such rejection;
 - (ii) the period within which an appeal against such rejections may be preferred;
 - (iii) the particulars of the appellate authority.
- 7(8) Information shall ordinarily be provided in the form in which it is sought unless it would disproportionately divert the resources of the public authority or would be detrimental to the safety or preservation of the record in question.
- 8(1) Notwithstanding anything contained in this Act, there shall be no obligation to give any person:
- (a) information, disclosure of which would prejudicially affect the sovereignty and integrity of India, the security, strategic, scientific or economic interests of the State, relation with foreign State or lead to incitement of an offence;
 - (b) information which has been expressly forbidden to be published by any court of law or tribunal or the disclosure of which may constitute contempt of court ;



- c) information, 'the disclosure of which would cause a breach of privilege of Parliament or the State Legislature ;
- d) information including commercial confidence, trade secrets or intellectual property, the disclosure of which would harm the competitive position of a third party, unless the Competent Authority is satisfied that larger public interest warrants the disclosure of such information ;
- (e) information available to a person in his fiduciary relationship, unless the Competent Authority is satisfied that the larger public interest warrants the disclosure of such information ;
- (f) information received in confidence from foreign government;
- (g) information, the disclosure of which would endanger the life or physical safety of any person or identify the source of information or assistance given in confidence for law enforcement or security purposes ;
- (h) information which would impede the process of investigation or apprehension or prosecution of offenders ;
- (i) cabinet papers including records of deliberations of the Council of Ministers, Secretaries and other officers, provided that the decisions of Council of Ministers, the reasons thereof, and the material on the basis of which the decisions were taken shall be made public after the decision has been taken, and the matter is complete, or over; provided further that those matters which come under the exemptions listed in Section 8 shall not be disclosed.
- (j) information which relates to personal information the disclosure of which has no relationship to any public activity or interest, or which would cause unwarranted invasion of the privacy of the individual unless the Information Officer or the appellate authority, as the case might be, is satisfied that the larger public interest justifies the disclosure of such information.

Provided that the information, which cannot be denied to the Parliament or a State Legislature, shall not be denied to any person.

Notwithstanding anything in the Official Secrets Act 1923 nor any of the exemptions permissible in accordance with section 8 (1), a public authority may not refuse to allow access to information, unless the harm to the protected interest outweighs the public interest in disclosure.

- (2) Subject to the provisions of clause (a) and (i) of sub section I of section 8, any information relating to any occurrence, event or matter which has taken place, occurred or happened ten years before the date on which any request is made under section 6 shall be provided to any person making a request under that section.

Provided that the matters covered by Sub-Section 8(a) and Sub-Section 8(i) may be disclosed after twenty-five years. Provided that where any question arises as to the date from which the



said period of ten years or twenty-five has to be computed, the decision of the Union Government shall be final, subject to the usual appeals provided for in this act.

9. Without prejudice to the provisions of section 8, a Public Information Officer may reject a request for information where such a request for providing access would involve an infringement of copyright subsisting in a person other than the State.]

10.(1) If a request for access to information is rejected on the ground that it is in relation to information which is exempted from disclosure, then notwithstanding anything contained in this Act, access may be given to that part of the record which does not obtain any information that is exempted from disclosure under this Act and which can reasonably be severed from any part that contains exempted information.

10(2) Where access is granted to a part of the record in accordance with sub-section (1), the Public Information Officer shall send a notice to the applicant, advising:

- (a) that only part of the record requested, after severance of the record containing information which is exempted from disclosure, is being furnished; and
- (a) The reasons for the decision; including any findings on any material questions of fact, referring to the material on which those findings were based;
- (b) The name and designation of the person giving the decision; and
- (c) Details of the fees determined by him/her and requesting the applicant to deposit the fees;
- (d) Information concerning his/her rights with respect to review of the decision regarding non-disclosure of part of the information, the amount of fees charged and/or the form of access provided, including the contact details of the appellate body, time limits, process and any relevant forms;

11. (1) Where a public authority intends to disclose any information or record, or part thereof on a request made under this Act which relates to, or has been supplied by a third party and has been treated as confidential by that third party, the Public Information Officer shall, within five days from the receipt of a request, give written notice to such third party of the request and of the fact that the public authority intends to disclose the information or record, or part thereof and invite the third party to make a submission, in writing or orally, regarding whether the information should be disclosed, which submission shall be taken into account when determining whether to disclose the information.

Provided that except in the case of trade or commercial secrets protected by law, disclosure may be allowed if the public interest in disclosure outweighs in importance any possible harm or injury to the interests of such party.

(2) where a notice is given by the public information officer under sub-section (1) to a third party in respect of any information or record or part thereof, the third party shall, within ten days from the date of issuance of notice, be given the opportunity to make representation against the proposed disclosure



- (3) Notwithstanding anything contained in section 7, the public information officer shall, within twenty days after receipt of the request under section 6, if the third party has been given an opportunity to make representation under sub-section (2), make a decision as to whether or not to disclose the information or record or part thereof and give in writing the notice of his decision to the third party.
- (4) A notice given under sub-section (3) shall include a statement that the third party to whom the notice is given is entitled to prefer an appeal against the decision under section 12(2).
- 12(1)(i)(a) The President shall appoint or designate a Chief Information Commissioner for all matters pertaining to the Union. Such appointment shall be made on the basis of a recommendation made by an Appointing Committee presided by the Prime Minister, with the Leader of Opposition in the Lok Sabha and the Chief Justice of India as members.
- (i)(b) The Governor shall appoint or designate a State Information Commissioner for all matters pertaining to the State. Such appointment shall be made on the basis of recommendation made by an Appointing Committee presided by the Chief Minister, with the Leader of Opposition in the Legislative Assembly and the Chief Justice of the High Court as members.
- (ii) Information Commissioners may be appointed by the President or the Governor, as the case may be, in consultation with the appropriate Appointing Committee and the Chief Information Commissioner or State Information Commissioners, as the case may be.
- (iii) Every Chief Information Commissioner, State Information Commissioners and the commissioners shall be persons with wide knowledge and experience of administration and governance.
- (iv) The Chief Information Commissioners and any Information Commissioners shall not be members of Parliament or members of the Legislative of any State or Union Territory and shall not hold any other office of profit and shall not be connected with any political party or be carrying on any business or practice any profession;
- (v) The requisite budgetary allocations for the emoluments and expenses, including office expenses, of the Chief Information Commissioner and of other Information Commissioners will be provided by the Government of India through special budgetary provisions made available to the respective states out of the Union Government Budget.
- (vi) The Chief Information Commissioner and of other Information Commissioners shall function autonomously without being subjected to directions by any other authority and would be under the administrative control of the Government of India, Ministry of Personnel, Administrative Reforms and Public Grievances.
- (vii) Every person appointed as a Chief Information Commissioner or an Information Commissioner shall hold office for a term of five years from the date on which he enters upon his office. He/she will not be eligible for reappointment.



12. (2) (i) Any person who does not receive a decision or is aggrieved by a decision of the Public information officer may, within thirty days of receipt of such a decision, or of the expiry of the time allowed for responding, prefer an appeal to an appellate authority prescribed for the purpose in each department and senior in rank to the Public Information Officer. Provided that such authority may entertain the appeal after the expiry of the said period of thirty days if it is satisfied that the appellant was prevented by sufficient cause from filing the appeal in time.
- (ii) A second appeal against the decision under sub-section (1) shall lie within 90 days from the time by which the decision should have been made or receipt of a decision, prefer an appeal to the relevant Information Commissioner, Provided that the relevant Information Commissioner may entertain appeal after the expiry of the said period of ninety days if it is satisfied that the appellant was prevented by sufficient cause from filing the appeal in time.
- (iii) Where an appeal is being preferred against an order made by the Public Information Officer under Section 11 to disclose "third party" information, the appeal by the concerned third party must be made within thirty days of the order.
- (iv) If the decision of the Public Information Officer against which the appeal is preferred relates to information of a third party, the relevant Information Commissioner shall give a reasonable opportunity of being heard to that third party.
- (v) In any appeal proceedings, the onus to prove that a denial of a request was justified will be on the public authority that denied the request.
- (vi) Appeals to any Information Commissioner shall be disposed of within thirty days of the receipt of the appeals, or within such extended period, not exceeding a total of forty five days from the date of filing of appeal, for reasons to be recorded in writing.
- (vii) The decision of the Information Commissioner shall be binding.
- (viii) In his/her decision, the relevant Information Commissioner has the power to:
- (a) require the public authority to take any such steps as may be necessary to bring it into compliance with the Act, including by;
 - (i) providing access to information, including in a particular form;
 - (ii) appointing an information officer;
 - (iii) publishing certain information and /or categories of information;
 - (iv) making certain changes to its practices in relation to the keeping, management and destruction of records;
 - (v) enhancing the provision of training on the right to information for its officials;



- (vi) providing him or her with an annual report, in compliance with section 4(b);
 - (b) require the public body to compensate the complainant for any loss or other detriment suffered;
 - (c) impose any of the penalties available under this Act;
 - (d) reject the application.
- (i) The Information Commissioner shall serve notice of his / her decision, including any rights of appeal, on both the complainant and the public authority.
- (ii) A decision of the Information Commissioner may be appealed to the High Court or the Supreme Court, on any point of fact and law.

12(3) Powers of the Chief Information Commissioner / State Information Commissioners / Information Commissioners

- (1) Subject to this Act, the Chief Information Commissioners / State Information Commissioners / Information Commissioners shall receive and investigate complaints from persons:
 - (a) who have been unable to submit a request to a Public Information Officer, either because none has been appointed as required under the Act or because the Public Information Officer has refused to accept their application;
 - (b) who have been refused access to information requested under this Act;
 - (c) who have not been given access to information within the time limits required under this Act;
 - (d) who have been required to pay an amount under the fees provisions that they consider unreasonable, including a person whose wishes to appeal a decision in relation to their application for a fee reduction or waiver;
 - (e) who believe that they have been given incomplete, misleading or false information under this act;
 - (f) in respect of any other matter relating to requesting or obtaining access to records under this Act.
- (2) Where a Chief Information Commissioner / State Information Commissioners / Information Commissioners are satisfied that there are reasonable grounds to investigate a matter relating to requesting or obtaining access to records under this Act, the Chief Information Commissioner may initiate a complaint in respect thereof.
- (3) The Chief Information Commissioners / State Information Commissioners / Information Commissioners have, in relation to the carrying out of the investigation of any complaint under this Act, power:



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- (a) to summon and enforce the appearance of persons and compel them to give oral or written evidence on oath and to produce such documents and things as the Commissioner deems requisite to the full investigation and consideration of the complaint, in the same manner and to the same extent as a superior court of record;
 - (b) to administer oaths;
 - (c) to receive and accept such evidence and other information, whether on oath or by affidavit or otherwise, as the relevant Information Commissioner sees fit, whether or not the evidence or information is or would be admissible in a court of law;
 - (d) to enter any premises occupied by any government institution on satisfying any security requirements of the institution relating to the premises;
 - (e) to converse in private with any person in any premises entered pursuant to paragraph (d) and otherwise carry out therein such inquiries within the authority of the Chief Information Commissioner under this Act as the Commissioner sees fit; and
 - (f) to examine or obtain copies of or extracts from books or other records found in any premises entered pursuant to paragraph (d) containing any matter relevant to the investigation.
 - (g) Shall impose the penalties prescribed under this act, after giving due opportunity to the concerned official of being heard.
 - (4) Notwithstanding any other Act of Parliament or any privilege under the law of evidence, an Chief Information Commissioner / State Information Commissioners / Information Commissioners may, during the investigation of any complaint under this Act, examine any record to which this Act applies that is under the control of a government institution, and no such record may be withheld from any Commissioner on any grounds.
 - (5) All the powers of the Chief Information Commissioner would also be enjoyed by the State Information Commissioners and other Information Commissioners.

12(4) Penalties

- (1) Subject to sub-section (3), where any Public Information Officer has, without any reasonable cause, failed to supply the information sought, within the period specified under section 7(1), the relevant Information Commissioner shall, on appeal, impose a penalty of rupees two hundred fifty, which amount must be increased by regulation at least once every five years, for each day's delay in furnishing the information, after giving such Public Information Officer a reasonable opportunity of being heard.
- (2) Subject to sub-section (3), where it is found in appeal that any Public Information Officer has –
 - (i) Refused to receive an application for information;
 - (ii) Mala fide denied a request for information;



- (iii) Knowingly given incorrect or misleading information,
- (iv) Knowingly given wrong or incomplete information, or
- (v) Destroyed information subject to a request;
- (vi) Obstructed the activities of a Public Information Officer, any Information Commission or the courts;

commits an offence and will be liable upon summary conviction to a fine of not less than rupees two thousand and imprisonment of up to five years, or both.

- (3) An officer whose assistance has been sought by the Public Information Officer for the performance of his/her duties under this Act shall be liable for penalty as prescribed in sub-sections (1) and (2) jointly with the Public Information Officer or severally as may be decided by the relevant Information Commissioner.
- (4) Any fines imposed under sub-sections (1), (2) and (3) shall be recoverable from the salary of the concerned officer, including the Public Information Officer, or if no salary is drawn, as an arrears of land revenue, recoverable within a maximum of six months of the order imposing the fine.
- (5) The Public Information Officer or any other officer on whom the penalty under sub-sections (1), (2) and (3) is imposed shall also be liable to appropriate disciplinary action under the service rules applicable to him. Provided that in cases where the officer is proved guilty of deliberate denial of information or misinformation, the punishment imposed shall be a major penalty, i.e., dismissal or removal or reduction in rank.

MISCELLANEOUS

- 13. No suit, prosecution or other legal proceeding shall lie against any person for anything which is in good faith done or intended to be done under this Act or any rule made thereunder.
- 14. The provisions of this Act shall have effect notwithstanding anything inconsistent therewith contained in the Official Secrets Act, 1923, and any other law for the time being in force or in any instrument having effect by virtue of any law other than this Act.
- 15. No court shall entertain any suit, application or other proceeding in respect of any order made under this Act and no such order shall be called in question otherwise than by way of an appeal under this Act.
- 16. (1) Nothing contained in this Act shall apply to the intelligence and security organisations, specified in the Schedule being organisations established by the Union Government or any information furnished by such organisations to that Government.

Provided that information pertaining to alleged violations of human rights, to the life and liberty of human beings and to the allegations of corruption will not be excluded under this clause.



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- (2) The Union Government may, by notification in the official Gazette, amend the Schedule by including therein any other intelligence or security organisation established by that government or omitting therefrom any organisation already specified therein and on the publication of such notification, such organisation shall be deemed to be included in or, as the case may be omitted from the Schedule.
 - (3) Every notification issued under sub-section (2) shall be laid before each house of parliament.
 - (4) Nothing contained in this Act shall apply to such intelligence and security organisations which may be specified, by a notification in the official gazette, by a state Government from time to time. Provided that information pertaining to alleged violations of human rights, to the life and liberty of human beings and to the allegations of corruption will not be excluded under this clause
 - (5) Every notification issued under sub section (4), shall be laid before the state legislature..

16A Monitoring and Reporting

- (1) The Chief Information Commissioners/State Information Commissioners/Information Commissioners shall, as soon as practicable after the end of each year, prepare a report on the implementation of this Act during that year and cause a copy of the report to be laid before the legislatures of the concerned state and each House of the Parliament.
- (2) Each responsible department/ministry shall, in relation to the public authorities within their jurisdiction, collect and provide such information to the Chief Information Commissioners as is required to prepare the report under this section, and shall comply with any prescribed requirements concerning the furnishing of that information and the keeping of records for the purposes of this section.
- (3) Each report shall, at a minimum, state in respect of the year to which the report relates:
 - (a) the number of requests made to each public authority;
 - (b) the number of decisions that an applicant was not entitled to access to a document pursuant to a request, the provisions of this Act under which these decisions were made and the number of times each provision was invoked;
 - (c) the number of appeals sent to the Information Commissioners for review, the nature of the complaints and the outcome of the appeals;
 - (d) particulars of any disciplinary action taken against any officer in respect of the administration of this Act;
 - (e) the amount of charges collected by each public authority under this Act;
 - (f) any facts which indicate an effort by public authorities to administer and implement the spirit and intention of this Act;



- (g) recommendations for reform, including recommendations in respect of particular public authorities, for the development, improvement, modernisation, reform or amendment of this Act or other legislation or common law or any other matter relevant to operationalise the right to access information, as appropriate.
 - (4) The Union Government Ministry responsible for the administration of this Act, as soon as practicable after the end of each year, prepare a summary report on the implementation of this Act during that year and cause a copy of the report to be laid before the concerned state legislatures and each House of the Parliament, drawing on the information provided in the reports of the Chief Information Commissioners for each State.
 - (5) If it appears to any Chief Information Commissioner that the practice of a public authority in relation to the exercise of its functions under this Act does not conform with provisions or spirit of the Act, s/he may give to the authority a recommendation specifying the steps which ought in his/her opinion to be taken for promoting such conformity.
- 16B (1) The Government must, to the extent that financial and other resources are available:
- (a) develop and conduct educational programmes to advance the understanding of the public, in particular of disadvantaged communities, of this Notification and of how to exercise the rights contemplated in this Act;
 - (b) encourage public authorities to participate in the development and conduct of programmes referred to in paragraph (a) and to undertake such programmes themselves; and
 - (c) promote timely and effective dissemination of accurate information by public authorities about their activities.
 - (d) train information officers of public authorities and /or produce relevant training materials for use by authorities themselves.
- (2) The Government must, within 18 months, compile in each official language a guide containing such information, in an easily comprehensible form and manner, as may reasonably be required by a person who wishes to exercise any right contemplated in this Act.
- (3) The Government must, if necessary, update and publish the guide at regular intervals. The guide must, without limiting the generality of subsection (2), include a description of-
- (a) the objects of this Act;
 - (b) the postal and street address, phone and fax number and, if available, electronic mail address of the Public Information Officer of every public authority as appointed under sub section (1) of section 5
 - (c) the manner and form of a request for access to a information of a public authority;



-
- (d) the assistance available from and the duties of Public Information Officers of a public authority in terms of this Act;
 - (e) the assistance available from the Information Commissioners in terms of this Act;
 - (f) all remedies in law available regarding an act or failure to act in respect of a right or duty conferred or imposed by this Act, including the manner of lodging an appeal with the Chief Information Commissioner and a court against a decision by the Public Information Officer of a public authority;
 - (g) the provisions providing for the voluntary disclosure of categories of records in accordance with section 4;
 - (h) the notices regarding fees to be paid in relation to requests for access; and
 - (i) any additional regulations or circulars relevant to obtaining access to information in accordance with this Act.
- (4) The Government must, if necessary, update and publish the guide at regular intervals.
- 17(1) The Union Government may by notification in the Official Gazette, make rules to carry out the provisions of this Act.
- (2) In particular, and without prejudice to the generality of the foregoing power, such rules may provide for all or any of the following matters, namely
- (a) intervals at which matters referred to in sub-clauses (i) to (vi) of clause (b) of section 4 shall be published.
 - (b) The fee payable under sub-section (1) of section 7;
 - (c) The authority before whom an appeal may be preferred under sub-section (2) of section 12;
 - (d) any other matter which is required to be, or may be, prescribed.
18. (1) The State Government may, by notification in the Official Gazette, make rules to carry out the provisions of the Act.
- (2) In particular, and without prejudice to the generality of the foregoing power, such rules may provide for all or any of the following matters, namely:-
- (a) the fee payable under sub-section (1) of section 7;
 - (b) the authority before whom an appeal may be preferred under sub-section (2) of section 12;
 - (c) any other matter which is required to be, or may be, prescribed;

Provided that initially the rules shall be made by the Union Government by notification in the official gazette.



19. (1) The competent authority may, by notification in the official gazette make rules to carry out the provisions of this Act.
- (2) In particular, and without prejudice to the generality of the foregoing power such rules may provide for all or any of the following matters, namely:-
- (a) the fee payable under sub-section (1) of section 7:
 - (b) the authority before whom an appeal may be preferred under sub-section (2) of section 12;
 - (c) any other matter which is required to be, or may be, prescribed.
- 20.(1) Every rule made by the Union Government under this Act shall be laid, as soon as may be after it is made, before each house of parliament, while it is in session, for a total period of thirty days which may be comprised in one session or in two or more successive sessions, and if, before the expiry of the session immediately following the session or the successive sessions aforesaid, both houses agree in making any modification in the rule or both houses agree that the rule should not be made, the rule shall thereafter have effect only in such modified form or be of no effect, as the case may be, so, however, that any such modification or annulment shall be without prejudice to the validity of anything previously done under that rule.
- (2) Every rule made under this Act by a State Government shall be laid, as soon as may be after it is notified, before the State Legislature.
- 21.(1) If any difficulty arises in giving effect to the provisions of this Act, the Union Government may, by order published in the official gazette, make such provision not inconsistent with the provisions of this Act as appear to it to be necessary or expedient for removal of the difficulty:
- Provided that no such order shall be made after the expiry of a period of two years from the date of commencement of this Act.
- (2) Every order made under this section shall as soon as may be after it is made, be laid before the houses of parliament.

STUDY NOTE - 17

THE COMPETITION ACT, 2002.

This Study Note includes:

- Introduction
- Definition and Basic Concepts
- Prohibition of certain agreements, abuse of dominant position and regulation of combinations
- Competition Commission of India
- Finance, Accounts and Audit
- Miscellaneous

17.1 INTRODUCTION

The Competition Commission of India was established in October 2003 under the Competition Act, 2002. It was, however, mired in litigation as the provisions governing its functions were challenged in a writ petition before the Supreme Court.

The apex court in January 2005 addressed the writ petition with certain directions to the government. Consequent to this, the Competition (Amendment) Bill, 2006 was introduced in March 2006, and was referred for examination to the parliamentary standing committee. Following the recommendations of the committee, the Competition (Amendment) Bill, 2007 was introduced and passed in August 2007.

The backdrop

To achieve its objective of not permitting an ‘appreciable adverse effect on competition in India’, the Competition Act, 2002 deals with three situations—prohibition of anti-competitive agreements and abuse of dominant position, and regulation of combinations (covered acquisitions, mergers and amalgamations).

The focus of this article is the recent amendments dealing with two aspects of the third situation, which merit special attention—a change in threshold limits to meet the criteria for intimating the Competition Commission, and making such reporting mandatory.

Domestic nexus

An acquisition or merger or amalgamation would be governed under the third situation, if it constitutes a ‘combination’ by exceeding certain prescribed threshold limits. The limits determine the trigger for reporting the proposed combination to the commission.



The amendment focuses on the provision of a domestic nexus (a nexus with assets and operations in India) in connection with the limits applicable to acquisitions in which a foreign entity and an Indian entity are involved. This would narrow down the scope for an acquisition being covered under 'combinations' to be regulated by the commission. Thus, if the acquirer is a foreign company without any Indian presence, the Competition Act trigger will not apply due to the provision of the India nexus.

Incidentally, the original limits continue to apply under the Competition Act to acquisitions of enterprises dealing in similar goods, and to mergers and amalgamations.

A corresponding amendment in the limits has not been made for those cases. The rationale for this is not very clear because it would have been better to restrict the applicability to all cases of combinations.

Intimation Mandatory

A very crucial aspect of the original provisions was that it was voluntary for an enterprise proposing to enter into a combination to intimate the Competition Commission.

Now, once the new law comes into force, such intimation of the combination to the commission would be mandatory and, in fact, such a coupling shall not take effect until 210 days from the date of notification or approval from the commission, whichever is earlier. This is likely to result in a long gestation period of about seven to eight months from the date of approval of the proposal.

This has some critical dimensions to be considered. Any uncertainty in a merger/ acquisition could have a serious and destabilizing impact on the businesses of the parties involved. In most cases, unlike an acquisition, a merger is dependent on the high court's approval (or, in the case of certain specified industries, any other regulatory body, such as the Reserve Bank of India in the case of banks).

The introduction of this new dimension of keeping the merger/acquisition pending until the approval of the commission will also (albeit for a different purpose) add a significant element of uncertainty, and can be a serious drag on 'big-ticket' M&A activities in India.

The uncertainty has several implications, including the following:

- Perception among customers
- Uncertainty as regards the 'identity' of the enterprise could create reluctance among customers, who could choose to shift to a more 'stable' competitor.
- Inability to make strategic and operational decisions: Strategic and operational business issues could remain in 'limbo'.
- Human resources: In any acquisition or merger, the human resources element is crucial. This has dimensions relating to alignment of titles, roles and responsibilities. A long period of uncertainty could seriously dent morale and heighten attrition.

- Enterprise value(s): As a result of the uncertainty, including the above factors, the market value of both enterprises could be severely dented due to the long period of uncertainty.

Interestingly, while such reference to a regulatory body is mandatory in a number of countries, the time limit prescribed by most of them is much shorter, ranging from 25-35 days for an initial investigation.

When the initial investigation results in serious doubts regarding its effect on competition, the next level investigation triggers the time limit, which is generally 90-180 days. For example, in the US and the European Union, the time limit for initial investigation is 30 days and 25 days, and for detailed investigation, an additional 30 days and 90 days, respectively.

Summing up

While the objective of the Competition Act, 2002, as stated in its preamble, is undoubtedly laudable, the timing issue needs to be addressed. In addition, it is very important to have detailed guidelines and a framework within which the approval would be given by the Competition Commission. This could help mitigate the likely element of uncertainty by an upfront evaluation of the parameters contained in the guidelines in connection with the planned combination. One hopes the government will take such issues seriously and take steps to address them.

17.2 DEFINITION AND BASIC CONCEPTS

The following Act of Parliament received the assent of the President on the 13th January, 2003

An Act to provide, keeping in view of the economic development of the country, for the establishment of a Commission to prevent practices having adverse effect on competition,

To promote and sustain competition in markets, to protect the interests of consumers and to ensure freedom of trade carried on by other participants in markets, in India, and for matters connected therewith or incidental thereto.

EXTENT

1.

- (1) This Act may be called the Competition Act, 2002.
- (2) It extends to the whole of India except the State of Jammu and Kashmir.
- (3) It shall come into force on such date as the Central Government may, by notification in the Official Gazette, appoint.

Provided that different dates may be appointed for different provisions of this Act and any reference in any such provision to the commencement of this Act shall be construed as a reference to the coming into force of that provision.



BASIC CONCEPTS

2.

In this Act, unless the context otherwise requires,—

(a) “acquisition” means, directly or indirectly, acquiring or agreeing to acquire—

- (i) shares, voting rights or assets of any enterprise; or
- (ii) control over management or control over assets of any enterprise;

(b) “agreement” includes any arrangement or understanding or action in concert,—

- (i) whether or not, such arrangement, understanding or action is formal or in writing; or
- (ii) whether or not such arrangement, understanding or action is intended to be enforceable by legal proceedings;

(c) “cartel” includes an association of producers, sellers, distributors, traders or service providers who, by agreement amongst themselves, limit, control or attempt to control the production, distribution, sale or price of, or, trade in goods or provision of services;

(d) “Chairperson” means the Chairperson of the Commission appointed under sub-section (1) of section 8;

(e) “Commission” means the Competition Commission of India established under sub-section (1) of section 7;

(f) “consumer” means any person who—

- (i) buys any goods for a consideration which has been paid or promised or partly paid and partly promised, or under any system of deferred payment and includes any user of such goods other than the person who buys such goods for consideration paid or promised or partly paid or partly promised, or under any system of deferred payment when such use is made with the approval of such person, whether such purchase of goods is for resale or for any commercial purpose or for personal use;
- (ii) hires or avails of any services for a consideration which has been paid or promised or partly paid and partly promised, or under any system of deferred payment and includes any beneficiary of such services other than the person who hires or avails of the services for consideration paid or promised, or partly paid and partly promised, or under any system of deferred payment, when such services are availed of with the approval of the first-mentioned person whether such hiring or availing of services is for any commercial purpose or for personal use;

(g) “Director General” means the Director General appointed under sub-section (1) of section 16 and includes any Additional, Joint, Deputy or Assistant Directors General appointed under that section;

(h) “enterprise” means a person or a department of the Government, who or which is, or has been, engaged in any activity, relating to the production, storage, supply, distribution, acquisition or control of articles or goods, or the provision of services, of any kind, or in investment, or in the business of acquiring, holding, underwriting or dealing with shares, debentures or other securities of any other body corporate, either directly or through one or more of its units or divisions or subsidiaries, whether such unit or division or subsidiary is located at the same place where the enterprise is located or at a different place or at different places, but does not include any activity of the Government relating to the sovereign functions of the Government including all activities carried on by the departments of the Central Government dealing with atomic energy, currency, defence and space.

Explanation.—For the purposes of this clause,—

(a) “activity” includes profession or occupation;

(b) “article” includes a new article and “service” includes a new service;

(c) “unit” or “division”, in relation to an enterprise, includes—

(i) a plant or factory established for the production, storage, supply, distribution, acquisition or control of any article or goods;

(ii) any branch or office established for the provision of any service;

(i) “goods” means goods as defined in the Sale of Goods Act, 1930 (8 of 1930) and includes—

(A) products manufactured, processed or mined;

(B) debentures, stocks and shares after allotment;

(C) in relation to goods supplied, distributed or controlled in India, goods imported into India;

(j) “Member” means a Member of the Commission appointed under sub-section (/) of section 8 and includes the Chairperson;

(k) “notification” means a notification published in the Official Gazette;

(l) “person” includes—

(i) an individual;

(ii) a Hindu undivided family;



- (iii) a company;
 - (iv) a firm;
 - (v) an association of persons or a body of individuals, whether incorporated or not, in India or outside India;
 - (vi) any corporation established by or under any Central, State or Provincial Act or a Government company as defined in section 617 of the Companies Act, 1956 (1 of 1956);
 - (vii) any body corporate incorporated by or under the laws of a country outside India;
 - (viii) a co-operative society registered under any law relating to cooperative societies;
 - (ix) a local authority;
 - (x) every artificial juridical person, not falling within any of the preceding sub-clauses;
- (m) "practice" includes any practice relating to the carrying on of any trade by a person or an enterprise;
- (n) "prescribed" means prescribed by rules made under this Act;
- (o) "price", in relation to the sale of any goods or to the performance of any services, includes every valuable consideration, whether direct or indirect, or deferred, and includes any consideration which in effect relates to the sale of any goods or to the performance of any services although ostensibly relating to any other matter or thing;
- (p) "public financial institution" means a public financial institution specified under section 4A of the Companies Act, 1956 (1 of 1956) and includes a State Financial, Industrial or Investment Corporation;
- (q) "regulations" means the regulations made by the Commission under section 64;
- (r) "relevant market" means the market which may be determined by the Commission with reference to the relevant product market or the relevant geographic market or with reference to both the markets;
- (s) "relevant geographic market" means a market comprising the area in which the conditions of competition for supply of goods or provision of services or demand of goods or services are distinctly homogenous and can be distinguished from the conditions prevailing in the neighbouring areas;
- (t) "relevant product market" means a market comprising all those products or services which are regarded as interchangeable or substitutable by the consumer, by reason of characteristics of the products or services, their prices and intended use;

(u) “service” means service of any description which is made available to potential users and includes the provision of services in connection with business of any industrial or commercial matters such as banking, communication, education, financing, insurance, chit funds, real estate, transport, storage, material treatment, processing, supply of electrical or other energy, boarding, lodging, entertainment, amusement, construction, repair, conveying of news or information and advertising;

(v) “shares” means shares in the share capital of a company carrying voting rights and includes—

(i) any security which entitles the holder to receive shares with voting rights;

(ii) stock except where a distinction between stock and share is expressed or implied;

(w) “statutory authority” means any authority, board, corporation, council, institute, university or any other body corporate, established by or under any Central, State or Provincial Act for the purposes of regulating production or supply of goods or provision of any services or markets therefor or any matter connected therewith or incidental thereto;

(x) “trade” means any trade, business, industry, profession or occupation relating to the production, supply, distribution, storage or control of goods and includes the provision of any services;

(y) “turnover” includes value of sale of goods or services;

(z) words and expressions used but not defined in this Act and defined in the Companies Act, 1956 (1 of 1956) shall have the same meanings respectively assigned to them in that Act.

17.3 PROHIBITION OF CERTAIN AGREEMENTS, ABUSE OF DOMINANT POSITION AND REGULATION OF COMBINATIONS

Prohibition of agreements

Anti competitive agreements

(1) No enterprise or association of enterprises or person or association of persons shall enter into any agreement in respect of production, supply, distribution, storage, acquisition or control of goods or provision of services, which causes or is likely to cause an appreciable adverse effect on competition within India.

(2) Any agreement entered into in contravention of the provisions contained in subsection (1) shall be void.

(3) Any agreement entered into between enterprises or associations of enterprises or persons or associations of persons or between any person and enterprise or practice carried on, or decision taken by, any association of enterprises or association of persons, including cartels, engaged in identical or similar trade of goods or provision of services, which—



- (a) directly or indirectly determines purchase or sale prices;
- (b) limits or controls production, supply, markets, technical development, investment or provision of services;
- (c) shares the market or source of production or provision of services by way of allocation of geographical area of market, or type of goods or services, or number of customers in the market or any other similar way;
- (d) directly or indirectly results in bid rigging or collusive bidding, shall be presumed to have an appreciable adverse effect on competition:

Provided that nothing contained in this sub-section shall apply to any agreement entered into by way of joint ventures if such agreement increases efficiency in production, supply, distribution, storage, acquisition or control of goods or provision of services.

Explanation.—For the purposes of this sub-section, “bid rigging” means any agreement, between enterprises or persons referred to in sub-section (3) engaged in identical or similar production or trading of goods or provision of services, which has the effect of eliminating or reducing competition for bids or adversely affecting or manipulating the process for bidding

(4) Any agreement amongst enterprises or persons at different stages or levels of the production chain in different markets, in respect of production, supply, distribution, storage, sale or price of, or trade in goods or provision of services, including—

- (a) tie-in arrangement;
- (b) exclusive supply agreement;
- (c) exclusive distribution agreement;
- (d) refusal to deal;
- (e) resale price maintenance,

shall be an agreement in contravention of sub-section (1) if such agreement causes or is likely to cause an appreciable adverse effect on competition in India.

Explanation.—For the purposes of this sub-section,—

- (a) “tie-in arrangement” includes any agreement requiring a purchaser of goods, as a condition of such purchase, to purchase some other goods;
- (b) “exclusive supply agreement” includes any agreement restricting in any manner the purchaser in the course of his trade from acquiring or otherwise dealing in any goods other than those of the seller or any other person;

(c) “exclusive distribution agreement” includes any agreement to limit, restrict or withhold the output or supply of any goods or allocate any area or market for the disposal or sale of the goods;

(d) “refusal to deal” includes any agreement which restricts, or is likely to restrict, by any method the persons or classes of persons to whom goods are sold or from whom goods are bought;

(e) “resale price maintenance” includes any agreement to sell goods on condition that the prices to be charged on the resale by the purchaser shall be the prices stipulated by the seller unless it is clearly stated that prices lower than those prices may be charged.

(5) Nothing contained in this section shall restrict—

(i) the right of any person to restrain any infringement of, or to impose reasonable conditions, as may be necessary for protecting any of his rights which have been or may be conferred upon him under—

(a) the Copyright Act, 1957 (14 of 1957);

(b) the Patents Act, 1970 (39 of 1970);

(c) the Trade and Merchandise Marks Act, 1958 (43 of 1958) or the Trade Marks

(d) the Geographical Indications of Goods (Registration and Protection) Act, 1999

(e) the Designs Act, 2000 (16 of 2000);

(f) the Semi-conductor Integrated Circuits Layout-Design Act, 2000 (37 of 2000);

(ii) the right of any person to export goods from India to the extent to which the agreement relates exclusively to the production, supply, distribution or control of goods or provision of services for such export.

Prohibition of abuse of dominant position

Abuse of dominant position

4(1) No enterprise shall abuse its dominant position.

(2) There shall be an abuse of dominant position under sub-section (1), if an enterprise.—

(a) directly or indirectly, imposes unfair or discriminatory—

(i) condition in purchase or sale of goods or service; or

(ii) price in purchase or sale (including predatory price) of goods or service,



Explanation.— For the purposes of this clause, the unfair or discriminatory condition in purchase or sale of goods or service referred to in sub-clause (i) and unfair or discriminatory price in purchase or sale of goods (including predatory price) or service referred to in sub-clause (ii) shall not include such discriminatory condition or price which may be adopted to meet the competition;

Or (b) limits or restricts—

(i) production of goods or provision of services or market therefore; or

(ii) technical or scientific development relating to goods or services to the prejudice of consumers; or

(c) indulges in practice or practices resulting in denial of market access; or

(d) makes conclusion of contracts subject to acceptance by other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts; or

(e) uses its dominant position in one relevant market to enter into, or protect, other relevant market.

Explanation.—For the purposes of this section, the expression—

(a) “dominant position” means a position of strength, enjoyed by an enterprise, in the relevant market, in India, which enables it to—

(i) operate independently of competitive forces prevailing in the relevant market; or

(ii) affect its competitors or consumers or the relevant market in its favour;

(b) “predatory price” means the sale of goods or provision of services, at a price which is below the cost, as may be determined by regulations, of production of the goods or provision of services, with a view to reduce competition or eliminate the competitors. Regulation of combinations

Combination

5. The acquisition of one or more enterprises by one or more persons or merger or amalgamation of enterprises shall be a combination of such enterprises and persons or enterprises, if—

(a) any acquisition where—

(i) the parties to the acquisition, being the acquirer and the enterprise, whose control, shares, voting rights or assets have been acquired or are being acquired jointly have,—

(A) either, in India, the assets of the value of more than rupees one thousand crores or turnover more than rupees three thousand crores; or

(B) in India or outside India, in aggregate, the assets of the value of more than five hundred million US dollars or turnover more than fifteen hundred million US dollars; or

(ii) the group, to which the enterprise whose control, shares, assets or voting rights have been acquired or are being acquired, would belong after the acquisition, jointly have or would jointly have,—

(A) either in India, the assets of the value of more than rupees four thousand crores or turnover more than rupees twelve thousand crores; or

(B) in India or outside India, in aggregate, the assets of the value of more than two billion US dollars or turnover more than six billion US dollars; or

(b) acquiring of control by a person over an enterprise when such person has already direct or indirect control over another enterprise engaged in production, distribution or trading of a similar

or identical or substitutable goods or provision of a similar or identical or substitutable service, if—

(i) the enterprise over which control has been acquired along with the enterprise over which the acquirer already has direct or indirect control jointly have,—

(A) either in India, the assets of the value of more than rupees one thousand crores or turnover more than rupees three thousand crores; or

(B) in India or outside India, in aggregate, the assets of the value of more than five hundred million US dollars or turnover more than fifteen hundred million US dollars;

or

(ii) the group, to which enterprise whose control has been acquired, or is being acquired, would belong after the acquisition, jointly have or would jointly have,—

(A) either in India, the assets of the value of more than rupees four thousand crores or turnover more than rupees twelve thousand crores; or

(B) in India or outside India, in aggregate, the assets of the value of more than two billion US dollars or turnover more than six billion US dollars; or

(C) any merger or amalgamation in which—

(i) the enterprise remaining after merger or the enterprise created as a result of the amalgamation, as the case may be, have,—

(A) either in India, the assets of the value of more than rupees one thousand crores or turnover more than rupees, three thousand crores; or



(B) in India or outside India, in aggregate, the assets of the value of more than five hundred million US dollars or turnover more than fifteen hundred million US dollars;

or

(ii) the group, to which the enterprise remaining after the merger or the enterprise created as a result of the amalgamation, would belong after the merger or the amalgamation, as the case may be, have or would have,—

(A) either in India, the assets of the value of more than rupees four-thousand crores or turnover more than rupees twelve thousand crores; or

(B) in India or outside India, the assets of the value of more than two billion US dollars or turnover more than six billion US dollars.

Explanation.— For the purposes of this section,—

(a) “control” includes controlling the affairs or management by—

(i) one or more enterprises, either jointly or singly, over another enterprise or group;

(ii) one or more groups, either jointly or singly, over another group or enterprise;

(b) “group” means two or more enterprises which, directly or indirectly, are in a position to—

(i) exercise twenty-six per cent. or more of the voting rights in the other enterprise; or

(ii) appoint more than fifty percent, of the members of the board of directors in the other enterprise; or

(iii) control the management or affairs of the other enterprise;

(c) the value of assets shall be determined by taking the book value of the assets as shown, in the audited books of account of the enterprise, in the financial year immediately preceding the financial year in which the date of proposed merger falls, as reduced by any depreciation, and the value of assets shall include the brand value, value of goodwill, or value of copyright, patent, permitted use, collective mark, registered proprietor, registered trade mark, registered user, homonymous geographical indication, geographical indications, design or layout-design or similar other commercial rights, if any, referred to in sub-section (5) of section 3.

Regulation of combinations

6. (1) No person or enterprise shall enter into a combination which causes or is likely to cause an appreciable adverse effect on competition within the relevant market in India and such a combination shall be void.

(2) Subject to the provisions contained in sub-section (1), any person or enterprise, who or which proposes to enter into a combination, may, at his or its option, give notice to the Com-

mission, in the form as may be specified, and the fee which may be determined, by regulations, disclosing the details of the proposed combination, within seven days of—

(a) approval of the proposal relating to merger or amalgamation, referred to in clause (c) of section 5, by the board of directors of the enterprises concerned with such merger or amalgamation, as the case may be;

(b) execution of any agreement or other document for acquisition referred to in clause (a) of section 5 or acquiring of control referred to in clause (h) of that section.

(3) The Commission shall, after receipt of notice under sub-section (2), deal with such notice in accordance with the provisions contained in sections 29, 30 and 31.

(4) The provisions of this section shall not apply to share subscription or financing facility or any acquisition, by a public financial institution, foreign institutional investor, bank or venture capital fund, pursuant to any covenant of a loan agreement or investment agreement.

(5) The public financial institution, foreign institutional investor, bank or venture capital fund, referred to in sub-section (4) shall, within seven days from the date of the acquisition, file, in the form as may be specified by regulations, with the Commission the details of the acquisition including the details of control, the circumstances for exercise of such control and the consequences of default arising out of such loan agreement or investment agreement, as the case may be.

Explanation.—For the purposes of this section, the expression—

(a) “foreign institutional investor” has the same meaning as assigned to it in clause (a) of the Explanation to section 115AD of the Income-tax Act, 1961(43 of 1961);

(b) “venture capital fund” has the same meaning as assigned to it in clause (b) of the

Explanation to clause (23 FB) of section 10 of the Income-tax Act, 1961(43 of 1961);.

17.4 COMPETITION COMMISSION OF INDIA (CCI)

Establishment of Commission

7. (1) With effect from such date as the Central Government may, by notification, appoint, there shall be established, for the purposes of this Act, a Commission to be called the “Competition Commission of India”.

(2) The Commission shall be a body corporate by the name aforesaid having perpetual succession and a common seal with power, subject to the provisions of this Act, to acquire, hold and dispose of property, both movable and immovable, and to contract and shall, by the said name, sue or be sued,



- (3) The head office of the Commission shall be at such place as the Central Government may decide from time to time.
- (4) The Commission may establish offices at other places in India.

Composition of Commission

8. (1) The Commission shall consist of a Chairperson and not less than two and not more than ten other Members to be appointed by the Central Government:

Provided that the Central Government shall appoint the Chairperson and a Member during the first year of the establishment of the Commission.

(2) The Chairperson and every other Member shall be a person of ability, integrity and standing and who, has been, or is qualified to be, a judge of a High Court; or, has special knowledge of, and professional experience of not less than fifteen years in international trade, economics, business, commerce, law, finance, accountancy, management, industry, public affairs, administration or in any other matter which, in the opinion of the Central Government, may be useful to the Commission.

(3) The Chairperson and other Members shall be whole-time Members.

Selection of Chairperson and other Members

9. The Chairperson and other Members shall be selected in the manner as may be prescribed.

Term of office of Chairperson and other Members

10. (1) The Chairperson and every other Member shall hold office as such for a term of five years from the date on which he enters upon his office and shall be eligible for re-appointment:

Provided that no Chairperson or other Member shall hold office as such after he has attained,—

(a) in the case of the Chairperson, the age of sixty-seven years;

(b) in the case of any other Member, the age of sixty-five years.

(2) A vacancy caused by the resignation or removal of the Chairperson or any other Member under section 11 or by death or otherwise shall be filled by fresh appointment in accordance with the provisions of sections 8 and 9.

(3) The Chairperson and every other Member shall, before entering upon his office, make and subscribe to an oath of office and of secrecy in such form, manner and before such authority, as may be prescribed.

(4) In the event of the occurrence of a vacancy in the office of the Chairperson by reason of his death, resignation or otherwise, the senior-most Member shall act as the Chairperson,

until the date on which a new Chairperson, appointed in accordance with the provisions of this Act to fill such vacancy, enters upon his office.

(5) When the Chairperson is unable to discharge his functions owing to absence, illness or any other cause, the senior-most Member shall discharge the functions of the Chairperson until the date on which the Chairperson resumes the charge of his functions.

Resignation, removal and suspension of Chairperson and other members

11. (1) The Chairperson or any other Member may, by notice in writing under his hand addressed to the Central Government, resign his office:

Provided that the Chairperson or a Member shall, unless he is permitted by the Central Government to relinquish his office sooner, continue to hold office until the expiry of three months from the date of receipt of such notice or until a person duly appointed as his successor enters upon his office or until the expiry of his term of office, whichever is the earliest.

(2) Notwithstanding anything contained in sub-section (1), the Central Government may, by order, remove the Chairperson or any other Member from his office if such Chairperson or Member, as the case may be,—

- (a) is, or at any time has been, adjudged as an insolvent; or
- (b) has engaged at any time, during his term of office, in any paid employment, or
- (c) has been convicted of an offence which, in the opinion of the Central Government, involves moral turpitude; or
- (d) has acquired such financial or other interest as is likely to affect prejudicially his functions as a Member; or
- (e) has so abused his position as to render his continuance in office prejudicial to the public interest; or
- (f) has become physically or mentally incapable of acting as a Member.

(3) Notwithstanding anything contained in sub-section (2), no Member shall be removed from his office on the ground specified in clause (d) or clause (e) of that subsection unless the Supreme Court, on a reference being made to it in this behalf by the Central Government, has, on an inquiry, held by it in accordance with such procedure as may be prescribed in this behalf by the Supreme Court, reported that the Member, ought on such ground or grounds to be removed.

Restriction on employment of Chairperson and other Members in certain cases

12. The Chairperson and other Members shall not, for a period of one year from the ' date on which they cease to hold office, accept any employment in, or connected with the manage-



ment or administration of, any enterprise which has been a party to a proceeding before the Commission under this Act:

Provided that nothing contained in this section shall apply to any employment under the Central Government or a State Government or local authority or in any statutory authority or any corporation established by or under any Central, State or Provincial Act or a Government company as defined in section 617 of the Companies Act, 1956 (1 of 1956).

Financial and administrative powers of Member Administration

13. The Central Government shall designate any Member as Member Administration who shall exercise such financial and administrative powers as may be vested in him under the rules made by the Central Government:

Provided that the Member Administration shall have authority to delegate such of his financial and administrative powers as he may think fit to any other officer of the Commission subject to the condition that such officer shall, while exercising such delegated powers continue to act under the direction, superintendence and control of the Member Administration.

Salary and allowances and other terms and conditions of service of Chairperson and other Members

- 14.** (1) The salary, and the other terms and conditions of service, of the Chairperson and other Members, including travelling expenses, house rent allowance and conveyance facilities, sumptuary allowance and medical facilities shall be such as may be prescribed.
- (2) The salary, allowances and other terms and conditions of service of the Chairperson or a Member shall not be varied to his disadvantage after appointment.

Vacancy, etc. not to invalidate proceedings of Commission

15. No act or proceeding of the Commission shall be invalid merely by reason of—

- (a) any vacancy in, or any defect in the constitution of, the Commission; or
- (b) any defect in the appointment of a person acting as a Chairperson or as a Member; or
- (c) any irregularity in the procedure of the Commission not affecting the merits of the case.

Appointment of Director General, etc.

16. (1) The Central Government may, by notification, appoint a Director General and as many Additional, Joint, Deputy or Assistant Directors General or such other advisers, consultants or officers, as it may think fit, for the purposes of assisting the Commission in conducting inquiry into contravention of any of the provisions of this Act and for the conduct of

cases before the Commission and for performing such other functions as are, or may be, provided by or under this Act

(2) Every Additional, Joint, Deputy and Assistant Directors General or such other advisers, consultants and officers, shall exercise his powers, and discharge his functions, subject to the general control, supervision and direction of the Director General.

(3) The salary, allowances and other terms and conditions of service of the Director General and Additional, Joint, Deputy and Assistant Directors General or such other advisers, consultants or officers, shall be such as may be prescribed.

(4) The Director General and Additional, Joint, Deputy and Assistant Directors General or such other advisers, consultants or officers shall be appointed from amongst persons of integrity and outstanding ability and who have experience in investigation, and knowledge of .accountancy, management, business, public administration, international trade, law or economics and such other qualifications as may be prescribed.

Registrar and officers and other employees of Commission

17. (1) The Commission may appoint a Registrar and such officers and other employees as it considers necessary for the efficient performance of its functions under this Act.

(2) The salaries and allowances payable to and other terms and conditions of service of the Registrar and officers and other employees of the Commission and the number of such officers and other employees shall be such as may be prescribed.

DUTIES, POWERS AND FUNCTIONS OF COMMISSION

Duties of Commission

18. Subject to the provisions of this Act, it shall be the duty of the Commission to eliminate practices having adverse effect on competition, promote and sustain competition, protect the interests of consumers and ensure freedom of trade carried on by other participants, in markets in India: Provided that the Commission may, for the purpose of discharging its duties or performing its functions under this Act, enter into any memorandum or arrangement with the prior approval of the Central Government, with any agency of any foreign country.

Inquiry into certain agreements and dominant position of enterprise

19. (1) The Commission may inquire into any alleged contravention of the provisions contained in subsection (1) of section 3 or sub-section (1) of section 4 either on its own motion or on—

- (a) receipt of a complaint, accompanied by such fee as may be determined by regulations, from any person, consumer or their association or trade association; or
- (b) a reference made to it by the Central Government or a State Government or a statutory authority.



(2) Without prejudice to the provisions contained in sub-section (1), the powers and functions of the Commission shall include the powers and functions specified in sub-sections (3) to (7).

(3) The Commission shall, while determining whether an agreement has an appreciable adverse effect on competition under section 3, have due regard to all or any of the following factors, namely:—

- (a) creation of barriers to new entrants in the market;
- (b) driving existing competitors out of the market;
- (c) foreclosure of competition by hindering entry into the market;
- (d) accrual of benefits to consumers;
- (e) improvements in production or distribution of goods or provision of services;
- (f) promotion of technical, scientific and economic development by means of production or distribution of goods or provision of services.

(4) The Commission shall, while inquiring whether an enterprise enjoys a dominant position or not under section 4, have due regard to all or any of the following factors, namely:—

- (a) market share of the enterprise;
- (b) size and resources of the enterprise;
- (c) size and importance of the competitors;
- (d) economic power of the enterprise including commercial advantages over competitors;
- (e) vertical integration of the enterprises or sale or service network of such enterprises;
- (f) dependence of consumers on the enterprise;
- (g) monopoly or dominant position whether acquired as a result of any statute or by virtue of being a Government company or a public sector undertaking or otherwise;
- (h) entry barriers including barriers such as regulatory barriers, financial risk, high capital cost of entry, marketing entry barriers, technical entry barriers, economies of scale, high cost of substitutable goods or service for consumers;
- (i) countervailing buying power;
- (j) market structure and size of market;

(k) social obligations and social costs;

(/) relative advantage, by way of the contribution to the economic development, by the enterprise enjoying a dominant position having or likely to have an appreciable adverse effect on competition;

(m) any other factor which the Commission may consider relevant for the inquiry.

(5) For determining whether a market constitutes a “relevant market” for the purposes of this Act, the Commission shall have due regard to the “relevant geographic market” and “relevant product market”.

(6) The Commission shall, while determining the “relevant geographic market”, have due regard to all or any of the following factors, namely:—

(a) regulatory trade barriers;

(b) local specification requirements;

(c) national procurement policies;

(d) adequate distribution facilities;

(e) transport costs;

(f) language;

(g) consumer preferences;

(h) need for secure or regular supplies or rapid after-sales services.

(7) The Commission shall, while determining the “relevant product market”, have due regard to all or any of the following factors, namely:—

(a) physical characteristics or end-use of goods;

(b) price of goods or service;

(c) consumer preferences;

(d) exclusion of in-house production;

(e) existence of specialised producers;

(f) classification of industrial products.

**Inquiry into combination by Commission**

20. (1) The Commission may, upon its own knowledge or information relating to acquisition referred to in clause (a) of section 5 or acquiring of control referred to in clause (b) of section 5 or merger or amalgamation referred to in clause (c) of that section, inquire into whether such a combination has caused or is likely to cause an appreciable adverse effect on competition in India: Provided that the Commission shall not initiate any inquiry under this sub-section after the expiry of one year from the date on which such combination has taken effect.

(2) The Commission shall, on receipt of a notice under sub-section (2) of section 6 or upon receipt of a reference under sub-section (1) of section 21, inquire whether a combination referred to in that notice or reference has caused or is likely to cause an appreciable adverse effect on competition in India.

(3) Notwithstanding anything contained in section 5, the Central Government shall, on the expiry of a period of two years from the date of commencement of this Act and thereafter every two years, in consultation with the Commission, by notification, enhance or reduce, on the basis of the wholesale price index or fluctuations in exchange rate of rupee or foreign currencies, the value of assets or the value of turnover, for the purposes of that section.

(4) For the purposes of determining whether a combination would have the effect of or is likely to have an appreciable adverse effect on competition in the relevant market, the Commission shall have due regard to all or any of the following factors, namely:—

- (a) actual and potential level of competition through imports in the market;
- (b) extent of barriers to entry into the market;
- (c) level of combination in the market;
- (d) degree of countervailing power in the market;
- (e) likelihood that the combination would result in the parties to the combination being able to significantly and sustainably increase prices or profit margins;
- (f) extent of effective competition likely to sustain in a market;
- (g) extent to which substitutes are available or are likely to be available in the market;
- (h) market share, in the relevant market, of the persons or enterprise in a combination, individually and as a combination;
- (i) likelihood that the combination would result in the removal of a vigorous and effective competitor or competitors in the market;

- (j) nature and extent of vertical integration in the market;
- (k) possibility of a failing business;
- (l) nature and extent of innovation;
- (m) relative advantage, by way of the contribution to the economic development, by any combination having or likely to have appreciable adverse effect on competition;
- (n) whether the benefits of the combination outweigh the adverse impact of the combination, if any.

Reference by statutory authority

21. (1) Where in the course of a proceeding before any statutory authority an issue is raised by any party that any decision which such statutory authority has taken or proposes to take, is or would be, contrary to any of the provisions of this Act, then such statutory authority may make a reference in respect of such issue to the Commission.

(2) On receipt of a reference under sub-section (1), the Commission shall, after hearing the parties to the proceedings, give its opinion to such statutory authority which shall thereafter pass such order on the issues referred to in that sub-section as it deems fit: Provided that the Commission shall give its opinion under this section within sixty days of receipt of such reference.

Benches of Commission

22. (1) The jurisdiction, powers and authority of the Commission may be exercised by Benches thereof.

(2) The Benches shall be constituted by the Chairperson and each Bench shall consist of not less than two Members.

(3) Every Bench shall consist of at least one Judicial Member.

Explanation.—For the purposes of this sub-section, “Judicial Member” means a Member who is, or has been, or is qualified to be, a Judge of a High Court.

(4) The Bench over which the Chairperson presides shall be the Principal Bench and the other Benches shall be known as the Additional Benches.

(5) There shall be constituted by the Chairperson one or more Benches to be called the Mergers Bench or Mergers Benches, as the case may be, exclusively to deal with matters referred to in sections 5 and 6.

(6) The places at which the Principal Bench, other Additional Bench or Mergers Bench shall ordinarily sit, shall be such as the Central Government may, by notification, specify.

**Distribution of business of Commission amongst Benches**

23. (1) Where any Benches are constituted, the Chairperson may, from time to time, by order, make provisions as to the distribution of the business of the Commission amongst the Benches and specify the matters, which may be dealt with by each Bench.

(2) If any question arises as to whether any matter falls within the purview of the business allocated to a Bench, the decision of the Chairperson thereon shall be final.

(3) The Chairperson may—

- (i) transfer a Member from one Bench to another Bench; or
- (ii) authorise the Members of one Bench to discharge also the functions of the Members of other Bench: Provided that the Chairperson shall transfer, with the prior approval of the Central Government, a Member from one Bench situated in one city to another Bench situated in another city.

(4) The Chairperson may, for the purpose of securing that any case or matter which, having regard to the nature of the questions involved, requires or is required in his opinion or under the rules made by the Central Government in this behalf, to be decided by a Bench composed of more than two Members, issue such general or special orders as he may deem fit.

Procedure for deciding a case where Members of a Bench differ in opinion

24. If the Members of a Bench differ in opinion on any point, they shall state the point or points on which they differ, and make a reference to the Chairperson who shall either hear the point or points himself or refer the case for hearing on such point or points by one or more of the other Members and such point or points shall be decided according to the opinion of the majority of the Members who have heard the case, including those who first heard it.

Jurisdiction of Bench

25. An inquiry shall be initiated or a complaint be instituted or a reference be made under this Act before a Bench within the local limits of whose jurisdiction—

- (a) the respondent, or each of the respondents, where there are more than one, at the time of the initiation of inquiry or institution of the complaint or making of reference, as the case may be, actually and voluntarily resides, or carries on business, or personally works for gain; or
- (b) any of the respondents, where there are more than one, at the time of the initiation of the inquiry or institution of complaint or making of reference, as the case may be, actually and voluntarily resides or carries on business or personally works for gain provided that in such case either the leave of the Bench is given, or the respondents who do not reside, or carry on business, or personally work for gain, as aforesaid, acquiesce in such institution; or

(c) the cause of action, wholly or in part, arises.

Explanation.—A respondent, being a person referred to in sub-clause (iii) or sub-clause (vi) or sub-clause (vii) or sub-clause (viii) of clause (l) of section 2, shall be deemed to carry on business at its sole or principal place of business in India or at its registered office in India or where it has also a subordinate office at such place.

Procedure for inquiry on complaints under Section 19

26. (1) On receipt of a complaint or a reference from the Central Government or a State Government or a statutory authority or on its own knowledge or information, under section 19, if the Commission is of the opinion that there exists a prima facie case, it shall direct the Director General to cause an investigation to be made into the matter.
- (2) The Director General shall, on receipt of direction under sub-section (1), submit a report on his findings within such period as may be specified by the Commission.
- (3) Where on receipt of a complaint under clause (a) of sub-section (1) of section 19, the Commission is of the opinion that there exists no prima facie case, it shall dismiss the complaint and may pass such orders as it deems fit, including imposition of costs, if necessary.
- (4) The Commission shall forward a copy of the report referred to in sub-section (2) to the parties concerned or to the Central Government or the State Government or the statutory authority, as the case may be.
- (5) If the report of the Director General relates on a complaint and such report recommends that there is no contravention of any of the provisions of this Act, the complainant shall be given an opportunity to rebut the findings of the Director General.
- (6) If, after hearing the complainant, the Commission agrees with the recommendation of the Director General, it shall dismiss the complaint.
- (7) If, after hearing the complainant, the Commission is of the opinion that further inquiry is called for, it shall direct the complainant to proceed with the complaint.
- (8) If the report of the Director General relates on a reference made under sub-section (/) and such report recommends that there is no contravention of the provisions of this Act, the Commission shall invite comments of the Central Government or the State Government or the statutory authority, as the case may be, on such report and on receipt of such comments, the Commission shall return the reference if there is no prima facie case or proceed with the reference as a complaint if there is a prima facie case.
- (9) If the report of the Director General referred to in sub-section (2) recommends that there is contravention of any of the provisions of this Act, and the Commission is of



the opinion that further inquiry is called for, it shall inquire into such contravention in accordance with the provisions of this Act.

Orders by Commission after inquiry into agreements or abuse of dominant position

27. Where after inquiry the Commission finds that any agreement referred to in section 3 or action of an enterprise in a dominant position, is in contravention of section 3 or section 4, as the case may be, it may pass all or any of the following orders, namely:—

- (a) direct any enterprise or association of enterprises or person or association of persons, as the case may be, involved in such agreement, or abuse of dominant position, to discontinue and not to re-enter such agreement or discontinue such abuse of dominant position, as the case may be;
- (b) impose such penalty, as it may deem fit which shall be not more than ten per cent. of the average of the turnover for the last three preceding financial years, upon each of such person or enterprises which are parties to such agreements or abuse:

Provided that in case any agreement referred to in section 3 has been entered into by any cartel, the Commission shall impose upon each producer, seller, distributor, trader or service provider included in that cartel, a penalty equivalent to three times of the amount of profits made out of such agreement by the cartel or ten per cent. of the average of the turnover of the cartel for the last preceding three financial years, whichever is higher;

- (c) award compensation to parties in accordance with the provisions contained in section 34;
- (d) direct that the agreements shall stand modified to the extent and in the manner as may be specified in the order by the Commission;
- (e) direct the enterprises concerned to abide by such other orders as the Commission may pass and comply with the directions, including payment of costs, if any;
- (f) recommend to the Central Government for the division of an enterprise enjoying dominant position;
- (g) pass such other order as it may deem fit.

Division of enterprise enjoying dominant position

28 (1) The Central Government, on recommendation under clause (f) of section 27, may, notwithstanding anything contained in any other law for the time being in force, by order in writing, direct division of an enterprise enjoying dominant position to ensure that such enterprise does not abuse its dominant position.

(2) In particular, and without prejudice to the generality of the foregoing powers, the order referred to in sub-section (1) may provide for all or any of the following matters, namely:—

- (a) the transfer or vesting of property, rights, liabilities or obligations;
- (b) the adjustment of contracts either by discharge or reduction of any liability or obligation or otherwise;
- (c) the creation, allotment, surrender or cancellation of any shares, stocks or securities;
- (d) the payment of compensation to any person who suffered any loss due to dominant position of such enterprise;
- (e) the formation or winding up of an enterprise or the amendment of the memorandum of association or articles of association or any other instruments regulating the business of any enterprise;
- (f) the extent to which, and the circumstances in which, provisions of the order affecting an enterprise may be altered by the enterprise and the registration thereof;
- (g) any other matter which may be necessary to give effect to the division of the enterprise.

(3) Notwithstanding anything contained in any other law for the time being in force or in any contract or in any memorandum or articles of association, an officer of a company who ceases to hold office as such in consequence of the division of an enterprise shall not be entitled to claim any compensation for such cesser.

Procedure for investigation of combination

29. (1) Where the Commission is of the opinion that a combination is likely to cause, or has caused an appreciable adverse effect on competition within the relevant market in India, it shall issue a notice to show cause to the parties to combination calling upon them to respond within thirty days of the receipt of the notice, as to why investigation in respect of such combination should not be conducted.
- (2) The Commission, if it is prima facie of the opinion that the combination has, or is likely to have, an appreciable adverse effect on competition, it shall, within seven working days from the date of receipt of the response of the parties to the combination, direct the parties to the said combination to publish details of the combination within ten working days of such direction, in such manner, as it thinks appropriate, for bringing the combination to the knowledge or information of the public and persons affected or likely to be affected by such combination.
- (3) The Commission may invite any person or member of the public, affected or likely to be affected by the said combination, to file his written objections, if any, before the Commission within fifteen working days from the date on which the details of the combination were published under sub-section (2).



- (4) The Commission may, within fifteen working days from the expiry of the period specified in sub-section (3), call for such additional or other information as it may deem fit from the parties to the said combination.
- (5) The additional or other information called for by the Commission shall be furnished by the parties referred to in sub-section (4) within fifteen days from the expiry of the period specified in sub-section (4).
- (6) After receipt of all information and within a period of forty-five working days from the expiry of the period specified in sub-section (5), the Commission shall proceed to deal with the case in accordance with the provisions contained in section 31.

Inquiry into disclosures under sub-section (2) of section 6

30. Where any person or enterprise has given a notice under sub-section (2) of section 6. The Commission shall inquire—

- (a) whether the disclosure made in the notice is correct;
- (b) whether the combination has, or is likely to have, an appreciable adverse effect on competition.

Orders of Commission on certain combinations

- 31.** (1) Where the Commission is of the opinion that any combination does not, or is not likely to, have an appreciable adverse effect on competition, it shall, by order, approve that combination including the combination in respect of which a notice has been given under sub-section (2) of section 6.
- (2) Where the Commission is of the opinion that the combination has, or is likely to have, an appreciable adverse effect on competition, it shall direct that the combination shall not take effect.
 - (3) Where the Commission is of the opinion that the combination has, or is likely to have, an appreciable adverse effect on competition but such adverse effect can be eliminated by suitable modification to such combination, it may propose appropriate modification to the combination, to the parties to such combination.
 - (4) The parties, who accept the modification proposed by the Commission under sub-section (3), shall carry out such modification within the period specified by the Commission.
 - (5) If the parties to the combination, who have accepted the modification under sub-section (4), fail to carry out the modification within the period specified by the Commission, such combination shall be deemed to have an appreciable adverse effect on competition and the Commission shall deal with such combination in accordance with the provisions of this Act.

- (6) If the parties to the combination do not accept the modification proposed by the Commission under sub-section (3), such parties may, within thirty working days of the modification proposed by the Commission, submit amendment to the modification proposed by the Commission under that sub-section.
- (7) If the Commission agrees with the amendment submitted by the parties under sub-section (6), it shall, by order, approve the combination.
- (8) If the Commission does not accept the amendment submitted under sub-section (6), then, the parties shall be allowed a further period of thirty working days within which such parties shall accept the modification proposed by the Commission under sub-section (3).
- (9) If the parties fail to accept the modification proposed by the Commission within thirty working days referred to in sub-section (6) or within a further period of thirty working days referred to in sub-section (8), the combination shall be deemed to have an appreciable adverse effect on competition and be dealt with in accordance with the provisions of this Act.
- (10) Where the Commission has directed under sub-section (2) that the combination shall not take effect or the combination is deemed to have an appreciable adverse effect on competition under sub-section (9), then, without prejudice to any penalty which may be imposed or any prosecution which may be initiated under this Act, the Commission may order that—
 - (a) the acquisition referred to in clause (a) of section 5; or
 - (b) the acquiring of control referred to in clause (b) of section 5; or
 - (c) the merger or amalgamation referred to in clause (c) of section 5, shall not be given effect to: Provided that the Commission may, if it considers appropriate, frame a scheme to implement its order under this sub-section.
- (11) If the Commission does not, on the expiry of a period of ninety working days from the date of publication referred to in sub-section (2) of section 29, pass an order or issue direction in accordance with the provisions of sub-section (1) or sub-section (2) or sub-section (7), the combination shall be deemed to have been approved by the Commission.

Explanation.—For the purposes of determining the period of ninety working days specified in this subsection, the period of thirty working days specified in sub-section (6) and a further period of thirty working days specified in sub-section (8) shall be excluded.

- (12) Where any extension of time is sought by the parties to the combination, the period of ninety working days shall be reckoned after deducting the extended time granted at the request of the parties.



- (13) Where the Commission has ordered a combination to be void, the acquisition or acquiring of control or merger or amalgamation referred to in section 5, shall be dealt with by the authorities under any other law for the time being in force as if such acquisition or acquiring of control or merger or amalgamation had not taken place and the parties to the combination shall be dealt with accordingly.
- (14) Nothing contained in this Chapter shall affect any proceeding initiated or which may be initiated under any other law for the time being in force.

Acts taking place outside India but having an effect on competition in India

32. The Commission shall, notwithstanding that,—

- (a) an agreement referred to in section 3 has been entered into outside India; or
- (b) any party to such agreement is outside India; or
- (c) any enterprise abusing the dominant position is outside India; or
- (d) a combination has taken place outside India; or
- (e) any party to combination is outside India; or
- (f) any other matter or practice or action arising out of such agreement or dominant position or combination is outside India, have power to inquire into such agreement or abuse of dominant position or combination if such agreement or dominant position or combination has, or is likely to have, an appreciable adverse effect on competition in the relevant market in India.

Power to grant interim relief

- 33.(1)** Where during an inquiry before the Commission, it is proved to the satisfaction of the Commission, by affidavit or otherwise, that an act in contravention of sub-section (1) of section 3 or sub-section (1) of section 4 or section 6 has been committed and continues to be committed or that such act is about to be committed, the Commission may, by order, grant a temporary injunction restraining any party from carrying on such act until the conclusion of such inquiry or until further orders, without giving notice to the opposite party, where it deems it necessary.
- (2) Where during the inquiry before the Commission it is proved to the satisfaction of the Commission by affidavit or otherwise that import of any goods is likely to contravene sub-section (1) of section 3 or subsection (1) of section 4 or section 6, it may, by order, grant a temporary injunction restraining any party from importing such goods until the conclusion of such inquiry or until further orders, without giving notice to the opposite party, where it deems it necessary and a copy of such order granting temporary injunction shall be sent to the concerned authorities.

- (3) The provisions of rules 2A to 5 (both inclusive) of Order XXXIX of the First Schedule to the Code of Civil Procedure, 1908 (5 of 1908) shall, as far as may be, apply to a temporary injunction issued by the Commission under this Act, as they apply to a temporary injunction issued by a civil court, and any reference in any such rule to a suit shall be construed as a reference to any inquiry before the Commission.

Power to award compensation

- 34.(1) Without prejudice to any other provisions contained in this Act, any person may make an application to the Commission for an order for the recovery of compensation from any enterprise for any loss or damage shown to have been suffered, by such person as a result of any contravention of the provisions of Chapter II, having been committed by such enterprise.
- (2) The Commission may, after an inquiry made into the allegations mentioned in the application made under sub-section (1), pass an order directing the enterprise to make payment to the applicant, of the amount determined by it as realisable from the enterprise as compensation for the loss or damage caused to the applicant as a result of any contravention of the provisions of Chapter II having been committed by such enterprise.
- (3) Where any loss or damage referred to in sub-section (1) is caused to numerous persons having the same interest, one or more of such persons may, with the permission of the Commission, make an application under that sub-section for and on behalf of, or for the benefit of, the persons so interested, and thereupon, the provisions of rule 8 of Order 1 of the First Schedule to the Code of Civil Procedure, 1908 (5 of 1908), shall apply subject to the modification that every reference therein to a suit or decree shall be construed as a reference to the application before the Commission and the order of the Commission thereon.

Appearance before Commission

35. A complainant or defendant or the Director General may either appear in person or authorise one or more chartered accountants or company secretaries or cost accountants or legal practitioners or any of his or its officers to present his or its case before the Commission.

Explanation.—For the purposes of this section,—

- (a) “chartered accountant” means a chartered accountant as defined in clause (b) of sub-section (1) of section 2 of the Chartered Accountants Act, 1949 (38 of 1949) and who has obtained a certificate of practice under sub-section (1) of section 6 of that Act;
- (b) “company secretary” means a company secretary as defined in clause (c) of sub-section (1) of section 2 of the Company Secretaries Act, 1980 (56 of 1980) and who has obtained a certificate of practice under sub-section (1) of section 6 of that Act;



- (c) “cost accountant” means a cost accountant as defined in clause (b) of sub-section (1) of section 2 of the Cost and Works Accountants Act, 1959 (23 of 1959) and who has obtained a certificate of practice under sub-section (1) of section 6 of that Act;
- (d) “legal practitioner” means an advocate, vakil or an attorney of any High Court, and includes a pleader in practice.

Power of Commission to regulate its own procedure

36. (1) The Commission shall not be bound by the procedure laid down by the Code of Civil Procedure, 1908 (5 of 1908), but shall be guided by the principles of natural justice and, subject to the other provisions of this Act and of any rules made by the Central Government, the Commission shall have powers to regulate its own procedure in cluding the places at which they shall have their sittings, duration of oral hearings when granted, and times of its inquiry.
- (2) The Commission shall have, for the purposes of discharging its functions under this Act, the same powers as are vested in a civil court under the Code of Civil Procedure, 1908(5 of 1908), while trying a suit, in respect of the following matters, namely:—
- (a) summoning and enforcing the attendance of any person and examining him on oath;
 - (b) requiring the discovery and production of documents;
 - (c) receiving evidence on affidavits;
 - (d) issuing commissions for the examination of witnesses or documents;
 - (e) subject to the provisions of sections 123 and 124 of the Indian Evidence Act, 1872 (1 of 1872), requisitioning any public record or document or copy of such record or document from any office;
 - (f) dismissing an application in default or deciding it ex parte;
 - (g) any other matter which may be prescribed.
- (3) Every proceeding before the Commission shall be deemed to be a judicial proceeding within the meaning of sections 193 and 228 and for the purposes of section 196 of the Indian Penal Code (45 of 1860) and the Commission shall be deemed to be a civil court for the purposes of section 195 (2 of 1974) and Chapter XXVI of the Code of Criminal Procedure, 1973.
- (4) The Commission may call upon such experts, from the fields of economics, commerce, accountancy, international trade or from any other discipline as it deems necessary, to assist the Commission in the conduct of any inquiry or proceeding before it.

(5) The Commission may direct any person—

- (a) to produce before the Director General or the Registrar or an officer authorised by it, such books, accounts or other documents in the custody or under the control of such person so directed as may be specified or described in the direction, being documents relating to any trade, the examination of which may be required for the purposes of this Act;
- (b) to furnish to the Director General or the Registrar or any officer authorised by it, as respects the trade or such other information as may be in his possession in relation to the trade carried on by such person, as may be required for the purposes of this Act.

(6) If the Commission is of the opinion that any agreement referred to in section 3 or “abuse of dominant position referred to in section 4 or the combination referred to in section 5 has caused or is likely to cause an appreciable adverse effect on competition in the relevant market in India and it is necessary to protect, without further delay, the interests of consumers and other market participants in India, it may conduct an inquiry or adjudicate upon any matter under this Act after giving a reasonable oral hearing to the parties concerned.

Review of orders of Commission

37. Any person aggrieved by an order of the Commission from which an appeal is allowed by this Act but no appeal has been preferred, may, within thirty days from the date of the order, apply to the Commission for review of its order and the Commission may make such order thereon as it thinks fit:

Provided that the Commission may entertain a review application after the expiry of the said period of thirty days, if it is satisfied that the applicant was prevented by sufficient cause from preferring the application in time: Provided further that no order shall be modified or set aside without giving an opportunity of being heard to the person in whose favour the order is given and the Director General where he was a party to the proceedings.

Rectification of orders

38. (1) With a view to rectifying any mistake apparent from the record, the Commission may amend any order passed by it under the provisions of this Act.

(2) Subject to the other provisions of this Act, the Commission may make—

- (a) an amendment under sub-section (1) of its own motion;
- (b) an amendment for rectifying any such mistake which has been brought to its notice by any party to the order.



Explanation.— For the removal of doubts, it is hereby declared that the Commission shall not, while rectifying any mistake apparent from record, amend substantive part of its order passed under the provisions of this Act.

Execution of orders of Commission

39. Every order passed by the Commission under this Act shall be enforced by the Commission in the same manner as if it were a decree or order made by a High Court or the principal civil court in a suit pending therein and it shall be lawful for the Commission to send, in the event of its inability to execute it, such order to the High Court or the principal civil court, as the case may be, within the local limits of whose jurisdiction,—

(a) in the case of an order against a person referred to in sub-clause (iii) or sub-clause (vi) or subclause (vii) of clause (l) of section 2, the registered office or the sole or principal place of business of the person in India or where the person has also a subordinate office, that subordinate office, is situated;

(c) in the case of an order against any other person, the place, where the person concerned voluntarily resides or carries on business or personally works for gain, is situated, and thereupon the court to which the order is so sent shall execute the order as if it were a decree or order sent to it for execution.

Appeal

40. Any person aggrieved by any decision or order of the Commission may file an appeal to the Supreme Court within sixty days from the date of communication of the decision or order of the Commission to him on one or more of the grounds specified in section 100 of the Code of Civil Procedure, 1908 (5 of 1908):

Provided that the Supreme Court may, if it is satisfied that the appellant was prevented by sufficient cause from filing the appeal within the said period, allow it to be filed within a further period not exceeding sixty days:

Provided further that no appeal shall lie against any decision or order of the Commission made with the consent of the parties.

DUTIES OF DIRECTOR GENERAL

Director General to investigate contravention

41. (1) The Director General shall, when so directed by the Commission, assist the Commission in investigating into any contravention of the provisions of this Act or any rules or regulations made thereunder.

(2) The Director General shall have all the powers as are conferred upon the Commission under subsection (2) of section 36.

- (3) Without prejudice to the provisions of sub-section (2), sections 240 and 240A of the Companies Act, 1956 (1 of 1956), so far as may be, shall apply to an investigation made by the Director General or any other person investigating under his authority, as they apply to an inspector appointed under that Act.

PENALTIES

Contravention of orders of Commission

42. (1) Without prejudice to the provisions of this Act, if any person contravenes, without any reasonable ground, any order of the Commission, or any condition or restriction subject to which any approval, sanction, direction or exemption in relation to any matter has been accorded, given, made or granted under this Act or fails to pay the penalty imposed under this Act, he shall be liable to be detained in civil prison for a term which may extend to one year, unless in the meantime the Commission directs his release and he shall also be liable to a penalty not exceeding rupees ten lakhs.
- (2) The Commission may, while making an order under this Act, issue such directions to any person or authority, not inconsistent with this Act, as it thinks necessary or desirable, for the proper implementation or execution of the order, and any person who commits breach of, or fails to comply with, any obligation imposed on him under such direction, may be ordered by the Commission to be detained in civil prison for a term not exceeding one year unless in the meantime the Commission directs his release and he shall also be liable to a penalty not exceeding rupees ten lakhs.

Penalty for failure to comply with directions of Commission and Director General

43. If any person fails to comply with a direction given by—

- (a) the Commission under sub-section (5) of section 36; or
- (b) the Director General while exercising powers referred to in sub-section (2) of section 41, the Commission shall impose on such person a penalty of rupees one lakh for each day during which such failure continues.

Penalty for making false statement or omission to furnish material information

44. If any person, being a party to a combination,—

- (a) makes a statement which is false in any material particular, or knowing it to be false; or
- (b) omits to state any material particular knowing it to be material, such person shall be liable to a penalty which shall not be less than rupees fifty lakhs but which may extend to rupees one crore, as may be determined by the Commission.

**Penalty for offences in relation to furnishing of information**

45. (1) Without prejudice to the provisions of section 44, if any person, who furnishes or is required to furnish under this Act any particulars, documents or any information,—
- (a) makes any statement or furnishes any document which he knows or has reason to believe to be false in any material particular; or
 - (b) omits to state any material fact knowing it to be material; or
 - (c) wilfully alters, suppresses or destroys any document which is required to be furnished as aforesaid, the Commission shall impose on such person a penalty which may extend to rupees ten lakhs.
- (2) Without prejudice to the provisions of sub-section (1), the Commission may also pass such other order as it deems fit.

Power to impose lesser penalty

46. The Commission may, if it is satisfied that any producer, seller, distributor, trader or service provider included in any cartel, which is alleged to have violated section 3, has made a full and true disclosure in respect of the alleged violations and such disclosure is vital, impose upon such producer, seller, distributor, trader or service provider a lesser penalty as it may deem fit, than leviable under this Act or the rules or the regulations: Provided that lesser penalty shall not be imposed by the Commission in cases where proceedings for the violation of any of the provisions of this Act or the rules or the regulations have been instituted or any investigation has been directed to be made under section 26 before making of such disclosure:

Provided further that lesser penalty shall be imposed by the Commission only in respect of a producer, seller, distributor, trader or service provider included in the cartel, who first made the full, true and vital disclosures under this section:

Provided also that the Commission may, if it is satisfied that such producer, seller, distributor, trader or service provider included in the cartel had in the course of proceedings,—

- (a) not complied with the condition on which the lesser penalty was imposed by the Commission; or
- (b) had given false evidence; or
- (c) the disclosure made is not vital,

and thereupon such producer, seller, distributor, trader or service provider may be tried for the offence with respect to which the lesser penalty was imposed and shall also be liable to the imposition of penalty to which such person has been liable, had lesser penalty not been imposed.

Crediting sums realised by way of penalties to Consolidated Fund of India

47. All sums realised by way of penalties under this Act shall be credited to the Consolidated Fund of India.

Contravention by companies

48. (1) Where a person committing contravention of any of the provisions of this Act or of any rule, regulation, order made or direction issued thereunder is a company, every person who, at the time the contravention was committed, was in charge of, and was responsible to the company for the conduct of the business of the company, as well as the company, shall be deemed to be guilty of the contravention and shall be liable to be proceeded against and punished accordingly:

Provided that nothing contained in this sub-section shall render any such person liable to any punishment if he proves that the contravention was committed without his knowledge or that he had exercised all due diligence to prevent the commission of such contravention.

(2) Notwithstanding anything contained in sub-section (1), where a contravention of any of the provisions of this Act or of any rule, regulation, order made or direction issued thereunder has been committed by a company and it is proved that the contravention has taken place with the consent or connivance of, or is attributable to any neglect on the part of, any director, manager, secretary or other officer of the company, such director, manager, secretary or other officer shall also be deemed to be guilty of that contravention and shall be liable to be proceeded against and punished accordingly.

Explanation.—For the purposes of this section,—

(a) “company” means a body corporate and includes a firm or other association of individuals: and

(b) “director”, in relation to a firm, means a partner in the firm.

COMPETITION ADVOCACY

Competition advocacy

49. (1) In formulating a policy on competition (including review of laws related to competition), the Central Government may make a reference to the Commission for its opinion on possible effect of such policy on competition and on receipt of such a reference, the Commission shall, within sixty days of making such reference, give its opinion to the Central Government, which may thereafter formulate the policy as it deems fit.

(2) The opinion given by the Commission under sub-section (1) shall not be binding upon the Central Government in formulating such policy.



- (3) The Commission shall take suitable measures, as may be prescribed, for the promotion of competition advocacy, creating awareness and imparting training about competition issues.

17.5 FINANCE, ACCOUNTS AND AUDIT

Grants by Central Government

50. The Central Government may, after due appropriation made by Parliament by law in this behalf, make to the Commission grants of such sums of money as the Government may think fit for being utilised for the purposes of this Act.

Constitution of Fund

51. (1) There shall be constituted a fund to be called the “Competition Fund” and there shall be credited thereto—

- (a) all Government grants received by the Commission;
- (b) the monies received as costs from parties to proceedings before the Commission;
- (d) the fees received under this Act;
- (e) the interest accrued on the amounts referred to in clauses (a) to (c).

(2) The Fund shall be applied for meeting—

- (a) the salaries and allowances payable to the Chairperson and other Members and the administrative expenses including the salaries, allowances and pension payable to the Director General, Additional, Joint, Deputy or Assistant Directors General, the Registrar and” officers and other employees of the Commission;
- (b) the other expenses of the Commission in connection with the discharge of its functions and for the purposes of this Act.

(3) The Fund shall be administered by a committee of such Members of the Commission as may be determined by the Chairperson.

(4) The committee appointed under sub-section (3) shall spend monies out of the Fund for carrying out the objects for which the Fund has been constituted.

Accounts and Audit

52. (1) The Commission shall maintain proper accounts and other relevant records and prepare an annual statement of accounts in such form as may be prescribed by the Central Government in consultation with the Comptroller and Auditor-General of India.

- (2) The accounts of the Commission shall be audited by the Comptroller and Auditor-General of India at such intervals as may be specified by him and any expenditure incurred in connection with such audit shall be payable by the Commission to the Comptroller and Auditor-General of India.

Explanation.—For the removal of doubts, it is hereby declared that the orders of the Commission, being matters appealable to the Supreme Court, shall not be subject to audit under this section.

- (3) The Comptroller and Auditor-General of India and any other person appointed by him in connection with the audit of the accounts of the Commission shall have the same rights, privileges and authority in connection with such audit as the Comptroller and Auditor-General of India generally has, in connection with the audit of the Government accounts and, in particular, shall have the right to demand the production of books, accounts, connected vouchers and other documents and papers and to inspect any of the offices of the Commission.
- (4) The accounts of the Commission as certified by the Comptroller and Auditor-General of India or any other person appointed by him in this behalf together with the audit report thereon shall be forwarded annually to the Central Government and that Government shall cause the same to be laid before each House of Parliament.

Furnishing of returns, etc., to Central Government

53. (1) The Commission shall furnish to the Central Government at such time and in such form and manner as may be prescribed or as the Central Government may direct, such returns and statements and such particulars in regard to any proposed or existing measures for the promotion of competition advocacy, creating awareness and imparting training about competition issues, as the Central Government may, from time to time, require.
- (2) The Commission shall prepare once in every year, in such form and at such time as may be prescribed, an annual report giving a true and full account of its activities during the previous year and copies of the report shall be forwarded to the Central Government.
- (3) A copy of the report received under sub-section (2) shall be laid, as soon as may be after it is received, before each House of Parliament.



17.6 MISCELLANEOUS

Power to exempt

54. The Central Government may, by notification, exempt from the application of this Act, or any provision thereof, and for such period as it may specify in such notification—

- (a) any class of enterprises if such exemption is necessary in the interest of security of the State or public interest;
- (b) any practice or agreement arising out of and in accordance with any obligation assumed by India under any treaty, agreement or convention with any other country or countries;
- (c) any enterprise which performs a sovereign function on behalf of the Central Government or a State Government;

Provided that in case an enterprise is engaged in any activity including the activity relatable to the sovereign functions of the Government, the Central Government may grant exemption only in respect of activity relatable to the sovereign functions.

Power of Central Government to issue directions

55. (1) Without prejudice to the foregoing provisions of this Act, the Commission shall, in exercise of its powers or the performance of its functions under this Act, be bound by such directions on questions of policy, other than those relating to technical and administrative matters, as the Central Government may give in writing to it from time to time: Provided that the Commission shall, as far as practicable, be given an opportunity to express its views before any direction is given under this sub-section.

(2) The decision of the Central Government whether a question is one of policy or not shall be final.

Power of Central Government to supersede Commission

56. (1) If at any time the Central Government is of the opinion—

- (a) that on account of circumstances beyond the control of the Commission, it is unable to discharge the functions or perform the duties imposed on it by or under the provisions of this Act; or
- (b) that the Commission has persistently made default in complying with any direction given by the Central Government under this Act or in the discharge of the functions or performance of the duties imposed on it by or under the provisions of this Act and as a result of such default the financial position of the Commission or the administration of the Commission has suffered; or

- (c) that circumstances exist which render it necessary in the public interest so to do, the Central Government may, by notification and for reasons to be specified therein, supersede the Commission for such period, not exceeding six months, as may be specified in the notification: Provided that before issuing any such notification, the Central Government shall give a reasonable opportunity to the Commission to make representations against the proposed supersession and shall consider representations, if any, of the Commission.

(2) Upon the publication of a notification under sub-section (1) superseding the Commission,—

- (a) the Chairperson and other Members shall as from the date of supersession, vacate their offices as such;
- (b) all the powers, functions and duties which may, by or under the provisions of this Act, be exercised or discharged by or on behalf of the Commission shall, until the Commission is reconstituted under sub-section (3), be exercised and discharged by the Central Government or such authority as the Central Government may specify in this behalf;
- (c) all properties owned or controlled by the Commission shall, until the Commission is reconstituted under sub-section (3), vest in the Central Government.

(3) On or before the expiration of the period of supersession specified in the notification issued under subsection

(1), the Central Government shall reconstitute the Commission by a fresh appointment of its Chairperson and other Members and in such case any person who had vacated his office under clause

(a) of sub-section (2) shall not be deemed to be disqualified for re-appointment.

(4) The Central Government shall cause a notification issued under sub-section (1) and a full report of any action taken under this section and the circumstances leading to such action to be laid before each House of Parliament at the earliest.

Restriction on disclosure of information

57. No information relating to any enterprise, being an information which has been obtained by or on behalf of the Commission for the purposes of this Act, shall, without the previous permission in writing of the enterprise, be disclosed otherwise than in compliance with or for the purposes of this Act or any other law for the time being in force.

**Members, Director General, Registrar, officers and other employees, etc. of Commission to be public servants**

58. The Chairperson and other Members and the Director General, Additional, Joint, Deputy or Assistant Directors General and Registrar and officers and other employees of the Commission shall be deemed, while acting or purporting to act in pursuance of any of the provisions of this Act, to be public servants within the meaning of section 21 of the Indian Penal Code (45 of 1860).

Protection of action taken in good faith

59. No suit, prosecution or other legal proceedings shall lie against the Central Government or Commission or any officer of the Central Government or the Chairperson or any Member or the Director- General, Additional, Joint, Deputy or Assistant Directors General or Registrar or officers or other employees of the Commission for anything which is in good faith done or intended to be done under this Act or the rules or regulations made thereunder.

Act to have overriding effect

60. The provisions of this Act shall have effect notwithstanding anything inconsistent therewith contained in any other law for the time being in force.

Exclusion of jurisdiction of civil courts

61. No civil court shall have jurisdiction to entertain any suit or proceeding in respect of any matter which the Commission is empowered by or under this Act to determine and no injunction shall be granted by any court or other authority in respect of any action taken or to be taken in pursuance of any power conferred by or under this Act.

Application of other laws not barred

62. The provisions of this Act shall be in addition to, and not in derogation of, the provisions of any other law for the time being in force.

Power to make rules

63. (1) The Central Government may, by notification, make rules to carry out the provisions of this Act.

(2) In particular, and without prejudice to the generality of the foregoing power, such rules may provide for all or any of the following matters, namely:—

- (a) the manner in which the Chairperson and other Members shall be selected under section 9;
- (b) the form and manner in which and the authority before whom the oath of office and of secrecy shall be made and subscribed to under sub-section (3) of section 10;

- (c) the financial and administrative powers which may be vested in the Member Administration under section 13;
 - (d) the salary and the other terms and conditions of service including travelling expenses, house rent allowance and conveyance facilities, sumptuary allowance and medical facilities to be provided to the Chairperson and other Members under sub-section (1) of section 14;
 - (e) the salary, allowances and other terms and conditions of service of the Director General, Additional, Joint, Deputy or Assistant Directors General or such other advisers, consultants or officers under sub-section (3) of section 16;
 - (f) the qualifications for appointment of the Director General, Additional, Joint, Deputy or Assistant Directors General or such other advisers, consultants or officers under sub-section (4) of section 16;
 - (g) the salaries and allowances and other terms and conditions of service of the Registrar and officers and other employees payable, and the number of such officers and employees under sub-section (2) of section 17;
 - (h) for securing any case or matter which requires to be decided by a Bench composed of more than two Members under sub-section (4) of section 23;
 - (i) any other matter in respect of which the Commission shall have power under clause (g) of subsection (2) of section 36;
 - (j) the promotion of competition advocacy, creating awareness and imparting training about competition issues under sub-section (3) of section 49;
 - (k) the form in which the annual statement of accounts shall be prepared under sub-section (1) of section 52;
 - (l) the time within which and the form and manner in which the Commission may furnish returns, statements and such particulars as the Central Government may require under sub-section (1) of section 53;
 - (m) the form in which and the time within which the annual report shall be prepared under sub-section (2) of section 53;
 - (n) the manner in which the monies transferred to the Central Government shall be dealt with by that Government under the fourth proviso to sub-section (2) of section 66;
 - (o) any other matter which is to be, or may be, prescribed, or in respect of which provision is to be, or may be, made by rules.
- (3) Every notification issued under sub-section (3) of section 20 and section 54 and every rule made under this Act by the Central Government shall be laid, as soon as may be after it is made, before each House of Parliament, while it is in session, for a total period of thirty days which may be comprised in one session, or in two or more successive sessions, and if, before the expiry of the session immediately following the session or the successive sessions afore-



said, both Houses agree in making any modification in the notification or rule, or both Houses agree that the notification should not be issued or rule should not be made, the notification or rule shall thereafter have effect only in such modified form or be of no effect, as the case may be; so, however, that any such modification or annulment shall be without prejudice to the validity of anything previously done under that notification or rule, as the case may be.

Power to make regulations

64. (1) The Commission may, by notification, make regulations consistent with tills Act and the rules made thereunder to carry out the purposes of this Act.

(2) In particular, and without prejudice to the generality of the foregoing provisions, such regulations may provide for all or any of the following matters, namely:—

- (a) the cost of production to be determined under clause (b) of the Explanation to section 4;
- (b) the form of notice as may be specified and the fee which may be determined under sub-section (2) of section 6;
- (c) the form in which details of the acquisition shall be filed under subsection (5) of Section 6;
- (d) the fee which may be determined under clause (a) of sub-section (1) of section 19;
- (e) any other matter in respect of which provision is to be, or may be, made by regulations.

(3) Every regulation made under this Act shall be laid, as soon as may be after it is made. before each House of Parliament, while it is in session, for a total period of thirty days which may be comprised in one session or in two or more successive sessions, and if, before the expiry of the session immediately following the session or the successive sessions aforesaid, both Houses agree in making any modification in the regulation, or both Houses agree that the regulation should not be made, the regulation shall thereafter have effect only in such modified form or be of no effect, as the case may be;

so, however, that any such modification or annulment shall be without prejudice to the validity of anything previously done under that regulation.

Power to remove difficulties

65. (1) If any difficulty arises in giving effect to the provisions of this Act, the Central Government may, by order published in the Official Gazette, make such provisions, not inconsistent with the provisions of this Act as may appear to it to be necessary for removing the difficulty:

Provided that no such order shall be made under this section after the expiry of a period of two years from the commencement of this Act.

(2) Every order made under this section shall be laid, as soon as may be after it is made, before each House of Parliament.



Study Note - 18

MERGER AND ACQUISITION

This Study Note includes

- Introduction
- What is Merger?
- Acquisitions
- Distinction between Mergers and Acquisitions
- Accounting for Mergers and Acquisitions
- How to Value an Acquisition Candidate
- Reconstruction
- Demerger

18.1 INTRODUCTION

In business or economics a merger is a Combination of two Companies into one large Company, i.e a merger is said to occur when two or more business Combine into one.

An acquisition is the buying of one company by another. Acquisition usually refers to a purchase of a Smaller firm by a large one. Sometimes, however, a smaller firm will acquire management control of a larger or longer established company and keep its name for the Combined entity. This is known as a reverse merger.

The United Kingdom Financial Reporting Standard 6 defines the term ‘merger’ as: “Merger is a business combination which results in the creation of a new reporting entity formed from the combining parties, in which the shareholders come together in a substantially equal partnership for the mutual sharing of risks and benefits of the combined entity; and in which no party to the combination, in substance, obtains control over any other.”

A majority vote of shareholders is generally required to approve a merger. A merger is just one type of acquisition. One company can acquire another in several other ways, including purchasing some or all of the company’s assets or buying up its outstanding shares of stock.

In general, mergers and other types of acquisitions are performed in the hopes of realizing an economic gain. For such a transaction to be justified, the two firms involved must be worth more together than they were apart. Some of the potential advantages of mergers and acquisitions include achieving economies of scale, combining complementary resources, garnering tax advantages, and eliminating inefficiencies. Other reasons for considering growth through acquisitions include obtaining proprietary rights to products or services, increasing market power by purchasing competitors, shoring up weaknesses in key business areas, penetrating new geographic regions, or providing managers with new opportunities for career growth and advancement. Since mergers and acquisitions are so complex, however, it can be very difficult to evaluate the transaction, define the associated costs and benefits, and handle the resulting tax and legal issues.



18.2 WHAT IS MERGER?

Merger or amalgamation contemplates joining two or more companies to form a new company, an altogether a new entity or absorbing of one or more companies by an existing company. The term “merger” and “amalgamation” are used synonymously.

$$\boxed{\text{Co. K}} + \boxed{\text{Co. L}} = \boxed{\text{New Co. M}}$$

Figure 1

Co. K and Co. L = Transferor / Amalgamating Company

$$\boxed{\text{Co. K}} + \boxed{\text{Co. L}} + \boxed{\text{Co. M}} = \text{Existing Co. K}$$

Figure 2

Co. L and Co. M = Transferor / Amalgamating Company

Co. K = Transferee / Amalgamated Company

In other words, merger involves consolidation of business of Company A and Company B into a new Company C on a going concern basis as shown in Figure 1 above or transfer of business of Company B and Company C to Company A on a going concern basis as shown in Figure 2 above. The transaction involves arrangement with the shareholders.

The consideration for transfer of business may be discharged either through issue of shares (equity or preference) or other instruments of the transferee company or by cash.

18.2.1 Varieties of Mergers

From the perspective of business structures, there are a whole host of different mergers. Here are a few types, distinguished by the relationship between the two companies that are merging:

- Horizontal merger take place where the two merging companies produce similar product in the same industry.
- Vertical merger occur when two firms each working at different stages in the production of the same good combine.
- Market-extension merger: Two companies that sell the same products in different markets.
- Product-extension merger: Two companies selling different but related products in the same market.
- Conglomeration: Two companies that have no common business areas.

From the perspective of how the merge is financed, there are two types of mergers: purchase mergers and consolidation mergers. Each has certain implications for the companies involved and for investors:

- Purchase Mergers - As the name suggests, this kind of merger occurs when one company purchases another one. The purchase is made by cash or through the issue of some kind of debt instrument, and the sale is taxable.



Acquiring companies often prefer this type of merger because it can provide them with a tax benefit. Acquired assets can be “written-up” to the actual purchase price, and the difference between book value and purchase price of the assets can depreciate annually, reducing taxes payable by the acquiring company (we discuss this further in part four of this tutorial).

- Consolidation Mergers - With this merger, a brand new company is formed and both companies are bought and combined under the new entity. The tax terms are the same as those of a purchase merger.

18.3 ACQUISITIONS

As you can see, an acquisition may be only slightly different from a merger. In fact, it may be different in name only. Like mergers, acquisitions are actions through which companies seek economies of scale, efficiencies, and enhanced market visibility. Unlike all mergers, all acquisitions involve one firm purchasing another—there is no exchanging of stock or consolidating as a new company. Acquisitions are often congenial, with all parties feeling satisfied with the deal. Other times, acquisitions are more hostile.

In an acquisition, as in some of the merger deals we discuss above, a company can buy another company with cash, with stock, or a combination of the two. Another possibility, which is common in smaller deals, is for one company to acquire all the assets of another company. Company X buys all of Company Y’s assets for cash, which means that Company Y will have only cash (and debt, if they had debt before). Of course, Company Y becomes merely a shell and will eventually liquidate or enter another area of business.

Another type of acquisition is a reverse merger, a deal that enables a private company to get publicly-listed in a relatively short time period. A reverse merger occurs when a private company that has strong prospects and is eager to raise financing buys a publicly-listed shell company, usually one with no business and limited assets. The private company reverse merges into the public company, and together they become an entirely new public corporation with tradable shares.

Regardless of their category or structure, all mergers and acquisitions have one common goal: they are all meant to create synergy that makes the value of the combined companies greater than the sum of the two parts. The success of a merger or acquisition depends on how well this synergy is achieved.

18.3.1 Types of Acquisitions

In general, acquisitions can be horizontal, vertical, or conglomerate. A horizontal acquisition takes place between two firms in the same line of business. For example, one tool and die company might purchase another. In contrast, a vertical merger entails expanding forward or backward in the chain of distribution, toward the source of raw materials or toward the ultimate consumer. For example, an auto parts manufacturer might purchase a retail auto parts store. A conglomerate is formed through the combination of unrelated businesses.

Another type of combination of two companies is a consolidation. In a consolidation, an en-



tirely new firm is created, and the two previous entities cease to exist. Consolidated financial statements are prepared under the assumption that two or more corporate entities are in actuality only one. The consolidated statements are prepared by combining the account balances of the individual firms after certain adjusting and eliminating entries are made.

Another way to acquire a firm is to buy the voting stock. This can be done by agreement of management or by tender offer. In a tender offer, the acquiring firm makes the offer to buy stock directly to the shareholders, thereby bypassing management. In contrast to a merger, a stock acquisition requires no stockholder voting. Shareholders wishing to keep their stock can simply do so. Also, a minority of shareholders may hold out in a tender offer.

A bidding firm can also buy another simply by purchasing all its assets. This involves a costly legal transfer of title and must be approved by the shareholders of the selling firm. A takeover is the transfer of control from one group to another. Normally, the acquiring firm (the bidder) makes an offer for the target firm. In a proxy contest, a group of dissident shareholders will seek to obtain enough votes to gain control of the board of directors.

18.4 DISTINCTION BETWEEN MERGERS AND ACQUISITIONS

Although they are often uttered in the same breath and used as though they were synonymous, the terms “merger” and “acquisition” mean slightly different things.

When a company takes over another one and clearly becomes the new owner, the purchase is called an acquisition. From a legal point of view, the target company ceases to exist and the buyer “swallows” the business, and stock of the buyer continues to be traded.

In the pure sense of the term, a merger happens when two firms, often about the same size, agree to go forward as a new single company rather than remain separately owned and operated. This kind of action is more precisely referred to as a “merger of equals.” Both companies’ stocks are surrendered, and new company stock is issued in its place. For example, both Daimler-Benz and Chrysler ceased to exist when the two firms merged, and a new company, DaimlerChrysler, was created.

In practice, however, actual mergers of equals don’t happen very often. Often, one company will buy another and, as part of the deal’s terms, simply allow the acquired firm to proclaim that the action is a merger of equals, even if it’s technically an acquisition. Being bought out often carries negative connotations. By using the term “merger,” dealmakers and top managers try to make the takeover more palatable.

A purchase deal will also be called a merger when both CEOs agree that joining together in business is in the best interests of both their companies. But when the deal is unfriendly—that is, when the target company does not want to be purchased—it is always regarded as an acquisition.

So, whether a purchase is considered a merger or an acquisition really depends on whether the purchase is friendly or hostile and how it is announced. In other words, the real difference lies in how the purchase is communicated to and received by the target company’s board of directors, employees and shareholders.



Synergy is the magic force that allows for enhanced cost efficiencies of the new business. Synergy takes the form of revenue enhancement and cost savings. By merging, the companies hope to benefit from the following:

- Staff reductions - As every employee knows, mergers tend to mean job losses. Consider all the money saved from reducing the number of staff members from accounting, marketing and other departments. Job cuts will also include the former CEO, who typically leaves with a compensation package.
- Economies of scale - Yes, size matters. Whether it's purchasing stationery or a new corporate IT system, a bigger company placing the orders can save more on costs. Mergers also translate into improved purchasing power to buy equipment or office supplies—when placing larger orders, companies have a greater ability to negotiate price with their suppliers.
- Acquiring new technology - To stay competitive, companies need to stay on top of technological developments and their business applications. By buying a smaller company with unique technologies, a large company can keep or develop a competitive edge.
- Improved market reach and industry visibility - Companies buy companies to reach new markets and grow revenues and earnings. A merge may expand two companies' marketing and distribution, giving them new sales opportunities. A merger can also improve a company's standing in the investment community: bigger firms often have an easier time raising capital than smaller ones.

That said, achieving synergy is easier said than done—it is not automatically realized once two companies merge. Sure, there ought to be economies of scale when two businesses are combined, but sometimes it works in reverse. In many cases, one and one add up to less than two.

Sadly, synergy opportunities may exist only in the minds of the corporate leaders and the dealmakers. Where there is no value to be created, the CEO and investment bankers—who have much to gain from a successful M&A deal—will try to build up the image of enhanced value. The market, however, eventually sees through this and penalizes the company by assigning it a discounted share price. We talk more about why M&A may fail in a later section of this tutorial.

Conclusion & Resources

One size does not fit all. Many companies find that the best route forward is expanding ownership boundaries through mergers and acquisitions. For others, separating the public ownership of a subsidiary or business segment offers more advantages. At least in theory, mergers create synergies and economies of scale, expanding operations and cutting costs. Investors can take comfort in the idea that a merger will deliver enhanced market power.

By contrast, de-merged companies often enjoy improved operating performance thanks to re-designed management incentives. Additional capital can fund growth organically or through acquisition. Meanwhile, investors benefit from the improved information flow from de-merged companies.



M&A comes in all shapes and sizes, and investors need to consider the complex issues involved in M&A. The most beneficial form of equity structure involves a complete analysis of the costs and benefits associated with the deals.

18.5 ACCOUNTING FOR MERGERS AND ACQUISITIONS

The two principal accounting methods used in mergers and acquisitions are the pooling of interests method and the purchase method. The main difference between them is the value that the combined firm's balance sheet places on the assets of the acquired firm, as well as the depreciation allowances and charges against income following the merger.

The pooling of interests method assumes that the transaction is simply an exchange of equity securities. Therefore, the capital stock account of the target firm is eliminated, and the acquirer issues new stock to replace it. The two firms' assets and liabilities are combined at their historical book values as of the acquisition date. The end result of a pooling of interests transaction is that the total assets of the combined firm are equal to the sum of the assets of the individual firms. No goodwill is generated, and there are no charges against earnings. A tax-free acquisition would normally be reported as a pooling of interests.

Under the purchase method, assets and liabilities are shown on the merged firm's books at their market (not book) values as of the acquisition date. This method is based on the idea that the resulting values should reflect the market values established during the bargaining process. The total liabilities of the combined firm equal the sum of the two firms' individual liabilities. The equity of the acquiring firm is increased by the amount of the purchase price.

Accounting for the excess of cost over the aggregate of the fair market values of the identifiable net assets acquired applies only in purchase accounting. The excess is called goodwill, an asset which is charged against income and amortized over a period that cannot exceed 40 years. Although the amortization "expense" is deducted from reported income, it cannot be deducted for tax purposes.

Purchase accounting usually results in increased depreciation charges because the book value of most assets is usually less than fair value because of inflation. For tax purposes, however, depreciation does not increase because the tax basis of the assets remains the same. Since depreciation under pooling accounting is based on the old book values of the assets, accounting income is usually higher under the pooling method. The accounting treatment has no cash flow consequences. Thus, value should be unaffected by accounting procedure. However, some firms may dislike the purchase method because of the goodwill created. The reason for this is that goodwill is amortized over a period of years.

Accounting Standard (AS-14) as prescribed by the Institute of Chartered Accountants of India deals with accounting for amalgamation and treatment for resulting goodwill or reserves. AS-14 classifies amalgamation into two types, viz.:

Amalgamation in nature of merger; and

Amalgamation in nature of purchase.



Amalgamation in nature of merger is an amalgamation, which satisfies all the following conditions:

- i. All the assets and liabilities of the transferor company become the assets and liabilities of the transferee company;
- ii. Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than transferee company and its nominees) become equity shareholders of the transferee company after amalgamation;
- iii. The consideration is to be discharged by way of issue of equity shares in the transferee company to the shareholders of the transferor company on the amalgamation;
- iv. The business of the transferor company is to be carried on by the transferee company;
- v. No adjustments are intended to be made to the book values of the assets and liabilities of the transferor company.

If any one or more of the aforesaid conditions are not satisfied then the amalgamation is in nature of purchase.

Amalgamation in the nature of merger is to be accounted as per the Pooling of interest Method and in case of amalgamation in the nature of purchase accounting needs to be done as per the Purchase Method.

18.5.1 Under the Pooling of Interest Method:

- i. The assets, liabilities and reserves of the transferor company are to be recorded at their existing carrying amounts and in the same form as it was appearing in the books of the transferor company.
- ii. The identity of the reserves of the transferor company is to be kept intact in the balance sheet of the transferee company.
- iii. Difference between the amounts of share capital issued plus any other additional consideration paid by the transferee company and the amount of the share capital of the transferor company should be adjusted in Reserves.

18.5.2 Under purchase method

- i. The assets and the liabilities of the transferor company are to be recorded at their existing carrying amounts or, alternatively, the consideration should be allocated to individual assets and liabilities on the basis of fair values at the date of amalgamation while preparing the financial statements of the transferee company.
- ii. The identity of the reserves of the transferor company other than the statutory reserves is not preserved. The identity of the statutory reserves is preserved in the same form and is recorded in the books of the transferee company by a



corresponding debit to the amalgamation adjustment a/c.

- iii. Excess or shortfall of consideration over the value of net assets acquired should be credited / debited as capital reserve / goodwill, as the case may be.
- iv. It is appropriate to amortize goodwill over a period of not exceeding 5 years unless a longer period is justified.

The accounting treatment as specified in AS-14 needs to be followed for accounting of reserves. In case the scheme of amalgamation sanctioned prescribes a separate treatment to be given to the reserves of the transferor company on amalgamation, it can be followed.

However the Institute of Chartered Accountants of India has issued a general clarification wherein the following disclosure is to be made in case the accounting treatment for reserves is different from that specified in AS-14:

- i. Description of the accounting treatment given to reserves;
- ii. Deviation in the Accounting Treatment and the reasons for following a treatment different from that prescribed in the AS-14;
- iii. The financial effect, if any, arising due to such deviation is to be disclosed.
- iv. Other Disclosure Requirements

a. General

- Names and general nature of business of the amalgamating companies
- Effective date of amalgamation for accounting purposes
- Method of accounting used to reflect the amalgamation & Exchange Ratio
- Particulars of the scheme sanctioned by the Court

b. If Pooling of Interest Method is used

- Description and number of shares issued, together with the percentage of each company's equity shares exchanged.
- The amount of any difference between the consideration and the value of net identifiable assets acquired and the treatment thereof

c. If Purchase Method is used

- Consideration for the amalgamation and description of consideration paid / payable
- The amount of difference between the consideration and the value of net identifiable assets acquired and the treatment thereof including the period of amortization of any goodwill arising on amalgamation



18.6 HOW TO VALUE AN ACQUISITION CANDIDATE

Valuing an acquisition candidate is similar to valuing any investment. The analyst estimates the incremental cash flows, determines an appropriate risk-adjusted discount rate, and then computes the net present value (NPV). If firm A is acquiring firm B, for example, then the acquisition makes economic sense if the value of the combined firm is greater than the value of firm A plus the value of firm B. Synergy is said to exist when the cash flow of the combined firm is greater than the sum of the cash flows for the two firms as separate companies. The gain from the merger is the present value of this difference in cash flows.

18.6.1 SOURCES OF GAINS FROM ACQUISITIONS

The gains from an acquisition may result from one or more of the following five categories: 1) revenue enhancement, 2) cost reductions, 3) lower taxes, 4) changing capital requirements, or 5) a lower cost of capital. Increased revenues may come from marketing gains, strategic benefits, and market power. Marketing gains arise from more effective advertising, economies of distribution, and a better mix of products. Strategic benefits represent opportunities to enter new lines of business. Finally, a merger may reduce competition, thereby increasing market power. Such mergers, of course, may run afoul of antitrust legislation.

A larger firm may be able to operate more efficiently than two smaller firms, thereby reducing costs. Horizontal mergers may generate economies of scale. This means that the average production cost will fall as production volume increases. A vertical merger may allow a firm to decrease costs by more closely coordinating production and distribution. Finally, economies may be achieved when firms have complementary resources—for example, when one firm has excess production capacity and another has insufficient capacity.

Tax gains in mergers may arise because of unused tax losses, unused debt capacity, surplus funds, and the write-up of depreciable assets. The tax losses of target corporations can be used to offset the acquiring corporation's future income. These tax losses can be used to offset income for a maximum of 15 years or until the tax loss is exhausted. Only tax losses for the previous three years can be used to offset future income.

Tax loss carry-forwards can motivate mergers and acquisitions. A company that has earned profits may find value in the tax losses of a target corporation that can be used to offset the income it plans to earn. A merger may not, however, be structured solely for tax purposes. In addition, the acquirer must continue to operate the pre-acquisition business of the company in a net loss position. The tax benefits may be less than their "face value," not only because of the time value of money, but also because the tax loss carry-forwards might expire without being fully utilized.

Tax advantages can also arise in an acquisition when a target firm carries assets on its books with basis, for tax purposes, below their market value. These assets could be more valuable, for tax purposes, if they were owned by another corporation that could increase their tax basis following the acquisition. The acquirer would then depreciate the assets based on the higher market values, in turn, gaining additional depreciation benefits.



Interest payments on debt are a tax-deductible expense, whereas dividend payments from equity ownership are not. The existence of a tax advantage for debt is an incentive to have greater use of debt, as opposed to equity, as the means of financing merger and acquisition transactions. Also, a firm that borrows much less than it could may be an acquisition target because of its unused debt capacity. While the use of financial leverage produces tax benefits, debt also increases the likelihood of financial distress in the event that the acquiring firm cannot meet its interest payments on the acquisition debt.

Finally, a firm with surplus funds may wish to acquire another firm. The reason is that distributing the money as a dividend or using it to repurchase shares will increase income taxes for shareholders. With an acquisition, no income taxes are paid by shareholders.

Acquiring firms may be able to more efficiently utilize working capital and fixed assets in the target firm, thereby reducing capital requirements and enhancing profitability. This is particularly true if the target firm has redundant assets that may be divested.

The cost of debt can often be reduced when two firms merge. The combined firm will generally have reduced variability in its cash flows. Therefore, there may be circumstances under which one or the other of the firms would have defaulted on its debt, but the combined firm will not. This makes the debt safer, and the cost of borrowing may decline as a result. This is termed the coinsurance effect.

Diversification is often cited as a benefit in mergers. Diversification by itself, however, does not create any value because stockholders can accomplish the same thing as the merger by buying stock in both firms.

18.6.2 VALUATION PROCEDURES

The procedure for valuing an acquisition candidate depends on the source of the estimated gains. Different sources of synergy have different risks. Tax gains can be estimated fairly accurately and should be discounted at the cost of debt. Cost reductions through operating efficiencies can also be determined with some confidence. Such savings should be discounted at a normal weighted average cost of capital. Gains from strategic benefits are difficult to estimate and are often highly uncertain. A discount rate greater than the overall cost of capital would thus be appropriate.

The net present value (NPV) of the acquisition is equal to the gains less the cost of the acquisition. The cost depends on whether cash or stock is used as payment. The cost of an acquisition when cash is used is just the amount paid. The cost of the merger when common stock is used as the consideration (the payment) is equal to the percentage of the new firm that is owned by the previous shareholders in the acquired firm multiplied by the value of the new firm. In a cash merger the benefits go entirely to the acquiring firm, whereas in a stock-for-stock exchange the benefits are shared by the acquiring and acquired firms.

Whether to use cash or stock depends on three considerations. First, if the acquiring firm's management believes that its stock is overvalued, then a stock acquisition may be cheaper. Second, a cash acquisition is usually taxable, which may result in a higher price. Third, the use



of stock means that the acquired firm will share in any gains from merger; if the merger has a negative NPV, however, then the acquired firm will share in the loss.

In valuing acquisitions, the following factors should be kept in mind. First, market values must not be ignored. Thus, there is no need to estimate the value of a publicly traded firm as a separate entity. Second, only those cash flows that are incremental are relevant to the analysis. Third, the discount rate used should reflect the risk associated with the incremental cash flows. Therefore, the acquiring firm should not use its own cost of capital to value the cash flows of another firm. Finally, acquisition may involve significant investment banking fees and costs.

Mergers and acquisitions and corporate restructuring—or M&A for short—are a big part of the corporate finance world. Every day, Wall Street investment bankers arrange M&A transactions that bring together separate companies to make larger ones. When they're not creating big companies from smaller ones, corporate finance deals do the reverse and break up companies through spinoffs, carve-outs, or tracking stocks.

Not surprisingly, these types of actions often make the news. Deals can be worth hundreds of millions or even billions of dollars, and they can dictate the fortunes of the companies involved for years to come. For CEOs, leading M&A can represent the pinnacle of their careers.

18.7 RECONSTRUCTION

Reconstruction means reorganization of a company's financial structure. In reconstruction of a company, usually the assets and liabilities of the company are revalued, the losses suffered by the company are written off by a deduction of the paid-up value of shares and /or varying of the rights attached to different classes of shares and compounding with the creditors. It may be done without liquidating the company and forming a new company in which case the process is called internal reconstruction. However, there may be external reconstruction in which case the undertaking being carried on by the company is transferred to a newly started company consisting substantially of the same shareholders with a view to the business of the transferee company being continued by the transferee company. An attempt is made that the newly started company has a sound financial structure and a good set of assets and liabilities recorded in the books of the transferee company at their fair values.

From the point of view of an accountant, external reconstruction is similar to amalgamation in the nature of purchase; the books of the transferee company are closed and in the books of the transferee company, the purchase of the business is recorded. But otherwise external reconstruction and amalgamation differs as follows:

- (i) In external reconstruction, only one company is involved whereas in amalgamation, there are at least two existing companies which amalgamate.
- (ii) In external reconstruction, a new company is certainly formed whereas in amalgamation a new company may be formed or in the alternative one of the existing companies may take over the other amalgamating company or companies and no new company may be formed.
- (iii) The objective of the external reconstruction is to reorganize the financial structure of the company, on the other hand, the objective of the amalgamation is to cut competition and reap the economies of larger scale.



18.7.1 Scheme of Reconstruction

The need for reconstruction arises when a company has accumulated losses or when a company finds itself overcapitalized which means either that the value placed on assets is too much as compared to their earning capacity or that the profits as a whole are insufficient to pay a proper dividend. Apart from clarity, wide acceptance and justice, the reconstruction scheme must take into account the following:-

The fundamental basis of any proposals is the earning power of the company. Even the interest to debenture holders cannot be paid unless the company's activities are profitable. A very careful estimate should, therefore, be made of the profits expected by the company in the future. Unless the profits are sufficient to meet all the expenses including adequate depreciation, interest to debenture holders and other creditors, preference dividend, and a reasonable return to the equity shareholder, it would be useless to process with any reconstruction scheme because, otherwise, the need for reconstruction will soon arise again.

Assuming that adequate profits can be expected, the reconstruction scheme should not adversely affect the rights of preference shareholders (not to speak of creditors and debenture holders) unless it is absolutely necessary. Suppose, the profits are such that after paying dividends to preference shareholders little remains for equity shareholders: the preference shareholder may be persuaded to accept a sacrifice either by reduction of capital or by reduction in the rate of dividend or both because the alternative to such acceptance of sacrifice may be the liquidation of the company (in which case, due to forced sale, the asset may not realize much and the preference shareholder may not be able to get back what they have invested). If the company is in very bad position, even the debenture holders may be prevailed upon to accept a reduction of their claims. But, so far as is possible, contractual and legal rights and priorities should be maintained.

The equity shareholder will naturally have to bear the brunt of the losses and sacrifice. This is not as bade as it sounds because (a) the equity shareholders realize from the very beginning that if losses occur they have to bear them before anybody else can be called upon to do so, and (b) they must have already known that the value of their holding is small due to absence of dividend. The market price of share is related to dividend and not to the face or nominal value of the share. It really does not matter, therefore, whether the nominal value of an equity share is Rs.1 or Rs.100 or Rs.1,000 as long as it is not 0. (This does matter in case of preference shareholders and debenture holders whose earnings depend on the nominal value). In fact, a reconstruction scheme may be beneficial to the equity shareholders by enabling the payment of a dividend on such shares. On this ground, it would be unjust to ask the preference shareholders to accept a sacrifice when the equity shareholders improve their position.

There is, however, one important right which the equity shareholders enjoy. This is control over the affairs of the company. The equity shareholders will not easily give up this rite, and hence the reconstruction scheme should keep this in mind. The equity shareholder may not agree to the conversion of preference share or debenture into equity share even if the holders of preference shares or debenture are willing to accept lower security for their holdings. The equity share holders may agree to this only if there is a threat of the company being wound up (in which case they will lose almost all). It should also be noted that without the consent of the parties their liability cannot be increased. For instances, fully paid shares cannot be converted into partly paid shares without the consent of the shareholders.

The requirements of the working capital must not be overlooked. Cash may require to pay certain dissenting creditor or even to pay arrears of preference dividend. Generally, therefore, a company under reconstruction will have to raise funds to enable it to pay off such dissenters and to carry on its work smoothly. Which of the various parties are willing to subscribe more shares will have to be seen. The equity share holders will like to consolidate their position by buying more shares. Sometimes, outsiders are willing to subscribe to the shares but they will generally prefer to do so if they are given a controlling share.

Steps

- (1) First of all the total amounts to be written off should be ascertained. This would mean totaling up the debit balance of the profit and loss account, all fictitious assets like goodwill, preliminary expenses, discount on shares or debentures, any fall in value of assets, any increase in liabilities and arrears of dividends on cumulative preference shares. If the value of any share can be legitimately increased the amount of loss would then be reduced accordingly. The other way to get at the same figure would be to add up the present value as a going concern, of all the assets and deduct there from the amount of liabilities and also the arrears of dividend on cumulative preference shares. What is left is “net assets”. The share capital compared with net assets will show how much amount is to be written off.
- (2) The question now arises as to who is to bear the loss. If the net assets are more than the preference share capital, it is obvious the whole of the loss will have to be borne by the equity share holders. The nominal value of the equity shares should be reduced by a sufficient margin to cover the loss. If the net assets are not sufficient to cover the preference share capital (or if the net assets are just sufficient), the preference share holder will have to accept a sacrifice, although their sacrifice will be smaller than that of the equity share holders. (Equity share holders should not be completely wiped off). If the future earning power of the company permits, the dividend rate should be increased so that, in terms of rupees, the dividend remains unchanged. Thus if 10.5% preference share of Rs 100 are converted into preference share of Rs 75 each, rate of dividend should be raised to 14%, if possible. In both cases, then the dividend will be Rs 10.5 per share.
- (3) Payment of arrears of dividend (question arises only in case of cumulative preference shares) in cash immediately may present difficulties. In such a case a good method is to issue deposit certificates. This is preferable to issuing shares because (a) it will not upset the voting power and (b) the certificate can be redeemed as soon as opportunity arises. The rate of interest need not be heavy, but of course, it will depend on the future earning capacity of the company.
- (4) Debenture holders and other creditors are affected by the reconstruction scheme only if the total assets in the company are insufficient to cover even the liabilities (although they are concerned is necessary to any scheme that may be formulated). In such an eventuality, the creditors (including debenture holders) will have to accept sacrifice unless they think that by sending the company into liquidation we will be able to realize substantial portion of their claims. The share holders, both preference and equity will have to accept a heavy



reduction in the value of share but they cannot be expected to agree to complete wiping of the shares, in which case they will have no interest in keeping the company going. Generally, the sacrifice to be borne by the creditors will be as follows:

Preferential creditors

Nil

(According to law)

In short, the whole scheme should broadly depend upon the expected earning power and upon the position as it likely to obtain if the company is sent to liquidation.

Internal vs. External Reconstruction: Having decided who is to bear how much sacrifice of loss and having settled the broad details of the scheme, an important question remains to be decided. Will the reconstruction be internal or external? Internal reconstruction means that the scheme will be carried out by liquidating the existing company and incorporating immediately another company (with the name only slightly changed such as A B Ltd, to take over the business of the outgoing company. There are advantages in both, but generally internal reconstruction is preferred. The advantages in its favour are:-

- (a) Creditors, specially bank overdraft and debenture holders, may continue whereas they may not if the company is formally liquidated which will involve payment of claims to outsiders. If they do not continue, the company may suffer from want of financial assistance. This is, however, only academic since no reconstruction scheme, even internal, will be really formulated without the consent of the bank, debenture holders. Etc.
- (b) The company will be able to set off its past losses against future profits for income-tax purposes. This will materially reduce the income-tax liability depending on the losses suffered during the preceding eight years. Losses can be carried forward for eight years provided the business is carried on. The business will technically end when the company is liquidated. Hence, in case of external reconstruction, losses cannot be carried forward for income tax purposes.

The arguments in favour of external reconstruction are as under:-

- (a) External reconstruction may be the only way to bring about speedy reconstruction because sometimes a few people hold up the scheme by delaying tactics by means of legal objections.
- (b) It may help in raising more finance by issuing to the existing shareholders partly paid shares in the new company. It should be remembered that in internal reconstruction fully paid up shares unless every shareholder gives his assent in writing. This may prove cumbersome. However, if shareholders are willing to accept partly paid shares in the new company, there is not much reason why they should refuse to buy new shares under a scheme of internal reconstruction.

Legal position as regards external reconstruction:

Sec 494 of the Companies Act permits the liquidator of a company to transfer the whole or any part of the company's business or property to another company and receive from the transferee company for distribution among the share holders of the company under liquidation. The liquidator must obtain the sanction of the company by a special resolution. Any sale of arrangement in pursuance of this section is binding on the members of the transferor company.

But a share holder who has not voted for the special resolution may, within seven days of the resolution, serve a notice on the liquidator expressing his dissent and requiring the liquidator either, (a) to abstain from carrying the resolution into effect, or (b) to purchase his interest at a price to be determined by agreement or by arbitration.

18.8 DEMERGER

Demerger is the converse of a merger or acquisition. It describes a form of restructure in which shareholders or unitholders in the parent company gain direct ownership in a subsidiary (the 'demerged entity'). Underlying ownership of the companies and /or trusts that formed part of the group does not change. The company or trust that ceases to own the entity is known as the 'demerging entity'. If the parent company holds a majority stake in the demerged entity , the resulting company is referred to as the subsidiary.

In a market of falling prices, mergers and IPOs are less popular, and the merchant banks who earn their fees from corporate activity will start to look at demerger possibilities for their clients.

Study Note - 19

CORPORATE GOVERNANCE

This Study Note includes

- Introduction
- History
- The Emergence of Corporate Governance Issues in India
- Recommendations of the Narasimham Committee, 1991
- Formation of Narasimham Committee on Banking Sector Reforms
- Report of Kumar Mangalam Birla Committee on Corporate Governance
- Summary of Naresh Chandra Committee on Corporate Audit and Governance
- Narayan Murthy Committee Report, 2003
- Dr. J. J. Irani Committee Report on Company Law, 2005

19.1 INTRODUCTION

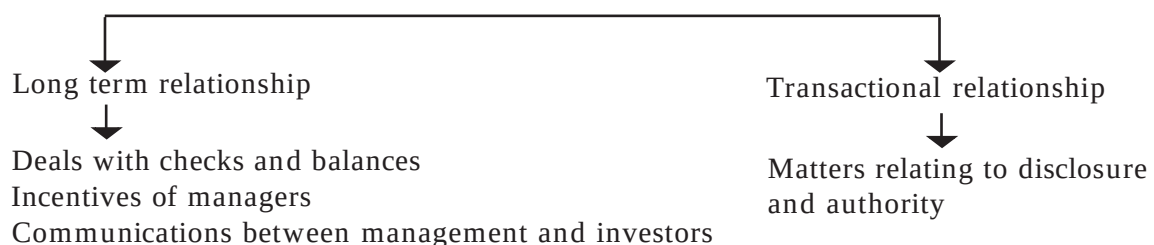
Corporate governance is the set of processes, customs, policies, laws and institutions affecting the way a corporation is directed, administered or controlled. Corporate Governance also includes the relationships among the many stakeholders involved and the goals for which the corporation is governed. The principal stakeholders are the shareholders, management and the board of directors. Other stakeholders include employees, suppliers, customers, banks and other lenders, regulators, the environment and the community at large.

The stakeholders may be internal stakeholders (promoters, members, employees, management and the board of directors) and external stakeholders (suppliers, customers, lenders, banks, the environment and the community at large, government and regulators).

Corporate governance is a voluntary ethical code of business of companies. According to Cadbury Committee on financial aspects of corporate governance:

“it is the system by which companies are directed and controlled. The board of directors are responsible for the governance of their companies. The shareholders' role in the government is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place”.

Elements of corporate Governance:



19.2 HISTORY

In the 19th century, state corporation laws enhanced the rights of corporate boards to govern without unanimous consent of shareholders in exchange for statutory benefits like appraisal rights, to make corporate governance more efficient. Since that time, and because most large publicly traded corporations in the US are incorporated under corporate administration friendly Delaware law, and because the US's wealth has been increasingly securitized into various corporate entities and institutions, the rights of individual owners and shareholders have become increasingly derivative and dissipated. The concerns of shareholders over administration pay and stock losses periodically has led to more frequent calls for corporate governance reforms.

In the 20th century in the immediate aftermath of the Wall Street crash of 1929 legal scholars pondered on the changing role of the modern corporation in society.

Since the late 1970's, corporate governance has been the subject of significant debate in the U.S. and around the globe. Bold, broad efforts to reform corporate governance have been driven, in part, by the needs and desires of shareowners to exercise their rights of corporate ownership and to increase the value of their shares and, therefore, wealth. Over the past three decades, corporate directors' duties have expanded greatly beyond their traditional legal responsibility of duty of loyalty to the corporation and its shareowners.

In the first half of the 1990s, the issue of corporate governance in the U.S. received considerable press attention due to the wave of CEO dismissals (e.g.:IBM, Kodak,Honeywell) by their boards.

19.3 THE EMERGENCE OF CORPORATE GOVERNANCE ISSUES IN INDIA

The Stock Exchange of London appointed the famous Cadbury Committee which submitted its report in 1992 that included the "Code of Best Practices "to be practiced by listed companies. Sir Cadbury report was implemented by the London Stock Exchange as part of its Listing Agreement with its member companies. The Cadbury Report is generally considered to be the foundation stone of Corporate Governance.

In India , the real history of corporate governance dates back to the year 1992, following efforts made in many countries of the world to put in place a system suggested by the Cadbury Committee. The Confederation of Indian Industry framed a voluntary code of corporate governance for listed companies in 1998. This was followed by the recommendations of the Kumar Mangalam Birla Committee set up in 1999 by SEBI culminating in the introduction of Clause 49 of the standard listing agreement to be complied with by all the listed companies in stipulated phases. The Kumar Mangalam Birla Committee divided its recommendations into mandatory and non mandatory efforts to initiate Corporate Governance in India

The Companies Amendment Act, 2000 : Many provisions relating to corporate governance such as additional ground of disqualification of directors in certain cases, setting up of audit committee, directors responsibility statement in the directors report were introduced by the Companies (Amendment) Act , 2000. Corporate Governance was also introspected in 2001 by

the advisory group constituted by the standing committee on International Finance Standards and codes of Reserve Bank of India under the chairmanship of Dr.Y.V.Reddy, the then Deputy Governor.

The Enron debacle of 2001 involving the hand-in-glove relationship between the auditor and the corporate client, the scam involving the fall of the corporate giants in the US like the Worldcom, Qwest, Global Crossing, Xerox and the consequent enactment of the stringent Sarbanes-Oxley Act were some important factors which prompted the Indian government to do something to put in place proper governance mechanism in the structure and system of administration of listed public limited companies.

Appointment of Naresh Chandra Committee, 2002

In the year 2002 a high level committee was appointed to examine and recommend drastic amendments to the law involving the auditor client relationship and role of independent directors by the department of company affairs under the chairmanship of Naresh Chandra. The various mandatory and non mandatory recommendations given by this committee are discussed in detail in the next chapter of this study material.

Appointment of Narayana Murthi Committee, 2003

The Committee summed up the utility of corporate governance saying that neither corporate governance be legislated by law nor it be static in dynamic environment but on the contrary it should be continuously evolved. Further their recommendations raise the standard of corporate governance in Indian firms and make them attractive for domestic and global capital.

Legislative Changes

In order to achieve levels of management and governance that inspire the investor confidence, Department of Corporate Affairs (erstwhile Dpt. of Company Affairs) has taken several initiatives in the recent past. The Companies Act, 1956 has been amended thrice since 1999 and some further amendments are under consideration.

A bill was passed in both the Houses of Parliament in Dec 2002 enabling Primary Producer to produce and market products in a modern and professional manner at par with other companies.

A bill was passed in August 2001 which ushers in a new era of insolvency laws and provides for constitution of Company Law Tribunal.

Introduction of Regulations

SEBI was set up by the Government in 1992 to counter the shortcomings found in the functioning of stock exchanges such as long delays, lack of transparency in procedures and vulnerability to price rigging and insider trading and to regulate the capital market. On the insistence of SEBI stock exchanges have amended listing agreements to ensure that a listed company furnishes them annual statements showing the variations between financial projections and projected utilization of funds which would enable shareholders to make comparisons between promises and performance.

19.4 RECOMMENDATIONS OF THE NARASIMHAM COMMITTEE, 1991

India has witnessed a phenomenal expansion in the geographical coverage and functional spread of our banking and financial system since bank nationalization in 1969. Despite impressive quantitative achievements in resource mobilization and in extending the credit reach, several distortions had over the years crept into the banking and financial system. As a result productivity and efficiency of the system had suffered; its portfolio quality had badly deteriorated and profitability had been eroded. Several public sector banks and financial institutions had become weak financially and some public sector banks had been incurring losses year after year. Their customer service was poor, their work technology outmoded and they were unable to meet the challenges of a competitive environment. It was under these circumstances that the Government of India set up a High Level Committee with Mr. M. Narasimham, a former Governor of the Reserve Bank of India as Chairman to examine all aspects relating to structure, organization, functions and procedures of the financial system. This Committee on the financial systems submitted its report in November 1991.

The Narasimham Committee's recommendations were based on the fundamental assumption that the resources of the banks come from the general public and were held by the banks in trust and that they were to be deployed for maximum benefit of the depositors. This assumption automatically implied that even the Government had no business to endanger the solvency, health and efficiency of the nationalized banks under the pretext of using banks resources for economic planning, social banking, poverty eradication, etc. Besides the Government had no right to get hold of the funds of the banks at low rates of interest and use them for financing its consumption expenditure – paying the salary of the employees, for example and thus defraud the depositors.

The Narasimham Committee recommendations were aimed at

- (i) ensuring a degree of operational flexibility;
- (ii) internal autonomy for the public sector banks in their decision making process; and
- (iii) a greater degree of professionalism in banking operations.

A. On Directed Investment

The Committee gave two important recommendations as regards SLR and CRR.

- 1] **Statutory Liquidity Ratio (SLR)** : In order to discourage Government using SLR for them as well as Financial Institutions, the Narasimham Committee recommended that Government should reduce SLR from 38.5 % of the net demand and time liabilities of banks to 25 % over next five years which will enable more funds with banks for allocation to agriculture, industry, trade, etc. The Government borrowing rates should be progressively market-related and that these higher rates would help banks to increase their income from their SLR investments.
- 2] **Cash Reserve Ratio (CRR)** : RBI should rely on open market operation increasingly and reduce its dependence on CRR. Further CRR should be progressively reduced from the

present high level of 15 % to 3 % to 5 % and RBI should pay interest on impounded deposits of banks above the basic minimum at a rate of interest equal to the level of banks one year deposits.

The above two recommendations would reduce the amount of idle cash balances kept by the banks with RBI under CRR and release the amount for more productive and remunerative purposes. Besides banks would also earn more income from the cash balance they kept with RBI.

B. On Directed Credit Programmes

- 1] Directed credit programmes to be gradually phased out as agriculture and small industry had already grown to a mature stage and they did not require any special support.
- 2] Directed credit programme should be a case of extraordinary support to certain weak sections of the economy. Besides it should be temporary and not a permanent one.
- 3] The concept of priority sector to be redefined to include only the weakest sections of rural community such as marginal farmers, rural artisans, village and cottage industries, tiny sector etc and directed credit programme should be fixed at 10 % of the aggregate bank credit.
- 4] The system should be reviewed after a period of three years so to assess the need to continue or terminate the programme.
- 5] The postulates of social banking need not clash with the sound banking.

C. On the Structure of Interest Rates

- 1] The level and structure of interest rates in the country should be broadly determined by market forces.
- 2] All controls and regulations on interest rates on lending and deposit rates of banks and financial institutions on debentures and company deposits, etc. should be removed.
- 3] Concessional rates of interest for priority sector loans of small sizes should be phased out and subsidies in IRDP loans should be withdrawn.
- 4] The RBI should be the sole authority to simplify the structure of interest rates. The bank rate should be the anchor rate and all other interest rates should be closely linked to it.

D. On Structural Reorganisation of the Banking Structure

To bring about greater efficiency in banking operations the Narasimham Committee proposed a substantial reduction in the number of public sector banks through mergers and acquisitions. According to the Committee the broad pattern should consist of

- 1] 3 or 4 large banks (including the State Bank of India) which could become international in character
- 2] 8 to 10 national banks with a network of branches throughout the country engaged in general or universal banking

- 3] Local banks whose operations would be generally confined to a specific region and
- 4] Rural banks including RRBs whose operations would be confined to the rural areas and whose business would be predominantly engaged in financing of agriculture and allied activities.
- 5] The present system of licensing of branches with the objective of spreading the banking habit should be discontinued and banks should have freedom to open new branches purely on profitability considerations.
- 6] Government to make a positive declaration that there would be no more nationalization of banks.
- 7] RBI should permit the setting up of new banks in private sector provided they confirm to the minimum start up capital and other requirements. There should be no difference in the treatment between public sector banks and private sector banks.
- 8] Government should allow foreign banks to open offices in India either as branches or as subsidiaries provided they confirm same social obligation as Indian Banks. Foreign banks and Indian banks to be permitted to set up joint ventures in regard to merchant and investment banking, leasing and other newer forms of financial services.

E. Other Recommendations relating to Banking system

- 1] The setting of Assets Restructuring Fund

The main idea of forming this fund was to take over at a discount & in a phased manner Non Performing Assets of nationalized banks and financial institutions to ensure smooth and effective functioning of ARF. This will help banks and financial institutions to take off bad and doubtful debts from their balance sheets and recycle the funds realized through this process into more productive uses.

- 2] Remove Duality of Control :

The present system of dual control over the banking system between RBI and Banking divisions of the Ministry of Finance should end immediately and only RBI should be the primary agency for the regulation of the banking system.

- 3] Free and autonomous banks:

Public sector banks should be free and autonomous. Every bank should go for radical change in work technology and work culture so as to become competitive internally and to be in step with wide ranging innovations taking place abroad. The appointment of Chief Executive of a Bank should not be based on political considerations but on professionalism and integrity and should be made by an independent expert panel and not by the Government as at present.

19.5 FORMATION OF NARASIMHAM COMMITTEE ON BANKING SECTOR REFORMS :

In April 1998 The Ministry of Finance, Government of India appointed one more committee to review the progress of banking sector reforms to date and chart a programme on financial sector reforms necessary to strengthen India's Financial system and make it internationally competitive. Important recommendation of this committee are as follows

- 1] Need for a stronger banking system : The committee recommended the merger of strong banks with weak banks to have multiplier effect on industry but they also cautioned that this merger should take place properly otherwise this might have negative effect on the assets of the stronger banks.
- 2] Experiment with the concept of Narrow Banking : Narrow banking implies that the weak banks place their funds only in the short term in risk free assets – these banks attempt to match their demand deposits by safe liquid assets and in case the concept of narrow banking is found to be non-applicable to rehabilitate the weak bank then the possibility of closure of the banks to be examined.
- 3] Small local banks : The committee suggested the setting up of small, local banks which would be confined to States or cluster of districts in order to serve local trade, small industry and agriculture. At the same time these banks should have strong corresponding relationship with the larger national and international banks.
- 4] Capital Adequacy Ratio : Government should consider raising the prescribed Capital Adequacy ratio to improve the inherent strength of banks and to improve their risk absorption capacity.
- 5] Public ownership and real autonomy : The Committee has recommended review of the functions of Board so that the Board remain responsible for enhancing shareholder value through formulation of corporate strategy. Also Committee expressed need to segregate the regulatory and supervisory functions of RBI and RBI should maintain an arms length from those being regulated and hints at need for withdrawing the nominee director of RBI from bank boards. Regulation should not get involved into day to day management of banks but only in procedural and disclosure norms and sound procedures.
- 6] Review and update Banking Laws: Committee suggested urgent need to review and amend the provisions of RBI Act, Banking Regulation Act, State Bank of India Act, Bank Nationalization Act, etc so as to bring them in line with the current needs of the banking industry. Also need was expressed for computerization process in Public Sector Banks, professionalizing and depoliticizing bank boards, review of recruitment procedures, training and remuneration policies, etc.

19.6 REPORT OF KUMAR MANGALAM BIRLA COMMITTEE ON CORPORATE GOVERNANCE.

Suggested List of Items to be included in the Report on Corporate Governance in the Annual Report of Companies

19.6.1 Board of Directors:

Composition and category of directors for example promoter, executive, non-executive, independent non-executive, nominee director, which institution represented as Lender or as equity investor. Attendance of each director at the BoD meetings and the last AGM. Number of BoD meeting held, dates on which held.

19.6.2 Audit Committee.

Brief description of terms of reference

Composition, name of members and Chairperson

Meetings and attendance during the year.

19.6.3 Remuneration Committee.

Brief description of terms of reference.

Composition, name of members and Chairperson

Attendance during the year

Remuneration policy

Details of remuneration to all the directors, as per format in main report.

19.6.4 Shareholders Committee.

Name of Non-executive director heading the committee.

Name and designation of compliance officer.

Number of shareholders complaints received so far

Number not solved to the satisfaction of shareholders

Number of pending share transfers

19.6.5 General Body meetings.

Location and time, where last three AGMs held.

Whether special resolutions were put through postal ballot last year, details of voting pattern

Person who conducted the postal ballot exercise

Are proposed to be conducted through postal ballot

Procedure for postal ballot.

19.6.6 Disclosures.

Disclosures on materially significant related party transactions i.e. transactions of the company of material nature, with its promoters, the directors or the management, their subsidiaries or relatives etc. that may have potential conflict with the interests of company at large.

Details of Non compliance by the company, penalties, and strictures imposed on the company by Stock Exchange or SEBI or any statutory authority, on any matter related to capital markets, during the last three years.

19.6.7 Means of Communication.

Half yearly report sent to each shareholders.

Quarterly results:

Which newspapers normally published in.

Any web-site, where displayed

Whether it also displays official news releases; and

The presentations made to institutional investors or the analysts

Whether MD &A (Management Discussion & Analysis) is a part of annual report or not.

19.6.8 General Shareholder information

A.G.M. : Date, time and venue

Financial Calendar

Date of Book closure

Dividend Payment Date

Listing on Stock Exchanges

Stock Code

Market Price Data : High, Low during each month in last financial year.

Performance in comparison to broad-based indices such as BSE Sensex, CRISIL index etc.

Registrar and Transfer Agents

Share Transfer System

Distribution of shareholding

Dematerialization of shares and liquidity

Outstanding GDRs/ ADRs/ Warrants or any Convertible instruments, conversion date and likely impact on equity.

Plant locations

Address for correspondence.

19.7 SUMMARY OF NARESH CHANDRA COMMITTEE REPORT ON CORPORATE AUDIT AND GOVERNANCE**19.7.1 Recommendations : The Auditor Company Relationship.****Disqualification for Audit Assignments.**

Prohibition of any direct financial interest in the audit client by the audit firm, its partners or members of the engagement team as well as their 'direct relatives'. This prohibition would also

apply if any 'relative' of the partners of the audit firm or member of the engagement team has an interest of more than 2 per cent of the share of profit or equity capital of the audit client.

Prohibition of any business relationship, which the audit client by the auditing firm, its partners or any member of the engagement team and their 'direct relatives'.

Prohibition of personal relationship, which would exclude any partner of the audit firm or member of the engagement team being a 'relative' of any of key officers of the client company, i.e. any whole time director, CEO, CFO, Company Secretary, senior manager belonging to the top two managerial levels of the company, and the officer who is in default (as defined in section 5 of the Companies Act). In case of any doubt, it would be the task of the Audit Committee of the concerned company to determine whether the individual concerned is the key officer.

Prohibition of service or cooling off period, under which any partner or member of the engagement team of an audit firm who wants to join an audit client, or any key officer of the client company wanting to join the audit firm, would only be allowed to do so after two years from the time they were involved in the preparation of accounts and audit of that client.

Prohibition of undue dependence on an audit client, so that no audit firm is unduly dependent on an audit client, the fees received from any one client and its subsidiaries and affiliates, all together, should exceed 25 percent of the total revenues of the audit firm. However, to help newer and smaller audit firms, this requirement will not be applicable to audit firms for the first five years from the date of commencement of their activities, and for those whose total revenues are less than Rs 15 lakhs per year.

Note: A 'direct relative' is defined as the individual concerned, his or her spouse, dependent parents, children or dependent siblings. For the present, the term 'relative' is as defined under Schedule IA of the Companies Act. However, the Committee believes that the Schedule IA definition is too wide, and needs to be rationalized for effective compliance.

Recommendation: List of prohibited non-audit services.

The committee recommends that the following services should not be provided by an audit firm to any audit client:

Accounting and book keeping services, related to the accounting records or financial statements of the audit client.

Internal audit services.

Financial information systems design and implementation, including services related to IT systems for preparing financial or management accounts and information flows of a company.

Actuarial services.

Broker, dealer, investment adviser or investment banking services.

Outsourced financial services.

Management functions, including the provision of temporary staff to audit clients.

Any form of staff recruitment, and particularly hiring of senior management staff for the audit client.

Valuation services and fairness opinion.

Further in case the firm undertakes any service other than audit, or the prohibited services listed above, it should be done only with the approval of the audit committee.

19.7.2 Recommendation : Independence Standards for Consulting and Other Entities that are Affiliated to Audit Firms.

Prohibition of undue dependence. Where an audit firm has subsidiary associate or affiliated entities, yardstick of no more than 25 per cent of revenues coming from a single audit client stated in earlier Recommendation should be widened to accommodate the consolidated entity, Thus no more than 25 percent of the revenues of the consolidated entity should come from a single corporate client with whom there is also an audit engagement.

The other prohibitions listed in earlier Recommendation should also apply in full to all affiliated consulting and specialized service entities of any audit firm that are either subsidiaries of the audit firm, or have common ownership of over 50 per cent with the audit firm. And all the tests of independence outlined in earlier Recommendation should be carried over to the consolidated entity.

Consolidation tests should test fully, line-by-line for all subsidiaries, whether the audit firm, or its partners, own over 50 percent of equity, or share of profit.

Recommendation: Compulsory Audit Partner Rotation.

There is no need to legislate in favour of compulsory rotation of audit firms.

However, the partners and at least 50 per cent of the engagement team (excluding article clerks and trainees) responsible for the audit of either a listed company, or companies whose paid up capital and free reserves exceeds Rs.10 crore, or companies whose turnover exceeds Rs.50 crore, should be rotated every five years.

Also, in line with the provisions of the European Union and the IFAC, persons who are compulsorily rotated could, if need be, allowed to return after a break of three years.

19.7.3 Recommendation : Auditor's disclosure of contingent liabilities.

It is important for investors and shareholders to get a clear idea of company's contingent liabilities because these may be significant risk factors that could adversely affect the corporation's future health. The Committee recommends that management should be followed by the auditor's clearly worded comments on the management's view. This section should be highlighted in the significant accounting policies and notes on accounts, as well as, in the auditor's report, where necessary.

19.7.4 Recommendation: Auditor's disclosure of qualifications and consequent action.

- Qualifications to accounts, if any must form a distinct, and adequately highlighted, section of the auditor's report to the shareholders.
- These must be listed in full in plain English- what they are (including quantification thereof), why these were arrived at, including qualification thereof).
- In case of a qualified auditor's report, the audit firm may read out the qualifications, with explanations, to shareholders in the company's annual general meetings.
- It should also be mandatory for the audit firm to separately send a copy of the qualified report to the ROC, the SEBI and the principal stock exchange (for listed companies), about the qualifications, with a copy of this letter being sent to the management of the company. This may require suitable amendments to the Companies Act, and corresponding changes in the Chartered Accountant Act.

19.7.5 Recommendation: Management's certification in the event of auditor's replacement.

- Section 225 of the Company's Act needs to be amended to require a special resolution of shareholders, in case an auditor, while being eligible to reappointment, is sought to be replaced.
- The explanatory statement accompanying such a special resolution must disclose the management's reasons for such a replacement, on which the outgoing auditor shall have the right to comment. The Audit Committee will have to verify that this explanatory statement is 'true and fair'.

19.7.6 Recommendation : Auditors annual certification of independence.

- Before agreeing to be appointed as per Section 224(1)(b), the audit firm must submit a certificate of independence to the Audit Committee or to the board of directors of the client company certifying that the firm, together with its consulting and specialized services affiliates, subsidiaries and associated companies: Are independent and have arm's length relationship with the client company; Have not engaged in any non-audit services listed and prohibited in earlier recommendations.

And are not disqualified from audit assignments by virtue of breaching any of the limits, restriction and prohibitions listed in earlier recommendations.

19.7.7 Recommendation : Appointment of Auditors.

The audit committee of the board of directors shall be the first point of reference regarding the appointment of auditors. To discharge this fiduciary responsibility the Audit Committee shall:

- Discuss the annual work programme with the auditor;
- Review the independence of the audit firm in line with above mentioned recommendations.
- Recommend to the board, with reasons, either the appointment / re appointment or removal of the external auditor, along with the annual audit remuneration.

Exception to this rule may cover government companies (which follow section 619 of the Companies Act) and scheduled 'commercial banks (where the RBI has a role to play.)

19.7.8 Recommendation : CEO and CFO certification of annual audited accounts.

For all listed companies as well as public limited companies whose paid-up capital and free reserves exceeds Rs.10 crore, or turnover exceeds Rs.50 crore, there should be a certification by the CEO (either the Executive Chairman or the Managing Director) and CFO (whole time Finance Director or otherwise) which should state that, to the best of their knowledge and belief:

- They, the signing officers, have reviewed the balance sheet and profit and loss account and all its schedules and notes on accounts, as well as the cash flow statements and the Directors Report.
- These statements do not contain any material untrue statement or omit any material fact nor do they contain statements that might be misleading.
- These statements together represent a true and fair picture of the financial and operational state of the company, and are in compliance with the existing accounting standards and / or applicable laws / regulations.
- They, the signing officers, are responsible for establishing and maintaining internal controls which have been designed to ensure that all material information is periodically made known to them; and have evaluated the effectiveness of internal control systems of the company.
- They, the signing officers, have disclosed to the auditors as well as the Audit Committee instances of significant fraud, if any, that involves management or employees having a significant role in the company's internal control systems.
- They, the signing officers, have indicated to the auditors, the Audit Committee and in the notes on accounts, whether or not there were significant changes in internal control and / or of accounting policies during the year under review.
- In the event of any materially significant misstatements or omissions, the signing officers will return to the company that part of any bonus or incentive or equity based compensation which has inflated on account of such errors, as decided by the Audit Committee.

19.7.9 Recommendation: Setting up of Independent Quality Review Board.

- There should be established, with appropriate legislative support, three independent Quality Review Boards (QRB), one each for the ICAI, the ICSI and ICWAI, to periodically examine and review the quality of audit, secretarial and cost accounting firms, and pass judgment and comments on the quality and sufficiency of systems, infrastructure and practices.
- In the interest of realism, the QRBs should, for the initial five years, focus their audit quality reviews to the audit firms, which have conducted the audit for the top 150 listed

companies, ranked according to market capitalization as on 31st March. Depending upon the record of success of such reviews, the DCA may subsequently consider altering the sample size or criterion.

- **Composition of ICAI 's QRB :** The board shall consist of 11 members, including the chairman. The chairman shall be nominated by the DCA, in consultation with, but not necessarily from, the ICAI. Five members of the board, excluding the chairman shall be nominated by the DCA who will be people of eminence, professional reputation and integrity including, but not limited to, nominees of the Comptroller and Auditor-General of India, RBI, SEBI, members or office bearers of the Bombay Stock Exchange or the National Stock Exchange, the three apex trade and industry associations (CII, FICCI, and ASSOCHAM), reputed educational and research institutions, bankers, economists, former public officials and business executives. The remaining five members of the Board will be nominated by the Council of the ICAI.
- **Composition of ICSI's QRB :** A five member board, including the chairman. The chairman shall be nominated by the DCA, in consultation with, but not necessarily from, the ICSI. Two members, excluding the chairman, shall be nominated by the DCA, who will have the same attributes suggested for ICAI's QRB above. The remaining two members will be nominated by the Council of the ICSI.
- **Composition of ICWAI's QRB :** A five member board, including the chairman. The chairman shall be nominated by the DCA, in consultation with, but not necessarily from, the ICWAI. Two members, excluding chairman, shall be nominated by the DCA, who will have the same attributes suggested for ICAI's QRB above. The remaining two members will be nominated by the Council of the ICWAI.
- **Funding :** Each of these QRBs will be funded by their respective institutes in a manner that will enable it to discharge its functions adequately.
- **Appellate forum :** In the instance of a dispute between the findings of the QRBs and reviewees, the matter should be referred to an appropriate appellate forum. This appellate forum should be the same as that suggested for disciplinary matters, which is discussed in blow recommendation.

19.7.10 Recommendation: Proposed disciplinary mechanism for auditors.

- **Classification of offences and merging of schedules:** At present there are two schedules of offences and misconduct with the second schedules requiring action by High courts. These two schedules need to be merged, so that the Council is empowered to award all types of punishments for all types of offences. Further offences need to be categorized according to the severity of misconduct, so that processes can be designed, and punishments awarded according to the severity of the offence.
- **Prosecution Directorate:** An independent permanent directorate within the structure of ICAI shall be created, which shall act as the Prosecution Directorate. This office will exclusively deal with all disciplinary cases and hence, expedite the process of enquiry and

decision making by fully devoting its time and energy towards processing these cases. The office should be headed by a person of the level of Director, and should be one with a legal background and conversant with the provisions of The Chartered Accountants Act and its regulations. He and his office shall be independent of the electoral process of ICAI. Suitable regulations need to be framed to uphold the independence of this office. The Prosecution Directorate shall have the same powers as are vested in a Civil Court under the Code of Civil Procedure, 1908 regarding (i) the discovery and production of any document; and (ii) receiving evidence on affidavit.

Procedure for dealing with complaint cases.

1. The complaints received in the appropriate form, manner, and complete in all respects, shall be registered by the Prosecution Directorate, and sent to the member or firm within 15 days of registration of such a complaint.
2. Depending on the category of the complaint, the Prosecution Directorate shall ask for and obtain necessary documents such as written statements, rejoinders, comments and other evidence from the complainant as well as the respondent. The time frame for this should be, under normal circumstances, no more than 60 days. Not submitting such documents within the prescribed time shall be treated as an offence, risking the initiation of additional obstruction of justice proceedings.
3. On receipt of the relevant documents, the complaint along with the views, if any, of the Prosecution Directorate, will be placed before that Disciplinary Committee. This has to be done within 20 days of receiving all relevant accompanying documents.

Procedure for dealing with information cases

1. Information received shall be examined by the Prosecution Directorate. After forming his views, the Director of the Prosecution Directorate will place the matter before the Secretary of ICAI.
2. If the Secretary agrees with the view expressed by the Director, then the information case will be placed before the President of ICAI and thereafter, it would be discussed at a meeting between the President, Secretary and the Director. If in this meeting, it is decided to refer the matter to the Disciplinary Committee, then reference be made accordingly. Upon such referral, the Prosecution Directorate shall argue the case before the Disciplinary Committee. If, however, the Secretary and President of ICAI decide that the information should be filed and closed, then the Director of the Prosecution Directorate will have the choice to either follow the majority opinion, or dissent and refer such a case to the Disciplinary Committee, with his as well as the Secretary's and President's opinion. In such instances, however, the President shall not function as the Presiding Officer of the Disciplinary Committee. Further, if the Director of Prosecution does not feel that a reference to the Disciplinary Committee is warranted, the Institute would still be free to take such cases to the Committee if it feels there is a need to do so.
3. After registering the 'information' case, the procedure outlined for the complaint case may be followed *mutatis mutandis*.

Disciplinary committee:

- Enquiries in relation to misconduct of members shall be held by the Disciplinary Committee. To expedite decision making the Council of ICAI shall be empowered to constitute one or more bench of the Disciplinary Committees in cities where there are regional headquarters of ICAI.
- Composition : Each bench should consist of five members. The President or the Vice-president of ICAI will be Presiding Officer. However, in 'information' cases put before the Committee by the Prosecution Director after disagreeing with the views of the President and the Secretary, the President shall not act as the Presiding Officer. In such cases, the Vice-President will perform this role. Two of other four members will be nominees of ICAI's Council, while the remaining two will be nominees of the DCA viz people of eminence, professional reputation and integrity such as retired judges, bankers, professionals, economist, business executives, former members of regulatory authorities and former public officials. As far as practicable, members of the disciplinary committee should be from the regions other than the one in which it is being constituted.

It needs to be stated that in terms of the existing requirement, a nominee of the central government is required to be nominated to the disciplinary committee. Until very recently, such a nominee was an official of the DCA. However, DCA officials have rarely had the time to attend the meetings of the disciplinary committee.

Hence the committee recommends that, given their preoccupation in the department, a sitting government official should not be nominated to the disciplinary committee.

It is pointed out that for each stage in the process, strict time lines should be prescribed. This is especially important in respect of scrutiny of information cases.

- Quorum: Three of the five members.
- Tenure: Co-terminus with the duration of the ICAI council.
- Functions: The disciplinary committees shall hear the compliant and information cases referred by the prosecution directorate and record their decision and conclusions in a report. This report shall also record the punishment awarded, if any, to the member which can constitute (i) reprimand (ii) removing the name of the member either permanently or for such period as thought fit. (iii) monetary penalty and /or (iv) a combination of any two.

Council

- Any report submitted by the disciplinary committee should normally be considered by the council within 45 days from the date of report. It shall be the duty of the council of ICAI to act upon the decisions of the disciplinary committee. While performing such duty, the council can;
 1. Endorse the decisions by the disciplinary committee and implement them

2. Refer any case back to the disciplinary committee for further enquiry ,when it finds that certain issues need further enquiry. However, in doing so, the council will have to frame the specific issues.
3. Direct the Prosecution Directorate to place the case before the Appellate body, In the event of the council deciding to appeal against the decisions of the disciplinary committee.

Appellate Body

- Headquartered in New Delhi, the appellate body shall consist of a Presiding Officer and four others members. The Presiding Officer shall be retired judge of the Supreme Court or a retired Chief Justice of a High Court. Two members should be past Presidents of the ICAI, nominated by the council. The remaining two shall be persons of eminence nominated by the DCA(but excluding any officer of the department or member of the council). The quorum shall be three.

Publication of decisions of the Disciplinary committee

Due publicity shall be given by the Prosecution Directorate about the punishment ultimately awarded, through periodicals, newsletters, website and any other means considered appropriate. However, no decision taken by the Disciplinary Committee be published unless and until the punishment is endorsed and implemented by the Council.

Funding

1. Appellate Body: Required funding arrangements should be made by the Central Government. This is essential for ensuring independence, and on the ground that the High Court stage can be said to have been always funded by the Government.
2. Disciplinary Committee: The expenses shall be borne by ICAI's Council, which shall also fix the emoluments, sitting fees, allowances, and other expenses of the members.
3. Prosecution Directorate: All expenses will be borne by the Council of ICAI.
4. Every complaint, other than a complaint made by or on behalf of the Central or any State Government shall be accompanied by a fee Rs.5,000 which will be returned as soon as the Disciplinary Committee recommends that case is not frivolous. Fees not refunded for frivolous cases will be used to partly defray the cost of investigation.

RECOMMENDATION: DEFINING AN INDEPENDENT DIRECTOR.

- An independent director of a company is a non-executive director who :
 1. Apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its senior management or its holding company, its subsidiaries and associated companies
 2. Is not related to promoters or management at the board level, or one level below the board (spouse and dependent, parents, children or siblings);

3. Has not been an executive of the company in the last three years.
4. Is not a partner or an executive of the statutory auditing firm, the internal audit firms that are associated with the company, and has not been a partner or an executive of any such firm for the last three years. This will also apply to legal firm and consulting firm that have a material association with the entity.
5. Is not a significant supplier, vendor or customer of the company.
6. Is not a substantial shareholder of the company, i.e. owning 2 percent or more of the block of voting shares;
7. Has not been a director, independent or otherwise of the company for more than three terms of the three years each (not exceeding nine years in any case);
 - An employee, executive director or nominee of any bank, financial institution, corporations or trustees of debenture and bond holders, who is normally called a 'nominee director' will be excluded from the pool of directors in the determination of the number of independent directors. In other words, such a director will not feature either in the numerator or the denominator.
 - Moreover, if an executive in, say, Company X becomes an non-executive director in another Company Y, while another executive of Company Y becomes a non-executive director in Company X, then neither will be treated as an independent director.
 - The committee recommends that the above criteria be made applicable for all listed companies, as well as unlisted public limited companies with a paid up share capital and free reserves of Rs.10 crore and above or turnover of Rs.50 crore and above with effect from the financial year beginning 2003.

RECOMMENDATION: PERCENTAGE OF INDEPENDENT DIRECTORS.

No less than 50 percent of the board of directors of any listed company, as well as unlisted public limited companies with a paid up share capital and free reserves of Rs.10 crore and above, or turnover of 50 crore and above, should consist of independent directors – independence being defined in earlier recommendation.

However this will not apply to: (1) unlisted public companies, which have no more than 50 shareholders and which are without debt of any kind from the public, banks, or financial institutions, as long as they do not change their character (2) unlisted subsidiaries of listed companies.

Nominee directors will be excluded both from the numerator and the denominator.

RECOMMENDATION: MINIMUM BOARD SIZE OF LISTED COMPANIES

The minimum board size of all listed companies, as well as unlisted public limited companies with a paid up share capital and free reserves of Rs.10 crore and above, or turnover of Rs.50 crore and above should be seven of which at least four should be independent directors.

However, this will not apply to: (1) unlisted public companies, which have no more than 50 shareholders and which are without debt of any kind from the public and banks, or financial institutions, as long as they do not change their character, (2) unlisted subsidiaries of listed companies.

RECOMMENDATION: DISCLOSURE ON DURATION OF BOARD MEETINGS/ COMMITTEE MEETINGS.

The minutes of Board meetings and Audit Committee meetings of all listed companies, as well as unlisted public limited companies with a paid up share capital and free reserves of Rs.10 crore and above or turnover of Rs.50 crore must disclose the timing and duration of each such meeting, in addition to the date and members in attendance.

RECOMMENDATION: TELE-CONFERENCING AND VIDEO CONFERENCING

If a director cannot be physically present but wants to participate in the proceedings of the board and its committees, then a minuted and signed proceedings of a tele conference or video conference should constitute proof of his or her participation. Accordingly this should be treated as presence in the meetings. However, minutes of all such meetings should signed and confirmed by the director/s who has/have attended the meeting through video conferencing.

RECOMMENDATION: ADDITIONAL DISCLOSURE TO DIRECTORS.

In addition to the disclosures specified in clause 49 under 'information to be placed before the board of directors', all listed companies, as well as unlisted public limited companies with a paid up share capital and free reserves of Rs10 crore and above or turnover of Rs.50 crore and above, should transmit all press releases and presentation to analysts to all board members. This will further help in keeping independent directors informed of how the company is projecting itself to the general public as well as a body of informed investors.

RECOMMENDATION: INDEPENDENT DIRECTORS ON AUDIT COMMITTEES OF LISTED COMPANIES:

Audit committees of all listed companies, as well as unlisted public limited companies with a paid up share capital and free reserves of Rs.10 crore and above, or turnover of Rs.50 crore and above, should consist exclusively, of independent directors, as defined in earlier recommendation.

However, this will not apply to : (1) unlisted public companies, which have no more than 50 shareholders and which are without debt of any kind from the public, banks, or financial institutions, as long as they do not change their character, (2) unlisted subsidiaries of listed companies.

RECOMMENDATION: AUDIT COMMITTEE CHARTER.

- In addition to disclosing the names of members of the Audit Committee and the dates and frequency of meetings, the Chairman of the Audit Committee must annually certify whether and to what extent each of the functions listed in the Audit Committee Charter were

discharged in the course of the year. This will serve as the Committee's action taken report' to the shareholders.

- This disclosure shall also give a succinct but accurate report of the tasks performed by the Audit Committee, which would include, among others, the Audit Committee's view on the adequacy of internal control systems, perceptions of risks and in the event of any qualifications, why Audit Committee accepted and recommended the financial statements with qualifications. The statements should also certify whether the Audit Committee met with the statutory and internal auditors of the company without the presence of management, and whether such meetings revealed materially significant issues or risks.

RECOMMENDATION: REMUNERATION OF NON-EXECUTIVE DIRECTORS.

- The statutory limit on sitting fees should be reviewed, although ideally it should be a matter to be resolved between the management and the shareholders.
- In addition, loss making companies should be permitted by the DCA to pay special fees to any independent director, subject to reasonable caps, in order to attract the best restructuring and strategic talents to the boards of such companies.
- The present provisions relating to stock options, and to the 1 per cent commission on net profits, is adequate and does not, at present, need any revision. However, the vesting schedule of stock options should be staggered over at least three years, so as to align the independent and executive directors, as well as managers two levels below the Board, with the long term profitability and value of the company.

RECOMMENDATION: EXEMPTING NON-EXECUTIVE DIRECTORS FROM CERTAIN LIABILITIES.

Time has come to insert provisions in the definitions chapter of certain Acts to specifically exempt non-executive and independent directors from such criminal and civil liabilities. An illustrative list of these Acts are the Companies Act, Negotiable Instruments Acts, Provident Fund Act, ESI Act, Factories Act, Industrial Disputes Act and the Electricity Supply Act.

Independent directors should also be indemnified.

RECOMMENDATION: TRAINING OF INDEPENDENT DIRECTORS.

- DCA should encourage institutions of prominence including their proposed Centre for Corporate Excellence to have regular training programmes for independent directors. In framing the programmes, and for other preparatory work, funding could possibly come from the IEPF.
- All independent directors should be required to attend at least one such training course before assuming responsibilities as an independent director, or considering that enough programmes might not be available in the initial years, within one year of becoming an independent director. An untrained independent director should be disqualified under section 274 (1)(g) of the Companies Act, 1956 after being given reasonable notice.

- Considering that enough training institutions and programmes might not be available in the initial years, this requirement may be introduced in a phased manner, so that the larger listed companies are covered first.
- The executing bodies must clearly state their plan for the year and their funding should be directly proportionate to the extent to which they execute such plans.
- There should be a 'trainee appraisal' system to judge the quality of the programme and so help decide, in the second round, which agencies should be given a greater role and which should be dropped.

RECOMMENDATION: SEBI AND SUBORDINATE LEGISLATION

- SEBI may refrain from exercising powers of subordinate legislation in areas where specific legislation exists as in the Companies Act, 1956.
- If any additional requirements are sought to be prescribed for listed companies, then, in areas where specific provision exists in the Companies Act, it would be appropriate for SEBI to have the requirement prescribed in the Companies Act itself through a suitable amendment.
- In recognition of the fact that SEBI regulates activities in dynamic market conditions, the DCA should respond to SEBI's requirements quickly. In case the changes proposed by SEBI necessitate a change in the Companies Act, the DCA should agree to the requirement being mandated in clause 49 of SEBI regulation until the Act is amended.
- It would be appropriated for SEBI to use its powers of subordinate legislation, in consultation with the DCA, and vice versa. All committees set up either by SEBI or DCA to consider changes in law, rules or regulations should have representatives of both SEBI and DCA.
- A formal structure needs to be set up to ensure that the DCA, which regulated all companies, and SEBI, which regulates only listed companies, act in coordination and harmony.

RECOMMENDATION: IMPROVING FACILITIES IN THE DCA OFFICES.

- The Government should increase the strength of the DCA's office, and substantially increase the quality and quantity of its physical infrastructure, including computerisation.
- This should be accompanied by increased outsourcing of work, contractual appointments of specialist and computerization all of which will reduce, though not eliminate, the need to increase the officer-level strength of the department.
- The inspection-capacity of the department needs to be increased sharply; inspections should be regular administrative function, carried out largely on random basis.
- Officers of the DCA need to go through refresher and training courses regularly. In view of the very dynamic world in which they function, continuous upgrading of their skills is essential.

RECOMMENDATION: CORPORATE SERIOUS FRAUD OFFICE.

- A Corporate Serious Fraud Office (CSFO) should be set up in the Department of Company Affairs with specialists inducted on the basis of transfer/ deputation and on special term contracts.
- This should be in the form of a multi-disciplinary team that not only uncovers the fraud, but is able to direct and supervise prosecutions under various economic legislations through appropriate agencies.
- There should be a Task Force constituted for each case under a designated team leader.
- In the interest of adequate control and efficiency, a Committee each, headed by the Cabinet Secretary should directly oversee the appointments to, and functioning of this office, and coordinate the work of concerned departments and agencies as described in earlier paragraph.
- Later, a legislative framework, along the lines of the SFO in the U.K. should be set up to enable the CSFO to investigate all aspects of the fraud and direct the prosecution in appropriate courts.

RECOMMENDATION PERTAINING TO ENSURING INVESTOR CONFIDENCE:

- Penalties ought to be rationalized and related to the sums involved in the offence. Fees, especially late fees, can be related to the size of the company in terms of its paid up capital and free reserves, or turnover, or turnover, or both.
- Disqualification under section 274 (1)(g) of the Companies Act, 1956 should be triggered for certain other serious offences than just non-payment of debt. However, independent directors need to be treated on a different footing and excepted as in the case of nominee directors representing financial institutions.
- A stricter regime should be prescribed for companies registered as brokers with SEBI. Greater accountability should be provided for companies registered as brokers with SEBI. Greater accountability should be provided for with respect to transfer of money by way of Inter Corporate Deposits, or advances of any kind from listed companies to any other company as a necessary concomitant of the liberalization the section 372A of the Companies Act, 1956 provides.
- DCA's prosecution wing needs to be 'considerably strengthened. Streamlined procedures be prescribed in the Companies Act, on the lines of the recent amendments to the Code of Civil Procedure.
- To ensure that proceeds from illegal acts and frauds do not escape recovery, Companies Act needs to be amended to give DCA the powers of attachment of bank accounts etc., on the lines of the powers recently given to SEBI.

- Managers/promoters should be held personally liable when found guilty of offences. In such cases, the legal fees and other charges should be recovered from the officers in default, especially if the offences pertain to betrayal of shareholder's trust, or oppression of minority shareholders. It is patently unfair that the shareholder is penalized twice, once when mulcted and again to have to incur the legal expenses to defend the fraudster.
- Consolidated Financial statements should be made mandatory for companies having subsidiaries.
- DCA should consider reducing workload at offices of ROCs by providing for a system of 'pre-certification' by company secretaries; the system should provide for monetary and other penalties on company secretaries who certify incorrectly, even through error or oversight.
- The Companies Act, be amended to enable the DCA to order a 'compliance audit' much in the same manner as it can order special audits under section 233A of the Companies Act.
- MAOCARO should be amended to provide that auditors report contain violations such as those listed earlier paragraph.
- Section 293(1)(a) should be strengthened to prevent any unnatural strapping of assets, or sale of shares by management/promoters.
- To reduce its workload in ROC offices, as well as to improve auditing standards, the Government should consider introducing a system of 'random scrutiny' of audited accounts, in the same way as is done by the Accountancy Foundation in the U.K. or is proposed to be done by the Public Oversight Board in the USA, however this recommendation should be implemented only if, and after, DCA can take care of concerns such as the genuineness of randomness, client confidentiality, etc. and is confident of its own manpower strengths and skills.
- ICAI should reconsider the limits it has set on the number of articles that a partner can train something that has unintended consequence of denying young prospective accountants the chance to train with the best in the profession.
- Companies should be required to establish and publish an "Internal Code of Ethics".
- DCA should sponsor and financially support from the IEPF research on corporate governance and allied subjects that have a bearing on investor/shareholder well-being.
- ICAI should propose to the government a regime and a regulatory framework that encourages the consolidation and growth of Indian firms in view of the international competition they face, especially with regard to non-audit services.
- The government should consider amending the Partnership Act to provide for partnerships with limited liability, especially for professions that do not allow their members to provide services as a corporate body.

19.8 NARAYAN MURTHY COMMITTEE REPORT, 2003

A committee on corporate governance set up by SEBI under the chairmanship of N.R.Narayana Murthy which submitted its report in February 2003 was yet another committee on the subject signifying the regulator's anxiety to expeditiously promote corporate governance practices in Indian Companies.

The committee's terms of reference were the following

- To review the performance of corporate governance.
- To determine the role of companies in responding to rumour and other price sensitive information circulating in the market in order to enhance the transparency and integrity of the market.

The Committee's reports express its total concurrence with the recommendations contained in the Naresh Chandra Committee's report on the following counts:

- (i) Disclosure of contingent liabilities.
- (ii) Certification by CEO's and CFO's.
- (iii) Definition of Independent Directors.
- (iv) Independence of Audit Committees.

The committee came out with two sets of recommendations namely, mandatory recommendations and non-mandatory recommendations. The mandatory recommendations focus on strengthening the responsibilities of audit committees, improving the quality of financial disclosures including those pertaining to related party transactions and proceeds from initial public offerings, requiring corporate executive boards to assess and disclose business risks in the annual reports of companies, calling upon the boards to adopt formal codes of conduct; the position of nominee directors and improved disclosures relating to compensation to non executive directors and shareholders.

MANDATORY RECOMMENDATIONS:

Audit Committee: An audit committee is the bedrock of quality governance. An effective audit committee is a pre-requisite for achieving high standard of governance. The committee recommended a bigger role for the audit committee. The committee suggested that the audit committee of publicly listed companies should be required to review the following information mandatorily.

- (i) Financial statements and draft audit reports including quarterly and half yearly information.
- (ii) Management discussion and analysis of financial condition and the results of operations.
- (iii) Report relating to compliance with laws and risk management.
- (iv) Management letters of internal control weaknesses issued by statutory internal auditors.
- (v) Records of related party transactions.

In the present dispensations, audit committee, set up as per Clause 49 of the Listing Agreement, is empowered to recommend the appointment and removal of statutory auditors, fixation of audit fee and also approval for payment for any other services in addition to the powers of review etc. If the above powers are added as per committee's recommendations, the audit committee of the listed companies in India will become one of the most empowered committees in a corporate setup.

Narayan Murthy Committee has not taken a view on rotation of auditors.

Related party transactions: A statement of all transactions with related parties including their bases should be placed before the audit committee for formal approval/ratification and that if any transaction is not on an arm's length basis, management should provide explanation to the audit committee justifying the same.

The existing requirement as per Clause 49 of the listing agreement has been reiterated.

PROCEEDS FROM INITIAL PUBLIC OFFERINGS:

Companies raising money through initial public offerings should disclose to the audit committee the Source and Application of Funds under major heads on a quarterly basis.

Each year, the company shall prepare a statement of funds utilised for purposes other than those stated in offer document / prospectus. This statement shall be certified by the independent auditors of the company. The audit committee should make appropriate recommendations to the board to take steps in the matter.

This suggestion was welcomed by many as it enlarges the existing requirement in this regard and is a response to manipulations perpetrated by some corporates in this area

RISK MANAGEMENT:

The committee has deemed it necessary for the boards of companies to be fully aware of the risks involved in the business and that it is also important for shareholders to know about the process by which companies manage their business risks. The mandatory recommendations in this regard are the following:

Procedures should be in place to inform board members about the risk assessment and minimization procedures. These procedures should be periodically reviewed to ensure that executive management controls risks through means of a properly defined framework.

Management should place a report before the entire board of directors every quarter documenting the business risks faced by the company, measures to address and minimize such risks and any limitation to the risk taking capacity of the corporations. The board should formally approve this document.

At present, in Clause 49 of the Listing Agreement, there is a stipulation that the management discussion and analysis report forming part of the board's annual report should include discussion on "risk and concerns". The suggestion contained in the report is more elaborate and this would encourage a meaningful discussion at the board level periodically and the company will have the benefit of advice from board members who are in day to day management.

Code of Conduct:

The committee has recommended that it should be obligatory for the board of a company to lay down a code of conduct for all board members and senior management of the company. This code should be posted on the company's website and all board members and senior management personnel shall affirm compliance with the code on an annual basis. The annual report of the company shall contain a declaration to this effect signed off by the CEO and COO.

This suggestion which is long overdue in the Indian context is in line with the best practices adopted by corporates in developed economies. In fact, such matters are included in the charters of companies, sending a clear message to the company's personnel, how serious the company is about ensuring that the code is followed both in the letter and spirit. It is found that in most of the cases the misdemeanours reported were caused by breach of the code of conduct.

Nominee directors : The committee recommended doing away with nominee directors. If a corporation wishes to appoint a director on the board, such appointment should be made by the shareholders. The committee insisted that an institutional director, if appointed, shall have the same responsibilities and shall be subject to the same liabilities as any other director. Nominees of the government on public sector companies shall be similarly elected and shall be subject to the same responsibilities and liabilities as other directors.

This suggestion has become an issue of hot debate in corporate circles and outside. However, in the present context where one finds a nominee director in the board of a company very often working or voting against matters perceived to be in interest to the company, and hence there is ample justification for this suggestion to be implemented. The board of a company is a cohesive team, characterized by mutual consultations and collective wisdom. There is no place for a person who does not fall in line. The inherent conflict would seriously harm the interests of the company.

Other mandatory recommendations of the committee are the following:

- Compensation to non-executive directors (to be approved by the shareholders in general meeting, restrictions placed on grant of stock option, requirement of proper disclosures of details of compensation).
- Whistle blower policy to be in place in a company.

All these suggestions are well merited and deserve implementation. Some objections raised in certain quarters about the recommendation of the committee with regard to whistle blowing can be met by suitable provisions to avoid frivolous and vexatious complaints.

The non-mandatory recommendations pertain to moving to a regime providing for unqualified corporate financial statements, training of board members and evaluation of non-executive director's performance by a peer group comprising the entire board of directors, excluding the director being evaluated.

19.9 DR.J.J.IRANI COMMITTEE REPORT ON COMPANY LAW, 2005.

The government of India constituted an expert committee on Company Law on 2 December 2004, under the chairmanship of Dr.J.J.Irani to make recommendations on (i) responses received from various stakeholders on the concept paper; (ii) issues arising from the revision of the Companies Act,1956 (iii) bringing about compactness by reducing the size of the Act and removing redundant provisions; (iv) enabling easy and unambiguous interpretation by recasting the provisions of the law, (v) providing greater flexibility in rule making to enable timely response to ever evolving business models; (vi) protecting the interest of the stakeholders and investors, including small investors, and (vii) any other related, or incidental, to the above.

Set up to structurally evaluate the views of several stakeholders in the development of company law in India in respect of the concept paper promulgated by the Union Ministry of Company Affairs, the J.J.Irani Committee has come out with suggestions that will go far in laying sound base for corporate growth in the coming years. There has been a movement for some years now in many countries to create better frameworks of corporate governance. This has happened along with a trend towards global alignment of laws governing companies. Drawing from developments in countries such as the U.K, Australia, New Zealand and Canada, the Irani Committee report has made suggestions to reform and update the basic corporate legal framework essential for sustainable economic reform.

The expert committee comprised experts drawn from trade and industry associations, Professional bodies and institutes, chamber of commerce, leading senior advocates and auditors. Representatives of government departments , regulatory bodies and other organizations were included as special invitees. The committee deliberated on various issues on company law requiring a review on the basis of comments and suggestions received in response to the concept paper, opinion expressed by experts, professional bodies etc. The committee submitted its report to the Government of India on 31st May 2004.

The committee's report is balanced and well rounded document and attempts to equate the pulls and pressure of modern business and those of shareholder democracy. It is a step towards providing a growth oriented modern company law, with the thrust on stakeholder democracy and self-regulation. The report sought to address the concerns of all the stakeholders to enable the adoption of internationally accepted best practices.

INDEPENDENT DIRECTORS IN LISTED COMPANIES.

SEBI had in the revised clause 49 of the listing agreement mandated that at least 50 per cent of the board of a listed company comprise independent directors. The capital market regulator has made it clear that the corporate India should comply with revised Clause 49 by 31st December 2005.

Taking a position that is at variance with that of the Securities and Exchange Board of India, the J J Irani committee has recommended that one third of the board of a listed company should comprise independent directors.

PYRAMIDAL STRUCTURE

The committee has also suggested that corporate should be allowed to maintain pyramidal corporate structures that are a company which is subsidiary of holding company could itself be a holding company. "We suggest that pyramidal structures should be allowed because it is in the interest of corporate sector, especially when many companies are making acquisitions abroad. Although the committee started its deliberations under the presumptions that only 1 layer should be allowed, we later decided against it", Dr Irani commented.

POWER TO SHAREHOLDER.

The main thrust of the committee's recommendations was to give liberty to shareholders and owners of the company to operate in a transparent manner. The committee calls for a significant shift from a government approval regime to a "shareholder approval and disclosures" regime. The report thus gives more power to shareholders, allowing them rather than the company law administration to decide on certain crucial matters. Mergers between willing companies will be quicker. They will not be subject to the vagaries of the legal system any more. Ratification by shareholders will be enough. To protect the rights of minority shareholders and also to ensure investor protection, the committee has aptly suggested that the new company law should recognize principles such as 'class actions' and 'derivative action'.

The capital market got plenty of attention from the committee. There are proposals to devise an exit option for shareholders who have stayed with a company and not participated in a buy back scheme implemented earlier.

SINGLE PERSON COMPANY

The Committee has also mooted the concept of single person company. Introducing the concept of One Person Company (OPC) as against the current stipulation of at least two persons to form a company, the committee has pitched for entrepreneurship in individuals. "The whole idea is that if there is an entrepreneur who wants to form his own company, he should not be bound down by company law to find other partners," according to Dr. Irani.

SELF REGULATION

One distinctive approach of the committee in allowing corporate to self regulate their affairs. This is a much needed orientation of corporate growth in an overall policy regime being provided by the government.

STRINGENT PENALTIES

In order to strengthen the deterrent provisions in the present framework, the report has mandated publication of information relating to conviction for criminal breaches of the Companies Act on the part of the company or its officers in the annual report. The suggestions to provide stringent penalties will certainly help the regulator to curb fraudulent behaviour of companies.

ACCOUNTS AND AUDIT

According to the committee, "proper and accurate compilation of financial information of a corporate and its disclosure in a manner that is standardized and understood by stakeholders is central to the credibility of the corporates and soundness of investment decisions by the investors. The preparation of financial information and its audit therefore needs to be regulated through law with stringent penalties for non-observance". The committee took note of the contributions made by the Institute of Chartered Accountants of India and the National Advisory Committee on Accounting Standards and favoured the continuance of the existing institutional mechanism for formulating and notifying Accounting Standards.

GOVERNANCE STANDARDS

Those who believe that the Irani Committee will make corporate law and governance standards less strong point to its advocacy of a smaller number of independent directors (just one-third of company's board) compared to the much higher proportion (one half specified by the Securities and Exchange Board of India) under Clause 49 of the listing agreement.

There are other points of difference too between the committee and SEBI. But it is not correct to look at an expert committee's report purely from the points of its departure from current developments in those areas.

STUDY NOTES - 20

BOARD OF DIRECTORS & DIFFERENT COMMITTEES

This Study Note includes

- Effectiveness of the Board of Directors:
- Role of The Board in Ensuring Corporate Governance
- Role of Directors
- Independent Directors
- Desirability of Having Independent Directors
- Audit Committee - Section 292A of the Companies Act, 1956
- Remuneration Committee
- Nomination Committee
- Internal Control
- Directors' Responsibility Statement
- Going Concern status
- Related party transaction
- Project Management Audit and Corporate Governance
- Risk Evaluation and Management

The Board of Directors of a company which includes all directors elected by shareholders to represent their interests is vested with the powers of the management. The board has extensive powers to manage a company, delegate its power and authority to executives and carry on all activities to promote the interests of the company and its shareholders, subject to certain restrictions imposed by public authorities. The board of directors of a company is authorized to exercise such powers and to perform all such acts and things as the company is entitled to.

20.1 EFFECTIVENESS OF THE BOARD OF DIRECTORS

Though the board is recognized legally as the top layer of management with the responsibility of governing the enterprise, in actual practice, board of directors delegates most of its managerial power to chief executives say managing director or manager. In some case Board also appoints various committees like executive committee but these committees cannot make radical changes in the policy of the company. Board of Directors rely more on Chief Executives who being whole time officers of the company naturally devote greater time and attention to the matters connected with the management of the company. They are placed at far more advantageous position than board which meets only occasionally. The realistic functions of the board be enumerated as follows:



- 1] Confirming management decisions on major changes in objectives, policies, and those transactions which will have a substantial effect on the success of the company.
- 2] Providing constructive advice to the executives through discussion on important matters such as business outlook, new government legislation, wage policy, etc with a view to guiding executives when the policies are still in the process of formation.
- 3] Selecting Chief Executives and confirming the selection of other executives in the company made by chief executives.
- 4] Reviewing the results of the company's current operations.

Thus as per the current practice the initiative in the management of the companies has passed into the hands of chief executives. Peter Drucker remarks “ In reality, the board as conceived by the lawmakers is at best a tired fiction. But this does not mean that board has no important function to perform. As ultimate responsibility of the management of the company rests with the board of directors. It is an organ of review, of appraisal, of appeal. Only in crisis it becomes an organ of action.

Problems can arise if the board were to become a mere rubber stamp. Particularly, when the company management is dominated by bureaucrats who cannot take a detached and objective view of company operation because they are too much involved with them.

For too long in India managing agents controlled the board of directors of companies and used them as mere tools. It is only through democratically elected boards consisting of professional men of deep insight into business affairs that the state of company management can be improved.

20.2 ROLE OF THE BOARD IN ENSURING CORPORATE GOVERNANCE

The clear message from the series of corporate debacles that occurred in America and several parts of the world, was simple that the board of directors is increasingly being recognized as a critical success factor for corporations, be they large or small, private or public. This understanding and appreciation of the role of the boards as being valuable has resulted in several recommendations to boost their contributions to success of companies by innumerable committees that have been appointed by governments and public spirited organizations all over the world.

Company laws enacted by various countries make it a point to stress that the duty of a statutory board is to protect and represent the interests of shareholders. The board cannot and does not run the company. There are executives who run the day to day affairs of the company as dictated by the board. The role of the board is to work out business strategy and address big issues. A board's role is evolved from law, customs, tradition and current practice, while it gets its authority from the shareholders as their representatives to run the company's mission. It is the broader responsibility of the board to ensure that the management works in the best interests of the corporation and the shareholders to enhance corporate economic value.



It is now clearly understood that no set of systems with a checklist and the laws of state governing them can ever ensure good governance. The quality of directors, their competence, commitment, willingness and ability to assume a high degree of obligation to the company and its shareholders as a member of the board alone drives the value of any board. A strategic board with broad governing responsibilities rather than one that acts in response to the demands of the CEO has become the need of an intensely competitive world. To strengthen their position and capacity to guide the company and protect the long term shareholder's value, many big corporates are turning to advisory boards to draw on the collective wisdom of several professionals. All of these decisions will, of course depend on the policy, its critical needs and long time goal of the company.

Susan F.Shultz, founder of SSA Executive Search International, author of several best sellers on the subject and member of several boards of directors condenses her experiences and research in the following summation.

How a Strategic Board can ensure good governance ?

1. If the board is smaller, the director's involvement will be greater.
2. Independence is the essence of strategic boards.
3. Diversity means that a company has access to the best. It also means that the company is not arbitrarily limited to a single subset of its global constituency.
4. If the board is not informed appropriately, intelligently and comprehensively, it cannot function. In simple words, the output is only as good as the input.
5. The board has a broader responsibility to long term shareholder value than the CEO who is necessarily focused on day to day operations.

Board of Directors and Corporate Governance

There is an increasing awareness that corporates owe their existence to shareholders and the long-term sustainability of companies depends on winning their confidence through disclosures and transparency in operations and accountability for their actions to them. This is achieved through voluntary actions on the part of board of directors and through regulatory framework such as stock exchanges, securities and exchange board and other regulatory bodies. These principles are codified as principles of corporate governance.

20.3 THE ROLE OF DIRECTORS

The board has to shoulder a larger responsibility than the CEO, whose role is limited to being actively engaged with routine management functions. However, "There are many boards that overlook more than they oversee". This is more so in family-owned enterprises, which are common in Asia and Latin America. In India for instance, it is common to find family-owned concerns being run by promoter as their personal fiefdoms. Though their investments may be meager, they manage the firms, holding positions of CEOs, managing directors, chairman and



members of the board of directors. In such a set-up the board acts more like a rubber stamp, rather than shouldering large responsibilities. For better governance the board should function as follows:

1. Directors should exhibit total commitment to the company: An efficient and independent board should be conscious of protecting the interests of all stakeholders and not concerned too much with the current price of the stock. According to Roz Ridgway, the hallmark of a good director is that he or she attends and actively participates in the meetings. This requires a cent percent commitment.
2. Directors should steer discussions properly: Another important function of the director is to set priorities and to ensure that these are acted upon. The directors should see that all important issues concerning the company's business are discussed and decision taken, and nothing trivial dominates and bogs them down. A good director rarely dominates or hijacks the discussion to his line of thinking but steps in when the discussion needs to be directed or adds newer thoughts after letting others have their say.
3. Directors should make clear their stand on issues: A director is also expected to have the courage of conviction to disagree. A good, responsible and duty-bound director should be willing to register dissent when and where needed. The management led by the CEO should know that they are being challenged, should be kept on alert and should not take things for granted. Directors should also be alert to any deteriorating situations in functional areas of finance, stock market, sales, personnel and especially those relating to moral issues.
4. Directors' responsibility to ensure efficient CEOs: Directors have great responsibility in the matter of employment and dismissal of the CEO. The board as a whole, should recruit the best CEO they can probably hire based on antecedents and market reports, evaluate objectively on a continuing basis his or her implementing effectively or otherwise the strategic planning devised by the board. Great boards are those which proactively govern, help avoid the big mistakes, strategies and most importantly the best leadership is in place with the resources to lead.
5. Challenges posed by decisions on acquisitions: One of the toughest challenges confronted by boards arises while approving acquisitions. It so happens in most cases that the board takes up the issue of acquisition only when the process has been set in motion and substantially gone through by the management. It will lead to a terrible embarrassment both the CEO and the board, if the half-way-gone-through proposal has to be shelved. More of these none-too-worthy proposed acquisitions have to be accepted because of these predicaments.
6. A Board should anticipate business events: An efficient board should be able to anticipate business events that would spell success or lead to disaster if proper measures are not adopted in time. The directors should be alert to such ensuing situations and be ready with the strategy to meet them so that either way the company stands to gain.



7. Directors should have long-term focus and stakeholder interests: Directors have a duty to act bona fide for the benefit of the company as a whole. This duty is owed to the company, that is, the separate legal person that incorporation would imply as per the current laws, that directors are required to act in the long time focus. They ought to help build producing relationships between the company and its employees, customers and suppliers or any other kind of investment that would serve the long term interests of its shareholders.
8. Promoting overall interests of the company and its stakeholders are of paramount importance: In recent times those who advocate reform of laws governing corporate practices stress the importance of reformulation of the concepts behind these laws. For instance, John Parkinson in his article “Reforming Directors’ Duties” opines that while accepting that directors should not be required to do anything that would be contrary to the interest of shareholders, stresses that these interests should be understood as long term ones. This reformulation of the concept should encourage managers to pay great attention to the relationships that are the source of long term value. Once this becomes accepted, it will be logically consistent for the directors to exercise their powers in order to promote the success of the company as business enterprise. By doing so they will have regard to the interest of shareholders, employees, creditors, customers and suppliers. Stretched further it would become imperative that directors guide the company to a socially-responsible company. Social responsibility in this context should be seen as a means of compensating the society for anti-social corporate behavior such as causing ecological damages, making money at the cost of patients by launching fully untested medicines, etc. These are some of the duties and responsibilities expected of a proactive, sincere and committed board of directors who by their actions and decisions will be able to promote the interest of not only shareholders but all stakeholders of the company.

20.4 INDEPENDENT DIRECTORS

There have been a lot of discussions and debates going on in corporate circles and among academicians in recent times on the need for role of and importance of independent directors. An independent director is defined as a non-executive director who is free from business or other relationship which could materially interfere with the exercise of his “independent judgment.”

The Companies Act provides a negative definition of an independent director, inasmuch as it renders ineligible eleven categories of persons to be appointed as independent directors in a company, for instance, if a person has held any post in a company at any point of time is disqualified to be independent director of the company. Likewise, any vendor, supplier or customer of goods and services of the company would stand disqualified, notwithstanding the fact that the amounts of transaction are insignificant.

20.5 DESIRABILITY OF HAVING INDEPENDENT DIRECTORS

Recent literature on corporate governance is replete with recommendations of various



committees on the desirability of having non-executive, independent directors on the boards of companies to promote better corporate governance practices. The Cadbury Report identifies two areas where non-executive directors can make an important contribution to the governance process as consequence of their independence from executive responsibility.

1. Reviewing the performance of executive management.
2. Taking the lead where potential conflicts of interest arise, as for instance, fixing the salary of the CEO and perquisites or dealing with boardroom succession. Apart from these, independent directors, being non-executives with no vested interests, can bring in objectivity to the boards decision making process. Opinions vary on how many independent non-executive directors are required to achieve good corporate practice. The UK Combined Code recommended that non-executive directors should make up at least one-third of the board and that a majority of them should be independent. The IFSA guidelines and the Toronto Report recommend a higher standard that the majority of directors should be independent, non-executive. IFSA argues that majority of directors should be genuinely independent in order to ensure that board has the power to implement decision, if and when the need arises contrary to the wishes of management or major share-holder. IFSA contends that this creates “a more desirable board culture” and imposes a responsibility on the independent majority to be “especially competent and diligent” in carrying out their role.
3. The Indian Capital Market Regulator, the Securities Exchange Board of India (SEBI) has recently amended clause 49 of the listing agreement to ensure that independent directors account for at least 50% of board of directors of listed companies, where an executive chairman heads the board. However, if the chairman is a non-executive director, at least one third of board should consist of independent directors.

20.6 AUDIT COMMITTEE - SECTION 292A OF THE COMPANIES ACT, 1956

- Every public company having paid-up capital of not less than five crores of rupees shall constitute a committee of the Board known as “Audit Committee” which shall consist of less than three directors and such number of other directors other than managing or wholetime directors.
- Every Audit Committee constituted under sub-section(1) shall act in accordance with times of reference to be specified in writing by the Board.
- The members of the Audit Committee shall elect a chairman from amongst themselves.
- The annual report of the company shall disclose the composition of the Audit Committee.
- The auditors, the internal auditor, if any, and the director-in-charge of finance shall attend and participate at meetings of the Audit Committee but shall not have the right to vote.
- The Audit Committee should have discussions with the auditors periodically about internal control systems, the scope of audit including the observations of the auditors and review the half-yearly and annual financial statements before submission to the Board and also ensure compliance of internal control systems.

- The Audit Committee shall have authority to investigate into any matter in relation to the items specified in this section or referred to it by the Board and for this purpose, shall have full access to information contained in the records of the company and external professional advice, if necessary.
- The recommendation of the Audit Committee on matter relating to Financial management including the audit report shall be binding on the Board.
- If the Board does not accept the recommendations of the Audit Committee, it shall record the reasons therefor and communicate such reasons to the shareholders.
- The Chairman of the Audit Committee shall attend the annual general meetings of the company to provide any clarification on matters relating to audit.
- If a default is made in complying with the provisions of this section, the company and every officer who is in default, shall be punishable with imprisonment for a term which may extend to one year, or with fine which may extend to fifty thousand rupees or with both.

20.7 REMUNERATION COMMITTEE

It is now a universally accepted proposition of corporate governance practice that boards appoint appropriately composed remuneration committees to work out executive remuneration on their behalf. The combined code of the UK says that the remuneration committee will be responsible for working out remuneration packages “to attract, retain and motivate executives of the quality required”. The committee should decide where to position their company relative to other companies and take account of comparable remuneration and relative performance. With regard to the composition of the committee, an overwhelming majority of guidelines suggest that it be composed exclusively of independent non-executive directors. The committee would make its well considered recommendations to the board for final decision. The following responsibilities are normally assigned to a remuneration committee, which should have a written terms of reference:

- a) Remuneration packages and service contracts of the CEO and other senior executives.
- b) Remuneration packages for non-executive directors.
- c) Remuneration policies and practices of the company.
- d) Any company share and other incentive schemes
- e) Company superannuation and pension arrangements.

20.8 NOMINATION COMMITTEE

Role

The Governance and Nominating Committee’s role is to determine the slate of director nominees for election to the Company’s Board of Directors, to identify and recommend candidates to fill vacancies occurring between annual shareholder meetings, to review, evaluate and recommend



changes to the Company's Corporate Governance Guidelines, and to review the Company's policies and programs that relate to matters of corporate responsibility, including public issues of significance to the Company and its stakeholders.

Membership

The membership of the Committee consists of at least two directors, each of whom shall meet the independence requirements established by the Board and applicable laws, regulations and listing requirements. The Board appoints the members of the Committee and the chairperson. The Board may remove any member from the Committee at any time with or without cause.

Operations

The Committee meets at least twice a year. The Committee shall meet periodically in executive session without Company management present. Additional meetings may occur as the Committee or its chair deems advisable. The Committee will cause to be kept adequate minutes of its proceedings, and will report on its actions and activities at the next quarterly meeting of the Board. Committee members will be furnished with copies of the minutes of each meeting and any action taken by unanimous consent. The Committee is governed by the same rules regarding meetings (including meetings by conference telephone or similar communications equipment), action without meetings, notice, waiver of notice, and quorum and voting requirements as are applicable to the Board. The Committee is authorized and empowered to adopt its own rules of procedure not inconsistent with (a) any provision of this Charter, (b) any provision of the Bylaws of the Company, or (c) the laws of the state

Authority

The Committee will have the resources and authority necessary to discharge its duties and responsibilities. The Committee has sole authority to retain and terminate outside counsel, any search firm used to identify director candidates, or other experts or consultants, as it deems appropriate, including sole authority to approve the firms' fees and other retention terms. Any communications between the Committee and legal counsel in the course of obtaining legal advice will be considered privileged communications of the Company and the Committee will take all necessary steps to preserve the privileged nature of those communications.

The Committee may form and delegate authority to subcommittees and may delegate authority to one or more designated members of the Committee.

Responsibilities

Subject to the provisions of the Corporate Governance Guidelines, the principal responsibilities and functions of the Governance and Nominating Committee are as follows:

1.	Annually evaluate and report to the Board on the performance and effectiveness of the Board to facilitate the directors fulfilling their responsibilities in a manner that serves the interests of Corporation shareholders.
2.	Annually present to the Board a list of individuals recommended for nomination for election to the Board at the annual meeting of shareholders, and for appointment to the committees of the Board (including this Committee). Review and consider shareholder recommended candidates for nomination to the Board.
3.	Before recommending an incumbent, replacement or additional director, review his or her qualifications, including capability, availability to serve, conflicts of interest, and other relevant factors.
4.	Assist in identifying, interviewing and recruiting candidates for the Board.
5.	Annually review the composition of each committee and present recommendations for committee memberships to the Board as needed.
6.	Develop and periodically review and recommend to the Board appropriate revisions to the Company's Corporate Governance Guidelines.
7.	Monitor compliance with the Corporate Governance Guidelines.
8.	Regularly review and make recommendations about changes to the charter of the Governance and Nominating Committee.
9.	Regularly review and make recommendations about changes to the charters of other Board committees after consultation with the respective committee chairs.
10.	Obtain or perform an annual evaluation of the Committee's performance and make applicable recommendations.
11.	Assist the Chairman of the Board, if the Chairman is a non-management director, or otherwise the Chairman of the Committee acting as Lead Independent Director, in leading the Board's annual review of the Chief Executive Officer's performance.
12.	Annually review the Company's policies and programs that relate to corporate responsibility.



20.9 INTERNAL CONTROL

Under section 210 of the Companies Act, directors are required to maintain adequate accounting records to enable them to disclose with reasonable accuracy at any time the financial position of the company and in order to meet this responsibility they must in practice maintain some form of control system over the company's process of financial management. However there is no explicit requirement in company law for them to maintain an effective system of internal control.

Auditors in turn as part of their usual audit procedures will consider how far they can rely on the company's internal control systems in carrying out their audit of the financial statements. As a normal part of their audit procedures the auditors thus evaluate the internal control systems and if they plan to rely on them in reaching their audit opinion they will test the operation of those systems. As a by-product of this auditors will usually comment to management on their findings in what is commonly known as the management letter. However there is at present no Companies Act requirement for auditors to report on the adequacy of internal control systems.

Management Accounting measures and reports financial and nonfinancial information that helps managers make decisions to fulfill the goals of an organization. Management Accounting focuses on internal reporting. Basically application of management accounting facilitates maintenance of effective internal control system.

Internal Control is a process – effected by an entity's board of directors, management and other personnel designed to provide reasonable assurance regarding the achievement of objectives in the following categories :

- (a) reliability of financial reporting;
- (b) effectiveness and efficiency of operations ; and
- (c) compliance with applicable laws and regulations.

Internal control consists of the following five interrelated components.

1. **Control Environment:** It sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure
2. **Risk Assessment:** It is the entity's identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed
3. **Control activities:** These are the policies and procedures that help ensure that management directives are carried out.
4. **Information and Communication:** It helps in are the identification, capture and exchange of information in a form and time frame that enable people to carry out their responsibilities.
5. **Monitoring :** It is a process that assesses the quality of internal control performance over time.



Consideration of Internal Control in planning an Audit – Auditor’s Responsibility

In all audits the auditor should obtain an understanding of each of the five components of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements, and whether they have been placed in operation.

In planning the audit, knowledge obtained above would be used to :

1. Identify the types of potential misstatements that occur (errors, frauds, illegal acts)
2. Consider factors that affect the risk of material misstatements
3. Make a preliminary evaluation of control risk and decide upon an initial audit approach.

The nature, timing and extent of procedures the auditor chooses to obtain an understanding will vary depending on the size and complexity of the entity, previous experience with the entity , the nature of controls, and the extent of client documentation.

Documentation of Understanding of controls

An independent auditor must document his/her understanding of the internal control components mainly to show compliance with GAAS in work papers and serve as point of reference for current and future audits and engagements.

Methods of Documentation: Form and extent is a matter of professional judgment based upon size and complexity of the client .But common forms of documentation used are as follows:

1. Internal Control Questionnaire – a series of questions designed to elicit a “yes” or “no” answer. A “yes” answer is considered a positive attribute of the system. Conversely a no answer is a weakness or deficiency in the system.
2. Narrative memoranda describing system.
3. Flow chart
4. Checklist

Assessing Control Risk : Application of Management Accounting applications

Control Risk – the risk that the client’s internal control policy and procedures are not effective in preventing or detecting material misstatements in the financial statements.

1. Control risk at the maximum
 - Conclusion based upon the auditor’s judgment that the client’s internal control policies and procedures do not reduce to a low level the potential that the financial statements are free of material errors and or irregularities.
 - After reaching this assessment the auditor would only be required to document in his / her work papers the fact that control risk is at the maximum and not the basis for reaching this conclusion.



- The auditor may decide control risk is at the maximum based upon management accounting technique called cost benefit decisions

2. Control risk at less than the maximum

- Based upon his/her initial understanding of the internal control components, the auditor may conclude that control risk may be less than the maximum.
- The auditor in this situation must evaluate the cost/benefit of extending his/her understanding of internal controls to make a final decision concerning control risk.
- The cost/benefit decision is based upon the audit time involved in extending the auditor's understanding of internal controls, including tests of control, versus the time that may be saved with the possible reduction of substantive audit tests.

Tests of controls – audit tests designed to determine whether specific control procedures that the auditor plans to rely on are actually in place and operating effectively in the entity under audit.

Substantive Tests – audit tests designed to substantive one or more financial statement assertions

Should the auditor decide not to extend his/her understanding of internal controls because of cost/benefit considerations, control risk would then be assessed at the maximum for all financial statement assertions.

Communication of Internal Control Related Matters Noted in an Audit

During the course of an audit of an entity's financial statement, the auditor may become aware of matters related to internal control that may be of interest to the audit committee of the Board of Directors or others of equivalent authority. These items are referred to as "reportable conditions". Some examples of reportable conditions are as follows

Deficiencies in internal control design

Inadequate overall internal control design

Absence of appropriate segregation of duties consistent with appropriate control objectives

Absence of appropriate reviews and approvals of transactions, accounting entries or systems output

Inadequate procedures for appropriately assessing and applying accounting principles

Inadequate provisions for safeguarding of assets

Absence of other control techniques considered appropriate for the type and level of transaction activity

Evidence that a system fails to provide complete and accurate output that is consistent with objectives and current needs because of design flaws.



Evaluating the work of Internal Auditors

In evaluating the work of internal auditors the Independent auditor should examine on a test basis documentary evidence of the work performed by internal auditors and should consider such factors as whether the scope of the work is appropriate, audit programmes are adequate, working papers adequately document work performed, conclusions reached are appropriate in the circumstances and any reports prepared are consistent with the results of the work performed. The independent auditor should also perform tests of some of the work of internal auditors. The extent of these tests will vary depending on the circumstances, including the type of transactions and their materiality. These tests may be accomplished by either (a) examining some of the transactions or balances that internal auditors examined or (b) examining similar transactions or balances but not those actually examined by internal auditors. The independent auditor should compare the results of his tests with the results of the internal auditors work in reaching conclusions on that work.

20.10 DIRECTORS' RESPONSIBILITY STATEMENT

Corporate Management is responsible for the preparation of financial statements. Section 210 of the Companies Act, 1956 requires the board of directors to lay before the annual general meeting the balance sheet and the profit and loss account. The International Standards on Auditing (ISA) Objective and Basic Principles Governing Audit issued by the International Auditing Practices Committee categorically states that :

“ While the auditor is responsible for forming his opinion on the financial statements, the responsibilities for the preparation of financial statements are that of management of the entity. Management's responsibilities include the maintenance of accounting records, and internal controls the selection and application of accounting policies and safeguarding the assets of entity. The audit of financial statements does not relieve management of its responsibilities “

Para 6 of IAS-1 “Presentation of Financial Statements” requires that the board of directors and / or other governing body of an enterprise is responsible for the preparation and presentation of its financial statements.

Section 217(2AA) of the Company's Act, 1956 requires that the report of the board of directors should include Directors' Responsibility Statement. This statement should specify

- i) That accounting standards had been followed in the preparation of annual accounts and / or explanation for material departures from accounting standards;
- ii) Accounting policies are selected and applied consistently and judgments and estimates are made that are reasonable and prudent so as to give true and fair view of the state affairs at the end of the financial year and profit or loss of the company during the year
- iii) Directors have taken proper and sufficient care for (i) maintenance of accounting records as per law (ii) safeguarding assets of the company and (iii) preventing and detecting fraud and other irregularities
- iv) Directors have prepared the accounts on a going concern basis



Focus of the newly inserted sub-section 2AA of section 217 is to impose responsibility of

- Maintenance of adequate internal control and protective measures to safeguard assets of the company ;
- Pursuance of going concern assumptions in the preparation of financial statements;
- Selection of accounting policies with prudence and its consistent application with an objective of reflecting true and fair view of the financial statements ; and
- Pursuance of accounting standards with an explanation if there is a departure.

20.11 GOING CONCERN STATUS

Management may not prepare financial statements applying going concern basis in case there exists significant doubt about the going concern status of the enterprise. This point has not been taken care of in section 217(2AA) .

In India preparation and presentation of corporate financial statements are governed by accounting policies stated in the Companies Act and any other statutes that govern the reporting entity, accounting standards and other documents stating accounting policies, measurement and disclosure issued by the Institute of Chartered Accountants of India or any other regulatory authority like SEBI, RBI, IRDA etc. They together form Indian GAAP. In fact while preparing financial statements it is necessary to follow Indian GAAP.

Corporate financial statements are prepared following “ going concern” assumption which implies that the reporting entity is expected to continue operations in the foreseeable future and it has neither the intention nor necessity of liquidation or of curtailing the scale of operations. In India the Corporate management is not required to make explicit disclosure as regards the validity of going concern assumption. The term foreseeable future is also not defined in the accounting standard. Considering the uncertainties involved in the prediction of business continuity, foreseeable future should not be taken as distant future.

Parameters of identifying going concern uncertainty:

Forecasts and budgets

Borrowing requirements

Liability management

Contingent liabilities

Products and markets

Financial risk management

Other factors including consistency of earnings, stability of cost base, recurring operating losses, arrears of dividends, work stoppage, etc.



The Institute of Chartered Accountants of India has issued SAP-16 Going Concern. This audit standard attempt to capture going uncertainty in the line of ISA-23. Generally, financial statements are prepared on the basis of fundamental assumption of going concern. It is necessary for the auditors to consider the appropriateness of the going concern assumptions. The auditors should consider the existence of the following indications which risks the going concern assumption.

Financial Indications

- 1) Negative net worth or negative working capital
- 2) Fixed term borrowing approaching maturity without realistic prospects of renewal or repayment or excessive reliance on short term borrowings to finance long term assets.
- 3) Adverse key financial ratios
- 4) Substantial operating losses
- 5) Substantial negative cash flows from operations
- 6) Arrears or discontinuance of dividends
- 7) Inability to pay creditors on due dates
- 8) Difficulty in complying with the terms of loan agreements
- 9) Change from credit to cash on delivery transactions with suppliers
- 10) Inability to obtain financing for essential new product development or other essential investments
- 11) Entering into a scheme of arrangement with creditors for reduction of liability

Operating Indications

- 1) Loss of key management without replacement
- 2) Loss of a major market, franchise, license, or principal supplier
- 3) Labour difficulties or shortages of important supplies

Other Indications

- 1) Non – Compliance with capital or other statutory requirements
- 2) Pending legal proceedings against the entity that may if successful result in judgments that could not be met
- 3) Changes in legislation or government policy



- 4) Sickness of the entity under any statutory definition
- 5) The significance of such indications can often be mitigated by other factors

To resolve the doubt about the appropriateness of the going concern assumption the auditor should gather sufficient audit evidence.

EVALUATION OF GOING CONCERN UNCERTAINTIES

In order to evaluate various going concern uncertainties an Auditor needs to follow certain procedures which may include

- 1) Analyse and discuss cash flow, profit and other relevant forecasts with management
- 2) Review events occurring after the balance sheet date for items affecting the entity's ability to continue as a going concern
- 3) Analyse and discuss the entity's latest available interim financial statements
- 4) Review the terms of debentures and loan agreements and determine whether any have been breached
- 5) Read minutes of the meetings of shareholders, the board of directors and important committees for reference to financing difficulties
- 6) Review the status of matters under litigation and claims
- 7) Confirm the existence legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assess the financial ability of such parties to provide additional funds.
- 8) Consider the entity's position concerning unfilled customer orders.

20.12 RELATED PARTY TRANSACTIONS

Related party relationship may cause influence over the other such that one party is favoured. By this process transaction between the related parties lost the arm's length relationship.

Sometimes two or more enterprises operate under the common ownership or management without entering into transactions among themselves. But by virtue of related party relationship it is possible to control the volume of business of one enterprise for the benefit of other. Also the nature of market competition and pricing policies could have been different in absence of such related party relationship.

Accordingly disclosures of related party transactions are necessary for proper understanding of the financial performance and financial position. Related party disclosures seem more relevant when any such relationship is expected to discontinue with substantial effect on future performance of the reported entity.



Related Party as per the Companies Act , 1956 : Following parties are considered as related parties

Managers

Directors

Companies under the same management and

Subsidiaries

Under section 370 (1B) of the Companies Act two bodies corporate deemed to be under the same management

- i] if the managing director or manager of one body is the managing director or manager of the other body corporate
- ii] if majority of directors of one body corporate constituted majority of the directors of the other at any time within six months preceding
- iii] if not less than one-third of the voting power of the bodies corporate is controlled by common individuals or body corporate
- iv] if holding company of one body corporate is under common management with other body corporate in terms of i or ii or iii above
- v] if one or more of the directors together with their relatives hold majority of the shares of both the bodies corporate

Related party :

A Related party is essentially any party that controls or can significantly influence the management or operating policies of the company during the reporting period. AS-18 deals only with the following related party relationship

Enterprises that directly or indirectly through one or more intermediaries control or are controlled by or are under common control with the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries)

Associates and joint ventures of the reporting enterprise and the investing party or venture in respect of which the reporting enterprise is an associate or a joint venture

Individuals owing directly or indirectly an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise and relatives of any such individual. Relative means the spouse, son, daughter, brother, sister, father and mother who may be expected to influence or be influenced by that individual in his / her dealings with the reporting enterprise

Key management personnel and relatives of such personnel are those persons who have authority and responsibility for planning, directing and controlling the activities of the reporting enterprise and Enterprise over which individual or key management personnel described as above is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise.



The concept and definition of related parties is based on the following basis :

Control Concept: One party has the ability to control the other party in followings ways

Control by ownership (directly or indirectly) more than 50 % of voting power of an enterprise

Control over composition of board of directors or other governing body

Control of substantial interest in the voting power and power to direct the financial or operating policies of the enterprise for example associate and joint venture companies

SIGNIFICANT INFLUENCE:

Significant influence can be exercised in many ways. For example

By representation of the board of directors

Participation in policy making process

Material inter-company transactions

Inter-change of managerial personnel

Dependence on technical information

Exceptions of Related Party

Following relationship will not be deemed as related party:

Two companies have a director in common but director is not able to influence the mutual dealing between the companies.

A single customer or supplier or franchiser or distributor or general agent with whom enterprise's transactions are in significant volume

Providers of finance

Trade union

Government department and agencies

State controlled enterprises as regards related party relationship with other State controlled enterprise

RELATED PARTY TRANSACTIONS

It means a transfer of resource or obligations between related parties regardless of whether or not a price is charged.

Para 19 of IAS 24 and AS-18 gives illustrative list of related party transactions

Purchase or sales of goods (finished or unfinished)

Purchase or sale of fixed assets

Rendering or receiving services

Leasing or hire purchase arrangements

Transfer of Research and development

License agreements

Finance (including loan and equity contributions)

Guarantees and collaterals

DISCLOSURE REQUIREMENTS:

	IAS-24	AS-18
1.	Related party relationships where control exists should be disclosed irrespective of whether there have been transactions between the related parties or not [Para 20]	Same as IAS-24 [Para 21]
2.	Elements of transactions necessary to be disclosed : disclose the following information : (a) Volume of transactions by amount or proportion; (b) Amount or appropriate proportion of outstanding items; (c) Pricing policies [Para 23] transaction (e) Any other element of the transaction which is necessary for understanding the financial statements. Example includes pricing policy. (f) Amount or appropriate proportion of outstanding items and provision for doubtful debts (g) Amount written off or written back in the period in respect of debt due from or to related party [Para 23] Note : AS-18 does not specifically requires to disclose pricing policy. However any other elements mentioned in Para 23(v) read with Para 25 of AS 18 may demand disclosure of pricing policy.	In case transaction between related parties exist , the reporting enterprise should (a) Name of transacting related party (b) Description of the relationship (c) Description of the nature of (d) Volume of transaction by amount of proportion



20.13 PROJECT MANAGEMENT AUDIT AND CORPORATE GOVERNANCE

Project Management is the discipline of planning, organizing, and managing resources to bring about the successful completion of specific project goals and objectives. A project is a finite endeavor—having specific start and completion dates—undertaken to create a unique product or service which brings about beneficial change or added value. This finite characteristic of projects stands in sharp contrast to processes, or operations, which are permanent or semi-permanent functional work to repetitively produce the same product or service. In practice, the management of these two systems is often found to be quite different, and as such requires the development of distinct technical skills and the adoption of separate management philosophy, which is the subject of this article.

The primary challenge of project management is to achieve all of the project goals and objectives while adhering to classic project constraints—usually scope, quality, time and budget. The secondary—and more ambitious—challenge is to optimize the allocation and integration of inputs necessary to meet pre-defined objectives. A project is a carefully defined set of activities that use resources (money, people, materials, energy, space, provisions, communication, motivation, etc.) to achieve the project goals and objectives.

Project management is quite often the province and responsibility of an individual project manager. This individual seldom participates directly in the activities that produce the end result, but rather strives to maintain the progress and productive mutual interaction of various parties in such a way that overall risk of failure is reduced.

A project manager is often a client representative and has to determine and implement the exact needs of the client, based on knowledge of the firm they are representing. The ability to adapt to the various internal procedures of the contracting party, and to form close links with the nominated representatives, is essential in ensuring that the key issues of cost, time, quality, and above all, client satisfaction, can be realized.

In whatever field, a successful project manager must be able to envision the entire project from start to finish and to have the ability to ensure that this vision is realized.

Any type of product or service — Pharmaceuticals, buildings, vehicles, electronics, computer software, financial services, etc. — may have its implementation overseen by a project manager and its operations by a product manager.

Project management activities

Project management is composed of several different types of activities such as:

Analysis and design of objectives and events

Planning the work according to the objectives

Assessing and controlling risk (or Risk Management)



Estimating resources
Allocation of resources
Organizing the work
Acquiring human and material resources
Assigning tasks
Directing activities
Controlling project execution
Tracking and reporting progress (MIS)
Analyzing the results based on the facts achieved
Defining the products of the project
Forecasting future trends in the project
Quality Management
Issues management
Issue solving
Defect prevention
Identifying, managing & controlling changes
Project closure (and project debrief)
Communicating to stakeholders
Increasing / decreasing a company's workers

Project control systems

Project control is that element of a project that keeps it on-track, on-time, and within budget. Project control begins early in the project with planning and ends late in the project with post-implementation review, having a thorough involvement of each step in the process. Each project should be assessed for the appropriate level of control needed: too much control is too time consuming, too little control is very risky. If project control is not implemented correctly, the cost to the business should be clarified in terms of errors, fixes, and additional audit fees.

Control systems are needed for cost, risk, quality, communication, time, change, procurement, and human resources. In addition, auditors should consider how important the projects are to the financial statements, how reliant the stakeholders are on controls, and how many controls exist. Auditors should review the development process and procedures for how they are



implemented. The process of development and the quality of the final product may also be assessed if needed or requested. A business may want the auditing firm to be involved throughout the process to catch problems earlier on so that they can be fixed more easily. An auditor can serve as a controls consultant as part of the development team or as an independent auditor as part of an audit.

Businesses sometimes use formal systems development processes. These help assure that systems are developed successfully. A formal process is more effective in creating strong controls, and auditors should review this process to confirm that it is well designed and is followed in practice. A good formal systems development plan outlines:

- A strategy to align development with the organization's broader objectives
- Standards for new systems
- Project management policies for timing and budgeting
- Procedures describing the process

PROJECT GOVERNANCE -key Roles

- 1) **Establish** the bases for project governance, approval and measurement—including defining roles and accountabilities, policies and standards and associated processes
- 2) **Evaluate** project proposals to select those that are the best investment of funds and scarce resources and are within the firm's capability and capacity to deliver
- 3) **Enable** through resourcing of projects with staff and consultants, harnessing and managing of business support and the provision of the governance resources
- 4) **Define** the 'desired business outcomes' (end states), benefits and value — the business measures of success and overall value proposition
- 5) **Control** the scope, contingency funds, overall project value and so on
- 6) **Monitor** the project's progress, stakeholder's commitment, results achieved and the leading indicators of failure
- 7) **Measure** of the outputs, outcomes, benefits and value — against both the plan and measurable expectations
- 8) **Act** to 'steer' the project into the organization, remove obstacles, manage the critical success factors and remediate project or benefit-realization shortfalls
- 9) **Develop** the organization's project delivery capability — continually building and enhancing its ability to deliver more complex and challenging projects in less time and for less cost while generating the maximum value.



Benefits of Project governance

Project governance will:

- 1) Outline the relationships between all internal and external groups involved in the project
- 2) Describe the proper flow of information regarding the project to all stakeholders
- 3) Ensure the appropriate review of issues encountered within each project
- 4) Ensure that required approvals and direction for the project is obtained at each appropriate stage of the project.

Elements of Project governance

Important specific elements of good project governance include:

- 1) A compelling business case, stating the objects of the project and specifying the in-scope and out-of-scope aspects
- 2) A mechanism to assess the compliance of the completed project to its original objectives
- 3) Identifying all stakeholders with an interest in the project
- 4) A defined method of communication to each stakeholder
- 5) A set of business-level requirements as agreed by all stakeholders
- 6) An agreed specification for the project deliverables
- 7) The appointment of a project manager
- 8) Clear assignment of project roles and responsibilities.
- 9) A current, published project plan that spans all project stages from project initiation through development to the transition to operations.
- 10) A system of accurate upward status- and progress-reporting including time records.
- 11) A central document repository for the project
- 12) A centrally-held glossary of project terms
- 13) A process for the management and resolution of issues that arise during the project
- 14) A process for the recording and communication of risks identified during the project
- 15) A standard for quality review of the key governance documents and of the project deliverables.



20.14 RISK EVALUATION AND MANAGEMENT

Introduction

The rapidly changing global economy has created an expanding array of risks to be managed if the viability and success of an enterprise are to be ensured. Corporations face the task of managing their risk exposures while remaining profitable and competitive at the same time. The challenges and demands of contemporary markets, customer expectations, regulatory authorities, employees and shareholders present organizations with an interesting paradox. Today a risk manager must generate a comprehensive matrix of risks being faced by the organization and act as a catalyst in successfully dealing with those risks. It is impossible for an organization to avoid risk.

Business risk is the possibility that an event, action or inaction will not positively affect the organisation's ability to increase shareholder value. After studying the definition of the business risk let us try to find out the risk sources and exploration of the forms of risk. Historically risk management has been confined to the traditionally insurable risks such as loss from fire, earthquakes, wind, flood etc. Solutions involving purchase of insurance were emphasized with focus on type of coverage ,adequacy of limits.

Classification of Risks

Risks may be classified broadly under the following heads :

(a) Industry and Services Risks : These risks can be broadly categorised as follows namely

- Economic risks such as dependence on one product, one process, one client, one industry, etc in the short and long term.
- Service risks
- Market structure
- Business Dynamics
- Competition risks affecting tariff prices, costs, revenues and customer preferences
- Customer relation risks

(b) Management and Operation Risks :These risks relate broadly to the company's organization and management such as planning, monitoring and reporting system in the day to day management process namely :

- Risks to property
- Clear and well defined work processes
- Changes in Technology / upgradation
- R & D risks
- Agency network risks



- Personnel risks such as labour turnover risks involving replacement risks, training risks, cost risks, skill risks etc There are also unrest risks due to strikes and lockouts.
 - Environmental and Pollution Control regulations
 - Locational benefits near metros, railway stations, ports, cities, etc
- (c) Market Risks : These risks relate to market conditions namely
- raw material rates
 - quantities, quality, suppliers, lead time, interest rate risks and forex risk namely fluctuation risk and interest rate risk in respect of foreign exchange transaction
- (d) Political Risks : These risks relate to political uncertainties namely
- Elections
 - War risks
 - Country / area risks
 - Insurance risks like fire, strikes, riots and civil commotion, marine risks, cargo risks, etc
 - Fiscal / monetary policy risks including taxation risks
- (e) Credit Risks : These risks relate to commercial operations namely :
- creditworthiness risks
 - risks in settlement of dues by clients
 - provisions for doubtful and bad debts
- (f) Liquidity Risk : These are financial risk factors namely :
- Financial solvency and liquidity risks
 - Borrowing limits, delays
 - Cash / reserve management risks
 - Tax risks
- (g) Disaster Risks : These risks relate to disasters from following factors :
- Natural risks like fires, floods, earthquakes, etc
 - Man-made risks factors arising under the Factories act, mines act, etc
 - Risk of failure of effective disaster management plans formulated by the company
- (h) Systems Risks : These risks relate to the company's system namely :
- systems capacities
 - system reliability



- obsolescence risks
- Data integrity risks
- Coordinating and interface risks

(i) Legal Risks : These risks relate to the following :

- Contract risks
- Contractual liability
- Frauds
- Judicial risks
- Insurance risks

Risk Evaluation

Risk evaluation is concerned with assessing probability and impact of individual risks, taking into account any interdependencies or other factors outside the immediate scope under investigation:

- Probability is the evaluated likelihood of a particular outcome actually happening (including a consideration of the frequency with which the outcome may arise). For example, major damage to a building is relatively unlikely to happen, but would have enormous impact on business continuity. Conversely, occasional personal computer system failure is fairly likely to happen, but would not usually have a major impact on the business
- Impact is the evaluated effect or result of a particular outcome actually happening
- Impact should ideally be considered under the elements of:
 - time
 - quality
 - benefit
 - people/resource

Some risks, such as financial risk, can be evaluated in numerical terms. Others, such as adverse publicity, can only be evaluated in subjective ways. There is a need for some framework for categorising risks, for example, high, medium and low.

When considering a risk's probability, another aspect is when the risk might occur. Some risks will be predicted to be further away in time than others and so attention can be focused on the more immediate ones. This prediction is called the risk's proximity. The proximity of each risk should be included in the Risk Log.

Management of Risk

Risk management covers all the processes involved in identifying, assessing and judging risks, assigning ownership, taking actions to mitigate or anticipate them, and monitoring and reviewing progress. Risk is a major factor to be considered during the management of a project. Project management must control and contain risks if a project is to stand a chance of being successful.

Risk can be defined as uncertainty of outcome (whether positive opportunity or negative threat). Some amount of risk taking is inevitable if the project is to achieve its objectives. The task of risk management is to manage a project's exposure to risk (that is, the probability of specific risks occurring and the potential impact if they did occur).

The management of risk is not a linear process; rather it is the balancing of a number of interwoven elements which interact with each other and which have to be in balance with each Risk management at the project level focuses on keeping unwanted outcomes to an acceptable minimum. Decisions about risk management at this level form an important part of the Business Case.

Where suppliers and/or partners are involved, it is important to gain a shared view of the risks and how they will be managed.

The aim is to manage that exposure by taking action to keep exposure to an acceptable level in a cost-effective way. Risk management involves having:

- 1) Access to reliable, up-to-date information about risks
- 2) Decision-making processes supported by a framework of risk analysis and evaluation
- 3) Processes in place to monitor risks
- 4) The right balance of control in place to deal with those risks.

Risk Principles

Risk is the chance, great or small, that damage or an adverse outcome will occur from a particular hazard. There are some essential elements that need to be in place in a project if risk management is to be effective and innovation encouraged, i.e. that:

- The Project Board supports and promotes risk management, understands and accepts the time and resource implications of any countermeasures
- Risk management policies and the benefits of effective risk management are clearly communicated to all staff
- A consistent approach to risk management is fully embedded in the project management processes
- Management of risks is an essential contribution to the achievement of business objectives



- Risks through working with programmes and other projects are assessed and managed
- There is a clear structure to the risk process so that each element or level of risk identification fits into an overall structure
- Where the project is part of a programme, changes in the state of any project risks that are also identified as programme risks must be flagged to programme Projects bring about change and change incurs risk. Change is usually about moving forward and this often means the use of new methods or new technology. These aspects can increase the risks. It is the combination of likelihood and impact, including perceived importance. management or the designated risk management function in the programme.

Projects bring about change and change incurs risk. Change is usually about moving forward and this often means the use of new methods or new technology. These aspects can increase the risks. It is the combination of likelihood and impact, including perceived importance.

Risk tolerance looks at acceptable / unacceptable deviations from what is expected. Risk appetite looks at how much risk a company is willing to accept. There can still be deviations that are within a risk appetite.

Before determining what to do about risks, the Project Board and Project Manager must consider the amount of risk they are prepared to tolerate. This will vary according to the perceived importance of particular risks.

For example, the view of financial risks and how much the project team is prepared to put at risk will depend on a number of variables, such as budgets, the effect on other parts of the programme or organisation or additional risks such as political embarrassment. A project team maybe prepared to take comparatively large risks in some areas and none at all in others, such as risks to health and safety.

Risk tolerance can be related to other tolerance parameters; risk to completion within time scale and /or cost and to achieving product quality and project scope within the boundaries of the Business Case. Perceptions of risk tolerance have to be considered in detail to establish the optimum balance of a risk occurring against the costs and value for money of limiting that risk.

The organisation's overall tolerance of exposure to risk must also be considered as well as a view of individual risks.

Risk Responsibilities

The management of risk is one of the most important parts of the job done by the Project Board and the Project Manager. The Project Manager is responsible for ensuring that risks are identified, recorded and regularly reviewed. The Project Board has four responsibilities:

Notifying the Project Manager of any external risk exposure to the project

Making decisions on the Project Manager's recommended reactions to risk

Striking a balance between the level of risk and the potential benefits that the project may achieve



Notifying corporate or programme management of any risks that affect the project's ability to meet corporate or programme objectives.

The Project Manager modifies plans to include agreed actions to avoid or reduce the impact of risks.

Risk analysis requires input from the management of the organisation. The organisation's management, in turn, is kept informed by the Project Board of the risk analysis results. Communication is particularly important between the project and programme levels within the organisation.

Where the project is part of a programme, the management of risk procedures used by the project must be consistent and compatible with those of the programme unless there are valid reasons not to do so. Where a risk is uncovered in the programme, any affected projects should be involved in the analysis of that risk. Similarly, project risk evaluation should include staff from the programme. Project risks that threaten programme milestones or objectives must be escalated to programme management.

Risk Ownership

An 'owner' should be identified for each risk, who should be the person best situated to keep an eye on it. The Project Manager will normally suggest the 'owner' and the Project Board should make the decision. Project Board members may be appointed 'owners' of risks, particularly risks from sources external to the project. Allocating ownership of the risk process as a whole and the various components is fundamental from the outset. When describing who owns the various elements of risk, it is important to identify who owns the following:

- The risk framework in totality
- Setting risk policy and the project team's willingness to take risk
- Different elements of the risk process, such as identifying threats, through to producing risk response and reporting
- Implementation of the actual measures taken in response to the risks
- Interdependent risks that cross organisational boundaries, whether they be related to business processes, IT systems or other projects.

Overall ownership of the Risk Log is likely to lie with the Executive. However, the Executive will need to ensure that the people who own the various parts of the risk process are clearly defined, documented and agreed, so that they understand their various roles, responsibilities and ultimate accountability with regard to the management of risk. Normally the risk 'owner' will have the responsibility of monitoring each risk. If the owner is a Project Board member, the actual task of monitoring may be delegated, but the responsibility stays with the owner. The Executive, for example, has ultimate responsibility for monitoring any risks or opportunities facing the Business Case, particularly any external ones, such as changes in company policy.

The Project Manager has the job of keeping a watching brief over all risks and checking that



the defined actions, including monitoring, are taking place and are having the desired effect. Risks owned at team level should be reported on in the Checkpoint Reports. The Project Manager includes some form of report on any significant risks in the Highlight Report. The End Stage Report also summarises the risk status. Where a risk or opportunity actually occurs, the Project Manager will either instigate contingency action, or deal with the issue under Change Control.

The risk management cycle

Every project is subject to constant change in its business and wider environment. The risk environment is constantly changing too. The project's priorities and relative importance of risks will shift and change. Assumptions about risk have to be regularly revisited and reconsidered, for example at each end stage assessment.

The figure on the right shows the main steps through the risk management cycle.

- Identify the risks
- Evaluate the risks
- Identify suitable responses to risk
- Select
- Plan and resource
- Monitor and report

Risk Identification

This step identifies the potential risks (or opportunities) facing the project. It is important not to judge the likelihood of a risk at this early time. This is done in a controlled manner in a later step. Attempting to form judgments while 'brainstorming' a list of potential risks may lead to hurried and incorrect decisions to exclude some risks.

Once identified, risks are all entered in the Risk Log. This contains details of all risks, their assessment, owners and status. A suggested list of contents is given in Appendix A, Product Description outlines. The Risk Log is a control tool for the Project Manager, providing a quick reference to the key risks facing the project, what monitoring activities should be taking place and by whom. Reference to it can lead to entries

Identify suitable responses to risk

The actions break into broadly five types, as shown below.

- 1. Prevention** Terminate the risk - by doing things differently and thus removing the risk, where it is feasible to do so. Countermeasures are put in place that either stop the threat or problem from occurring or prevent it having any impact on the project or business.
- 2. Reduction** Treat the risk - take action to control it in some way where the actions either reduce the likelihood of the risk developing or limit the impact on the project to acceptable levels.

3. **Transference** This is a specialist form of risk reduction where the management of the risk is passed to a third party via, for instance, an insurance policy or penalty clause, such that the impact of the risk is no longer an issue for the health of the project. Not all risks can be transferred in this way.
4. **Acceptance** Tolerate the risk - perhaps because nothing can be done at a reasonable cost to mitigate it or the likelihood and impact of the risk occurring are at an acceptable level.
5. **Contingency** These are actions planned and organised to come into force as and when the risk occurs.

Any given risk could have appropriate actions in any or all these categories. There may be no cost-effective actions available to deal with a risk, in which case the risk must be accepted or the justification for the project revisited (to review whether the project is too risky), possibly resulting in the termination of the project.

The results of the risk evaluation activities are documented in the Risk Log. If the project is part of a programme, project risks should be examined for any impact on the programme (and vice versa). Where any cross-impact is found, the risk should be added to the other Risk Log.

Control Action - Balancing the risk

The risk response process should involve identifying and evaluating a range of options for treating risks and preparing and implementing risk management plans. It is important that the control action put in place is proportional to the risk. Every control has an associated cost. The control action must offer value for money in relation to the risk that it is controlling.

Selection of the risk actions to take is a balance between a number of things. For each possible action it is, first, a question of balancing the cost of taking that action against the likelihood and impact of allowing the risk to occur. For example, if a charity carnival is arranged, is it worth taking out insurance for Rs.3,000 guaranteeing Rs.6,000 if the carnival is rained off? Or, since the carnival date is in summer, do we take the risk and not spend the insurance money? But the selection is usually more complex than that. There are many elements to be taken into consideration.

Risk Action Selection

There may be several possible risk actions, each with different effects. The choice may be one of these options or a combination of two or more. We then have to consider the impact of (a) the risk occurring and (b) the risk action on:

- The team, Stage and / or Project Plans
- The business or programme
- The Business Case
- Other parts of the project.



The consideration has to be done in the light of the risk tolerances.

Planning and resourcing

Having made the selection, the implementation of the selected actions will need planning and resourcing and is likely to include plan changes, new or modified Work Packages:

- Planning, which, for the countermeasure actions itemised during the risk evaluation activities, consists of:
 - identifying the quantity and type of resources required to carry out the actions
 - developing a detailed plan of action; this will be included in Project and Stage Plans either as additional activities or as a contingency plan
 - confirming the desirability of carrying out the actions identified during risk evaluation in light of any additional information gained
 - obtaining management approval along with all the other aspects of the plans being produced
- Resourcing, which will identify and assign the actual resources to be used to conduct the work involved in carrying through the actions; these assignments will be shown in Project and Stage Plans; note that the resources required for the prevention, reduction and transference actions will have to be funded from the project budget since they are actions that we are committed to carry out; contingent actions will normally be funded from a contingency budget.

Monitoring and reporting

There must be mechanisms in place for monitoring and reporting on the actions selected to address risks. Some of the actions may have only been to monitor the identified risk for signs of a change in its status. Monitoring, however, may consist of:

- Checking that execution of the planned actions is having the desired effect
- Watching for the early warning signs that a risk is developing
- Modelling trends, predicting potential risks or opportunities
- Checking that the overall management of risk is being applied effectively.

Budgeting for risk management

A project needs to allocate the appropriate budget, time and resources to risk management. The risk process must be embedded in the project environment, rather than being tacked on as an afterthought.

The cost of carrying out risk management and the level of commitment and time, such as

contingency plans, risk avoidance or reduction, needs to be recognised and agreed.

While the budget may be allocated to actions relating to risk treatment, there is often a failure to provide sufficient budget to the earlier parts of the process, such as risk assessment that can require a diverse range of skills, tools and techniques.

Experience has shown that allocating the correct budget to the risk management process early on will pay dividends later.

Risks may have additional factors relating to them that increase the complexity of assessing your overall exposure to risk. These include interdependencies. It is essential to understand the interdependencies of risks and how they can compound each other. For example, a skills shortage combined with serious technical problems and a requirement to bring the delivery date forward are common examples of risk compounding. Interdependencies can occur at all levels and across different levels.

A project may have interdependencies with other projects. A project maybe dependent upon a supplier delivering products or services that have a further interdependency upon another internal project delivering its objectives and so on in the supply chain. These need to be explicitly identified and assessed as part of the process of risk management.

Interdependencies often cross different boundaries, such as ownership, funding, decision making, organisational or geographical boundaries. You must be able to assess risk and communicate across these boundaries.

Risk management considerations

The relationship between benefit and delivery risks

Often the risk management process is focused primarily on delivery rather than benefit. Changes to delivery dates, costs, quality, etc. are not related back to the benefits.

The drive to deliver may continue long after the potential benefits have been significantly reduced or lost. A common cause of this is that the owners of benefit objectives are not the same as the owners of delivery. Decisions taken with regard to delivery must be related back to benefit and vice versa.

Internal versus external risks

Much is made of the difference between internal and external risks. The major differences, however, relate to the ability to apply the risk process to them. Internal risks can be just as difficult to identify, assess and evaluate as external risks and thus just as com The cost of setting up a management of risk process for a project depends on the technical, political and organisational complexity involved. There are some general guidelines that can be applied, however. Planners for projects should expect to spend 1-3 per cent of their budget on an initial risk management effort and an additional 2 per cent on monitoring and updating this throughout the development life cycle.

**Checklist on assignment of risk ownership:**

- Have owners been allocated to all the various parts of the complete risk process and the full scope of the risks being catered for? For example, suppliers may be tasked with ownership of assessing and evaluating risk as part of their contracts.
- Are the various roles and responsibilities associated with ownership well defined?
- Do the individuals who have been allocated ownership actually have the authority in practice to fulfill their responsibilities?
- Have the various roles and responsibilities been communicated and understood?
- Are the nominated owners appropriate?
- In the event of a change, can ownership be quickly and effectively reallocated?
- Are the differences between benefit and delivery risks clearly understood and, if required, do they have different owners?

The Project Manager's Daily Log can be very useful in monitoring risks. Entries can be made in it for the Project Manager to check on the status of any risks where he/she is the owner. Other entries can be made to remind the Project Manager to check that other owners are monitoring and controlling their risks and feeding the information back.

Where the project is part of a programme:

- Programme management is responsible for ensuring the management of those risks with interdependencies between projects and programme.
- Where appropriate, the programme should take part in the risk management activities at the project level. This can normally be done by attendance at end stage assessments by either a member of programme management or a designated risk management function.
- Risks are frequently common across projects and would benefit from being centralised at programme level. The cost of corrective action can be reduced if it is planned, agreed and actioned only once. Also, problems can result from an inconsistent approach being taken by projects.

Study Note - 21

EVALUATION OF KEY FINANCIAL DECISIONS AND DISCLOSURES

This Study Note includes

- Key financial decisions and disclosures
- Management Audit for investor's protection in the context of corporate governance
- Corporate Governance norms as prescribed by SEBI

21.1 KEY FINANCIAL DECISIONS AND DISCLOSURES

Corporate governance is the system by which companies are directed and controlled. Board of directors is responsible for the governance of their companies. The shareholders role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place.

Within that overall framework the specifically financial aspects of financial aspects of corporate governance are the way in which boards set financial policy and oversee its implementation including the use of financial controls and the process whereby they report on the activities and progress of the company to the shareholders.

The role of auditors is to provide the shareholders with an external and objective check on the director's financial statements which form basis of that reporting system.

The Committee's objective is to help to raise the standards of corporate governance and the level of confidence in financial reporting and auditing by setting out clearly what it sees as the respective responsibilities of those involved and what it believes is expected of them.

While evaluating key financial decisions like Capital Investment as well as borrowings required for the Capital expenditure. The first important point in the evaluation is to take into account time value of money to be invested / borrowed which takes into account that a rupee received today is worth more than rupee received at any future time. The time value of money is the opportunity cost from not having the money today. For this purpose there are following techniques

Discounted Cash Flow: Under this there are two methods viz Net Present Value method and Internal Rate of Return method. DCF focuses on cash inflow and cash outflow rather than on operating income as determined in conventional accrual accounting.

NPV is calculated using the required rate of return which is the minimum acceptable rate of return on an investment. The required rate of interest is the return that an organization could expect to receive elsewhere for an investment of comparable risk. This rate is also called Discount rate, hurdle rate, or opportunity cost of capital

The NPV method calculates the expected monetary gain or loss from a project by discounting all expected future cash inflows and outflows to the present point in time using the required



rate of return. Only projects with a zero or positive net present value are acceptable because the return from these projects equals or exceeds the cost of capital.

The Internal Rate of Return method calculates the discount rate at which the present value of expected cash inflows from a project equals the present value of expected cash outflows. That is the IRR is the discount rate that makes NPV equal to zero. While determining the discount rate the experts always have a calculator or computer programme and in the absence of both the trial and error method.

Sensitivity Analysis: To examine how a result will change if the predicted financial outcomes are not achieved or if an underlying assumption changes, managers can use sensitivity analysis a what-if technique .

Payback Method : Payback measures the time it will take to recoup in the form of expected future cash flows, the net initial investment in a project.

Cost Benefit Analysis : It is also necessary in some cases to do cost benefit analysis of the capital expenditure just to ensure that the benefits exceed the cost. Of course this is not possible in each case as sometimes it is difficult to quantify the benefits in monetary terms but at the same time incurring the expenditure is necessary.

All the abovementioned techniques would enable to find out the justification as well as evaluation of various financial decisions taken in business.

Disclosure

There are different accounting standards which specify the disclosure requirements for various financial decisions like borrowing, investments in fixed assets as well as securities. So let us discuss one by one.

Accounting for Fixed Assets (AS-10)

Gross and net book values of fixed assets at the beginning and at the end of accounting period showing additions, disposal, acquisition and other movements.

Expenditure incurred on account of Fixed Assets in the course of construction or acquisition.

Revalued amount substituted for historical cost of fixed assets, the method adopted to compute the revalued amount and whether an external valuer has valued the fixed assets in case where fixed assets are stated at revalued amount.

Further only non-refundable taxes and duties in respect of fixed asset should be included in the cost of that fixed asset. Cenvatable excise duty can be considered as a refundable tax. Therefore CENVAT credit of such duty should be reduced from the purchase cost of capital goods concerned and recognized as a separate asset provided

- (a) The enterprise is entitled to the cenvat credit as per the rules
- (b) There is a reasonable certainty that the cenvat credit would be utilized

(c) Enterprise intends to avail cenvat credit.

In case Enterprise does not intend to avail or recognition criteria is not satisfied then excise duty even though cenvatable should be included in the cost of fixed asset.

Accounting for Investments (AS – 13)

The standard deals with the following aspects

Classification of investment

Cost of investment

Carrying amount / valuation of investment

Disposal of investment

Reclassification of investment

Disclosure of investment in the financial statements

Disclosures:

Accounting policies followed for valuation of investment.

Classification of investment into current and long term in addition to classification as per Schedule VI of the Companies Act in case of company.

Aggregate amount of quoted & unquoted securities separately.

Any significant restriction on investment like minimum holding period for sale / disposal, utilization of sale proceeds, or non remittance of sale proceeds of investment held outside India.

Borrowing Costs: AS – 16

Enterprises are borrowing the funds to acquire, build and install the fixed assets and other assets, these assets take time to make them useable or saleable therefore the enterprises incur the interest to acquire and build these assets. The objective of the Accounting Standard is to prescribe the treatment of borrowing cost in accounting i.e. whether the cost of borrowing should be included in the cost of assets or not.

As per this accounting standard borrowing cost which is directly related to the acquisition, construction or production of qualifying asset should be capitalized. Qualifying asset is asset which takes substantial period of time to get ready for its intended use or sale, is called qualifying asset.

The financial statement should disclose -

The accounting policy adopted for borrowing cost.

The amount of borrowing cost capitalized during the period.



Significant difference among AS-16, IFRS/IAS and US GAAP

There is no significant difference among Indian GAAP (AS-16), IFRS/IAS-23 and USGAAP except the slight difference as regards to the disclosure requirements.

US GAAP (FAS -34) requires disclosure for an accounting period in which no interest cost is capitalized the amount of interest cost incurred and charged to expense during the period further for an accounting period in which some interest cost is capitalized the total amount of interest cost incurred during the period and the amount thereof that has been capitalized.

IFRS/IAS-23 requires the disclosures of the capitalization rate used to determine the amount of borrowing costs eligible for capitalization.

21.2 MANAGEMENT AUDIT FOR INVESTOR'S PROTECTION IN THE CONTEXT OF CORPORATE GOVERNANCE

Report of SEBI committee (India) on Corporate Governance defines corporate governance as the acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal & corporate funds in the management of a company." The definition is drawn from the Gandhian principle of trusteeship and the Directive Principles of the Indian Constitution. Corporate Governance is viewed as ethics and a moral duty.

In any industrial enterprise big or small resources are pooled for the purpose of generating further wealth. All these resources in the form of assets are quantifiable in terms of money. These are placed in the hands of the management of the enterprise who are expected to put the resources to the best use in the interest of the industry and the economy as a whole. It is true irrespective of whether an organization is in the public or private sector, it is therefore essential to ascertain by an independent appraisal as to how far the management has performed in fulfilling the tasks entrusted to them. This exercise needs to be carried out at all the levels of the management.

Management Audit begins where a statutory financial audit ends. The statutory financial audit has lot of limitations and therefore there is need for an independent appraisal of managerial performance at various levels including the top most level. The thought of management audit had arisen some decades back. These management audits are substantially different from those performed by public accountants and are not concerned with the verification of financial data. They are performed either for the top management, for the stockholders or the for the owners. Management audits provide a device for surveying the management of the enterprise critically and objectively from the broadest point of view.

Of late in attesting the financial statements to be presented to the shareholders, the accountants are more preoccupied with disclosure of more information like capacity utilization, raw material consumption, etc which in a way leans towards management audit. The figures reported in the financial statements exhibit the results of the company but they do not show why the management acted in the way they did. Moreover, the financial statements also do not reveal

the constraints within which the management acted. It is therefore expected that the new concept of management audit is to be developed to report the results more qualitatively than quantitatively.

The following definitions of management audit are useful in assessing its scope and areas of activities.

I] Management Audit is an examination of the conditions and a diagnosis of deficiencies with recommendations for correcting them. It is basically constructive in its conception and objective in its approach. It has but one purpose that of helping the management to better the position of the company. The net result is diagnosis of the present state of health of the business with attention focused on what needs improvement and with clear cut recommendations.

II] Management Audit is a systematic fact finding approach that examines appraises and reports on the understanding and effectiveness of an organisation's objectives, policies, standards, structure, procedures and controls to spotlight friction, waste, red tape etc. and to identify areas for improvement.

From the above definitions considered above we may summarise the activities of the management audit to consist broadly of

- A] Analytical and objective examination of the organization of the company, the plan and policies, control, etc in the different functional areas of the business to ensure optimum utilization of resources and facilities available.
- B] An objective evaluation of the performance of the business
- C] Identification of weak links in the organization and the internal controls with a view to giving signals on the potential dangers arising out of such weaknesses.
- D] Identification of waste, inefficiency, delay and other areas, which require improvement.
- E] Reporting on the effectiveness of the organization, objectives, policies, standards, procedures and control with a view to helping the management to better the company's performance.
- F] Make recommendations for the improvement
- G] The entire approach is constructive in conception and objective in analysis.

Management Audit incorporates in itself an efficiency audit. Efficiency audit ensures "application of the basic economic principles so that resources flow into the most remunerative channels." The main object of efficiency audit is to ensure that

1. Every rupee invested in capital or in other fields give the optimum returns and
2. The planning of investment between the different functions and aspects is designed to give optimum results.



The parameters for measuring efficiency with its concomitant details are

1. Overall rate of return on capital employed
2. Better capacity utilization
3. Better utilization of raw material, power, labour, equipments and finance
4. Effective incentive system
5. Better export performance and import substitution'
6. Cost Control

It is necessary to make study activity wise so as to identify areas of deficiency in particular activity.

To conclude we can infer saying that Investor in order to protect his investment in any company expects proper exhibition of corporate governance which is taken care by Management Audit as Management audit would encompass compliance audit, efficiency audit, propriety audit and systems audit as well as management audit is concerned with the overall objectives of an organization.

21.3 CORPORATE GOVERNANCE NORMS AS PRESCRIBED BY SEBI

21.3.1 The Securities and Exchange Board of India

The Securities and Exchange Board of India Act, 1992 was enacted by the Indian Parliament “to provide for the establishment of a Board to protect the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto”

Objectives of the Board

Section 11(1) of the Securities and Exchange Board of India Act, 1992 explains the powers and functions of SEBI. As per the Act, it shall be the duty of the board to protect interests of the investors in securities and to promote the development of, and to regulate the securities market by such measures as it thinks fit.

The statutory objectives of the SEBI as per the Act are given below:

1. Protection of investor's interest in securities.
2. Promotion of the development of the securities market.
3. Regulation of the securities market and
4. Matters connected therewith and incidental thereto.

21.3.2 SEBI's Role in Promoting Corporate Governance.

With the objective of improving market efficiency, enhancing transparency, preventing unfair trade practices and bringing the Indian market up to international standards, a package of reforms consisting of measures to liberalise, regulate, and develop the securities market was introduced in 1990s. The practice of allocation of resources among different competing entities as well as its terms by a central authority was discontinued. The issuers complying with the eligibility criteria now have freedom to issue the securities at market determined rates. The secondary market overcame the geographical barriers by moving to screen based trading, which made trading system accessible to everybody anywhere in the Indian sub-continent. Trades enjoy counterparty guarantee. The trading cycle shortened to a day and trades are settled within two working days while all deferral products are banned. Physical security certificates have almost disappeared. A variety of derivatives are available. In fact, some reforms such as straight through processing in securities, T+2 rolling settlement, clearing corporation being the central counter party to all the trades on the exchanges, real time monitoring of brokers positions and margins, and automatic disabling of brokers' terminals are singular to the Indian securities market. Indian disclosure and accounting standards are as modern, updated, potent and versatile as those of any other market. Today, the Indian securities market stands shoulder to shoulder with most developed markets in North America, Western Europe and Far East.

According to SEBI's former chairman, The Securities and Exchange Board of India have been focusing on the following areas to improve corporate governance.

1. Ensuring timely disclosure of relevant information.
2. Providing a n efficient and effective market system.
3. Demonstrating reliable and effective enforcement.
4. Enabling the highest standards of governance.

21.3.3 Disclosure standards.

The erstwhile SEBI Chairman, G.N.Bajpai claims quoting academicians and researchers that disclosure standard in the Indian regulatory jurisdiction are at par with the best in the world. According to him this is a feedback from several global organizations, both regulatory and market participants.

SEBI has ensured that a company is required to make specified disclosures at the time of issue and make continuous disclosures as long as its securities are listed on exchanges. The standards for these disclosures including the content , medium and time of disclosures have been specified in the companies Act, Disclosure and Investor Protection Guidelines, Listing Agreement Regulations relating to insider trading and takeover etc. These disclosures are made through various documents such as prospectus, quarterly statements, annual reports etc. and are disseminated through media, websites of the company and the exchanges, and through EDIFAR (Electronic Data Information Filing and retrieval) system maintained by the regulator. These disclosures relate to financial performance, shareholding pattern, trading by insiders, substantial



acquisitions, related party disclosures, audit qualifications, buyback details, corporate governance, actions taken against company, risk management, utilization of issue proceeds, remuneration of directors etc. All listed companies and organizations associated with securities markets including the intermediaries, asset management companies, Trustees of mutual funds, SROs, stock exchanges, clearing houses / corporations, public financial institutions, professional firms such as auditors, accountancy firms, law firms, consultants, etc. assisting or advising listed companies are required to abide by the Code of Corporate Disclosure Practices specified in SEBI (Insider Trading) regulations.

21.3.4 Efficient and effective market system.

In the opinion of the Chairman of SEBI, the Indian securities market has a large infrastructure to meet the demands of a sub-continental market. Presently there are 25 stock exchanges and about 10,000 brokers, 15000 sub-brokers, more than 10000 listed companies, 500 foreign institutional investors, 400 depository participants, 150 merchant bankers, 40 mutual funds offering over 450 schemes, and 20 million investors. Yet, there is only one regulator. Not only the numbers are gigantic but also the systems and infrastructure are equally Atlantean and sophisticated. All stock exchanges in India offer on line, fully automated, nationwide anonymous, order driven screen based trading system. It has a comprehensive risk management system. The depositor's legislation ensures free transferability of securities with speed, accuracy and security. The securities are transferred electronically in demat form. Further, Indian accounting standards follow international accounting standards (principle based) and are by and large aligned. In addition to creating an efficient trading platform and settlement mechanism, SEBI's focus is substantially directed towards the following:

- (a) Provisions of timely availability of high quality sensitive information to the market participants to enable them to take informed decision and ensure efficient price discovery
- (b) Maintenance of high quality of services and fair conduct for market participants. The regulations specify high standards to become market intermediaries and require them to abide by a code of conduct.
- (c) Ensuring that the market is fair, transparent and safe so that issuers and investors are at ease to carry out transactions.

21.3.5 Reliable and Effective Enforcement.

SEBI aims at ensuring that no misconduct goes unnoticed or unpunished. It keeps an eye on the happenings in the market and identifies anything unusual or undesirable which may adversely affect the efficacy of the market. Every market participants, irrespective of his size and influence in the market or in the policy is held accountable for his misdeeds. The proactive approach of the regulator in enforcement can be gauged from the fact that during the financial year 2002-2003, SEBI passed 561 orders, out of which over 350 were punitive.

21.3.6 Highest Standards of Governance.

SEBI has avowed that its regulation and guidance of the country's securities market would spell success in the area of corporate governance. The Kumar Mangalam Birla committee of

the Indian jurisdiction outlined a code of good corporate governance, which compared very well with the recommendations of the Cadbury Committee and the OECD codes. The code was operationalised by inserting a new clause to the listing agreement (LA) and have been made applicable to all the listed companies in India in a phased manner. Following the implementation of the Birla Committee recommendations, substantial developments took place in the corporate world and securities market, which required revisit of the issue. The Narayana Murthy Committee has refined the corporate governance norms, which are proposed to be implemented through modification in the listing agreement. Government also appointed few committees. Based on their recommendations, government is trying to provide statutory back up to corporate governance standards.

The initiatives for improvement in corporate governance, according to G.N.Bajpai, come mainly from three sources, namely, the market, regulator and the legislature. While the legislative initiative is directed towards bringing about amendments to the basic law India's Companies Act to include certain fundamental provisions related to corporate governance, dynamic aspects of corporate governance such as disclosures, accounting standards etc. are being pursued through the regulatory initiatives by bringing about amendments to the Listing Agreements. Such an approach is aimed at because a comparatively more complicated and protracted process is involved in the amendments to legislation in a truly democratic society like India's. The most important initiative comes from market forces and mechanisms, which encourage and insist on the management's improving the quality of corporate governance.

Indian market has formalized such forces in the form of a rating called "Corporate governance and Value Creation Rating", which according to SEBI chairman is quite unique in the world and is sought after voluntarily by companies.

21.3.7 SEBI's Record of Performance.

R.Rajagopalan in his book Directors and Corporate Governance makes the following observations on the role of SEBI: "The Securities and Exchanges Board of India and its various committees should be complimented for many things happening in the capital market in India. Be it in the area of protection of small investors' interests, or technology upgradation or development of securities market, SEBI has indeed been working with commensurate speed and efficiency in the last couple of years. There has, however been a common perception that SEBI has not developed a cadre of regulatory personnel to effectively track violations: After the Harshad Mehta's securities scam in 90's which was blamed on a systemic failure, the system needed a through overhauling. However, nothing really happened. Later another scamster, Ketan Parikh made use of the loopholes in the system to his advantage. He was instrumental in rigging the prices of shares resulting in heavy losses to the investing public, which led to erosion of faith in the capital market. Over the years, quite a few companies raised money through IPO's and disappeared without a trace. It is not seen that the perpetrators of these frauds are promptly brought to book.

21.3.8 SEBI'S Role in the New Era.

In the changed environment of the Indian economy, when after more than four decades of



heavy regulation and anemic growth, with the government slowly opening the economy to market forces, and promoting modification of financial institutions, SEBI has to play a proactive role as a capital market regulator. SEBI's performance has to be judged in the context of its efficiency in this dynamic environment.

The SEBI has made progress in a number of areas:

1. Abolition of capital issues control and retaining the sole authority for new capital issues.
2. Regulation and reform of the capital market by arming itself with necessary authority and powers.
3. Regulating stock exchanges under Securities Contracts Regulation Act.
4. Bringing all primary and secondary market intermediaries under the regulatory framework.
5. Enforcing the companies to disclose all material facts and specific risk factors associated with projects while going in for public issues.

The record of the SEBI, over the period, has indeed been encouraging. SEBI has sought to check and control unfair practices on the stock exchanges, acted against transgressing companies, brokers accused of rigging prices, and scrips showing large price movements. At the same time, SEBI has sought to reduce regulation, and instead to leave it largely to the players in the market.

The capital market is composed of two constituents : the primary market and secondary market. While the primary market deals with the issue of new stocks and shares, the secondary market deals with the buying and selling of existing stocks and shares. SEBI, as a regulator of capital market has to play a regulatory role in both these markets. With a view to improving practices and market development and promote corporate governance among companies, SEBI has taken several steps as given below:

21.3.9 Primary Market Reforms:

The primary capital market plays an important role in the overall functioning of securities market. Vibrancy of primary market, among other things, is a function of macro economic factors, industrial output and demand. Over the years, Securities and Exchange Board of India, the market regulator, has taken several initiatives to improve the operational efficiency and transparency of the primary market which provides investors with issues of high quality and for firms a market where they can raise resources in a cost effective manner. However, despite these measures the primary market remained lackluster in recent years.

Bonds have been the primary instruments for the resource mobilization in the primary market followed by equity. Equity with premium compared to the previous year, more than doubled in 2003-03, while issues in the public sector were dominant during the year, compared to the issues in the private sector, which raised about 87 percent in the previous year.

With regard to the primary market, the part of the capital market that concerns with the issues of new stocks and shares, the following major changes have been effected by SEBI:

1. Relating to new issues: In case of new issues, SEBI has introduced various guidelines and regulatory measures for capital issues with the objective of strengthening standards of disclosure, and certain procedural norms for the issuers and intermediaries with a view to removing the inadequacies and systemic deficiencies in the issue procedures. Companies issuing capital in the primary market are now required to disclose all material facts and specific risk factors regarding the projects, they should also give information regarding the basis of calculation of premium. SEBI has also introduced a code of advertisement for public issues with a view to ensuring fair and truthful disclosures. The prospectus should not contain statements that would mislead the investors. SEBI has also put in place a system of appointing its representatives to supervise the allotment process and to minimize malpractices in the allotment of oversubscribed issues. Prudential norms have been laid down for right issues.
2. Freedom to fix par value of shares: SEBI has dispensed with the requirement to issue shares with a fixed par value of Rs.10 and Rs.100 and has given the freedom to companies to determine the par value of shares issued by them. Companies with dematerialized shares have been allowed to alter the par value of a share indicated in the Memorandum and Articles of Association. The existing companies, which have issued shares at Rs.10 and Rs.100, can avail of this facility by consolidating, splitting their existing shares.
3. Guidelines for tightening the entry norms : Guidelines for tightening the entry norms for companies accessing capital market were issued by SEBI on 16th April 1996. Accordingly, a company should have a track record of dividend for a minimum 3 years out of the immediate preceding 5 years. If a manufacturing company does not have such a track record, it can access the public issue market subject to the condition that projects have been appraised by a public financial institution or a scheduled commercial bank and such appraising agency is also participating in the project fund.
4. Relating to IPOs : To encourage Initial Public Offers, (IPO), SEBI has let companies determine the par value of shares issued by them. SEBI has permitted issues of IPOs to go for “book building”, i.e. reserve and allot shares to individual investors. However, the issuer will have to disclose the price, the issue size and the number of securities to be offered to the public.
5. Investor protection measures: On 15th June 1998, SEBI advised investors to exercise a greater deal of caution while investing in plantation companies. At the same time, plantation companies and other collective investment schemes were directed to obtain credit rating from accredited agencies prior to the issue of advertisement.
6. Cost reduction measures: To reduce the cost of issue, SEBI has made underwriting of issue optional, subject to the condition that if an issue was not underwritten and was not able to collect 90% of the amount offered to the public, the entire amount collected should be refunded to the investors. The lead managers have to issue due diligence certificate, which has now been made part of the offer document.
7. Relating to private placement market: Private placement market has become popular with issuers because of stringent entry and disclosure norms for public issues. Low



cost of issuance, ease of structuring investments and saving of time lag in issuance has led to the popularity and rapid growth of private placement. Total resource mobilization through private placement market had risen by more than three times between 1995-96 and 98-99.

8. Banker to the issue under SEBI's purview : The "Banker to the Issue" is now brought under the purview of SEBI for investor protection. The Unit Trust of India (UTI) has been brought under the regulatory jurisdiction of SEBI.
9. Regulations on acquisitions and takeovers: SEBI has raised the minimum application size and also the proportion of each issue allowed for firm allotment to institutions such as mutual funds. SEBI has also introduced regulations governing substantial acquisition of shares and take-overs and lays down the conditions under which disclosures and mandatory public offers have to be made to shareholders.
10. Merchant banking under SEBI's jurisdiction : Merchant banking has been statutorily brought under the regulatory framework of SEBI. Merchant bankers are now to be authorized by SEBI and have to adopt the stipulated capital adequacy norms, abide by a code of conduct which stipulates a high degree of responsibility towards inspectors in respect of the pricing and premium fixation of issues. Merchant bankers will also have adhered to provisions relation to disclosures or offer letters for issues.
11. Permission to set up private mutual funds: The government has now permitted the setting up of private mutual funds. A few have already been set up. All mutual funds are allowed to apply for firm allotments in public issues. To improve the scope of investments by mutual funds, the latter are permitted to underwrite public issues. SEBI has relaxed the guidelines for investment in money market instruments. The market regulator has issued fresh guidelines for investment in money market instruments. The market regulator has issued fresh guidelines for advertising by mutual funds.
12. Making companies provide authentic information: SEBI has advised stock exchanges to amend the listing agreements to ensure that a listed company furnishes annual statement to the stock exchange showing the variations between financial projections and the projected utilization of funds in the offer documents and the actual utilization. This would enable shareholders to make comparisons between promises and performance of companies they invested in.
13. Making companies comply with issue norms: In order to make companies exercise greater care and diligence for timely action in matters relating to the public issues of capital. SEBI has advised stock exchanges to collect from companies making public issues, a deposit of 1% of the issue amount which could be forfeited in case of non-compliance of the provisions of the listing agreement and non-dispatch of refund orders and share certificates by registered post within the prescribed time.
14. Scrutiny of offer documents: SEBI scrutinizes offer documents to ensure that the company in the offer document has made all disclosures. All the guidelines and regulatory measures of capital issues are meant to promote healthy and efficient functioning of the issue market.

15. Access to international capital market: Since 1992, the Government of India has permitted Indian companies to access international capital markets through Euro equity shares. Initially, the Euro issue proceeds were to be utilized for approved end uses within a period of 1 year from the date of issue. Since there was continued accumulation of foreign exchange reserves with the Reserve Bank and there were long gestation periods of new investments, the government allowed the issuing companies to retain the Euro-issue proceeds abroad and repatriate them to the country only as and when expenditure for the approved end uses were incurred.

The Government of India has also liberalised investment norms for Non Resident Indians (NRIs) so that they and overseas corporate bodies can buy shares and debentures without prior permission of the Reserve Bank of India which has been the practice followed hitherto.

21.3.10 Secondary Market Reforms

In the matter of reform of the secondary market, a market that is engaged in the buying and selling of old stocks and shares, SEBI has initiated the following measures:

1. Registration of Intermediaries: SEBI has started the process of registration of intermediaries, such as the stockbrokers and sub-brokers under the provisions of the Securities and Exchange Board of India Act, 1992. The registration is made on the basis of certain eligibility norms such as capital adequacy, infrastructure etc., There has been much opposition and resistance to this step of SEBI. The capital market regulator has also made rules for making client broker relationships more transparent, particularly with reference to the segregating client and broker accounts.
2. Reconstitution of stock exchange governing bodies : To make the governing body (GB) of a stock exchange more broad based, SEBI has issued guidelines for its composition. According to these guidelines, the governing body of a stock exchange should have five elected members, of which not more than four nominated by the government or SEBI, and three of fewer persons nominated as public representatives. During 1994-95, SEBI has reconstituted the governing bodies of stock exchanges.
3. Measures to speed up settlements : SEBI has prohibited “renewal ” of transactions in ‘B’ group securities, so that transaction could be settled within 7 days.
4. Simplification of procedures : Since 1992, SEBI has constantly reviewed the traditional trading system in Indian stock exchanges. SEBI is simplifying procedures and achieving transparency in costs and prices at which customer orders are executed, speeding up clearing and settlement and finally transfer of shares in the names of buyers. SEBI is setting up depositories, which would immobilize securities and help eliminate paper work this would give impetus to the growth of stock markets.
5. Regulations on insider trading: SEBI has notified regulations on insider trading under the provisions of SEBI Act, Such regulations are meant to protect and preserve the integrity of stock markets and, in the long run, to help inspire investor confidence in them. Despite these regulations, insider trading rampant in our stock exchanges, and



rigging the market and manipulating stock market price quotations are quite common. M.S. Shoes East Ltd., fiasco was an example of market rigging in March 2001. SEBI could do nothing about it though it was known that coteries of stockbrokers connived to hammer the Bombay Stock Exchange with rigging.

6. Regulation of collective investment schemes : SEBI's regulations for collective investment schemes (CIS) were notified on 15th October 1999. CIS includes any scheme, or arrangement with respect to property of any of subscription and to receive profits or income or produce arising from the management of such property. Under the SEBI Act and Regulations framed thereunder, no person can carry on any CIS unless he obtains a certificate of registration from SEBI. All existing CISs were required to apply for registration by 14 December 1999.
7. Regulation of foreign investments: The government has allowed foreign institutional investors (FIIs) such as pension funds, mutual funds, investment trusts, asset or portfolio management companies etc. to invest in the Indian capital market provided they are registered with SEBI. Till January 1995, as many as 286 FIIs have been registered with SEBI. There were only ten in January 1993. The cumulative net investment of FIIs on Indian equities has increased from \$200 million in January 1993 to \$3 billion in January 1995, and to \$60 billion as on as on May 2005, according to report in Economic Times (11 May 2005) reflecting the healthy impact of economic liberalization policy of the country and to some extent, the prevalence of low rates of interest of the country and to some extent, the prevalence of low rates of interest abroad. The Government of India has now permitted joint venture stock broking companies to have non Indian citizens on their boards of directors.
8. Introduction of compulsory rolling settlement : In keeping with international best practice, SEBI has introduced compulsory rolling settlement of select scrips on 10th January 2000. In June 2000, SEBI introduced derivatives trading. As far as internet trading is concerned, SEBI has prescribed minimum technical standards to be enforced by stock exchanges for ensuring safety and security of transactions via the internet. Rolling Settlement has been extended to all scrips on all the stock exchanges with effect from 31 December 2001. SEBI has further decided to shorten the rolling settlement cycle from present T+5 to T+3 for all listed securities from 1 April 2002. The markets have now moved to T+2 settlement from 1 April 2003.
9. One point access to investors : In July 2002, SEBI launched a centralized internet based filing system for listed companies called EDIFAR(Electronic Data Information Filing and Retrieval System), which requires companies to post disclosures as per the listing agreement with the stock exchange on the EDIFAR website at the same time as they submit them to the exchange. The objective of EDIFAR is to provide investors simultaneous, one point access to key information on all listed companies.

Beginning July 2002, SEBI has been posting all orders passed by its chairman against errant companies and market intermediaries on its website. This provides useful information to investors.

10. Introduction of takeover codes : With regard to mergers and acquisition, SEBI has made several investor friendly amendments to the takeover code in September 2002. This would stop the practice of promoters making preferential allotments to avoid making an open offer to other shareholders. Acquirers also have to disclose their holding more frequently, which increases transparency
11. Trading of government securities through order driven screen based system :

With a view to encouraging wider participation of all classes of investors, trading in government securities through a nationwide, anonymous, order driven, screen based trading system of the stock exchanges, in the same manner in which trading takes place in equities, was launched on 16 January 2003, initially on Bombay Stock Exchange (BSE), National Stock Exchange (NSE) and Over the Counter Exchange of India (OTCEI).
12. Delisting guidelines: The market regulator has issued the (SEBI) (Delisting of Securities) Guidelines, 2003 on 17 February 2003. The guidelines provide that companies can delist from stock exchanges only by offering an exit route to remaining shareholders through a “reverse book building” process. This mechanism would leave the option of pricing to the investors and would be totally transparent to the market. Further, promoter shall offer a floor price on the basis of average of previous 26 weeks high and low prices to investors.
13. Central listing authority. To bring about the uniformity in scrutinizing listing applications across the stock exchanges and to strengthen the listing agreements, SEBI has, in April 2003, established the Central Listing Authority in Mumbai

Former Chief Justice of India, Justice M.N.Venkatachelliah, has been appointed as the president of the Authority. There shall be eight other members of the Authority, all of whom shall hold office for a period of 3 years. They shall discharge the following functions : (1) processing the application made by corporates, mutual funds, or collective investment schemes and (2) making recommendations as to listing conditions.
14. Derivative trading : The Central Government lifted the prohibition on forward trading in securities by a notification issued on 1 March 2000 rescinding the 1969 notification. With the enactment of the Securities Laws (Amendment) Act, 1999 in December 1999, trading in stock index futures started in June and July 2001 respectively. Single stock futures have also been introduced since 9 November 2001.

Interest Rate Derivatives trading was formalized on the stock exchanges with the launch of futures on 10 years zero yield coupon bond and zero coupon notional T-Bill in June 2003.
15. Demutualisation and corporatisation of regional stock exchanges : Recently (2004), the Securities Contract (Regulations) Act (SCRA) was amended through the promulgation of an ordinance to make corporatisation and demutualization of stock exchanges mandatory. The ordinance has been issued on the basis of the recommendation of a group under the chairmanship of Justice M.H.Kania, former Chief Justice of India, to advise the government on the issue of corporatisation of stock



exchanges. The amendment not only requires separation of ownership and trading rights, it also requires that the majority ownership rests with the public and those without any trading rights. Also through these conditions, the government has signaled a major shift in its earlier stand that stock exchanges should be self regulating agencies of their members. It now desires that they should be externally regulated.

Traditionally, the Regional Stock Exchanges (RSEs) functioned as mutual societies owned and operated by member brokers. A few of them have already switched to the corporate form. The new action plan now requires them to segregate ownership rights from trading rights. Professionals rather than broker representatives will conduct the affairs of the exchanges. Can the RSEs come together as has been proposed many times and transform themselves into the country's third exchange along with the National Stock Exchange (NSE) and Bombay Stock Exchange (BSE)? That is a moot question, though few will question the need for increased competition that will have greater choice to investors.

However, in practice, it has always been difficult to form a third all India exchange. Despite the current moves to restructure the RSEs there is no guarantee that a demutualised and corporate exchange by itself will be the recipe for survival and eventual success. On the contrary, in the opinion of experts, there are valid reasons to be skeptical. The RSEs, in their new form will require a large number of stock market professionals who are a scarce commodity. Besides, an exchange operating for profit may sacrifice regulatory concerns for commercial gains.

At present stock exchanges in India are "mutual" and non-profit organizations enjoying tax exemption. The trading members are stockbrokers who also own, control and manage such exchanges for their mutual benefit. The ownership rights and trading rights are combined together in a membership card, which is not freely transferable.

On the other hand, a "demutual" exchange is one in which three distinct sets of people own the exchange, manage it and use its services. The three stakeholders are shareholders, brokers and investing public. The management is vested in a board of directors, assisted by a professional team. A demutualised exchange is generally a profit organization and a tax paying entity. The ownership rights are freely transferable and there is no membership card.

A typical mutual exchange managed by broker's representatives is not an ideal model for an enlightened self regulatory organization. In this regard, a demutualised framework is expected to have a balanced approach without the inherent conflict of interest. It can generate a greater management accountability. In a competitive environment stock exchanges require funds to raise funds, mutualised organizations suffer from their own limitations, whereas a demutualised set up can tap capital markets. A publicly held organization is in a position to ensure greater transparency in dealings, accountability and market discipline and is amenable to changes. However, a demutualised and corporate form of stock exchange is not an unmixed blessing either. According to C.R.L.Narsimhan, an authority on the subject, they have the following disadvantages:

1. It is not as though the new governance structure will automatically be free from pitfalls. There may arise a different conflict of interest. The new look demutualised exchange operating on profit considerations may opt for a course that may conflict with the regulatory role expected of it.
2. Although it is unlikely to happen immediately in India, a corporate stock exchange may be listing its shares on an exchange possibly with its own self.
3. While a demutualised structure segregates the different roles of owner's controllers and traders, it is still necessary to invite eminent people on its Board. That is to ensure that the exchanges take care of public interest too and not merely ensure their commercial character.
4. In the demutualised exchanges, share capital will be subscribed to by different investors including the trading members. It may become necessary to prescribe a ceiling on voting powers somewhat akin to what obtains today in banking regulation and laws. This, of course, is a handicap that has to be overcome by anybody concerned with capital market.
5. An amendment to the Securities Contracts Regulation Act is on the cards: other legal changes/concessions are also necessary before demutualization takes place.
6. As in many other areas of the capital market it has been easy to identify what is wrong with existing system of stock exchange governance. It has been only slightly more difficult to suggest an alternative system, in this case the demutualised exchange.

It is also likely that the government will push for a speedy transition to the new mode of governance. However, even if the board objectives are achieved, it is likely that the perception of the exchange may not improve dramatically over the short term.

21.3.11 Clause 49 in Listing Agreement on Corporate Governance

SEBI had constituted a committee on Corporate Governance under the Chairmanship of Sri Kumar Mangalam Birla to promote and raise the standard of corporate governance in the corporate sector. The committee submitted its report to SEBI. Accepting the recommendations of the committee SEBI advised all stock exchanges to amend their listing agreements by inserting new clause 49 which deals with good Corporate Governance practices to be adopted by all listed private and public sector companies. However, for listed entities, which are not companies, but body corporate (e.g. private and public sector banks, financial institutions, insurance companies etc.) incorporated under other statutes, this clause will apply to the extent that it does not violate their respective statutes, and guidelines or directives issued by the relevant regulatory authorities. Clause 49 is inserted vide SEBI F.No.SMDRP/Policy Cir.10/2000 dated 21.2.2000.

As per Clause 49 of the Listing Agreement, the entity is required to obtain a certificate from the auditors of the entity as regards compliance of conditions of corporate governance as stipulated in that clause.

The certificate is required to be annexed with the Directors' Report, which is sent annually to



all the shareholders of the entity. This certificate is required to be sent to the Stock Exchange(s) alongwith the Annual Return filed by the entity. The expression “ auditors of the company” would mean the auditors appointed to audit the financial statements of the entity under the relevant statutes.

Features of Clause 49 of the Listing Agreement:

1.(a) All entities seeking listing for the first time are required to set up an audit committee at the time of listing.

(b) All existing listed entities with a paid – up capital of Rs.3 crores and above are required to setup an audit committee in a phased manner as per schedule of implementation specified in Clause 49.

2. The audit committee shall have minimum three members, all being non-executive directors, with the majority of them being independent, and with at least one director having financial and accounting knowledge.

3. The chairman of the audit committee shall be an “independent” director.

4. A representative of the external auditor, when required shall be present as an invitee for the meetings of the audit committee.

The following additional requirements are stipulated as per Clause 49 of the Listing Agreement which are silent in Section 292A of the Companies Act,1956:

- (i) The audit committee should invite such of the executives, as it considers appropriate (and particularly head of the finance function) to be present at the meeting of the committee, but on occasions it may Also meet without the presence of any executives of the company.
- (ii) The company secretary shall act as secretary to the committee.
- (iii) The audit committee shall meet at least thrice a year. One meeting shall be held before finalization of annual; accounts and once in every six months./
- (iv) The quorum of the audit committee shall be two members or one-third of the members of the audit committee whichever is higher and minimum of two independent directors.
- (v) The powers and role of the audit committee are elaborately contained in sub-paragraphs C & D of paragraph II.

The following additional requirements are stipulated as per Section 292A of the Companies Act,1956 which are silent in Clause 49 of the Listing Agreement:

- (i) The audit committee constituted shall act in accordance with terms of reference to be specified in writing by the board.
- (ii) The recommendations of the audit committee on any matter relating to financial management, including the audit report, shall be binding on the board.
- (iii) If the board does not accept the recommendations of the audit committee, it shall record the reasons therefore and communicate such reasons to the shareholders.



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